Quarterly Investment Review - Q3 2021

Fulcrum Diversified Absolute Return Fund (FARIX)

FUND OBJECTIVE

Fulcrum Diversified Absolute Return Fund aims to achieve long-term absolute returns.

In seeking to achieve its aim of long-term absolute returns, the Fund aims to hold a diversified portfolio and achieve long-term absolute returns in all market conditions over rolling five-year periods, with lower volatility than equity markets and in excess of inflation.

Investments are sought with a focus on liquidity and are multi-asset in nature with exposure across equity, fixed income, currency and commodity markets globally.

Fund Information

Institutional Class	FARIX
Management Fee	0.90%
Gross Expenses	1.19%
Net Expenses[1]	1.09%
40 Act Launch Date	7/31/2015
AUM ($)	$107.0m
Firm AUM	$5.4bn

PERFORMANCE SUMMARY

The Fund posted a negative performance of -3.50% for the third quarter, with Relative Value strategies being the main detractor, whilst Directional strategies were flat and Diversifying Strategies contributed positively.

Our exposure to Asian currencies, such as the Korean won, which we expected to benefit from a pick-up in global trade suffered, and our negative positioning in the Chinese renminbi was insufficient to offset these dynamics. Commodities also struggled but the losses were concentrated in precious metals, despite real rates moving further into negative territory and carbon emissions gave back some of their strong year-to-date gains.

Fixed income overall was marginally down with significant regional dispersion, as gains from European, UK and Chinese duration positions were offset by our short US duration exposure. Thematic equities posted positive returns, with gains from some of our cyclical and technology disruption themes. Whilst Volatility strategies were modestly down over the quarter, Directional strategies were close to unchanged, with a small positive contribution from our climate aligned equities. Finally, Diversifying strategies had a strong quarter continuing to capture the broad trends across commodity markets.

CUMULATIVE NET PERFORMANCE

	as of September 30, 2021							
	Q3	YTD	1 Year	3 Years	5 Years	Since Inception[2]	Equity Correlation[6,7]	Fixed Income Correlation[7,8]
FARIX	-3.50%	2.66%	5.95%	4.76%	4.24%	2.69%	0.3	-0.3
Wilshire Liquid Alternative[3]	-0.37%	4.08%	8.65%	3.32%	2.88%	2.09%	0.9	0.2
Wilshire Liquid Alts Global Macro[4]	-0.13%	4.05%	8.63%	3.41%	1.72%	0.84%	0.4	0.3
HFRI Macro Index[5]	0.02%	8.36%	13.65%	5.92%	3.44%	2.76%	0.4	0.2

[1]The Adviser has contractually agreed to waive a portion or all of its management fees and pay Fund expenses in order to limit the total annual fund operating expense to 1.05% through at least October 31, 2021, excludes shareholder servicing fees, acquired fund fees and expenses ("AFFE"), taxes, interest expense, dividends on securities sold short and extraordinary expenses; the net expense ratio includes these fees and 2021. This limit represents what investors have paid as of the prospectus dated 10/31/20. [2]Inception date: July 31, 2015. Annualized return. [3]Represents the Wilshire Liquid Alternative Index (Bloomberg ticker: WLIQA). [4]Represents the Wilshire Liquid Alternative Global Macro Index (Bloomberg ticker: WLIQAGM). [5]Represents HFRI Macro Total Index (Bloomberg ticker: HFRIMI). [6] Represents MSCI World TR USD Hedged (Bloomberg ticker: WHANWIHD). [7]Data analysis provided since inception of the Fund. [8]Represents BC Global Aggregate USD Hedged (Bloomberg ticker: LEGATRUH). Source: Fulcrum Asset Management LLP, Bloomberg.

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-855-538-5278.

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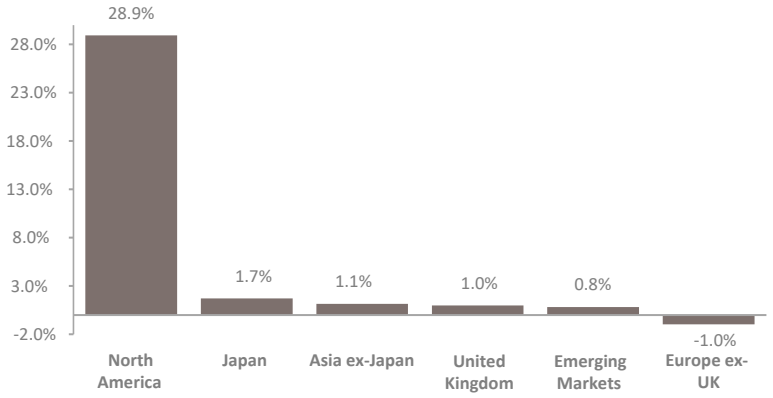
PORTFOLIO COMPOSITION

