

COMMONWEALTH LIQUID ALPHA FUND



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2019 PERFORMANCE REVIEW

What a difference a year makes. When we sat down to write this letter a year ago, global equity markets had just plunged into bear market territory and nearly every global asset class had just lost money for the year. Fast forward 12 months and we have just completed one of the best years in history to be an investor in both stocks and bonds, with global “60/40” portfolios returning nearly 20% (and US-centric portfolios performing even better). In 2018, when traditional portfolios lost money, our alternatives portfolios returned 2-3%. In 2019, when traditional portfolios recorded monster gains, our alts strategies generated similar returns. Commonwealth Liquid Alpha Common Trust Fund (“Liquid Alpha”) returned 3.2% and Commonwealth Structured Alpha (“Structured Alpha”), the strategy’s LP version, made 1.4%. These returns lagged the benchmark SG CTA Index, which gained 6.5%.

Liquid Alpha provides investors access to best-in-class, niche, non-correlated investment managers in a cost effective manner. Our goal with this strategy is to generate steady positive returns regardless of the market environment, with the potential for large returns in extreme market environments. We saw this lack of correlation in both of the past two calendar years. However, given that we target high single digit returns over a market cycle, it is hard to be overly enthused with 2019 performance. In response to this, we made several portfolio management changes at year-end, removing an underperforming strategy that we felt was not optimally set up to capture the current macro opportunity set, and concentrating exposure in our highest-conviction managers.

	FY 2019	Since Inception (Jan 2016)	Sharpe Ratio (1TD)
Liquid Alpha	3.19%	5.26%	0.23
SG CTA Index	6.47%	0.64%	0.02
MSCI World Index	23.86%	36.85%	0.83
Barclays Aggregate	7.21%	15.20%	0.81
60/40 Stock /Bond	17.20%	28.19%	1.00
50 / 30 / 20 Stock / Bond / Alts	14.40%	23.49%	1.00

Source: Morningstar, CBandT estimates

HOW WE MADE MONEY THIS YEAR

- One of our portfolio managers succinctly commented last month: “It was a rates year.” The impact of US 10-year Treasury yields dropping by nearly 50% (from around 2.7% at YE 2018 to below 1.5% in early September) is hard to overstate. Falling interest rates benefited fixed income longs and this was our best performing asset class for 2019. A lower discount rate also drove massive rallies in duration proxies (think utilities, REITs, and megacap equities with highly predictable earnings streams). As Warren Buffett commented in May, “stocks are ridiculously cheap **if** you believe... that 3% on the 30-year bond makes sense.” [emphasis ours]
- In addition to fixed income, currencies and global equity indices were modestly profitable
- Carry and trend strategies generally performed well

HOW WE LOST MONEY THIS YEAR

- Short-term tactical trading and value strategies lost money
- Commodities trading was a meaningful drag on returns
- These tend to be areas where large managers, especially those with 40 Act mutual funds and those comprising our benchmark index, have relative little exposure. Hence, while our more balanced approach generated nearly 800bps of relative outperformance versus the benchmark in 2018, it cost the fund over 300bps of relative performance in 2019.

	2019 Return
Global Equity Indices	0.29%
Global Currencies	0.77%
Global Fixed Income	4.20%
Commodities	-2.06%
TOTAL	3.19%

Source: Morningstar, CBandT estimates

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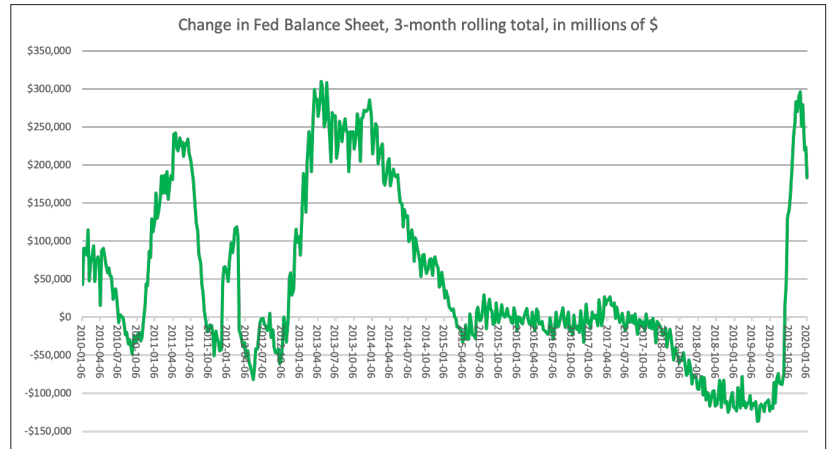


