December 2018

# Low Duration Fund Quarterly Review

William Blair

# William Blair Low Duration Fund Important Disclosures

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

**Risks:**
The Fund's returns will vary, and you could lose money by investing in the Fund. 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. 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. International investing involves special risk considerations, including currency fluctuations, lower liquidity, economic and political risk. Investing in emerging markets can increase these risks, including higher volatility and lower liquidity. 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. This is not a money market fund. 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. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

The views expressed in this report and the information about the holdings are as of the date of this material, unless otherwise noted, and are subject to change. 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. 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.**

This content is for informational and educational purposes only and is not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines and restrictions.

Most recent month-end performance information for the 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.

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



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# Market Commentary & Performance

## December 2018

The Bloomberg Barclays U.S. Aggregate Index returned +0.01% during 2018, as interest rates rose risk spreads widened over the course of the year. Fixed-rate U.S. Treasuries outperformed corporate and agency mortgage-backed securities after controlling for the effects of duration.

The Federal Open Market Committee (FOMC) increased the target range of the federal funds rate four times during 2018 by 0.25% each time. The FOMC has now hiked rates nine times since 2015 when the fed funds rate was near the zero lower bound. At the end of the year, the fed funds futures market carried an implied probability that the FOMC will not change the target range of the federal funds rate during 2019.

The FOMC continued to execute its plan to shrink its balance sheet during 2018. Beginning in October, the FOMC permitted the balance sheet to shrink by no more than $50 billion per month. At the $50 billion per-month pace of reduction, the FOMC was no longer required to purchase agency mortgage-backed securities.

While the FOMC's policy decisions influenced the markets during 2018, technical factors also impacted segments of the bond market. In the beginning of 2018, U.S. corporate tax reform and repatriation created heavy demand for U.S. money market instruments and simultaneous selling pressure of securities tied to the London Interbank Offering Rate (LIBOR) as cash held in offshore accounts came back to U.S. money market funds. The U.S. Treasury's issuance pattern also influenced the market, as issuance was concentrated on short- and intermediate-term maturities that put upward pressure on those interest rates. This issuance pattern likely contributed to the flattening yield curve experienced during the year. Finally, long-term fixed income mutual funds experienced sustained outflows during the fourth quarter of the year, and those outflows created selling pressure within segments of the bond market that increased risk spreads. These technical pressures impacted the market by increasing implied volatility and widening risk spreads.

U.S. Treasury Inflation-Protected Securities (TIPS) underperformed fixed-rate Treasuries during 2018. Market-implied breakeven inflation rates decreased to levels below the FOMC's stated objective of 2.0% - 2.5% per year.

Agency mortgage-backed securities generated positive total returns during 2018. The best-performing segments of the market were higher-coupon 30-year pools (coupons of 6.0% and 6.5%). 30-year pools with coupons of 5.5% and less earned positive total returns but underperformed similar-duration Treasuries.

Corporate bonds of all tenors, credit qualities, and sectors underperformed similar-maturity Treasury instruments during the year. Only high-quality, short-term corporate bonds generated positive total returns, and all other segments of the corporate bond market experienced negative total returns during the year. High yield corporate bonds underperformed investment-grade corporate bonds during the year.

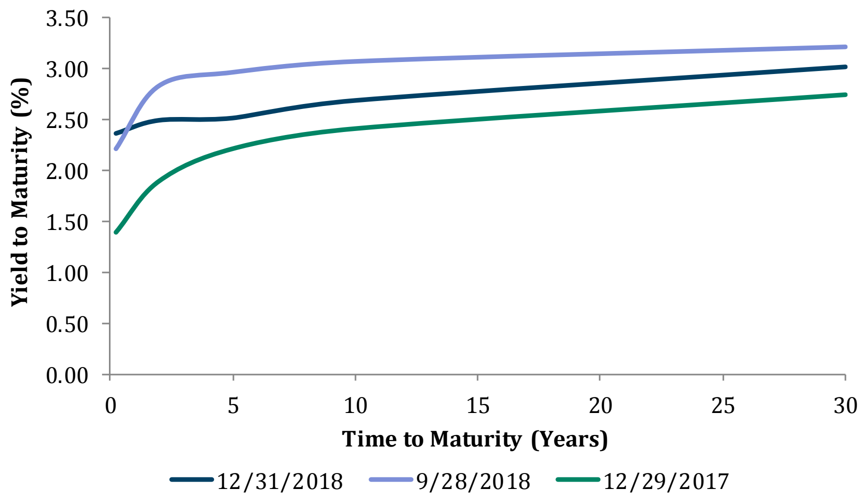
The William Blair Low Duration Fund (Class N) underperformed the Bank of America/Merrill Lynch 1-Year Treasury Note Index during the quarter. The Fund's holdings in agency mortgage-backed securities experienced gains during the quarter but underperformed the Index's return. The Fund's holdings in floating-rate corporate and asset-backed securities lagged the Index and hindered results during the quarter. The Fund had slightly more interest rate exposure than its Index, and this contributed to results as interest rates declined during the fourth quarter.

