Gateway Index/RA Composite Commentary

Q4
2016

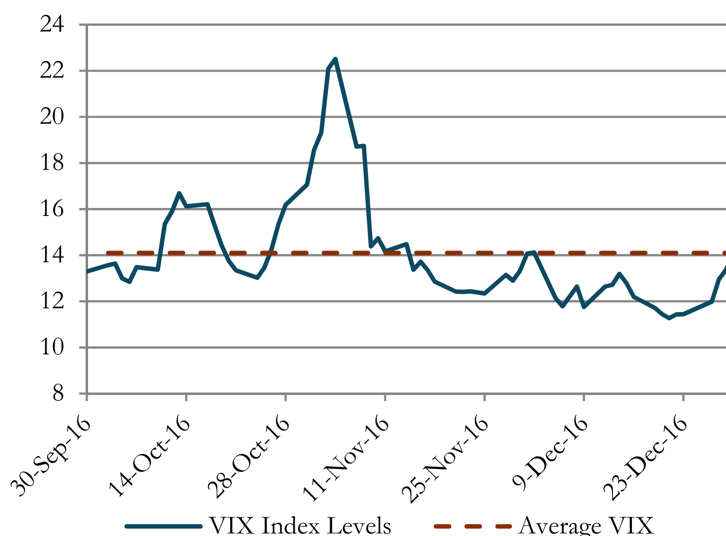
EQUITY MARKETS

The S&P 500® Index gained 3.82% for the fourth quarter, resulting in a total return of 11.96% for 2016. The quarter began with a 1.82% loss for the month of October, followed by returns of 3.70% and 1.98% for November and December, respectively.

October's loss was the only negative monthly return for the S&P 500® Index over the last 10 months of 2016 after sustaining losses in both January and February. The year began with a 10.27% loss through February 11th driven by macroeconomic concerns such as falling oil prices, slowing economic growth in China and Federal Reserve monetary policy that, to many investors, seemed overly hawkish relative to economic conditions. From this year-to-date low through year-end, the S&P 500® Index advanced 24.77% with only two downside episodes, both relatively minor and largely driven by political events.

Initial drivers of the recovery from the decline that began the year were firming oil prices and a series of monetary policy developments that included: the Bank of Japan announcing a policy of negative short-term interest rates, additional monetary stimulus from the European Central Bank and indications from the Federal Reserve that the likelihood of more than two rate increases during the year had lessened. By mid-April the market's advance slowed as attention became focused on the June 23rd United Kingdom (UK) referendum on whether to exit from or remain in the European Union (EU). A majority of UK voters surprised the market with the decision to exit the EU causing a sharp two-day selloff of 5.34% for the S&P 500® Index. However, the recovery from this was swift and the third quarter began with surprisingly calm equity market conditions. The market advance resumed, helped in part by positive June payroll data. By mid-August the market's trajectory began to plateau and then turn negative as attention shifted to the highly contentious U.S. presidential election. From August 15th through November 4th, the S&P 500® Index declined 4.38%. The decline accelerated in late October as both presidential campaigns struggled with negative developments, including news that the FBI was investigating newly obtained emails from Hillary Clinton's private server. A subsequent announcement that the emails contained no new information began a market advance that continued after the election despite the surprising outcome of a Trump victory. Anticipation of pro-growth economic policies from the incoming Trump administration plus mostly positive quarterly earnings and economic reports helped propel the equity market nearly 8% from November 4th to year-end.

Over 70% of the 498 S&P 500® Index companies that reported earnings after September 30, 2016 exceeded analysts' estimates and aggregate operating earnings for Q3 grew 3.31% from Q2, the first quarter of earnings growth since Q3 2014. The growth in earnings was not sufficient to achieve year-over-year earnings growth, however, as aggregate operating earnings declined by 2.61% from Q3 2015. The final estimate of third quarter 2016 GDP growth came in at 3.5%, which exceeded analysts' consensus estimates and was the highest rate in two years.



Datasource: Bloomberg, L.P.

Implied volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (the VIX), averaged 14.10 for the fourth quarter. The measure began at 13.57 and reached a peak of 22.51 on November 4th before steadily declining to its fourth quarter low of 11.27 on December 21st. Despite below-average volatility for nearly the entire quarter, average implied volatility exceeded S&P 500® Index realized volatility of 8.74% (as measured by its annualized standard deviation of daily returns) by over five points, more than one point greater than the long-term average differential between the two statistics.

312 Walnut Street, 35th Floor
Cincinnati, Ohio 45202
513.719.1100

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399 Boylston Street
Boston, Massachusetts 02116

Implied volatility averaged 15.83 for the year, based on the daily closing values of the VIX. This is well below its long-term average of 19.71 and a somewhat counter-intuitive outcome for an election year that included a great deal of uncertainty and multiple unexpected events. However, below-average volatility is not uncommon in election years and the pattern of volatility in 2016 was similar to typical election years in that the highest volatility readings came early in the year, troughed in the third quarter and rose in October and November.

