SLOCUM

43 Main Street SE, Suite 148
Minneapolis, Minnesota 55414
P: 612.338.7020 F: 612.338.7034
www.jslocum.com

Texas Hemmaplardh, CFA
Principal
612-252-9368
texash@jslocum.com

INVESTMENT UPDATE

ALBUQUERQUE COMMUNITY FOUNDATION
leadership • trust • legacy

JUNE 2016

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ACF INVESTMENT OBJECTIVE

Goals:

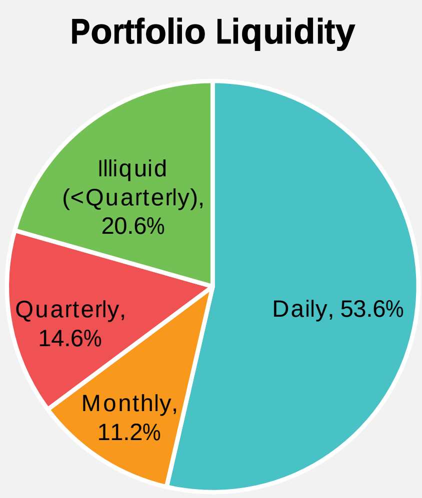
- Produce growth and income to support both donor goals and Foundation objectives
- Long-term objective:
  Inflation **+** spending rate **+** administration costs **=** ~7-8% per year

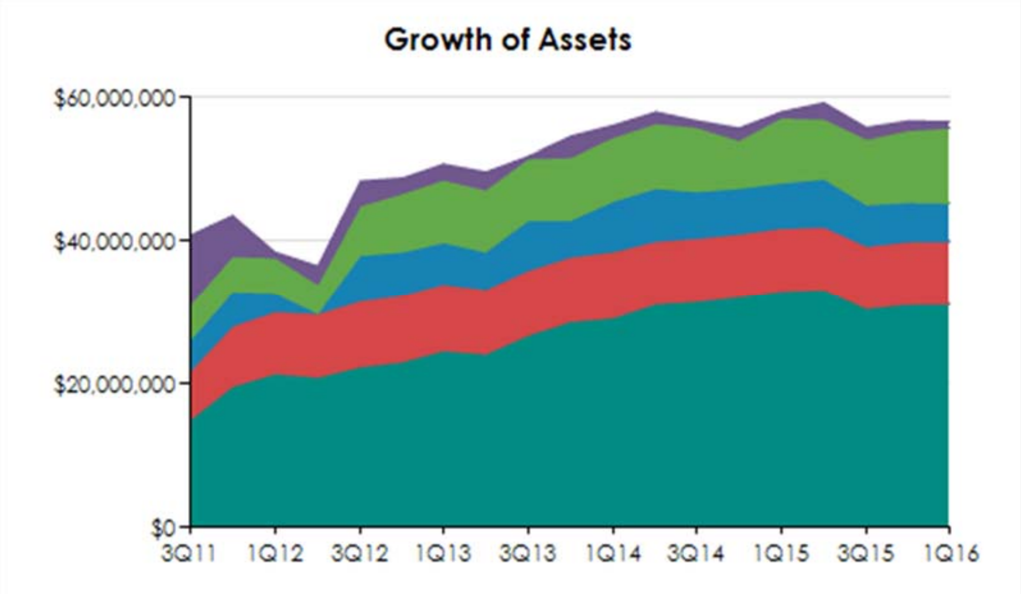
Strategy:

- Emphasize preservation and enhancement of purchasing power
- Total return philosophy (income + capital gains, not just income)
- Portfolio that "leans against consensus" and tilts toward value, as opposed to using a "growth" approach portfolio

ACF Asset Allocation and Growth

Asset Class		March 31, 2016		Target	Variance
Equity		$31,144,924	55.0%	55.0%	0.0%
Fixed Income		$8,770,392	15.5%	15.0%	0.5%
Real Asset		$5,432,248	9.6%	10.0%	-0.4%
Multi-Strategy		$10,468,728	18.5%	20.0%	-1.5%
Cash		$815,229	1.4%	0.0%	1.4%
Total Portfolio		**$56,631,521**	**100%**	**100%**	





