DENALI

Advisors, LLC

Quarter II, 2017 Performance Review

NV Small

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Market and Economy

The U.S. economy continued to grow steadily in the second quarter of 2017, but without much sign of a hoped-for acceleration. While reported GDP growth for the first quarter came in slightly less than expected at 2.1%, this was still a relatively strong first quarter performance by standards of recent years. Interestingly, despite anxieties about protectionist policies from the new administration, trade was a strong contributor to growth, with exports growing much faster than forecast, as economic conditions abroad remained generally benign. The U.S. unemployment rate dropped to 4.4%, the largest quarterly decline in two years. Profit growth for the S&P 500 companies declined to a still-respectable 11% over the prior year, with some re-acceleration forecast for the rest of the year, supporting valuations in the stock market. Prices are not rising as quickly as expected, however. While the Federal Reserve Board raised the Fed Funds rate by a quarter point as expected at their June meeting, the absence of inflationary pressure has made the future course of short term rates less clear. In fact, long-term rates actually settled a bit lower in the quarter once again, taking the 10-year Treasury yield from 2.40 to 2.31%, with a low of 2.14% in late June. Declining yield expectations contributed to a slip of almost 5% for the U.S. dollar exchange rate. One reason for the subdued inflation was another fall in the price of oil as production continues to grow. The price of crude in the U.S. fell from around $51 to $46 a barrel, trading as low as $42 during the quarter.

Russell Index Returns, Q2 2017

	Q2 2017		
Index	All	Growth	Value
Russell 3000	3.02%	4.65%	1.29%
Russell 1000	3.06%	4.67%	1.34%
Russell Midcap	2.70%	4.21%	1.37%
Russell 2000	2.46%	4.39%	0.67%
Russell Microcap	3.83%	5.29%	2.94%

Supported by growing earnings and low interest rates, the U.S. equity market continued to climb in the second quarter with fairly subdued volatility, despite some hyperbolic news cycles out of Washington. The broad Russell 3000 index produced a gain of 3.0%, spending the quarter within about a 5% range and finishing near record highs achieved in June. Dispersion in returns was much narrower in Q2, with most sector returns clustered between 2.2 and 4.2%. The Health Care sector outperformed again this quarter as the status quo prevailed on health care policy, gaining 7.4%. The next-best sector in the period was Technology, although its rapid gains stalled noticeably in June as investors began to question valuation levels for internet-linked stocks, finishing the quarter up 4.2%. Falling oil prices drove down the Energy sector, producing a loss of 7.6%. The Telecom sector was also weak, losing 6.6% in the period; however, within the Russell 2000, Telecom was the quarter's *best* performing sector, as smaller tech-oriented stocks far outperformed the giant carrier stocks. With most of these trends carrying over from the first quarter, these sectors were also the market's best and worst in Q1 and, by a large margin, for the year so far. Accordingly, the Growth style indexes again outperformed in all size categories. Meanwhile, dispersion across market cap size ranges was also narrow in Q2.

Denali Performance

	Q2 2017			One Year			Since 9/30/2012		
Strategy	Gross	Net	Bench-mark	Gross	Net	Bench-mark	Gross	Net	Bench-mark
Denali NV Large	0.99%	0.93%	1.34%	18.66%	18.38%	15.53%	15.45%	15.06%	13.22%
Denali NV Mid	0.39%	0.29%	1.37%	21.04%	20.59%	15.93%	17.00%	16.58%	14.63%
							Since 5/31/2013		
Denali NV Small	0.54%	0.29%	0.67%	21.94%	20.78%	24.86%	13.09%	11.99%	10.37%
							Since 12/31/2013		
Denali NV Micro	5.45%	5.14%	2.94%	32.84%	31.29%	31.26%	11.43%	10.08%	7.41%

Returns for Denali's NV Large, Mid, Small and Micro composites are presented gross and net of management fees. Please refer to disclosures at the end of this commentary.

In this fairly subdued quarter, most of Denali's U.S. strategies returned a fraction of a percent, and were a fraction of a percent behind their benchmarks, with the exception of NV Micro, which outperformed significantly in a segment where there was more action to be found. All Denali strategies remain well ahead of benchmark for the period since the inception of the Network Value based forecasts. Denali's NV Small composite returned 0.54% in the quarter before fees, 0.13% behind the benchmark Russell 2000 Value Index return. For the trailing year, NV Small returned 21.94%, trailing the strong 24.86% benchmark return by 2.92%. For the 49 month period since its inception, NV Small has returned 13.09% annualized, outperforming the benchmark's 10.37% return by 2.72% annually before fees.

The return of our small cap Network Value reference portfolio was 2.19% for Q2, outperforming both our composite and the Russell 2000 Value index. However, the cross-sectional performance of the NV Arbitrage forecast model was only neutral for the period, reflecting the general underperformance of Value. Our Characteristics Trend model had modestly positive predictive performance in the second quarter (better among large caps). The biggest positive factor impact was from our exposure to higher current earnings-to-price ratios, whereas higher *forecast* earnings-to-price was the strongest negative impact, and sales-to-price was also negative for the quarter. Higher sales-to-assets and lower cap-ex-to-sales ratios, along with higher gross profit margins and ROE, were smaller positive contributing factors in the period, while our exposure to lower earnings variance was a negative. The sector trend portion of the model was also successful, correctly forecasting outperformance for Health Care, helping to mitigate our underweight against that sector. Our detailed estimate revision forecast and our intrinsic value model each produced moderately negative results during the quarter. Our live small cap portfolio experienced weaker performance in June than in the first two months of the period, along with the factor trend model, while our large and mid cap portfolios' performance showed the opposite pattern. Barra's attribution analysis shows that we were disadvantaged by our smaller average market cap and negative active exposures to Growth and Momentum factors, while gaining from our lower liquidity, currency sensitivity and volatility.

