QUARTERLY
Market
TALK

4TH QUARTER - 2017

We at Sterling Capital Management feel very privileged to partner with AE Wealth Management. As the outsourced chief investment officer for the AE Wealth Management platform, we're engaged in three key support areas for you and your clients: providing custom asset allocation frameworks, selecting high quality investment managers and constructing well-diversified portfolios. Importantly, of course, we remain engaged every day in the ongoing monitoring and periodic rebalancing of those portfolios over time.

Today, we are pleased to provide a review of global financial markets during the fourth quarter of 2017, to reflect on changes we made to our portfolios during the quarter, and to update our current positioning and outlook.

EQUITY MARKET REVIEW

Beginning with equity markets, global equities capped off a remarkably strong year by rising 5.75 percent in the fourth quarter of 2017. For the year, the Russell Global Index returned 23.9 percent, which represented the highest calendar year return since 2009. Emerging markets outperformed developed markets by a wide margin in 2017, and international developed markets outperformed U.S. equities for the first time since 2012. Synchronized global economic growth played an important role in pushing global equities higher in 2017. In fact, all 45 countries tracked by the Organization for Economic Cooperation and Development (OECD) were likely to generate positive economic growth in 2017, which would represent the first time since 2007 in which all countries simultaneously experienced positive growth. In addition, 33 of these countries were likely to experience accelerating growth compared to 2016, which would represent the highest number since 2010.

In the U.S., the Russell 3000 broad market equity index rose 21.1 percent for the year, marking the ninth consecutive year of positive gains, and posted a strong 6.3 percent gain in the fourth quarter, which represented the ninth consecutive quarter of positive returns. In fact, the index has now posted positive returns in 21 of the past 22 quarters. U.S. equities made multiple new highs during Q4, partially fueled by the passage of tax reform in late December. While Hurricanes Harvey and Irma put downward pressure on third quarter S&P 500 index earnings growth, consensus earnings estimates called for a return to double-digit earnings growth in Q4 of 2017 and throughout 2018. U.S. economic indicators such as consumer confidence, small business confidence, employment and manufacturing data generally remained favorable during the quarter, and a 3.2 percent U.S. GDP growth in Q3 was the highest quarterly rate of growth in over two years. Despite factors like the Fed hiking rates three times, the presence of above average equity valuations and rising tensions with North Korea, equity market volatility remains near record lows. Over the course of the third and fourth quarters, the S&P 500 index failed to decline by more than 0.5 percent for more for 50 consecutive days, a streak not seen since 1965. Additionally, the S&P 500 produced a positive return in every month during 2017, something

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that has never happened in a full calendar year. Investors clearly chose to focus on improving economic data, strong earnings growth and pro-growth developments from Washington such as deregulation and tax reform to fuel the equity market's nearly uninterrupted march higher in 2017.

On a sector, size and style basis, growth continued to outperform value in the fourth quarter. Consumer discretionary and technology were among the top-performing sectors during the quarter, while real estate and utilities underperformed the broader market. Large-cap stocks outperformed mid-cap and small-cap stocks during the quarter. For the year, growth outpaced value by a considerable margin largely as of a result of outsized returns from technology stocks such as Facebook, Amazon, Apple, Microsoft and Google. This group accounted for roughly one quarter of the S&P 500 index's gain in 2017. The technology sector as a whole was the best-performing sector during the year (up over 37 percent), while energy, the only sector to post a negative return in 2017, was the worst-performing sector, falling 1.7 percent.

Moving outside the U.S., international equities rose 5+ percent during the quarter. Emerging market equities were once again the top-performing geographic segment, rising 7.7 percent in Q4. Growth outperformed value, and small-caps outperformed large-caps in both international developed and emerging markets. Japan, South Korea and India were among the top-performing international equity markets during the quarter, while Italy, Brazil and Russia were among the worst.

For the full year of 2017, international equities returned 27.8 percent, with international developed markets delivering a 25.3 percent return and emerging markets rising 36.3 percent. Similar to U.S. equities, growth significantly outperformed value during the year in both international developed and emerging markets. Technology was the best-performing sector by a significant margin, rising over 50 percent during the year. The energy and telecom services sectors lagged behind the broader international equity market, but still generated double-digit returns. Small-caps outperformed in international developed markets, while large-caps outperformed in emerging markets.

