DENALI

Advisors, LLC

Quarter II, 2017 Performance Review

NV International

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International Markets

The global economy continued to strengthen in the second quarter, both in the U.S. and in most other developed markets, with growing U.S. international trade one driving factor. *The Economist's* latest estimates showed year-on-year growth in the largest developed regions between 1.1 and 2.3%, with North America leading. After sliding a bit in the first three weeks of April, international equity markets jumped sharply after a centrist independent candidate won the first round of French presidential elections, rising through May and finishing the quarter just a few percent below the record levels attained in 2014. For the quarter, the MSCI World ex US index returned a fairly strong 5.63% (in $US, net of withholding taxes). However, the bulk of this gain actually reflected the 4.7% fall in the US dollar, as expectations declined for relatively tighter monetary policy in the U.S., especially with respect to the euro zone. German government bond rates rose in the quarter, while declining, in a sign of confidence, in the riskier developed European countries. Sector performance trends largely persisted from the first quarter. Dispersion between sectors was again fairly subdued, with eight of 11 sectors falling in about a 3% range. Technology was again the leading sector, and Energy was again the only sector with a loss in the quarter, hurt by the further fall in oil prices. The materials sector also underperformed. These sector dynamics once again led to outperformance for the Growth style index over Value in the period. The Financial sector modestly outperformed the overall market on the strength of the non-bank financials. There was greater dispersion in performance between countries in the quarter. Europe generally outperformed, and some of the smaller European markets – Austria, Denmark and Finland – were the top performers by a wide margin, but Ireland and Portugal lagged. The resource-heavy markets of Canada and Australia had the weakest performance, with Australian stocks producing losses, while Norway and Britain also lagged.

Denali Performance Analysis

Denali's NV International strategy continued to outperform in the second quarter of 2017. Our NV International composite returned 7.28% in the quarter after fees, 1.65% ahead of the benchmark MSCI World ex US index return of 5.63% (net of tax withholding). For the year ending in June, NV International gained 26.81% net of fees vs. 19.49% (after withholding) for the benchmark, an active return of 7.32%. For the nineteen month period since its inception, NV International has returned 14.79% annualized after fees, outperforming the benchmark's 8.56% gain (net of withholding) by 6.23%.

Our Network Value index reference portfolio returned 7.87% in Q2, more than accounting for our composite's outperformance. Although Value underperformed in the period, the cross-sectional performance of the NV Arbitrage forecast was also fairly positive. Our intrinsic value forecast model's performance was again basically neutral in the quarter, as was our earnings estimate revision model. Our characteristics trend model had slightly positive average predictive performance in this period. The most positive factor impact came from our exposure to stocks with higher earnings-to-price ratios, with our exposure to lower cap-ex/sales also beneficial. As in Q1, the most negative factor impact was from our position favoring lower price relative to book value, consistent with the underperformance of Value in the period; our model's forecast for this factor turned negative during the quarter. Our trend model's continued correct forecast of underperformance for higher accruals/assets stocks again helped us to mitigate our exposure. The country-group factor forecasts were on the whole successful, and the correct prediction of outperformance for Europe helped us mitigate our underweight there; our forecast for Asia ex-Japan turned negative during the period. We were also helped by the model's forecast of underperformance for the Energy sector. The performance of the combined composite forecast was fairly strong for the quarter, although our portfolio did not perform as well as the Network Value index.

Barra analysis shows that we were helped by our intended exposure to lower liquidity, even while our smaller market cap size detracted; our higher momentum was also a benefit. Our overall exposures to risk indices, country factors, and industry factors were all positive in their framework, which also showed positive specific asset selection.

Our active positioning among countries made a positive contribution to the quarter's performance, as did our stock selection within countries. Our most positive exposures were our overweight to Austria and underweight to Australia, though we had negative impacts from underweighting Switzerland and Denmark. We benefited significantly from good stock selection results in European markets (France, UK, Netherlands and Norway) as well as Australia, partly offset by negative selection results in Japan and Hong Kong.

Similar to the previous quarter, our portfolio's active sector positioning was approximately neutral to performance in Q2, with the gain from underweighting Energy offset by net losses from positions in other sectors. Our positive active return was basically accounted for by successful stock selection within sectors. Our specific stock selection was particularly beneficial in the Financial sector and also positive in Materials and the Consumer sectors, but had negative results in the Technology and Industrial sectors. Within the Financials, several bank stocks from different regions were significant contributors, but holdings in Canadian insurers detracted. In both the Industrial sector and within Technology, last quarter's biggest positives were this time the most significant negative impacts, while on the other hand, in the Materials and Utilities sectors the biggest losers from Q1 became the significant positive contributors.

Outlook

The world economy for the moment seems to be following the consensus expectations for continued gradual strengthening. The U.S. Federal Reserve will likely proceed with balance sheet tapering and rate increases, though perhaps more gradually now, and no further monetary stimulus is likely from central banks in Europe. Long-term interest rates may at last have begun to move upwards to more normal levels as foreign bond markets compete with higher U.S. debt yields and demand for credit revives; for instance, Swiss government 10-year yields broke above zero in July for the first time in two years. This will eventually begin to pressure valuation multiples, especially for those stocks which investors have sought for income yield, as well as those whose prices are more heavily based on expectations for future growth. U.S. oil production elasticity should continue to limit increases in oil prices, benefiting energy users but limiting the potential returns of Energy sector equities. An increased source of risk to this fairly benign scenario is continued provocation by North Korea, which endangers U.S.-China trade relations. In international stock markets, after the fairly rapid rise of the first half of this year, we expect some period of consolidation in the short term with more muted gains, less of a tailwind from dollar devaluation, and relative outperformance for those stocks whose valuations have not yet risen as much. In fact, we see the short term outperformance of Growth this year as strengthening our relative-valuation-based assessment that Value is likely to outperform in the mid to long term. Denali's attention to earnings-supported valuation should position our portfolios advantageously.

Disclosures

Returns are presented gross and net of management fees and include the reinvestment of all income. Past performance is not indicative of future results. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Denali was established in 2001 and manages equity and alternative assets for primarily institutional clients. The U.S. dollar is the currency used to express performance.

NV International: Composite consists of fully discretionary International (large cap) portfolios. Results are compared against the returns of the MSCI World ex-U.S Index and intended to outperform this benchmark while maintaining similar sector, industry and security characteristics. The NV International portfolio construction is based on the analysis of earnings, liquidity and other characteristics of selected large and mid cap companies from developed international stock markets (e.g. the markets represented in the MSCI World ex-U.S Index). The Denali NV International Composite was created November 30, 2015. Portfolio rebalancing is done monthly or more frequently if judged to be advantageous. The fee schedule for this product is 0.75% on the first $50 million, 0.65% on the next $50 million, and 0.50% on the balance. Actual investment advisory fees incurred by clients may vary. There is a marketing minimum of $10 million. Client returns will be reduced by advisory and other expenses the client may incur. Net returns have been calculated by reducing gross returns by actual management fees incurred. Leverage is not used.