COMMONWEALTH LIQUID ALPHA FUND

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4Q18 PERFORMANCE REVIEW

Commonwealth Liquid Alpha Common Trust Fund ("Liquid Alpha") returned 0.77% during 4Q18 and 1.89% for 2018 (net of all fees and expenses). This compares favorably to the benchmark SG CTA Index, which lost -2.44% in the 4th quarter and -5.84% for the year. During the quarter, Liquid Alpha benefitted from weakness in risk-sensitive assets like global equities and crude oil, and from the decline in interest rates. During 2018 as a whole, interest rate differentials in global currencies and relative value opportunities in commodity markets were the largest drivers of positive returns.

	FY 2018	Since Inception (Jan 2016)	Sharpe Ratio (LTD)
Liquid Alpha	1.89%	2.07%	0.11
SG CTA Index	-5.84%	-6.23%	-0.23
S&P 500	-4.39%	27.72%	0.81
Barclays Aggregate	0.01%	6.21%	0.72
60/40 Stock /Bond	-2.63%	19.12%	0.95
50 / 30 / 20 Stock / Bond / Alts	-1.81%	16.14%	0.92

Source: Morningstar, CBandT estimates

The LP version of the strategy, Commonwealth Structured Alpha ("Structured Alpha"), launched January 1, 2018 in order to give Qualified Eligible Participants (QEPs) access to CB&T's alternatives platform. Structured Alpha returned 3.1% net during 2018. The performance spread is due to minor changes in investment and performance allocations between the two funds. As we have discussed with clients, there will be month-to-month slippage between Liquid Alpha and Structured Alpha, but we expect the tracking error between the two to be de minimus over time.

When we launched Liquid Alpha in 2016, our stated goal was to build an absolute return strategy that makes money over a market cycle, does so in a way that is uncorrelated to traditional investment portfolios, and therefore has the potential to provide downside diversification during stress periods. The fund is benchmarked to the SG CTA Index, which has lost -6.23% since inception, versus a positive return of +2.07% for Liquid Alpha. Periods like 2018, and 4Q in particular (and December especially), are precisely why we preach the inclusion of diversifying alternative investments in client portfolios. In a year when all but one major asset class lost money, Liquid Alpha generated a modest positive return. (The lone positive asset class was the Barclays Aggregate Bond index, which returned +0.01% for 2018, presumably a negative total return if an investor is paying any fees at all on their investments.) In December, when equities suffered their worst year-end performance since the Great Depression, Liquid Alpha returned 1.26%, and was up about 3% on the month when equities were on their lows.

Liquid Alpha is not in the business of predicting the stock market or the economic cycle. We are not a discretionary macro or market timing fund. As Warren Buffett wrote in his 1963 letter to partners in his fund (a strategy which we would now recognize as a hedge fund): "If you think I can do this [predict markets and economic cycles], or think it is essential to an investment program, you should not be in the partnership." Liquid Alpha is in the business of constructing portfolios that make some returns, come what may, especially in extreme market environments. In 2018, with all asset classes lower, the fund ground out a low single digit positive return. As a mentor on the floor of the New York Mercantile Exchange used to say, after a hard-fought, ultimately unimpressive, but positive trading day: "It's better than a sharp stick in the eye." Investors who eschewed diversification for levered equity beta got the wrong end of that sharp stick in the fourth quarter of 2018.

Liquid Alpha provides investors access to non-correlated investment managers. By accessing best-in-class niche managers in a cost effective manner, our funds look to create structural alpha on top of the managers' investment alpha. We believe 2018 serves as a strong proof of concept for this approach. As we will discuss later in this letter, the factors that drove market conditions in 2018 are unlikely to suddenly abate in 2019, and so the diversification that strategies like Liquid Alpha can offer is likely to remain valuable.

HOW WE MADE MONEY THIS YEAR

Liquid Alpha invests in global macro and managed futures strategies. Most such managers are heavily focused on trendfollowing strategies, which generally performed poorly last year, particularly in currencies and equity index markets. The fund's best drivers of returns from a style perspective came from carry (buying a high-yielding asset and selling a lower-yielding one) and value or reversion-based models. Both approaches worked particularly well in currencies and commodities.

