Our Investment Philosophy

Executive Summary

❑ An investment philosophy is a set of guiding principles that inform and shape the investment decision-making process. It originates from the fundamental beliefs concerning the most effective way to generate investment returns.

❑ Asset allocation is the main determinant of portfolio returns. The centrality of asset allocation stems from its role in determining the optimal portfolio allocations to distinct asset classes based on the investor time horizon and risk tolerance.

❑ The ultimate goal of investing is the growth and preservation of capital. Such objective requires a long-term focus and investing in well-diversified portfolios that target optimal combinations of capital appreciation and preservation.

❑ We partition asset classes according to their contribution to portfolio risk and return. We see equity as the engine of growth. We believe that the main role of fixed income is capital preservation, and secondarily, income generation. Alternative investments have the potential to enhance portfolio diversification thanks to their low correlation to equities and fixed income.

❑ We embrace strategic asset allocation - a portfolio strategy that establishes an asset mix appropriate for a given level of risk tolerance and involves periodically rebalancing the portfolio in order to maintain a targeted long-term goal for asset allocation.

❑ Strategic, not static. The asset policy mix is periodically reviewed in conjunction with investor changing needs, re-evaluation of asset classes' expected returns and type and availability of investment instruments.

Massimo Santicchia
Co-Founder and Chief Investment Officer
Crest Investment Partners
Massimo.Santicchia@CrestInvestmentPartners.com

CREST INVESTMENT PARTNERS, LLC

Investment Philosophy

An investment philosophy is a set of guiding principles that inform and shape an individual's investment decision-making process. It should reflect a coherent way of thinking about markets and how they work. It stems from the fundamental beliefs concerning the most effective way to generate investment returns.

The Role of Asset Allocation

Investment performance can be achieved through three different approaches: asset allocation, security selection and market timing. Asset allocation is the major determinant of portfolio returns.[1] Therefore, establishing an appropriate asset allocation is the most important single investment decision investors need to make in building an appropriate portfolio structure to reach their investment goals. Asset allocation refers to the process employed to determine the portfolio's appropriate allocations to various asset classes. Only after the allocations to asset classes have been defined, security selection is employed to choose the individual securities to fill the asset class sleeves. The centrality of asset allocation stems from its role in determining the optimal portfolio allocations to distinct asset classes based on the investor time horizon and risk tolerance. Time horizon is the expected number of years an investor will be investing to achieve a particular financial goal. Investors with a longer time horizon are able to take on a riskier, or more volatile, investment because they can endure the ups and downs of the markets. By contrast, investors with a shorter time horizon are more sensitive to short-term losses and volatility and need to invest more conservatively. Risk tolerance is the degree of variability in investment returns that an investor is able and willing to withstand.

In practice asset allocation is a quantitative process driven by two types of inputs: investor's risk tolerance and horizon, and the risk and return characteristics of available asset classes. The output of asset allocation are "optimal portfolios" – portfolios structured to provide the greatest expected return given a certain accepted level of risk.

The quantitative nature of asset allocation derives from modern portfolio theory and specifically from Markowitz work on mean-variance optimization.[2] In his seminal work, Markowitz provided a mathematical formulation of the concept of portfolio diversification, whereby a pool of investment assets can be selected to have collectively lower risk than any individual asset. Intuitively, this is possible thanks to the fact that the returns from different assets are not perfectly correlated. For example, stocks and bonds don't move in the same direction all the times. In turn, this low -and sometimes negative - correlation results from a different response to economic events and prospects.

The economic cycle drives the relative performance of assets. During periods of economic growth, stocks tend to perform strongly driven first by expansion of valuation multiples and then, as the economic expansion matures, by widening corporate profit margins and earnings growth. As the economy nears its cyclical peak, earnings growth slows down, economic prospects are progressively less attractive, as the combination of tighter monetary policy and inflation conspires to undermine equities. Investors sell stocks and move towards safer investments such as bonds.

The linkage between the economic cycle and the performance of the various asset classes is the fundamental underpinning of asset allocation and portfolio diversification. An understanding of how different asset classes perform throughout the business cycle is crucial to appreciate the role of asset allocation to investment performance.