A weakening U.S. dollar played a meaningful role in driving international equity outperformance in 2017, but improving economic conditions and strong earnings growth were also key reasons for the improved relative performance for international equities. For example, eurozone unemployment fell to eight-year lows in 2017, and European manufacturing indicators reached six-year highs. In addition, the unemployment rate in Japan declined to a 23-year low, and inflation indicators in Europe and Japan trended in a positive direction throughout the year. As economic growth improved in Europe, the European Central Bank announced it would scale back its quantitative easing program, but also announced an extension of the bond buying program into late 2018. Nevertheless, key international central banks generally remain more accommodative when compared to the U.S.

PORTFOLIO POSITIONING

In terms of portfolio positioning, we made a few minor net-of-benchmark asset allocation changes to the equity portion of portfolios. As of Dec. 31, the portfolio continued to maintain an underweight to U.S. equities, primarily as a result of underweights to U.S. mid-cap value and U.S. large-cap growth. Conversely, the portfolio had an overweight to international developed equities largely as a result of an overweight to international developed growth. Emerging markets exposure remains in line with the benchmark. More notably, during Q4, we increased actively managed exposure within the equity portion of portfolios from just under 50 percent to approximately 75 percent, as the environment for active management appears to be improving. While we believe increasing actively managed exposure is prudent at this stage of the market cycle, we continue to utilize passive strategies and believe the selective use of low-cost passively managed investment strategies in combination with actively managed strategies in more efficient segments of the market can help maximize the portfolio's risk and return profile and reduce fees.

BOND MARKETS

Now, turning to bond markets, the Bloomberg Barclays Aggregate Bond Index, a proxy for overall fixed income performance, posted a positive 3.5 percent return for the year, moving higher by 0.39 percent for the final quarter. Most all areas of the bond market produced positive absolute returns and, similar to the equity markets, volatility in fixed income was muted.

Looking at different segments of fixed income markets during the quarter, corporate credit spreads continued to compress, pushing the annual return for investment grade corporate bonds to 6.2 percent and high yield corporates to 7.5 percent.

Within the structured space, Agency mortgage-backed securities outpaced the broad market again, and Treasury inflation protected securities (TIPS) outpaced nominal Treasuries for both the quarter and the year as break-evens moved higher.

Foreign developed and emerging market debt both outpaced the broad market during the quarter and produced annual returns of 2.1 percent and 9.3 percent, respectively.

And, finally, municipal bonds returned 0.75 percent for the quarter and 5.5 percent for the year. Volatility picked up within the sector during the quarter due to tax reform proposals. As a result, issuers fast-tracked deals into 2017 and supply accelerated during the quarter, specifically in December, which set a monthly record.

During the fourth quarter, we did make both asset allocation and manager selection changes to our core fixed income portfolio.

From an asset allocation perspective, following an increase in market-implied inflation over the previous quarter, Sterling's analytics forecasted TIPS to underperform comparable Treasury securities over the next year. As a result, we removed TIPS from the portfolio and those proceeds largely went to a currency-hedged international fixed income allocation.

Regarding manager selection, we added the Prudential Total Return Fund to the core fixed income portfolio in Q4. This fund, similar to the other funds in the core/aggregate sleeve of the portfolio, seeks to outperform the Bloomberg Barclays Aggregate Bond Index over a full market cycle. To fund this allocation, the three other funds currently in the core/aggregate sleeve were trimmed.

With respect to positioning, similar to last quarter, our taxable core fixed income portfolio remains short duration relative to its benchmark. It also maintains an overweight to credit, both corporate and structured, and an underweight to government-related securities, specifically Treasuries. Yield curve positioning remains a focus.

Our municipal bond portfolio also remains slightly short duration and maintains an overweight to essential service revenue bonds and an underweight to general obligation bonds.

FOURTH-QUARTER REVIEW

For the fourth quarter overall, our balanced portfolio posted strong absolute returns of more than 3.5 percent, which pushed 2017 calendar year returns to a 16.3 percent increase with relative returns that compared favorably to both benchmark and peers for the year. Manager selection decisions drove relative outperformance versus both benchmark and peers during 2017.

Leading contributors on the equity side for Q4 included our international developed market large-cap value manager, which outperformed the quarter's benchmark by 1.7 percent. On the fixed income side, the most significant contributor was the recently added Prudential Total Return Bond Fund which outperformed its Barclays Aggregate bond benchmark by half a point in Q4.

Overall, we're pleased with Q4 and full-year 2017 results and remain confident that we're well-positioned for markets ahead.

Thank you very much as always for your interest, trust and support, and we look forward to a continued strong and successful partnership.

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