Quarterly Investment Review - Q4 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	1.32%
Net Expenses[1]	1.11%
40 Act Launch Date	7/31/2015
AUM ($)	$89.1m
Firm AUM	$5.9bn

PERFORMANCE SUMMARY

The Fund posted a positive performance of +1.61% for the fourth quarter and finished the year at +4.31%. Gains in the final quarter were distributed across Directional, Relative Value and Diversifying Strategies.

Directional strategy gains were driven by our exposure to US and Climate-aligned equities. Within Relative Value, Commodities performed well, with exposure to oil and carbon emissions yielding strong grains. Our negative view on the UK, based on a stagflationary environment and potential tough Brexit repercussions, was the main detractor from currency performance within Relative Value. Given the evolving situation in the UK we have since closed our short UK pound position. Also our negative exposure to the Chinese renminbi, which we expected would hedge against a fall in economic activity in China, also contributed negatively as the Chinese government loosened policy to cushion growth.

Fixed income overall was marginally profitable over the quarter with significant regional dispersion, as gains from European, CEEMEA and Chinese duration positions more than offset our short UK duration exposure. Thematic equities posted positive returns, with gains from some of our energy and technology disruption themes. Whilst the equity macro strategy detracted, our volatility and dynamic convexity strategies both contributed positively.

Finally, Diversifying strategies capping off a strong year with a broad-based contribution across sub-strategies.

CUMULATIVE NET PERFORMANCE

	as of December 31, 2021							
	Q4	YTD	1 Year	3 Years	5 Years	Since Inception[2]	Equity Correlation[6,7]	Fixed Income Correlation[7,8]
FARIX	1.61%	4.31%	4.31%	6.95%	4.08%	2.84%	0.3	-0.3
Wilshire Liquid Alternative[3]	0.62%	4.72%	4.72%	4.85%	3.01%	2.11%	0.9	0.2
Wilshire Liquid Alts Global Macro[4]	-1.33%	2.67%	2.67%	3.93%	1.97%	0.60%	0.4	0.2
HFRI Macro Index[5]	-1.23%	6.77%	11.03%	6.27%	3.45%	2.45%	0.4	0.2
Bloomberg US Agg Total Return[9]	0.01%	-1.54%	-1.54%	4.79%	3.57%	3.18%	0.0	0.9

[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). [9] Represents the Bloomberg US Agg Total Return Value Unhedged USD (Bloomberg ticker LBUSTRUU). 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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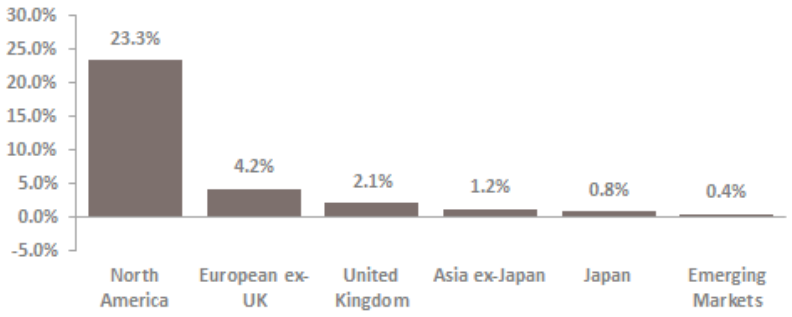
PORTFOLIO COMPOSITION

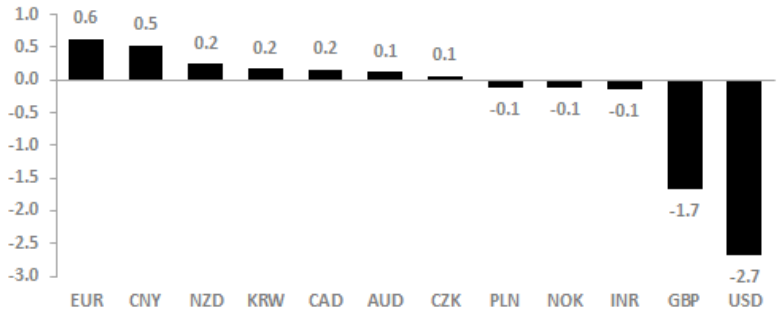
Given the increasing prospect of a stagflationary environment, the portfolio was positioned conservatively at the start of the quarter, with a below average allocation to equities, minimal exposure to government bonds and a positive stance on the US dollar.

