Global Economic & Investment Outlook

2016 — A Year of Transition

commonfund

Table of Contents

About Commonfund

Global Economic & Investment Outlook

2016 — A Year of Transition

Executive Summary

A year ago we were among the relatively few asset managers that expected the combination of continued strength in the U.S. economy, improving conditions in Japan, and weakness most everywhere else. We expected — and saw — that lackluster economic activity and earnings in the emerging markets would produce a "value trap." Further, while we did not expect the price of oil to fall as precipitously as it did, our outlook for commodity weakness and dollar appreciation was accurate. On a relative basis, our investors' portfolios benefited from these macro views. Yet absolute returns were weak, leaving most investors short of their long-term targets.

For 2016, we expect a year of transition in world capital markets as we enter the later stages of the post crisis market cycle in the United States. In this environment, markets are more discerning, volatility increases, earnings matter more and investors are more likely to benefit from the skill of active managers than the momentum and flows of the broader market. Our portfolio positioning for 2016 reflects this transition. We anticipate as the year unfolds investment opportunities will develop outside the United States which should fuel an asset allocation rebalancing to non-U.S. regions.

Headline Views

- Entering the eighth year of the post-crisis recovery, the path ahead will likely be volatile, and return expectations should be tempered. Earnings and valuations are anticipated to be a key driver of returns in the upcoming year.

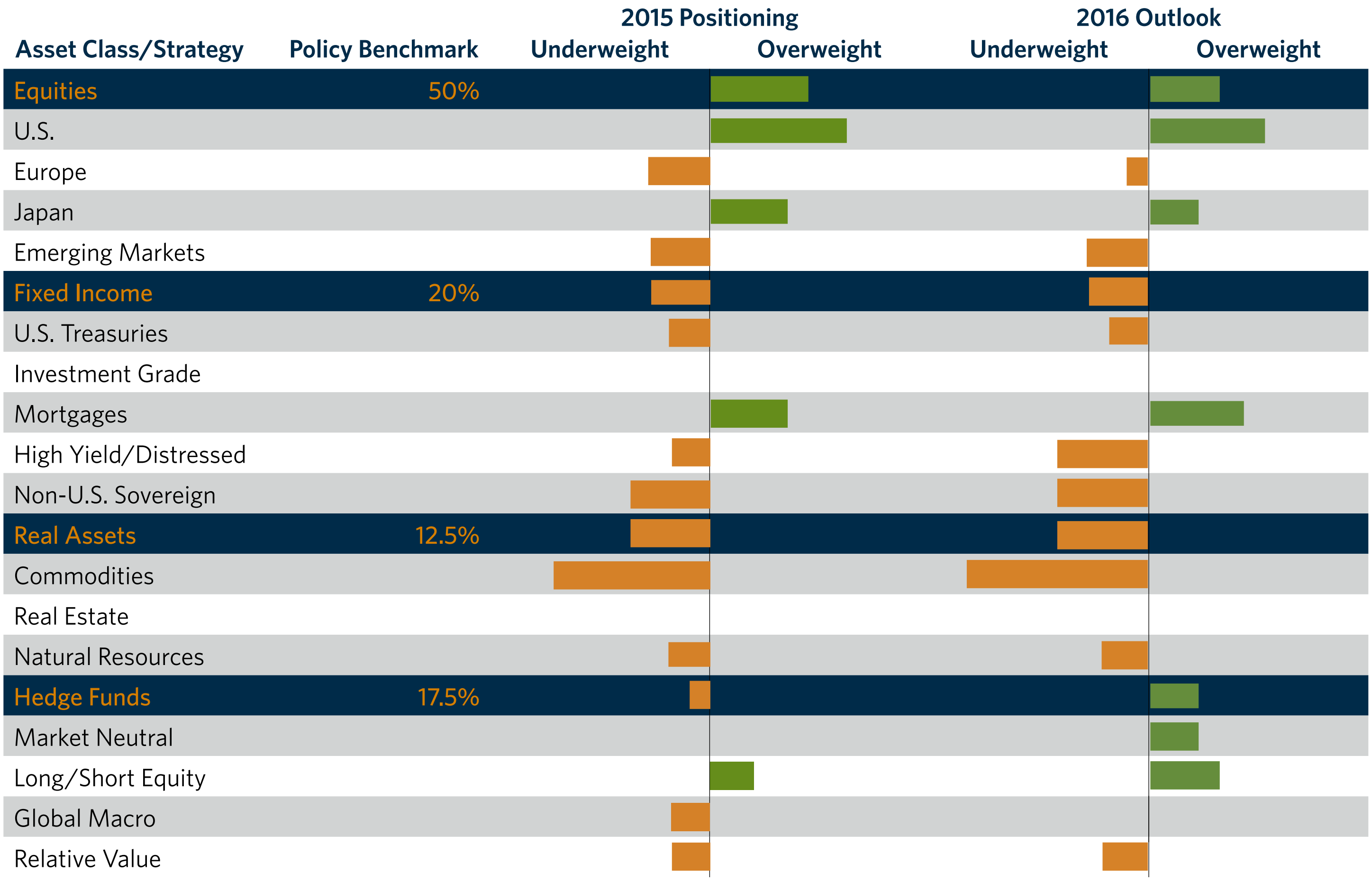
- Equities are fully priced, but remain attractive on a relative basis when viewed in the context of low Treasury yields and inflation.

- The Fed's path to normalization represents confidence in the U.S. economy and we do not believe that this action is bearish for U.S. equities provided it is slow and measured; on the other hand, returns from fixed income face major challenges.

- Near term, low energy prices provide a benefit to consumers. However, ongoing deterioration in the energy sector represents the greatest macro risk to our outlook. Any significant and sustained drop in oil prices precipitated by fears over global growth could spur a flight to quality in U.S. Treasuries and spark added challenges in credit markets.

