Diversification is not dead

With that said, we first turn our attention to diversification, the time-worn foundation of modern investing that has not provided the bulwark against risk in recent years that it generally has over past generations. In short, we still very much believe that it will prove effective over time even as a number of factors has muted its benefits of late and will likely take time to recede.

Diversification is the not-so-secret sauce that makes most of the asset allocation process work. It has been described as the only “free lunch” in the investment world, as its benefits have been available to all without any extra premium to be paid. However, diversification needs a bit of chaos to work and right now we are seeing far more uniformity in the world. For example, significantly varying growth rates around the world will likely generate big return differentials, providing investment opportunities. In today’s world, however, we are witnessing relatively slow global growth as both developed and emerging worlds are struggling to return to pre-financial crisis expansion patterns. Fixed income markets are held in check by central banks that are intent on keeping interest rates low or even negative. The 10-year U.S. Treasury has traded from 1.50% to 3.0% for a period approaching...
five years. Variations in interest rates following global growth patterns help to create uncorrelated asset performances between equities and fixed income that fuel the diversification process.

An additional reason that diversification benefits have become harder to come by has been that structural “risk on/risk off” sentiment shifts have become dominant drivers of markets. In the wake of the financial crisis, investors remain very sensitive to any events that could cause markets to stumble. Combined with high-speed trading, we have seen markets move swiftly with the rapid declines last fall and this winter (Figure 1).

Despite this unfavorable environment, we believe that diversification as a benefit is not dead. While in our view the continued economic normalization process following the financial crisis will need to continue its gradual course before the power of diversification fully reemerges, we see telling new potential as positive economic stirrings in the U.S. seem to put the domestic economy on a notably stronger course than that of most of the rest of the world.

Positive economic stirrings
Overall, the domestic economic data have begun to turn decidedly more positive, improving across a broad swath of areas, which makes the resurgence even more impressive. In terms of economic growth, the U.S. appeared to stumble once again to start the year with a quarterly advance of just 0.8% in gross domestic product (GDP), mimicking the weak annual performances in 2014 and 2015. The Fed largely tied its near-term rate hike prospects to evidence of “economic growth picking up in the second quarter,” as well as continued strength in the labor market and progress on inflation. The first readings for 2Q have been encouraging, with consumer spending (two-thirds of the economy) surging in April following three weak months. Consumers accelerated their spending on autos and other durable goods, as well as on services. On the labor front, job growth continued in April, albeit at a slower rate, while wage growth accelerated and job openings remained near all-time highs. And inflation data continued to move back toward normal levels.

In the wake of the financial crisis, investors remain very sensitive to any events that could cause markets to stumble.

Even with the improvement in the economic picture we are keeping an eye on how this may translate into a better picture for the financial markets. Given its larger than life presence in the financial world, there is a strong tendency to focus on the equity market. However, we think that another market is telling us more about what is happening and may provide better insight as to what it will take for these markets to break from recent ranges—as is often the case, the credit markets seem to reflect a more coherent and realistic potential economic picture.

Fixed income market shows signs of promise
Within the fixed income market, our attention is drawn to two things: credit spreads and the breakdown between real yields and inflation expectations. Let’s start with the second of these, decomposing the yield of the 10-year Treasury market. Since the U.S. Treasury market generally does not incorporate a credit risk premium, its yield is largely a function of setting a return at least equal to the expected rate of inflation plus some positive
premium over this rate; in other words, providing a positive real return. In Figure 2, we’ve shown the history of the “breakeven,” i.e., market-implied inflation rates, along with current real rates based on 10-year Treasury securities. The chart clearly depicts that of late, the two components have been moving in opposite directions. The breakeven rate has been moving higher, which makes sense as we expect to see higher inflation rates as the impact of the oil price decline fades and the effects of a tighter labor market take hold.

The concomitant decline in current real yield, however, is at first blush a bit more puzzling. Typically, one would expect real yields to increase as the overall economy picks up steam and Treasury markets in turn are forced to provide greater compensation to attract capital.

The current environment is unfortunately a bit different insofar as the financial markets are not yet convinced that the economy will be strong enough to force up nominal yields faster than inflation expectations, which is why real yields have in fact dropped. If, by contrast, real yields start to move up while inflation breakevens level off, we believe this will signal more fulsome economic growth as well as confidence in the Fed’s ability to manage inflation.
Significantly, such a scenario should also provide a green light to equity markets. Credit spreads present an additional excellent check on the internal health of the economy and corporations. As reflected in Figure 3, the big rise in spreads that took place earlier in the year has reversed, and spreads are not indicating any significant underlying weaknesses in the overall corporate market.

While spreads are no doubt still impacted by the energy sector, which has been the weak link in this complex, the rise in oil prices and reduction in rig capacity is relieving some pressure in this sector.

Overall, the fixed income market paints a guardedly optimistic picture. The absolute low levels of real rates need to rise to provide further proof of strengthening prior to making a meaningful tack away from our current neutral positioning. Hence, as we continue to closely monitor credit markets, we feel quite comfortable standing pat on our current portfolios.

Our new strategic asset allocations
Last, in this month’s “In Focus” we take a look at our new investment framework and the adoption of our strategic asset allocations (SAA) from our capital markets forecast. I strongly urge you to read up on our new approach in developing portfolios, a topic that you are sure to hear more about in the coming months.