During the year, the Fund had slightly more interest rate exposure than its Index, and this hindered results as interest rates rose. The Fund's holdings in agency mortgage-backed securities experienced gains during the year but underperformed the Index's return. The Fund's holdings in floating-rate corporate and asset-backed securities contributed to relative performance during the year.

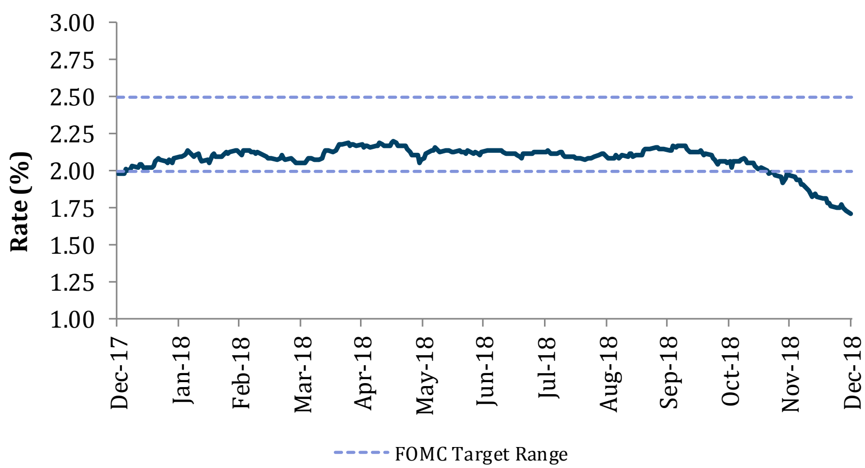
# Treasury Market Overview

## December 31, 2018

### U.S. Treasury Yield Curve




### 10-Year Breakeven Inflation Rate




| | Total Returns | | YTD Change in Yield | | |
|---|---|---|---|---|---|
| | QTD | YTD | 12/31/18 | 12/29/17 | Difference |
| 3 Month | 0.57% | 1.88% | 2.36 | 1.38 | 0.98 |
| 2 Year | 1.28% | 1.40% | 2.49 | 1.89 | 0.61 |
| 5 Year | 2.81% | 1.42% | 2.51 | 2.21 | 0.31 |
| 10 Year | 3.87% | 0.00% | 2.69 | 2.41 | 0.28 |
| 30 Year | 4.10% | -2.72% | 3.02 | 2.74 | 0.28 |

- U.S. Treasuries generated positive returns QTD as longer-term interest rates fell.
- U.S. Treasuries of all tenors experienced rising rates YTD. However, only the 30-year Treasury experienced a negative total return.
- TIPS underperformed nominal Treasuries QTD and YTD after adjusting for maturity.
- The current breakeven rates on U.S. TIPS are at levels below the lower end of the FOMC's stated target range for inflation of 2.0% - 2.5% per year.