Source: Slocum report, 3/31/2016

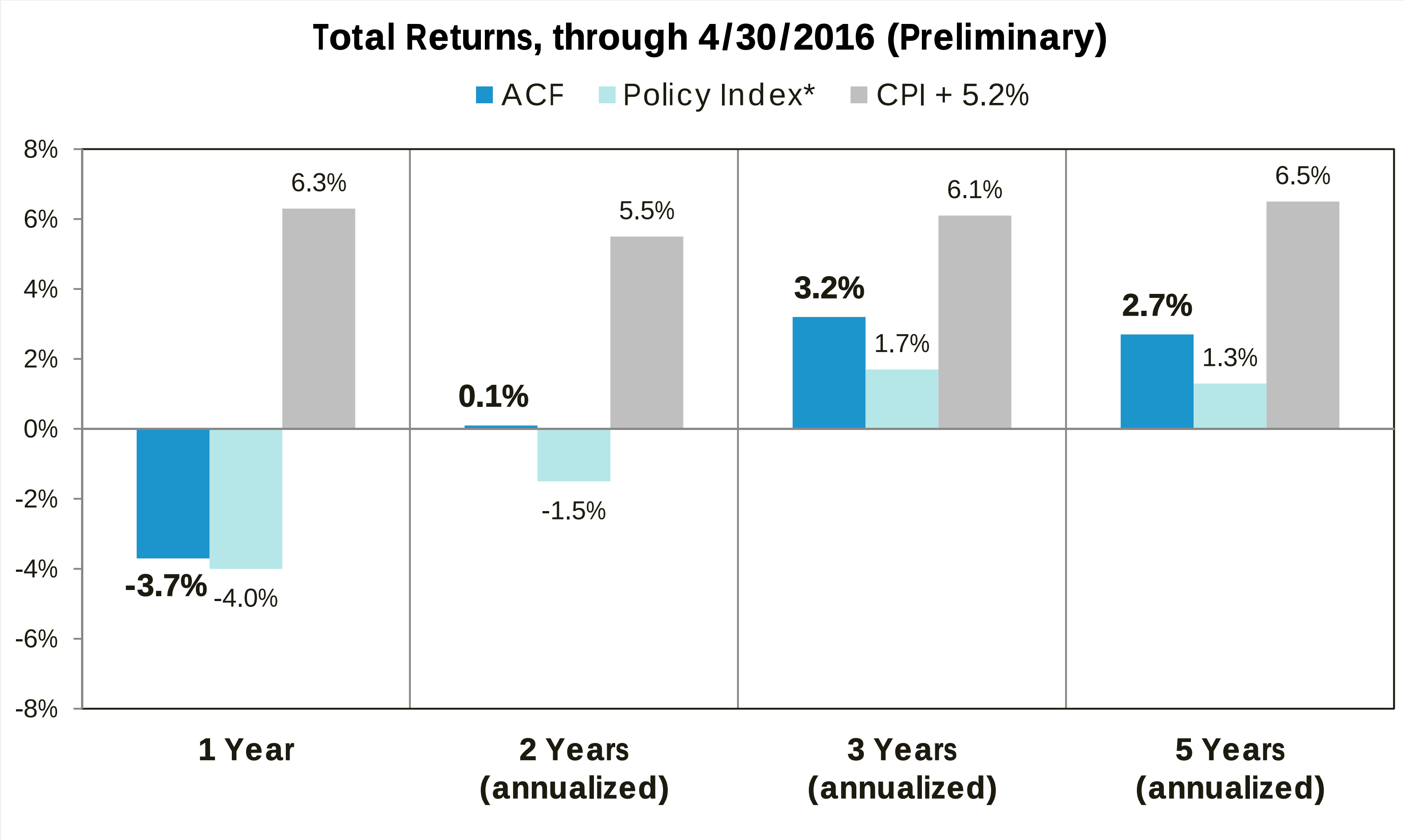
ACF Investment Managers*

Asset Class:	Style	Investment Manager	Style	Investment Manager
Equities:	Global Value	**Dodge & Cox**	Long/Short Equity	**Titan**
	Global Growth	**Walter Scott**	Long/Short Equity	**Common Sense**
	Global All Cap	**Vanguard (Total World Stk)**	Private Equity	**Audax**
	US "Smid" Cap	**DFA**	Private Equity	**Commonfund**
	Emerging Markets	**Parametric**	Private Equity	**Permal**
			Private Equity	**TIFF**
Fixed Income:	Core	**Baird**	Global	**Templeton**
	Opportunistic	**Goldman Sachs**	Private Opportunistic	**PIMCO**
Real Assets:	Commodities	**Blackstone**	Private Real Estate	**Bridge**
	MLPs	**Atlantic Trust**	Private Energy	**Quantum**
Multi-Strategy:	Multi-Strategy	**Hudson Bay**	Market Neutral	**Alyeska**
	Event-Driven	**Pentwater**	Multi-Strategy	**BlackRock**
	Event-Driven	**HG Vora**	Multi-Strategy	**Silver Creek**
	Opportunistic Trading	**River Birch**		

Manager names in **GRAY** are in the process of liquidation.

* as of 3/31/2016

ACF Investment Performance



*As of October 2015, the Policy Index consists of 55% MSCI ACWI IMI Index, 20% HFRI FoF: Conservative Index, 15% Barclays Global Aggregate Index, and 10% Real Assets Custom Benchmark. The Real Assets Custom Benchmark is an equally weighted benchmark comprised of 1/3 Bloomberg Commodity Index, 1/3 FTSE/NAREIT Global Index, and 1/3 Barclays U.S. TIPS 1-10 Yr Index. Prior to October 2015, the Policy Index consisted of 55% MSCI ACWI IMI Index, 20% HFRI FoF: Conservative Index, 15% Barclays Global Aggregate Index, and 10% Bloomberg Commodity Index. Returns are stated net of fees.

2015-2016 ACF Portfolio Activity

<u>2015</u>

- As part of a larger shift away from funds of funds and into direct investments:
  - Redeemed from Magnitude and Blackrock Tempus
  - Hired Hudson Bay, Pentwater, HG Vora, River Birch, and Alyeska
- Redeemed from PIMCO (All Asset)
- Approved commitments to Audax (Private Equity)
- Replaced Vanguard Dividend Appreciation Fund (US Equity) with Vanguard Total World Stock Index (Global Equity)

<u>2016 Year-to-Date:</u>

- Replaced Janus with Baird (Fixed Income)

Key Drivers of Performance

1. **Diversified globally, both in equities (stocks) and fixed income (bonds)**

   → This has held back performance as the U.S. has outperformed the rest of the world, even as both U.S. stocks and bonds have become increasingly expensive

2. **Very low exposure (~5%) to traditional "core" U.S. fixed income (bonds)**

   → This has held back performance as the U.S. interest rates have continued to fall

   → Multi-Strategy investments (20% of the portfolio), used as less volatile alternatives to equity, have not outperformed traditional "core" bonds

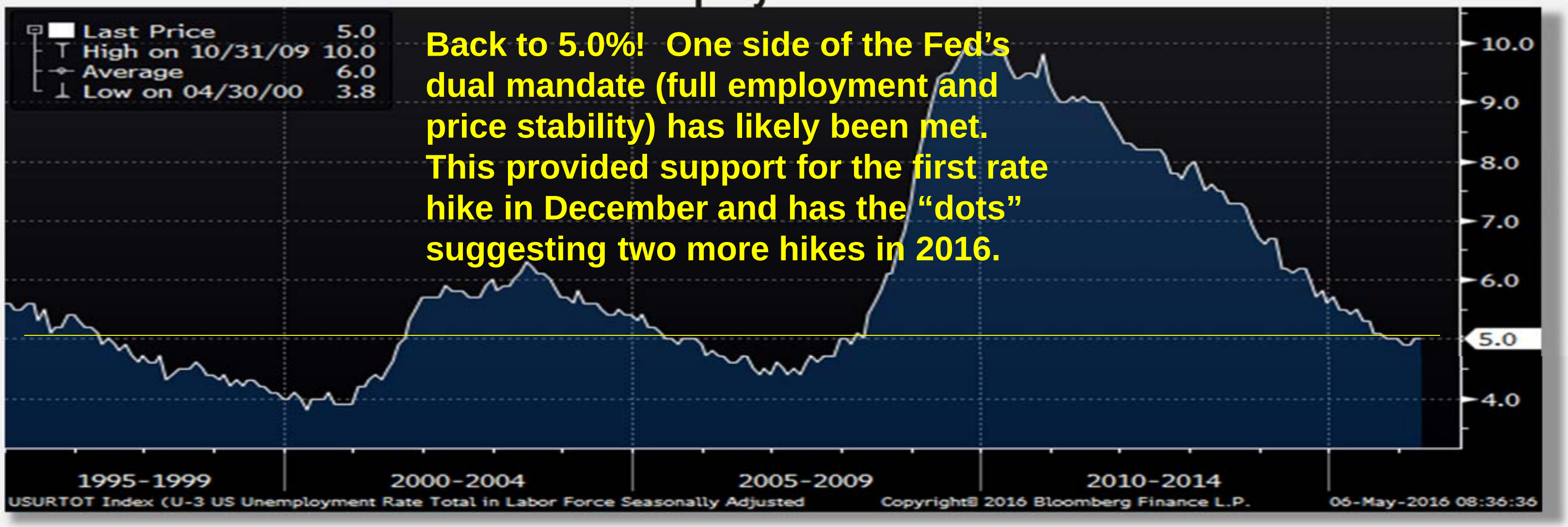
3. **Significant exposure (~18%) to private investments**

   → These funds have materially boosted performance over the intermediate and long term (one year and longer), although with a "lag" given their private nature

Economic & Market Update

Employment has Improved

U.S. Unemployment Rate

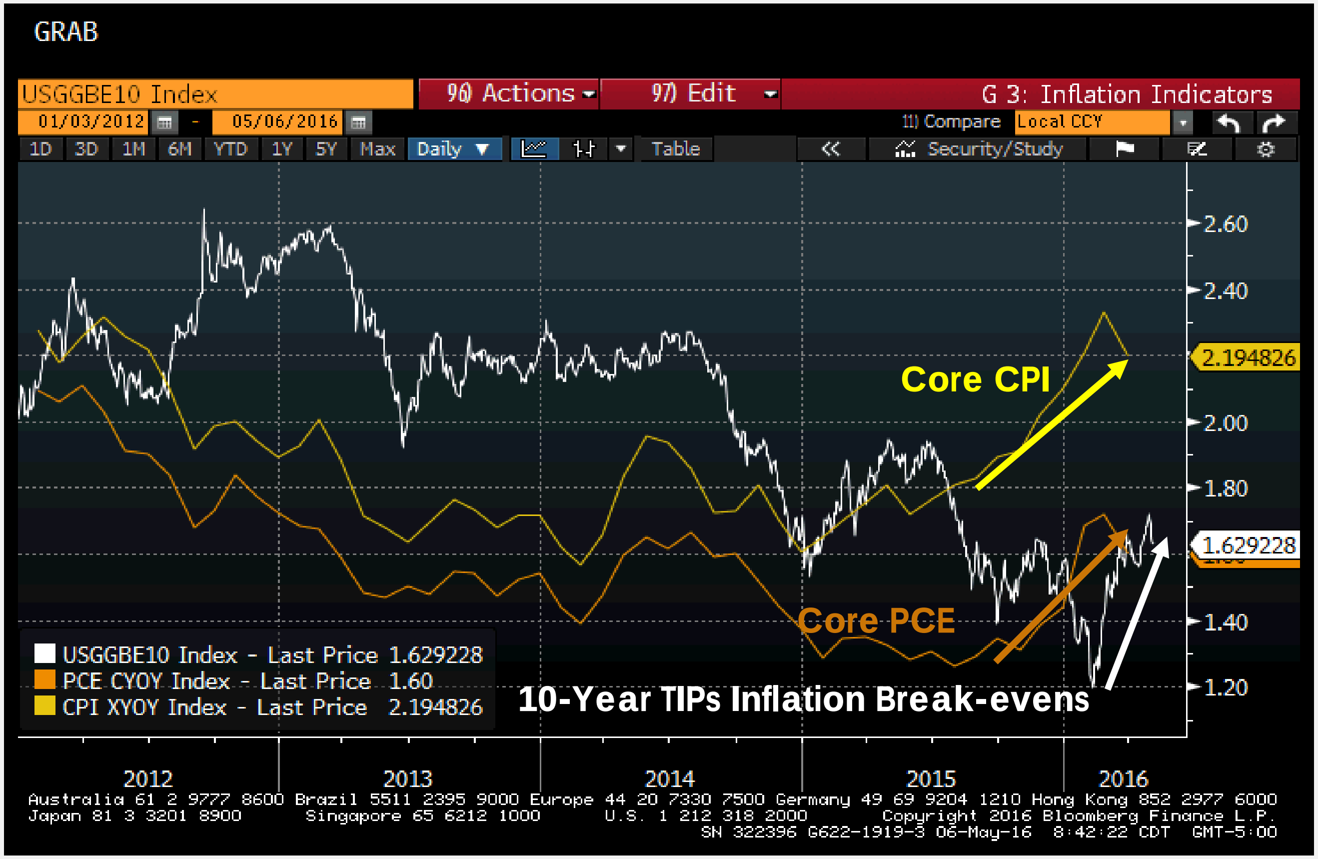


U.S. Initial Jobless Claims

Source: Bloomberg

Inflation has Finally Begun to Turn Up, Too

Inflation Measures



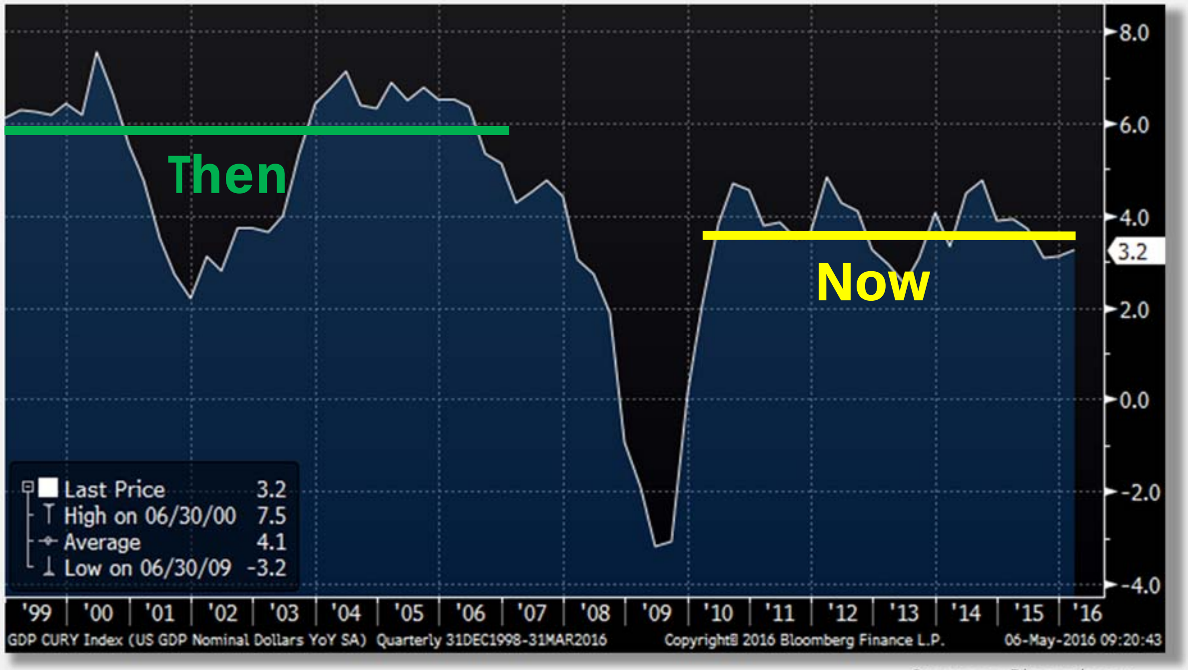
Source: Bloomberg

Employment measures have been improving, but inflation had been absent. The Fed's price stability mandate had been difficult to achieve as deflationary forces outweighed inflationary forces. That appears to be changing recently.

GDP – Improving but Still Below Potential

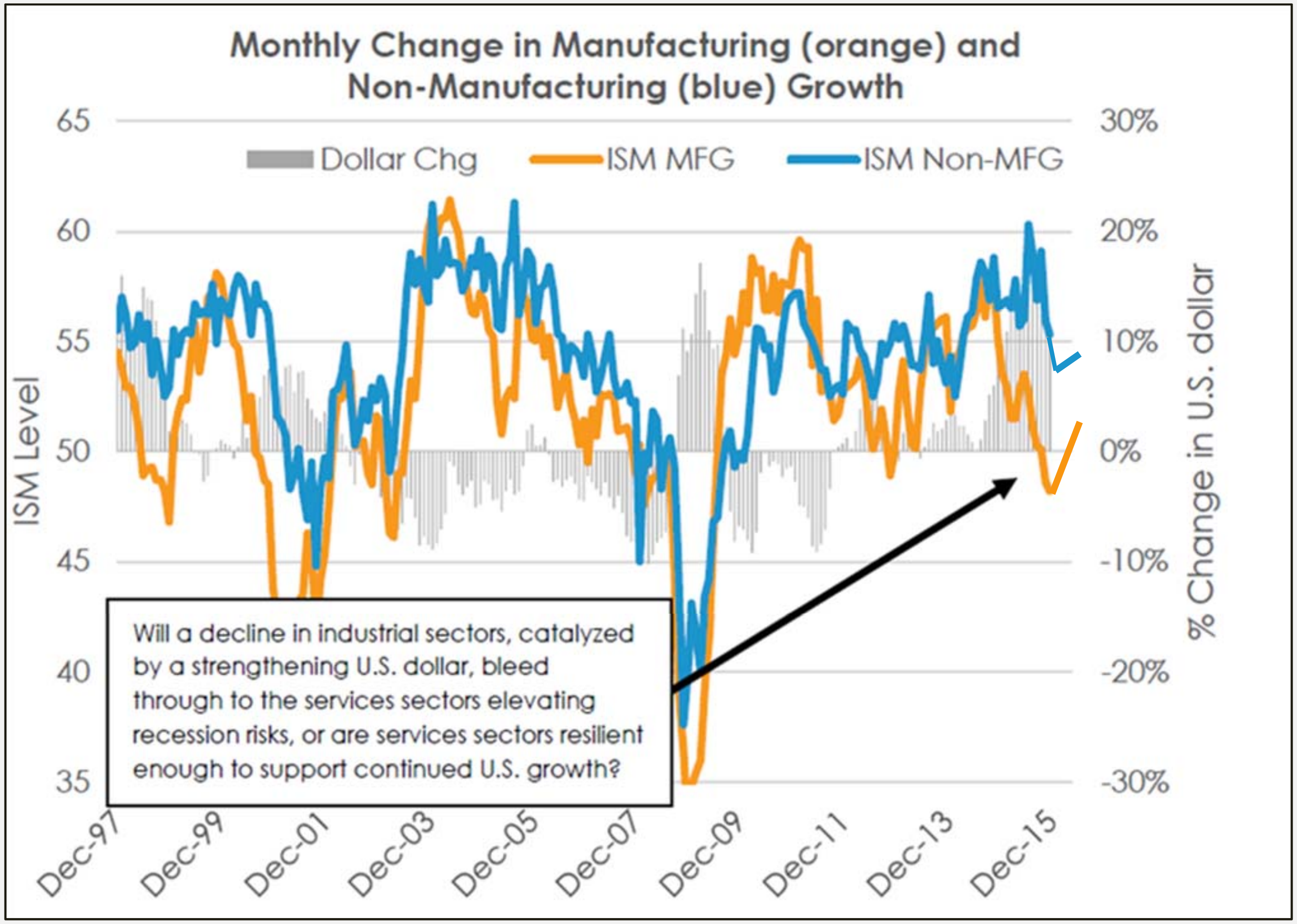
- **Nominal GDP is trending towards 4% in 2016** (despite the soft Q1) – consisting of roughly 2% inflation and 2% real growth. Risks from the slowdown in China and collapse in the energy and materials sectors are being offset by strength in the U.S. consumer and housing sectors.

- **This is a notable deceleration from the 6% rate of the 1990s and early 2000s**, though the remarkable decline in energy prices should boost economic growth despite not showing up in the data thus far.



Source: Bloomberg

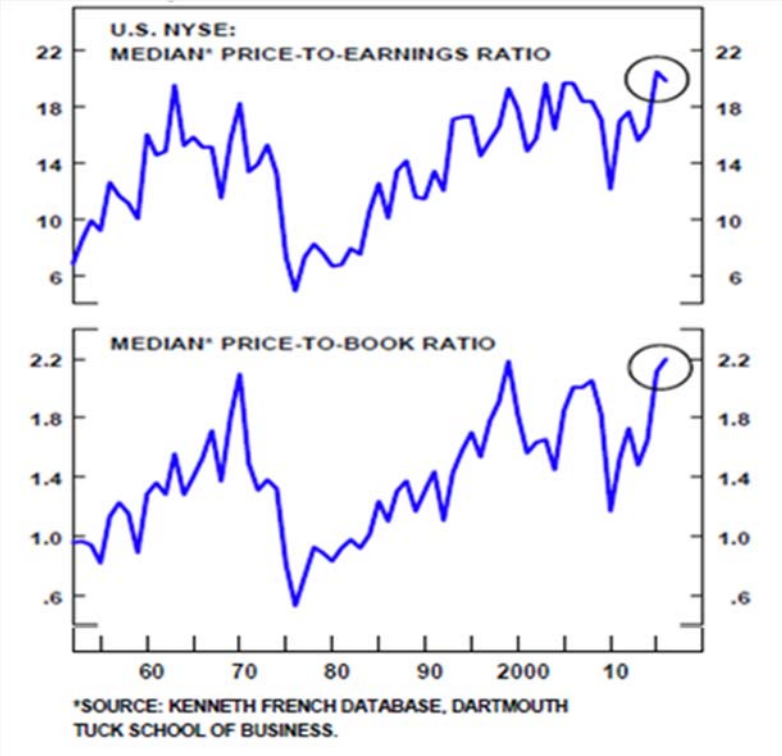
U.S. Manufacturing Recovering From a Mild Recession



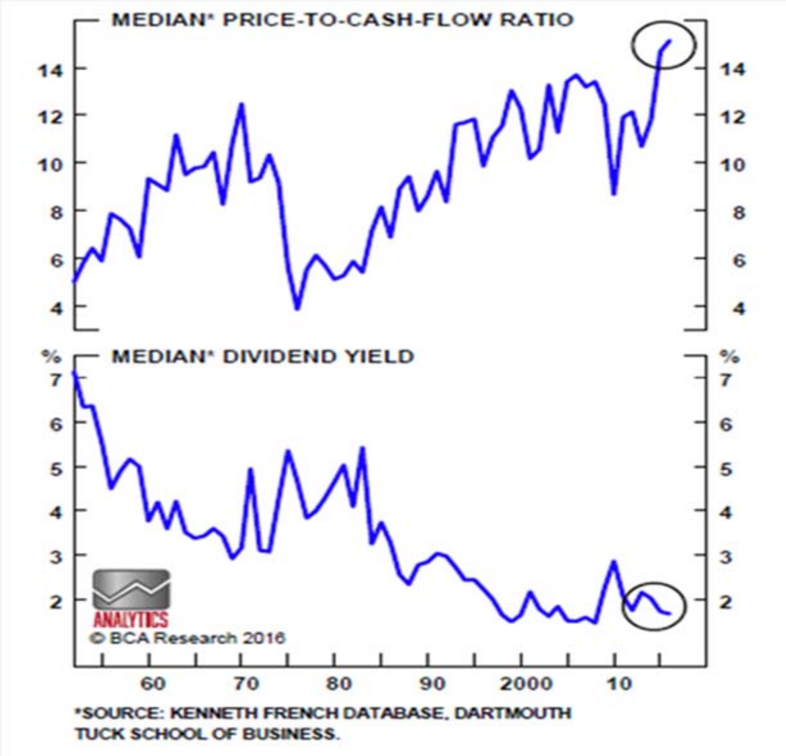
Source: Bloomberg, Slocum

Weakness in the manufacturing sector is a risk, but it represents only ~10% of the U.S. economy. The recent rebound reduces risks that the rest of the economy would be dragged down with manufacturing.

Equities are Pricey Relative to History



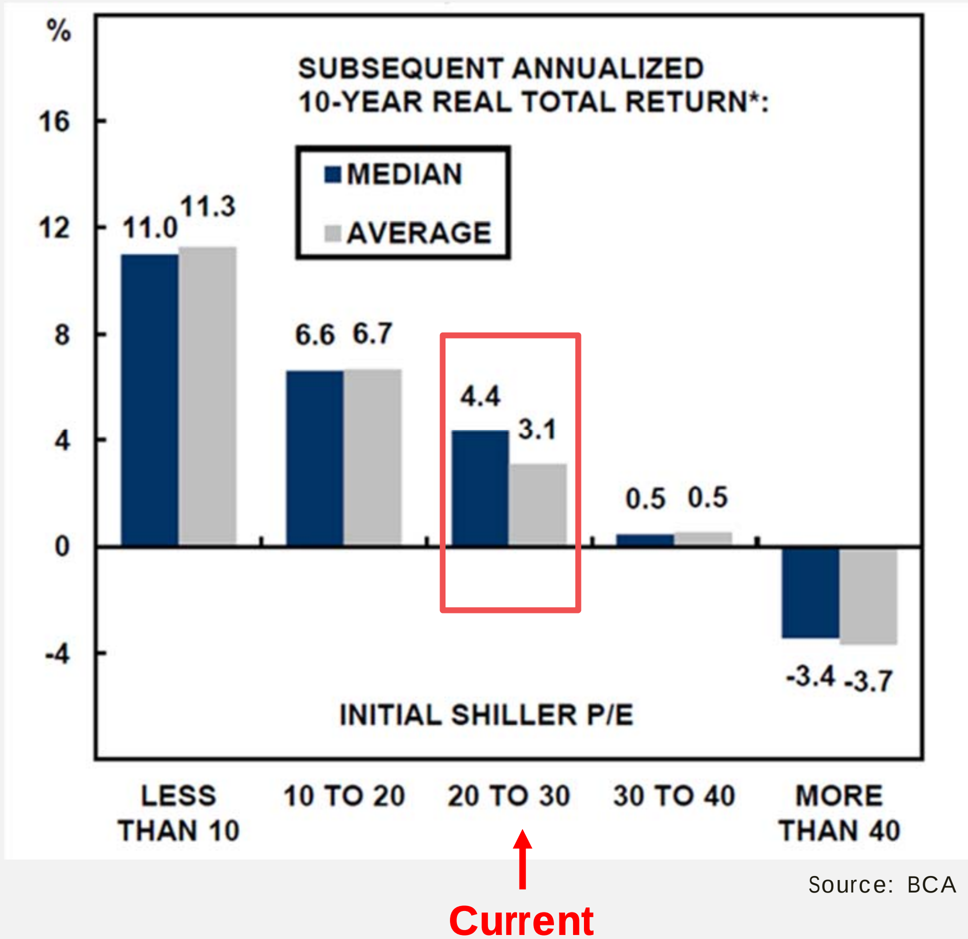
Source: BCA



Source: BCA

Equities are priced at the high end of virtually every valuation measure. This may not result in an imminent correction, but at a minimum, return expectations should remain quite low.

SHILLER P/E INDICATES LOW RETURNS



Source: BCA

The price one pays for equities is a very good determinant of the subsequent returns that are likely to be achieved. The Shiller P/E currently is 25, suggesting 10-year real total returns of about 4%.