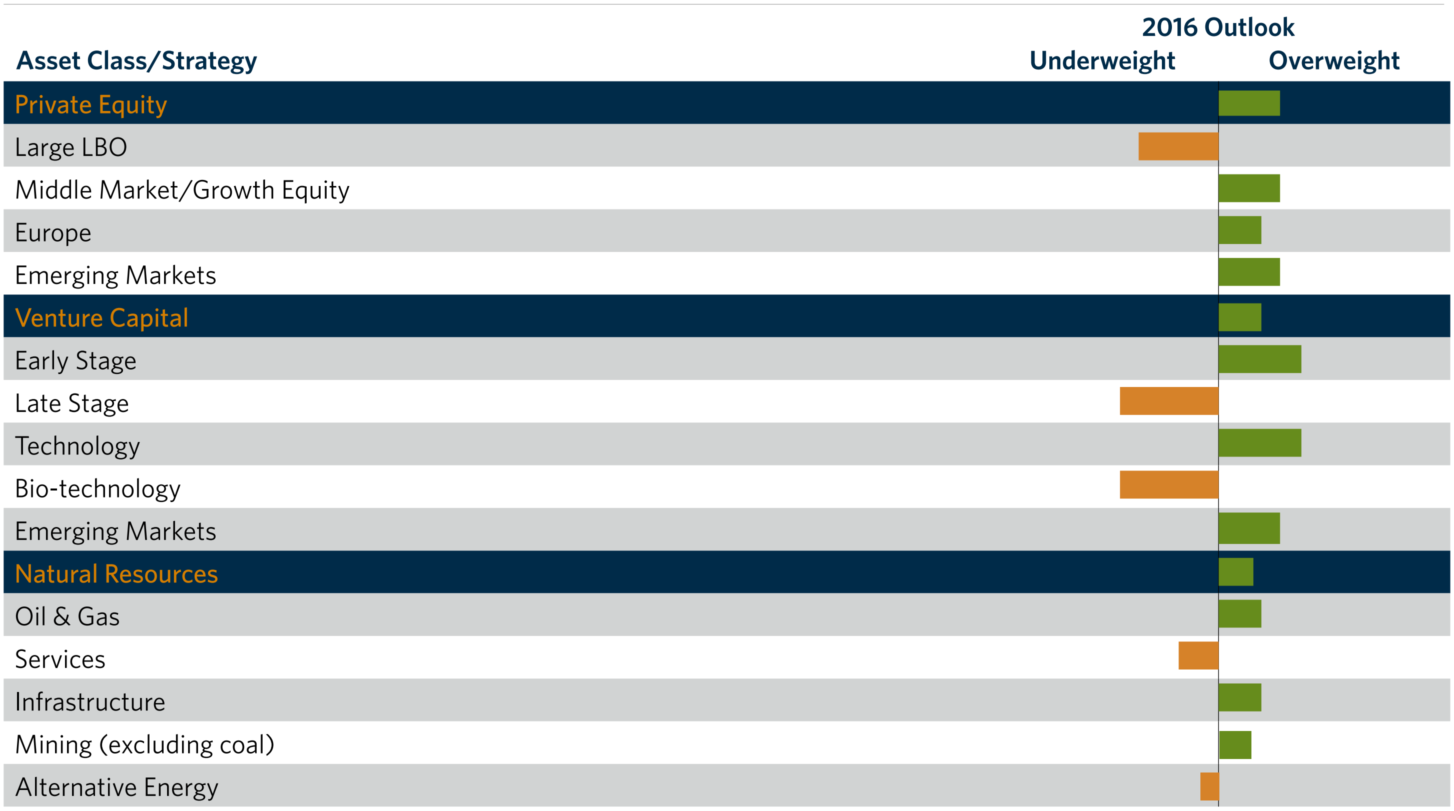
- Weak corporate earnings in Europe and China remain a challenge to improved equity returns in those markets; however, we are looking for signs of improvement in 2016, specifically an improvement in purchasing managers indices and industrial production.

PORTFOLIO POSITIONING | MARKETABLE STRATEGIES*



*Policy benchmark represents the target allocation for a Commonfund Policy Portfolio and excludes private capital. Please see Important Notes | Eligible Investors.

PORTFOLIO POSITIONING | PRIVATE STRATEGIES



Asset Allocation & Portfolio Positioning

- Consistent with 2015, we still favor an overweight to equities and underweights to fixed income and real assets.
- U.S. and Japanese public equities markets remain more attractive than Europe and the emerging markets; however, we anticipate an opportunity to increase allocations to these markets during the course of the year. Our portfolio positions favor quality (i.e. sustainable cash flow and low leverage) and value.
- For investors that are able to accept illiquidity in their portfolios, we favor commitments at the top end of policy ranges for private capital strategies to take advantage of the illiquidity premium over public market indices.
- Our outlook for fixed income is negative in the context of rising rates and a deteriorating credit environment; however, credit spreads already reflect some of these risks. Our portfolio positions favor lower duration and credit exposure in favor of higher quality mortgages and a barbelled allocation to U.S. Treasuries.
- Real asset strategies, in the absence of inflation, are unlikely to contribute significantly to returns; we will maintain an underweight to public market strategies in this asset class.
- Hedge fund strategies that have struggled for much of the post crisis period are more likely to be important contributors to portfolio performance this year; we favor strategies that mitigate equity beta and credit risk and see 2016 as an "alpha rich" environment for short sellers, and for long/short strategies in general.

OUTLOOK AT-A-GLANCE

	2016 Forecast
Global Equity Markets (total return)	
MSCI ACWI	+5.7%
S&P 500	+6.3%
MSCI EAFE	+5.4%
MSCI Emerging Markets	+4.3%
U.S. Debt Markets	
Fed Funds Rate (target range)	1.00% - 1.25%
10-Year U.S. Treasury Note (yield)	2.65%
Barclays U.S. Aggregate Bond Index (total return)	0.1%
Currencies, Commodities and Inflation	
Euro/ U.S. Dollar	1.05
Crude Oil (per barrel)	$45
U.S. Core Inflation (core CPI & PCE average)	1.8%

2016 Macro Indicators

Five indicators form the basis of our asset allocation views and portfolio positioning for the coming year:

- Late Stage Economic Cycle
- Slow and Steady Fed
- Stable U.S. Dollar
- Stable/Modestly Rising Oil Prices
- Earnings Matter

Late Stage Economic Cycle

The current economic cycle is long by historical terms. To put this in context, the current cycle which began in 2009 is now almost seven years old in comparison to the longest post-World War II economic expansion of nearly ten years (1991 - 2000). While we believe that we are late in the cycle, we also believe that the world's economies have further room to expand in 2016.