As the quarter progressed, we reduced our cautious stance, closed our short UK pound exposure, and increased our short duration positions, especially in regions where markets are insufficiently pricing interest rate hikes given the underlying inflation backdrop. We continue to maintain a small positive stance on the US dollar, especially against the Japanese yen, but are mindful that currency dynamics in this next phase can change abruptly. Finally, we more recently liquidated all exposure to precious metals but continue to own other commodities, such as carbon emissions and oil.

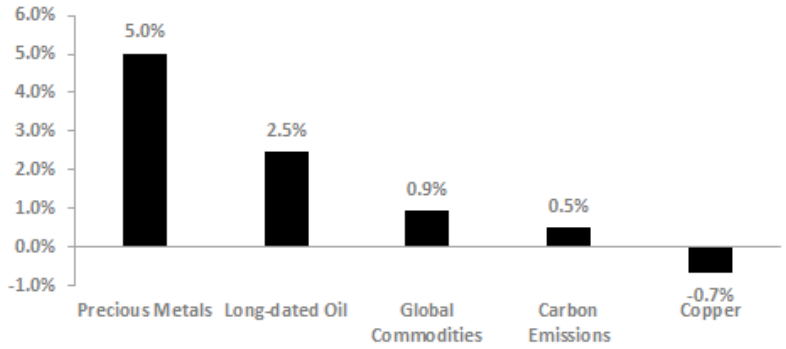
Net Equity Exposure by Region: 32.0%



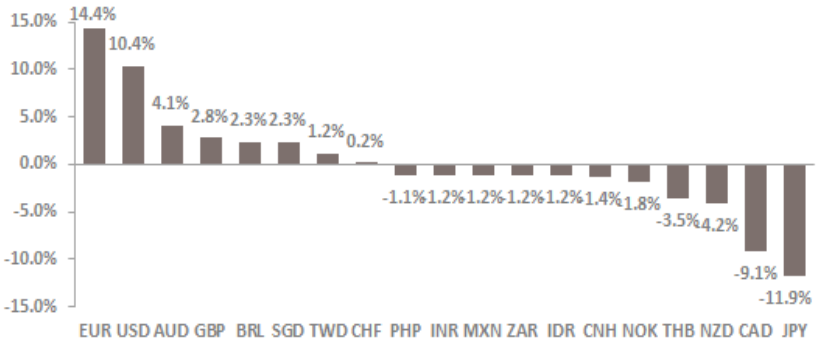
Net Duration Exposure (years): -2.8



Net Commodity Exposure: 8.2%



Net Currency Exposures



Data as at 12/31/2021. Source: Fulcrum Asset Management LLP.

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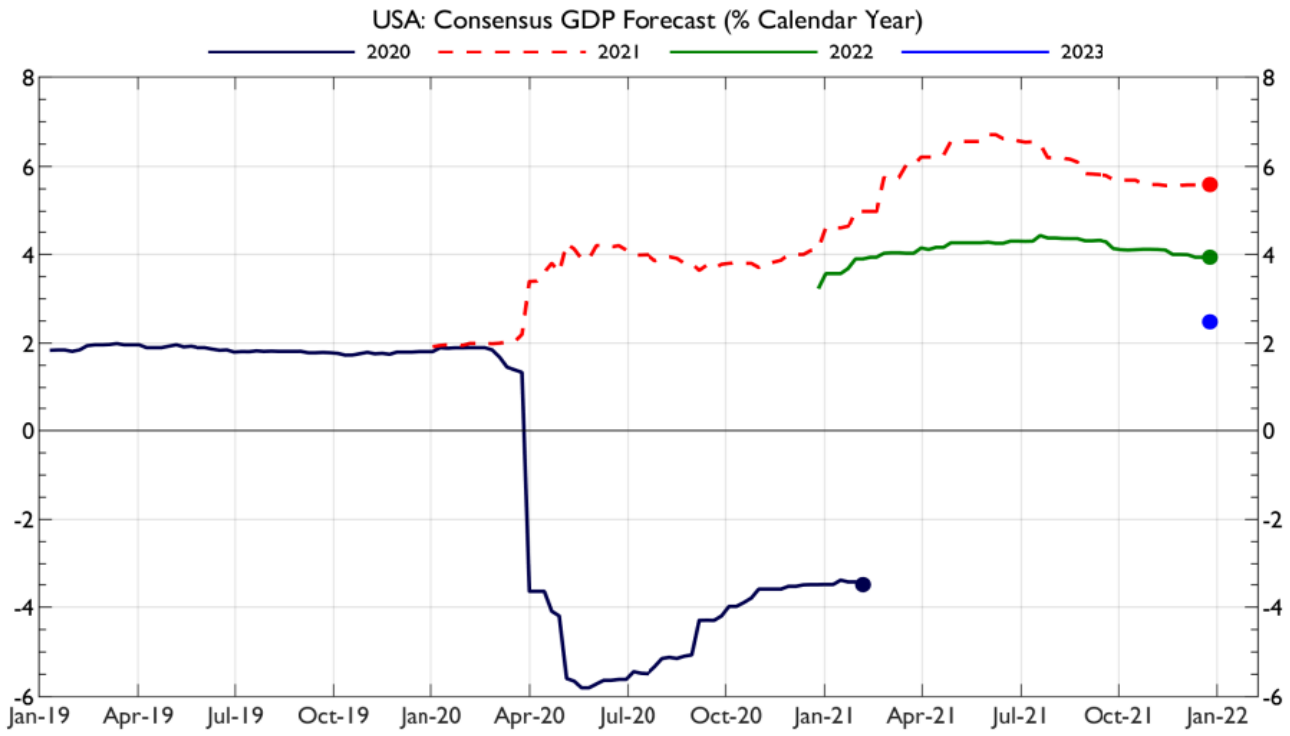
MARKET REVIEW AND OUTLOOK

