2018 HEDGE FUND OUTLOOK

INTRODUCTION
Throughout 2017, many investors were well rewarded for owning risk assets in their portfolios. From the developed markets to the emerging markets, equities have performed well. Global equities, as measured by the MSCI All Country World Index, were up every month in 2017 and achieved this with record low volatility. Credit also performed well, with both investment-grade and high-yield markets producing attractive gains. Even commodities, which struggled mightily to begin the year, rallied in the latter half of 2017, pushing most markets into positive territory.

Not wanting to be left out, hedge funds certainly regained their footing in 2017. Historically, a one-way, low-volatility market is not conducive to strong hedge fund performance, but 2017 proved to be an exception. The HFRI Fund Weighted Composite Index performance rebounded to achieve one of its best years since 2010. After a period of outflows, flows into the industry turned positive once again. Fee reductions continue, transparency has never been better and a number of interesting new funds are coming to market, making it a terrific time to be a hedge fund allocator.

2017 STRATEGY REVIEW
In our 2017 Hedge Fund Outlook published in January, we were correct about the positive environment for risk assets, but underestimated the strength of the markets. After the 2016 U.S. presidential election, we expected the new administration, with control of both houses of Congress and the White House, to be able to pass market-friendly policies focused on fiscal spending and tax reform. Unfortunately for our forecast, the policy debate in Washington has taken longer than expected with tax reform only being addressed in late December. Despite this gridlock, markets largely ignored the noise coming out of Washington and moved steadily higher throughout the year. Tied to our forecast of increased fiscal spending was a belief that the U.S. Federal Reserve would use the opportunity to normalize monetary policy. While we have seen three rate hikes in 2017, monetary policy remains accommodative. We also forecasted a risk in increased populist rhetoric and trade isolationism. While there was considerable populist talk around the world and the U.S. has withdrawn or been omitted from some trade deals, the strong performance of risk markets was not derailed.

In this strong market, the performance of our underlying managers was mixed. The majority of our event driven managers excelled in 2017, and nearly all of them outperformed the index. Our forecast that a market-friendly Washington would provide a tailwind to event equity strategies, particularly M&A, was especially beneficial for our investors. Although the opportunity set for traditional developed market macro was less robust than we had expected, our tilt toward managers focused on emerging markets enabled us to outperform the macro benchmark. The performance from our long/short equity managers was mixed, as our non-U.S. managers performed well on the long and short side in both Europe and Japan, while our sector specialists and U.S. equity managers struggled. Our U.S. managers struggled on the short sides of their portfolios in a difficult environment for identifying declining stocks, and a few were tactically overweight to long energy exposure, detracting from performance. We bolstered our relative value book over the year with the addition of managers that have higher expected returns by operating distinctive strategies that continue to maintain the low-correlation and risk-diversifying attributes of the strategy.

We have been able to use our strong position in the marketplace to our advantage this year by gaining access to scarce capacity and negotiating better terms and fees for our investors. We are very pleased with our roster of managers, and we are confident in their prospects for attractive, unique returns for our investors.

VIEWPOINT ON HEDGE FUNDS
2018 OUTLOOK

As we build our base case for the next year, we expect 2018 to look much like 2017. Global economic growth maintains at stable, but not awe-inspiring, levels. Alongside steady growth, we see inflation in the developed world at or below central bank targets. Low inflation will allow monetary policy to remain accommodative and keep rates lower than the market expects next year. These factors bode well for further gains in risk assets, specifically global equities. While equities may look fully valued based on historical absolute levels, they continue to look attractive compared to low-yielding fixed income assets. In 2017, a similarly benign environment led to lower correlation amongst equities, which created a good environment for stock picking and active management. We expect more of the same in 2018.

While our base case is positive for risk assets, markets are not without risk, and we are closely watching several areas that would cause us to reevaluate our outlook. First is the potential for a monetary policy misstep. In the U.S., we expect the Fed to remain accommodative, but the installment of a new chairman and multiple new governors could heighten the risk for a misstep. Globally, we will be monitoring the slow unwinding of central bank balance sheets around the world for any disruption to fixed income markets. Secondly, we will be watching closely for unexpected changes in inflation levels either in the U.S. or elsewhere in the developed markets. An inflation surprise would have a material impact on our view of monetary policy and risk asset valuations. Finally, we continue to watch the global political landscape. As we highlighted last year, the possibility of trade disputes and other economically disruptive policies continues to be a risk focus for our team.

As our investors know, we seek to allocate to hedge fund strategies that have tailwinds and move away from strategies facing headwinds, but we do not take “beta bets”. We seek to invest with managers that will be positioned well if our outlook is correct but will still produce an attractive risk-adjusted return even if risk scenarios play out.

2018 ALLOCATION OUTLOOK

Based on our view that the economic landscape in 2018 will look quite similar to that of 2017, we do not anticipate a significant change in where we will find the most attractive hedge fund opportunities. Shifts in allocations will likely be more nuanced than in years past and should occur at the sub-strategy level rather than noteworthy changes at the strategy level.

