DENALI

Advisors, LLC

Quarter III, 2017 Performance Review

NV Large

October, 2017 5075 Shoreham Place, Suite 120, San Diego, CA 92122 • www.DenaliAdvisors.com 858-558-3600

Market and Economy

Growth in the American economy showed signs of picking up pace in the third quarter of 2017. GDP growth for the second quarter was reported at 3.1% annualized over the prior quarter, with consumer spending, private investment and export growth all contributing, while government spending decreased. The unemployment rate declined to 4.3%, the lowest quarterly rate since 2001. Earnings for the S&P 500 companies increased by an estimated 14% over the prior year in Q3, at least partially validating the growth expectations priced into stocks. While inflation remains low (and forecasts have declined), the Federal Reserve's Open Market Committee confirmed that the Fed will begin this month to reverse its quantitative easing program by reducing the holdings of bonds on its balance sheet. Nevertheless, partly driven by safe-haven demand due to flaring international tension over North Korean nuclear and missile tests, the 10-year Treasury bond yield declined to a post-election low of 2.05% in early September. This was followed by a steep rise through the end of the quarter as investors became more optimistic that growth-friendly tax reform, or at least rate reductions, would actually materialize, leaving the yield almost unchanged on the quarter at 2.33%. The dollar exchange rate followed a similar path but only partially recovered, ending 2.7% lower on the quarter as economic prospects in other developed markets also brightened. Meanwhile the price of U.S. oil basically reversed its drop from the prior quarter, based on increasing demand and supply disruption from Hurricane Harvey, ending the quarter near $52 per barrel.

Russell Index Returns, Q3 2017

	Q3 2017		
Index	All	Growth	Value
Russell 3000	4.57%	5.93%	3.27%
Russell 1000	4.48%	5.90%	3.11%
Russell Midcap	3.47%	5.28%	2.14%
Russell 2000	5.67%	6.22%	5.11%
Russell Microcap	6.65%	6.95%	6.44%

Volatility in the U.S. stock market remained low in the third quarter, but dispersion increased from the low levels of Q2. After rising amid positive earnings reports in July, equity prices dropped through mid-August under the influence of political and social unrest, geopolitical tension and three major hurricanes. The market then rallied steadily through the rest of the quarter on hopes of more business-friendly tax policy, with the broad Russell 3000 Index ending at another record high with a solid 4.6% return for the quarter. Investors continued to favor Technology stocks, as that sector led the market with an 8.4% gain. Reflecting the rally in oil prices, the Energy sector regained most of its Q2 loss, returning 6.8%. The Telecom sector also reversed from last quarter's weakness with a 6.3% gain, perhaps reflecting optimism for cellular carrier consolidation. Materials stocks also outperformed. This quarter's laggards were the defensive Consumer Staples (-1.2%) and Real Estate (+1.1%) sectors. Meanwhile, the usually pro-cyclical Consumer Discretionary sector also trailed the market at 1.3% despite strong auto industry returns, dragged down by losses in media companies and sports and leisure product stocks. For a third quarter running, Growth style indexes outperformed Value throughout the market cap spectrum. Smaller cap stocks outgained large caps during the quarter; unusually, the midcap segment trailed both large and small caps, reflecting the prevalence of defensive Real Estate and Utility stocks in the midcap indexes.

Denali Performance

	Q3 2017			One Year			Since 9/30/2012		
Strategy	Gross	Net	Bench-mark	Gross	Net	Bench-mark	Gross	Net	Bench-mark
Denali NV Large	3.85%	3.79%	3.11%	19.64%	19.35%	15.12%	15.49%	15.10%	13.20%
Denali NV Mid	3.15%	3.05%	2.14%	17.59%	17.14%	13.37%	16.80%	16.39%	14.33%
							Since 5/31/2013		
Denali NV Small	6.03%	5.78%	5.11%	19.78%	18.64%	20.55%	13.81%	12.71%	11.01%
							Since 12/31/2013		
Denali NV Micro	6.07%	5.75%	6.44%	29.89%	28.37%	26.15%	12.37%	11.01%	8.69%

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.

