Structured Equity

Quarterly Commentary

Third Quarter 2015

Market Commentary

For U.S. equities, volatility arrived with a vengeance in August 2015. In fact, volatility was 34% higher than at the end of the second quarter. Meanwhile, intra-stock correlations increased significantly in the third quarter. The continued turbulence in the global economy – including China, Europe, and Japan – led to a significant sell-off in August and September. In the U.S., fallout from the Federal Reserve's interest-rate policy decision and lack of action also contributed to the increased volatility.

Oil prices continued to move lower, credit spreads widened, and the profit cycle slowdown remained a challenge, for large-, mid- and small-cap U.S. equities, which were at stretched valuations. Large-cap stocks fell the least, as the Russell 1000 gave up -6.83%. The fallout was more severe among mid- and small-cap stocks, with the Russell Midcap Index falling -8.01% and the Russell 2000 dropping -11.92%.

The Russell 2000 Growth Index (-13.06%) underperformed the Russell 2000 Value Index (-10.73%). Among small caps, the growth style has been in the lead for a long stretch of time, but finally gave way to the value style in the third quarter. Year-to-date, the Russell 2000 Growth Index (-5.47%) is still ahead of Russell 2000 (-7.73%) and the Russell 2000 Value (-10.06%).

Among small caps, all sectors had negative absolute performances, led by the Energy, Durable Goods, Materials, and Health Care sectors. REITs and Utilities were the least affected. Although monetary policy continues to be facilitative for equity investors, momentum strategies (such as price and earnings) are waning among small caps. Allocations that were high quality, larger-sized, and had a defensive bias helped managers with active investments. The Commodities and Materials sectors continue to sell-off, while the Health Care sector (particularly biotechs) has also joined this party.

The PNC Capital Advisors Structured Equity portfolios are based on an approach to stock selection that emphasizes reasonable valuations, improving fundamentals, and increasing awareness of investor behavior. Risk management in portfolio construction also contributed in our steady march to add positive performance relative to the benchmark for the Structured Small Cap Growth Equity and Structured Small Cap Value Equity strategies.

Momentum strategies and cash flow metrics were the drivers of our relatively strong performance. Revenue-based factors like sales-to-price and sales growth were poor indicators. Our allocation to the Financial, Energy, and Industrial sectors was additive and majority of our performance detractors were in the Health Care and Information Technology sectors.

Our best factor overlay shows short-term investor interest in companies with net income surprises, free cash flow, and momentum factors. Revenue-based factors are at the bottom in terms of short-term effectiveness. A stock, its correlations, and its factors should be monitored diligently during the upcoming quarter and in early 2016.

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Portfolio Commentary

Structured Small Cap Core

The Structured Small Cap Core Equity portfolio returned -6.52% in the third quarter versus -11.92% for the Russell 2000 Index (Composite returns are gross of fees. Net of fees the strategy returned -6.73%).

During the quarter, the portfolio was overweight in the Industrial and Financial sectors and underweight in the Information Technology, Utilities, and Consumer Discretionary sectors.

Sector allocation was a slight detractor, deducting -27 basis points (bps) and was positive only in the Energy and Financial sectors. Security selection was strong (565 bps), particularly in the Industrial (201 bps), Consumer Discretionary (112 bps), and Information Technology (108 bps) sectors.

Heading into the fourth quarter, the portfolio is overweight in the Industrial and Materials sectors and underweight in the Utilities, Information Technology, and the rest of the sectors.

Structured Small Cap Growth

The Structured Small Cap Growth Equity portfolio returned -8.57% in the third quarter versus -13.06% for the Russell 2000 Growth Index (Composite returns are gross of fees. Net of fees the strategy returned -8.78%).

During the quarter, the portfolio was overweight in the Financial, Industrial, and Materials sectors and underweight in the Health Care, Consumer Discretionary, and Information Technology sectors. Sector allocation was positive (14 bps) for the quarter. Security selection (415 bps) was a strong contributor in the Health Care, Industrial, Consumer Discretionary, and Materials sectors, while the Financial sector was the only negative contributor (-20 bps). The portfolio's slight underweight in the Health Care sector (12 bps) and overweight in the Financial sector (20 bps) helped us.