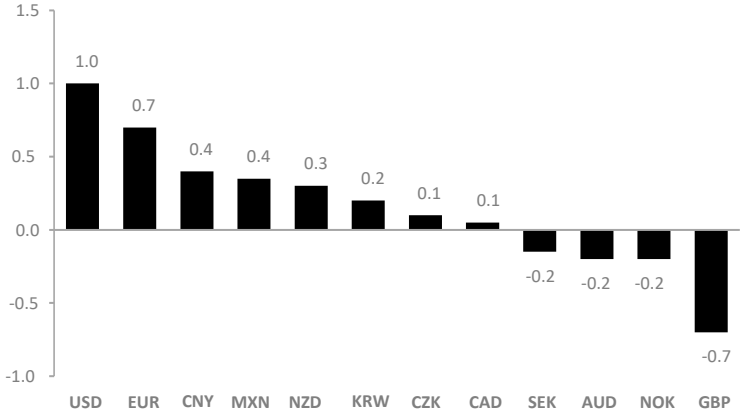
Coming into the quarter, we were pro-cyclically positioned, net short duration (in the US and UK versus Europe and Asia), neutral the US dollar and held defensive precious metals. We believed that recent economic weakness had been overstated due to supply bottlenecks, rather than being a pure reflection of falling demand, and expected to see key underlying trends to re-assert themselves.

However, as the quarter progressed, it became apparent that supply bottlenecks were more persistent and economic activity was slowing in some parts of the world, creating the conditions for a stagflationary environment. We hence reduced our pro-cyclical exposures and positioned the portfolio more conservatively, with a below average allocation to equities, minimal exposure to government bonds and a positive stance on the US dollar.

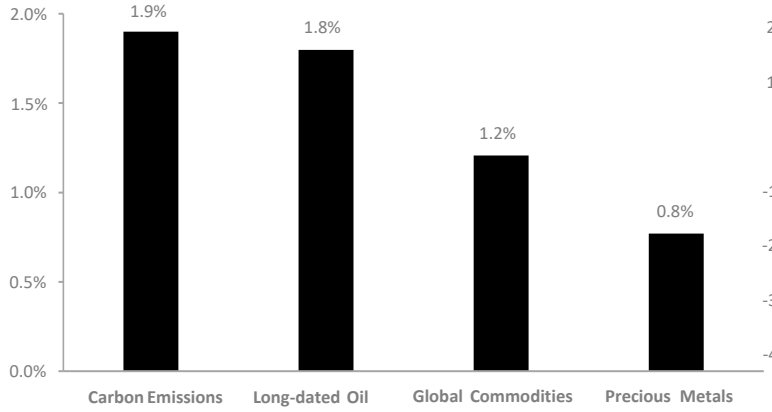
Net Equity Exposure by Region: 32.6%



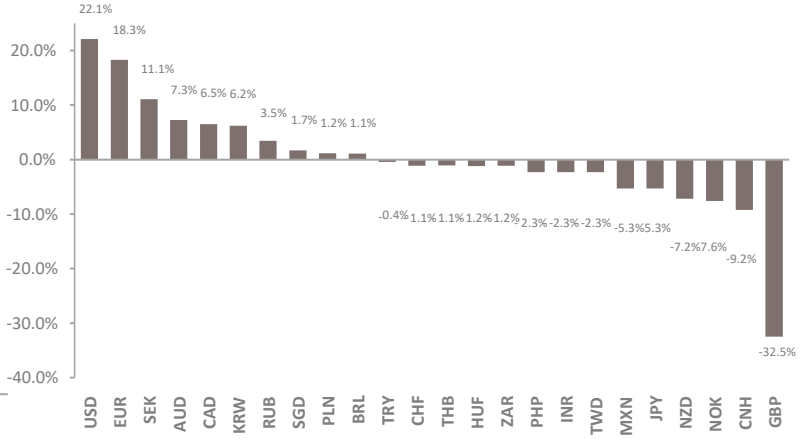
Net Duration Exposure (years): 1.8



Net Commodity Exposure: 5.7%



Net Currency Exposures



Data as at 09/30/2021. Source: Fulcrum Asset Management LLP.