Our active positions in GICS sectors had a basically neutral effect in the quarter, with our slight underperformance due to stock selection within sectors. We gained modestly from overweighting Industrials, but this was offset by the drag from underweighting Health Care. Within sectors, we benefited significantly from successful stock selection in the Financial sector and also outperformed in Energy, but were hindered by adverse selection results in the Consumer sectors and, most notably, Industrials. Within Energy, we gained from favoring transportation and services over oil producers. Within Financials, we added most value from holdings in financial services and insurance firms. In the Consumer Discretionary sector, holdings in automobile retailers underperformed, while within Staples our holdings in grocery markets produced losses. In the Industrials, office equipment and supply makers were among the largest detractors, along with transportation-related stocks.

Outlook

Growth in the American economy appears steady at present. Consensus estimates for 2017 GDP growth remain at about 2.25%, with 2.4% for 2018. Despite this fairly sedate pace, companies have been able to increase profits, with earnings forecast to increase by 18-22% year-on-year in the next two quarters. The financial sector is reasonably healthy as reflected by the most recent round of Federal Reserve stress tests for banks, which may enable higher returns for shareholders in that sector. The valuation of the U.S. stock market is high by historical standards, but appears reasonable given current levels of growth and interest rates. What appears more questionable than a quarter or two ago is whether this new-normalish scenario can be invigorated by the enactment of government policies that reduce tax and regulatory burdens. This question is probably the most visible source of upside or downside to market expectations, and the recent flattening of the yield curve seems to reflect the increased uncertainty. It does seem possible at this point that some resolution may materialize within a matter of weeks. If the answer is affirmative, rate increases will likely resume at a steady pace; if negative, interest rates may remain low in the short term but be driven up eventually by increasing fiscal deficits. Meanwhile, 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; the recent behavior of internet stocks may indicate that investors' support for very high relative valuations is reaching its limits. 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. Leverage is not used in these products.

NV Mid: Composite consists of fully discretionary mid cap value portfolios, measured against the Russell Mid Cap Value Index, and intends to outperform that benchmark while maintaining similar sector, industry and security characteristics. The NV Mid Composite was created October 1, 2005. As of January 07, 2014 the Denali Mid Cap Russell Composite was renamed the Denali NV Mid Composite., and then on July 17, 2014 renamed the NV Mid Composite. In September 2012, the investment process changed to select stocks using Denali's proprietary Network Value forecast model that ranks stocks by earnings and illiquidity in addition to the other factors that were previously being used to rank stocks. There were no changes to the investment objective. The sector and industry characteristics of the NV Model are still similar to the Russell Mid Cap Value Index. The management fee schedule is as follows: First $25 million 0.75%, next $25 million 0.70%, balance 0.65%. Actual investment advisory fees incurred by clients may vary. There is a marketing minimum of $5 million

NV Large: Composite consists of fully discretionary large cap value portfolios measured against the Russell 1000 Value Index , and intends to outperform that benchmark while maintaining similar sector, industry and security characteristics. The Denali NV Hi Concentrated Composite was created September 30 2012. As of July 17, 2014 the Denali NV Hi Concentrated Composite has been renamed the NV Large Composite. As of 02-18-2016 the secondary benchmark S&P 500 was removed as it is no longer representative of the strategy. The NV Large portfolio construction was based on the analysis of earnings and liquidity of selected companies from the Russell 3000 index combined with a factor forecast applied to stocks in this same universe. Portfolio rebalancing is done once or twice per month using a reference portfolio of the Denali NV Hi Index. The management fee schedule was as follows: First $50 million 0.50%, next $50 million 0.45%, balance 0.40%. There is a marketing minimum of $5 million.

NV Small: Composite consists of fully discretionary small cap portfolios. Results are compared against the Russell 2000 value and intends to outperform that benchmark while maintaining similar sector, industry and security characteristics. The Denali NV Small Composite was created May 31, 2013. As of July 17, 2014 the Denali NV Small Composite has been renamed the NV Small Composite. As of 02-18-2016 the secondary benchmark Russell 2000 was removed as it is no longer representative of the strategy. The NV Small portfolio construction is based on the analysis of earnings, liquidity and other characteristics of selected companies from the Russell 2000 index. Portfolio rebalancing is done monthly. The management fee for this product is 1.00%. The composite is comprised of 100% non-fee paying accounts for all periods presented. Net returns have been calculated by reducing gross returns by a model management fee of 1%. There is a marketing minimum of $100,000.

NV Micro: Composite consists of fully discretionary micro cap portfolios. Results are compared against the returns of the Russell Microcap Value Index and intended to outperform this benchmark while maintaining similar sector, industry and security characteristics. The NV Micro portfolio construction is based on the analysis of earnings, liquidity and other characteristics of selected companies from the Russell Microcap Index. As of February 4, 2014, the benchmark was changed from the Russell Microcap Index to the Russell Microcap Value Index retroactively. This change was made because we believed that the Value style index would provide a more useful performance comparison for clients and prospective clients in this strategy. The Denali NV Micro Composite was created December 31, 2013. As of July 17, 2014 the Denali Network Value Micro has been renamed the NV Micro Composite. Portfolio rebalancing is done monthly, or more frequently if judged to be advantageous. The fee schedule for this product is 125 bps on the first $50 million and 75 bps on the remainder. The composite is comprised of 100% non-fee paying accounts for all periods presented. Net returns have been calculated by reducing gross returns by a model management fee of 1%. There is a marketing minimum of $1,000,000. Client returns will be reduced by advisory and other expenses the client may incur.