September 2016

# Income Fund
# Quarterly Review

William Blair

5086079

# Important Disclosure

Please refer to the last page of this Quarterly Review for definitions of the financial terms and Indices used in this report.

The views expressed in this report and the information about the William Blair Income Fund's holdings are as of the quarter ended 3/31/2016 and are subject to change thereafter. Information about the Fund's holdings should not be considered investment advice. There is no guarantee that the Fund will continue to hold any one particular security or stay invested in any one particular sector. Holdings are subject to change at any time.

Performance cited represents past performance. **Past performance does not guarantee future results and current performance may be lower or higher than the data quoted.** Investment returns and principal will fluctuate with market and economic conditions and you may have a gain or loss when you sell shares. Current performance may be lower or higher than the data quoted. Please refer to the final two pages of this Quarterly Review for definitions of the financial terms and Indices used in this report.

**Risk:** The Fund's returns will vary, and you could lose money by investing in the Fund. As interest rates rise, bond prices will fall and bond funds become more volatile. The Fund is subject to credit risk. The Fund's net asset value and total return may be adversely affected by the inability of the issuers of the Fund's securities to make interest payments or payment at maturity. The Fund's investments in obligations issued or guaranteed by U.S. Government agencies or instrumentalities may not be backed by the full faith and credit of the United States and may differ in the degree of support provided by the U.S. Government. The Fund is also subject to interest rate and foreign investments risk. Foreign investments often involve additional risks, including political instability, differences in financial reporting standards and less stringent regulation of securities markets. Rule 144A securities are not registered for resale in the general securities market and may be classified as illiquid. It may not be possible to sell or otherwise dispose of illiquid securities both at the price and within a time period deemed desirable by the Fund. Investments with longer maturities, which typically provide higher yields than securities with shorter maturities, may subject the Fund to increased price changes resulting from market yield fluctuations. The Fund's investments in collateralized mortgage obligations are subject to prepayment and extension risk. Prepayment of high interest rate mortgage-backed securities during times of declining interest rates will tend to lower the return of the Fund and may even result in losses to the Fund if the prepaid securities were acquired at a premium. Slower prepayments during periods of rising interest rates may increase the duration of the Fund's mortgage-backed securities and asset-backed securities and reduce their value.

***Please carefully consider the Fund's investment objective, risks, charges, and expenses before investing. This and other information is contained in the Fund's prospectus, which you may obtain by calling 1-800-742-7272. Read it carefully before you invest or send money. Investing includes the risk of loss.***

Most recent month-end performance information for the William Blair Income Fund is available by visiting the William Blair Funds' Web site at www.williamblairfunds.com, or by calling the William Blair Funds at 1-800-742-7272.

Distributed by William Blair & Company, L.L.C., member FINRA/SIPC.

# Market Commentary

## September 2016

High-quality, U.S. dollar-denominated generated gains during the third quarter, as the Barclays U.S. Aggregate returned +0.46%. Coupon return more than offset the impact of a slight rise in the level of longer-term rates during the quarter.

The Federal Open Market Committee (FOMC) continued to signal its desire to raise the federal funds rate, although the FOMC has not changed the rate during the calendar year to date. The FOMC decided to "wait for further evidence of continued progress toward its objectives" of full employment and price stability. However, the FOMC cited improvements in economic growth and labor market conditions as reasons that support raising the federal funds rate target at a meeting in the not-too-distant future. With the next FOMC announcement scheduled for November 2, six days before the U.S. presidential election, the market is pricing in a FOMC rate hike at its December 14 meeting.

A perhaps-confounding aspect of the FOMC's monetary policy regards the Committee's ongoing practice of purchasing Treasury and agency mortgage-backed securities with principal payments from its portfolio of Treasury securities, agency debt, and agency mortgage-backed securities. While the FOMC is signaling a hawkish tone on the direction of the federal funds rate, this policy is dovish and puts downward pressure on longer-term interest rates. This is part of the reason that shorter-term interest rates have risen year-to-date while longer-term interest rates have declined.

One often-overlooked area of the market received increased attention as the quarter ended: U.S. dollar LIBOR (London Interbank Offering Rate) rates. LIBOR rates increased steadily throughout the quarter, especially when compared to comparable-term U.S. Treasury bills. The TED Spread, which captures the difference between 3-month LIBOR and 3-month Treasury bills, rose to its highest level since 2009 during the quarter. The recent rise in this metric is attributable to the pending deadline for the SEC's money market reform (October 14, 2016) and uncertainty over the buyer base for instruments that used to be targeted by prime money market funds after the deadline passes. While a rising TED Spread is normally a cause for concern about liquidity conditions, we believe the recent rise does not create any concerns about systemic liquidity. The primary and secondary markets for longer-term investment-grade bonds are open and functioning well.