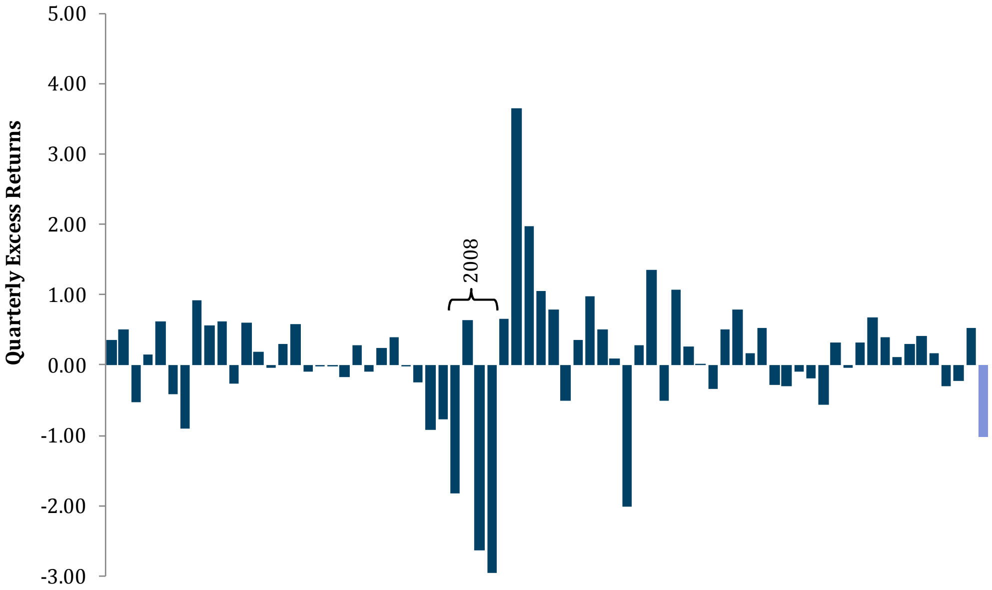
Source: Bloomberg, Barclays, Bank of America/Merrill Lynch

**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 Spread Sectors Overview

## December 31, 2018

**Bloomberg Barclays Capital Aggregate Index – Since 2001**




- The major spread sectors experienced spread widening and negative excess returns in 2018.
- Mortgage-backed securities generated negative excess returns YTD.
- The credit markets generated negative performance YTD: investment-grade corporate bonds, high yield corporate bonds, and emerging market-related bonds generated negative excess returns.
- Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries.

**Annual Excess Returns – Through 12/31/18**

| | Bloomberg 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 | 1.38 | -0.11 | 4.93 | 15.73 | 8.80 |
| 2017 | 1.21 | 0.52 | 3.46 | 6.10 | 6.14 |
| 2018 | -1.01 | -0.59 | -3.15 | -3.58 | -3.45 |

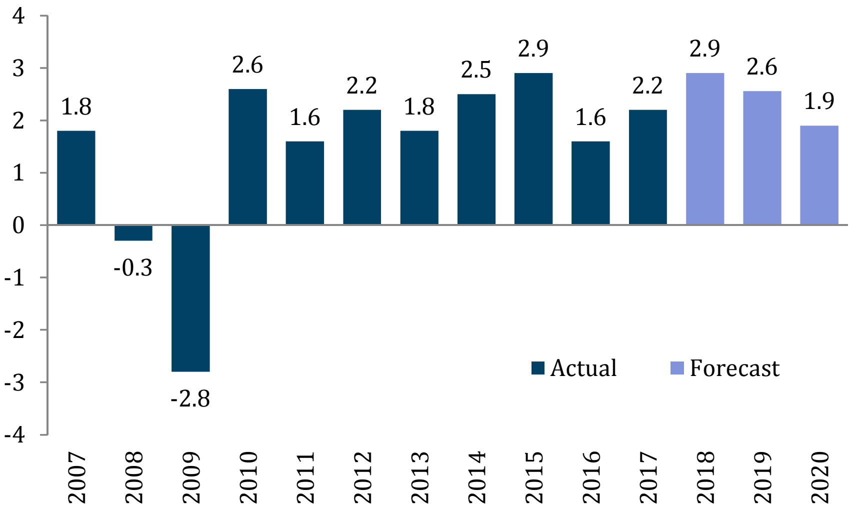
Source: Bloomberg Barclays.