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2020 OUTLOOK

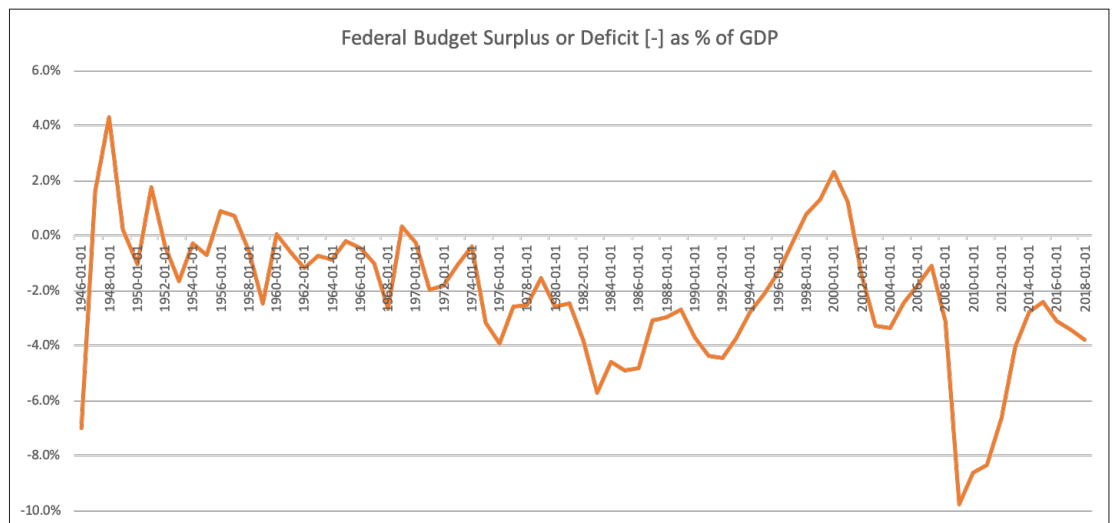
The Fed completely reversed their policy stance during 2019 and this was the most important story of the year for financial markets. A year ago, Chairman Powell was still in rate-hiking mode, doubling down on his desire to normalize rates even as stocks plunged and financial conditions tightened in 4Q18. Market expectations were for 1-2 rate hikes in 2020. That expectation didn't last long, as the Fed signaled a shift in tone as early as January, then lowered rates in July, September, and October.



Source: fred.stlouis.org

Perhaps more importantly, Powell reversed from quantitative tightening (QT) to quantitative easing (QE) in the late Summer. In fact, the central bank grew its balance sheet at the fastest rate since the aftermath of the Global Financial Crisis during 4Q19 (see Figure 1). The chart above does not take into account the unprecedented liquidity which the Fed pumped into the overnight repo market in 4Q19, culminating in \$255B in overnight and term repo operations in the final week of the year. If we had to point to a single driver for the epic rally from the December 2018 stock market lows to the December 2019 highs, it would be the Fed's shift to accommodative policy and investors' ensuing scramble for yield and duration across all asset classes. However the Fed is set to end their shadow QE (buying \$60B a month in Treasury bills) in 2Q20. Can equities continue climbing higher absent continued monetary easing?

Financial leverage continues to build and virtually all global growth we have seen in the past few years is fueled by debt. The marginal growth generated by each incremental dollar of debt is ever-diminishing. The average new car loan is now 69 months. The global credit market multiplier has never been lower than it is today. The modern US economy has never run at this level of deficit in a peacetime economic expansion (see Figure 2).