Our global growth outlook is for moderate, albeit above consensus, growth of three percent. We expect U.S. real GDP growth to rebound to 2.7 percent, and look for a modest growth rate in Europe (1.7 percent) and Japan (1.5 percent), while emerging economic activity is expected to remain below historical trends at close to four percent. We forecast that structurally, economic growth in China will decelerate to roughly five percent, with the Chinese government likely to announce real GDP in the range of its official target of 6.8 percent.

United States

Consumer spending has been expanding at a 3.2 percent pace, benefiting from a strong rise in real income and favorable demographics. We have seen what we believe is the start of a solid rise in household formations among millennials which is providing a boost to the housing and auto sectors of the economy. In fact, both of these sectors are registering the best readings in the current economic cycle. The civilian unemployment rate has dropped to 5.0 percent and will likely decline to 4.5 percent in 2016. The combination of improving wages and low energy prices is likely to spur consumer spending more broadly.

Europe

We still see significant macroeconomic challenges in Europe that are now being exacerbated by a weaker northern European export market as well as geopolitical and economic difficulties. Middle East tensions, the conflict with Germany (which is opposed to aggressive additional ECB stimulus), combined with the separatist challenges across Europe suggest that the EU is more fragile. Moreover, the upcoming U.K. referendum on EU membership at a minimum underscores, and could exacerbate, this fragility.

Europe will continue to face low growth and low inflation. We remain cautious and concerned that the fundamental factors needed to fuel a major upturn in earnings from Europe, specifically better profit margins and stronger economic activity, will take longer to develop. We anticipate that 2016 will be a year of transition that will eventually fuel a better investment environment and a likely rebalancing to regional allocations as the year unfolds.

Japan

Abenomics has aged well, and the final pillar, that of engaging in sustainable structural change in the economy, is likely to support the economy and the equity markets in the coming year. One example, the JPY-Nikkei 400 Index was launched in January 2014 to entice corporate Japan to boost equity returns. The index will only include companies that score favorably on ROE, operating profits and market cap metrics, with additional weight given to their willingness to elect independent outside directors, adoption of IFRS (international accounting standards), among other criteria. With the GPIF (Japan's largest pension fund) throwing its weight behind the index by using it as its equity benchmark instead of TOPIX, there is a virtual race to the top in corporate Japan to improve profitability.

The combination of a low unemployment rate, positive real income growth, and capital flows into the Japanese equity market will likely remain favorable developments for the near-term; however demographic challenges are likely to impede growth longer term.

Emerging Economies

The BRIC's are no longer a bloc: Brazil and Russia face deep recessions and growth in China has slowed dramatically. We are also alert to any signals that the large dollar-denominated debt that has been issued by large resource oriented companies, several of which are in Brazil and Russia, could be the spark that leads to a credit-related tail risk for the global economy in 2016.

India remains a bright spot as it benefits from lower resource prices and has taken the right monetary and fiscal policy actions to stimulate its economy, without fueling inflation pressures. More broadly, non-energy producing emerging markets economies outside of the BRICs are likely to be more stable in comparison to the last few years – a period marked by dramatic currency depreciation on the heels of the "taper tantrum" of 2013 and 2014.

China's near term issues remain a concern as the rotation to a more service-oriented economy has not gone smoothly. The Chinese economy remains hampered by weak corporate profits associated with the housing bubble and redundant capacity in the industrial and resource sectors. China has stepped up its stimulus efforts as government spending has surged to 12 percent of real GDP, with a likely increase into the mid-to-upper teens in the upcoming year. We will take our clues from the underlying components of GDP and earnings to evaluate how well China is transitioning to a more balanced economy.

Slow and Steady Fed

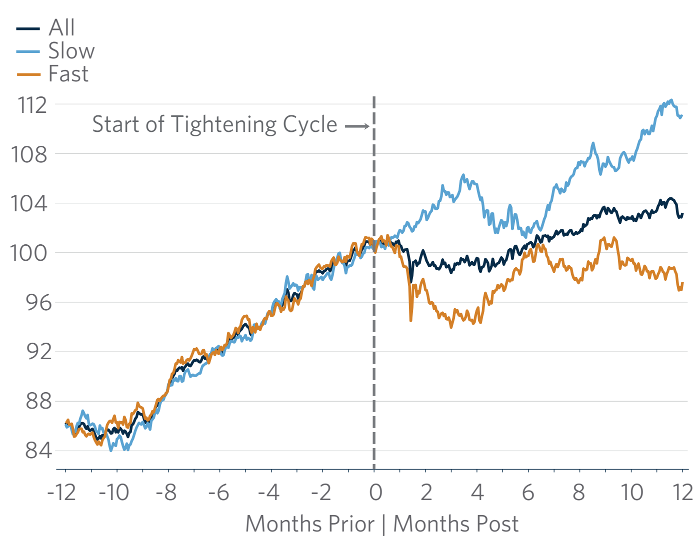
The United States has started to normalize rates, while Europe, Japan, and China are trying to find new ways to provide additional stimulus in a more difficult political world. The divergent paths for policy actions and the greater political, economic, and financial market uncertainty outside of the United States are risks today that at some point in the future should become investment opportunities.

With the turn of the calendar to 2016, a new group of regional Federal Reserve presidents will become voters on the FOMC. In comparison to the 2015 voting group, the 2016 policy voters have a significantly more hawkish bias and a more positive view on structural economic conditions. We anticipate the future direction of monetary policy to be a low and slow normalization process that will likely be comprised of 25 basis point rate hikes every two or three FOMC meetings for the next 12 to 15 months if the incoming data support such action.

Our year-end 2016 target range for the Fed funds rate is 1.00 - 1.25 percent, and by the end of 2017 we believe that the Fed funds target rate will be 1.75 - 2.00 percent. This is higher than what is currently implied by the term structure of interest rates, but it is lower than the Fed's latest central tendency forecast. In contrast, Europe is likely to continue on its path of negative interest rates and quantitative easing, Japan will continue to use monetary and fiscal actions to boost growth, while China's stimulus measures are likely to include a combination of targeted tax cut programs as well as further rate and currency adjustments.

Although many market participants fear any rate adjustment upward by the Fed, historically a low and slow tightening cycle by the Fed has been reasonably well-received by the equity markets. As shown in the graph below, since 1946, the S&P 500 Index has posted an average gain of about 11 percent in the year following the first low and slow rate hike. We believe that if the Fed normalizes monetary policy at a low and slow pace (our most likely scenario) the equity market should ultimately be able to withstand it. However, we should also note that we are in the later stages of an extended economic cycle, and our asset class return forecasts are lower than recent years.

S&P 500 INDEX AROUND THE START OF FED TIGHTENING CYCLES



Source: Ned Davis Research

Stable U.S. Dollar

The consensus call among economists and market participants has been uniformly bullish for the U.S. dollar to move to parity against the euro and for the dollar/yen exchange rate to move to 135. We believe that the dollar will remain strong, but are less bullish than the consensus view forecasting that euro/dollar will end next year near 1.05 and the dollar to Yen will be at 125.

Longer term we foresee a weaker euro beyond 2016 which should benefit European exporters and provide positive stimulus to European equities.

Monetary policy movements and interest rate differentials are often perceived to be the key drivers of currency valuations. In recent months, the general perception in the financial markets has been that an easing in monetary policy by the ECB and a tightening in monetary policy by the Federal Reserve would drive the dollar higher. However in FOREX markets the dollar actually weakened slightly versus the euro in the weeks prior to the initial rate hike by the Federal Reserve. While dollar weakening may have been counterintuitive, it was consistent with the initial phases of tightening cycles in 1994, 1999 and 2004.

This suggests to us that the dollar might not strengthen as much as many traders and investors seem to expect. A generally stable dollar could have other implications, including providing support to the badly beaten commodity- and resource-producing sectors, as well as tempering a portion of the challenges among U.S. global multinational companies, energy companies and market resource providers.

However, aggressive quantitative easing outside of the United States combined with the currency devaluation could lead to an unanticipated strengthening of the dollar. Under this scenario, deflation risks would increase which would further challenge growth, commodities and emerging market asset valuations.

Stable/Rising Oil Prices

The impact of the price of oil on the world economy over the last year has been dramatic, with naturally divergent impacts for consumers and producers. The sharp drop in energy prices and revenues has fueled a major recession in resource rich economies such as Russia and Brazil. In contrast to 1998, when Russia and Brazil defaulted on sovereign debt, our concern today is corporate debt. Russia and Brazil are better protected with reserves today than in 1998. However, a few corporations (particularly in the energy and mining sectors) in both countries are saddled with significant debt that will be difficult to service and repay. For producers in the United States the fall in oil prices has been painful as well. The energy investment boom in the United States may be ending and the decline in CAPEX from this industry will likely be followed by lean months and quarters ahead. We expect a dramatic disruption in the energy complex as much of the U.S. investment in the last several years was based on $50-60 per barrel (and higher) oil. This year we anticipate that crude oil prices will rise to $45 per barrel, which is about $3 to $5 above today's implied forward curve in the futures market. This could still lead to many bankruptcies, with a pick-up in defaults from high yield and distressed bonds.

The larger impact of lower energy costs in the United States however, is positive. For 2016, we look for low energy costs to continue to provide stimulus to the U.S. consumer and manufacturing. The drop in energy prices has been the equivalent of a tax cut, with the greatest benefits being received by traditional manufacturing companies and the middle class U.S. consumer via a solid rise in real personal income. This should help to boost discretionary consumer spending. Similarly, capital expenditures outside of the energy sector have remained strong, reflecting the positive benefits of lower energy costs and a stronger consumer.

If oil prices continue to weaken, we would expect lower global growth, potential contagion from debt defaults and a flight to quality to U.S. Treasuries.

Earnings Matter

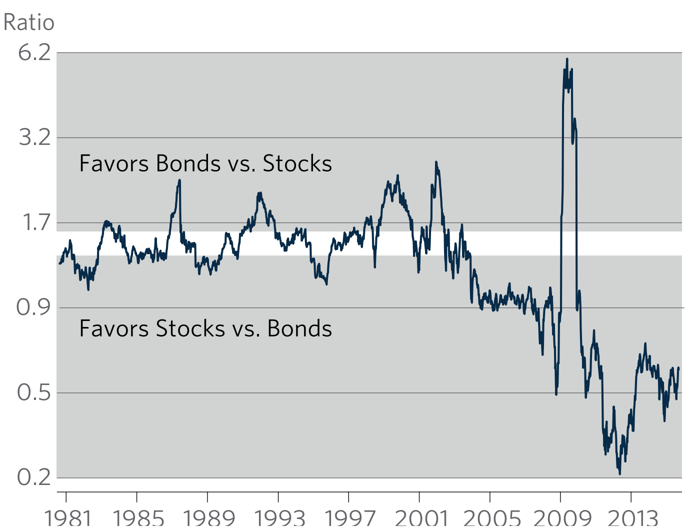
In the later stages of an economic cycle, valuations – and earnings – become more important. Momentum and funds flows no longer "raise all boats" and markets become more discerning, separating winners from losers. In this environment, we believe it is prudent to allocate to sectors and regions that demonstrate the ability to generate sustained earnings growth.

For U.S. equities, we see several good fundamental conditions, including moderate economic growth with low inflation, a likely rebound in earnings, share repurchases, and M&A activity. One of the external influences that could support equities is the "cheap" relative valuation of U.S. stocks versus Treasuries. Although the S&P 500 index is fully-priced at a P/E of 18.5 times trailing earnings, it is "cheap" versus the 2.25 percent yield on 10-year Treasuries. Forty percent of the S&P 500 companies have dividends above the yield on 10-year Treasuries, with the overwhelming majority at high coverage ratios, which should provide underlying support for stocks from bondholders looking for higher income returns.

In contrast, European equities and some emerging markets have had earnings shortfalls that have boosted trailing P/E multiples to 20 or 30 times. While valuations are more reasonable on a forward looking basis, particularly in Europe, these higher multiples outside the U.S. are factors to watch, especially if earnings fail to meet or exceed expectations. That said, valuation is rarely the primary driver of positive market performance. Earnings growth and external influences should be the keys to market performance. Many European companies have been right-sized and have the potential for a rebound in earnings if top line revenue growth is realized. On a comparative basis, the drag from lower energy prices and a stronger dollar should temper in 2016 as the sharp moves of the last year are unlikely to be repeated.

STOCKS CHEAP TO BONDS

S&P 500 P/E vs. Earnings Yield 10-Year Treasuries | 1981 - 2015



Source: Ned Davis Research

Asset Allocation & Portfolio Positioning

As we start 2016 our asset allocation view is similar to last year, but more likely to change over the coming 12 months:

- Overweight U.S. and Japanese public equities.
- Underweight European and emerging market public equities.
- Underweight fixed income, including credit.
- Underweight real assets, neutral on real estate and underweight commodities and public market natural resources.
- Overweight private capital strategies to the extent investors are able to accept illiquidity in their portfolios.

The next five years will be challenging for our investors, most of whom seek a real return of approximately five percent (or nominal return of approximately seven percent) in order to maintain purchasing power. Most paths to CPI plus five percent are projected to fall short over the next five years and the path may also involve substantial volatility:

- Our market forecast for a 70/30 passive portfolio consisting of the S&P 500 Index and the Barclays U.S. Aggregate Bond Index will post a nominal return of just four percent over the next five years.
- A more diversified portfolio based on the NACUBO - Commonfund Study of Endowments® (NCSE) data is projected to earn 4.6 percent over the next five years, if we assume no alpha.
- If we incorporate our sub-asset class assumptions for alpha revealed in our five-year forecasts we expect median returns of 6.0 percent.

The Path to CPI Plus Five Percent

Over the next five years the current market cycle will likely end. We do not expect that in 2016 but given our late cycle view, we are allocating to managers who will execute strategies on our behalf that emphasize quality, low leverage and increased liquidity. At the same time, over the longer five-year period we are focused on tactical asset allocation and investment strategies that can bridge this CPI plus five percent gap consistent with prudent risk taking. Key elements of our strategy are:

- Anticipating an equity rotation from momentum to value.
- Increased allocations to high conviction active managers and stock pickers.
- Reallocating capital to Europe and, to a lesser extent, emerging markets contingent on improving indicators.
- Greater use of equity market neutral strategies in portfolios to provide a more flexible approach to manage market exposure while still maximizing opportunity to generate uncorrelated returns.
- Increased allocations to lower-net hedged equity managers that seek to offer more opportunity for active security selection (including shorting) to achieve diversification benefits.
- Taking advantage of market dislocations in distressed segments (e.g. credit, energy, real estate) via hybrid duration funds.
- Higher allocation to private strategies (e.g. private capital, mezzanine debt, direct lending, real estate) for investors that can accept increased illiquidity.

Equities

We have slightly narrowed our relative overweight to the United States and Japan and reduced relative underweights to Europe, and are looking for market indications to neutralize and perhaps overweight Europe in the months ahead. The factors that would drive this decision are:

- A softening of Germany's stance within the ECB that could lead to additional monetary policy easing.

MACRO INDICATORS & POSITIONING

Our strategy and portfolio positioning decisions are centered on five macro indicators that will drive the timing and execution of the following specific strategies.

Macro Indicators	Strategy/Portfolio Positioning
Late Stage Economic Cycle	• Favor companies with quality, low leverage and strong cash flow • Increase allocations to long/short equity • Allocate to upper range of policy ranges for private capital for investors able to accept illiquidity risk
Slow and Steady Fed	• Favor short duration, high coupon mortgages and a barbell exposure to U.S. Treasuries • Maintain emphasis on quality across all sectors • Overweight to U.S. financial sector equities
Stable U.S. Dollar	• Favor increased allocation to non-dollar equities • Overweight U.S. industrials • Maintain unhedged currency exposures
Stable/Modestly Rising Oil Prices	• Overweight global equities • Reallocate opportunistically to energy/natural resources and commodities • Reduce duration in fixed income
Earnings Matter	• Overweight sectors and regions that demonstrate the ability to generate sustained earnings growth • Maintain tactical equity overweight to Japan • Favor active share managers over closet indexers and broad-based indices

- Improvement in earnings among European companies; evidence of stronger earnings is emerging among small and mid-cap stocks, but not among large caps.

- Eurozone geopolitical stability, specifically indications that more extreme political parties on the right and left do not significantly increase their power.

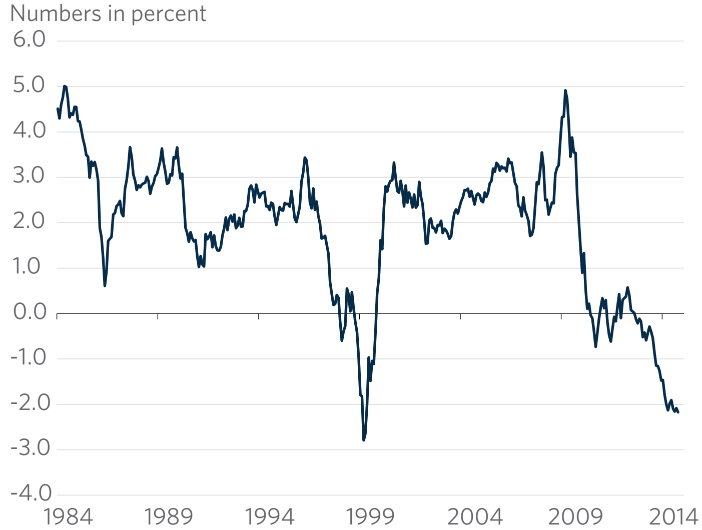
Our underweight to the emerging markets is predominantly among the energy and resource providers. Should crude oil prices reverse and settle above our forecast of $45 per barrel we could see a broader boost for the resource producing emerging markets. Another indicator in addition to improved earnings that would cause us to reallocate to emerging market equities is a move down in the U.S. dollar. Specifically, if the modest reaction of the dollar to the latest monetary actions continues, it could provide a trigger, as emerging market equities are highly sensitive to the U.S. dollar.

Our equity strategy for 2016 will focus on earnings, which we believe will drive equity returns rather than any further expansion in the P/E ratio. This is true in the United States, Europe and emerging markets. We will focus on managers with high conviction, concentrated portfolios and will balance that with allocations to low volatility managers (including stable high dividend equities with favorable cash flow) with less market exposure to reduce portfolio volatility. We are moderately optimistic with regards to U.S. earnings. Low domestic input costs associated with improved production efficiency, cost advantages from the decline in energy costs, and strong productivity gains in the business sector are expected to produce an increase in earnings in 2016. Our current view on earnings outside the United States is less sanguine, but this is likely to evolve during the year.

Within the equity markets, momentum continues to win as a factor, although signs are growing for a possible shift to a more value-oriented environment. As shown in the following chart, on a 10-year rolling return basis, value as a style is near an historic performance low versus growth, topped only by the technology, media, and telecommunication (TMT) bubble era. This may provide an opportunity for rebalancing into value strategies in 2016 and would support the notion that the upcoming year could be one of transition.

MSCI WORLD VALUE VS. GROWTH

10-year Rolling Excess Returns | 1984 - 2015



Source: FactSet

Fixed Income

We continue to support an underweight to fixed income securities. Within U.S. Treasuries, we favor a barbell positioning as we anticipate the yield curve to flatten with longer-dated securities outperforming shorter-maturity notes in a modestly rising rate environment. We favor an overweight to mortgages (including short-duration higher-coupon mortgages) and an underweight to high yield and distressed credit due to deterioration in corporate credit quality and increasing leverage from share buybacks and merger and acquisition activity. However, credit spreads have already widened substantially in late 2015, at least partially reflecting this more uncertain environment.

While valuations have moved to reflect these poorer fundamentals, on an intermediate term basis, we continue to favor a gradual transition to a more defensive posture within the credit markets, acknowledging there is potential for some shorter term gains from current levels. In the non-U.S. markets we see pockets of value in some stressed countries and currencies, but remain somewhat cautious given the strong momentum and relatively poor fundamentals pushing the other way.

On the other hand, low inflation, the economic problems in several resource-oriented emerging markets, combined with business difficulty in high-cost energy providers, could fuel a continuation of the flight-to-safety buying in longer-dated U.S. Treasuries.

Over the next several years, we still believe that the yield on 10-year Treasury notes will back up, but we anticipate that the adjustment process will be limited and that 10-year notes will see strong support as yields approach low-to-mid three percent. Similarly, we anticipate that the next cycle in monetary policy from the Fed will only take the funds rate up towards three percent over the next several years, which is lower than the terminal rate projected by most Fed officials. The net result of these events could provide an opportunity for investors to rebalance back into Treasuries and fixed income securities as we move further along in the interest rate adjustment cycle in 12 to 24 months.

We believe that risks far exceed rewards in fixed income in 2016. The structure of fixed income markets has been changing through the combination of increased banking and market regulation and less dealer activity supporting underlying liquidity. The significant growth in the size of the fixed income ETF's and increased market share of retail products offering intraday and daily liquidity are significant issues. The result may be a market where the actual underlying assets might not be liquid enough to meet daily redemption requirements in times of stress, producing a market more susceptible to volatility and dislocation. Today's larger and more fluid credit markets have lost the traditional shock absorbers of broker/dealer balance sheets and have a less stable ownership profile. We continue to be particularly concerned about potential liquidity mismatches such as what unfolded in December in the high yield and distressed bond markets. Likewise, we are concerned about liquidity issues that exist with ETF's, particularly in times of market stress.

Real Assets

Inflation in the United States is low and will likely remain low in 2016. The sharp drop in energy costs will continue to hold down headline inflation while the core CPI and core consumption deflator components should remain in check near the Fed's two percent target. We believe that inflation will bottom in the first half of the year, and the subsequent rise will be limited. As such, we continue to advocate an underweight to inflation hedging strategies, specifically an underweight to commodities and public natural resources and a neutral weight to real estate.

Commodities struggled in 2015 with a strong U.S. dollar, solid production, reduced demand from emerging markets, and favorable weather patterns that fueled a cutback in energy usage in North America which exacerbated oversupply conditions into year-end.

We anticipate that the weak current price conditions should lead to further cuts in production and capital investment across the commodities complex. Eventually this should alleviate at least a portion of the inventory overhang in the second half of 2016. Similarly, curtailments in base metals should help move these markets back towards better balance. We expect 2016 to be a transition year for commodities and natural resource public equities, with the year beginning with oversupply challenges but ending with a somewhat better balance between output and demand. We are looking for a bottom in input costs in 2016 that may provide an opportunity to increase allocations in the commodity, natural resources, and resource-providing sectors. We do believe that there will be an opportunity for active managers; however our broad view is that any improvement in natural resource equities must be preceded by a sustained recovery in commodity prices.

Our neutral weighting to real estate is based on our expectation that real estate will deliver moderate returns in 2016, although at a likely decelerated rate from the torrid pace of the last few years. Fundamentals in the domestic real estate market continue to be positive with employment gains and favorable household formations. However, near-term challenges within the energy sector, and the fact that capitalization rates are at an all-time low in certain sectors (e.g. multi-family housing, class-A office space in Tier I cities), could temper gains in this asset class as the Fed continues to normalize interest rates. On a positive note, the current interest rate environment is priced with some cushion as cap rates today are about 250 basis points higher than 10-year Treasury note yields. Moreover, speculative real estate activity has been limited as underwriting standards have remained high, leverage in the industry has remained low, and speculative pre-development activity has been light.

Hedge Fund Strategies

Hedged equity strategies in 2016 will be important to dampen portfolio volatility and generate alpha from long and short positions.

We are increasingly cautious about equity and credit beta. Accordingly, we are shifting our primary focus to managers who seek to generate returns from sources other than direct market risk. Given that we are in the later stages of the current credit cycle, we see no reason to expect a reduction in volatility, and indeed would anticipate that volatility normalizes at generally higher levels. Such a heightened volatility environment should favor hedge fund managers who manage with tighter net exposures and typically more stable beta properties over longer-biased managers. A deteriorating credit environment, rising interest rates, commodity prices at levels low enough to be materially disruptive for many companies and industries, and the continuing development of industry altering technologies all suggest an above average or "alpha rich" environment for short sellers.

We remain focused on seeking both attractive risk-adjusted returns and significant diversification benefits from our hedge fund portfolios. In this context, we are particularly sensitive to overlapping risks across our hedge fund managers. We are sourcing managers who target niche opportunity sets, control smaller amounts of assets, operate in less competitive geographies and have unique competitive advantages.