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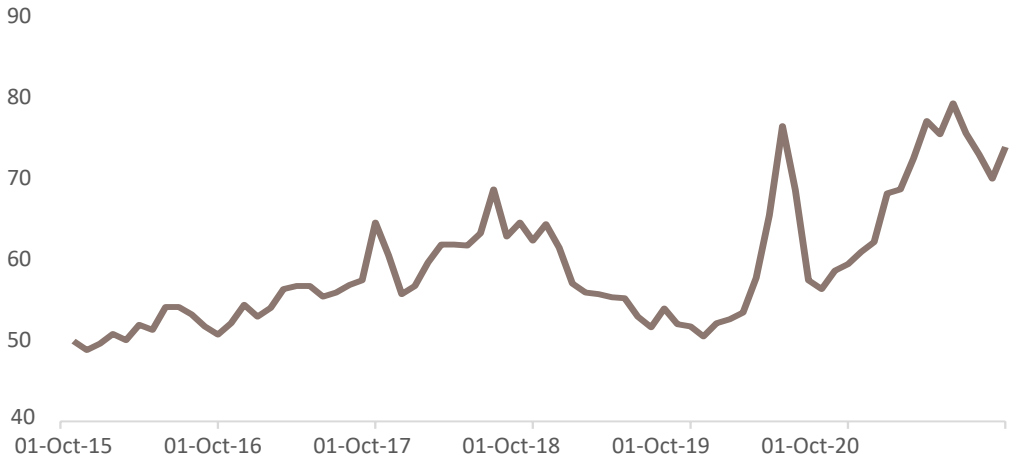
MARKET REVIEW AND OUTLOOK

At present, covid related disruptions, combined with years of underinvestment in energy assets and just-in-time manufacturing cycles, have slowed down the global supply chain and caused several shortages from semiconductors to energy. The ensuing supply chain bottlenecks have meant that some factories, from Asia to Europe, have been shut down or had to curtail production.

Institute for Supply Management (ISM) Manufacturing Report on Business Supplier Deliveries (%)



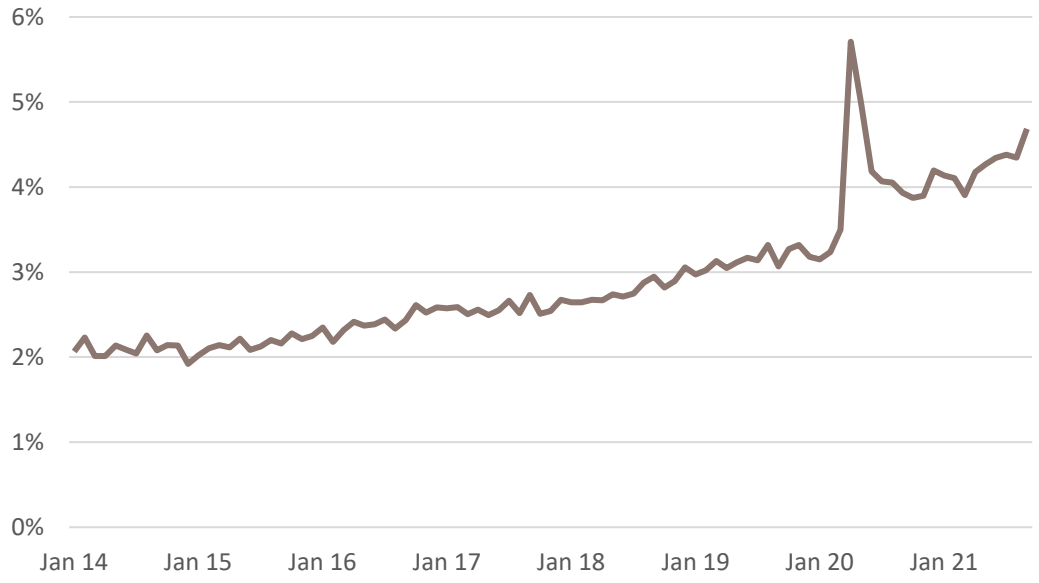
Source: Fulcrum Asset Management LLP

Meanwhile, demand has been very strong, supported by high savings and accommodative monetary and fiscal policy. The imbalance of demand versus supply has put persistent upward pressure on prices, which in turn has led to a jump in inflation expectations. Global food prices have risen by roughly a third over the past year, while gas and coal prices have hit record levels in some parts of the world.