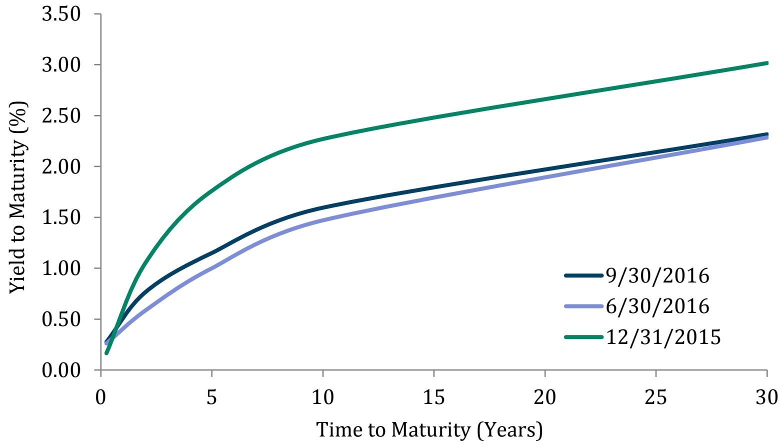
The Barclays U.S. Aggregate Index returned +0.46% during the third quarter. Fixed-rate U.S. Treasuries were the worst-performing sector of the market and the only segment with a negative total rate of return during the quarter. U.S. Treasury Inflation-Protected Securities (TIPS) outperformed nominal Treasuries as market-implied inflation expectations increased during the quarter. Agency mortgage-backed securities earned positive returns after controlling for duration during the quarter. Within the sector, some higher-coupon 30-year pools were among the best-performing segments of the market. Credit instruments generated robust returns, as investment-grade, high yield, and emerging market bonds gained during the quarter. Lower quality securities outperformed higher quality securities during the quarter.

Source: Bloomberg as of 9/30/16

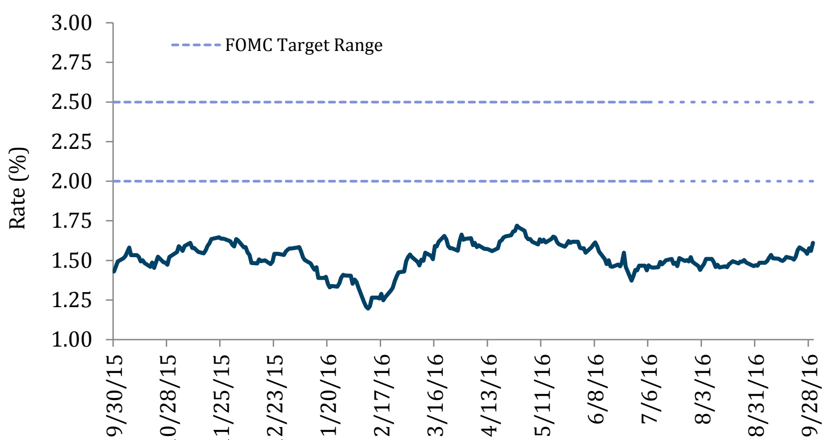
# U.S. Treasury Rates

## September 30, 2016

### U.S. Treasury Yield Curve




### 10-Year Breakeven Inflation Rate




| | Total Returns | | YTD Change in Yield | | |
|---|---|---|---|---|---|
| | QTD | YTD | 9/30/16 | 12/31/15 | Difference |
| 2 Year | -0.13% | 1.20% | 0.76 | 1.05 | -0.29 |
| 5 Year | -0.38% | 3.96% | 1.15 | 1.76 | -0.61 |
| 10 Year | -0.75% | 7.14% | 1.60 | 2.27 | -0.68 |
| 30 Year | 0.12% | 16.96% | 2.32 | 3.02 | -0.70 |

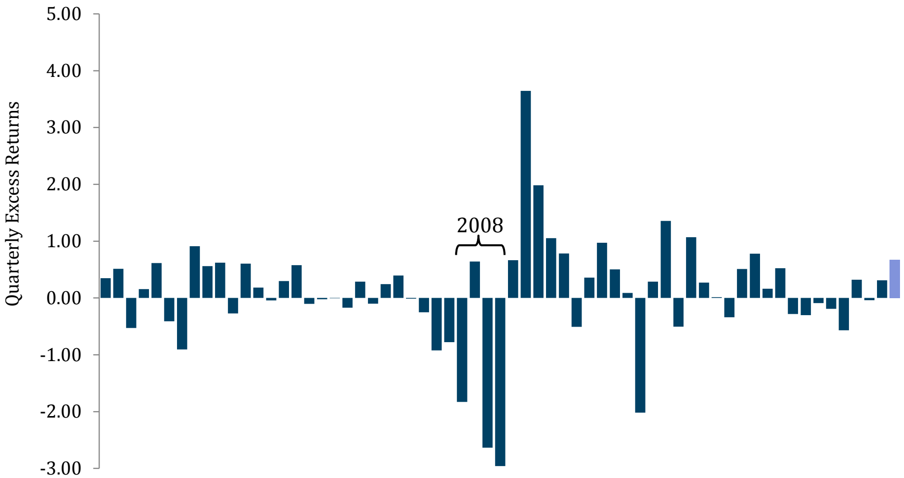
- The last FOMC statement was released on September 21, and the FOMC left the target range for the Fed Funds rate unchanged at a range of 0.25–0.50%. The FOMC will release their next statement on November 2.
- The FOMC concluded its asset purchase program (“QE”) in October 2014. The FOMC has maintained its policy of reinvesting principal payments of its Treasury, agency, and mortgage-backed security holdings.

Source: Bloomberg, Barclays

# Fixed Income Spread Sectors Overview

## September 30, 2016

### Barclays Capital Aggregate Index – Since 2001




- Mortgage-backed securities generated positive excess returns YTD.
- The credit markets generated positive excess returns YTD: investment-grade corporate bonds, high yield corporate bonds, and emerging market-related bonds all outperformed comparable-duration Treasuries.
- Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries.

