

Second Quarter 2016 Commentary

July 19, 2016

Dear Investor,

I referred to the First Quarter of 2016 like Mr. Toad's Wild Ride at Disneyland due to the unexpected dips, turns, dark spots and ascension that brought new meaning to the colloquial caution "Please keep your arms and legs inside the car at all times and do not stand up."

As I reflect on the Second Quarter of 2016, I recall the cartoon figure Tweety Bird saying, "When someone tells you to Expect the Unexpected, slap them in the face and ask them if they expected it." Just when you thought things could not get any weirder, they did.

We witnessed the historical decision for Britain to abandon the EU, which sent global markets, interest rates and currencies reeling. We believe that the Brexit overhang, together with lingering concerns about the Chinese economy, diminished expectation for U.S. earnings, and an epidemic of negative interest rates will muddle the global economic outlook.

The good news is while our investment portfolios were jostled a bit, the constitutional design of our portfolios held fast and performed as designed.

And now we must thank you, our clients for your support as we navigated the wild ride and in the end were able, in most cases, to deliver modest positive returns on a net-of-fees composite level within our STAR Spectrum, VEGA and Alpha programs.

Currently, we are cautious about the near term return prospects and invite you to read on as we lay out what happened, and how it affected your investment returns. And what we believe will happen and what we are doing to seek returns and avoid material losses where possible.

Sincerely,



David Young, CFA
Chief Investment Officer

MARKET COMMENTARY

- The World Bank lowered its forecast for global growth this year to 2.4%, down from the previous 2.9% estimate in January.
- We forecast US second-quarter annualized GDP growth at 2.0 percent, below the Federal Reserve's projection of 2.4%, due to uncertainty following the "Brexit" - Britain's decision to abandon the EU – as well as other factors.
- The S&P 500 Index gained 2.5% in the second quarter, continuing its rebound from steep winter losses. The index recovered from a deep swoon in response to the Brexit and is now trading at record highs.
- The yield on the benchmark 10-year U.S. Treasury bond continued to erode - to 1.5% at the quarter's end - as investors sought shelter from turbulent markets.
- Inflation idled at 0.8% for the quarter while gold prices rose along with other precious metals as safe havens from Brexit concerns, mixed jobs reports and a range-trading dollar.
- Driven largely by demand for precious metals, the MSCI Emerging Market Index finished the quarter up 0.70% following a 5.7% surge for the preceding three months.
- A strong non-farm payroll report, following two months of lackluster job growth, did little to shake Fed dovishness.
- Brexit overhang, together with lingering concerns about the Chinese economy, diminished expectation for U.S. earnings, and an epidemic of negative interest rates will muddle the global economic outlook.

MARKET OUTLOOK

- We are concerned that European banks, which rely heavily on London for capital and expertise, may be the first big casualties of the Brexit. That, in addition to the spread of negative-yielding debt augers for slower growth worldwide.
- Similarly, we wonder whether the summer rally in over-priced US shares could be the seedbed for a bitter autumn harvest.
- We expect energy prices to remain range-bound between \$40 and \$60 per barrel having recovered from historic lows early this year. However, the market will remain hostage to continued Middle East instability and fickle demand trends.
- We are losing hope that the Fed will tighten credit this year despite the fact that a policy-rate increase of 0.50 to 0.75 basis points is needed to pre-empt asset inflation. Unless the Fed becomes serious about the current global liquidity glut a new generation of asset bubbles is inevitable.
- With interest rates static the dollar is unlikely to break out of its current trading range.

PORTFOLIO STRATEGY

Having correctly identified the Brexit as a serious risk factor, we:

- Reduced unpromising positions during Q1, where applicable by strategy, to raise a cash reserve in the value of 8% of funds under management.
- Remain neutral on US equity strategic weightings, and maintain lower allocations of non-US equity.
- Keep vigil for attractive macro-economic valuation and technical conditions as opportunities to redeploy our cash cushion.
- Maintain short-to-intermediate fixed income maturity and interest-rate exposure to minimize the impact of rising or volatile interest rates.
- Emphasize high quality yield enhancing corporate credit / MBS / ABS fixed income allocations.
- Continue to limit our exposure to high-yield and emerging market debt.