We expect global growth to remain strong, with demand remaining firm enough in the US (+4.0%) and some parts of Europe (+4.0%) to keep global growth robust. After almost two years, we are also seeing signs of easing supply chain bottlenecks, which should help maintain the strong momentum. However, a good environment for economic recovery may not necessarily mean much further upside for asset prices.



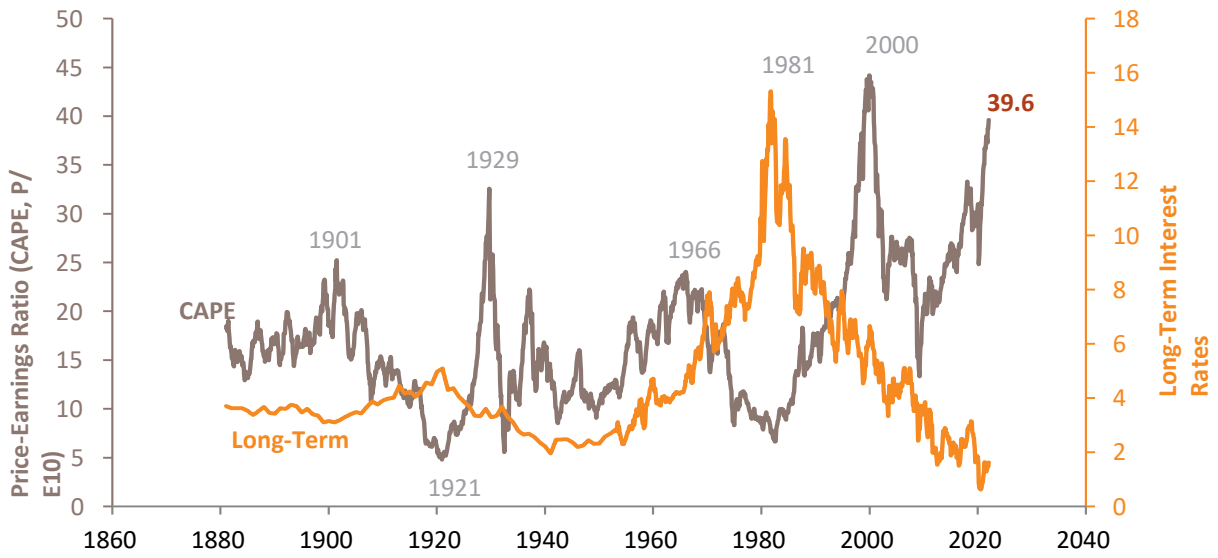
Consensus GDP forecast in the US points to a growth of 4% over 2022. Source: Fulcrum Asset Management LLP

For the most part of the past decade, namely the period since the Global Financial Crisis (GFC), returns have been fully supported by macroeconomic fundamentals, including attractive valuations, high growth rates in corporate earnings, a lack of adverse and disruptive supply shocks, and the long-term reduction in nominal and real interest rates. Holders of classic "balanced" 60/40 equity/bond portfolios have enjoyed consistently good performance.

However, supercharged market returns during the pandemic, on the back of accommodative monetary and fiscal policies, have not been fully justified by fundamentals. Looking ahead, the post-pandemic economic cycle is unlikely to share the same favourable characteristics that applied during the recovery from the GFC, when supply-side shocks were largely absent.

It is our belief that none of the fundamental factors that supported investment returns prior to the pandemic are likely to be as supportive in coming years:

- Equity valuations are elevated, with the Shiller CAPE now standing at nearly 40, close to an all-time high.



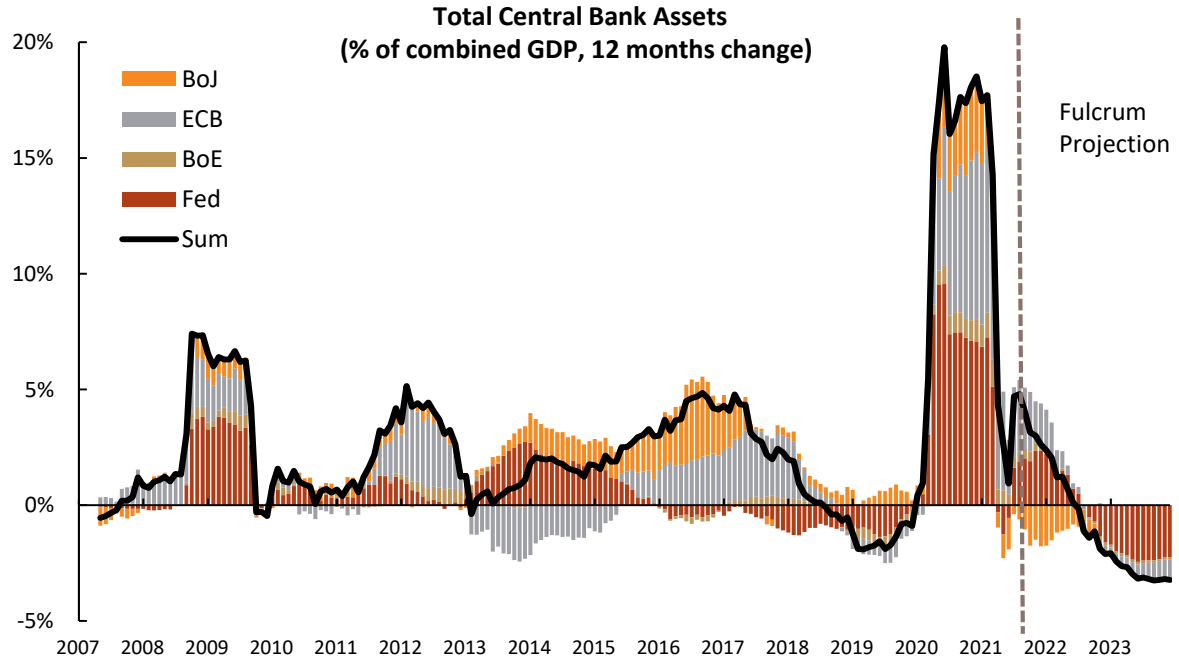
The Shiller CAPE (cyclically-adjusted P/E) ratio is close to all time-highs. Source: http://www.econ.yale.edu/~shiller/data.htm

- The long term decline in R-star might be slowed or reversed by expansionary fiscal policy in the US and EU, and by the impact of clean energy investment. Rising interest rates would put downward pressure on equity multiples.

- Supply shocks from the climate crisis may become disruptive. As abrupt and urgent mitigation measures are introduced to fight climate change, sudden supply shocks to the global economy might become much more important, relative to the demand shocks that have been dominant in the advanced economies since the 1980s and been counteracted by monetary policy. While equities and bonds tend to hedge each other during a demand shock, the opposite is true when a contractionary supply shock happens. A decline in equities is not offset by a fall in bond yields as higher inflation increases interest rates and reduces bond prices. Both main asset classes turn negative, increasing overall portfolio volatility and disrupting portfolio performance.

Meanwhile, central bankers are increasingly acknowledging that inflationary pressures have been less transitory than expected, with inflation hitting record levels over the past decade in many countries. We have heard from both the Chair and Vice-Chair of the Federal Reserve that fighting inflation is the Fed's "most important task".

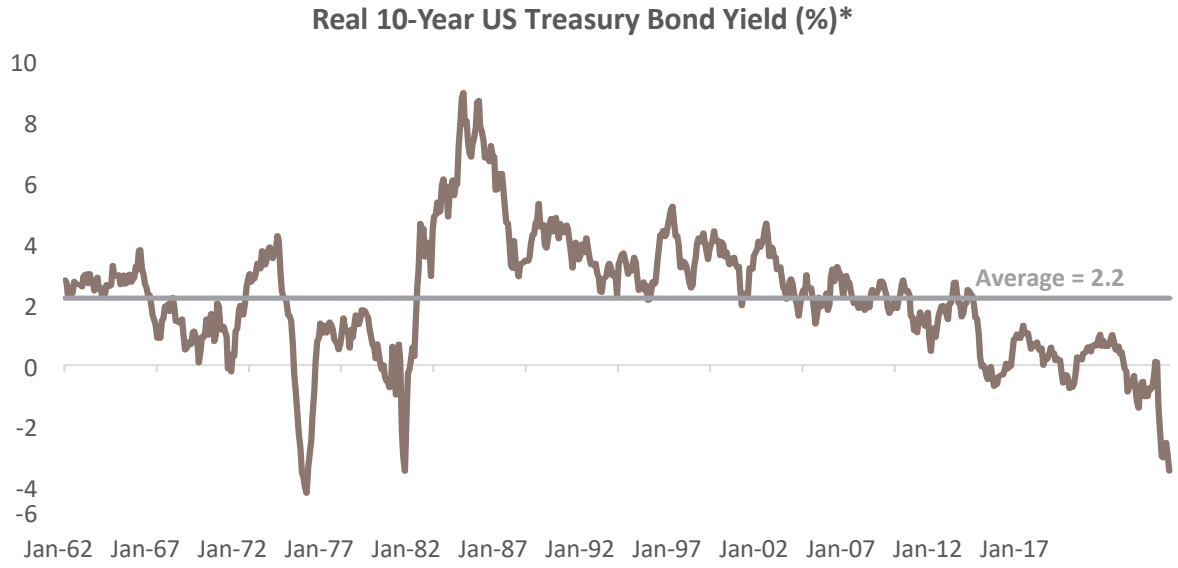
We expect the FOMC will begin balance sheet runoff during the second half of 2022. In the last cycle the FOMC capped its balance sheet decline each month at $50 billion ($30 billion for Treasuries, $20 billion for agency MBS). The aim was to avoid forcing the market to digest too much bond supply. It is likely that these caps could be larger going forward, perhaps around double the size of the last cycle—a $60 billion monthly cap for Treasuries and $40 billion for MBS.



The huge expansion of global balance sheets may be coming to an end in the next year or two. Sources: IMF, National Data, Haver Analytics, Fulcrum Asset Management LLP. 'BoJ' represents the Bank of Japan. 'ECB' represents the European Central Bank. 'BoE' represents the Bank of England. 'Fed' represents the US Federal Reserve.