FIXED INCOME MARKET

The Barclays U.S. Aggregate Bond Index (the Aggregate) returned -2.98% for the fourth quarter, resulting in a return of 2.65% for 2016. The year was split almost exactly in half with regard to yield trends and total returns for investment grade fixed income. The yield on the 10-year U.S. Treasury Note fell from 2.27% on December 31st, 2015 to an all-time low of 1.36% on July 8th and ended the year at 2.44%, rising steadily at first and then spiking after the election.

COMPOSITE PERFORMANCE

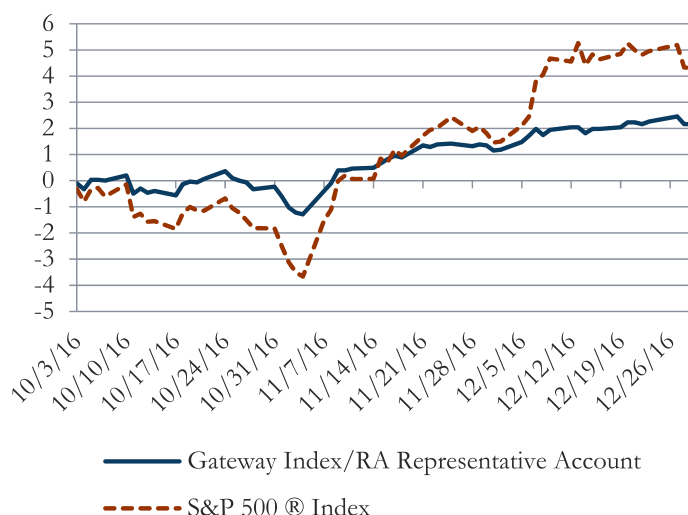
The Gateway Index/RA Composite (net of fees) (the Composite) returned 2.03% for the fourth quarter, underperforming the S&P 500® Index by 179 basis points (bps) and bringing its 2016 return to 5.57%.

The partial period returns, portfolio performance contributions, annualized standard deviation and portfolio statistics quoted for the Composite in the following paragraphs are those measured by a representative account.*

The Composite delivered 159 bps of downside protection during October's market decline with a return of -0.23%, while the S&P 500® Index declined 1.82%. The Composite's overall underperformance for the quarter was mainly the result of its 1.59% return in November lagging the S&P 500® Index by 211 bps. In December, the Composite returned 0.64%, lagging the S&P 500® Index's return of 1.98% by 134 bps. November and December returns were consistent with expectations when the market advances at an above-average rate in a low-volatility environment.

*Represents supplemental information to the GIPS-compliant presentation. This representative account was selected as it is the largest account in the Composite.

For the fourth quarter, the Composite's underlying equity portfolio contributed a total return of 4.24%, resulting in a positive performance differential of 42 bps relative to the S&P 500® Index. The Composite's index call option portfolio helped provide downside protection in October but detracted from return for the quarter primarily due to the losses generated during the market's post-election advance. Index put options detracted modestly from the Composite's return in each month of the quarter, though only slightly in October. The Composite's annualized standard deviation of daily returns for the quarter was 3.92% as compared to 8.74% for the S&P 500® Index. The Composite exhibited a beta to the Index of 0.39 for the quarter.



Datasource: Bloomberg, L.P.

As volatility increased in October, Gateway's index call option activity was focused on selling contracts that offered attractive combinations of cash flow and market exposure. As the U.S. Presidential election approached, the investment management team took advantage of election-related volatility by selling contracts with early-November expirations. After the election, call option activity focused on trading several contracts well in advance of their expirations. This was done to increase cash flow generation while implied volatility was elevated and, later in the month and into December, strike prices were adjusted higher to maintain typical market exposure as the market rallied.

312 Walnut Street, 35th Floor
Cincinnati, Ohio 45202
513.719.1100

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399 Boylston Street
Boston, Massachusetts 02116

The investment management team also took advantage of elevated short-term volatility near the election by selling soon-to-expire index put option contracts with relatively high annualized premiums and replacing them with longer-dated index put options offering similar downside protection but at a lower annualized cost. As implied volatility declined in November and December, the team found opportunities to improve downside protection at attractive prices.