Market Commentary

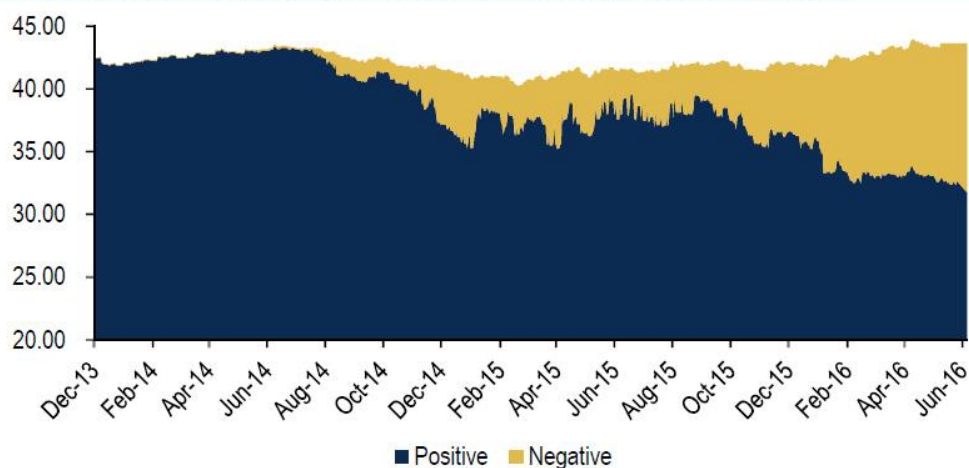
ECONOMIC

- We can no longer comfortably rule out the prospect of a global recession given mounting concerns over the Brexit, the solvency of some European banks, negative interest rates, China jitters and a muddled credit environment.
- Though US non-farm payrolls grew by a larger-than-expected 287,000 in June, the three-month average, at 147,000, is by itself unlikely to impel a policy-rate increase from the Fed.
- The unemployment rate rose to 4.9% from 4.7% as more people entered the labor force in search of work.
- Inflation is well below the Fed's 2.0% target rate.
- Personal consumption came in at 0.4% in May down from a 1.1% increase in April while savings held steady during the same period at 5.4% and 5.3% respectively. We note that previous quarterly savings increases have been reduced in revision.
- Factory activity in June expanded for the fourth straight month and at its fastest rate in more than a year as the Institute for Supply Management's index increased to 53.2% thanks to a relatively cheap dollar. The manufacturing sector added 14,000 new positions in June.
- Having rebounded in the first quarter from a 13-year low in February, oil prices stumbled to a two-month low in early July despite strong summertime demand. Analysts cited concerns of a global slowdown triggered by the Brexit as well as heavy output from both OPEC and non-cartel producers, namely Saudi Arabia and Russia.
- Precious metals, led by gold and silver and building on a strong first-quarter, surged following the Brexit as traditional hedges against the unknown. More than \$4 billion was invested in precious metal funds in the first week of July, according to Bank of America Merrill Lynch, the largest such transfer on record.

FIXED INCOME

- The yield on the 10-year Treasury note in the second quarter continued its descent into record-low territory, slipping from 1.8% to 1.5%.
- The volume of negative-yielding debt has risen to \$11.7 trillion, according to Fitch, up from \$10 trillion just a month ago.

The world is even poorer....In yield terms...after Brexit (Global fixed-income debt, \$tr.)



Source: GFIM bond index.

- The Barclays US Aggregate Bond Index returned 2.2% in the second quarter.
- Credit spreads on investment-grade and high-yield bonds tightened in April and settled into a narrow trading range for the rest of the quarter.

Market Commentary

EQUITY

- Share prices finished strong for the second consecutive quarter. The S&P 500 ended the three-month period ending June up 2.5%.
- The Russell 2000, meanwhile, recovered from a post-Brexit sell-off to end the quarter 3.8% in the black.
- Relative values between equity and debt continue to diverge. The S&P 500 dividend yield of 2.2% is nearly 50% higher than the ten-year U.S. Treasury yield and the Barron's Stock-Bond Yield Gap has reached an unprecedented minus -0.67%.
- The volume of corporate buy-backs has reached record levels despite historically high valuations.

