COMMONWEALTH LIQUID ALPHA FUND

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4Q16 PERFORMANCE REVIEW

Commonwealth Liquid Alpha Fund ("Liquid Alpha") returned -2.01% during 4Q16 and -1.00% for full-year 2016 (net of all fees). This compares favorably to the strategy's most relevant benchmark, the SG CTA Index, which lost -3.82% in the 4th quarter and -2.89% for the year. Liquid Alpha entered 4Q16 with a meaningful long position in global sovereign bonds, a position it had held in varying size most of the year and that had (along with other positions) helped provide strong positive performance for Liquid Alpha during both the Jan/Feb equity downturn and the June/July market volatility surrounding Brexit. As interest rates backed up in rapid fashion following the Presidential election, those positions generated the bulk of the losses we saw in 4Q16. However, due to the strategy's flexible nature, positioning quickly reversed and our managers established what are currently profitable short positions in global fixed income during the second half of November.

Liquid Alpha is an absolute return strategy and we are disappointed that the fund was flat in gross terms and down in net return terms in 2016. However when evaluating investment performance it's important to begin by revisiting a strategy's core goals. In this case, those goals are:

(1) to make money over a market cycle,

(2) to make money in a way that is uncorrelated to traditional investment portfolios, and

(3) to provide the potential for downside diversification during stress periods.

How did we do in 2016 relative to these goals?

(1) 2016 was a down year after fees (modest positive performance before fees), but we remain confident that, over a market cycle, risk-adjusted returns will be reasonable. This is due to both macro factors (the historical value proposition of the managed futures space) and the micro (the quality of the practitioners in our portfolio). The macro: Since 2000, the managed futures benchmark has realized about a 0.6 Sharpe Ratio which, while far from eye-popping, is better than the US stock market over the same period. The micro: Moreover, we have high confidence in the quality and differentiated nature of the underlying managers that comprise Liquid Alpha. Had the strategy been invested for the entire year as it was from late July through year-end, the fund would have gained about 6.5% net of all fees in 2016. Additionally, realized 2016 returns come despite the strategy being significantly underinvested in 1Q16, when the SG CTA Index returned over 4%. The fund outperformed the benchmark by over 700bps, while taking significantly less risk, in 2H16.

(2) Liquid Alpha's performance was strongly negatively correlated to the S&P 500 last year (-31%), providing significant portfolio risk mitigation for our investors, and…

(3) Returns were, as noted above, strongly positive during the two major stress periods of the year. Returns were also strongly positive overnight on the evening of the US Presidential Election. Had markets continued to freefall following Trump's victory, as they initially did late on Election Night, the strategy would have been well-positioned. As it turned out, we were quite poorly positioned for a Trump victory, and still only lost appx 1% in the final 2 months of the year.

In summary, we believe that the investment opportunity set for the strategy will be positive going forward, given increased political uncertainty in the US and Europe, elevated geopolitical tensions, and rising interest rates globally. Particularly in a rising interest rate environment, we believe truly uncorrelated alternative investments such as Liquid Alpha will be an increasingly important portfolio diversifier and return generator for our clients.

COGNITIVE BIAS, MARKET TIMING, AND PERFORMANCE CHASING

"The investor's chief problem – even his worst enemy – is likely to be himself." - Benjamin Graham

Best-selling author Michael Lewis' (Liar's Poker, The Blind Side, Moneyball) new book, The Undoing Project, chronicles the groundbreaking work of Amos Tversky and Daniel Kahneman, two Israeli psychologists who documented a host of "cognitive biases" afflicting rational thinking. For instance, people tend to overestimate their own abilities and underestimate uncertainty. Hindsight bias, wherein people misremember their own predictions as being correct, is one example of this. Tversky explained, "we find ourselves unable to predict what will happen; yet, after the fact we explain what did happen with a great deal of confidence…