Inflation expectations in the US are at multi-year highs driven by a shortage of commodities as demand remains strong and supply constrained. The dotted line represents the level that is generally consistent with the Federal Reserve Board's inflation target.
Sources: Bloomberg LLP, Fulcrum Asset Management LLP

Elsewhere, wages have continued to accelerate. As an example, wages in the US have accelerated from an average annual rate of 3.2 per cent in the pre-pandemic period of 2018-2019 to an annual rate of 4.9 per cent in the period from December 2019 to September 2021. Looking closely at the most recent data, they have accelerated to an annualised growth of 5.1 per cent in the third quarter from 4.7 per cent in the second quarter. These "second round" effects of wage increases are likely to maintain pressure on prices.

2-year Annualised Change in US Nominal Wages



Sources: Bloomberg LLP, Fulcrum Asset Management LLP

Acknowledging the persistence of inflation, some central banks have acted pre-emptively by increasing interest rates, with many others warning of a less transitory nature than they initially anticipated. The most recent examples are the Norges Bank, the Czech National Bank, and the National Bank of Poland. The US Federal Reserve has also indicated its willingness to reduce its accommodative policy stance by curtailing its asset purchase programme, starting as early as November this year.

Historically, periods of high inflation have been negative for traditional investments with fixed income acting as a less effective portfolio diversifier. We split the past 50 years into three inflation regimes – rising, falling and stable inflation – and studied the performance of assets under each regime.

Our findings show that US Treasuries lost value in real terms during the inflationary regime (1971 to 1980), with longer duration bonds devaluing more. Though equities and a 60/40 equity-bond portfolio lost 0.8 per cent and 1.5 per cent in real terms over the inflationary regime, this masked large drawdowns in the interim.

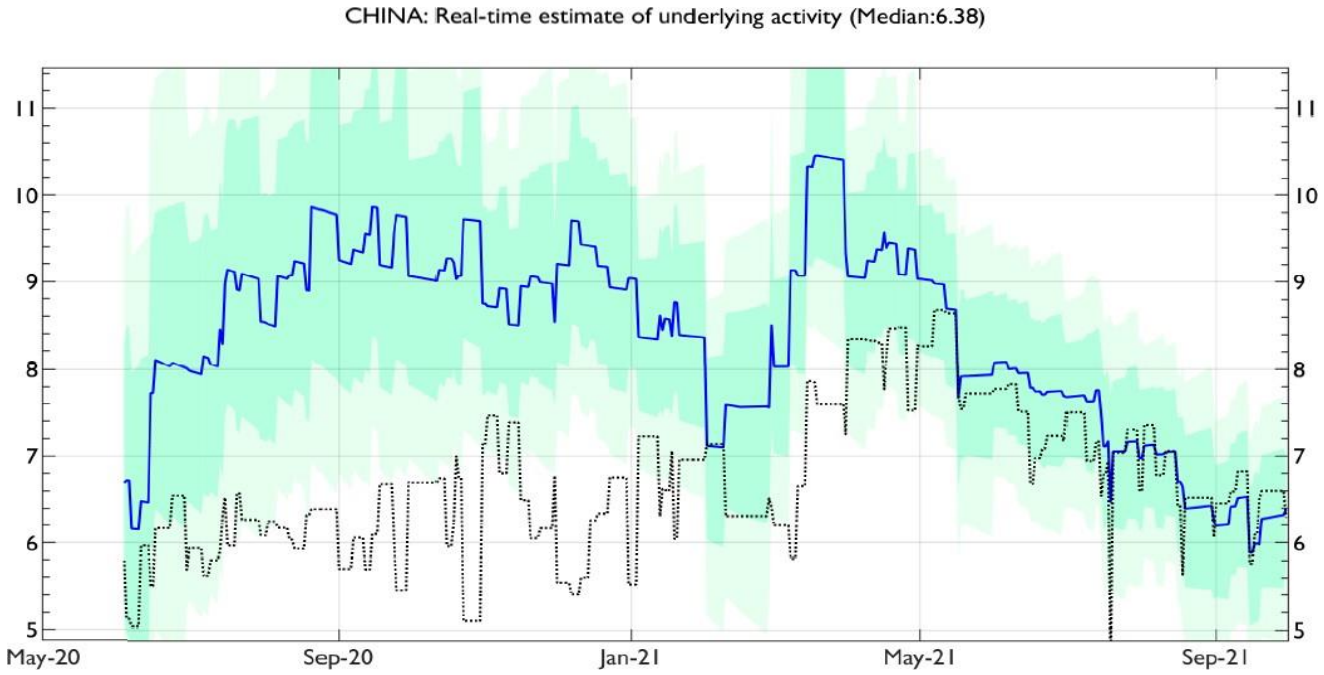
The table below focuses on asset returns during the first three years of the inflationary regime – the worst period for risk assets such as equities and a 60/40 equity-bond portfolio. The latter lost 10.5 per cent annualised in real terms and the former lost 16 per cent annualised in real terms, while assets such as gold, oil and commodities in general performed well during this time.