### Annual Excess Returns – Through 9/30/16

| | Barclays Aggregate Index | U.S. Mortgage Backed Securities | U.S. Corporate Investment Grade | U.S. Corporate High Yield | EM USD Aggregate |
|---|---|---|---|---|---|
| 2001 | 0.54 | -0.75 | 2.72 | -2.85 | -5.41 |
| 2002 | 0.29 | 1.73 | -2.45 | -13.29 | 0.23 |
| 2003 | 1.55 | 0.11 | 5.80 | 26.42 | 24.65 |
| 2004 | 1.03 | 1.42 | 1.63 | 8.00 | 8.23 |
| 2005 | -0.31 | -0.37 | -1.15 | 0.47 | 9.59 |
| 2006 | 0.85 | 1.22 | 1.26 | 8.43 | 7.02 |
| 2007 | -2.06 | -1.77 | -5.23 | -7.77 | -4.57 |
| 2008 | -7.10 | -2.32 | -19.88 | -38.32 | -28.42 |
| 2009 | 7.46 | 4.95 | 22.76 | 59.55 | 37.97 |
| 2010 | 1.71 | 2.25 | 2.29 | 9.74 | 5.08 |
| 2011 | -1.14 | -1.06 | -3.67 | -2.40 | -5.37 |
| 2012 | 2.26 | 0.91 | 7.34 | 13.94 | 15.03 |
| 2013 | 0.93 | 0.98 | 2.86 | 9.23 | -0.32 |
| 2014 | 0.10 | 0.40 | -0.48 | -1.12 | -1.20 |
| 2015 | -0.53 | -0.05 | -1.61 | -5.77 | 0.03 |
| 2016 | 1.00 | 0.30 | 3.05 | 11.31 | 7.89 |

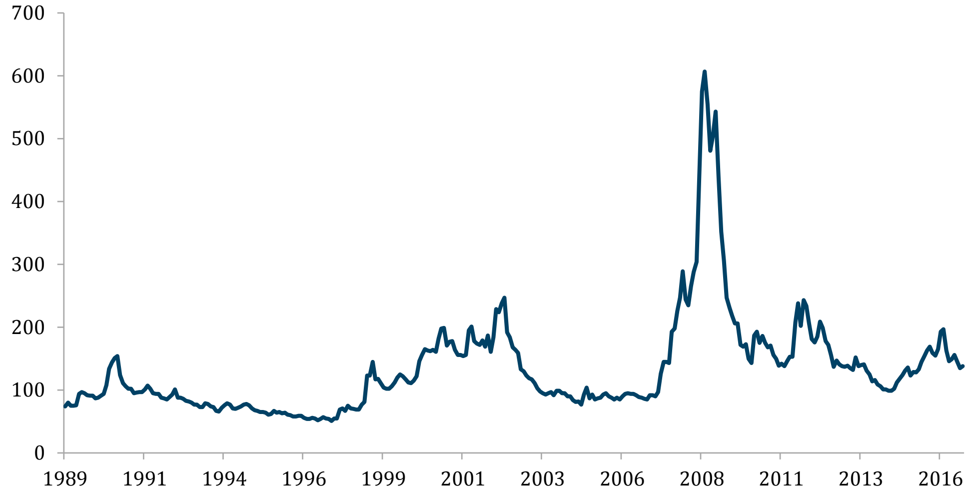
Source: Barclays Family of Indices, Bloomberg.

**Past performance is not indicative of future returns.** Excess Return is a security's return minus the return from a Treasury security of the same duration. The performance shown is for illustrative purposes and is not intended to represent the performance of any account or investment strategy managed by William Blair. A direct investment in an unmanaged index is not possible.

# Credit Market Overview

## September 30, 2016

### U.S. Corporate Investment Grade – Treasury OAS




- Corporate bonds generated positive excess returns QTD and YTD
- All major segments of the credit markets had positive duration-adjusted returns QTD and YTD
- Longer-term corporate bonds outperformed shorter-term bonds QTD and YTD after controlling for the effects of duration.
- Lower-quality bonds outperformed higher-quality bonds QTD and YTD
- Industrials have been the best-performing sector of the market, while financials have trailed the other major credit sectors YTD
- Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries

| | Total Returns | | Excess Returns | |
|---|---|---|---|---|
| | QTD | YTD | QTD | YTD |
| Barclays Credit Index | 1.23 | 8.86 | 1.55 | 2.85 |
| 1-5 Year Credit | 0.43 | 3.51 | 0.57 | 1.33 |
| 5-10 Year Credit | 1.24 | 8.80 | 1.63 | 2.84 |
| 10+ Year Credit | 2.26 | 16.50 | 2.74 | 5.04 |
| AA+ | 0.22 | 5.87 | 0.50 | 0.84 |
| A | 0.93 | 8.11 | 1.25 | 1.89 |
| BBB | 1.95 | 10.94 | 2.28 | 4.64 |
| High Yield | 5.55 | 15.11 | 5.76 | 11.31 |
| BB | 4.36 | 12.29 | 4.60 | 8.17 |
| B | 5.70 | 13.52 | 5.89 | 9.83 |
| CCC | 8.20 | 25.55 | 8.37 | 22.39 |
| Industrial | 1.58 | 10.63 | 1.91 | 4.11 |
| AA Industrial | 0.59 | 7.79 | 0.89 | 1.69 |
| A Industrial | 0.92 | 8.93 | 1.25 | 2.26 |
| BBB Industrial | 2.24 | 12.45 | 2.57 | 6.02 |
| Financial | 1.21 | 6.02 | 1.49 | 1.08 |
| AA Financial | 0.20 | 3.69 | 0.46 | 0.73 |
| A Financial | 0.96 | 5.86 | 1.24 | 0.98 |
| BBB Financial | 1.75 | 6.77 | 2.06 | 1.30 |
| Utillity | 0.83 | 10.67 | 1.22 | 2.60 |
| Non-Corporate | 0.42 | 7.33 | 0.73 | 1.92 |
| EM USD Corporate | 2.59 | 11.27 | 2.91 | 7.38 |
| EM USD Corporate: IG | 1.82 | 10.20 | 2.28 | 4.80 |
| EM USD Corporate: HY | 5.43 | 17.49 | 5.77 | 13.39 |

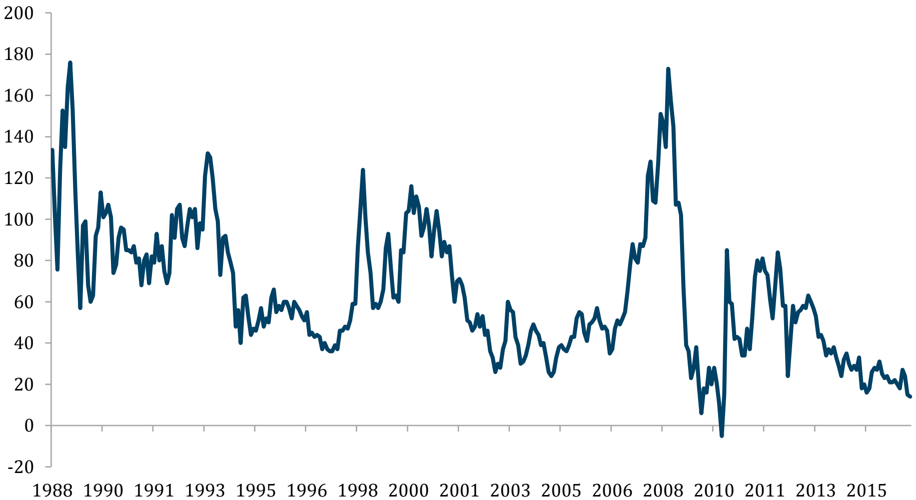
Source: Barclays Family of Indices.

**Past performance is not indicative of future returns.** The performance shown is for illustrative purposes and is not intended to represent the performance of any account or investment strategy managed by William Blair. A direct investment in an unmanaged index is not possible.

# MBS Market Overview

## September 30, 2016

**U.S. Mortgage Backed Securities – Treasury OAS**




- Mortgage-backed securities (MBS) earned positive excess returns QTD and YTD.
- Two of the largest coupon segments of the Index have had the weakest excess returns QTD and YTD: 30-year 3.5% and 4.0% coupon pools. These coupon segments are sensitive to concerns over increased prepayments as interest rates declined to historically low levels.
- Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries.