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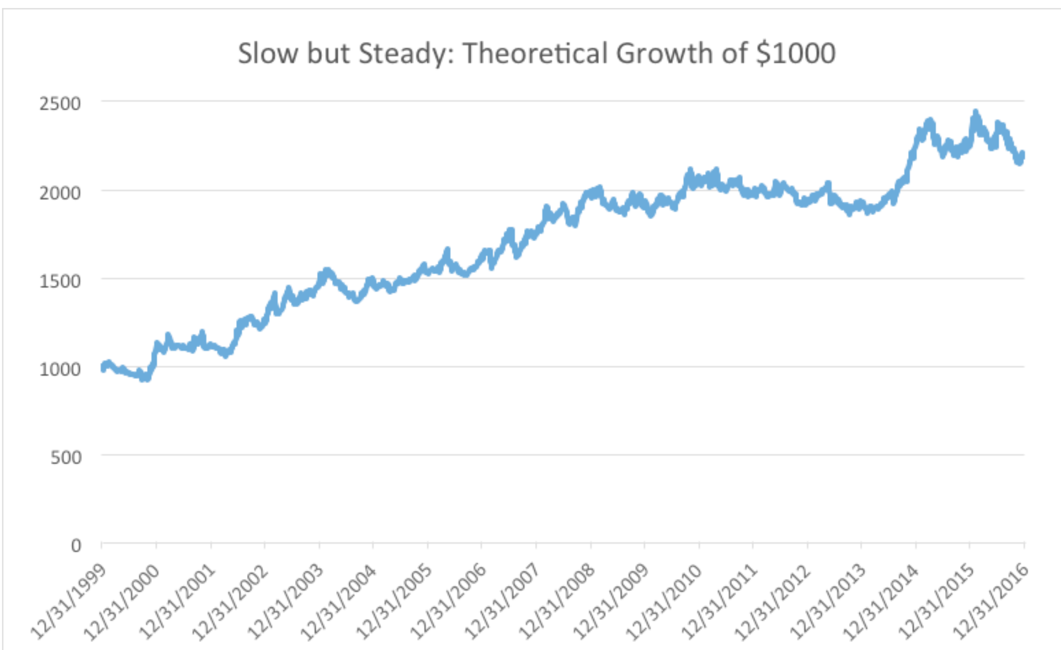
It leads us to believe there is less uncertainty in the world than their actually is." As William Easterly recently described in his book review the Wall Street Journal, "Failing to process uncertainty correctly, we attach too much importance to too small a number of observations. Basketball teams believe that players suddenly have a "hot hand" after they've made a string of baskets, so you should pass them the ball. Tversky showed that the hot hand was a myth – among many small samples of shooting attempts, there will randomly be some streaks. Instead of a hot hand, there was "regression to the mean' – players fall back down to their average shooting prowess after a streak."

The same is true with investing, a field where fear and greed are the two dominant emotions we must work to keep in check. Every prospectus or marketing document we have ever read bears the famous disclaimer "past performance is no guarantee of future results." Yet one of the great temptations of investing is to buy into the myth of the hot hand by extrapolating recent performance indefinitely into the future. This is also related to a bias Kahneman and Tversky call "recency effect," wherein we place more importance on recent events than earlier events, even when there may be no reason to do so. These same cognitive biases are the forces that lead greedy investors to pile into "hot" stocks at their all-time highs, only to be disappointed when they inevitably correct. Worse, it's what leads fearful investors to panic and sell a cheap stock at the bottom, only to watch from the sidelines as it recovers.

While it would be reassuring to believe that allegedly sophisticated institutional investors allocating capital to hedge funds don't fall prey to these same traps, they are as prone to them as anyone (possibly moreso, as we shall soon see). As an illustration, we'll look at the behavior of institutional investors, allocating to managed futures hedge funds (the same type of alternative asset managers that primarily comprise Liquid Alpha). If you'd been invested in a diversified basket of these funds, as represented by the SG CTA Index, since 2000, the blue line has been your investment experience:



Lumpy at times, multi-year flat periods, but in all you've more than doubled your money in a decade and a half, returning appx 4.2% p.a. with an 8% volatility. This compares to 4.7% p.a. with a 20% volatility for the S&P 500 over the same period. Excitingly, and most important, these assets are -11% correlated on a daily basis over this period, making them exceedingly complementary and diversifying to one another. In fact, a 50/50 combination of these two would have generated about the same return as either independently (4.4%) but with half the risk of equities (10% annualized volatility).