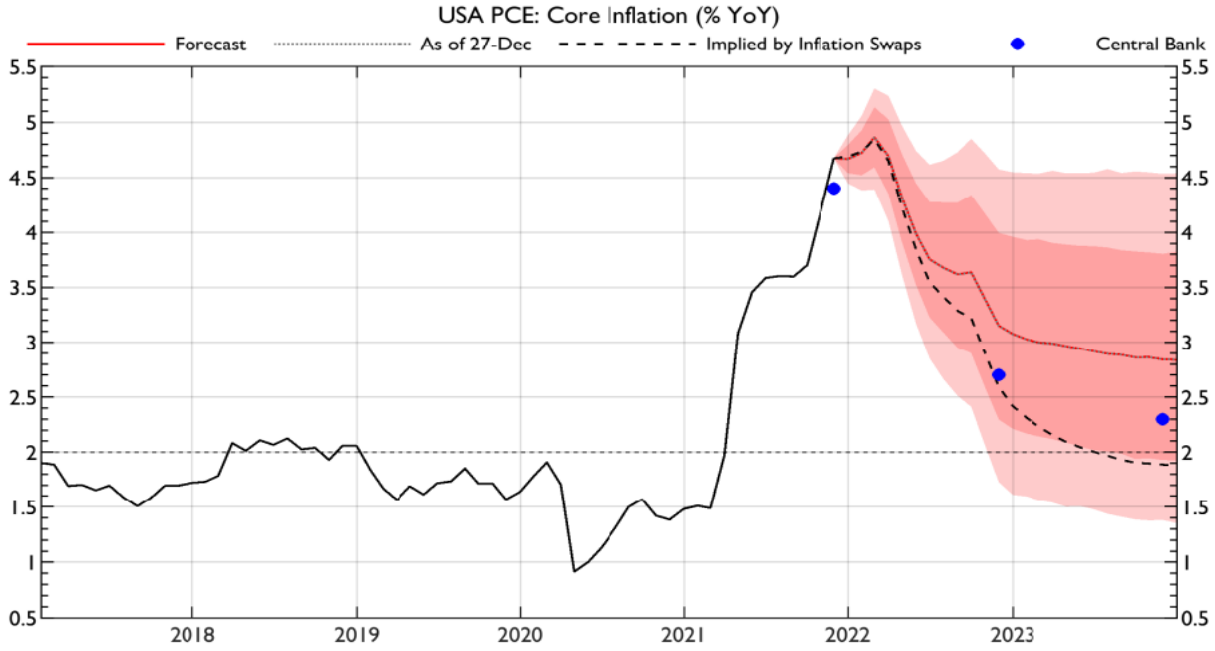
If the Fed starts to run down its balance sheet in this more hawkish manner, it would probably mean that the total balance sheet assets of the global central banks – often known as "global QE" or "global liquidity" – will start to fall at the fastest pace as a percentage of world GDP since the GFC in 2009.

While the market has remained relatively sanguine with inflation-adjusted yields at their lowest level since the 1970s, and inflation expected to return to target by the end of the next year, Fulcrum models continue to predict an upward revision to FOMC inflation projections throughout the forecast horizon.



**10-year Treasury yield less yearly percent change in core inflation.*

Real 10-year yields in the US are at their lowest since the 1970s.Sources: Bloomberg LLP, Fulcrum Asset Management LLP



The Federal Reserve summary of economic projections shows that inflation is expected to fall to 2.5 per cent by the end of 2023 while markets expect inflation to get back to target over the same time period. Our economic models show that inflation is likely to remain elevated relative to target. Sources: Bloomberg LLP, Fulcrum Asset Management LLP

Final Word

The past decade has experienced consistently high returns for holders of 60/40 portfolios, driven largely by macroeconomic fundamentals. However, as we have recovered from the pandemic, the further acceleration in returns has not been fully justified by macro fundamentals and has led to a meaningful decline in expected returns for traditional asset classes. Moreover, urgent action to fight climate change is likely to introduce supply-side shocks leading to higher volatility for asset allocators.

We expect major assets to deliver low expected returns, with the current environment particularly unfavourable to government bonds. Since 2008, bonds have provided both great diversification and positive returns, with monetary policy being the dominant market stabiliser. However, with inflation looming large and central banks under increasing political pressure to control inflation, the role of bonds as a defensive asset within portfolios should not be taken for granted.

Therefore, we prefer to maintain minimal structural exposure to bonds. As we have argued before, given the level of expected returns, we also do not think it is appropriate to replace bonds with even riskier equities. Our preferred approach is to express our pro-growth views with selective exposure to commodities, which are more sensitive to economic activity and less impacted by the discount factor applied to future revenue streams.

In coming years, asset allocators will need to respond much more actively when macro shocks (both demand and supply) occur to preserve absolute returns for their clients. Moreover, the uncertainty regarding appropriate policy setting is unclear but will certainly lead to increased economic and asset class volatility and dispersion.

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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).

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

P/E Ratio - known as the price-to-earnings ratio, it is the ratio for valuing a company that measures its current share price relative to its earnings per share.

R-Star - known as the natural rate of interest, it is the inflation-adjusted, short-term interest rate that is consistent with full use of economic resources and steady inflation near the US Federal Reserve's target level.

Shiller CAPE - also known as the cyclically adjusted price-to-earnings ratio, it is a valuation measure usually applied to the US S&P 500 equity market and is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

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).

Bloomberg US Aggregate Total Return Value Unhedged USD - a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughts), ABS and CMBS (agency and non-agency).

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