Best,

Tony
Investment positioning

Portfolio targets effective 6/1/16 for high-net-worth clients with nontraditional assets

<table>
<thead>
<tr>
<th>Portfolio allocations (%)</th>
<th>Growth &amp; Income</th>
<th>Strategic asset allocation (long term)</th>
<th>Tactical asset allocation (current)</th>
<th>Change this month</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Baseline allocation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Large-Cap Core*</td>
<td>16.9%</td>
<td>16.3%</td>
<td>22.6%</td>
<td>—</td>
</tr>
<tr>
<td>U.S. Large-Cap Sectors*</td>
<td>16.9%</td>
<td>16.3%</td>
<td>13.6%</td>
<td>—</td>
</tr>
<tr>
<td>U.S. Small-Cap</td>
<td>3.4%</td>
<td>8.1%</td>
<td>5.0%</td>
<td>—</td>
</tr>
<tr>
<td>International Developed</td>
<td>21.5%</td>
<td>12.7%</td>
<td>12.4%</td>
<td>—</td>
</tr>
<tr>
<td>International Emerging Markets</td>
<td>3.4%</td>
<td>3.6%</td>
<td>2.0%</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total Equities</strong></td>
<td>62.1%</td>
<td>57.0%</td>
<td>55.6%</td>
<td></td>
</tr>
<tr>
<td><strong>Fixed Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Investment Grade–Tax-Exempt</td>
<td>35.9%</td>
<td>30.0%</td>
<td>25.4%</td>
<td>—</td>
</tr>
<tr>
<td>High-Yield–Tax-Exempt</td>
<td>0.0%</td>
<td>2.0%</td>
<td>5.0%</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total Fixed Income</strong></td>
<td>35.9%</td>
<td>32.0%</td>
<td>30.4%</td>
<td></td>
</tr>
<tr>
<td><strong>Real Assets</strong></td>
<td>0.0%</td>
<td>4.0%</td>
<td>7.0%</td>
<td></td>
</tr>
<tr>
<td><strong>Nontraditional Hedge</strong></td>
<td>0.0%</td>
<td>5.0%</td>
<td>5.0%</td>
<td></td>
</tr>
<tr>
<td><strong>Cash &amp; Equivalents</strong></td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>100%</td>
<td>100.0%</td>
<td>100.0%</td>
<td></td>
</tr>
</tbody>
</table>

* Large-cap allocations are broken down into the portion designated for use with active or passive managers (U.S. large-cap core) and the portion using our Sector Allocation Strategy (U.S. large-cap core sectors). Current positions are shown on page 7 in the graph “Our sector inputs and allocations.” Source: Wilmington Trust Investment Advisors, Inc. (WTIA)

Note: Rounding errors may cause the allocation subtotals of some asset classes to differ slightly from the building blocks of their allocations.

Our reference allocations are developed from our long-term economic outlook, reflecting our highlighted themes as well as the insights of our investment and economic professionals, reference allocations serve as a baseline strategic allocation for long-term investors. The expected returns presented constitute the informed judgments and opinions of Wilmington Trust about likely future capital market performance. No assurance can be given as to actual future market results or the results of Wilmington Trust’s investment products and strategies. Strategy forecasts are derived from the expected return and volatility assumptions in Wilmington Trust’s Capital Markets Forecast 2016–2026, which is available on www.WilmingtonTrust.com or upon request from your Investment Advisor. A summary of the calculations used to develop these numbers can be found in the disclosures section under Forecasted Performance. Return projections are pre-tax and pre-fees. Volatility (standard deviation of return) estimates are based on pre-tax return projections.

There is no assurance that forecast results will be realized or that any investment strategy will be successful.

Please see disclosures for information about our asset allocation strategies, risk assumptions, performance forecasts, fee assumptions, and other important information.
Major themes

<table>
<thead>
<tr>
<th>Investment themes</th>
<th>Current positioning</th>
<th>Potential tipping points</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prefer healthcare &amp; technology</strong></td>
<td>Through our sector approach, our underlying sector allocations favor both technology and healthcare. However, we are reducing our overweights due to the upcoming elections, political uncertainty, and credit concerns.</td>
<td><strong>SIGNS:</strong> Regulations restricting growth, profitability, or the ability to innovate new products; too-rich valuations.</td>
</tr>
<tr>
<td>An aging population, medical science break-throughs, expanding social media applications, various mobile devices, and new innovations could create investment opportunities.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Inflation picking up but still manageable</strong></td>
<td>Real assets are positioned to benefit from market opportunities in U.S. TIPS but the limited inflation threats are supported by no allocation to commodities.</td>
<td><strong>SIGNS:</strong> Tighter labor markets that force wage growth toward 4%. A pickup in global investment that reverses commodity price declines. A dramatic drop in the U.S. dollar.</td>
</tr>
<tr>
<td>Year-over-year inflation readings are likely to reach 2% but we believe any major threat should be well contained even after the impacts from lower oil prices are absorbed.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Income a main component of returns</strong></td>
<td>Current exposures include high-yield bonds and REITs which have the potential to provide high income levels. Active managers aim to reduce high-yield credit concerns and manage around riskier sectors such as materials and energy.</td>
<td><strong>SIGNS:</strong> Dividend growth does not keep pace with GDP growth. Dramatic, longer-term collapse in credit conditions. Yields remain at current levels.</td>
</tr>
<tr>
<td>Higher yield levels and overall modest stock/bond returns over the next few years should result in income being the main source of returns.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Emerging markets to reemerge</strong></td>
<td>Within international stocks, we favor developed markets. Underweighting emerging markets stocks with no exposure to emerging markets debt.</td>
<td><strong>SIGNS:</strong> Indications that the commodity markets are taking a greater toll making a recovery very difficult. Signs that economies are not shifting from old to new.</td>
</tr>
<tr>
<td>Portfolios should have a meaningful allocation to emerging markets in the long term. Short term, commodity exporters should continue to struggle with growth, inflation, and currency depreciation.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Q&A