**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.

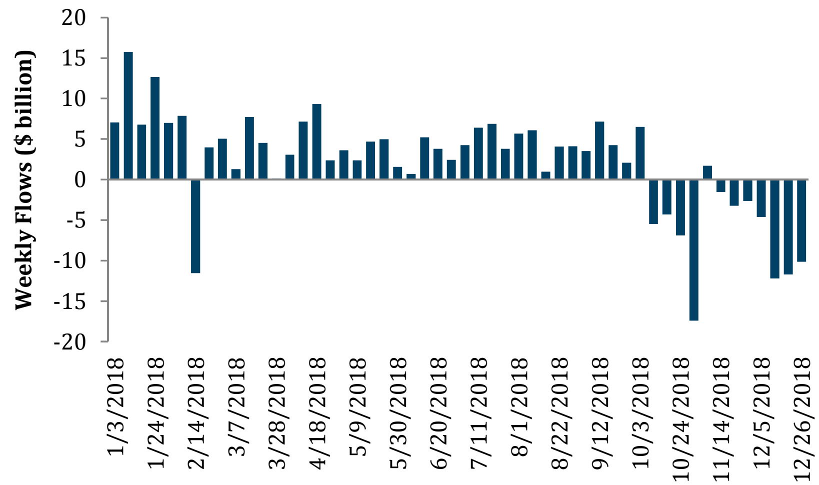
# Credit Market Overview

## December 31, 2018

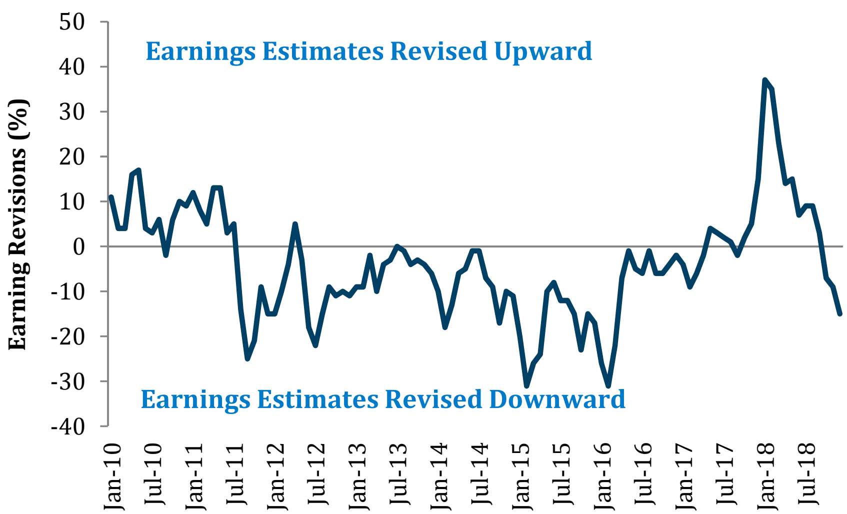
### Real U.S. GDP Growth (%) Since 2007




### ICI Taxable Bond Long-Term Mutual Fund and ETFs Flows




### U.S. Earnings Revisions, 10 Years Ending 12/31/18




- Corporate bond risk spreads widened throughout the year in 2018.
- Corporate fundamentals were mixed. U.S. GDP is growing, and it is forecasted to grow steadily. Corporate leverage statistics remain relatively stable. Corporate earnings sentiment was strong during the beginning of the year following U.S. corporate tax reform, but the revisions turned negative later in the year perhaps due to concerns over trade wars and/or equity market volatility.
- Fund flows had a negative impact on corporate bonds in 2018. Many technical factors impacted bonds negatively in 2018, including rising interest rates, a flattening yield curve, U.S. Treasury issuance patterns, and outflows from the asset class.

Source: Bloomberg, MSCI, William Blair Investment Management, ICI Investment Company Institute.

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# Credit Market Overview: Performance

## December 31, 2018

| | Total Returns (%) | | Excess Returns ( %) | |
|---|---|---|---|---|
| | 3 Month | YTD | 3 Month | YTD |
| **U.S. Corporate Investment Grade** | **-0.18** | **-2.51** | **-3.10** | **-3.15** |
| U.S. Corporate High Yield | -4.53 | -2.08 | -6.75 | -3.58 |
| EM USD Aggregate | -0.18 | -2.46 | -2.91 | -3.45 |
| 1-5 Year Credit | 0.76 | 0.95 | -0.94 | -0.59 |
| 5-10 Year Credit | 0.49 | -1.55 | -2.76 | -2.56 |
| 10+ Year Credit | -1.80 | -7.24 | -5.97 | -6.51 |
| AA+ | 1.08 | -0.52 | -1.49 | -1.35 |
| A | 0.27 | -2.50 | -2.66 | -3.15 |
| BBB | -0.82 | -2.85 | -3.77 | -3.47 |
| BB | -2.91 | -2.41 | -5.27 | -3.80 |
| B | -4.35 | -1.31 | -6.47 | -2.86 |
| CCC | -9.28 | -3.84 | -11.27 | -5.47 |
| Industrial | -0.46 | -2.81 | -3.50 | -3.34 |
| Financial | 0.27 | -1.68 | -2.33 | -2.62 |
| Utillity | 0.20 | -3.75 | -3.25 | -3.94 |
| Non-Corporate | 1.02 | -0.08 | -1.52 | -1.01 |
| EM USD Corporate Investment Grade | -0.23 | -1.83 | -2.51 | -2.04 |
| EM USD Corporate: High Yield | -0.98 | -5.16 | -3.36 | -6.00 |

Source: Bloomberg Barclays.

Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries

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# MBS Market Overview

## December 31, 2018

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


| | Total Returns | | Excess Returns | |
|---|---|---|---|---|
| | 3 Month | YTD | 3 Month | YTD |
| **MBS Fixed Rate Index** | **2.08** | **0.99** | **-0.53** | **-0.59** |
| Conventional 30 Year | 2.18 | 0.97 | -0.53 | -0.60 |
| 3.0 Coupon | 2.70 | 0.91 | -0.30 | -0.42 |
| 3.5 Coupon | 2.49 | 0.96 | -0.33 | -0.67 |
| 4.0 Coupon | 1.92 | 1.13 | -0.67 | -0.64 |
| 4.5 Coupon | 1.36 | 0.95 | -1.05 | -0.85 |
| 5.0 Coupon | 0.93 | 1.08 | -1.29 | -0.55 |
| 5.5 Coupon | 0.55 | 0.85 | -1.58 | -0.52 |
| 6.0 Coupon | 2.30 | 2.33 | 0.13 | 0.87 |
| 6.5 Coupon | 2.24 | 2.47 | 0.15 | 0.99 |
| Conventional 15 Year | 1.82 | 1.00 | -0.29 | -0.49 |
| 2.5 Coupon | 1.95 | 0.90 | -0.23 | -0.52 |
| 3.0 Coupon | 1.87 | 1.06 | -0.28 | -0.44 |
| 3.5 Coupon | 1.60 | 1.21 | -0.44 | -0.41 |
| 4.0 Coupon | 1.14 | 1.56 | -0.61 | -0.29 |
| 4.5 Coupon | 1.08 | 1.45 | -0.26 | -0.16 |

- The mortgage-backed securities (MBS) Index earned negative excess returns QTD and YTD.
- 30-year pools with coupons of 6.0% and 6.5% generated positive total returns and excess returns QTD and YTD. 30-year pools with coupons of 5.5% and lower experienced negative excess returns QTD and YTD.
- Excess returns measure relative performance versus a duration-neutral basket of U.S. Treasuries.

Source: Bloomberg Barclays.

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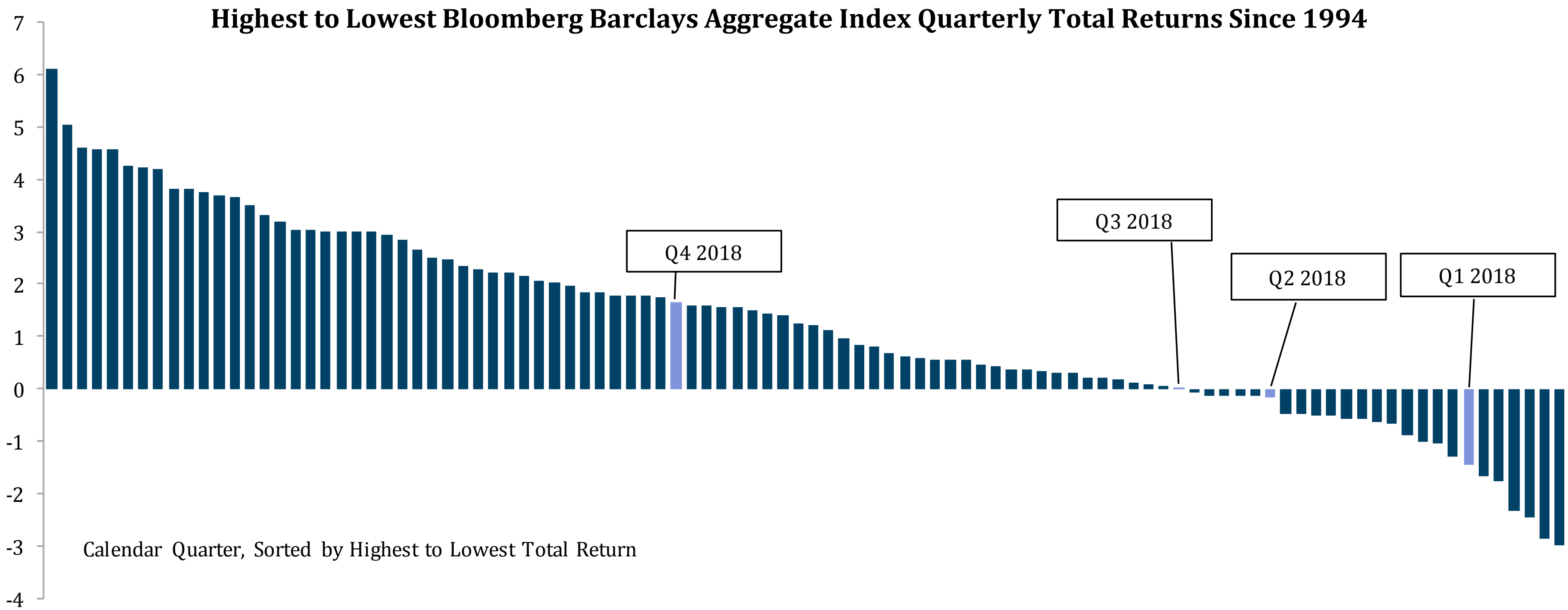
# Fixed Income Market Returns