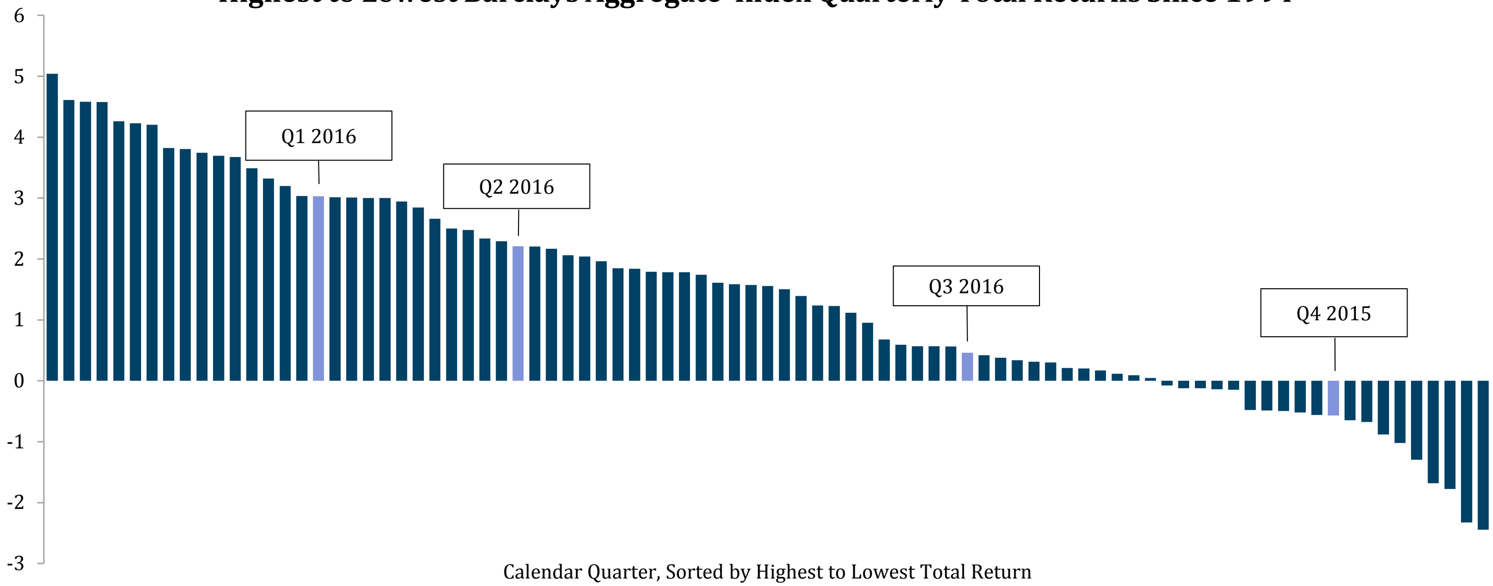
| | Total Returns | | Excess Returns | |
|---|---|---|---|---|
| | QTD | YTD | QTD | YTD |
| MBS Fixed Rate Index | 0.60 | 3.73 | 0.64 | 0.30 |
| Conventional 30 Year | 0.61 | 4.01 | 0.65 | 0.38 |
| 3.0 Coupon | 0.74 | 5.93 | 0.86 | 0.89 |
| 3.5 Coupon | 0.53 | 4.23 | 0.55 | 0.13 |
| 4.0 Coupon | 0.58 | 3.15 | 0.58 | 0.01 |
| 4.5 Coupon | 0.69 | 3.08 | 0.66 | 0.87 |
| 5.0 Coupon | 0.54 | 2.63 | 0.58 | 0.45 |
| 5.5 Coupon | 0.78 | 2.78 | 0.88 | 0.39 |
| 6.0 Coupon | 0.77 | 3.09 | 0.86 | 0.79 |
| 6.5 Coupon | 0.48 | 3.12 | 0.59 | 0.59 |
| Conventional 15 Year | 0.45 | 3.27 | 0.55 | 0.15 |
| 2.5 Coupon | 0.51 | 3.97 | 0.63 | 0.51 |
| 3.0 Coupon | 0.55 | 3.33 | 0.64 | 0.13 |
| 3.5 Coupon | 0.00 | 2.26 | 0.09 | -0.57 |
| 4.0 Coupon | 0.49 | 1.57 | 0.54 | -0.59 |
| 4.5 Coupon | 0.51 | 1.58 | 0.50 | 0.04 |
| 5.0 Coupon | 0.24 | 1.06 | 0.13 | 0.02 |

Source: Barclays Family of Indices.
**Past performance is not indicative of future returns.** The performance shown is for illustrative purposes and is not intended to represent the performance of any account or investment strategy managed by William Blair. A direct investment in an unmanaged index is not possible.

# Fixed Income Market Returns

## September 30, 2016

**Highest to Lowest Barclays Aggregate  Index Quarterly Total Returns Since 1994**




| | Total Returns | |
|---|---|---|
| | QTD | YTD |
| Barclays Aggregate Index | 0.46 | 5.80 |
| Barclays Treasury Index | -0.28 | 5.07 |
| Barclays U.S. TIPS Index | 0.97 | 7.27 |
| Barclays U.S. MBS Index | 0.60 | 3.72 |
| Barclays Corporate Index | 1.41 | 9.20 |
| Barclays U.S. High Yield Index | 5.55 | 15.11 |
| Barclays EM USD Aggregate Index | 3.13 | 12.82 |

Source: Barclays Family of Indices.

**Past performance is not indicative of future returns.** A direct investment in an unmanaged index is not possible. The performance shown is for illustrative purposes and is not intended to represent the performance of any account or investment strategy managed by William Blair. A direct investment in an unmanaged index is not possible.

# Income Fund Performance

## September 30, 2016

| Performance % | QTD | YTD | 1 Year | 3 Years | 5 Years | 10 Years | Gross Expense %* |
|---|---|---|---|---|---|---|---|
| Income Fund - Class I | 0.44 | 3.64 | 3.49 | 2.55 | 2.68 | 3.38 | 0.55 |
| Income Fund - Class N | 0.50 | 3.45 | 3.24 | 2.34 | 2.46 | 3.17 | 0.81 |
| Barclays Int. Gov/Credit Index | 0.16 | 4.24 | 3.52 | 2.80 | 2.45 | 4.17 | |
| Morningstar Short-Term Bond Category | 0.48 | 2.52 | 2.11 | 1.38 | 1.69 | 2.79 | |

**Expense ratio as of the Fund's most recent prospectus*

*Please refer to the most recent prospectus for more information on the Fund's expenses. Performance cited represents past performance. Past performance does not guarantee future results and current performance may be lower or higher than the data quoted. William Blair Income Fund Class N and Class I shares performance shown is net of expenses and all performance shown reflects a reinvestment of dividends and capital gains. Investment returns and principal will fluctuate and you may have a gain or loss when you sell shares. Current performance may be lower or higher than the data quoted. Class N shares are available to the general public without a sales load. Class I shares are available only to investors who meet certain eligibility requirements.*

*Most recent month-end performance information for the William Blair Income Fund is available by visiting the William Blair Funds' Web site at www.williamblairfunds.com, or by calling the William Blair Funds at 1-800-742-7272. Also call this number for a prospectus, which provides more complete information about the Income Fund, including investment objective, risk considerations, charges and expenses. Read it carefully before you invest or send money.*

*Index performance is shown for illustrative purposes only. You cannot invest directly in an unmanaged index.*

*The Morningstar Short-Term Bond Category represents the average annual composite performance of all mutual funds listed in the Short-Term Bond Category by Morningstar.*

Distributed by William Blair & Company, L.L.C., member FINRA/SIPC.