Q. Where are you finding opportunity in the large-cap markets these days?

A. The U.S. equity markets have struggled to advance recently given a lack of aggregate earnings growth over the last two years. While valuations for most large-cap companies are reasonable, the lack of earnings growth puts a question mark on the multiple they deserve. Markets were volatile to start the year due to the slowdown in China and persistent weakness in the oil and gas sectors. Outperformance has been tied to low volatility and dividend yield, which is an outcrop of the extremely low interest rate environment and subdued economic growth. In the long run, earnings growth and valuation will ultimately dictate a stock’s value. We prefer the healthcare, financials, and technology sectors where we see reasonable valuations relative to the broader market given their growth potential. We view the healthcare and financials sectors as cheap on a longer-term basis versus higher-yielding sectors such as utilities and consumer staples. These defensive sectors are expensive relative to their long-term earnings growth potential. Rate increases from the Fed should boost near-term performance of banks, while the biotech/pharmaceutical industries continue to produce good earnings growth to support their reasonable valuations. The technology sector continues to be at the forefront of growth and innovation for almost any industry.

Have a question? Please submit it to your advisor who will forward it to the editor. All questions may be edited and are published anonymously.
# Asset Class Overview

## Equities

**Equities**

**Sources:** FactSet, Bloomberg.

Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

<table>
<thead>
<tr>
<th>AS OF MAY 31, 2016</th>
<th>Month to date</th>
<th>Year to date</th>
<th>Trailing 12-month return</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1.8%</td>
<td>3.6%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>2.3%</td>
<td>2.3%</td>
<td>−6.0%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>−0.9%</td>
<td>−1.1%</td>
<td>−9.7%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>−3.7%</td>
<td>2.3%</td>
<td>−17.6%</td>
</tr>
</tbody>
</table>

Sources: FactSet, Bloomberg. Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

### U.S. equities

U.S. equities advanced in May with large caps pushing against recent highs, while international markets lost ground. The U.S. market has remained relatively resilient, with the mid-cap value segment providing the best year-to-date results. An S&P 500 index trading range of 1830–2130 is still in force. First-quarter earnings are likely to print a decline of roughly 6% on a year-over-year basis. A return to positive year-over-year growth in earnings is expected by the fourth quarter as the energy drag abates.

We expect modestly positive equity returns and economic strength supported by a more stable dollar and oil prices. We see some potential for multiples to expand only if investors have more confidence in the prospects for domestic and global growth improvement.

Our year-ahead target for the S&P 500 is 2123 ($137 times 15.5x forward P/E). This would produce a 4.5% total return from the current level of 2074. The final outcome is a portfolio with a balanced view. Our preferred sectors from the model are now telecom, technology, and industrials, where we see reasonable valuations relative to the broader market.

The macro view still has a pro-cyclical tilt, reflecting an expectation for better industrial activity. The quant model favors telecom, technology, and industrials. The fundamental view is more positive on healthcare, financials, and technology, which have reasonable valuations given their long-term growth potential. We find large-cap and small-cap equities equally attractive.

### International

European and Japanese equity markets were fairly steady in euro and yen terms through the end of May. There was slight depreciation in the yen and euro after months of appreciation, which dampened returns in dollar terms. The U.K. equity market and pound sterling were resilient as market concern about Brexit diminished. Within European and Japanese equities, the large banks continued to struggle given that the European Central Bank and the Bank of Japan’s negative interest rates had led to compressed interest margins. The first-quarter rally in emerging markets equities fizzled, as China signaled it was planning to ratchet back stimulus and Brazilian politics were upended with its president’s impeachment.

### Our sector inputs and allocations, as of 5/31/2016

<table>
<thead>
<tr>
<th>GICS sector</th>
<th>Sector rank</th>
<th>Macroeconomic</th>
<th>Quantitative</th>
<th>Fundamental</th>
</tr>
</thead>
<tbody>
<tr>
<td>Telecom</td>
<td>1</td>
<td>7</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Technology</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Industrials</td>
<td>3</td>
<td>8</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Financials</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Energy</td>
<td>5</td>
<td>6</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Utilities</td>
<td>6</td>
<td>4</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Healthcare</td>
<td>7</td>
<td>2</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Discretionary</td>
<td>8</td>
<td>9</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Materials</td>
<td>9</td>
<td>10</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Staples</td>
<td>10</td>
<td>3</td>
<td>9</td>
<td>10</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, WTIA

**Our assessment**

**U.S. large-cap sector allocations**

<table>
<thead>
<tr>
<th>Benchmark: Russell 1000</th>
<th>Current allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>20%</td>
<td>25%</td>
</tr>
</tbody>
</table>

**CONTINUED**
U.S. Treasuries
The U.S. Treasury curve continued to flatten over the course of May. Expectations of a June rate hike rose abruptly to a 40% probability in the federal funds futures market. This resulted in the two-year U.S. Treasury note to cheapen toward a 1% yield to maturity for the third time this year. The market’s view that a higher federal funds rate would have a dampening effect on both the U.S. economy and potential inflation also led to wider breakeven rates for TIPS, causing them to underperform nominal Treasuries.