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[1] Brinson L. Randolph Hood, and Gilbert L. Beebower, Determinants of Portfolio Performance, The Financial Analysts Journal, 1986.
[2] Harry Markowitz, "Portfolio Selection," Journal of Finance, 1952.

The ultimate goal of investing is the growth and preservation of capital. Such objective requires a long-term focus. It also requires the ability to structure well-diversified portfolios that exhibit a combination of growth potential and capital preservation.

We evaluate asset classes to include in a portfolio both qualitatively and quantitatively. We partition asset classes according to the function they play in the overall portfolio in terms of growth, capital preservation and diversification. As Figure 1 shows, we see equity as a portfolio’s “engine of growth” given its link to economic and earnings growth. However, stocks fluctuate with the economic cycle and therefore investing in pure equity portfolios requires high risk tolerance and a very long-term horizon. For investors with lower risk tolerance and shorter horizons, portfolios need to be structured to include assets that will tend to maintain their values during equity market downturns. We believe that the main portfolio role of fixed income is capital preservation by protecting against periods of severe financial distress. The third category of asset classes, alternatives, Include traditional alternative assets such as real estate and high yield bonds; and non traditional, absolute return strategies such as long-short equity and fixed income strategies. While the returns patterns of equities and fixed income are intrinsically linked to the economic and interest rate cycles, absolute return strategies are expected to behave independently of market forces thus reducing investors’ systematic risk when they are included in a portfolio. Figure 2 reports the average return s and volatility by asset class. Higher returns are accompanied by higher volatility, as expected. More importantly, the low correlations of equity with bonds and the negative

Figure 1. Portfolio Role of Asset Classes

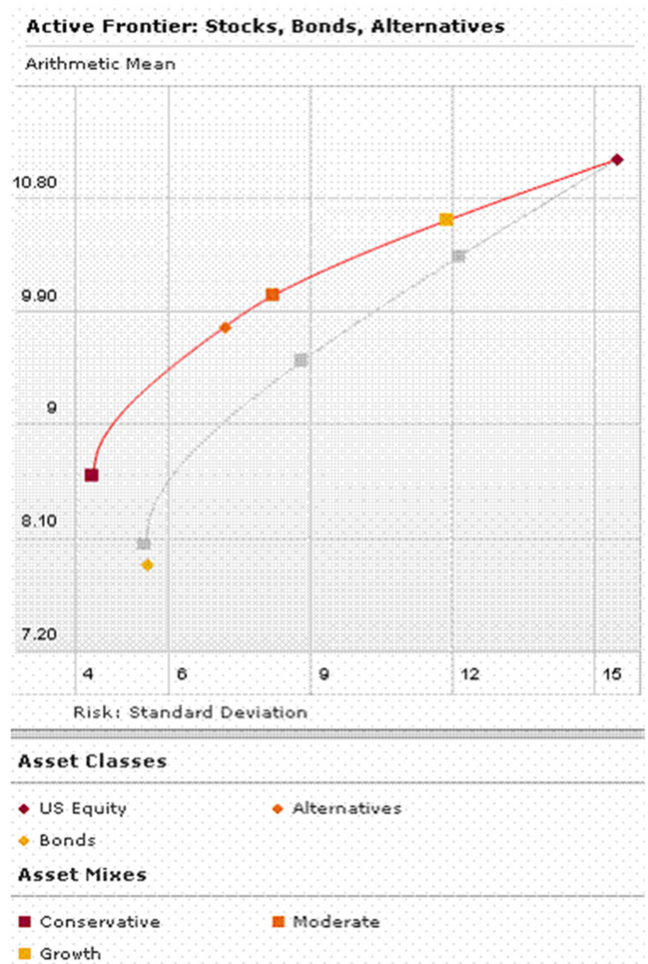
Asset Class	Portfolio Role
Equity	Capital growth
Fixed Income	Capital Preservation
Alternatives	Diversification

Source: Crest Investment Partners

correlation of alternatives with bonds signal potential diversification benefits in blending the three asset classes. In fact, the inclusion of alternatives results in improving portfolio efficiency (north-west shift of the efficient frontier).

