

Premise Capital 1st Quarter 2016 Summary

Premise Investors

The first quarter ended with much of the same uneasiness and volatility we have seen since the end of 2015. The year's first few days led to one of the worst calendar year starts since the Great Depression, and continued downward with increasing volatility. Event risk from topics such as the oil glut, China going bust, and the Federal Reserve sent buyers running for the doors. This dramatic down move saw us move to a risk off position at the beginning of the year. The move was unusual for us in frequency as we exited and reentered the markets at the end of last year, and is a reflection of the large increase in volatility we are experiencing.

For the first month, we were on the right side of the trade. As of February 11, our risk off position had us ahead of the 'buy and hold' benchmarks for the respective models, just as we were ahead of them in the end of the third quarter of 2015, before the swift up move. The volatility and the downward movement had us once again step to the side as we did not feel we would be adequately compensated for the increased risk of staying in the markets.

Unfortunately, recent history repeated itself with a sharp "V" bottom followed by an equally aggressive move back to the upside. Eventually, the move took out our exit prices and we

	Q1 2016		2015	
	Return	Std Dev	Return	Std Dev
Barclays US Agg Bond TR USD	3.03	3.64	0.55	4.52
Barclays US Treasury US TIPS TR USD	4.46	5.42	-1.44	6.59
Barclays US Treasury 20+ Yr TR USD	8.49	15.17	-1.59	18.93
Barclays US Corporate High Yield TR USD	3.35	10.08	-4.47	4.92
S&P 500 TR USD	1.35	22.31	1.38	18.65
S&P MidCap 400 TR	3.78	25.09	-2.18	17.95
MSCI EAFE NR USD	-3.01	24.03	-0.81	17.17
MSCI EM NR USD	5.71	28.14	-14.92	19.44
FTSE NAREIT All Equity REITs TR	5.84	24.80	2.83	19.96

once again fell behind the benchmarks, as "staying in" proved to be the strategy in favor for another quarter. The following chart shows the channel that developed over the past few months and highlights the extreme movements that happened in a relatively short period of time, as we saw two down moves, and subsequent up moves of around 12% in an 8 month period in the S&P 500. This leads to a few points I want to make about investing in general, and then our approach to constructing a portfolio within that framework.

I would first like to discuss 'buying and holding' as it is known, versus a tactical approach that attempts to time certain trends in the market. No matter how good someone may be at identifying and timing market trends, there will always be a time when 'buying and holding' outperforms tactical. Con-

trary to what you may think a tactical manager would say, I believe 'buying and holding' will be in favor MOST of the time. There are also times when a tactical strategy is in favor, and while those times are less in frequency, they tend to occur when 'buying and holding' is particularly destructive to wealth. We don't attempt to time the market because we think we can predict direction, we do it because the past 16 years have shown us that the amount of drawdown at a given risk tolerance (see the max drawdown of your appropriate 'buy and hold' benchmark) is greater than we have come to expect. The actual drawdowns in diversified 'buy and hold' models are much more than people anticipated before 2000.

Let me explain further by using the approximate S&P500 long term risk and return characteristics of 9% return with a 18% standard deviation. Not to get into the statistics too deeply, but it roughly means 95% (two standard deviations) of your yearly returns would fall between a 45% gain, and a 27% loss. It is easy, but not advisable, to throw out the other 5% on the tails as highly unlikely occurrences (actually 1 out of 20, how long is your time horizon?), and look at the 27% downtrend as a maximum loss. People might say "27% down would really sting, but the opposite 45% up move would more than make up for it."

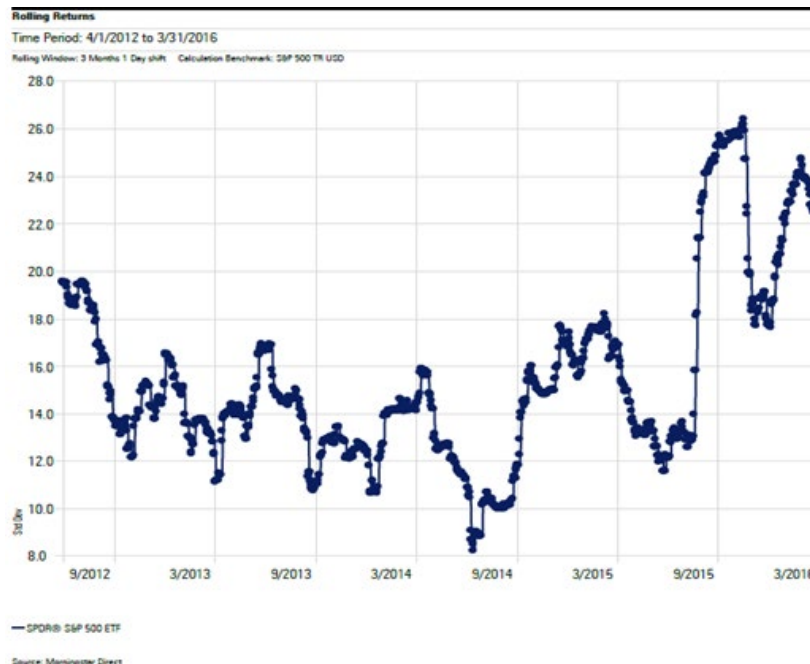
Without even getting into the math, our experience tells us that these



Premise Capital 1st Quarter Continued

types of returns are not what we see in the market. How could that be the prevalent risk and return characteristic when we experienced two 50% drawdowns in 8 years? Where are all the years with returns at 45%?