We continue to see several opportunities in the long/short equity strategy. Our research efforts in this space have always focused on managers that bring a unique return stream to an overall portfolio. If a return profile can be replicated in a long-only mandate, our view is that it does not belong in a hedge fund program. This principle has led us to managers that run with both a meaningful short book and a variable net exposure. While managers fitting this profile in the past have generally run their portfolios with a roughly neutral exposure, we are now seeing a number of interesting managers that take a more opportunistic approach to their net exposure, and are willing to run moderately net long when the environment is favorable and closer to neutral, or even net short, when markets are struggling. We are very excited to be seeing managers that fit this profile globally, not just in the U.S, and we expect to expand our non-U.S. exposure in long/short equities.

Event driven strategies are another area in which we see several interesting opportunities, primarily on the equity side. The economic environment continues to favor a robust corporate calendar driven by cheap funding in 2018, with regulators – for the most part – taking a hands-off approach to mergers and acquisitions. While undue influence by U.S. regulators is a risk scenario, we anticipate a more corporate-friendly U.S. tax policy. We will look to take advantage of this tailwind by expanding our event equity capacity in the U.S. as well as in Europe. However, we are less positive on event credit opportunities. Our view is that rates will stay low in 2018, spreads will remain tight, and there will be few defaults. These factors may prove to be a headwind for traditional distressed credit hedge fund opportunities as well as many carry strategies. We will continue to move away from traditional event credit and favor more trading-oriented strategies in high yield, as well as less efficient areas of the credit markets.

Our macro allocation positioning going into 2018 will look different from a year ago. Entering 2017, the growing divergence in global monetary and fiscal policies led us to believe the environment for traditional developed markets macro was the best it had been in recent years. Unfortunately, that opportunity did not fully materialize, and developed market macro strategies continued to struggle. While we believe this view will prove correct in the longer term, our current analysis of the market and that of our managers does not support a shift towards developed markets. As a result, we have moved to eliminate traditional macro from our allocations and maintain our allocation to emerging markets-focused macro. Until we see a significant change in the economic environment, we will maintain this positioning and lower our overall macro allocation.
Finally, we remain very selective and opportunistic around our allocation to relative value managers. Over the last two years, we have built a moderate allocation to systematic strategies, and while we have high conviction in the managers we work with, we disagree with the narrative that systematic strategies will replace traditional active managers. Fixed income relative value strategies suffer from many of the same headwinds as traditional credit strategies, such as low volatility, low rates and tight spreads. When the environment improves, we will look to re-engage in fixed income relative value. In the meantime, we will aim to take advantage of regulatory-driven dislocations by continuing to seek out relative value strategies that focus on market-making opportunities in less efficient areas of the credit and equity markets.

We are enthusiastic about the opportunities we see in the coming year and anticipate that smaller, more nimble managers will be well-placed to capture them. Our seasoned team, thoughtful process and cooperative culture give us an edge in unearthing and building a dynamic portfolio of these hedge fund managers.

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<table>
<thead>
<tr>
<th>Strategy</th>
<th>Outlook</th>
<th>Conviction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long/Short Equity</td>
<td>We continue to see attractive opportunities in long/short equity. 2017 has experienced a strong comeback in active management as fundamental stock pickers are on track to record one of their strongest absolute and relative performance years since the Global Financial Crisis. We anticipate that the improving trends in stock market correlations and stock dispersion that have been beneficial for the strategy in 2017 are likely to continue into 2018. We are especially interested in managers that take a more opportunistic approach to their net market exposures, willing to run moderately net long when the environment is favorable, and closer to neutral or even net short when markets are struggling. We are very excited that we are finding managers that fit this profile globally. We expect to expand our exposure in Europe and Asia.</td>
<td>HIGH Global Long/Short and Specialist Strategies</td>
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<td>Event-Driven</td>
<td>As credit spreads have tightened and default rates are expected to remain low amidst a positive growth environment, we continue to reduce exposure to traditional distressed credit managers, and prefer balanced trading oriented managers who can tactically short tight credits ahead of catalysts. We expect the environment to remain conducive for event-equity oriented strategies, particularly amidst a more business friendly regulatory environment and the potential for clarity around tax-reform. This should continue to favor merger arbitrage and special situation opportunities globally in this pro-cyclical environment.</td>
<td>HIGH Equity Strategies</td>
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<td>Global Macro</td>
<td>The wind down of extraordinary monetary policy accommodation is just beginning, bringing with it the danger of unintended consequences and policy error. While not our base case, if the exit of QE were to bring about a return of global volatility, we would expect global macro to be well suited to capture the resulting opportunity set. We continue to prefer global macro managers with a focus on trade structuring, as these managers have the best chance of finding trade expressions that can weather the gap risk and low liquidity of modern markets. We also like the diverse opportunity set available to emerging markets focused macro managers, but are wary of crowding and liquidity risks.</td>
<td>LOW Traditional G3 Macro Strategies</td>
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<td>Relative Value</td>
<td>Changes to market structure and the demographic of market participants have created new opportunities for the next generation of relative value managers. We see opportunities for managers who aim to profit from changes in global market flows, sector rotations, and the regulatory limitations on the balance sheet and proprietary risk taking of investment banks. The unwinding of QE should create interesting opportunities for arbitrage strategies.</td>
<td>MODERATE Quantitative &amp; Trading-Oriented Market Neutral Strategies</td>
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