Returns During the Onset of the Inflationary Regime (1971-1974)

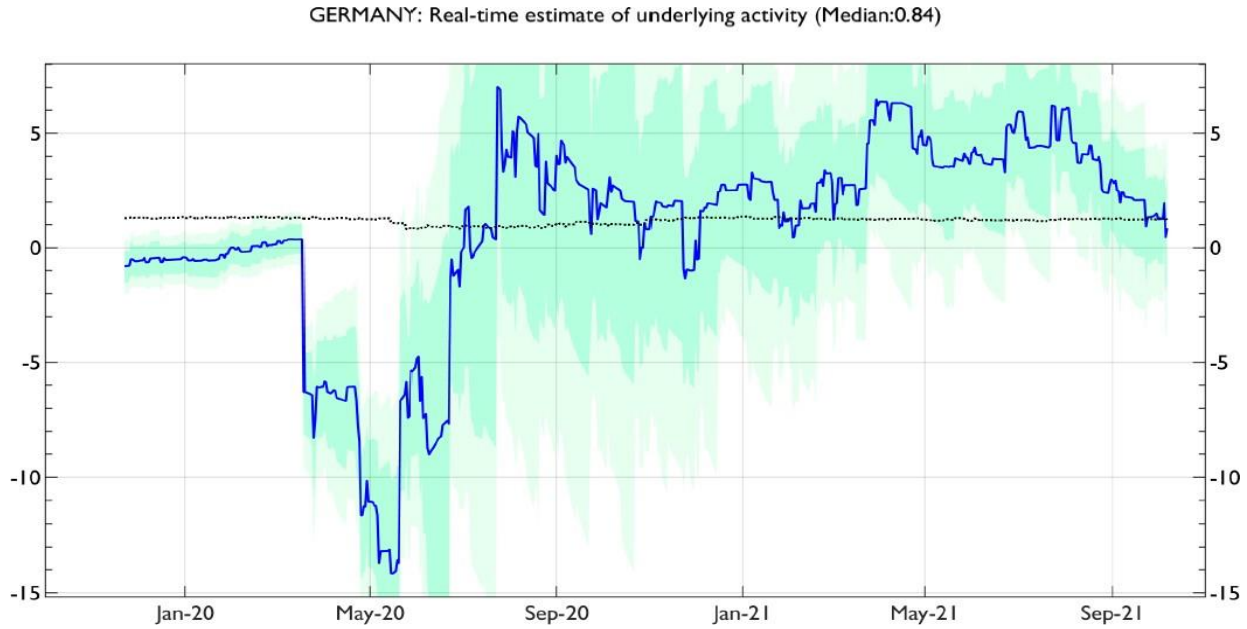
	Nominal return (%, ann.)	Real return (%, ann.)
S&P 500	-9.3	-16.1
3m UST	6.6	-1.4
10y UST	4.6	-3.2
0-3y TIPS	-	-
10y TIPS	-	-
REITs	-22.4	-28.2
Gold	61.7	49.6
Oil	46.4	35.4
Commodities	33.1	23.1
60/40 Eq-bond	-3.2	-10.5
Δ Inflation (ppts)	+9.0	
Avg Inflation (%, ann.)	8.2	

Source: Fulcrum Asset Management LLP

Further clouding the outlook, economic activity has been softening in parts of the world, for example China, Germany and the UK. For the moment, demand remains strong enough in the US and some parts of Europe to keep global growth robust.