## December 31, 2018




| | Total Returns | |
|---|---|---|
| | QTD | YTD |
| Bloomberg Barclays Aggregate Index | 1.64 | 0.01 |
| Bloomberg Barclays Treasury Index | 2.57 | 0.86 |
| Bloomberg Barclays U.S. TIPS Index | -0.42 | -1.26 |
| Bloomberg Barclays U.S. MBS Index | 2.08 | 0.99 |
| Bloomberg Barclays Corporate Index | -0.18 | -2.51 |
| Bloomberg Barclays U.S. High Yield Index | -4.53 | -2.08 |
| Bloomberg Barclays EM USD Aggregate Index | -0.18 | -2.46 |

Source: Bloomberg Barclays.

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# Low Duration Fund Performance

## December 31, 2018

| Performance % | Quarter | YTD | 1 Year | 3 Years | 5 Years | Since Inception (12/1/09) |
|---|---|---|---|---|---|---|
| Low Duration Fund (WBLIX) Class I | 0.15 | 1.12 | 1.12 | 1.14 | 0.99 | 1.18 |
| Low Duration Fund (WBLNX) Class N | -0.01 | 0.80 | 0.80 | 0.94 | 0.80 | 1.01 |
| B of A ML 1-yr. U.S. Tsy Note | 0.78 | 1.86 | 1.86 | 1.06 | 0.70 | 0.58 |
| Morningstar Ultrashort Bond Category | 0.28 | 1.61 | 1.61 | 1.47 | 0.99 | |

**Performance cited represents past performance. Past Performance does not guarantee future results and current performance may be lower or higher than the data quoted. Results shown are average annual returns, which assume reinvestment of dividends and capital gains. Investment returns and principal will fluctuate with market and economic conditions and you may have a gain or loss when you sell shares. For the most current month end performance information, please call 1-877-962-5247, or visit our Web site at www.williamblairfunds.com. 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.**

Low Duration Fund Expense Ratios:

| | Gross | Net |
|---|---|---|
| Class I Shares | 0.45% | 0.40% |
| Class N Shares | 0.64% | 0.55% |

Expenses shown are as of the most recent prospectus. The Fund's Adviser has contractually agreed to waive fees and/or reimburse expenses to limit fund operating expenses until 4/30/19.

*The Bank of America Merrill Lynch 1-Year U.S. Treasury Note Index is comprised of a single U.S. Treasury Note issue purchased at the beginning of the month and held for a full month. Each month the index is rebalanced and the issue selected is the outstanding U.S. Treasury Note that matures closest to, but not beyond, one year from the rebalancing date. A direct investment in an index is not possible.*

The Morningstar Ultrashort Bond Category represents the average annual composite performance of all mutual funds listed in the Ultrashort Bond Category by Morningstar. Distributed by William Blair & Company, L.L.C., member FINRA/SIPC

# Low Duration Fund Performance Analysis

## December 31, 2018

| QTD Contributors | YTD Contributors |
|---|---|
| • Interest rate positioning contributed to results as interest rates declined. | • Floating-rate corporate and asset-backed securities were additive to performance. |
| **QTD Detractors** | **YTD Detractors** |
| • Positioning in agency mortgage-backed securities and floating-rate asset-backed and corporate securities hindered results as those segments underperformed the risk-free benchmark. | • Residual cash held in the portfolio detracted from results as high-quality, short-term securities experienced gains during the year. |

Source: William Blair, BlackRock Solutions.

**Past performance is not indicative of future returns.** Holdings are subject to change at any time. References to specific securities and their issuers are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such securities. William Blair may or may not own the securities referenced and, if such securities are owned, no representation is being made that such securities will continue to be held. The above securities do not represent all of the securities purchased, sold or recommended for all William Blair clients.