Investment-grade corporates
Following several months of volatility, the month of May has been relatively tranquil with risk premiums moving modestly wider during the month. The current option adjusted spread (OAS) of the Barclay’s U.S. Credit Index was 144 basis points, or bps (1.44%), slightly wider than the 139bps on April 30. Market stability created a fertile environment for new issuance throughout the month, with several large multi-billion dollar deals coming to market. According to Bloomberg, supply thus far in May has totaled $167 billion and is on pace to become the highest volume month of the year, surpassing January’s total issuance of $169 billion. During the month, Dell priced its widely anticipated $20 billion deal to help finance the company’s acquisition of EMC Corp. Despite the deal’s marginal investment-grade rating, demand was strong with orders totaling over $80 billion, according to dealers involved in marketing the transaction. The deal pipeline remains strong and we expect issuance to remain robust, although the summer months will likely lead to a more moderate pace of issuance.

High-yield corporates
High-yield bond yields continued to grind lower in May to a low not seen since early November 2015 amid solid gains for equities, a fresh high for oil prices due to supply constraints, and a resumption of inflows for ETFs. The adoption of a more hawkish Fed narrative has not been too disruptive for high yield as the asset class has posted decent gains, although down from the stronger performances of April and March. Despite May’s mutual fund and ETF outflows to date (–$2.4 billion), year-to-date inflows for high-yield mutual funds total +$9.6 billion, better than the +$8.0 billion inflow that occurred during the comparable period in 2015.

Municipals
Impressive fund flows are driving yields lower, credit spreads tighter, and relative values more expensive. Municipal funds experienced over 30 weeks of positive flows, with the last three months averaging over $1 billion per week. Yields in the 10-year range are down over 40bps year to date. BBB to AAA spreads are now about 90bps, tighter by 10bps–20bps from most of 2015. The 10-year yield ratio, relative to the 10-year Treasury, is below 90%. The average over the last five years is above 95%. High-yield spreads have paralleled investment-grade tightening. Puerto Rico faces a massive general obligation (GO) debt payment on July 1.

International
Ten-year European and Japanese government bond yields fell further, as the bond market shifted to higher-yielding U.S. and emerging markets (EM) bonds. While EM bonds have produced relatively strong returns in recent months, in part due to the rising oil revenues of some sovereigns, their valuations are likely too expensive, given rising default risks for EM corporates, notably in China. European corporates are issuing much larger bond volumes in anticipation of the launch of the European Central Bank’s corporate bond-buying program.
Relative-value strategies had their strongest results of the year in April, with all sub-strategies showing solid gains. For the year, all sub-strategies are positive except for managers specializing in asset-backed securities, which experienced severe dislocations early in January and February.

**Real Assets and Nontraditional**

### As of May 31, 2016

<table>
<thead>
<tr>
<th>Hedge Fund Research Institute Indexes</th>
<th>Month to date</th>
<th>Year to date</th>
<th>Trailing 12-month return</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P Developed Property Index</td>
<td>0.1%</td>
<td>5.7%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Barclays Inflation-Linked Bond Index</td>
<td>0.5%</td>
<td>4.1%</td>
<td>1.4%</td>
</tr>
<tr>
<td>UBS Bloomberg CMCI (commodity) Index</td>
<td>-0.2%</td>
<td>8.8%</td>
<td>-15.3%</td>
</tr>
</tbody>
</table>

### As of April 29, 2016

<table>
<thead>
<tr>
<th>Hedge Fund Research Institute Indexes</th>
<th>Month to date</th>
<th>Year to date</th>
<th>Trailing 12-month return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Weighted</td>
<td>1.0%</td>
<td>0.4%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>Equity Hedge</td>
<td>1.2%</td>
<td>-0.6%</td>
<td>-5.1%</td>
</tr>
<tr>
<td>Event Driven</td>
<td>2.0%</td>
<td>1.3%</td>
<td>-5.2%</td>
</tr>
<tr>
<td>Macro</td>
<td>-0.1%</td>
<td>1.5%</td>
<td>-1.8%</td>
</tr>
<tr>
<td>Relative Value</td>
<td>1.6%</td>
<td>1.1%</td>
<td>-2.1%</td>
</tr>
</tbody>
</table>

Sources: FactSet, Bloomberg.

Investing involves risks and you may incur a profit or a loss. Past performance is no guarantee of future results.

**Nontraditional Hedge**

**Equity hedge funds**

After a disappointing first quarter, equity hedge funds had a strong April, outperforming the S&P 500 benchmark by a healthy margin. Managers focusing on energy, technology, and healthcare saw the greatest gains.

**Event-driven hedge funds**

Event driven was up strongly in April, bringing the returns to positive for the year. Merger arbitrage was the sole negative sub-strategy as the Allergan-Pfizer deal broke early in the month and spreads widened. Distressed, activists, and special situations managers all returned more than 2%.

**Macro hedge funds**

Macro was down slightly in April as model-driven systematic managers struggled for the second consecutive month. Commodity-focused discretionary managers had the best results due to the asset class appreciation in April.

**Relative-value hedge funds**

Relative-value strategies had their strongest results of the year in April, with all sub-strategies showing solid gains. For the year, all sub-strategies are positive except for managers specializing in asset-backed securities, which experienced severe dislocations early in January and February.