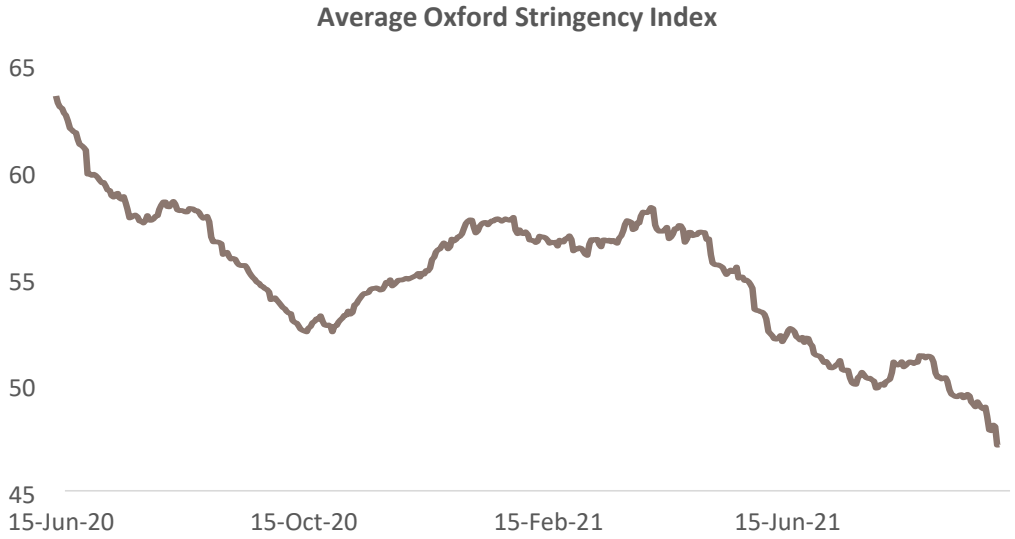
The real time estimate of underlying activity represents a real time estimate of Gross Domestic Product (GDP) growth, in annualized terms.
Source: Fulcrum Asset Management LLP



The real time estimate of underlying activity represents a real time estimate of Gross Domestic Product (GDP) growth, in annualized terms. Source: Fulcrum Asset Management LLP

However, China remains a weak spot relative to its own history and shows little sign of turning. Its gargantuan domestic property market continues to slow, while the government is also cracking down on activities which it regards as detrimental to society. Concurrently, the country is facing an energy crunch whereby factories have had to curtail production or shut down altogether. This slew of factors is likely to exert downward pressure on Chinese economic growth, which will likely have global spill-over consequences. Already, recent surveys indicate a sharp slowdown of the German manufacturing powerhouse, with investors increasingly concerned about a "bottleneck recession". Further propagation of weakness emanating from China poses material risks to global activity and is something that we are watching carefully, given the important implications for asset prices.

With regards to the pandemic, we do not expect any major disruptions to global economic activity from Covid-19 lockdowns going forward and expect most major economies to have minimal restrictions by the end of this year as countries are more receptive to removing restrictions, with increasing recognition from health experts and policymakers of Covid-19 becoming an endemic. We are, of course, monitoring the emergence of new strains, which couldmaterially change the outlook.



The chart shows average Oxford stringency index across 185 countries. Oxford Stringency Index shows the level of restrictions within a country; a decreasing number shows restrictions being eased and vice versa. Sources: Our World in Data, Fulcrum Asset Management LLP

Final Word

In summary, while we expect a continuation of the broad economic recovery from post-pandemic lows, it will be far from linear and uniform across regions, as the economy must contend with ongoing supply chain disruptions and an energy crunch. These factors are putting upward pressure on inflation and are responsible to a large extent for a slowdown in activity across major economies such as China, the UK and Germany, thereby raising stagflationary fears.

Forecasting future levels of inflation continues to be a real challenge; even the best macroeconomic models are still not very good at it, and this crucially includes the forecasting ability of central banks. Hence, it generally pays to be somewhat contrarian when markets get overly concerned (one way or another). Ultimately, whilst we do think inflation risks are likely to persist in the medium-term, in the short-term these concerns may well be overdone. Recent short-term market moves pricing in inflation mean that the bond/equity correlation, among others, has become very unstable and unpredictable. This uncertainty, however, has made it very cheap to hedge against a traditional, non-inflationary risk off episode or even recession.

