

First Quarter 2018

The Strategist's Corner

Where Do We Go From Here?

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*“There comes a
time when
strong returns
can fade away.”*

Where do we go? This is the first line in a chart-topping duet recorded by Johnny Gill and Stacy Lattisaw in 1989. Both recording artists grew up together in Washington, D.C. Lattisaw and Gill had a personal relationship that changed over time, especially when Gill became a member of the singing group New Edition. The song was written by LeMel Humes to bring up the direction and future course of their commitment.

Where do we go?

Equity market performance has been extraordinary since the Great Recession. Broad equity indices have had 10-year annualized returns of over 9%, 5-year annualized returns of over 15% and returns of over 25% in 2017. Nine years into a bull market, investors should be mindful of strategies for diversification and portfolio stability. Bond yields remain in a state of fluctuation. Prospects for sharp interest rate increases are keeping equity markets on edge. Investors are also concerned about a severe shift in the macroeconomic environment as inflation pressures are anticipated to rise.

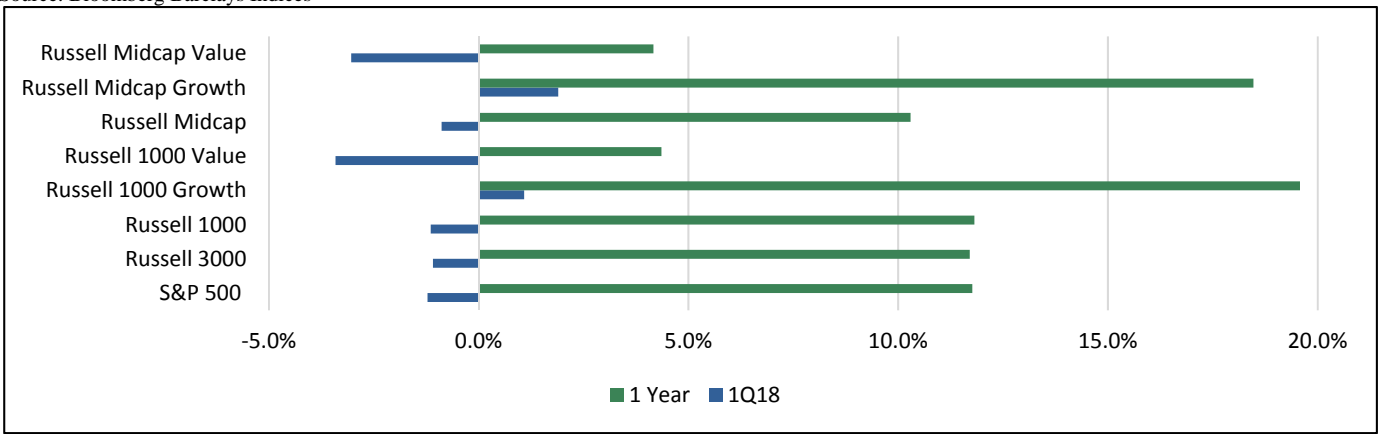
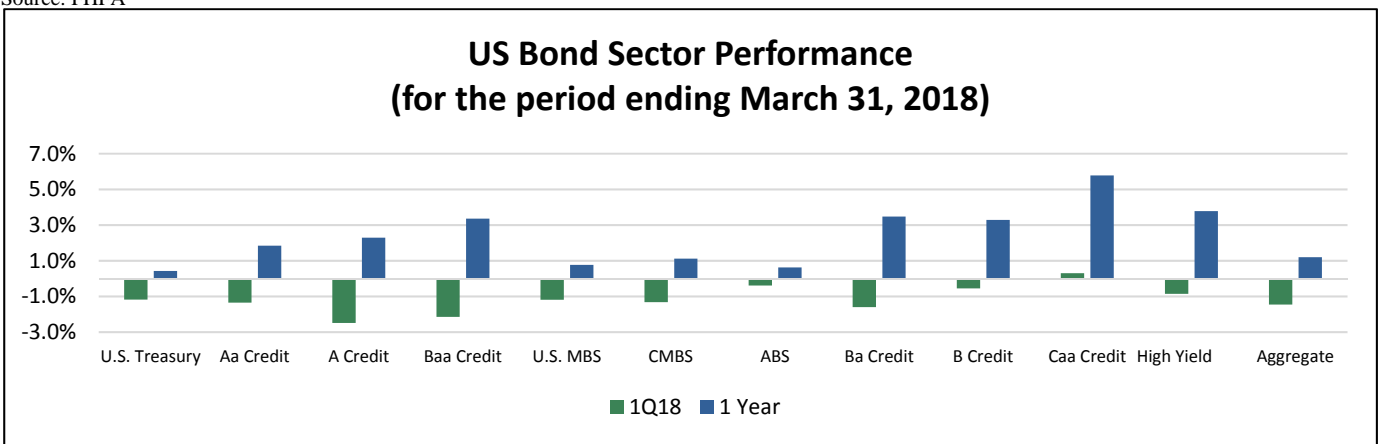
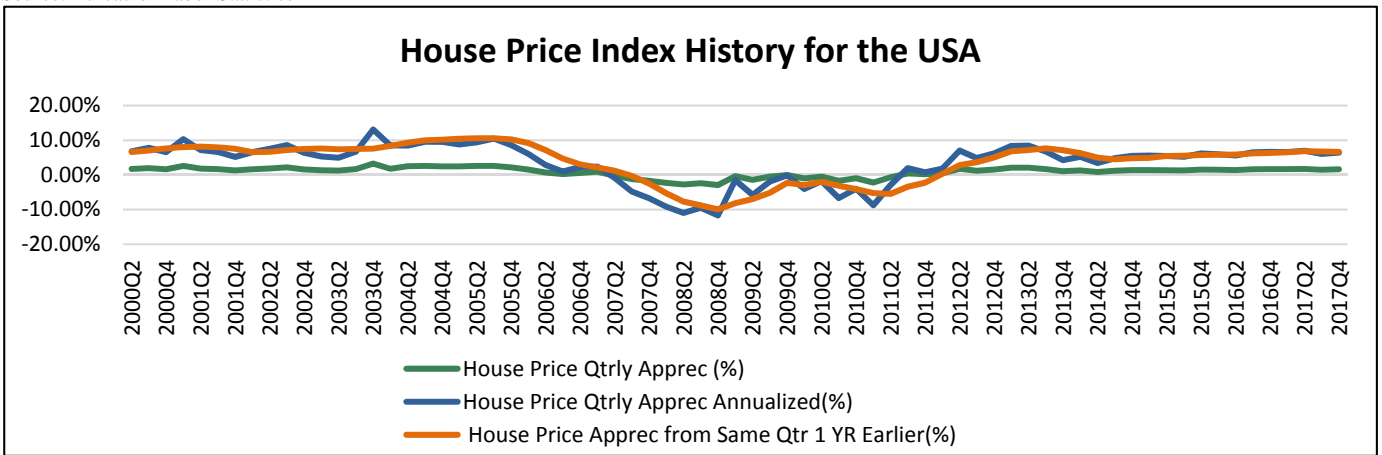
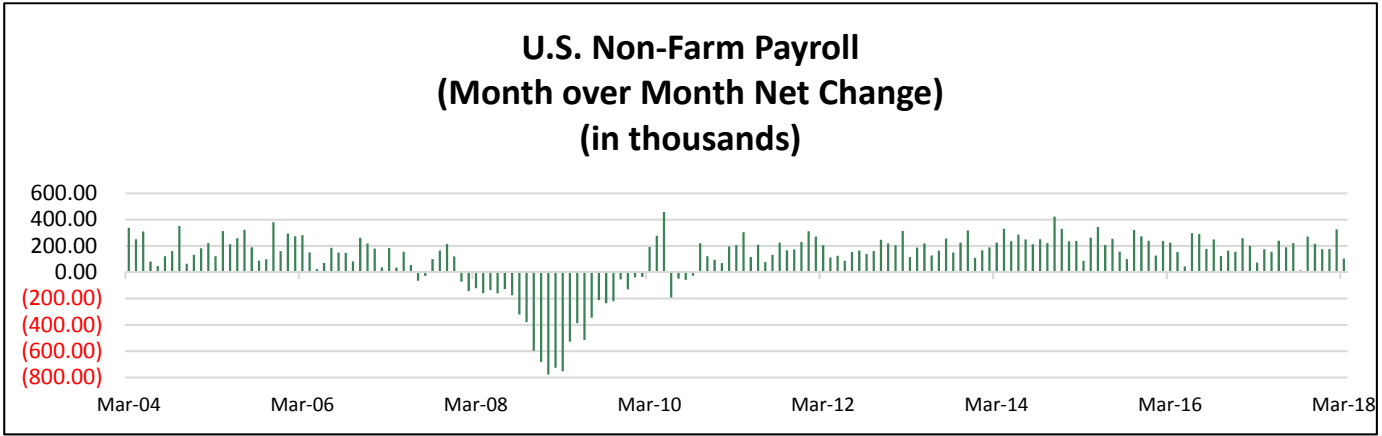
*There comes a time when love can fade away
And it came across for you and I
And I don't know how or where to go from here
I really don't know just what to do
So baby, can you tell me*

There comes a time when strong returns can fade away. Factors and strategies can get relatively expensive after periods of great performance and can get relatively cheap after periods of poor performance. When a factor or a strategy is cheap relative to its own history, it tends to perform well. Valuations that are high relative to historical averages can suggest future underperformance.