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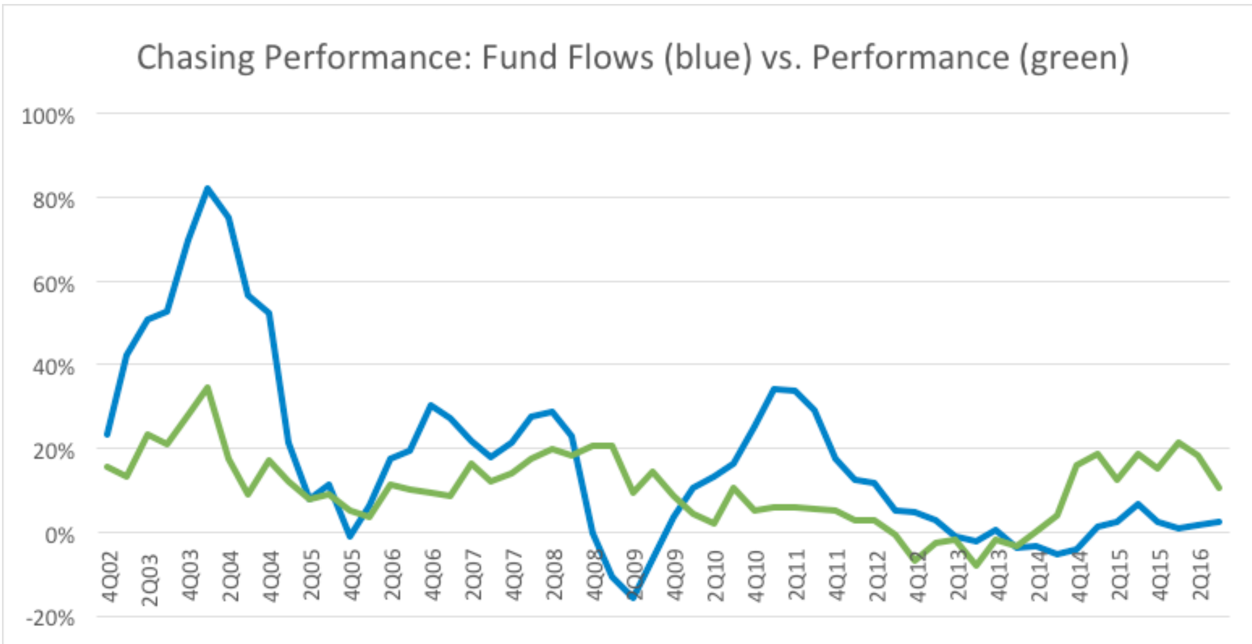
However, unfortunately few investors have had the patience to stay the course with such investments over the years. The chart below graphs the year-on-year change in total assets under management of the managed futures industry against the trailing 2-year performance of the SG CTA Index.



As you can guess from eyeballing this chart, the two series are meaningfully correlated (49%). When investment performance is at its best in late 2003, following the tech bubble and 9/11 bear market in stocks, the managed futures value proposition was clear, and inflows were also their largest. When performance stagnates in 2005 as the economy recovers and market volatility drops, that value proposition is quickly forgotten, and net inflows drop to zero. When performance surges again during the Global Financial Crisis, there is a brief pick-up in inflows. Following the Crisis, we see large redemptions. These highlight another advantage of managed futures: liquidity. While other hedge fund strategies put up gates, enforced lock-ups, and demanded early redemption penalties (among other legal shenanigans), managed futures funds operate in highly liquid markets, had made strong profits in 2008, and generally had no need to take such measures. As a result, many investors used managed futures strategies as a sort of “ATM,” withdrawing cash to (hopefully) put it to work in distressed assets elsewhere. However, with the strong performance of managed futures in 2008 fresh in investors’ minds, it wasn’t long before money flowed back to the space, with AUM exploding almost 40% year-on-year by mid-2011. These fresh inflows were just in time to participate in… three years of flat performance. Finally, as returns picked up strongly in late 2014 and 2015, predictably, assets flowed back to the space (in time for another 2 years of flat returns for the index).