In terms of our outlook for the major asset classes, for the first time in over a decade, central banks are having to contemplate becoming less accommodative to avoid a de-anchoring of inflation expectations, thereby putting the role of bonds as a defensive asset on even shakier ground. Much has been written about the potential long-term demise of bonds, but how should you then build resilient portfolios if your "safe" asset becomes less safe? Given the level of expected returns, we do not think it is appropriate to replace bonds with even riskier equities. Our preferred approach is to have minimal structural exposure to bonds and simultaneously reduce exposure to equities.

We remain constructive on commodities in general, given the underinvestment and bottleneck issues mentioned earlier, though we believe it is prudent to be careful in the short-term. Even the biggest rallies are beset with at times vicious drawdowns. With regards to equities, we see slowing activity and reduced support from central banks as a less supportive environment and we look for longer term thematic ideas that are less sensitive to the overall direction of markets to drive future returns.

Whilst the third quarter was disappointing from a performance perspective, we believe our disciplined approach and ability to implement investment ideas across a broad range of assets, time horizons and strategies, is key to producing attractive risk-adjusted returns in a broad range of market environments going forward. With the outlook for traditional assets looking bleak, an environment of high uncertainty and dispersion between economic outcomes provides for a rich opportunity set to the macro investor.

Appendix 1. Table "Returns During the Onset of the Inflationary Regime (1971-1974)" Description of Data and Sources

Inflation - represented by the Consumer Price Index (CPI) which is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services in the US. Source: Bureau of Labour Statistics.

S&P 500 - represented by the S&P Total Return Index. It measures the US equity performance based on changes in the aggregate market value of 500 stocks representing all major industries. Source: Center for Research in Security Prices (CRSP) through Wharton Research Data Services (WRDS)

3m T-Bill - represented by the 90-day Treasury Bill Total Return Index which tracks the daily performance of 3 month US Treasury bills. Source: CRSP through WRDS

10y Treasuries - represented by the 10y Treasury Bond Total Return Index which tracks the performance of 10 year US Treasury bills. Source: CRSP through WRDS

0-3y TIPS - represented by the 0-3y TIPS Total Return Index which measures the performance of the U.S. Treasury Inflation-Protected Securities (TIPS) market and tracks TIPS with a maturity between 0 and 3 years. Source: Standard & Poor's

10y TIPS - represented by the 10y TIPS Total Return Index. The S&P US TIPS Index is a broad, comprehensive, market value-weighted index that seeks to measure US TIPS market performance. Source: Standard & Poor's

REITS - represented by the US Total Return Index which comprises of equity Real Estate Investment Trusts (REITs) based on the US REIT universe. Source: NA REITS

Gold - represented by the GSCI Gold Total Return Index which is a benchmark that tracks the Commodity Exchange (COMEX) gold future. Source: Standard & Poor's

Oil - WTI price (pre-1987) which refers to the price of the New York Mercantile Exchange (NYMEX) West Texas Intermediate (WTI) Crude Oil futures contract or the contract itself. Source: Energy Information Administration; GSCI Oil Total Return Index (post-1987) which reflects the returns that are potentially available through an unleveraged investment in the WTI crude oil futures contract. Source: Standard & Poor's.

Commodities - represented by the GSCI Board Commodity Total Return Index which is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. Source: Standard & Poor's

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Glossary of Terms:

60/40 Equity Portfolio - represented by 60% global equities (MSCI World TR USD Hedged) and 40% global fixed income (BC Global Aggregated USD Hedged).

Correlation - statistical measure of the degree to which two variables move in relation to each other.

Duration - measure of a bond's sensitivity to changes in the interest rate.

Indices:

BC Global Aggregate USD Hedged - a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

HFRI Macro Total Index - representative of investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity market.

MSCI World TR USD Hedged - free float-adjusted market capitalization weighted index designed to provide a broad measure of large and mid-cap equity performance across 23 developed markets countries.

Wilshire Liquid Alternative Global Macro Index - measures the performance of the global macro strategy component of the Wilshire Liquid Alternative Index. It is designed to provide a broad measure of the liquid alternative global macro market.

Wilshire Liquid Alternative Index - measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe. It is designed to provide a broad measure of the liquid alternative market by combining the performance of the Wilshire Liquid Alternative Equity Hedge Index (WLIQAEH), Wilshire Liquid Alternative Global Macro Index (WLIQAGM), Wilshire Liquid Alternative Relative Value Index (WLIQARV), Wilshire Liquid Alternative Multi-Strategy Index (WLIQAMS), and Wilshire Liquid Alternative Event Driven Index (WLIQAED).

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