DISCIPLINED EQUITY

ALLCAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Fourth Quarter 2018

Jon Quigley, CFA
Chief Investment Officer
Disciplined Equities

John D. Bright, CFA
Senior Portfolio Manager
Disciplined Equities

Dmitri Prokhorov
Research Analyst

Lyn Taylor
Research Analyst

Deepesh Bhatia
Research Analyst

MARKET REVIEW

U.S. equities suffered through a very poor fourth quarter, despite a good underlying economy and continued strong profitability. The relatively high valuation with which we entered Q4 combined with the Fed's measured rate normalization and slow runoff of the Treasury's massively expanded balance sheet are key drivers of the increased volatility of late.

Across the broader U.S. equity market, larger-cap stocks outperformed smaller-cap stocks, with performance steadily declining as we move down the capitalization range. The dramatic outperformance of growth stocks during the first three quarters gave way to a fairly sharp reversal during the last quarter. Within the Russell 3000 Index, growth stocks ended 2018 with an advantage of nearly 6.5% - despite underperforming by over 4% during Q4.

Size/Style

- Within the R3000, small-caps outperformed both mid-caps and large-caps during Q4, similar to what we saw in the first half of 2018.
- From a style perspective, value outpaced growth across the cap spectrum. Interestingly, the biggest spread was within the mega-cap Top 200 Index.

Russell 3000 Sectors

We again saw a lack of quarter-to-quarter correlation of relative sector performance:

- Higher-yielding, counter-cyclical issues paced the market during the pullback. The Utilities and Consumer Staples sectors were the top two performers. Health Care was the third-best performer for Q4, and was the best performing Russell 3000 sector for the calendar year.
- Energy stocks repeated their poor relative showing from the prior quarter, and their 26% decline resulted in the largest decline of any sector for the year. The Technology sector declined 18%, erasing all gains from the first nine months of the year.

FOURTH QUARTER ATTRIBUTION

The AllCap strategy declined 14.8% during the quarter, trailing the benchmark Russell 3000 Index's -14.3% return. The table below breaks down the contributions from sector positioning and stock selection.

In total, sector positioning detracted 0.58% from active return:

- Underweighting the Utilities sector detracted 42bps, as the sector outperformed the benchmark by about 15% during the quarter.
- Underweighting the Energy sector added 37bps to active performance, as the sector underperformed the Russell 3000 Index by about 10%.

Stock selection within the respective sectors added 0.12% to active return.

MARKET OUTLOOK

Any change from what we called the "pretty Goldilocks" condition of Q3 2018 could only be in one direction – and it was. But conditions are still pretty darned good.

Last quarter, we noted corporate profits had eclipsed their previous record; they did so again in the latest reported quarter, with margins still sitting north of 10%.

We also noted price pressures remained in check; since that writing, oil prices have slid into a bear market, pulling headline CPI back closer to 2% per year.

Employment numbers are also very strong. In addition to very low headline unemployment, we have workers re-entering the labor force (as evidenced by the simultaneous increase in the U-6 unemployment rate). And with a near-term supply-demand imbalance, employment costs continue to rise – meaning more than just

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SECTOR	GLA WEIGHTING	R3000 WEIGHTING	% ACTIVE	GLA RETURN	R3000 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIB
Comm Services	3.57%	8.96%	-5.39%	-17.84%	-13.33%	-4.52%	-0.07%	-0.05%	-0.11%
Consumer Disc.	11.71%	10.22%	1.49%	-15.46%	-16.44%	0.98%	-0.06%	0.12%	0.05%
Cons. Staples	5.81%	6.55%	-0.74%	-18.04%	-5.58%	-12.46%	-0.25%	-0.74%	-0.99%
Energy	2.60%	5.40%	-2.80%	-36.43%	-25.88%	-10.55%	0.37%	-0.36%	0.01%
Financials	13.55%	13.96%	-0.41%	-9.89%	-13.51%	3.62%	-0.05%	0.44%	0.39%
Health Care	20.89%	14.84%	6.05%	-8.00%	-10.85%	2.85%	0.18%	0.57%	0.76%
Industrials	14.76%	10.12%	4.64%	-14.78%	-18.12%	3.34%	-0.17%	0.49%	0.33%
Technology	22.84%	20.08%	2.75%	-19.44%	-17.33%	-2.12%	-0.10%	-0.51%	-0.61%
Materials	0.44%	2.94%	-2.50%	-20.41%	-14.98%	-5.43%	-0.03%	-0.06%	-0.08%
Real Estate	3.83%	3.79%	0.04%	0.10%	-6.46%	6.56%	0.00%	0.22%	0.22%
Utilities	0.00%	3.12%	-3.12%	0.00%	0.82%	-0.82%	-0.42%	0.00%	-0.42%
TOTAL	100.00%	100.00%	0.00%	-14.76%	-14.30%	-0.46%	-0.58%	0.12%	-0.46%

Source: GLA and Bloomberg. Performance numbers are gross of fees.

shareholders are beginning to share in the fruits of this long expansion. And that has people – consumers and producers – feeling confident. But not as confident as they felt a month or two ago…

Washington, D.C. is right in the bullseye if we’re looking for the cause of the withering confidence, lack of visibility, and increased volatility.

The mid-term elections held few surprises, but investors collectively wonder what the Democratic resurgence will mean – both in terms of policy, and in terms of the Presidency. We seem to have withstood the known unknowns of the Trump Presidency, but fret over the political unknowns which lie ahead.

To this political uncertainty, we add the usual rate hiking cycle of the Federal Reserve Board late in an economic expansion. All cycles are unique, and the Fed typically does not execute perfectly in attempting to allow a moderate expansion with little price pressure. This cycle is unique in at least two ways: The Fed is raising rates from a very low level, and it’s embarked on the hikes with little sign of above-target inflation.

More impactful: The Fed is raising rates as the Treasury allows its massively-expanded balance sheet to runoff. This combination is as unprecedented as Trump and Pelosi’s televised tête-à-tête… Americans like good reality TV, but markets generally don’t like unprecedented combinations.

With all of this said, U.S. equities do appear attractive on a number of measures. Companies are generating high returns on assets/equity, are maintaining high margins, and now trade at a discount to historic valuation measures.

The AllCap model remains biased against stocks with high earnings yield and high estimate dispersion; high dividend yield is no longer out of favor. From a style perspective, the model still prefers growth over value – especially in the max- and mid-cap segments. Consumer Staples (Food & Beverages) and Technology (Software) stocks are most in favor, while Financials (Securities & Asset Management) and Energy (Energy Reserves) are most out-of-favor.

For more information, please contact us at:
marketing@greatlakesadvisors.com or 312-553-3700

The data in the attribution table represent the returns for each sector and for the gross returns for a representative composite account for one quarter ending the current calendar quarter. Individual account returns may vary.

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