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Our ability to focus on niche managers who can allocate in meaningful size to smaller commodity and currency markets contributed to the fund's relative outperformance in 2018. So did the choice to diversify across carry- and value-based strategies, in addition to momentum/trend.

Since inception, Liquid Alpha has outperformed its benchmark by about 2.5% per annum. This is in part for the reasons alluded to above: the large, late life-cycle managers that comprise the benchmark cannot access smaller markets in meaningful size. The niche managers we allocate to have the ability be more nimble, and play in these less efficient areas. Moreover, our focus on structural alpha accounts for at least half of the life-to-date outperformance. By reducing costs wherever we can, and negotiating advantageous fee structures for our investors, we are able to construct a cost-effective vehicle that has all-in fees equivalent to or less than those of the typical hedge fund, and far less than those of the typical multi-manager fund.

	2018 Return
Global Equity Indices	-0.76%
Global Currencies	1.01%
Global Fixed Income	-0.15%
Commodities	1.79%
TOTAL	1.89%

Source: Morningstar, CBandT estimates

HOW WE LOST MONEY THIS YEAR

As discussed above, momentum strategies, especially in equities, fared poorly in 2018. While Liquid Alpha has a much lighter allocation to these approaches than peers, we are careful to maintain some exposure in this area, as these strategies perform best in truly extreme markets like 2008. However, they are also susceptible to whipsaw conditions in "normal" market environments. 2018 was a year of many whipsaw moves and false breakouts in global equity index markets, with the steady upward trend witnessed in 2017 being punctuated with "flash crash" corrections back to unchanged for the year. This was true, to a lesser extent, in fixed income markets, with long-end yields finishing the year only a bit above where they began, but with several large swings throughout the year. However, these were generally sharp 1-2 month breakouts, punctuated by a reversal. The type of persistent 3-6 month trends that most momentum strategies thrive on were notably absent. As a result, it was a fairly poor year for trend strategies, especially in financial futures markets.

We have been asked several times since equity market volatility picked up in 4Q18 if our managers see a recession or a full-scale bear market in 2019. Not to be coy, but this is a question that misses the point of how our managers take risk. In most cases, the underlying strategies in Liquid Alpha are 100% rules-based and systematic. In all cases, they are process-based and rooted in a repeatable discipline. As such, they don't make predictions ("my research and intuition tell me there will be a recession next year, therefore I will be short stocks") but rather employ simple heuristics: they take data inputs, and generate an investment output ("the data is consistent with periods in the past when it was profitable to be short stocks, therefore I will be short stocks"). But, to paraphrase Keynes, if the data inputs change, so will the investment output.

BUILDING INVESTMENT PORTFOLIOS

One of the many criticisms of investment and wealth managers, particularly in our current age of nearly-free passive investing, is that we charge a fee for a service that investors can supposedly do themselves for nearly nothing. The alleged proof of this contention is that a simple 60/40 stock/bond portfolio (60% S&P 500 / 40% Barclays Agg), which any investor could recreate at minimal cost, generated 6.4% annualized return over the 10-year period ended 2017. Importantly however, the average investor, as measured by JP Morgan using proprietary fund flow data, only made about 2.6%, scarcely above the rate of inflation. Why is this? Because, as human beings, we have cognitive biases that make us fearful when we should be bold (think March 2009 or February 2016, when the play was to buy stocks, but it was scary to do so), and greedy when we should be cautious (think this past August, when the play was to sell stocks, but it felt stupid to do so). These biases make it painful and difficult to rebalance and take appropriate risk when we should. Our instinct is to panic, not to display grace under pressure. An advisor that "just" matched a simple 60/40 return, even if they charged 1% in fees, would have handily outperformed the average investor. There is a cost to cognitive bias, and a value to staying disciplined.