*Where do we go from here, my love
Do we walk away
Do we keep on trying?
After the feeling's gone, my love*

We think volatility is likely to continue. Do we walk away from risky assets? Or do we keep trying with equities believing that there will be no major declines? Until bond yield volatility calms down and the inflation picture becomes clearer, we think stock markets are likely to remain uneven and trade sideways.

Please see “ETF’s” on page 4



Review and Outlook

The first quarter of 2018 was not particularly kind to equity investors because of volatility but continued the two most positive factor investing themes established in 2017. Growth and momentum strategies outperformed the most during the quarter with value strategies continuing to lag. Following a selloff that began in late January, the broader equity markets managed to recapture some of their lost ground. However, stocks have moved lower again in recent weeks to close out the quarter. Information Technology and Consumer Discretionary were the only positive S&P 500 sectors for the quarter.

“Deteriorating international relationships have increased the volatility threat even with good news on the domestic economic front.”

The Federal Reserve raised the target range for the federal funds rate 25 basis points to 1.75% in March. The Federal Reserve is becoming more aggressive, with the bank recently voting to raise interest rates and signaling that it could boost borrowing costs twice more this year. After that it figures to step up the pace of monetary tightening in 2019. The Fed is planning for an acceleration of GDP growth, higher inflation, and lower unemployment.

The major domestic fixed income indices could not produce positive returns numbers for 1Q2018, given the 36-basis point increase in yield on the 5-year Treasury and double-digit widening of corporate spreads. The U.S. Aggregate index was down -1.46% during the quarter. High yield and investment-grade debt posted negative returns during the first quarter, according to Bloomberg Barclays Capital indices. The total returns from corporate high yield were -0.86% for the quarter, while returns from investment-grade corporate debt produced total returns -2.32%. The yield on the High Yield Index, at 6.20%, is almost 50 basis points higher than year-end 2017 levels. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The 2-year Treasury yield climbed 38 basis points while the 10-year Treasury yield increased 33 basis points during the quarter to yield 2.27% and 2.74% for the period, respectively. Asset-Backed Securities and Government-Related were the best performing sectors within the U.S. Aggregate index. The two sectors returned -0.39% and -1.03%, respectively, for the quarter. U.S. Treasury bonds produced total returns of -1.18%. Aa bonds were the best-performing investment-grade credit quality during the first quarter, posting a -1.35% loss. Wirelines, Aerospace/Defense, Chemicals and Health Care were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly survey of bond yields – which includes input from more than 60 economists – forecasts that U.S. Treasury 10-year yields will increase to 2.95% in 2Q2018 and then rise to 3.27% in 1Q2019. All the yields are more than the forecasted yields of the February survey.

Where do we go from here? Will the economic environment be chaotic or calm? Things are not very settled globally, as our peculiar relationships with Russia, North Korea and China continue to unsettle the markets. Deteriorating international relationships have increased the volatility threat even with good news on the domestic economic front. Volatility has returned to the markets and is unlikely to go away anytime soon. If the equity market and global outlook remain in flux, the nine-year bull market will get weary and put stress on the treasury yield curve and descending force on long-term interest rates. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed over the long term.