Source: fred.stlouis.org

But the debt load of the US economy has yet to become a systemic problem and the conventional wisdom of the CBNC pundits seem to that it never will be. As a former Vice President famously claimed: "deficits don't matter." Dick Cheney's claim has proven prescient since he made it in 2004, but economic history would teach us otherwise. If 2020

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shows a pick-up in inflation (which may already be happening, see Figure 3) and long-term interest rates (did rates bottom in September?), debt levels could go from a non-issue to a big issue quickly. This isn't our base case, but given that we have just seen the largest peacetime expansion of the fiscal deficit in US history, it's a risk that bears monitoring.

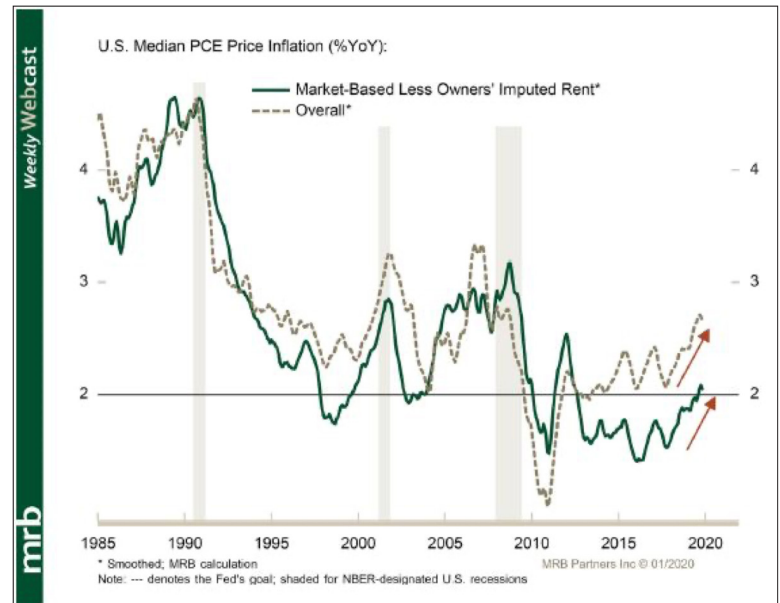
A year ago, markets were in the midst of a deflationary scare and fretful investors were concerned the Fed would raise rates into a weakening macro backdrop. Today, multiples have expanded, stocks are at new all-time highs, and complacent investors are discounting continued money-printing and monetary easing even as inflation and stock prices rise. Will today's outlook prove as wrong as last year's? We are certainly unlikely to see a repeat of 2019's massive

drop in interest rates. In order for the 10-year Treasury yield to again drop 30-50%, long rates would need to move down to around the 1% level, and long rates dropping to 1% absent a recession is difficult to envision given the Fed's stated decision framework. (And if we do get a recession, it's a safe bet that equities would not move higher.) So the type of equity multiple expansion we saw in 2019 seems unlikely. At the same time, sell-side expectations for 2020 S&P 500 earnings growth are in the 8-10% range (our own estimates are in the mid-single digits). As a result, our 2020 base case would be mid-single digit returns for equities and low single digit returns for fixed income, with downside risks to stocks (and upside for bonds) if the trade war rears its head again or a far-left Presidential candidate is elected. If inflation picks up unexpectedly, it could be a toxic scenario for 60/40 portfolios, as stocks and bonds would likely both trade lower. In short, we cannot envision a reasonable scenario where passive 60/40 portfolios repeat their monster 2019 gains. As a London-based manager we follow wrote recently: "Our in-house models certainly foresee no credible outcomes where a restart in productivity growth is accompanied by a continuation of near-zero natural real interest rates. Can you?"

We continue to believe that in the context of uncharted fiscal deficit waters and underappreciated macro uncertainty, diversifying alternatives are a sensible complement to traditional portfolio allocations. To underscore this point, a couple statistics:

- There have only been 13 negative months for global equities (MSCI World Index) since Liquid Alpha launched in 2016, and the fund generated positive returns in 10 of those 13 months.
- In the average negative month for global equities, the MSCI World Index lost -3.2%, whereas Liquid Alpha made 0.5%.
- In positive months for the MSCI World Index over this period, Liquid Alpha also generated positive returns on average.

While 2019 wasn't a year in which investors were paid to diversify, 2018 certainty was. No one knows what 2020 will bring but we continue to believe that cost effective, positive carry strategies with the ability to perform well in extreme market conditions make sense within diversified stock/bond portfolios.



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