# Performance Analysis

## September 30, 2016

### QTD Contributors

- Agency mortgage-backed securities (MBS) contributed to results, as the MBS held performed well relative to comparable-duration securities in the Index.
- Security selection of corporate bonds was a contributing factor to relative performance. Positions in bonds issued by Masco, Toll Brothers, JP Morgan, and BRF SA impacted the portfolio's results favorably.
- Sector allocation was additive to results. The Fund was underweight to fixed-rate Treasuries, which was the worst-performing sector of the market.

### QTD Detractors

- Sector positioning in credit detracted from performance. The Fund was underweight to corporate bonds, and in particular to BBB-rated corporate bonds.
- A position in bonds issued by Simon Property Group hindered relative performance.

### YTD Contributors

- Positioning in the credit sectors had a favorable impact on performance results. Positions in bonds issued by ConocoPhillips, Masco, JP Morgan, Synchrony Financial, BRF SA, and Fibria Cellulose were additive to performance.
- Agency mortgage-backed securities (MBS) contributed to results, as the MBS held performed well relative to comparable-duration securities in the Index.

### YTD Detractors

- The Fund had a defensive interest rate posture, and this detracted from performance as short- and intermediate-term interest rates declined year-to-date.
- Sector positioning in credit detracted from performance. The Fund was underweight to corporate bonds, and in particular to BBB-rated corporate bonds.
- Positions in bonds issued by Seagate Technology and Embraer impacted performance results negatively.

Listed holdings are intended to illustrate examples of the securities that the Fund has bought and do not represent all of the Fund's holdings or future investments. The holdings do not include other assets or instruments that may be held by the Fund, including cash, cash equivalents, and derivatives such as futures, options and swaps. Holdings are as of the date shown above, may change at any time and are not a recommendation to buy or sell any security.

# Income Fund Portfolio Strategy

## September 30, 2016

| Decision Factor | Positioning | Strategy |
|---|---|---|
| Interest Rates & Yield Curve | Neutral | • Strategy risk discipline to maintain benchmark-like duration and yield curve exposures. |
| Treasuries & Agencies | Underweight | • Allocation to TIPS. We believe the embedded option that can benefit from unexpected inflation is an appealing feature versus owning nominal Treasury notes and bonds.<br>• Underweight agencies. We view agency MBS as a more attractive alternative. |
| Securitized Sectors | Overweight | • Overweight agency MBS. In our view, we find valuations of higher-coupon pools comprised of low loan balances attractive as such pools offer superior spreads within the MBS sector, defensive duration posture, and manageable prepayment experiences.<br>• We avoid the lower-coupon MBS that dominate the Index because we find that comparable-duration credit instruments offer more appealing valuations.<br>• Overweight ABS. We believe certain floating-rate ABS offer attractive yields and protection against rising interest rates.<br>• Underweight CMBS. We favor owning corporate REITs instead due to their better liquidity profile, in our view, and their actively-managed approach to commercial real estate. |
| Credit Sectors | Overweight | • Overweight investment-grade industrials and financials. We seek to emphasize companies with positive free cash flows and strong and experienced management teams.<br>• Overweight corporations domiciled in emerging markets. Within the sector, we have found value in "Global Leaders"—large, multinational companies with a market leadership position and strong management teams.<br>• Allocation to high yield in accounts that allow. We believe higher-quality (BB- and B-rated) issuers offer attractive yields and potential benefits in a rising-rate environment. |

Information subject to change without notice. Not intended as investment advice.

# Income Fund Portfolio Attribution

## Through September 30, 2016

### Quarter to Date

| Description | Market Value Weight | | | Total Return | | | Total Return Contribution | | | Active Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Port | Bench | Active | Port | Bench | Active | Port | Bench | Active | Interest Rates | Sector Allocation | Security Selection |
| **Total Fund** | **100.0%** | **100.0%** | **0.0%** | **64** | **16** | **48** | **64** | **16** | **48** | **4** | **24** | **20** |
| Treasuries | 5.9% | 55.9% | -50.0% | 26 | -26 | 52 | 1 | -15 | 16 | 11 | 21 | 3 |
| Agencies | 0.0% | 4.0% | -4.0% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 |
| Residential Mortgages | 48.7% | 0.0% | 48.7% | 29 | 0 | 29 | 14 | 0 | 14 | -11 | 4 | 0 |
| ABS | 8.6% | 0.0% | 8.6% | 67 | 0 | 67 | 6 | 0 | 6 | 1 | 2 | 0 |
| IG Corps | 29.6% | 38.0% | -8.4% | 119 | 76 | 43 | 34 | 29 | 6 | 2 | -5 | 12 |
| Emerging Markets | 3.6% | 1.9% | 1.7% | 253 | 112 | 141 | 8 | 2 | 6 | 0 | 2 | 4 |
| Derivatives | 0.0% | 0.0% | 0.0% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Cash Securities | 3.4% | 0.1% | 3.3% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -1 | 0 |