**Nontraditional Private Markets**

The volatility in equity markets during the first quarter of 2016 led to declining U.S. private equity activity, both in the number and volume of deals. The exception to this trend took place in the lower middle market (roughly defined as deals valued between $25 million and $100 million), which surged to its highest level since the first quarter of 2008 as managers found opportunities in a less trafficked segment of the market.
Revitalizing our investment framework

Sailors used to look to the stars to help them reach their destinations. Today, there are global positioning systems with satellites to guide the way with unprecedented precision. We consider our enhanced risk management approach to be equally transformative. It all turns on a perspective of risk that is not the norm for the investment industry. We call it “drawdown.” Unlike the traditional view of risk that focuses just on volatility (how variable returns may be in ordinary markets), we look at risk through a new lens, one that reflects what you can actually see, understand, and care most about.

**Drawdown**—the expected degree of capital loss over a fixed, long-term period, ideally one that includes significant market stress—captures the reality of how much a portfolio actually dropped in value (Figure 1). In our experience, nothing can be as much of a barrier to achieving your goals as having oversized drawdowns. Not only are outsized drawdowns very difficult to recover from as a practical matter, but in many cases they prompt investors to withdraw from the markets at just the wrong time. As a result, going forward we will optimize our portfolios in an effort to hedge against normal volatility and mitigate drawdown potential.

**The process begins with the basics**

Long before your Investment Advisor even begins to think about which specific investment managers and securities to recommend for your portfolio, you will work together to establish a trust-based relationship. That step starts with a comprehensive assessment of your individual circumstances, such as your investment capital.

---

**Figure 1**

**Example of drawdown loss** (All-stock portfolio as represented by total return of the S&P 500)

Past performance is no guarantee of future results.

Source: WTIA
objectives, time horizon, risk tolerance, income and liquidity needs, and tax considerations. Together, you will develop a personalized roadmap that aims to take you from where you are now to where you want to be. At that point, you will have reached your “baseline benchmark.” The simple benchmark includes U.S. and international equities, investment-grade municipal bonds, and cash. To look at its performance, you’d have to see its asset classes’ long-term historic return streams, which have been applied under baseline benchmark in the positioning table on page 5. Next we bring into play our investment views and with them, a big jump in the efficiency of our portfolios.

Strategic asset allocation
Our 10-year capital markets assumptions reflect our economic and thematic calls, and are designed to result in portfolios that offer both enhanced diversification potential and a more realistic picture of how economic factors impact asset class returns. This in turn enables us to build portfolios that we believe will be more resilient in the face of adverse economic shocks. By understanding the portfolio implications of a sudden shift in interest rates or GDP expectations, we can construct portfolios designed to soften these blows. We take the four basic asset class building blocks mentioned earlier and expand them into a number of other asset and sub-asset classes, which can include high-yield corporate bonds, emerging markets stocks, and perhaps nontraditional investments, such as private markets, for qualified investors.

Our analysis provides a framework for investment returns we expect over the next 10 years, which is then translated into optimized portfolios that become our strategic asset allocations. It is at this point that we incorporate drawdown considerations. Rather than simply develop portfolios that seek to meet return goals...
We apply our investment intelligence to the basic asset classes in order to develop comprehensive long-term strategic asset allocations.

while minimizing volatility, a drawdown ratio (expressed as expected return per unit of drawdown, with a higher number being a better result) is incorporated into the optimization process. The goal is to produce the best return for a given amount of drawdown risk. This is not to say that investors can have their cake and eat it too—unfortunately opportunity begets risk, and there are tradeoffs—but we believe that more positive investment experiences can be created using this approach. We compare the performance of a baseline allocation to a broader one that is optimized (Figure 2). The baseline and optimized allocations will be subjected to the same forces that push down markets. However, the optimized allocation—optimized to the drawdown ratio across the broader investment universe—should experience softer down moves that would give it an advantage when markets begin to move higher. Over time, this should give it the ability to outperform the baseline allocation.

We expect these optimized portfolios to serve as a long-term allocation for every client portfolio, remaining fairly stable for three to five years. At that point, we begin the exercise anew to embed new visions for the succeeding 10 years. Because these portfolios reflect our long-term ideas about how the investment world will perform, we expect them to give us an advantage by keeping us focused on the parts of themes and trends we see unfolding profitably in the years to come. Understand that the development of strategic asset allocations is by no means a cookie-cutter process. You receive a personalized strategic asset allocation, pursuant to a particular investment strategy.

**Tactical asset allocation**

Our strategic asset allocations are those we would turn to in the event that we had no significant views about current markets. However, that is not likely to happen very often. Instead, the ebbs and flows of market dynamics will make the various asset classes more or less attractive at different points in time. As this happens, we will move to take advantage of these opportunities to try and add value over up to a one-year timeframe. These adjustments form the basis of tactical asset class shifts for your portfolio.

Using the strategic asset allocations as our starting point, we gather inputs from our deep bench of experienced economists and strategists that perform extensive quantitative analysis to produce a stream of expected returns, which ultimately inform our tactical adjustments and portfolio weightings. That investment intelligence guides us in determining how to divvy up assets into, for example, the stocks of various U.S. economic sectors. The latter is reflected in our more refined way of pursuing value by looking at economic sectors like energy, as opposed to market capitalization or style, such as growth or value.