Denali's U.S. strategies mostly performed well in the third quarter, all leading their benchmarks with the exception of NV Micro, which gave up a fraction of its prior quarter's outperformance. All Denali strategies remain well ahead of benchmark for the period since the inception of the Network Value based process. Denali's NV Large composite returned 3.85% in the quarter before fees, 0.74% above the benchmark Russell 1000 Value Index return. For the trailing year, NV Large returned 19.64%, leading the fairly strong 15.12% benchmark return by 4.52%. It is now five years since the inception of the NV Large strategy, and over that period it has returned 15.49% annualized, outperforming the benchmark's 13.20% return by 2.29% annually before fees.

The positive active return of the NV Large composite largely reflected the performance of our large cap Network Value reference portfolio, which gained 4.05% in the quarter. However, the cross-sectional performance of the NV Arbitrage forecast model was somewhat negative, reflecting the general underperformance of Value for the period, especially in August. Our Characteristics Trend model again had fairly good predictive success in Q3, although there was a fair amount of change in factor performance effects from the prior period. The biggest positive factor impact was from our exposure to higher volatility stocks, followed by higher momentum and higher sales-to-assets ratios. Unlike last quarter, our exposure to higher forecast earnings-to-price ratios had a positive impact, but our higher *current* earnings-to-price ratio was a slight negative. Our lower cap-ex-to-sales ratios, a positive impact last quarter and very frequently in recent periods, was the biggest negative in Q3, followed by our exposure to higher cash-flow-to-price ratios. In the sector trend portion of the model, we were helped by the positive forecast for Technology, but hindered by the negative forecast for Energy. Our detailed estimate revision forecast had good predictive results this quarter, and despite the general anti-Value tone, our intrinsic value forecast also produced overall positive results, mostly generated in September, when Value rallied vs. Growth. Barra's attribution analysis agrees that we were helped by our above-benchmark exposures to momentum and volatility, while hindered by our higher earnings yield and smaller size, but shows positive specific asset selection as more significant than the systematic effects captured by their linear model.

Our active positions in GICS sectors accounted for just under half of our outperformance in the quarter, with the majority due to stock selection within sectors. We had modest gains from our overweights to Materials and Technology and underweight to Health Care, and a modest loss from underweighting Energy. Within sectors, we had beneficial stock selection in the Consumer Staples, Materials, Energy and Technology sectors, partly offset by negative selection results in Financials, Health Care, and Consumer Discretionary stocks. Given the major hurricane damage during the quarter, it is unsurprising that our holdings of insurance companies underperformed in Financials. In Health Care, our overall underweight to drug and biotech stocks detracted from active return. In the Discretionary sector, while our position in the auto industry performed very well, our holdings in media companies produced losses as investors worried about consumer price resistance for TV services. In the Consumer Staples sector the biggest contributors to our outperformance were food and beverage producers. The rising price of oil produced losses for our position in airlines, but the increased price of gasoline helped our refinery position to outperform.

Outlook

Although not yet reflected in the consensus of economists' forecasts for U.S. GDP growth, currently at about 2.2% for 2017 and 2.4% for 2018, we do see harbingers of possible acceleration and solidification in economic growth. Corporate profits are increasing considerably faster than GDP, and are expected to grow more than 20% this quarter over the prior year. The unemployment rate is forecast to decline to 4.1% next year, virtually full employment. This labor market strength may start to trim back profit margins, but also help to put growth on a more solid footing. The FOMC is widely expected to raise short term interest rates again in December, while its asset sales provide gradual upward pressure on longer-term rates. With the Fed turning both knobs, high-yielding stocks will likely face a headwind, but the bond yield curve could either compress or steepen depending on the relative rates of adjustment, which may impede or propel profit growth for banks, which are now generally producing healthy earnings. The valuation of the U.S. equity market remains high, but not unreasonably so in the context of expected growth and interest rates. Just as last quarter, the most evident source of uncertainty in the market scenario is whether Congress will enact policies to reduce tax and regulatory burdens on business. Market participants now seem to assess a higher probability of this occurring, in which case interest rates will likely increase at a steady pace, but a failure on this front could well spark a market correction, especially for stocks priced based on high growth assumptions, in which case Denali's attention to realized earnings should be an advantage. Finally, although our expectations have not yet begun to be realized, we continue to see the relative valuations of Growth and Value stocks implying mid to long term outperformance for Value.

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. Leverage is not used.

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 $25 million 0.55%, next $25 million 0.50%, next $50 million 0.45%, balance 0.40%. There is a marketing minimum of $5 million. Leverage is not used.

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 $ 5,000,000. Leverage is not used.

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. Leverage is not used.