Throughout 2016, the Composite's two-part option strategy delivered protection during market declines and participation during market advances. The Composite's downside protection was consistent throughout the year, delivering shallower losses than the S&P 500® Index in each of the three market drawdowns: from December 31st, 2015 to February 11th, 2016, the Composite's -5.28% return outperformed by 499 bps, from June 23rd to June 27th, the Composite's -2.30% return outperformed by 304 bps and from August 15th to November 4th, the Composite's 1.01% loss outperformed by 337 bps. But the consistently low volatility environment during the year produced cash flow from call writing that was insufficient for the Composite to keep pace with the market's above-average rate of advance. From February 11, 2016 to year-end, the Composite's return of 11.37% underperformed the S&P 500® Index by 13.40 percentage points.

As of December 31, 2016, the Composite's diversified equity portfolio was over 95% hedged with index call options with average strike prices between 1.5% in-the-money and 1.5% out-of-the-money, average time to expiration of 38 days and annualized premium to earn of 10% to 12.5%. The Composite ended the quarter hedged with index put options on over 95% of the notional value of its portfolio with average strike prices between 7.5% and 10% out-of-the-money, average time to expiration of 53 days and annualized cost of less than 2.5%. Relative to the beginning of the quarter, this positioning represented slightly less market exposure and slightly lower net cash flow potential.

MARKET PERSPECTIVE

As we transition from the old year to the new one, we close the books on a year of unexpected events. But with several notable phenomena and trends—both within and outside of the market—2017 may deliver some significant directional turning points of its own. As these inflection points play out, they could contribute significantly either on the positive or negative side for stocks and bonds.
Here are the main inflection points and their potential impact on stock and bond markets:

Interest rates and monetary policy – The amount debtors pay to borrow money has been increasing since mid-2016 and that accelerated after the U.S. Presidential election in November. It looks to be developing into a trend that bears remarkable resemblance to the 2013 'Taper Tantrum' when the yield on the 10-year U.S. Treasury note rose from 1.62% to 3.03% in a matter of months. So far, the stock market has embraced rising rates as a harbinger of economic acceleration. However, as rates rose over the second half of 2016, the bond market gave back about half of its peak year-to-date return. As this happened, credit spreads narrowed and mortgage refinancing slowed resulting in increased interest rate sensitivity for many types of bonds.

Meanwhile, the Federal Reserve has prepared the market for additional rate hikes in 2017, creating a similar expectation as at year-end 2015. Will the Federal Reserve be able to follow through on its anticipated policy path in 2017? Or will events conspire to delay their plans and drive interest rates back toward historic lows as in the first half of 2016? Only time will tell. The impact that potential short-term rate hikes may have on longer-term bond yields is also unknown. Whether rates increase or decrease in 2017, the magnitude of investment grade bond gains or losses may be surprising given their increase in rate sensitivity.

Market volatility – While market volatility seemed surprisingly low in 2016, that economic aspect actually went according to script. Historically, typical election years produce below average market volatility relative to non-election years. There are several potential volatility triggers in play for 2017. Some are pre-existing, like concern over the pace of interest rate hikes and geopolitical tensions, and some are newer, such as policy uncertainty under the new U.S. presidential administration.

Corporate earnings – Domestic corporate earnings may be affected positively by promised pro-growth policies under a Trump administration, and the market appears to have priced in at least some of that potential with its post-election advance. After several quarters of declines in aggregate earnings for the S&P 500® Index, growth resumed in the third quarter of 2016. Corporate-friendly tax cuts and deregulation could help to accelerate or extend that growth. On the flip side, stock prices could face headwinds from currently high equity valuations, rising interest rates, a strong dollar and any potential changes to trade policy including tariffs on imports, especially if such policies inspire retaliatory moves by trade partners.

Several different scenarios are possible as these three inflection points unfold. As we enter 2017, stock market indexes are near record highs and just a few months shy of extending to the second longest bull market in history. Just because the bull market is extended doesn't mean that a bear market is imminent. Even if the bull market would continue for more than four years and more than double, it still wouldn't be the longest or highest-returning bull market in history.

However, given the number of uncertainties facing the markets, if positive assumptions priced into the market today do not come to pass, stocks could endure a correction or possibly even a bear market. Whether or not stocks continue to advance, an increase in day-to-day volatility is certainly possible as the dynamics of the various inflection points play out. With a recent survey showing that the equity risk concentration (the portion of total portfolio risk driven by equity exposure) has been climbing in recent years and is currently over 90%**, investors may not be adequately prepared for an increase in volatility or a significant downside event.

This is particularly true at a time when many investors have reached for yield in both bond and equity investments and have exhibited a marked preference for passive approaches, such as passive stock index funds and ETFs, in lieu of actively managed funds with flexibility to mitigate risk. This means that, should an increase in volatility or market correction materialize, investors may be more exposed to the negative effects of such scenarios than they realize.

Regardless of what the new year brings, investors seeking a smoother path towards reaching long-term investment objectives may benefit from remaining diversified while incorporating different approaches to risk management. As the inflection points play out in this economic and political environment, incorporating low volatility equity investments with reduced interest rate sensitivity may prove beneficial.