Drawdown risk management is also applied in tactical asset allocation. We believe the drawdown consideration will help create better portfolios, but it also feeds directly into the goals-based planning process utilized by your Investment Advisor in implementing your Investment Policy Statement. Our goal is for you to see the beneficial results of these enhancements reflected in your statements and performance reports. In the meantime, your Investment Advisor can advise how these latest developments might impact your portfolio.

CONTINUED
Optimized allocation and baseline allocation illustrations

There is no representation that these results could, or would, have been achieved had the allocations been used over the period presented. It is provided solely as a general picture of market behavior and the interactions produced across asset classes. Actual results for securities investments would be expected to vary, sometimes materially, from the index assigned. There is no assurance that a given index will accurately reflect the past or future performance of any strategy or asset class for which it serves as a proxy.

Optimized and baseline allocation data reflect index returns and do not represent the results of actual management of client assets. Index allocations are calculated by means of the retroactive application of static weights to monthly index returns. No deductions are made for trading costs, management fees, or other expenses. Such fees, costs, and expenses would reduce the returns shown—and have a compounded effect over time. Please see the Disclosures for an illustration of the impact of Fees over time.

Return data assume the reinvestment of any dividends and other earnings and monthly rebalancing. It may not be practical to rebalance an actual portfolio at the same interval, which will affect results. No brokerage commissions, reflecting the costs of rebalancing holdings, are included in the illustration. Transaction costs, along with any other applicable fees or expenses, will reduce returns.

The compositions of the allocations are as follows:

**Optimized allocation**
- 32.5% U.S. Large-cap Equities (Russell 1000 Index), 8.1% U.S. Small-cap Equities (Russell 2000 Index), 12.7% Developed International Equities (MSCI EAFE Index), 3.6% Emerging Markets Equities (MSCI Emerging Markets Index), 30.0% Core Bonds (Barclays Municipal Bond Index), 2.0% High Yield Municipal Bonds (Barclays Capital 60% HY Muni TR USD/40% Municipal TR USD), 0.8% U.S. TIPS (Barclays U.S. Govt Inflation Linked TR USD), 0.8% U.S. REITS (S&P United States REIT TR USD), 2.5% Global REITS (Dow Jones Global Ex U.S. Select RESI NR USD), 5.0% Nontraditional Hedge (HFRI Fund of Funds Composite Index), 2% Cash (Ibbotson U.S. 30 Day T-Bill)

**Baseline allocation**
- 33.8% U.S. Large-cap Equities (Russell 1000 Index), 3.4% U.S. Small-cap Equities (Russell 2000 Index), 21.5% Developed International Equities (MSCI EAFE Index), 3.4% Emerging Markets Equities (MSCI Emerging Markets Index), 35.9% Core Bonds (Barclays Municipal Bond Index), 2% Cash (Ibbotson U.S. 30 Day T-Bill)
**Glossary**

**Barclays Ba U.S. High Yield Index**
Measures the performance of a subset of Barclays U.S. Corporate High Yield Index with issues rated Ba, the highest speculative-grade quality rating.

**Barclays Inflation-Linked Bond Index**
Measures the performance of publicly issued U.S. Treasury inflation-protected securities (where par value is adjusted semi-annually based on measures of broad inflation) that have at least one year to maturity on index rebalancing date.

**Barclays U.S. Aggregate Bond Index**
Measures the performance of the U.S. market of taxable, fixed-rate, investment-grade bonds with at least one year to maturity.

**Barclays U.S. Corporate High Yield Index**
Measures the performance of taxable, fixed-rate bonds issued by U.S. companies rated below investment-grade quality rating (i.e., speculative grade or high yield) with at least one year to maturity.

**Barclays U.S. Credit Index**
Measures the performance of U.S. investment-grade corporate and government agency bonds with at least one year to maturity.

**Cambridge Associates U.S. Private Equity Index**
Measures the performance of a broad range of private equity funds (e.g., buyout, growth equity, sector focus, and mezzanine funds) based on end-to-end calculation of data compiled from over 1,100 U.S. private equity funds formed since 1986, including fully liquidated funds.

**Collateralized loan obligation (CLO)**
A security backed by a pool of debt; often low-rated corporate loans.

**Commercial mortgage-backed securities (CMBS)**
A type of fixed income security, typically in the form of a bond, that uses commercial real estate loans as collateral.

**Commodities**
A basic, physical good used in commerce—such as corn, gold, beef, oil, and natural gas—that is interchangeable with similar types of goods. Investment exposure in commodities may be obtained directly, through futures or other derivatives, or by investment in companies with business exposure to one or more commodities.

**Collateralized loan obligation (CLO)**
A security backed by a pool of debt; often low-rated corporate loans.

**Exchange-traded fund (ETF)**
A security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

**DXY Index**
Measures the value of the U.S. dollar relative to the currencies of several significant trading partners.

**Euro Stoxx 50 Index**
Europe’s leading Blue-chip index for the Eurozone, provides a Blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

**Global Industry Classification Standard (GICS)**
Developed in 1999 by Standard & Poor’s and MSCI Barra in response to the global financial community’s need for a complete, consistent set of global sector and industry definitions.

**Gross domestic product (GDP)**
Often cited as an indication of the economy’s overall health, GDP measures the value of all finished goods and services produced over a certain period, expressed on an annualized basis.

**Hedge funds**
A nontraditional investment, these funds afford their managers more latitude to pursue their insights than traditional, long-only investing. Hedge fund strategies include trading across financial markets, employing leverage and taking concentrated or short positions. Some common examples of types of hedge fund strategies include:

- **Event-driven**
  Strategies that seek to take advantage of pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition, or spinoff.

- **Macro**
  Strategies that seek to take advantage of movements in broad economic variables and the impact these can have on capital flow across equity, bond, currency, and commodity markets.

- **Relative-value arbitrage**
  Describes a basket of strategies using an array of related securities; purchasing the side that is expected to appreciate while shorting the related security that is expected to depreciate, e.g., stocks of the acquiring versus the acquired companies in an acquisition, convertible bonds versus stocks of the same issuer, etc.

**High-yield (speculative-grade) credit**
Bonds of issuers deemed to be at risk of (or in) default on interest and/or principal payments, as reflected in their quality ratings. Such issuers typically offer higher yields to compensate investors for higher credit risk.
Glossary continued

Hedge Fund Research Institute (HFRI) Fund of Funds Composite
Benchmark designed to reflect the results of over 800 domestic and offshore fund of funds using a broad range of hedge strategies. The index is equal-weighted among reporting funds, which must have at least $50 million in assets or have been active for 12 months. Funds report returns net of fees. The broad index is used to illustrate the results of hedge funds of funds generally, with sub-indexes focusing on specific strategies.

HFRI Fund Weighted Composite Index
Encompasses over 2000 funds, to the increasingly specific-level of the sub-strategy classifications. The funds are weighted based on the asset size of the underlying indices.

HFRI Equity Hedge Index
Index of hedge funds that mainly manage their portfolios through both long and short positions in equity securities and derivatives.

Investment-grade credit
Bonds of issuers deemed to have at least adequate protection of their capacity to meet financial commitments, as reflected in their quality ratings. Such issuers tend to offer lower interest rates than more speculative issuers as a result of the higher credit quality implied by such ratings.

iShares Currency Hedged MSCI Eurozone ETF (HEZU)
An exchange-traded fund provides broad exposure to exporters and local Europe-focused companies, while hedging exposure to fluctuations between the euro and the U.S. dollar.

ISM Non-manufacturing Index
An index that tracks economic data, it is based on surveys of more than 400 non-manufacturing firms’ purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management.

J.P. Morgan Global High Yield Index
Consists of fixed income securities of domestic and foreign issuers with a maximum credit rating of BB+ or Ba1. This index seeks a high level of current income by investing primarily in a diversified portfolio of debt securities that are unrated or rated below investment grade. Capital appreciation is a secondary objective.

J.P. Morgan Leveraged Loan Index
Designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers.

J.P. Morgan U.S. Liquid Index
Market-weighted index that measures the performance of the most liquid issues in the investment-grade, U.S. dollar-denominated corporate bond market.

MSCI ACWI ex USA Investable Market Index
Captures large-, mid-, and small-cap representation across 22 developed market countries outside the U.S. and 23 emerging markets countries. With over 6,000 constituents, the index covers approximately 99% of the equity opportunity set outside the U.S.

MSCI EAFE Index
Measures the performance of global developed equity markets in Europe, Australasia, and the Far East, excluding U.S. and Canada.

MSCI Emerging Markets Index
Measures stock market performance in the global emerging markets, covering over 800 securities across 23 markets and representing roughly 13% of world market capitalization.

Nontraditional assets
(also referred to as alternative investments)
Seek risk exposures and return drivers that are different from traditional, long-only financial market investments. Exposure may be sought by targeting particular assets, such as real estate or commodities, or through strategies with more latitude to pursue manager insights, such as trading across financial markets and/or taking short positions (i.e., hedge strategies).

Private equity
Nontraditional asset that pursues investment in equity or debt securities of operating companies, typically with the intent to exert control over the management of company and often targeting a particular industry, financial condition, and/or stage of development.

Quality ratings
Used to evaluate the likelihood of default by a bond issuer. Independent rating agencies analyze the financial strength of each rated issuer. Moody’s ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa and better are considered “investment grade.” Bonds rated Ba and below are “speculative grade” or “high yield.” Similarly, Standard & Poor’s ratings range from AAA to D. Bonds rated BBB– and below are considered “investment grade” and bonds rated BB+ and below are “speculative grade.”

Speculative grade (also “high yield”)
Bonds of issuers deemed to be at risk of or in default of interest and/or principal payments, as reflected in their quality ratings. Such issuers tend to offer higher interest rates than investment-grade bond issuers as a result of the lower credit quality implied by such ratings.

Russell 1000 Index
Measures the performance of the 1,000 largest companies in the Russell 3000 Index, representing approximately 90% of U.S. equity market cap.

Russell 2000 Index
Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 8% of U.S. equity market cap.

Russell 3000 Index
Measures the performance of the 3,000 largest U.S. companies based on total market capitalization, representing approximately 98% of the investable U.S. equity market.

Russell Midcap Index
Measures the performance of the 800 smallest companies in the Russell 1000 Index, representing approximately 25% of U.S. equity market cap.

Continued
S&P 500 index
Measures the performance of approximately 500 widely held, typically large-cap, common stocks listed on U.S. exchanges, as selected by S&P.

S&P Developed Property Index
Measures an investable universe of publicly traded companies in developed markets that are engaged in real estate-related activities such as property rental, development, or management.

