Quarterly Market Review—Second Quarter 2021

Harpswell CAPITAL ADVISORS, LLC

Table of Contents

Harpswell's Market Outlook *cover*

The Value Rally *cover*

Welcome to Crypto-Burger *p.2*

The CPI and the PPI *p.3*

Diversity, Equity, Inclusion & Accessibility in ESG *p. 8*

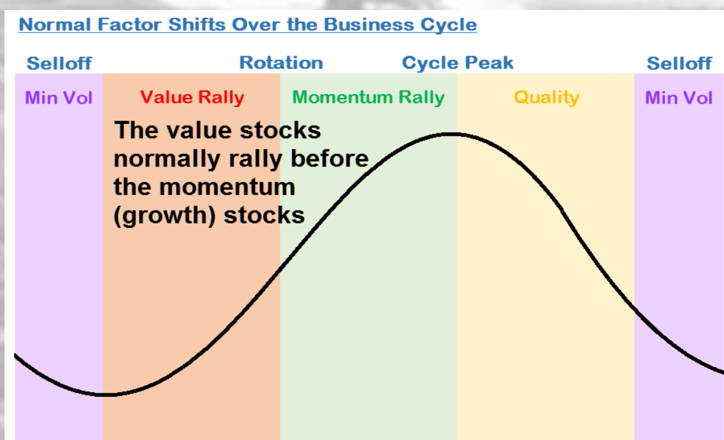
The Times They are a Changin' *p.8*

March 2021 Flash Report *p.9*

The Value Rally

One of the ways to add incremental performance while staying invested in the market is to tilt the equity portion of the portfolio towards or away from factors (either by using factor funds or as part of manager-allocation). Factors are characteristics that have been shown by empirical research to provide a risk premium (the risk premium being the extra return investors receive for accepting the risk to that factor).

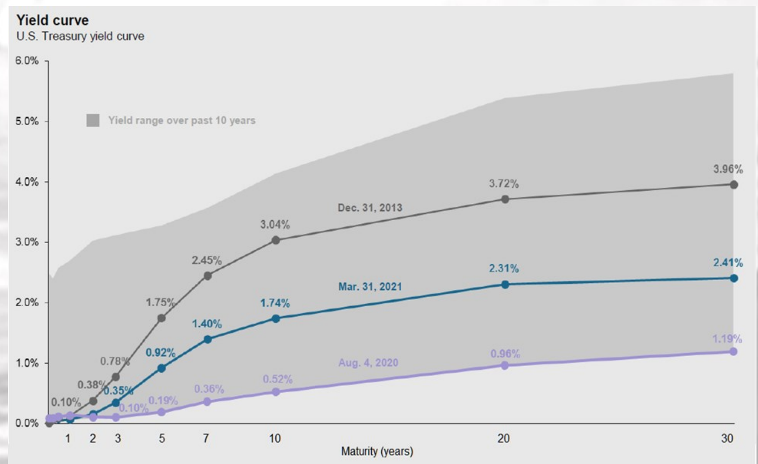
There are four factors that are investable as part of the S&P 500 – two based on accounting measures and two based on historical price movements. The two based on accounting analysis are Value (low price to fundamental value) and Quality (low debt, high return on equity), and the two based on price movements are Minimum-Volatility (historically lower downside risk) and Momentum (exhibited outperformance in recent years). ***Continued on p. 2***



2021 Market Outlook

There are a multitude of market drivers we feel can drive heighted volatility and the trajectory of the market. Some factors are positive and some paste the wall of worry that the market ever so much loves to climb.

Likely, the most influential market phenomenon which occurred in 1Q2021 was the rise in long-term interest rates. The US ten-year treasury bond was yielding only 0.91% at YE2020 and it jumped to 1.75% at the end of 1Q2021! That was a meaningful move that resulted in the Barclays Bond Aggregate Index (the most widely utilized bond index) losing over 3.5% of its value. As bond math goes, the further extended your bond portfolio is in terms of years to average maturity, the more you will experience losses when interest rates rise. As rates were extraordinarily low at the end of 2020, Harpswell tactically shortened the duration of all portfolios to tactically preserve value when rates rose and that served as a nice tailwind for performance.



Valuations

At the end of 1Q2021, the S&P 500 was trading at an earnings multiple of 21.9x earnings. While the term "earnings multiple" might be vague to many, I like to conceptualize it by looking at it as a metric for how long it would take to pay off the purchase of that business. Thus, if you buy a company at a multiple of 10X, you could theoretically pay for the company completely in 10 years. If you purchase it at 22X, the period extends beyond two decades. ***Continued on p. 6***

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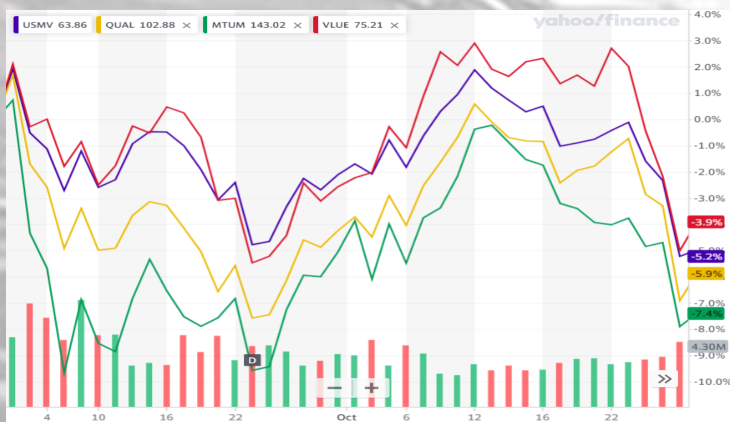
www.harpswelladvisors.com | info@harpswelladvisors.com | 877.427.7227

The Value Rally continued from cover

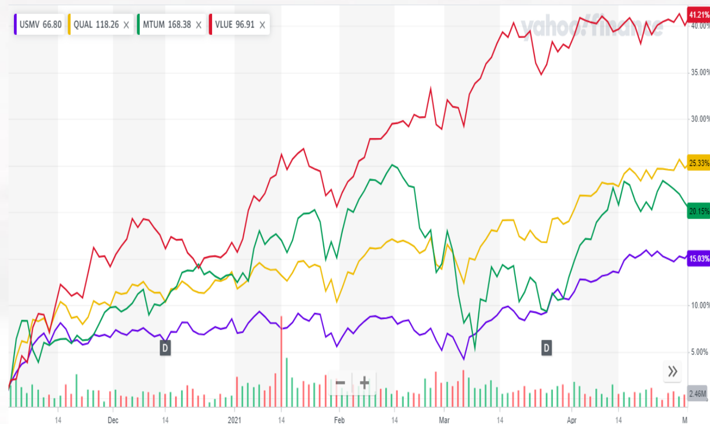
The Momentum factor also tends to be a proxy for Growth because a rising stock price reflects the market's anticipation of future growth. Throughout previous business cycles, the four factors affecting large cap stocks have been observed to take turns leading the market. Usually, Value leads the initial recovery from the bottom, followed by Momentum. Quality takes the lead when there is still positive but decelerating economic growth, and Minimum Volatility preserves value relative to other factors in a bear market.

However, in the recovery from the market crash last year, the value factor did not lead the way, because the lock-downs gave the advantage to online-economy sectors, and because the monetary-policy guidance (that interest rates would remain low) increased the present value of the future earnings of growth companies. From April to September, the Momentum factor outperformed the value factor by 30% (shown here using iShares Factor ETFs).

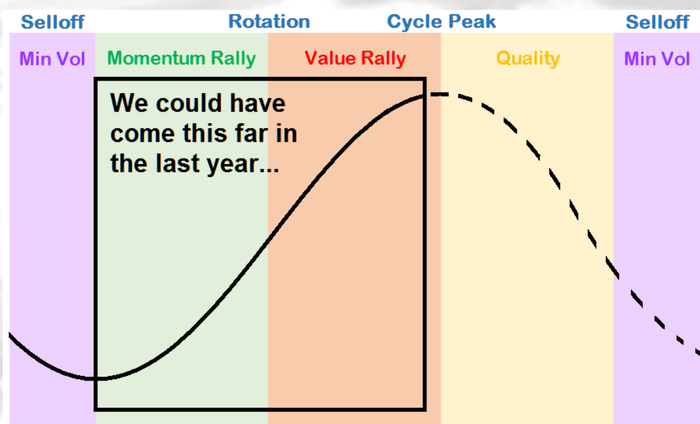
Factor leadership rotated leadership during the volatility of September and October (below).

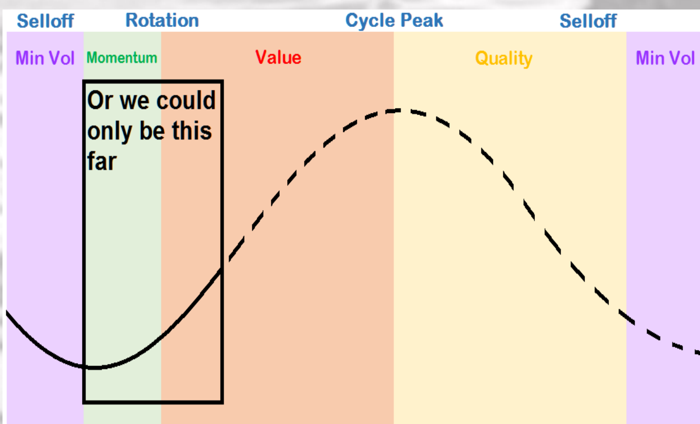


When the rally continued in November, Value stocks led the way, outperforming growth by over 20% up to the end of April (below).



The fact that Momentum and Value traded places in the cycle is evident, but what's not clear is how long the Value leadership lasts before investors get cautious, and the market rotates into Quality. ■





Welcome to Crypto-Burger

Imagine it's the 1920's and you're out for a drive in the country. Approaching the next town, on the outskirts, you come across a roadside diner with a sign that reads "Welcome to Crypto-Burger, World's First Drive Thru Restaurant".

A long line of cars has already formed outside, as other motorists are eager to try this new invention of the drive-thru. The townspeople have gathered excitedly, too. Barefoot kids run up to car windows and hand out pamphlets explaining the revolutionary nature and far-reaching implications of the drive thru.

According to the pamphlets, the old way of eating at restaurants is soon to be no more. In the future, most (if not all) food will be picked up in drive-thru windows by people in cars. And because Crypto-Burger is the first drive-thru, there's special value in being a patron.

When your turn comes, you place your order at the intercom, which is easy because there is only one thing on the menu – the original Crypto-Burger. You pay your money at the first window and continue to the next window. However, when you finally pick up your order, it feels a little light. You reach in the bag and pull out a wrapper – only to find that there is no burger in the wrapper!

It looks like the sign out front was not entirely accurate. If there had been truth in advertising, then instead of "World's First Drive Thru Restaurant" the sign would have read "World's First Drive Thru, Burgers Sold Separately". The crypto-"currency" and crypto-"asset" bubble appears to be built on a similar half-truth.

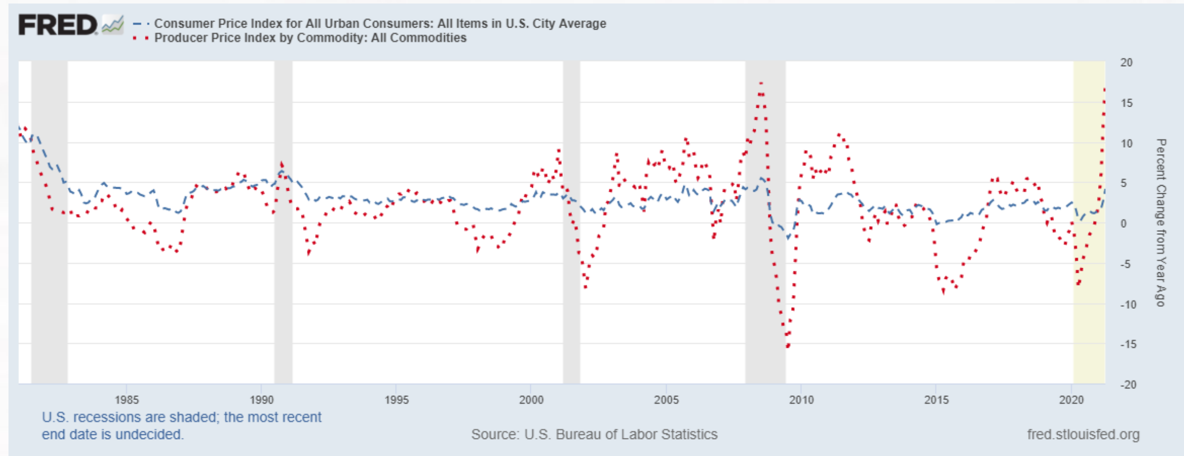
The part that is true is that there is a new technology out there, called the distributed ledger. Unlike a traditional accounting ledger, which exists at a central location (like a bank, for example) a distributed ledger is a network, where each entry is authenticated using a cryptographic code. Individual Bitcoins and other cryptocurrencies – called tokens – are accounting entries on a distributed ledger.

But accounting entries don't have value in and of themselves – they are used to record claims on real things that people do value. Like the Crypto-"Burger" and the innovation of the drive thru, tokens on a distributed leger are like sandwich wrappers that don't have anything in them. However, the new-ness and the technical sophistication of crypto has been a wow-factor that causes people to worry they're missing out on something big.

What the crypto bubble reveals is a wider set of assumptions driving parts of the equity market - that innovative business models, network effects, and first-mover advantages provide their own sources of value that are beyond question. To the extent that encrypted accounting entries on distributed ledgers make it cheaper and faster to do business, companies will adopt it, and they won't have to pay licenses and royalties because there is no patent. Over the long term, to the extent you are invested in the global stock market (especially passively) you have the most to gain from crypto and the least to lose. ■

The CPI and the PPI

If you plot the trend of Consumer Price Index and the Producer Price Index as a series (below), they look something like the footprints of a person walking an energetic dog (the CPI being the person and the PPI being the dog). There's a good reason for that resemblance, which we'll get to later. But first, what are these series of data points and why does one of them fluctuate so much compared to the other?



The CPI is an index of prices that households pay for finished goods and services, while the PPI is an index of prices businesses receive for the goods and services they sell to other stages of production. The Bureau of Labor Statistics has used several methods over the years to survey producers. One method categorizes the producers by industry, one categorizes the products into commodity groups, and another categorizes the products by the type of buyer. The commodity-grouping-PPI, shown here, was revised to include services and construction in 2009, and is the most volatile of the three PPIs.

When the BLS publishes the monthly CPI and PPI, they are publishing the trend, or year-over-year change, in the index. In March 2021, the CPI trend was 2.7%, which meant prices were 2.7% higher than they were a year before. In April 2021, the index was up 4.2% year-over-year, the biggest change since July 2008, which was 5.5%. Meanwhile, March's commodity-grouping-PPI was up 12% year-over-year and April's commodity-grouping-PPI was up 17.3% - once again the highest since July 2008, which was 17.4%.

One of the reasons these series don't match is because they measure different populations. The CPI measures the prices *domestic* consumers pay for *global* production, while the PPI measures the price *domestic* producers receive for products that are sold to *global* producers. Did CPI and PPI move together when we had a more closed economy? It appears they did. In the first 40 years after WWII (below), changes in the CPI and PPI appear to have been much closer in terms of magnitude.

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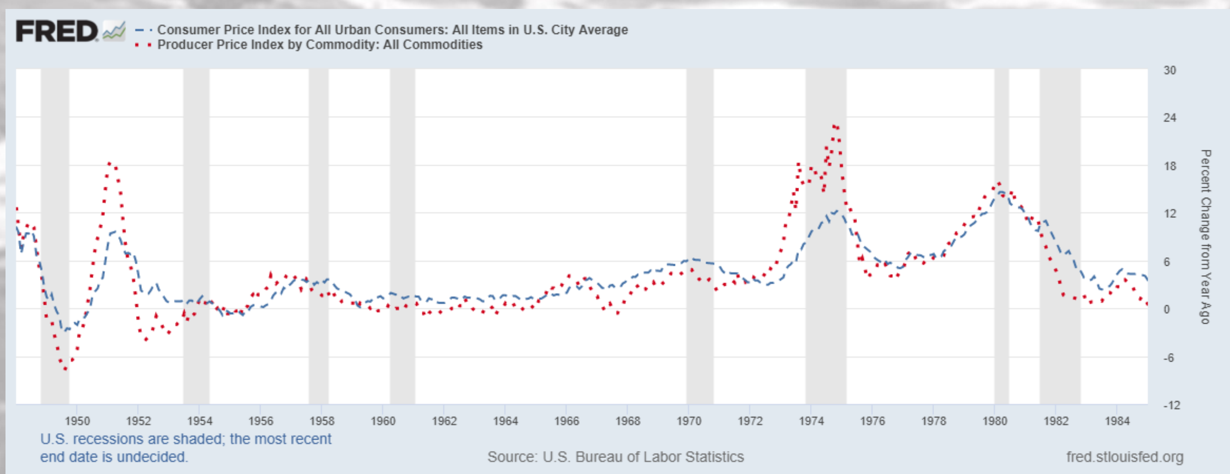
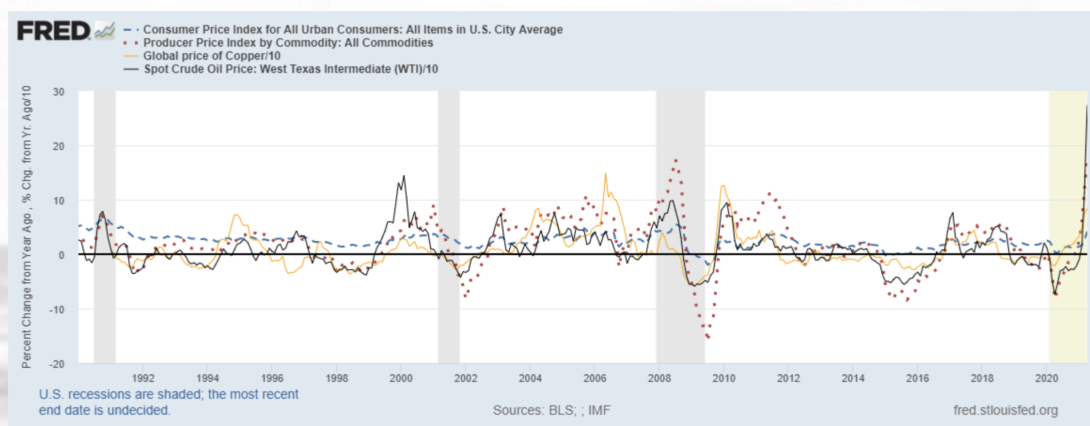


The CPI and the PPI continued from p.4

Along with globalization, technology has probably also helped to suppress CPI volatility. In the early post-war decades, increasing unit production also meant writing more paychecks, and those paychecks would then be used to bid up the consumer prices. Better technology in offices and factories gives employers greater operating leverage from their existing workforce, so increasing unit production doesn't have to require a proportionately higher labor spend.

While CPI volatility has been smoothed out by technology and globalization, why has the relative magnitude of PPI volatility increased? Oil and copper provide a clue. In the entire global structure of production, they are two of the most widely used inputs. When producers in general are bullish, they reach for these commodities at the same time, causing their prices to spike. When producers are bearish, they pull back at the same time, causing prices to crash. Changes in the commodity-grouping-PPI have coincided with spikes and crashes in these two commodities, at about 1/10th of their magnitude (this chart shows 1/10th of the year-over-year change in oil and copper, compared to the full year-over-year change in CPI and PPI).



This brings us to the reason why Trend PPI is so much more volatile than Trend CPI. Production is entrepreneurial and competitive. It must rely on an appraisal of future months and years and take action before the competition does. Producers might get more inventory ready for tomorrow than they sold yesterday, and pay higher prices today than they paid yesterday, based on their appraisal of future market conditions. The resulting inventory cycle, of building up and paring down inventory, spans 2 to 4 years.

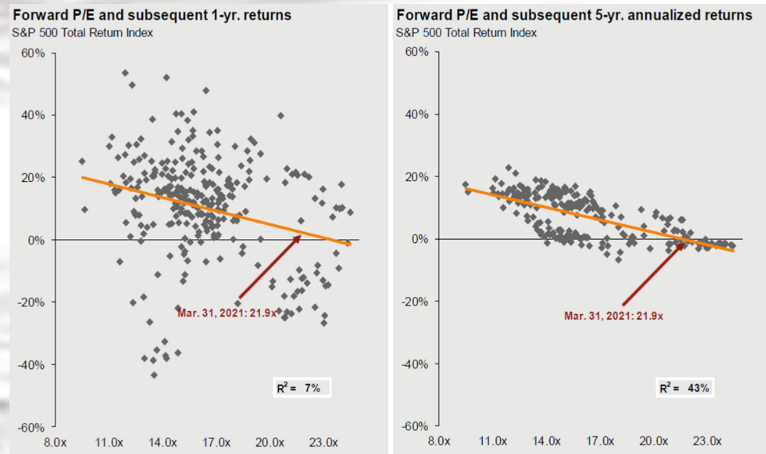
Consumption, on the other hand, tends to be on a regular, 2-4-week schedule. It's more habitual than entrepreneurial (except for the household-formation stage of life). When it does come to normal discretionary spending, consumers don't have to be as competitive as producers. The producer who misses the chance to make a sale will lose market share and will be gradually pushed out of business, but the consumer who misses a chance to make a purchase can just wait their turn or buy something else, and they are often rewarded with a better price.

In the same way a dog walks ahead of its master and pretends to lead the way, but is actually held in check by the leash, businesses have to go first, ahead of their customers, and test the limits of the household budget constraint. Many households have loosened up on that constraint and accepted the price increases today, but that came after a year of receiving extra income and also having fewer ways to spend it. That's an unusual circumstance in the last 40 years, and it doesn't undo the productive capacity built up over the last 40 years of globalization and technology improvements. What would really be needed to cause a sustained rise in inflation, for our economy, would be a boom in *household-formation*, not a just a temporary shortage of producer inputs.■

2021 Market Outlook continued from cover

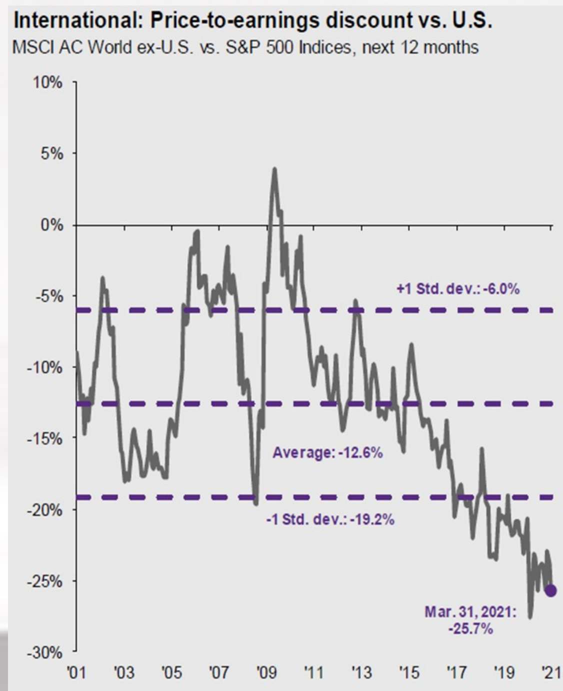
While it is worth noting that investors often assume earnings will grow and shorten that period, we see heightened risks when valuations are stretched. First, a lot can change between 10 and 22 years. Industries appear to be evolving at a warp speed and banking on earnings in two+ decades from now seems like a very uncertain endeavor. We feel that no industry or company is safe as there are more than a handful of companies carrying $100B of cash on their balance sheet and with low interest rates, they can deploy it with a very low hurdle making accretive investments. Furthermore, as interest rates rise, the cost of financing rises, and valuations typically contract.

As the graphs below highlight, there seems to be a robust relationship with the return you earn over the following one- and five-year period and the market's valuation at the time of your initial investment. While these statistical generalizations are not a crystal ball, the premise makes sense. We will note, the randomness (or heteroskedasticity, to be more precise) is more pronounced in the one-year graph suggesting even a higher level of uncertainty with the relationship of valuations and one-year returns.

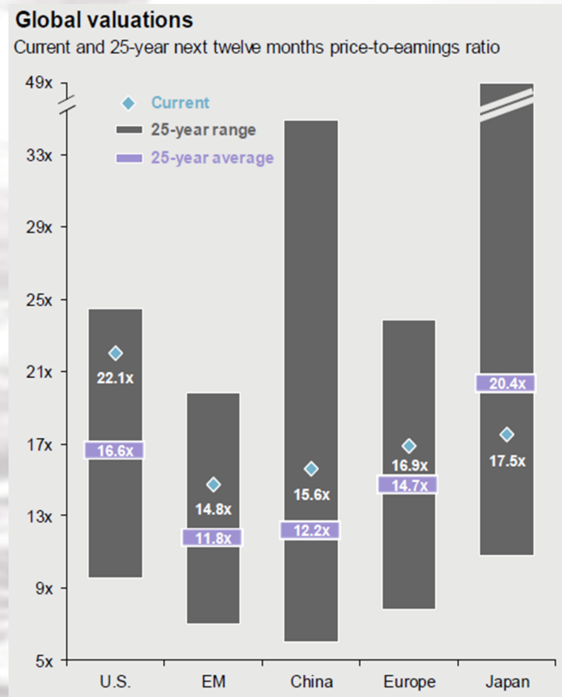


Domestic vs. International Markets

While most equity markets' valuations are stretched relative to their historical averages, domestic (US) equities are particularly rich. Harpswell attributes part of the differentiation in valuation to the fact that US markets have a higher proportion of high-growth technology stocks and those stocks have meaningfully outperformed most other sectors. However, as the following graph illustrates, the discount that international markets trade at has surpassed any level we have seen over the last two decades.



As the chart below highlights, US markets are trading closer to the top end of their 25-year historical range relative to international equity markets. Thus, not only are US markets rich relative to international stocks they are expensive relative to their historic average and ranges.



Beyond that, Harpswell feels the US markets are prone with the prospects of elevated event risks. Some policy related risks may subside (to a degree) as we approach mid-term elections however others may grow. We feel a sweeping tax change may disrupt markets and send investors running for the doors.

Continued on p. 7

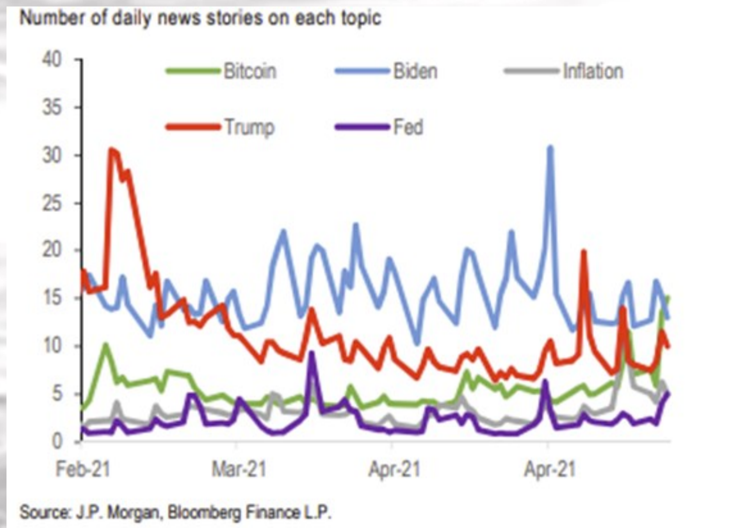
2021 Market Outlook continued from p.6

We have seen both politicians and central bankers pander to the equity markets more and more and feel they may pin their hopes on a victorious 2024 before embracing too much change. By then, we will certainly have a lot of financing needs and tax revenue will likely have to go up. Conversely, we could envision heightened risk associated with anti-trust related undertakings as policy makers look to reign in the market power that some companies have (e.g., FANGS). Just another reason to monitor exposure to the large tech allocations in the US markets (in addition to valuations).

Inflation….finally

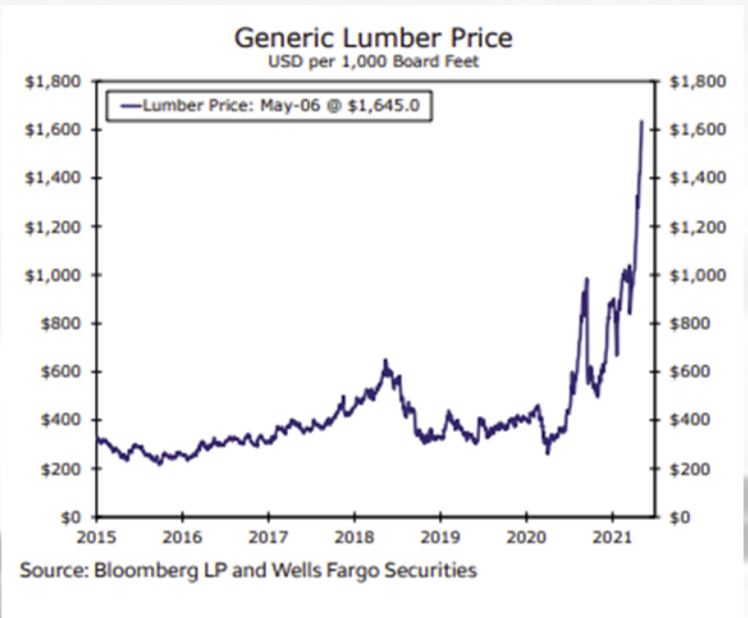
We have been seeing signs of inflation firsthand and the debate framed by the Federal Reserve revolves around the notion of it being transitory (temporary) or not.

Inflation has a sweeping impact on almost all aspects of the economy and underlying markets. It essentially devalues currencies, increases input costs and shifts advantages from renters to owners. Drivers for inflation can come from both the supply side or demand and we seem to be encountering



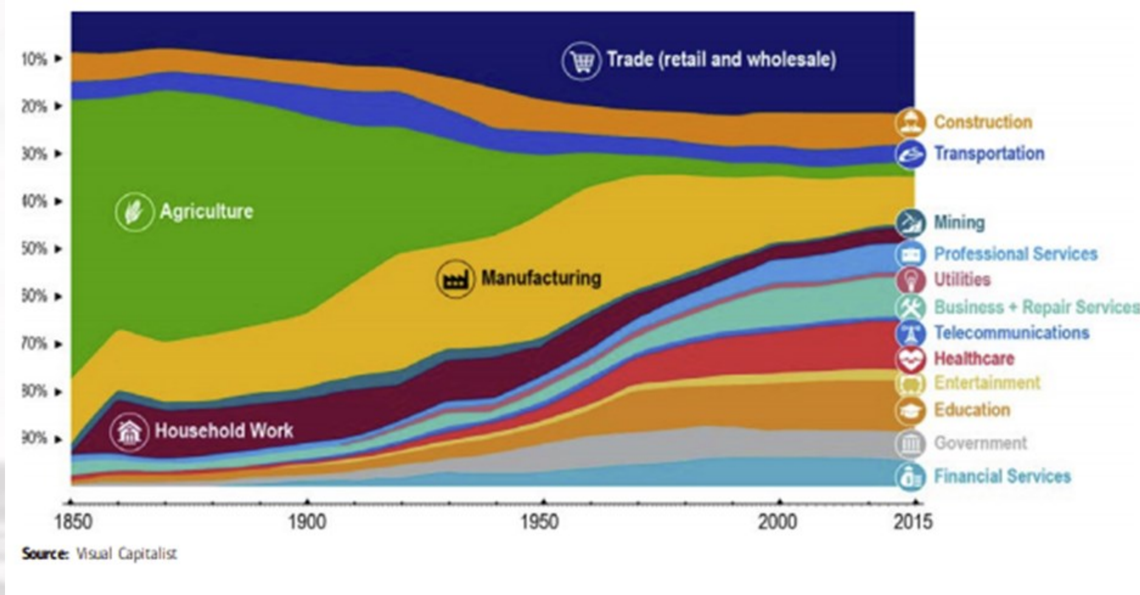
both at this time. Changes in supply (e.g., oil and logistical supply chain constraints) coupled with the government flooding the economy with cash and consumers looking to spend their savings combine for the perfect (inflation) storm.

Lumber prices are a particularly interesting aspect of inflation as the rampant climb in prices are the byproduct of a clogged supply chain (associated with COVID) and the housing boom (demand). It is worth noting, as a Maine based firm, we would normally welcome such a move as our state is flush with trees, yet the prices unfortunately do not seem to flow all the way down the supply chain.■



The Times They are a Changin'

If you have read more than one of our Quarterly Newsletters, you will know we are fascinated with long-term trends relating to demographics, the economy and technology. It is not lost on us how the evolution of our economy shifts resources and commerce away from the essentials (food, housing, clothes, etc.) to services and luxuries. Harpswell sees the basis for this far-reaching trend to be the byproduct of improved efficiencies and innovation freeing up resources to be devoted elsewhere. Looking to the future, we could envision healthcare and entertainment to be the runaway outperformers over the next century.



Diversity, Equity, Inclusion and Accessibility in ESG

With the interest in ESG investing (a.k.a. values-based investing, SRI, or Impact Investing) gaining increasing momentum and coverage, issues related to diversity, equity, inclusion and accessibility (DEIA) have also come to the forefront. We believe it is important to recognize and examine the wider implications DEIA has on performance.

Prioritizing social issues in investing no longer requires sacrificing returns. Investors have seen the viability in placing equal importance on DEIA and their financial goals. For years, extensive research and reporting have shown that diverse companies perform better. A more equitable, diverse workplace is better positioned to attract top talent, which results in higher customer satisfaction, innovation, and more sustainable growth. In broader terms, a trend toward a more equitable society promotes increased economic opportunity and sustainability.

Tracking and reporting on these issues is complex, but as investor interest in the area grows, more companies are releasing data related to DEIA. A longstanding goal of Harpswell is to further the missions and impact of our nonprofit clients. We are focused on staying ahead of the curve when it comes to the DEIA and we continue to go well beyond the typical fund screening that most advisors undertake. (See Harpswell's 2020 DEI Study on our website: www.harpswell.com/library)

Harpswell
CAPITAL ADVISORS, LLC

April 2021 Flash Report

Overview: GDP jumped 6.4% for the first three months of the year on an annualized basis in a consumer fueled recovery. The rise in GDP was widespread, including increased personal consumption, fixed residential and nonresidential investment and government spending. Declines in inventories and exports as well as an increase in imports subtracted from the gain. Overseas markets have been slower in recovering from the pandemic, contributing to the domestic trade imbalance. In a separate report, initial jobless claims fell to a pandemic-era low but the number was higher than expected. **Federal Reserve:** Chairman Powell reported that the Federal Reserve will keep its policy interest rate near zero and continue $120 billion in monthly asset purchases while acknowledging that there had been an improvement in the economic conditions.

Equities: Domestic – Equities rallied again in April as the economy continued to reopen, reflected by the substantial GDP growth in the 1st quarter. The **S&P 500** gained 5.3% in April and has increased by 11.8% YTD. The NASDAQ rebounded in the month, gaining 5.6% but has only gained 8.7% for the year.

The R1000 Value index gained 4.0% in April led by Utilities & Real Estate gains, offset somewhat by Energy. Growth stocks rose 6.8% as the Technology & Communications sectors rallied in the month.

The **R2000** gained 2.1%, lagging the returns of larger companies. Small Value increased by 2.0% while Small Growth earned slightly more, gaining 2.1%. Value has earned an impressive 23.6% in the 1st four months of the year.

International – Overseas economies lagged the US resulting in lower market returns. **EAFE** gained 3.1% in April as a weaker Dollar added 1.8% to the results. Japan was down 1.5% in the month and ahead by only 0.2% YTD.

Emerging Mkts – The Emerging markets gained 2.5% in April. China gained 1.4% and has turned positive by 1.0% YTD. India fell by 0.9% in the month as rising Covid infections concerned investors.

Fixed Income: Fed policymakers continued their accommodative policies by maintaining low interest rates and continuing their bond buying program. Recently, longer term rates have risen but fell in April as inflation concerns abated somewhat. Short term yields fell slightly, closing at 0.00% for the **90 Day T-bill.** The **10 Year Treasury** yield fell by 11bps to 1.63% while the **30 Year Treasury** yield closed at 2.30%, 11bps lower than last month.

Municipal short-term yields remained stable in April while decreasing modestly on the longer end. The **1 Year Municipal** yield fell by 2bps to 0.08% trading at a premium to a comparable Treasury. The **30 Year Municipal** yield decreased by 16bps to 1.65%; a 65bps discount versus the **30 Year Treasury**.

International yields moved in a narrow range again. **German** rates were modestly more negative moving to a (0.7%) yield for the **2 Year Bund** and to a (0.20%) yield for the **10 Year.** The **UK 10 Year Gilt** yield remained unchanged at 0.84%. The **Japanese 10 Year Gov't** bond yield was unchanged at 0.08% in April. The **2 Year** Yield remained at (0.13%).

High Yield bonds gained 1.1% in April closing with an average yield of 4.7%. The Aggregate Bond Index rose by 0.8% in the month as longer rates declined in the month, reflecting an approximate yield of 1.6%.

	1 Month	3 Months	YTD	1 Year	3 Years	5 Years
Domestic Equities						
Dow Jones	2.8%	13.5%	11.3%	42.1%	14.5%	16.5%
S&P 500	5.3%	13.0%	11.8%	46.0%	18.7%	17.4%
Russell LG Value	4.0%	16.8%	15.7%	45.9%	12.3%	12.2%
Russell LG Growth	6.8%	8.6%	7.8%	51.4%	25.4%	22.9%
Russell 2000	2.1%	9.6%	15.1%	74.9%	15.2%	16.5%
NASDAQ	5.6%	7.1%	8.7%	58.5%	26.8%	25.3%
MLP Index	7.2%	23.5%	30.7%	45.5%	-3.3%	-2.0%
REIT Index	8.1%	17.2%	17.1%	33.4%	13.5%	9.3%
International Equities						
EAFE	3.1%	7.9%	6.8%	40.5%	6.8%	9.4%
EAFE Small Companies	4.1%	9.3%	8.9%	53.2%	7.6%	11.3%
Emerging Markets	2.5%	1.8%	4.9%	49.2%	7.9%	12.9%
China	1.4%	-6.0%	1.0%	37.2%	8.9%	16.7%
Fixed Income						
US Agg	0.8%	-1.9%	-2.6%	-0.3%	5.2%	3.2%
US High Yield	1.1%	1.6%	2.0%	19.7%	7.0%	7.5%
Municipal Bonds	0.8%	-0.2%	0.5%	7.8%	5.3%	3.5%
Currencies						
EURO	2.5%	-0.9%	-1.6%	10.1%	-0.1%	1.0%
British Pound	0.3%	0.8%	1.3%	9.8%	0.2%	-1.1%
Japanese Yen	1.2%	-4.3%	-5.6%	-2.1%	0.0%	-0.4%
Commodities						
Bloomberg Commodity	8.3%	12.8%	15.8%	48.5%	1.6%	2.3%
S&P GSCI Crude Oil	7.4%	22.1%	31.3%	164.8%	-21.5%	-9.6%
Gold	3.0%	-4.6%	-7.1%	1.3%	8.7%	5.2%

Commodities: WTI Crude Oil gained **$4.1/barrel to $63.6/barrel** in April. Positive economic data and a weaker dollar helped the price of WTI crude move towards its post-pandemic high of $67.87 seen on March 7th. **Gold** prices rose by **$60/oz to $1767/oz** in the month as the dollar weakened and interest rates eased in the month. Gold remains "influenced by U.S. Treasury yields, the dollar's performance, reflation trade and global risk sentiment," said Lukman Otunuga, senior research analyst at FXTM.

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Risks

Harpswell invests in stocks, bonds, mutual funds and sometimes alternative investments. Each asset class, along with each individual investment, carries varied degrees of risk of loss. Harpswell analyses investments from a long-term fundamental perspective and aims to engineer portfolios that have an attractive risk and reward balance. Despite a strong bias for diversification, all Harpswell portfolios do carry risks of losses, particularly in times of escalated market volatility. Harpswell does focus on capital preservation yet extraordinary markets can potentially generate material losses.

Our investment decisions and recommendations are based upon our professional judgment. We do not guarantee the results of any of our investment decisions or recommendations, the future performance of your Assets or Accounts, any specific level of performance, the success of any Independent Manager, investment decision, strategy or recommendation made by an Independent Manager, or the overall success of the Account. Past performance is not indicative of future results. Investments in your Account may go up or down in value depending on market conditions.

Alternative investments are designed only for sophisticated investors who are able to bear the economic risk of losing all of their investment. Alternative investments: (1) often engage in leveraging and other speculative investment practices that may increase the risk of investment loss; (2) can be highly illiquid; (3) are not required to provide periodic pricing or valuation information to investors; (4) may involve complex tax structures and delays in distributing important tax information; (5) are not subject to the same regulatory requirements as mutual funds; and (6) often charge high fees.

Current Information

Opinions expressed are current opinions as of the date appearing in this material only. While the data contained herein has been prepared from information that Harpswell Capital Advisors believes to be reliable, Harpswell Capital Advisors does not warrant the accuracy or completeness of such information.

Use of Indices

Market index information shown herein, such as that of the S&P 500 Stock Index, is included to show relative market performance for the periods indicated and not as standards of comparison, since these are unmanaged, broadly based indices which differ in numerous respects from the portfolio composition of the Fund. Market index information was compiled from sources that Harpswell Capital Advisors believes to be reliable. No representation or guarantee is made hereby with respect to the accuracy or completeness of such data.

Index Definitions

The S&P 500 Stock Index is an unmanaged market capitalization index of 500 US equities generally considered to be representative of US stock market activity. The Morgan Stanley Capital International World Index is a market capitalization-weighted equity index of over 1,500 stocks traded in 22 world markets. The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on the NASDAQ Stock Market. The Index is market value-weighted. The SB World Bond Index is a market capitalization weighted index of 18 Government bond markets composed of sovereign debt denominated in the domestic currency. The Lehman Aggregate Index is a benchmark index made up of the Lehman Brothers. The Hennessee Hedge Fund Indices® are calculated from performance data obtained from publicly available information, internally developed data and other third party sources believed to be reliable. MSCI EAFE is a stock market index that is commonly used as a benchmark for the performance of major international equity markets. The MSCI Emerging Market Index is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. The Russell 1000 seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities. The Russell 2000 seeks to track the investment results of an index composed of small-capitalization U.S. equities. The Russell 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Barclays Capital Global Aggregate Bond Index is designed to be a broad based measure of the global investment-grade, fixed rate, fixed income corporate markets outside the United States. The Barclays Capital US Gov/Credit bond Index measures the performance of U.S. Dollar denominated U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year.

For further information please contact Harpswell Capital Advisors at
www.harpswelladvisors.com | info@harpswelladvisors.com | 877.427.7227