While there are many possible reasons for this, and leaving the 'fat tails' conversation for a special piece we are developing, I would like to expand on the concept of 'stability in the standard deviation'. If the standard deviation was relatively stable, meaning it stays close the longer term number of 18% through time, it would not be necessary to look at alternative methods of constructing portfolios.



The problem is that standard deviation is not stable over time. If you look at the following SPY chart courtesy of Morningstar, you see the daily standard deviation over a rolling three month period displayed as an annualized number.

You can see that the standard deviation is anything but stable. This might help you understand the meaning of the phrase "compensated for the risk." From 2012 until September of 2015, you see that the standard deviation stays close to or below its historical long term average of 18%. This period roughly corresponds to a time when the Premise portfolios were in their respective "risk on" positions. It is a time where we believe risk is being adequately compensated, and hence a time when 'buy and hold' strategies would likely be in favor.

Now look at what happens at the end of 2015. The standard deviation spikes above 26% in a very short period of time. So now, not to get deep into math, we think of a two standard deviation move (about 95% of occurrences) going from the previous -27% to 45% range, to a new -43% to 62% range. All of a sudden, trying to get that 9% long term return doesn't seem as appealing.

If you think of a loss of 43% as a two standard deviation move in this shorter time frame, as opposed to a four standard deviation move on the long term historical time period, you may see a higher likelihood of an extreme move than when viewed from the longer perspective. This is a problem with assuming that the standard deviation is stable over time, which is how 'buy and hold', long term portfolios are usually constructed. Moves that are seen as black swan events or extreme outliers in the long term, are not as unlikely when viewed in light of the current higher volatility in the short term.

This represents a period where we think risk is NOT being adequately compensated and thus you saw us move to our low risk target levels in the models. The S&P 500 saw a return of 1.35% for the quarter while the standard deviation hovered near the above normal, 22%. Unfortunately, volatility is a double edge sword and increased volatility can cause drastic moves in both directions. While we were initially up on our position, the quarter ended with another huge upswing, and we fell behind the 'buy and hold' benchmark.

Our portfolios begin with the premise that we accept underperformance in certain time periods, in an attempt to minimize the downside that we have seen in traditional 'buy and hold' models. While we use 'buy and hold' benchmarks, we are NOT a buy and hold manager. We use the benchmark as a representation of a diversified model that matches a risk tolerance, but understand it also has a drawdown characteristic that we have deemed undesirable. Because it is undesirable, we do something different.

When the trend is down and the volatility is up, we lighten up on our exposure. This is the same type of pattern that occurred before the 2000 and the 2008 selloffs, but in those cases there was more downside to come. When the market snaps back, we fall behind the traditional portfolios, but that is the cost of getting out.



This underperformance is baked into the creation of the model and deemed worth the cost in the attempt to outperform 'buy and hold' during drastic down moves. If you look at each quarterly report and compare us to the 'buy and hold' benchmark, you may be disappointed in the periods when 'buy and hold' is in favor.

Therefore, I like to ask the following question. "Is the amount of underperformance compared to a 'buy and hold' model worth it in the long run in an attempt to minimize the drawdowns that potentially exist at my risk tolerance?"

If the biggest drawdown expected from the S&P was 27% as shown above in the long term risk statistics, we might be recommending a 'buy and hold' model that only adjusted the classes relative to each other and never went 'risk off'. History shows us that this is not the case.

If we took the 12% upswing against our position twice in the last eight months and trailed the benchmark by 24% as a result of the wiggles, we would either need a new model or we would go back to recommending the 'buy and hold' strategy, as the 'cost' of timing would be greater than the potential benefit of missing a large down move. Fortunately, just as in last year's wiggle, other factors have mitigated that number, and our models are no where near that far behind.

At Premise, we believe in the long term value of creating a portfolio that attempts to minimize the effect of drawdowns like those that have occurred in recent history. We specifically acknowledge the cost of timing, and purposely create a systematic approach that attempts to minimize that cost while still doing the things that can potentially provide a benefit during the periods of time that 'buy and hold' models have shown to be even more undesirable. This does not mean that our portfolios will outperform 'buy and hold' strategies in all periods, and in fact implies quite the opposite. We accept that we will underperform during certain environments and have carefully weighed that cost against the potential benefits. So while we may lose some of the quarterly battles of return, we believe through a full market cycle, we can win the war.

Thank you again for your continued confidence in Premise.

Jason Rolence