# Low Duration Fund Attribution

## Through December 31, 2018

### Quarter to Date

| Description | Market Value Weight | | | Total Return | | | Total Return Contribution | | | Active Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Port | Bench | Active | Port | Bench | Active | Port | Bench | Active | Rates | Sector Allocation | Security Selection |
| **Total Fund** | **100.0%** | **100.0%** | **0.0%** | **26** | **78** | **-52** | **26** | **78** | **-52** | **24** | **-77** | **0** |
| Treasuries | 0.0% | 100.0% | -100.0% | 0 | 78 | -78 | 0 | 78 | -78 | -76 | 0 | 0 |
| Residential Mortgages | 36.9% | 0.0% | 36.9% | 57 | 0 | 57 | 21 | 0 | 21 | 64 | -45 | 0 |
| ABS | 18.2% | 0.0% | 18.2% | 54 | 0 | 54 | 10 | 0 | 10 | 10 | -1 | 0 |
| IG Corps | 32.5% | 0.0% | 32.5% | -14 | 0 | -14 | -4 | 0 | -4 | 18 | -22 | 0 |
| Cash Securities | 12.3% | 0.0% | 12.3% | 0 | 0 | 0 | 0 | 0 | 0 | 7 | -7 | 0 |

### Year to Date

| Description | Market Value Weight | | | Total Return | | | Total Return Contribution | | | Active Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Port | Bench | Active | Port | Bench | Active | Port | Bench | Active | Rates | Sector Allocation | Security Selection |
| **Total Fund** | **100.0%** | **100.0%** | **0.0%** | **155** | **186** | **-31** | **155** | **186** | **-31** | **-21** | **-10** | **0** |
| Treasuries | 0.0% | 100.0% | -100.0% | 12 | 186 | -174 | 0 | 186 | -188 | -203 | 0 | 0 |
| Residential Mortgages | 38.5% | 0.0% | 38.5% | 112 | 0 | 112 | 42 | 0 | 42 | 70 | -22 | 0 |
| ABS | 18.0% | 0.0% | 18.0% | 209 | 0 | 209 | 37 | 0 | 38 | 33 | 7 | 0 |
| IG Corps | 33.6% | 0.0% | 33.6% | 185 | 0 | 185 | 64 | 0 | 65 | 60 | 10 | 0 |
| Cash Securities | 9.9% | 0.0% | 9.9% | 0 | 0 | 0 | 0 | 0 | 0 | 19 | -18 | 0 |

Source: BlackRock Solutions.

**Past performance is not indicative of future returns.** The above information is based on the Low Duration Fund. 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 Fund’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. A direct investment in an index is not possible.

# Low Duration Fund Strategy

## December 31, 2018

| Decision Factor | Positioning | Strategy |
|---|---|---|
| Interest Rates & Yield Curve | Defensive | • The FOMC has begun its campaign of raising the federal funds rate, and the fed funds futures market predicts that the FOMC will raise rates twice during 2018.<br>• Portfolios are allocated to floating-rate corporate and asset-backed securities, subject to client guidelines, in an effort to capture increasingly-competitive yields while mitigating the impact of an unexpected rise in interest rates |
| Treasuries & Agencies | Underweight | • No allocation to fixed-rate Treasuries. We believe valuations in the spread sectors, in particular agency MBS, ABS, and corporates, are appealing<br>• No allocation to agencies. We currently find agency MBS valuations more attractive |
| Securitized Sectors | Overweight | • Allocation to agency MBS. We believe valuations of higher-coupon pools comprised of low loan balances are 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 MBS Index because we find that valuations are unappealing due to the Fed's targeting of the securities during their large-scale asset purchase programs, most recently "FedTrade."<br>• Allocation to ABS. For accounts that allow, we find fixed- and floating-rate ABS that can offer attractive yields and protection against rising interest rates |
| Credit Sectors | Overweight | • Allocation to investment-grade industrials and financials. We seek to emphasize companies with positive free cash flows and strong and experienced management teams |