Figure 2. Risk, Return and Correlations

	Equity	ALTs	Bonds
Return	11.1%	9.8%	7.9%
Volatility	15.5%	7.2%	5.5%
Correlations (1995-2013)			
US Equity	1	0.72	0.00
Alts	0.72	1	-0.01
Bonds	0.00	-0.01	1



Source: Morningstar. For equity was used the S&P 500, for bonds the Barclay Aggregate Index, and for Alternatives (ALTs) the Greenwich Global HF

The Role of Market Timing
Broadly speaking, market timing is the strategy of making buy or sell decisions of financial assets by attempting to predict future market price movements. The prediction may be based on an outlook of market or economic conditions resulting from technical or fundamental analysis. An example of market timing is a strategy that switches between equities and cash.

Market timing causes portfolio characteristics to deviate from those dictated by strategic asset allocation, changing the overall portfolio risk profile. For example, over-weight of riskier assets (e.g., equities) increases the overall risk of the portfolio making it more sensitive to the earnings cycle and to its recurring swings. Conversely, if an investor holds cash and the markets move against him (i.e., stocks rally), he might sustain irreversible opportunity losses which – within a long-term horizon - translate into permanent impairment of value. We don't practice market timing, because we don't believe that investors can consistently add value by timing broad asset classes. The potential cost associated with being wrong is too high to warrant such an approach.

The Role of Security Selection
The extent of the opportunity for active management in various asset classes provides a guide in choosing between an active or passive approach to security selection. We draw from our empirical research and direct experience in researching and investing in various asset classes.

Equities
Our empirical research and experience demonstrate that excess returns can be earned through disciplined and systematic investment strategies. For example, a number of papers have documented the value effect – excess returns to buying stocks with low valuation multiples such P/E, P/B or P/CF. There is also extensive evidence on price momentum – excess return to buying stocks which have strongly appreciated.[3]

Alternatives
Alternative investments can be categorized in: traditional such as commodities, real estate and high yield fixed income; and nontraditional such as private equity, hedge funds and managed futures. We see traditional alternatives providing positive but limited benefit to overall portfolio efficiency due to their significant positive correlation to equities. Nontraditional alternative strategies generate returns employing different approaches to investing than traditional equity or fixed income investments. These strategies may involve holding both long and short positions and adopting derivatives or hedging strategies, as well. Thanks to their low correlation to equities and fixed income, alternative investments have the potential to enhance the risk and/or return profile of an investment portfolio. Absolute return strategies such as event-driven and value-driven strategies, tend to exhibit little or not correlation with equities and bond investments and therefore provide powerful diversification benefits. Ultimately, we see nontraditional alternatives as tools to enhance overall portfolio diversification.

Investment Process
Our investment process employs both qualitative and quantitative methods. In structuring portfolios we take into account the portfolio role of each asset class (growth, capital preservation, diversification), their historical and expected returns and volatility and their cross-correlation of returns. We also evaluate the available instruments to gain exposure to asset classes (individual securities, mutual funds, ETFs). In the decision to employ ETFs or mutual funds we evaluate the track record of active managers in the various asset classes against the quality and cost of ETFs available in the same asset classes.

Ultimately, the output of our asset allocation process are portfolios that are optimal not just from a risk-return perspective, but also from a cost perspective.[6]

[3] See our report: "Our Equity Investment Philosophy" available on www.crestinvestmentpartners.com
[4] Gary Klein, "Sources of Power: How People Make Decisions", MIT Press, 1999; James Montier, "Behavioural Investing, A Practitioners Guide to Applying Behavioral Finance", Wiley Finance, 2007; [5] For example see: Antti, Petajisto, 2013, Active share and mutual fund performance, available on www.ssrn.com.; Lewellen, Jonathan, 2011, Institutional investors and the limits of arbitrage, Journal of Financial Economics. [6] For a detailed description of our asset allocation investment process see "Multi-Asset Portfolios", available on www.crestinvestmentpartners.com.

Portfolio Management Massimo Santicchia is a Co-Founder and Chief Investment Officer of Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages quantitative equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of the JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.

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