STEPHEN J. BOWERY, PRESIDENT

Year-End Commentary 2017

Looking Back: 2017 Market Review

- Global stocks posted very strong gains for the year, led by the emerging markets.
- The steady rally in U.S. stocks was unprecedented.
- Bond returns were in the low- to mid-single digits, with credit-oriented strategies outperforming core bonds.

December Benchmark Returns (Preliminary)	Dec	Q4	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	1.1%	6.6%	21.7%
iShares Russell 1000 ETF	1.2%	6.7%	21.5%
iShares Russell 1000 Growth ETF	0.9%	8.0%	30.0%
iShares Russell 1000 Value ETF	1.6%	5.5%	13.5%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	-0.4%	3.3%	14.6%
iShares Russell 2000 Growth ETF	0.2%	4.5%	22.3%
iShares Russell 2000 Value ETF	-1.0%	2.0%	7.7%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	1.6%	4.3%	26.4%
Vanguard FTSE Europe ETF	1.5%	1.9%	27.0%
Vanguard FTSE Emerging Markets ETF	3.7%	5.9%	31.5%
Vanguard REIT Index	-0.2%	1.4%	4.8%
Vanguard Total Bond Market Index	0.4%	0.4%	3.5%
Vanguard Intermediate-Term Tax-Exempt	0.9%	0.3%	4.5%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.3%	0.4%	7.5%
S&P/LSTA Leveraged Loan Index	0.4%	1.1%	4.1%

The fourth quarter capped yet another stellar year for U.S. stocks. Large-cap U.S. stocks gained 6.6% for the quarter and ended the year with a 21.7% total return. This was the ninth consecutive year of positive returns for the S&P 500—tying the historic 1990s bull market and capping a truly remarkable run from the depths of the 2008 financial crisis. The broad driver of the market's rise for the year was rebounding corporate earnings growth, supported by solid economic data, synchronized global growth, still-quiescent inflation, and a generally accommodative monetary policy. U.S. stocks got an additional catalyst in the fourth quarter with the passage of the Republican tax plan, presumably reflecting investors' optimism about its potential to further boost corporate after-tax profits, at least over the shorter term.

2017 was a record year for stocks from many perspectives. The market's 1.1% gain in December crowned 2017 as the first year *ever* that stocks rose in each and every month. By year-end, the S&P 500 Index had rallied for more than 400 days without registering as little as a 3% decline. This is the longest such streak in *90 years* of market history, according to Ned Davis Research.

Foreign stock returns were even stronger, with developed international markets gaining 26.4% and emerging markets up 31.5% for the year. In the fourth quarter, however, these markets couldn't match the S&P 500, gaining 4%–6% versus a 6.6% return for U.S. stocks.

Moving on to bonds, core bonds jumped 3.5% in 2017. Most of this return was interest, as intermediate-term yields changed little during the year with the benchmark 10-year Treasury yield ending 2017 at 2.4%. Although the Federal Reserve raised short-term rates three times (75 basis points total), yields at the long end of the Treasury curve declined modestly and the yield curve flattened. Corporate bonds across all credit qualities and maturities had positive returns due to the improvement in economic conditions. Moreover, high-yield bonds gained 7.5% due to both improving economic conditions and increased investor appetite for riskier securities in the bond space.

Key Drivers of Our 2017 Portfolio Performance

- Our portfolios generated both strong absolute and relative returns for the year versus similar-risk strategies.
- Our international and emerging-markets investments added value to our portfolios.
- Our investments in flexible actively managed bond funds added value over core investment-grade bonds.
- Our merger/arbitrage investments outperformed cash and other low-risk investments
- Most of our U.S. stock investments are in the large-cap category, the best performing portion of the domestic stock market in 2017. Small and mid-cap funds earned "only" returns in the mid-teens, whereas many large cap categories offered significantly higher returns.