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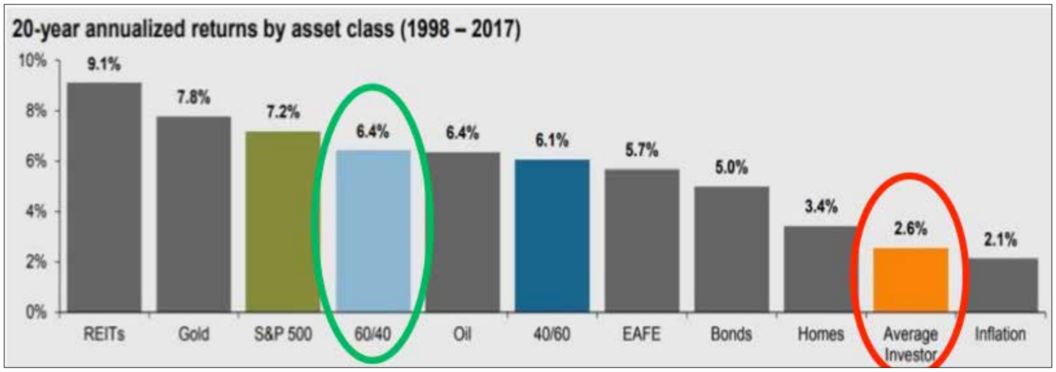
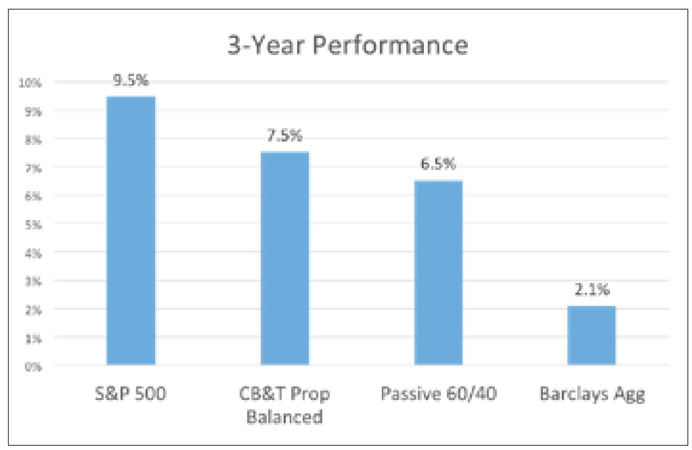


Source: JP Morgan

What struck us most in reviewing these 20-year returns is how non-repeatable the performance of so many of these portfolio building blocks seems to be. If gold compounds at 7.8% a year for the next 20 years, it will rise to over $5300. Same with oil, which would trade just shy of $170. But the most obviously non-repeatable performance is surely Treasury bonds. 10-year yields fell from around 5% in 1998 to closer to 2.5% today. To repeat the performance of the last two decades, long-term interest rates would need to approach zero in the year 2039. It's difficult to envision this happening, given the massive government debt load our country faces. In order to justify an investor lending to the US government for nothing, it would presumably require deflation, or some other economic environment necessitating much lower risk assets, not a good environment for 60/40 portfolios. If we assume that markets are perfectly efficient and bond prices move nowhere over 20 years (big assumptions, obviously), then bonds stand to return their current yield, call it 2.7%. According to Rob Arnott (Research Affiliates) and Antti Ilmanen (AQR), the premium of equities over bonds since 1800 has averaged 2.7%. So that gives us an expected nominal return for a 60/40 portfolio of a little over 4%.



Source: Morningstar, CBandT estimates

These are rough and unscientific numbers, but they give us some sense for the difficulty inherent in extrapolating 7-10% equity market returns forward, forever. In order to boost that 4% return to something closer to historical 60/40 experience, and do so without taking inordinate risk, active management and alternative assets will be required. The math simply does not work if we rely on passive investments in traditional assets. A useful case study in this area is the performance of CB&T's own proprietary products since 2015. By utilizing a balanced 50/30/20 stocks/bonds/alts portfolio comprised of CB&T's proprietary offerings in equities (Science & Technology Fund), bonds (Kentucky municipal funds), and alts (Liquid Alpha), an investor would have outperformed a passive 60/40 portfolio, and done so with less volatility, shallower drawdowns, and lower tax impact.