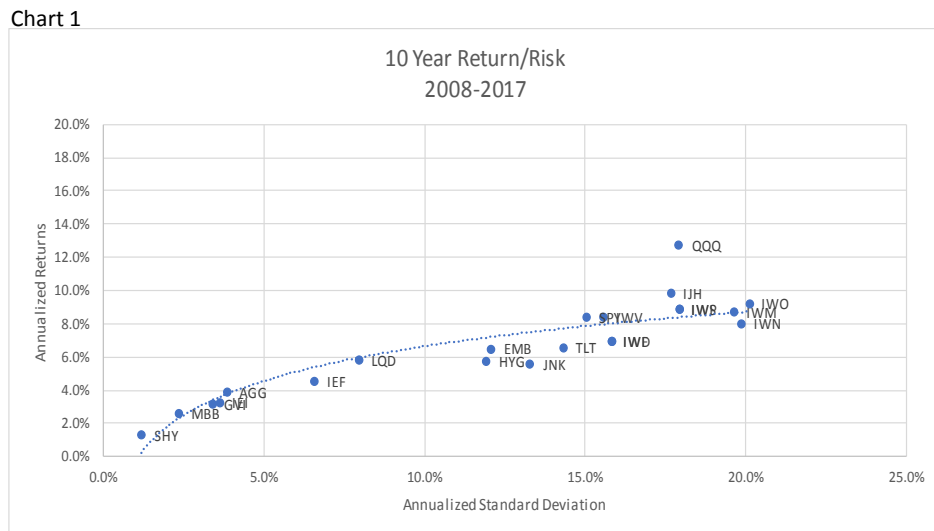
“ETF’s” from page 1

Where have we been regarding risk vs. return in various asset classes? To answer that question, I created a three-asset class scatterplot using standard deviation and total return. This allows us to focus on asset classes that have historically provided the best risk-adjusted returns. Risk and return data were gathered for sets of asset classes that could each be represented by an ETF proxy.

ETF is an acronym for exchange-traded fund. These types of investments have been around since the 1990s but they started to be traded more frequently about a decade later. These funds track various indices. When you buy shares of an ETF, you are buying shares of a portfolio that tracks the yield and return of its underlying index. Bond ETFs do not track the underlying index as well as equity ETFs do. ETFs combine the range of a diversified portfolio with the simplicity of trading a single stock. Investors can purchase ETF shares on margin, short sell shares, or hold for the long term.

I want to visualize the risk vs. return for various fixed income and equity asset classes. I use a logarithmic trendline which is a best-fit curved line. Logarithmic trendlines are most useful when the rate of change in the data increases or decreases quickly and then levels out.

“QQQ delivers an eccentric but wildly popular fusion of tech, growth and large-cap exposure.”



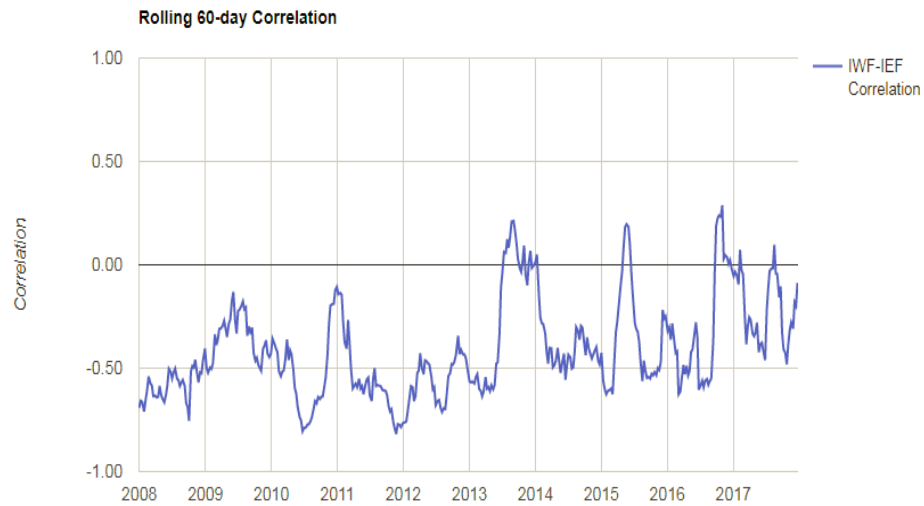
Source: iShares, Bloomberg and PIA

ETF Name:

Invmt Grade Corp Bond	LQD	Russell 3000	IWV
USD Emerging Mkts Bond	EMB	Nasdaq 100	QQQ
High Yield Corp Bond	HYG	S&P 500	SPY
High Yield Bond	JNK	Russell 1000 Growth	IWF
1-3 Year TSY Bond	SHY	Russell 1000 Value	IWD
7-10 Year TSY Bond	IEF	Core S&P Mid-Cap	IJH
3-7 Year TSY Bond	IEI	Russell Mid-Cap Growth	IWP
20+ Year TSY Bond	TLT	Russell Mid-Cap Value	IWS
MBS	MBB	Russell 2000	IWM
Core US Aggregate Bond	AGG	Russell 2000 Growth	IWO
Interm Govt/Credit Bond	GVI	Russell 2000 Value	IWN

Chart 1 shows insights from the broad asset classes that most equity strategies have outperformed other asset classes on a total return basis over the past ten years. On a risk-adjusted basis QQQ, AGG and MBS lead the way. QQQ delivers an eccentric but wildly popular fusion of tech, growth and large-cap exposure. The two high yield ETFs lagged on a risk-adjusted basis during the period.