S&P Municipal Bond Index
Measures the performance of U.S., fixed-rate bonds exempt from federal income tax, though they may be subject to the alternative minimum tax, with par outstanding of at least $2 million. The index includes bonds of all quality ratings, including non-rated and defaulted bonds, and from all sectors of the municipal bond market.

Treasury inflation-protected securities (TIPS)
A security issued by the U.S. Treasury that has both a fixed interest rate component and a par value that rises with inflation, as measured by the Consumer Price Index. Interest on TIPS is paid semiannually.

UBS Bloomberg CMCI (Constant Maturity Commodity Index)
Diversifies across both a broad range of commodities (27 futures contracts across a number of sectors, such as precious metals, agricultural and livestock) and investment maturities for each individual commodity. It is the first commodity index to include a time dimension.

WisdomTree Japan Hedged Equity ETF (DXJ)
An exchange-traded fund that aims to provide exposure to the Japanese stock market, while hedging exposure to fluctuations between the yen and the U.S. dollar.
Any investment products discussed in this commentary are not insured by the FDIC or any other governmental agency, are not deposits of or other obligations of or guaranteed by M&T Bank, Wilmington Trust, or any other bank or entity, and are subject to risks, including a possible loss of the principal amount invested.

Some investment products may be available only to certain “qualified investors”—that is, investors who meet certain income and/or investable assets thresholds. Past performance is no guarantee of future results. Investing involves risk and you may incur a profit or a loss.

Any positioning information provided does not include all positions that were taken in client accounts and may not be representative of current positioning. It should not be assumed that the positions described are or will be profitable or that positions taken in the future will be profitable or will equal the performance of those described.

Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that would reduce returns.

An overview of our asset allocation strategies:

Wilmington Trust offers five model asset allocation strategies each for taxable and tax-exempt investors with particular sets of risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. Each strategy can be implemented with or without allocations to hedge funds. Strategic asset allocations (SAA) are maintained for each strategy and, on a quarterly basis, we publish the results of all of these strategy models versus benchmarks representing static investments without tactical tilts.

Model strategies may include exposure to the following asset classes: U.S. large-capitalization equities, U.S. small-cap equities, international developed large-cap, international developed small-cap and emerging market stocks, real assets (including international inflation-linked bonds and commodity-related and international real estate-related securities), investment-grade bonds (corporate or municipal), high-yield corporate bonds and floating-rate notes, and cash equivalents. Directional and absolute return hedge funds are distinct to the strategies with hedge funds. Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.

Forecasted performance: Expected results are hypothetical and do not represent the performance of client accounts or actual investment products. “Expected returns” for each strategy are derived from our forecast returns for the underlying assets as described in the Capital Markets Forecast 2016–2026 and weighted based on their current allocation percentage. Forecasts are subject to a number of assumptions regarding future returns, volatility, and the interrelationship (correlation) of asset classes. Actual events may differ from underlying assumptions, which are subject to various uncertainties. No assurance can be given as to actual future market results. Expected returns for the individual asset classes are based on factors including, for equity-based securities, dividend growth rates and dividend yield changes. For fixed income securities, expected returns are calculated based on principal impacts from changes in the underlying U.S. Treasury curve, yield spread changes vs. the U.S. Treasury curve, and the interest income that could be earned. Estimates of default rates are also taken into consideration. “Expected standard deviations” are forecast from the trailing 10-year rolling standard deviation of the asset class and “Expected yield” is based on the current expected dividend or interest income and is expressed as a percentage of the underlying principal value.
Fee assumptions:
No adjustments are made for advisory fees, transaction costs, or any other expenses. In the course of implementing a given asset allocation, clients could select among a number of investment vehicles or strategies, each of which will have such fees and expenses. These expenses have the effect of reducing returns at a compound rate over time, and would reduce the results shown. In cases where Wilmington Trust, or an affiliate, provides advisory, brokerage, or other services to such an investment vehicle, Wilmington Trust may benefit directly or indirectly from those advisory, brokerage, or other fees. Investors should develop a thorough understanding of the fees, expenses, and other costs of any investment prior to committing funds.

Impact of fees:
The following is a hypothetical example of the impact over time of fees charged to a client’s account. It is not meant to suggest actual fees, which may vary, and does not reflect actual returns. Assuming an initial investment of $1,000,000 account value and an average annual return of 10%, an annual fee of 100 basis points (i.e., 1.00%) would result in account level fees of $10,641 the first year, $35,351 over three years, and $65,458 over five years. A schedule of Wilmington Trust’s fees is available upon request.

Actual results will vary from forecast results:
In the course of implementing a given asset allocation, clients could select among a number of investment vehicles or strategies, each of which would contribute differently to overall results. The returns for individual clients will vary depending upon the performance of each actual investment vehicle or activity, any restrictions, inception date, timing of rebalancing, actual expenses and fees, and other factors.

Risk assumptions:
All investments carry some degree of risk. This publication uses the return volatility, as measured by standard deviation, of asset classes as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. Investors should develop a thorough understanding of the risks of any investment prior to committing funds.

Tax disclosure:
This publication is intended to provide general information only and is not intended to provide specific investment, legal, tax, or accounting advice for any individual. Although the information contained herein was prepared from sources believed to be reliable, Wilmington Trust does not make any representations concerning the completeness or accuracy of such information. Opinions are subject to change without notice. Before acting on any information included in this publication you should consult with your professional adviser or attorney.