# Low Duration Fund Historical Characteristics

| | Low Duration Fund | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | European Debt Crisis | | Taper Tantrum | | | | | |
| | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 | 12/31/15 | 12/31/16 | 12/31/17 | 12/31/18 |
| Effective Duration | 1.35 | 1.49 | 1.35 | 1.31 | 1.19 | 1.09 | 1.69 | 1.32 | 1.58 | 0.94 |
| Convexity | -0.04 | -0.12 | -0.42 | -0.29 | -0.54 | -0.20 | -0.10 | -0.03 | -0.03 | 0.04 |
| % Floating-Rate | 12.1% | 13.6% | 6.3% | 7.0% | 13.7% | 35.0% | 43.8% | 48.4% | 41.1% | 47.9% |
| | | | | | | | | | | |
| U.S. Treasury | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 1.2% | 0.0% | 0.0% | 0.0% | 0.0% |
| Agency | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| MBS | 49.4% | 49.2% | 77.4% | 78.7% | 75.4% | 58.7% | 53.2% | 49.4% | 58.3% | 37.4% |
| CMBS | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| ABS | 28.0% | 31.2% | 9.7% | 8.9% | 14.7% | 19.3% | 18.0% | 16.6% | 9.6% | 18.1% |
| Credit | 20.0% | 18.6% | 12.7% | 11.9% | 8.4% | 19.2% | 27.1% | 32.5% | 31.5% | 29.4% |
| Cash | 2.6% | 1.0% | 0.2% | 0.5% | 1.5% | 1.6% | 1.7% | 1.5% | 0.6% | 15.1% |
| | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| | | | | | | | | | | |
| **Rating Categories*** | | | | | | | | | | |
| AAA | 81.0% | 81.4% | 87.3% | 88.1% | 90.9% | 80.1% | 72.2% | 68.2% | 68.4% | 70.6% |
| AA | 11.2% | 11.2% | 6.1% | 3.8% | 2.8% | 11.4% | 14.9% | 19.1% | 13.0% | 8.6% |
| A | 7.8% | 7.4% | 6.6% | 8.1% | 6.3% | 8.5% | 12.9% | 12.7% | 18.6% | 20.8% |
| BBB | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| <BBB | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 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%** |

Sources: BlackRock Solutions, Bloomberg 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 Fund 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

## December 31, 2018

We believe that the Federal Open Market Committee (FOMC) will be measured in its decisions to increase the target range of the federal funds rate in 2019. The U.S. economy is growing; forecasters predict a real GDP growth rate of approximately 3.0% during 2018. In addition, the U.S. labor market is adding jobs and the unemployment rate is at 3.8%. Estimates of wage inflation are roughly 3.9%, while estimates of core personal consumption expenditures (PCE) have been roughly 1.9%. Macroeconomic theory predicts that a robust labor market creates wage inflation, which in turns spurs broader inflation. We believe that the FOMC will not raise rates if inflationary pressures deteriorate.

We believe that the FOMC's plans to reduce the size of the Fed's balance sheet will continue to be executed with little disruption to the markets. We believe this is attributable, in part, to strong communication efforts, adequate advance notice, and the absence of security sales to reduce the balance sheet. However, we believe the lower-coupon MBS that was purchased by the Fed will underperform higher-coupon alternatives when the FOMC ends their campaign of purchasing agency MBS.

U.S. Treasury Inflation-Protected Securities (TIPS) have market-implied breakeven inflation rates that are below the FOMC's stated target range of 2.0%–2.5%. 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 remain attractive relative to Treasuries over the intermediate-to-long term. Corporate risk premiums are at levels above their longer-term averages, and we believe there are attractive opportunities after risk spreads increased during the year. 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 tightens the federal funds rate and reduces the scale of their asset purchases.

We believe that higher-coupon segments (30-year MBS coupon rates of 5.0% and above) 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 there are opportunities in the corporate bond market as risk spreads increased to levels above the Index's longer-term average. We remain concerned about company-specific 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

**BofA Merrill Lynch 1-Year U.S. Treasury Note Index**: Comprised of a single U.S. Treasury Note issue purchased at the beginning of the month and held for a full month. Each month the index is rebalanced and the issue selected is the outstanding U.S. Treasury Note that matures closest to, but not beyond, one year from the rebalancing date.

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

**Bloomberg Barclays U.S. Corporate Index**: measures the investment grade, fixed-rate, taxable corporate bond market.

**Bloomberg Barclays Corporate High Yield Bond Index**: Composed of fixed-rate, publicly issued, non-investment grade debt.

**Bloomberg Barclays U.S. Credit Index:** measures the investment grade, U.S dollar-denominated, fixed rate, taxable corporate and government-related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals and local authorities.

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

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

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

**Bloomberg 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.

**Bloomberg Barclays U.S. Treasury Index**: measures U.S. dollar-denominated fixed-rate, nominal debt issued by the U.S. Treasury.

**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.