Chart 2



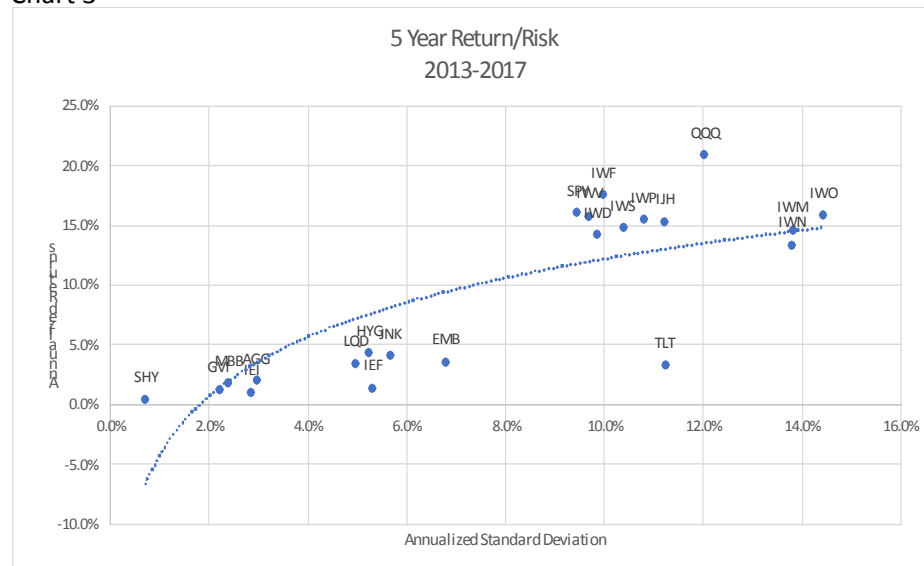
Source: Bloomberg Barclays Indices and PIA

The equity-bond relationship is very important. It drives pension models and asset allocation weights for liability sensitive investors. Correlations vary significantly over time. Chart 2 shows that the equity-bond correlation has been largely negative over the last ten years. More recently, the relationship has occasionally turned positive.

The volatility of an individual asset class is not as important as how that asset class impacts the volatility of the overall portfolio. An asset class with low correlations to other asset classes may reduce the total portfolio volatility even if the asset class itself is volatile. Portfolios are always in a constant search for that perfect combination.

“An asset class with low correlations to other asset classes may reduce the total portfolio volatility even if the asset class itself is volatile.”

Chart 3



Source: iShares, Bloomberg and PIA

In Chart 3 we can see examples of the strength of the broad equity markets. QQQ and IWF had the best absolute and best risk-adjusted returns for the past five years. For fixed income asset classes, we see that HYG, JNK and LQD had the best absolute and best risk-adjusted returns.

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Interest rate risk. Interest rate risk is the risk that debt securities will decline in value because of changes in market interest rates. Generally, when market interest rates rise, the value of debt securities declines, and vice versa. An account's investment in such securities means that the value of the account will tend to decline if market interest rates rise. The prices of long-term debt obligations generally fluctuate more than prices of short-term debt obligations as interest rates change.

Credit risk. Credit risk refers to an issuer's ability to make payments of principal and interest when they are due. Bond prices typically decline if the issuer's credit quality deteriorates. Lower grade securities may experience high default rates, which could mean that an account may lose some or all of its investments in such securities. If this occurs, the account's value would be adversely affected.

Investment grade bond risk. Investment grade bonds are considered less risky than bonds whose ratings are below investment grade; however, ratings are no guarantee of quality. The credit quality of these bonds can decline which would normally cause the prices of these bonds to decline.

Below investment grade bond risk. These bonds, commonly known as "junk bonds", involve a higher degree of credit risk. In the event of an unanticipated default, an account would experience a reduction in its income, a decline in the market value of the securities so affected and a decline in the account's value. During an economic downturn or period of rising interest rates, highly leveraged and other below investment grade issuers may experience financial stress that could adversely affect their ability to service principal and interest payment obligations, to meet projected business goals and to obtain additional financing. The market prices of below investment grade bonds are generally less sensitive to interest rate changes than higher-rated investments but are more sensitive to adverse economic or political changes or individual developments specific to the issuer. Periods of economic or political uncertainty and change can be expected to result in volatility of prices of these securities. NRSROs consider these bonds to be speculative in nature.

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Index Comparison - Barclays Capital indices have been used as comparative benchmarks because the goals are to provide fixed income like returns. These indices are some of the world's most recognized indices by investors and the investment industry for fixed income markets. These indices, however, are not managed portfolios and are not subject to advisory fees or trading costs. Investors cannot invest directly in these indices. These indices' returns also reflect the reinvestment of interest. Piedmont Investment Advisors, LLC is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients' performance results to a benchmark or a combination of benchmarks most closely resembling clients' actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance.

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