We increasingly believe that reduced long-term expected returns for major assets will necessitate more active strategies and more diversified portfolios in the future. Twenty years of disinflation and falling interest rates has conditioned us to think that 60/40 portfolios can't lose money. 2018 should have disabused us of that notion.

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2019 OUTLOOK

We wrote this letter last year in context of a seemingly risk-free environment for large cap US equities: FANG stocks had soared, the US stock market had just registered its best risk-adjusted calendar year performance in modern history, and foreign/emerging markets had performed even better, as synchronized global growth was the story of the day. Most investors had little interest in diversifying or non-correlated strategies.

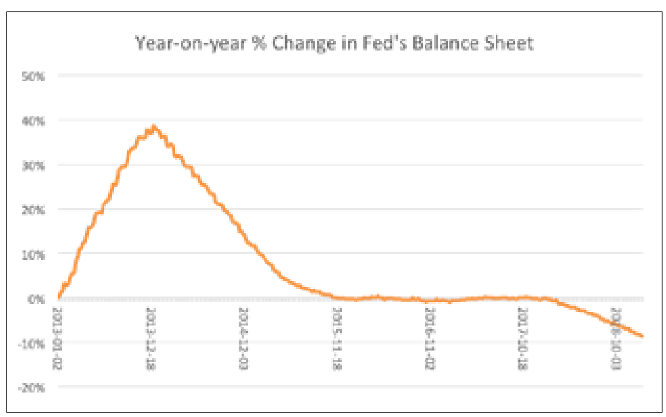
However, beginning at that time, we highlighted three major headwinds for global growth, liquidity, and by extension, asset prices. To quote from the 4Q17 letter:

> *"While it may take time to percolate through the system, we believe that the reversal of the Fed's near-decade long policy of liquidity provision, the slowing of ECB bond-buying, and the reduction in Chinese fixed asset investment together represent a three-pronged attack that will likely lead to less complacent, more volatile, and more divergent markets."*

As we have said over the ensuing year, macro themes don't change that often. These issues came to the fore quite a while ago, they precipitated a "rolling bear market" that began in late January of 2018, and they don't look likely to go away in the near-term, at least not without major market retrenchments forcing the hands of policymakers further. These drivers, along with worries over Trump's trade war, hit markets sporadically in the first 3 quarters of the year, pressuring risk assets in January, March, June, October, and most sharply in December. Risk-off pressures were partially offset by the stimulus of US tax cuts and continued, albeit decelerating, global growth. These offsetting forces contributed to a schizophrenic market that described seven round trips (moves higher that were then reversed back to where the year began) for the S&P 500 through November. It's worth pointing out that these whipsaw moves were far from ideal for the trend capture strategies we employ, and we found them as frustrating as most long-only investors. But worries over trade, slowing global economic growth, and the liquidity drainage associated with Quantitative Tightening ("QT") bit hard in December, resulting in the worst December stock market performance since the Great Depression and the worst fourth quarter since the Financial Crisis. Flight-to-safety positioning in gold and bonds worked well. Risk assets like stocks and economically sensitive commodities and related currencies did not. We do not think it is a coincidence that equity markets began to sink sharply in October, just as global central bank bond buying reversed from easing to tightening.

Source: Bloomberg

While we don't make predictions, the fund does hold positions. The Liquid Alpha portfolio enters 2019 positioned for further volatility, with modest short positions in equities, long positions in bonds, gold, and the US dollar, and a variety of relative value trades in the fixed income, commodity, and currency space. We are comfortable with these exposures, as we also enter 2019 with the liquidity trajectory, based on the ongoing balance sheet shrinkage of the Fed and the start of such QT by the ECB, decidedly worse than it was entering 2018. Growth is slower around the world, as evidenced by FedEx's and Apple's recent downward guidance in light of a decelerating China. The Fed is set to pause its rate hike cycle, partially placating both Donald Trump and Stan Druckenmiller, but that is now priced in to the forward rate curve, and QT continues apace.