### Year to Date

| Description | Market Value Weight | | | Total Return | | | Total Return Contribution | | | Active Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Port | Bench | Active | Port | Bench | Active | Port | Bench | Active | Interest Rates | Sector Allocation | Security Selection |
| **Total Fund** | **100.0%** | **100.0%** | **0.0%** | **410** | **424** | **-13** | **410** | **424** | **-13** | **-46** | **-4** | **37** |
| Treasuries | 5.9% | 56.5% | -50.7% | 477 | 339 | 138 | 28 | 193 | -168 | -176 | 39 | 5 |
| Agencies | 0.0% | 4.3% | -4.3% | 0 | 228 | -228 | 0 | 10 | -10 | -9 | 2 | 0 |
| Residential Mortgages | 51.4% | 0.0% | 51.4% | 272 | 0 | 272 | 143 | 0 | 146 | 154 | -45 | 0 |
| ABS | 8.5% | 0.0% | 8.5% | 129 | 0 | 129 | 11 | 0 | 12 | 2 | 2 | 0 |
| IG Corps | 28.6% | 37.2% | -8.7% | 695 | 560 | 135 | 194 | 207 | -12 | -31 | -5 | 27 |
| Emerging Markets | 3.2% | 1.8% | 1.4% | 1155 | 780 | 375 | 33 | 14 | 20 | 11 | 3 | 4 |
| Derivatives | 0.0% | 0.0% | 0.0% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Cash Securities | 2.4% | 0.1% | 2.3% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

Source: BlackRock Solutions.

**Past performance is not indicative of future returns.** The above information is based on the strategy's representative account. The attribution analysis contained herein is calculated by BlackRock Solutions and is intended to provide an estimate as to which elements of a strategy contributed (positively or negatively) to the strategy's representative account's performance. Attribution analysis is not a precise measure and should not be relied upon for investment decisions. Holdings are subject to change at any time. Not intended as investment advice. Please see composite disclosures for additional important information. A direct investment in an index is not possible.

# Portfolio Characteristics
## September 30, 2016

| | Income Fund | | | | | | | | | | Barclays Gov't/Credit Intermediate Index |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Global Financial Crisis | | | | European Debt Crisis | | Taper Tantrum | | | | |
| | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 | 12/31/15 | 9/30/16 | 9/30/16 |
| Effective Duration | 3.71 | 3.74 | 3.83 | 3.68 | 3.50 | 3.47 | 3.69 | 3.26 | 3.18 | 3.32 | 4.06 |
| Convexity | -0.04 | 0.05 | 0.04 | 0.02 | -0.14 | 0.08 | -0.22 | 0.01 | -0.04 | 0.06 | 0.21 |
| Average Yield | 5.77% | 5.75% | 3.83% | 2.95% | 2.73% | 1.80% | 2.18% | 2.33% | 2.36% | 2.00% | 1.51% |
| Sector Composition | | | | | | | | | | | |
| Nominal Treasuries | 25.8% | 17.3% | 3.3% | 5.2% | 3.9% | 0.7% | 0.8% | 0.9% | 1.0% | 0.9% | 55.8% |
| TIPS | 0.0% | 0.0% | 1.5% | 3.8% | 4.1% | 7.5% | 6.0% | 5.1% | 4.7% | 4.9% | 0.0% |
| Agency | 2.9% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 3.7% |
| MBS | 28.1% | 25.0% | 29.2% | 26.9% | 42.1% | 37.2% | 52.1% | 49.7% | 53.8% | 47.1% | 0.0% |
| CMBS | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| ABS | 12.3% | 4.2% | 5.9% | 9.1% | 5.3% | 3.6% | 7.0% | 9.6% | 8.8% | 8.2% | 0.0% |
| Credit | 31.9% | 52.5% | 60.0% | 53.1% | 43.5% | 50.0% | 33.0% | 33.4% | 26.3% | 34.1% | 40.5% |
| Cash | -1.0% | 1.0% | 0.1% | 1.9% | 1.1% | 1.0% | 1.1% | 1.3% | 5.4% | 4.8% | 0.0% |
| | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| Rating Categories* | | | | | | | | | | | |
| TSY/AGY/AAA | 55.8% | 44.5% | 38.6% | 44.8% | 44.8% | 53.3% | 80.9% | 90.6% | 91.3% | 64.1% | 71.4% |
| AA | 6.8% | 9.2% | 12.9% | 11.8% | 11.8% | 7.1% | 19.1% | 9.4% | 8.7% | 3.6% | 6.1% |
| A | 26.9% | 35.3% | 39.9% | 33.9% | 33.9% | 30.3% | 0.0% | 0.0% | 0.0% | 23.0% | 13.1% |
| BBB | 9.1% | 11.0% | 8.3% | 8.3% | 8.5% | 8.4% | 0.0% | 0.0% | 0.0% | 9.3% | 9.4% |
| <BBB | 1.4% | 0.0% | 0.3% | 0.3% | 1.0% | 0.9% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| Credit Composition | | | | | | | | | | | |
| DM IG Industrial | 16.7% | 28.1% | 35.1% | 30.4% | 30.2% | 23.1% | 11.1% | 8.5% | 10.2% | 12.7% | 18.9% |
| DM IG Financial | 6.0% | 15.2% | 16.3% | 15.5% | 9.8% | 19.0% | 18.2% | 16.8% | 12.7% | 17.6% | 12.2% |
| DM IG Utilities | 1.9% | 4.3% | 4.0% | 3.1% | 1.5% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 1.7% |
| Emerging Markets | 5.9% | 4.9% | 4.6% | 4.1% | 2.0% | 7.9% | 3.7% | 8.1% | 3.4% | 3.8% | 2.1% |
| DM High Yield | 1.4% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Non-Corp | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 5.6% |
| | **31.9%** | **52.5%** | **60.0%** | **53.1%** | **43.5%** | **50.0%** | **33.0%** | **33.4%** | **26.3%** | **34.1%** | **40.5%** |