Consistent with these views, heading into 2016 we are reducing redundant exposure to primary equity and credit factors and shifting allocations to managers who demonstrate an ability to generate alpha on the long and short side. We are paying particular attention to credit markets, where recent volatility has begun to create potentially significant dislocation opportunities. We are adding to diversifying liquid macro strategies (i.e. non-systematic, discretionary global macro managers), especially those that place a premium on drawdown control. We are similarly reducing redundant risk across our event driven manager portfolios while leaning into strategies, such as merger arbitrage, that are relatively insulated from primary equity beta risk.

Private Capital

Valuations in most sectors of the private equity and venture capital markets remain fully priced, typical of the late stage of a market cycle. We and our managers are using this environment to monetize investments at these relatively high prices and return capital to investors. Opportunities to deploy new capital in private strategies remain; however, we are cautious about certain segments of the market, most notably, more highly leveraged large buyouts and later stage venture where valuations are at their highest.

We do like a number of opportunities where capital is scarce and valuations tend to be more attractive, specifically:

- Strategies that take advantage of the growing consumer class in emerging markets, and in particular, China.
- Investments in distressed and turnaround companies in Europe, and eventually in the energy sector.
- Deep value sectors in the United States and Europe, which typically represent middle market generational transfers of wealth.
- Companies that demonstrate resilient growth and exhibit high levels of recurring cash flows, broad customer bases and high barriers to entry.
- Early stage venture capital to take advantage of the continued evolution of the tech cycle.

Given global private market and pricing dislocations, we continue to see compelling opportunities in the emerging markets and natural resources.

Emerging Markets

Private markets – both venture capital and private equity – provide an attractive entry point to the emerging markets global consumer versus public markets which tend to have high concentrations in current and former state owned enterprises, and the financial and materials sectors.

The developing consumer class in the emerging markets represents an opportunity for wealth creation in an order of magnitude far greater than what the United States realized in the post war baby boom. Notwithstanding the growth challenges facing China today, McKinsey estimates that the upper middle class as a percentage of urban households in China will rise from 13 percent in 2012 to 54 percent by 2022. This segment, more so than the mass middle market, is expected to be the principal engine of consumer spending in China over the next decade. In this environment we favor consumer services (e.g. healthcare) and mobile internet in particular.

Natural Resources

The environment for natural resources is challenged today in light of the dramatic fall in crude oil prices. Metals and mining, oilfield services and exploration and production public equities have fallen by 40-60 percent over the last 15 months. Many private companies have put in place commodity hedges which are providing some downside protection to this battered sector of the U.S. economy. Still, this market disruption will likely create investment opportunities over the next 12-18 months. Most important, we continue to favor opportunities that have low leverage and overall lower finding and development costs.

Conclusion

Our asset class projections for both 2016 and the next five years are below returns earned earlier in this cycle. For public markets, we project mid-single digit returns for equities, less for fixed income and credit. We believe that private investments will fare better, with median managers generating an illiquidity premium of approximately 300 basis points above public market indices. In this environment, it is our belief that active management - that is, alpha generation through security selection - will provide better opportunities than passive beta plays, however defined. The United States has already experienced one of history's longest economic expansions, and perhaps the end of one of the greatest economic experiments - quantitative easing. As this long cycle matures, we believe that 2016 will be a year of transition where fundamental valuation, and astute security selection, will again become the primary drivers of returns.

Appendix

2016 Market Scenarios

In formulating our projections for 2016, we calculated a weighted average of each of three scenarios below to generate our forecast. Our focus is on the most likely scenarios that we have termed our base case, bull base, and bear case. This scenario analysis looks at the most likely outcomes and does not focus on what we would view as the five percent extreme tails to either the upside or downside.

Base Case
50 percent probability

Our base case core scenario, for which we attach our highest probability, incorporates that the U.S. economy expands at a 2.8 percent real pace in 2016 and that the civilian unemployment rate drops to 4.5 percent. In this scenario we expect the yield on 10-year U.S. Treasury notes to increase from the current yield of 2.25 percent to 2.75 percent and for the S&P 500 Index to rise to 2185. On the monetary policy front, this most likely scenario would push the Fed to begin to normalize the funds rate at a slow and gradual pace every two to three FOMC meetings to a year-end upper target of 1.25 percent. Under our base case, European real economic activity would gradually recover to about a 1.7 percent pace, while real growth in Japan would expand to about a 1.5 percent pace. The greatest risk to our core scenario is valuations as the fear of contagion from continued problems among resource providers and in Europe could fuel a stronger reduction in P/E multiples.

Bull Case
20 percent probability

A return to an industrial production renaissance in the U.S., combined with employment gains that drive the unemployment rate down to 4 percent, a strong increase in real income, a rebound in discretionary spending from the middle class, and a moderate rise from housing and business investment, could provide the seeds to stronger economic growth. An associated rise in consumer net worth, consumer confidence, corporate cash flow, and profits, could provide the basis for a "bull case" growth surprise in 2016, with the added boost coming from stimulus associated from the drop in energy costs in similar fashion to what unfolded in early 1987 after the last large drop in oil prices almost 30 years ago. Under the bull case scenario real GDP in the United States could increase towards a 3.7 percent pace, while Europe could post a positive 2.5 percent gain in real growth. Likewise, emerging economies would potentially accelerate to a 5.0 percent pace, with crude oil prices rebounding toward $55 to $60 per barrel. S&P 500 earnings could increase at a double digit pace, with the financials, consumer discretionary, and energy sectors all performing well. The S&P 500 index could post a total return in the low- to mid-teens with a stable P/E multiple. Under this scenario, we would likely see a rotation from fixed income to equities as the 10-year Treasury note moves back towards 3.25 percent reflecting a somewhat faster monetary policy normalization by the Fed. If the "bull case" is realized, it is also anticipated to jump-start both economic activity and the equity markets in the non-U.S. developed and emerging world.

Bear Case
20 percent probability

For this scenario to unfold we would likely see renewed challenges associated with extremely weak materials and energy prices. U.S. real economic growth could slow to just 1.5 percent and the decline in the unemployment rate would end. If realized, the Fed would likely abandon the normalization process, the 10-year Treasury note could receive a further flight to safety boost that lowers the yield to 1.75 percent, the P/E multiple for the S&P 500 Index would contract, and the S&P 500 Index would likely post a negative total return for the year. Catalysts for this scenario could also include a sharper slowdown in economic activity in China, another retest of a recession in either Europe or Japan, or a significant recession in resource-centered countries and industries.