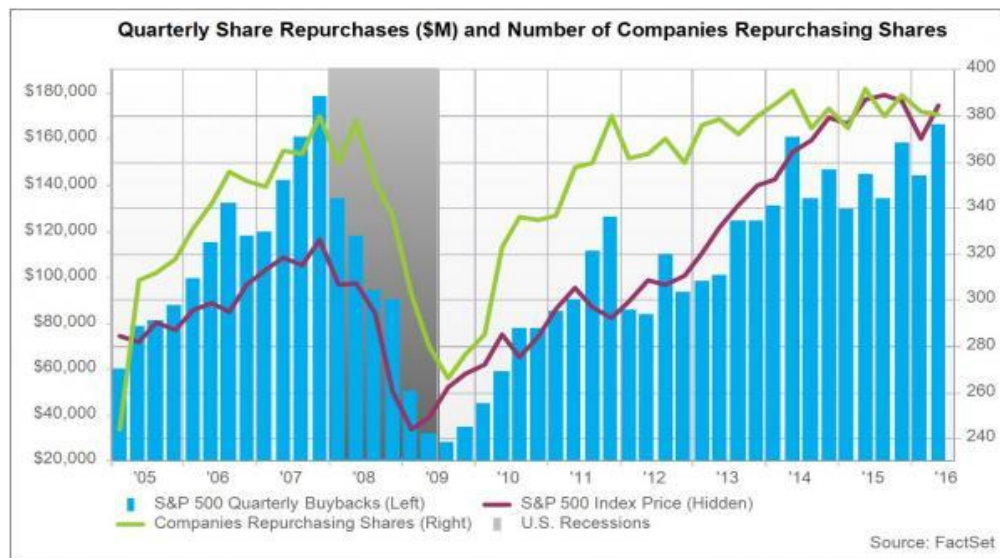


Exhibit 3: Median stock trades at the 99th percentile of historical valuation as of May 12, 2016

Metric	Aggregate		Median stock	
	Current	Historical %-ile	Current	Historical %-ile
Price-to-Earnings growth (PEG)	1.4 x	89 %	1.8 x	100 %
EV / Sales	2.0	91	2.5	100
EV / EBITDA	10.9	86	11.1	99
Forward P/E	16.8	86	17.5	96
Price / Book	2.7	66	2.9	83
Cyclically adjusted P/E (CAPE)	22.3	73	NA	NA
Median metric		86 %		99 %

Source: Compustat, I/B/E/S, and Goldman Sachs Global Investment Research.

Market Commentary

INTERNATIONAL & EMERGING MARKETS

- The World Bank cut its estimate for Japanese GDP growth for the year to 0.5%, down a full 100 basis points since the January projection, while holding steady Chinese growth projections at 6.7%.
- Citing the negative impact of the Brexit, the IMF forecast eurozone growth will slow to 1.6% this year and 1.4% in 2017, compared with last year's 1.7% expansion.
- Despite positive US fundamentals, the dollar continued to trade in a tight range owing to Fed reluctance to raise interest rates.
- Global equity in developed markets, as measured by the MSCI EAFE Index, posted a 1.5% loss in the second quarter.
- The Chinese yuan reached its lowest level against the dollar since November 2010, part of a gradual devaluation engineered by China's central bank to help struggling exporters. (Note: we track a close correlation between a receding yuan and global equity prices.)
- The Japanese yen continued to strengthen as a safe harbor for Brexit-driven capital flows.

Market Outlook

ECONOMIC

- Global equity prices and pound sterling recovered from the panic selling that greeted the news Britain's EU departure. (See <http://www.anfieldcapital.com/keep-calm-and-carry-on/> for Anfield's real-time response.) However, we fear the Brexit may imperil European banks thanks to their heavy reliance on London to sustain existing assets and to generate new ones.
- US corporate earnings expectations are modest given receding cash flow relative to debt load.
- Companies continue to convert debt into equity while robust cash balances suggest they are running lean operations and are thus poised for expansion.
- Continued low energy costs and rising incomes due to a tightening labor market will continue to offset eroded buying power as a result of a range-bound dollar.
- Despite a tepid recovery in commodities prices and cheap valuations we continue to underweight the energy sector.

FIXED INCOME & EQUITY

- A proliferation of negative-yielding debt in Europe and Japan threatens to undermine US Treasuries as the flight to quality becomes a race to the bottom – a trend foreshadowed by the heavy accumulation of yield-seeking long future positions on US sovereign debt.
- We expect continued high volatility to prevail at least until the end of this year and in turn we have increased our exposure to short-term, high-quality debt in sectors with strong cash positions.
- We remain heavily weighted in large-cap US stocks for the sake of value over growth having reduced our holdings in Europe and Japan.
- We continue to assign myriad global risks - from terrorist violence to divergent monetary policies – as potentially decisive factors in our outlook.

Market Outlook

INTERNATIONAL & EMERGING MARKETS

- The political and economic challenges facing the global economy outside the US continue to be vast and forbidding.
- Uncertainties associated with the American presidential election, particularly as it relates to trade and tax issues, could precipitate the occasional sell-off.
- Despite assurances from Beijing we believe the Chinese economy is in the early stage of an epic, long-delayed retrenchment that may well elude the grasp of the leadership. Deflation, diminished growth and political instability remain distinct possibilities.
- A recent international ruling against Beijing's sovereign claims on Asian waterways may aggravate already brittle Sino-US relations.
- The euro bloc and Japan have been pushing on negative interest rates with little to show for it. Europe is grappling with a refugee crisis, the not-unrelated scourge of terrorist violence and now the departure of one of its most important markets, Britain.
- We anticipate more weakness in emerging markets as economies and companies adapt to China's "new normal" of slower growth. To complicate matters, commodities-giant Brazil is embroiled in an executive-level political crisis even as it struggles to beat a recession.

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