Sources: BlackRock Solutions, Barclays, CMS BondEdge. Information is for illustrative purposes only and is not intended as investment advice. Subject to change without notice.
*The credit quality of securities in the representative portfolio is sourced through BlackRock Solutions and derived from Fitch Ratings, Moody's Investors Service, Inc. and Standard & Poor's. In cases where the credit rating agencies have assigned different credit ratings to the same security, the higher rating is used. In cases where only one rating agency has assigned a credit rating to a security, that rating is used.

# Capital Markets Outlook

## September 30, 2016

We believe that the Federal Open Market Committee (FOMC) will raise the federal funds rate at some point in 2016. The U.S. economy is growing; estimates indicate that GDP grew by approximately 2.5% in real terms during 2015, and forecasters predict a similar pace of growth during 2016. In addition, the U.S. labor market is adding jobs at a robust pace. Wage inflation has begun to accelerate to 2.5% year-over-year growth, a level consistent with the FOMC's target inflation range. Macroeconomic theory predicts that a robust labor market creates wage inflation, which in turns spurs broader inflation. We believe that the FOMC will raise rates if market conditions remain normal as wage inflation has risen. However, the FOMC will pay careful attention to its price stability objective when they decide whether to raise the federal funds rate to ensure that doing so will not spur disinflationary pressures.

While the FOMC is striking a hawkish tone on the direction of the federal funds rate, the FOMC's actions on longer-term rates are dovish. The FOMC continues to reinvest principal payments of its Treasury, agency, and mortgage-backed security holdings into Treasury and agency mortgage-backed securities. As a result, longer-term Treasury and mortgage rates face downward pressure.

U.S. Treasury Inflation-Protected Securities (TIPS) have market-implied breakeven inflation rates of 1.4% - 1.8%. These are below the FOMC's stated target range of 2.0%–2.5%, and it is also below recent wage inflation estimates. We believe TIPS are an attractive alternative to fixed-rate Treasuries to mitigate the effects of rising rates driven by accelerating inflationary pressures.

We believe that spread sectors are poised to lead the market over the longer term. Corporate risk premiums are at levels above their longer-term averages, and risk premiums of higher-coupon segments of the agency MBS market remain attractive. In addition, we believe Treasuries are likely to struggle as the FOMC embarks on a tightening cycle.

We believe that higher-coupon segments (coupon rates of 5.0% and above for 30-year) of the agency MBS market offer compelling value. These segments of the agency MBS market offer attractive spreads and a defensive duration profile. The key risk of these securities is that the underlying borrowers are in-the-money to refinance their loan. We believe this risk can be mitigated by focusing on pools comprised of borrowers that do not have the economic incentive to refinance their loans: low-loan balance pools.

We believe that the corporate bond market remains attractive. Although fundamentals have deteriorated lately, risk spreads remain at attractive levels on a historical basis. We observed an increase in leverage among industrial companies over the past year as companies secured financing at low nominal yields in the robust new issue market for corporate bonds. We remain concerned about idiosyncratic risks, including shareholder-friendly activities such as leveraged finance mergers and acquisitions, large share repurchases, and special dividends. Importantly, we do not believe the market will enter a period of excessive LBO activity.

# Index Definitions

**Barclays Aggregate Bond Index**: Composed of securities from the Barclays Aggregate Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index.

**Barclays Corporate Index**: Composed of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. Barclays Corporate High Yield Bond Index: Composed of fixed-rate, publicly issued, non-investment grade debt.

**Barclays Emerging Market Bond Index**: An unmanaged index that tracks total returns for external-currency-dominated debt instruments for emerging markets.

**Barclays Intermediate Govt./Credit Bond Index**: Fixed-rate government and corporate bonds rated investment grade or higher.

**Barclays U.S. Emerging Markets Index**: The Barclays Emerging Markets Index includes USD-denominated debt from emerging markets in the following regions: Americas, Europe, Middle East, Africa, and Asia. As with other fixed income benchmarks provided by Barclays, the index is rules-based, which allows for an unbiased view of the marketplace and easy replicability.

**Barclays U.S. MBS Index**: Measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA, and FHLMC.

**Barclays U.S. TIPS Index**: Includes all publicly issued U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value.

**MSCI EAFE IMI Index**: a free float-adjusted market capitalization index that is designed to measure equity market performance in the developed markets outside the United States.

**MSCI Emerging Markets IMI Index**: a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

**S&P 500 Index**: A measure of domestic equity market performance published by Standard & Poor's. It consists of 400 leading industrial issues, 20 transportation issues, 40 utilities and 40 finance issues weighted on a market capitalization basis. The S&P 500 is a broad-based index composed of domestic stocks representing 80% of the market value of all stocks traded on the New York Stock Exchange.

Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly.