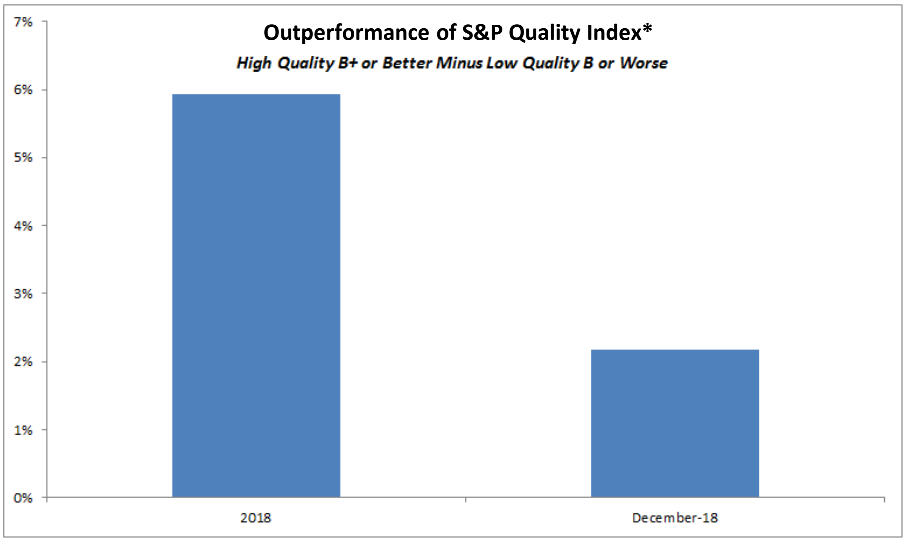
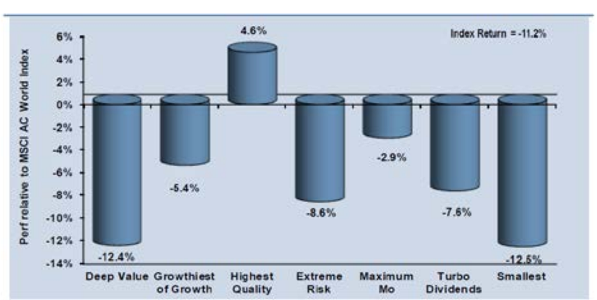



*The S&P Quality Indices measure the performance of stocks selected on three fundamental measures: return on equity, accruals ratio, and financial leverage ratio. Source: Merrill Lynch

Asset allocators and advisors perform an important job selecting investment managers who adhere to a specific style, in part because they can have an expectation of how their portfolio should perform in different environments. December 2018 provided a good test for equity portfolios in a unique month. The month of December recorded the worst December for the S&P 500 since 1931 according to Bloomberg and the most challenging for global equities since they began tracking them in 1988 per Merrill Lynch.

**Style Relative Performance vs. MSCI AC World**




Source: BofA Merrill Lynch Global Quantitative Strategy. Performance is based on our monthly-rebalanced 30-stock Extreme Styles.

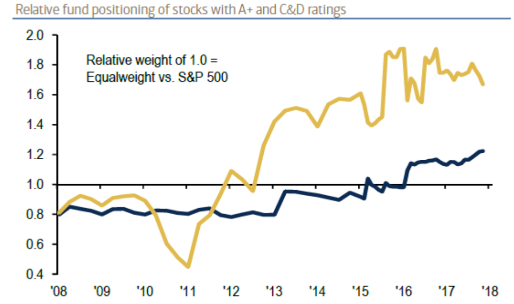
*Source: BofA Merrill Lynch Global Quantitative Strategy*

One characteristic that worked across geographies was quality. As we have noted in the past, quality can be defined in a number of ways but one of our favorites that is widely accepted is S&P's Quality definition. It has been in place for 50 years and reflects the long term growth of a company's earnings and dividends. Merrill Lynch uses the same definition to track the performance of equities on a domestic and global basis. As seen in the top chart, high quality stocks (defined as B+ or better) outperformed their low quality counterparts both in December and throughout the year. To the left, Merrill notes that quality was the only characteristic to outperform in the characteristics they track in terms of global equities.

You might assume that all equity investors focus on quality, but you'd be in for a surprise. Merrill Lynch tracks mutual funds and collects data on their holdings versus the quality rankings. Their work shows that active funds are increasingly overweight low quality and the level of low quality holdings (yellow) are close to record levels. Why are managers positioned in low quality? Merrill theorizes that managers have benefitted from owning low quality stocks that thrive on access to cheap capital and tend to be the biggest beneficiaries of fiscal and monetary stimulus.

**Chart 24: Active funds' positioning in the lowest quality stocks is hovering near record levels**

Relative fund positioning of stocks with A+ and C&D ratings



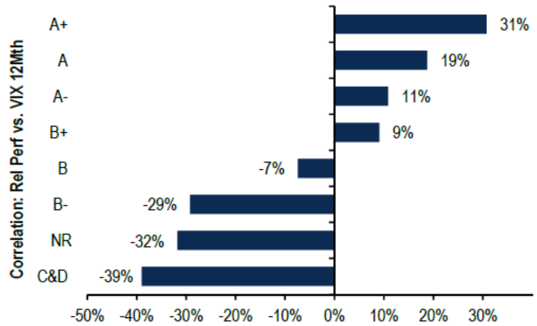

Source: BofA Merrill Lynch US Equity & US Quant Strategy, Lionshares, Standard & Poor's

*Source: BofA Merrill Lynch Global Quantitative Strategy*

## Best Hedge Against Higher Volatility? Consider High Quality

**Chart 19: High quality outperforms low quality when the VIX rises**

BofAML Quality indices 12m performance correlation to 12m chg. in the VIX (1991-now)




Source: BofA Merrill Lynch US Equity & US Quant Strategy

The highest quality stocks (based on S&P Quality Ranks) have historically been most positively correlated to changes in the VIX, while the lowest quality stocks have been most negatively correlated.

*Source: Merrill Lynch*

With the Federal Reserve in the United States raising rates and shrinking its balance sheet coupled with the European Central Bank ending its bond purchasing program in December, tightening credit appears to be favoring cash rich, self-funded companies that are in control of their own destiny. As Merrill notes, if investors are concerned over higher volatility (as frequently measured by the risk gauge, the VIX) high quality could add to performance.

Owning quality companies is one of the four pillars of the Equities Opportunities group and integral to the selection process for new positions. The exposure to quality companies is not based on an economic forecast, but common sense and the historic outperformance of high return on capital stocks based on data from Ned Davis Research. Should allocators and advisors have an outlook that includes higher levels of volatility in equity markets going forward, we believe Equity Opportunity strategies provide a "quality" option.

As always thank you for your interest and trust managing your investments.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