Asset class forecasts are presented in the tables and charts that follow. The one- and five-year forecasts incorporate economic growth, margins, income, valuations, stock buybacks, currencies, term structure of interest rates, monetary policy, credit spreads, default rates, and cap rates. Our five-year forecasts for the broader asset classes also add assumptions for beta to public markets, the illiquidity premium (based on median return assumptions), and lagged valuation factors. For our five-year outlook we anticipate a test of the economic cycle for both valuation and growth. We have also used our modeling process to forecast returns both excluding and including our projections for alpha for individual sub-asset classes. Please see Important Notes regarding forecasts.

FIVE-YEAR FORECASTS WITH ASSUMPTIONS

Numbers in percent

Passive 70/30 Portfolio[1]

	Allocation	Return
Equity Strategies	70.0	4.9
U.S. Large Cap	70.0	4.9
Fixed Income Strategies	30.0	1.8
Core Bonds	30.0	1.8
Total (Expected 5-year)	100.0	4.0
Total Beta		4.0
Total Alpha (α)		0.0

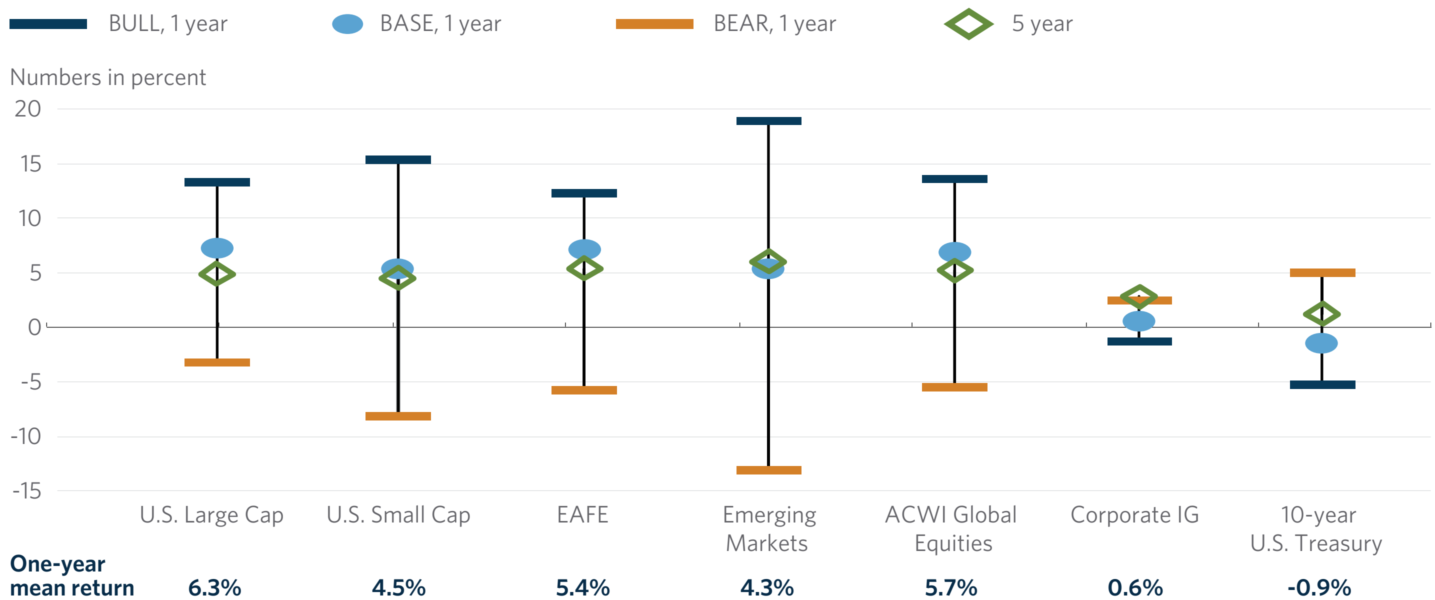
NCSE Average Portfolio[2]

		Median Returns	
	Allocation	excluding α	including α
Equity Strategies	51.0	5.3	6.8
U.S.	17.0	4.9	5.9
Non-U.S.	19.0	5.4	6.4
Private Equity	11.0	5.6	8.4
Venture Capital	4.0	5.6	8.4
Fixed Income Strategies	13.0	1.6	2.0
Short-term (3-moT-bill)	4.0	1.2	1.2
Core Bonds	9.0	1.8	2.3
Hedge Fund Strategies	24.0	4.2	5.7
Long/Short Equity	5.3	4.5	6.0
Global Macro	1.0	3.1	4.6
Relative Value	5.3	4.2	5.7
Equity Market Neutral	5.3	3.4	5.2
Event Driven	5.3	4.5	6.0
Distressed Debt	2.0	4.8	6.3
Real Asset Strategies	12.0	5.4	7.1
Public Natural Resources	6.0	6.1	6.8
Private Real Estate	6.0	4.7	7.4
Total (Expected 5-year)	100.0	4.6	6.0
Total Beta[3]			4.6
Total Alpha (α)			1.4

[1]S&P 500 Index/Barclays U.S. Aggregate Bond Index
[2]NACUBO-Commonfund Study of Endowments Total Institutions (dollar-weighted) as of June 30, 2014
[3]Includes median alpha for hedge funds and private capital

2016 FORECASTS: ONE- AND FIVE-YEAR HORIZONS

Return* excluding alpha



*The returns shown are for passive investment (i.e. excluding alpha).
Source: Commonfund

POTENTIAL SCENARIO ANALYSIS AND RETURNS OF THE S&P 500 IN 2016*

Scenario	Probability	Real GDP U.S.	Real GDP Europe	Real GDP Japan	U.S. Unem-ployment Rate	10-Year U.S. Treasury Note Yield	S&P 500 Index Level
Bear	20%	1.5%	0.6%	0.5%	5.0%	1.75%	1975
Base	50%	2.8%	1.7%	1.5%	4.5%	2.75%	2185
Bull	20%	3.7%	2.8%	2.5%	4.0%	3.25%	2300
Weighted Average	90%	2.7%	1.7%	1.5%	4.5%	2.65%	2165

* Excludes 5 percent positive and negative tail outcomes.

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Published January 2016

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