Source: FRED, CB&T Estimates

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Credit is also a worry. The BBB market (the lowest rung of investment grade bonds) is now the largest it has ever been, with 65% of S&P 500 companies now rated BBB, and almost half the investment grade index is BBB rated, up from about one-third ten years ago. For years, cheered on by the hedge fund crowd and other investors with quarter-to-quarter investment horizons, companies have been levering up their balance sheets in order to buy back their stock, as seen in the second chart on the right. A wave of downgrades, certainly not unusual in a strong but slowing economy, would risk a meaningful credit correction, as formerly investment grade bonds were moved to junk status and indiscriminately sold. The BBB market has grown from just $750B in 2007 to over $2.7T today. Moreover, as more stringent rules on capital requirements have led banks to derisk their balance sheets, their trading desks have cut their inventories of BBB bonds by about 80%, to just $20B. The market makers who in past cycles might have stepped into a falling market and provided liquidity no longer exist. Ironically, increased regulation may in fact lead to greater financial instability when the credit cycle turns.

Much ink has been spilled talking about the rise of passive/mechanized investing. We are not dogmatic on the active vs. passive debate. There are certain areas (like large cap US equities) where the dispersion between the best and worst active managers is fairly low (because most are closet indexers), and therefore using passive vehicles like index funds and minimizing costs makes sense. There are other areas, like emerging markets or certainly alternatives, where the spread between average and better-than-average is massive, and it makes sense to identify niche specialist managers, and to pay for performance. Exchange-traded funds (ETFs) can be powerful and useful tools, and give small investors flexibility to manage portfolios and risk that did not exist in years past. This is a good thing, to an extent. But just because a tool exists doesn't mean it's suitable for everyone. As we saw in February when certain volatility-linked ETFs blew up, these funds can be weapons of wealth destruction as easily as they can be tools for capital preservation.

Moreover, the rise of passive investing carries with it certain externalities. If investors mindlessly plow cash into an S&P 500 index fund every month, regardless of valuation or economic backdrop or other fundamentals, there is no price discovery. Investors are just employing a systematic trendfollowing strategy that buys ever more of the largest companies, which in turn inflates the values and those companies, leading to circular process that is virtuous until something happens and the cycle breaks. If there is no price discovery on the way in, there will be none on the way out. We saw this in December when equity markets seemed to overreact to the downside. In our view, the proliferation of ETFs made it perhaps too easy for investors to panic, resulting in record outflows from equity funds in December, even more acute than during the financial crisis.

The corollary to this problem is liquidity or, rather, a structural lack of liquidity. For one, many of the ETFs available today (which are by definition intraday-liquid) hold assets that are not daily-liquid in the same way. One can buy $100 million worth of HYG, the high-yield bond ETF, in a matter of minutes. However to actually buy and sell the underlying bonds that make up that fund would take much longer. There is a liquidity mismatch between the vehicle and its holdings. Even more importantly, as mentioned above, the inability of banks to hold inventory due to capital requirements, Dodd-Frank, and the Volcker Rule has created a vacuum of liquidity and inherent vulnerability in markets. Markets have become a mile wide, but an inch deep.

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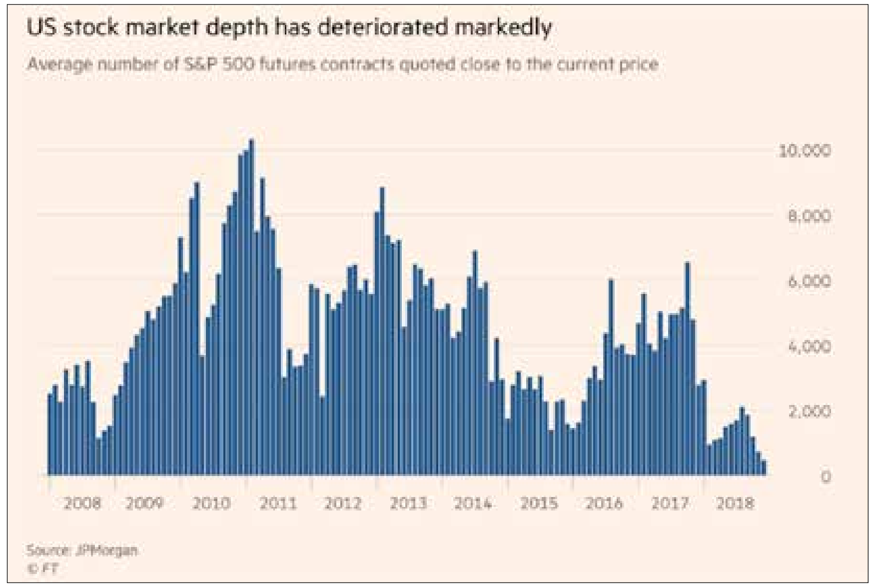

This is not to say that the macro outlook is all doom and gloom. A swift resolution of the trade conflict with China would certainly be one bullish catalyst, at least in the short term, for risk assets. And recent high level talks have stoked hopes in this area. As with all things related to the current Commander-in-Chief, it is dangerous to make predictions. Trump's unpredictability and refusal to play by traditional political rules are major reasons why he now occupies the Oval Office, and it has proven dangerous to underestimate him. But one anecdote: We saw the legendary former CEO of a global financial services company speak last year at a small investment conference. This is a company founded in Asia and with a strong focus there. There may be living Americans who know China better than this person (perhaps Henry Kissinger?) but, if there are, they can probably be counted on one hand. The speaker's point was simple: Xi is a dictator for life. He is not subject to popular elections, and therefore the Chinese can afford to play a long game that American politicians, however confident in their negotiating skills, cannot. As a result, this person posited, any comprehensive trade deal will take perhaps 5 years and require the participation of veteran and highly competent diplomats. If the current US negotiating team can accomplish this feat in less than 2 years, it would certainly not be the first time the Trump Administration has surprised its critics. But it also seems a long-shot, to be generous.

Moreover, the trade war fracas is something of an unforced error that, if reversed, would do little to alter the underlying trajectory of the credit and liquidity cycles that we believe are critical for determining economic trends and asset price movements. Again, we don't make predictions: we invest in managers that our research shows employ superior processes, and try to do so at a reasonable cost. But ongoing macroeconomic and capital flows trends are what tend to drive the positioning of those managers, and at present those trends are broadly signaling a defensive posture.

Paradoxically however, this gloomier backdrop could pave the way to much more accommodative Fed and ECB, and even the reversal of QT back to QE. (Could the recent strength in gold be discounting this possibility?) Chairman Powell has already clearly signaled a pause in rate hikes in wake of the ugly performance for equities in 4Q18. Could the ECB follow by walking back their own QT plans? With China growth slowing as it is currently (and PMI readings now slipping towards contraction territory), further deterioration could pressure the Chinese to engage in aggressive fiscal stimulus (they have already approved a nearly $1 trillion rail project in early 1Q19), and pressure both sides to reach a resolution on trade sooner than the market expects. Such a scenario would be unambiguously bullish for stocks, emerging markets, commodities, and risk assets in general. Whether this type of policy about-face can occur without further meaningful pain to risk assets remains to be seen.

Regardless of how 2019 plays out, we remain committed to combining uncorrelated macro investment strategies that generate reasonable returns over a market cycle, with little to no correlation to the rest of client portfolios, and maintain the potential to generate "crisis alpha" when markets enter extreme environments, be they deflationary or inflationary. Investing in sound scientific processes, not speculations, stories, or theories, is the approach that we believe best serves our clients. Such strategies can be likened to hurricane insurance, which does little in normal times, but can prove crucial in a disaster. For investors without proper diversification, 2018 could have been nearly a disaster. Liquid Alpha now has a 3-year track record and has outperformed its benchmark by nearly 8% over that period. We believe, with global markets decidedly late in the economic cycle, now is the time to add diversifying alternatives to portfolios, not far in the future after the "hurricane" has struck. Thank you for your support and best of luck in 2019.