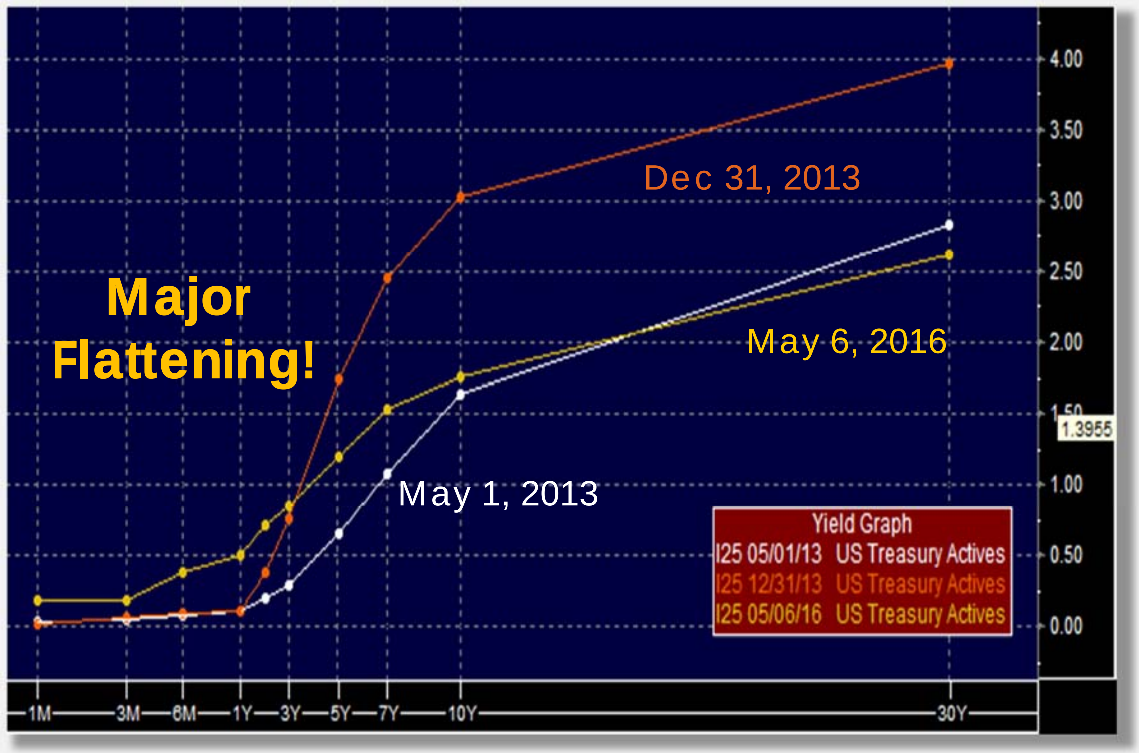
INTEREST RATE REGIME SHIFT

- **Interest rates have been on a wild ride.** Following 30 years of declining rates, Bernanke's "taper" speech in May 2013 led to higher rates for the balance of 2013. Global forces, however, including deflation in Europe and Asia, a strong dollar and pension de-risking drove rates lower in 2014 and again in early 2016. The overall yield curve is flattening at historically low interest rate levels.

- **The Fed increased the Fed Funds interest rate on December 16, 2015,** the first hike since 2006.

- **Long-term interest rates have fallen due to substantial demand for bonds** by liability-matching defined benefit pension plans: the 30-year Treasury bond traded at all-time low yield of 2.22% in January 2015.

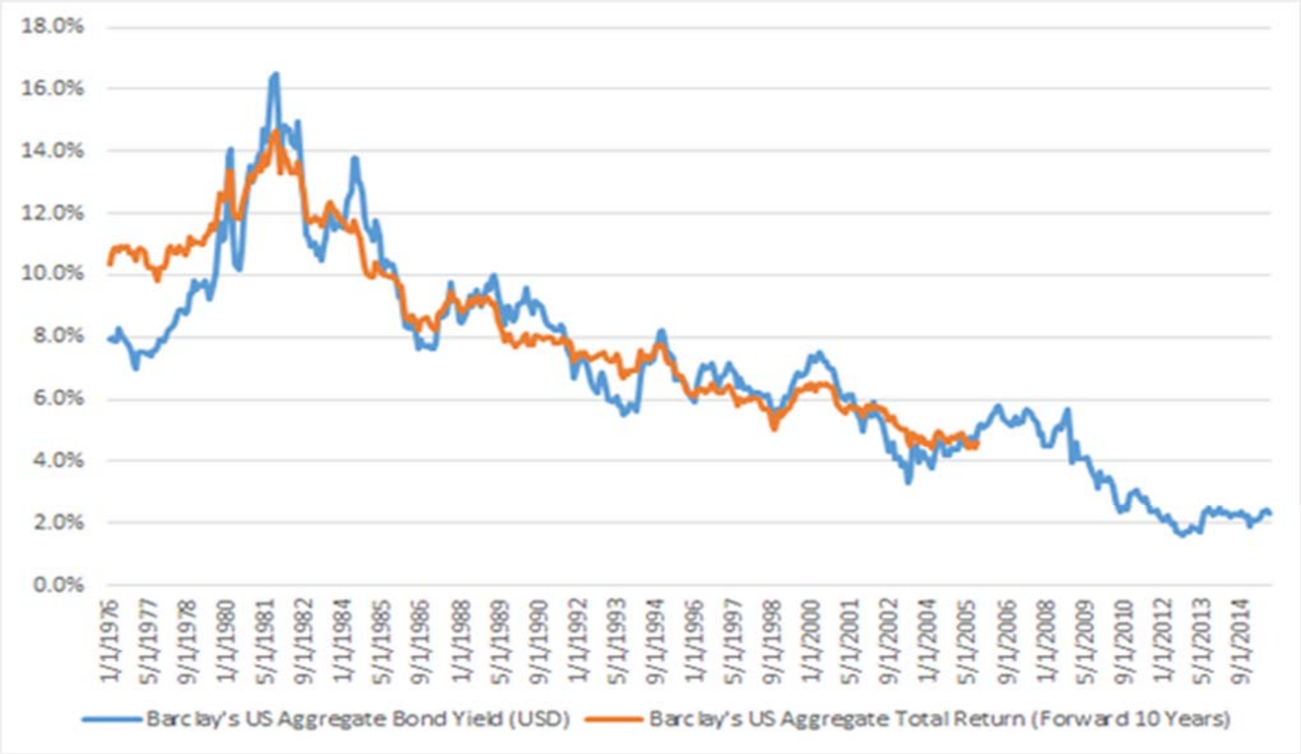
- **Massive capital flows into the U.S.** have also occurred as global investors seek to benefit from higher rates in the U.S. relative to their home markets.



Source: Bloomberg

FIXED INCOME RETURN PROSPECTS ARE MUTED

Seven-year return expectations for "core" fixed income are 0-2%, essentially the beginning yield.



Future returns of core fixed income exposures can largely be explained by the yield received at the time of investment. Currently, the Barclays U.S. Aggregate Bond Index yields ~2%, while the Global Aggregate yields ~1%.

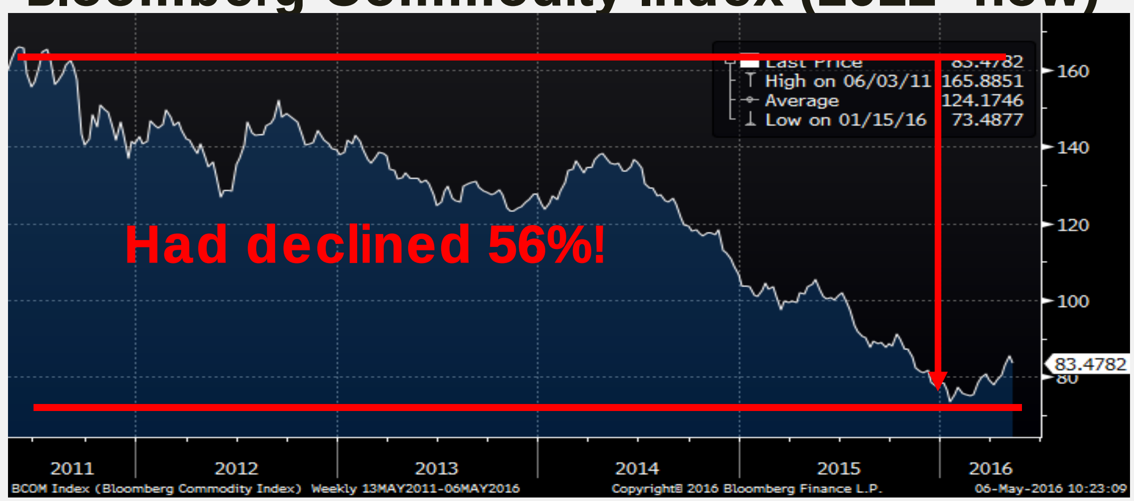
IS THE COMMODITY SELLOFF OVER?

- Using the last period of U.S. Dollar strength in the late 1990s as a guide, the commodity price rout appears to be well advanced

- While the rising strength of the U.S. dollar has only been playing out for about three years in what have historically been 3-5 year trends, the weakness in commodities has been going on for nearly 5 years.

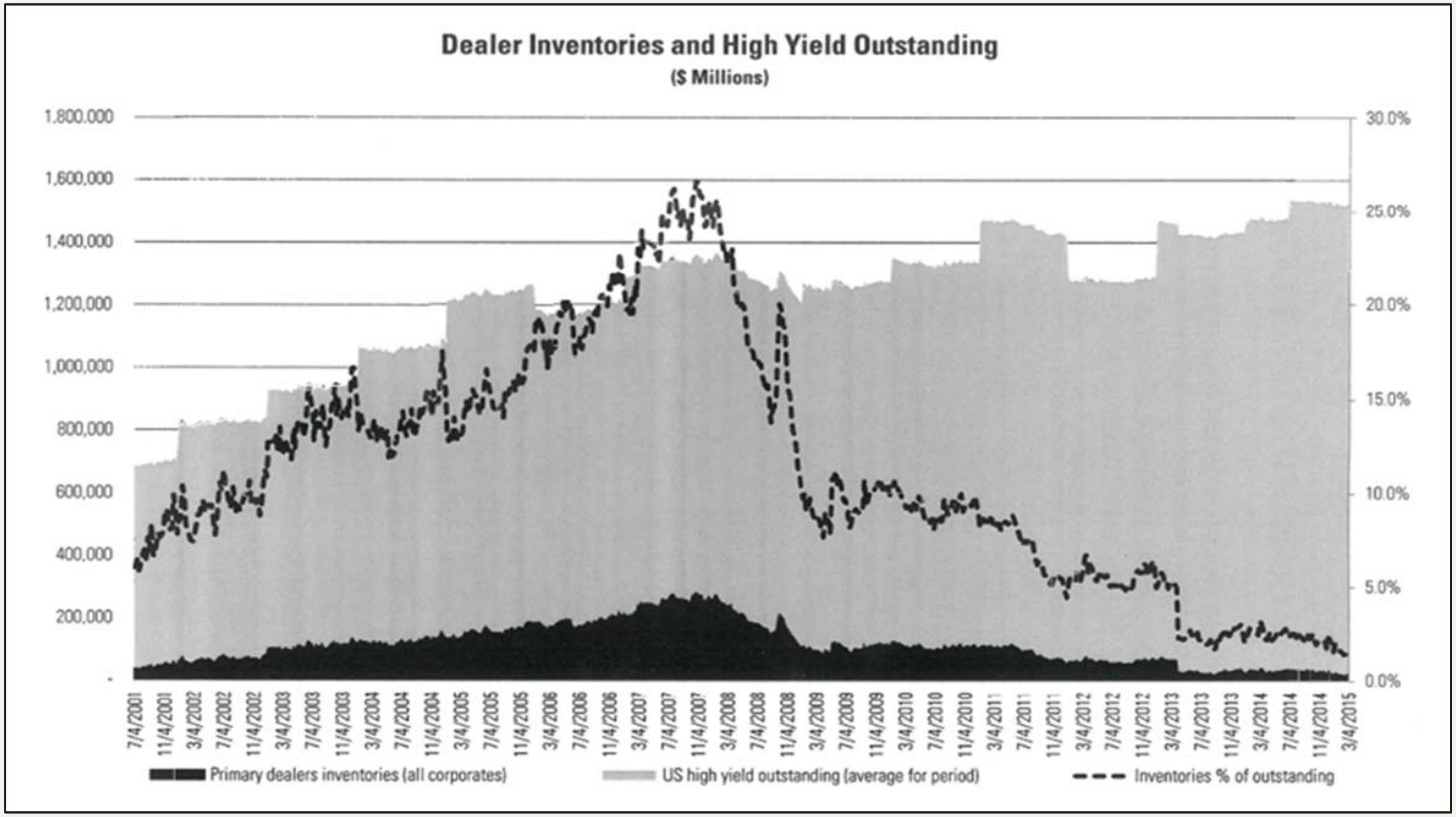
Bloomberg Commodity Index (1996-1999)

Bloomberg Commodity Index (2011- now)