Heading into the fourth quarter, the portfolio is overweight in the Financial and Material sectors, as well as the rest of the sectors, and underweight in the Information Technology, Health Care, and Consumer Discretionary sectors.

Structured Small Cap Value

The Structured Small Cap Value Equity portfolio returned -9.65% in the third quarter versus -10.73% for the Russell 2000 Value Index. (Composite returns are gross of fees. Net of fees the strategy returned 9.85%).

During the quarter, the portfolio was overweight in the Health Care, Consumer Discretionary, and Information Technology sectors and underweight in the Energy, Industrial, and Consumer Staples sectors. Sector allocation was a significant contributor adding 81 bps, as the allocation to the Energy sector contributed 59 bps. Security selection was also a major contributor, particularly in the Consumer Discretionary sector (68bps). The Health Care, Financial, and Information Technology sectors were negative contributors in terms of security selection.

Heading into the fourth quarter, the portfolio is overweight in the Information Technology, Health Care, and Financial sectors and underweight in the Energy, Industrial, Consumer Staples, Materials, and Utilities sectors.

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Important Disclosures

Structured Small Cap Value Equity Composite Performance. The investment objective of the Structured Small Cap Value Equity Composite is to provide capital appreciation by investing in a diversified portfolio of small cap securities. Results from all accounts have been continuous from the first full month under management to present or last full month under management. The Structured Small Cap Value Equity Composite was created May 1, 2005.

Structured Small Cap Core Equity Composite Performance. The investment objective of the Structured Small Cap Core Equity Composite is to provide capital appreciation by investing in a diversified portfolio of small cap securities. Results from all accounts have been continuous from the first full month under management to present or last full month under management. The Structured Small Cap Core Equity Composite was created May 1, 2005.

Structured Small Cap Growth Equity Composite Performance. The investment objective of the Structured Small Cap Growth Equity Composite is to provide long-term capital appreciation by investing in a diversified portfolio of small cap securities. Results from all accounts have been continuous from the first full month under management to present or last full month under management. The Structured Small Cap Growth Equity Composite was created May 1, 2005.

Composites include all fee-generating accounts managed in this style for which the Firm has full discretionary investment decision-making authority have been included in this composite. Accounts are included from the first full month under management to present or last full month under management. Accounts are valued using trade date accounting and are denominated in U.S. dollars. Performance results reflect the reinvestment of interest, dividends, and realized capital gains and include cash, cash equivalents, convertible securities, and preferred securities, if applicable. Dividends and interest are recorded on an accrual basis and are net of all applicable foreign withholding taxes, if any.

Performance Attribution. Performance attribution is an analysis of the composite's return relative to a selected benchmark and is calculated using daily holding information within FactSet for the composite. It does not reflect the payment of transaction costs, fees and expenses of the portfolio. Attribution is broken down into two primary effects: sector allocation (that portion of the composite's excess return that is attributable to over- or under-weighting a sector or industry relative to the benchmark) and security selection (the portion of the composite's excess return that is derived from choosing different securities from the benchmark). Total Returns shown above are calculated using the closing price of any given security and do not necessarily reflect the actual trading price of such security. Accordingly, Total Returns shown above may differ from actual portfolio returns. Contribution to Return measures the impact that each security has on the portfolio's total return and is calculated using daily holding information within FactSet by multiplying the beginning weight for a given security by its total return on a daily basis, and geometrically linked for any given period. Accordingly, the Contribution to Return shown above could differ from actual returns when there is a significant different between the trade price and the closing price of a given security. Portfolio holdings that are included in the benchmark index are assigned to the same industries and sectors to which they are assigned by the index provider. Portfolio holdings that are not assigned by the index provider, but included in the FactSet Database are assigned to the index providers industries and sectors by PNC Capital Advisors, LLC. Attribution is not exact, but should be considered an approximation of the relative contribution of each of the factors considered.

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