Our globally diversified balanced (stock/bond) portfolios generated strong returns for the year, consistent with the positive overall return environment for most financial markets and asset classes. Our portfolios benefited from meaningful exposure to emerging-market and established international stocks, both of which had very strong absolute returns and beat U.S. stocks for the year. Our decision earlier in the year to add to those categories worked out very well. Moreover, additional investments in these areas were made later in the year.

In the fixed-income portion of our portfolios, our long-held tactical positions in several flexible and absolute-return-oriented bond funds added value, outperforming core bonds by several percentage points.

Our investments in liquid alternative strategies, such as merger/arbitrage products fulfilled their portfolio diversification roles while generating low- to mid-single-digit returns. Every portfolio needs some "dry powder" and we're pleased we earned meaningful returns in the lower return space.

Large-cap U.S. stocks had outstanding performance, and we benefited from having significant exposure to these investments in both the value and growth area, although growth was clearly the dominate style for the period.

Looking Ahead: Updates on Our Asset Class Views

U.S. STOCKS

As noted above, U.S. stocks were up 22% for the year, driven in part by expectations of a historic corporate tax cut, which the Republican-led Congress duly delivered. We suspect much of the benefit of tax decreases might be priced in the market based on higher consensus earnings estimates for the S&P 500. Regarding the future, we are evaluating whether the boost in after-tax corporate earnings will be temporary or permanent. We project that earnings will probably see a boost in the short term: consensus seems to be around 10% in aggregate. In the new tax plan, there's an additional tax incentive for companies to pursue capital expenditures, and that could increase economic activity, boosting overall profits. But this would come at a time when we are in the later stages of the business cycle, when the economy arguably is running close to full employment. So, longer-term, this new growth may create inflationary pressures and/or cause the Fed to raise rates faster, both of which may counteract the benefit from rising profits.

As we've mentioned before, U.S. stocks look expensive from virtually any metric, and future returns may not measure up to historical levels, and certainly a repeat of 2017 would be most surprising. We continue to utilize the high-quality Blackrock Equity Dividend Fund in the value space, and the uber-conservative Jensen Quality Growth Fund in the growth space.

INTERNATIONAL STOCKS

Political uncertainties (Brexit, upcoming elections, etc.) notwithstanding, Europe continues its economic recovery within what appears to be a benign fiscal and monetary environment. Europe is matching the United States in terms of economic growth and, according to Capital Economics, is on track to generate its strongest growth since 2007. Earnings have rebounded strongly, with Ned Davis Research analysis showing continental Europe and U.K. local-currency earnings growing over 25% and 35%, respectively, over the past 12 months. (The United States has seen earnings growth of 14% over the same period, according to NDR). In U.S. dollar terms, Europe generated strong performance in 2017, up 27%, and outperformed U.S. stocks, although this includes a hefty contribution from currency, with the euro appreciating about 11% versus the dollar. Results from the Pacific Rim was very encouraging as well.

Foreign stocks remain attractive and should offer returns in excess of what will take place in the U.S. Foreign stocks are relatively less expensive and offer higher rates of earnings growth, a powerful combination which should push prices higher in 2018 and beyond. We favor Dodge & Cox International Stock, the Templeton Foreign Fund and the American Funds EuroPacific Growth Fund in this category.

EMERGING-MARKET STOCKS

Emerging-market stocks had a strong year, up 31.5% in U.S. dollar terms (including around a 6% boost from currency appreciation). Like established country international stocks, emerging-market stocks posted strong earnings growth (nearly 20%). Even after this recent run-up, we still expect emerging-market stocks to generate at least historical average returns over the next five years.

We believe the key risk to emerging-market stocks continues to be China. If there is a financial crisis in China, it would negatively impact Chinese demand for emerging-market exports. The resulting drop in commodity prices would compound the problem for some key emerging-market countries. Increasing risk aversion could also lead to capital outflows, exposing countries like Turkey and South Africa that have relatively large current-account deficits. Broadly speaking, though, most emerging-market countries have reduced their current-account deficits and are relatively less beholden to foreign capital. This is also the reason why we think emerging markets can handle a slow or managed rate increase by the Fed, as they did in 2017.

We are optimistic China can continue to march along at a decent clip, without a crisis or "hard landing." This scenario would be supportive for emerging markets more broadly. There are indications that China is implementing some supply-side reforms, such as eliminating excess, uneconomic manufacturing capacity. If China is successful in these and other policy efforts, we could get very solid returns from emerging markets stocks over the next five years.

We favor the American Funds New World Fund in this category.

CORE BONDS

Our return expectations for core bonds remain muted looking out over the next five years, in the range of 2.5% to 3.0%. And from a risk/reward standpoint core bonds look less compelling. For example, a 50-basis-point yield increase in the Bloomberg Barclays U.S. Aggregate Bond Index would wipe out more than a year of income. This explains our meaningful positioning away from core bonds in favor of flexible credit strategies, which we believe will outperform core bonds in a period of flat or rising rates. That said, we still maintain core bond exposure in our balanced portfolios to serve as ballast in the event of a risk-off environment.

We recommend the Dodge & Cox Income Fund in this category.

FLEXIBLE BOND FUNDS

As noted earlier, high-yield bonds offered solid returns in 2017, driven by signs of a firming macroeconomic backdrop (domestic and abroad), the Fed's measured and largely anticipated rate hikes, low stock market and interest rate volatility, relatively attractive yields, and overall healthy fundamentals. As a result, default rates remained at historically low levels. International bond funds offer a degree of diversification away from U.S. bonds, and shorter-term bond funds offer protection against rising interest rates.

With regard to flexible bonds, we prefer Osterweis Strategic Income Fund, Templeton Global Bond and Weitz Short-Intermediate Income Fund.

MERGER/ARBITRAGE STRATEGIES

Merger/arbitrage strategies generally experienced positive conditions last year. The merger-arbitrage universe experienced relatively few deal failures. That said, there have been damaging, high-profile developments in a few situations, most recently in the Time Warner-AT&T deal, which is being challenged in court by the Department of Justice. Spreads have been fairly range bound most of the year, but they widened in the third quarter on fears of protectionism hampering cross-border transactions. Announced deal activity is below its peak level of two years ago but remains above the long-term average. With borrowing costs still low, but short rates significantly above zero, conditions are supportive for reasonable expected returns.

We favor the Merger Fund and the Arbitrage Fund in this category.

Putting it All Together: Our Portfolio Positioning

As we are projecting lower returns for U.S. stocks over the next five years, we won't add to this space and may even reduce exposure to this category sometime in 2018 and beyond. Doing so will result in a more defensive position in U.S. stocks and we'll likely direct future stock monies towards the established international and emerging-markets, where, as noted earlier, our return expectations are materially higher.

Considering the particularly low expected returns for core bonds, along with the risk of rising interest rates (which correspond to lower core bond *prices)*, we will continue to have meaningful exposure to flexible, actively managed bond funds; they account for roughly half of our total fixed-income exposure in our balanced portfolios. While our base case five-year expected returns for these funds are several percentage points above that of core bonds, they do carry more credit risk than core bonds. Therefore, we assume they have more downside in the event of a recession or other macro shock (providing it's not an *inflationary* shock, which would be bad for core bonds). We factor this into our overall portfolio risk exposure, and it's why we still maintain some exposure to core bonds, particularly in our more conservative risk-sensitive portfolios. Despite their unexciting longer-term return outlook, we expect core bonds to perform well in a traditional bear market/recession.

We will maintain some exposure to merger/arbitrage funds as a low risk investment strategy.

Concluding Comments

Although Virginia Capital Strategies delivered excellent risk-adjusted returns to its clients in 2017, our company has the humility to know not every decision will turn out to be right and that simply having an opinion on a certain outcome doesn't mean it will actually happen. But VCS does have a sound investment process that is well defined and repeatable. Our process requires having a sound basis for each decision, and over time the process should be right more than wrong, ultimately resulting in very competitive risk-adjusted returns.

Thank you for your continued confidence and trust. All of us at Virginia Capital Strategies wish you and yours a very happy, healthy, peaceful, and prosperous New Year.