Source: Bloomberg

LACK OF DEALER INVENTORIES COULD EXACERBATE VOLATILITY

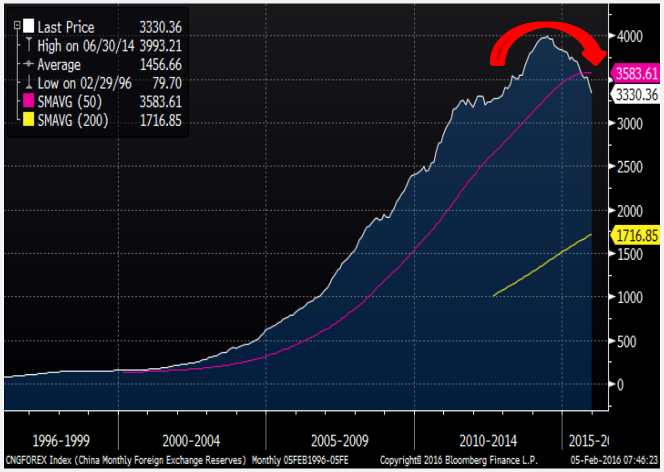


Source: SkyBridge

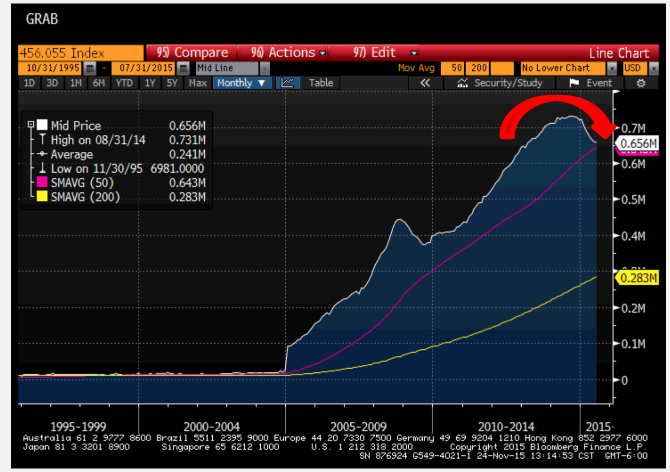
Dodd-Frank regulations have led dealers to dramatically reduce their inventory of corporate bonds. Dealers formerly acted as "shock absorbers" and liquidity providers. In a market shock, volatility may be significantly greater today. This likely contributed to the big rise in volatility in late August 2015 and in early 2016.

The Savings Tide is Flowing Out

China FX Reserves

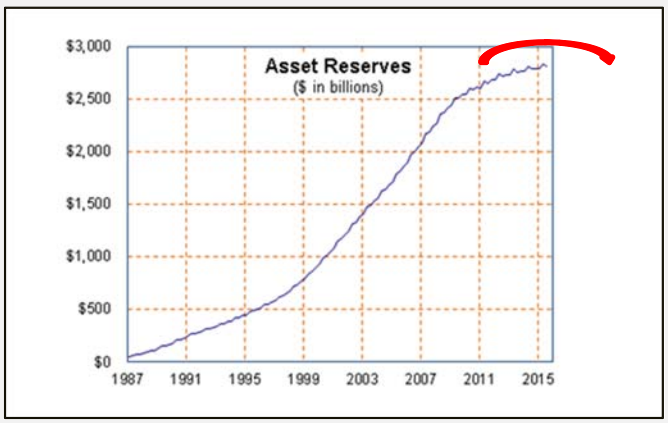


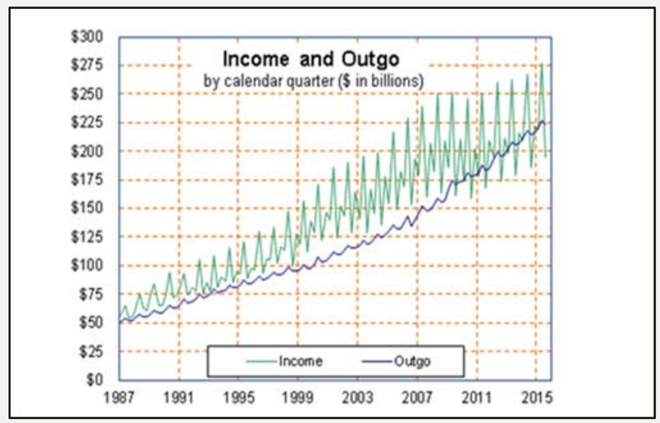
Saudi Arabia FX Reserves



U.S. Social Security System

Source: Bloomberg, ssa.gov





For decades, savings have accumulated in public systems of pensions, foreign exchange reserves, and sovereign wealth funds. A trifecta of aging demographics, low commodity prices, and poor budgeting has turned these asset accumulators into asset sellers.

KEY RISKS

- **Prices – U.S. equities are fully valued.** On the surface, a 17.1x P/E multiple doesn't seem extreme, however it is a full multiple applied to very high profit margins.

- **Emerging Markets – A strong dollar, weaker commodity prices, and geopolitical risks collided.** All of these are reversing the easy credit and money flows that EMs experienced in recent years.

- **China – China is in a credit bubble** and growth is slowing rapidly.

- **Capital Flows – For several decades, vast savings pools have been built up**, but many of the largest asset buyers of recent years into asset sellers.

- **Liquidity – Market liquidity has declined.** Expect more sharp moves as asset flows become one-sided. Market volatility will likely remain higher than in the previous several years.

- **Monetary Policy Misstep – Risks of a mistake are very high** as the largest stimulus effort in history is unwound. Faith in central banks is declining.

CONCLUSIONS

- **Expect low returns.**
  - Prices for risk assets have been driven higher due to unattractive returns in risk-free assets. We still expect positive returns for stocks in the intermediate term, but the returns will likely be low.
  - Despite rising rates, one can still make money owning bonds, but returns are likely to be low, and asymmetric risks exist. Treasury duration, while offering little absolute value, remains one of the few positive-carry assets that should protect portfolios in a market shock.

- **Rising U.S. rates are supportive of the U.S. dollar, at least in the short term.**
  - We need to respect the length of the cycle and price moves that have already occurred. Look for opportunities to add exposure to Emerging Markets and Natural Resources that have been crushed.

- **Stocks remain fundamentally cheap relative to bonds.**
  - However, prices now reflect "full" multiples on very high profit margins. Beware risks of a sharp repricing. Given the greater uncertainty, it is prudent to build in a greater margin of safety for stocks.

- **Seven-year return expectations for passive, balanced portfolios are muted.**
  - Fixed income returns are likely to be in the 0-2% range and global stocks in the 3-6% range.