Now let’s look at the impact of all these attempts to time strategies by extrapolating the recent past into the future. Imagine a stylized example where I have $1000 to invest (the same $1000 I started with in the first graph above). I allocate using a simple rule: if the prior calendar quarter was positive for the SG CTA Index, I will invest my portfolio 100% in that index for the following quarter; as long as I make money, I remain invested. But if my quarterly return is negative, I go to cash. Here’s the growth of my $1000 over time using such a rule:

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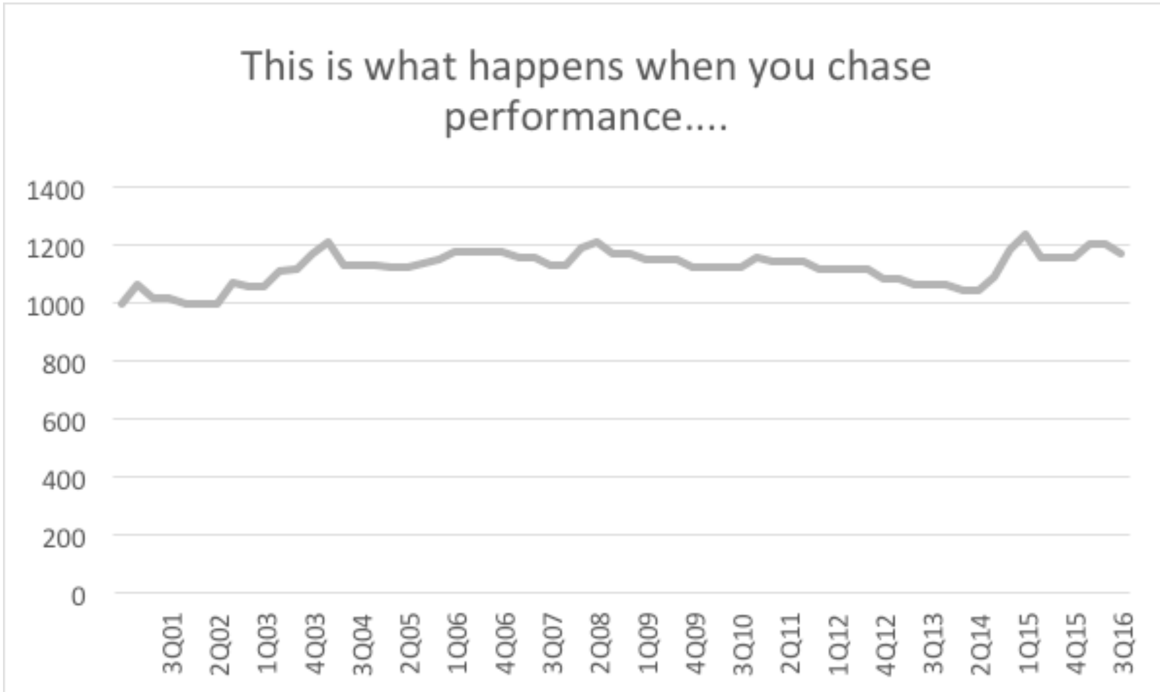

So, the cost of this performance chasing is real. The nice steady blue line in the first graph, which grinds methodically from lower left to upper right over 15 years, is now a flat line. While I reduced risk (the annualized volatility of this quarterly series is just 5%), I've also "risk managed" away nearly all of my return (which drops to 1% annualized). This also assumes one could make all these frenetic allocation changes with zero fees or transaction costs, which of course one could not.

Obviously the actual quarter-to-quarter changes of institutional allocators are more gradual and thus the costs are less dramatic, but the lesson remains the same: cognitive biases exist. They make us want to make sub-optimal decisions. Visualizing just how costly those decisions can be will hopefully help us be more patient and thoughtful investors. During 2016, Liquid Alpha was at one point (mid-February) up about 4% YTD, and at one point down about 4% (early June). Just as March 1 would have been a poor time to add to one's investment, mid-June would have been a poor time to redeem it. While we make no attempt to time the performance of our underlying managers, we have learned a few painful portfolio allocation lessons through the years, and we believe the data here back them up: (1) adding to a high quality investment manager when he is in a large drawdown is rarely a bad decision in the long run, and (2) chasing performance is often a bad decision in the short run. May your 2017 be a prosperous one (and may you resist the innate human cognitive bias to chase performance)!