** *Moderate Portfolio Trends Report*, October 2016, Natixis Global Asset Management, Portfolio Research and Consulting Group.

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Standard Performance

Average Annual Performance							
As of December 31, 2016							
	1 Year	**3 Years**	**5 Years**	**10 Years**	**20 Years**	**Return Since Inception***	**Risk** Since Inception***
Index/RA (Net)	5.57%	3.89%	5.00%	3.21%	5.02%	7.21%	6.32%
S&P 500® Index	11.96%	8.87%	14.66%	6.95%	7.68%	10.33%	14.26%
Bloomberg Barclays U.S. Aggregate Bond Index	2.65%	3.03%	2.23%	4.34%	5.29%	6.46%	3.78%

*Inception of Gateway Index/RA Composite is January 1, 1988
** Standard deviation is based on monthly performance

Periods over one year are annualized.
Datasource: Morningstar Direct℠ and Gateway Investment Advisers, LLC
Past performance is no guarantee of future results.

For important disclosures, please refer to page 5.

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Gateway Index/RA Composite

Annual Disclosure Presentation

Year End	Annual Performance Results: Composite Gross	Composite Net	S&P 500®	Bloomberg Barclays Aggregate	Composite 3-Year Std. Dev	S&P 500® 3-Year Std. Dev	BBg Barclays 3-Year Std. Dev	Number of Composite Accounts	Composite Dispersion	Composite Assets (millions)	Firm Assets (millions)
1993	8.44%	7.75%	10.08%	9.75%	N/A	N/A	N/A	15	0.7	$ 348	$ 408
1994	6.27	5.62	1.32	-2.92	N/A	N/A	N/A	14	0.5	303	660
1995	12.52	11.75	37.58	18.47	4.07%	8.34%	4.30%	12	1.6	283	473
1996	11.83	11.11	22.96	3.63	4.44	9.72	4.65	27	0.9	329	360
1997	13.34	12.58	33.36	9.65	3.83	11.30	4.06	27	1.1	399	476
1998	13.21	12.49	28.58	8.69	5.53	16.24	3.58	44	1.2	686	805
1999	12.94	12.27	21.04	-0.82	5.39	16.76	3.25	76	1.4	1,348	1,470
2000	6.55	6.08	-9.10	11.63	5.30	17.67	3.06	107	1.2	2,052	2,206
2001	-2.69	-3.28	-11.89	8.44	6.29	16.94	3.40	85	0.5	1,853	1,944
2002	-3.87	-4.45	-22.10	10.25	9.41	18.81	3.40	67	0.4	1,651	1,744
2003	12.53	11.84	28.68	4.10	9.70	18.32	4.26	59	0.4	2,029	2,160
2004	7.84	7.22	10.88	4.34	8.35	15.07	4.34	53	0.5	3,350	3,636
2005	5.86	5.17	4.91	2.43	4.09	9.17	4.12	35	0.5	3,879	6,134
2006	11.06	10.35	15.79	4.33	2.64	6.92	3.25	29	0.5	4,569	6,946
2007	8.67	7.99	5.49	6.97	3.10	7.79	2.80	25	0.5	4,780	7,892
2008	-13.39	-13.95	-37.00	5.24	8.41	15.29	4.03	22	1.0	5,073	7,071
2009	7.37	6.70	26.46	5.93	10.36	19.91	4.17	15	0.4	5,054	7,188
2010	5.76	5.11	15.06	6.54	11.01	22.16	4.22	12	0.1	5,552	7,699
2011	3.82	3.16	2.11	7.84	8.27	18.97	2.82	11	0.3	5,729	8,081
2012	5.41	4.74	16.00	4.22	5.84	15.30	2.42	10	0.2	7,424	10,517
2013	9.35	8.64	32.39	-2.02	4.23	12.11	2.75	11	0.2	8,899	12,475
2014	4.23	3.59	13.69	5.97	3.45	9.10	2.67	10	0.3	8,997	12,239
2015	3.20	2.54	1.38	0.55	3.97	10.62	2.92	11	0.2	8,783	12,210

N/A: The three year annualized ex-post standard deviation of the Composite and benchmarks is not presented as 36-month returns are not available.

Gateway Index/RA Composite contains fully discretionary hedged equity accounts which hold common stock and sell index call options on at least 95% of the underlying stock value. This call activity reduces volatility and provides cash flow. The accounts typically buy index put options that can protect the Composite from a significant market decline that may occur over a short period of time. Indexes utilized for call and put option activity are U. S. domestic equity indexes that include all sectors of the economy. The Gateway Index/RA Composite was created January 1, 1993. As of June 1, 2009, the Composite definition was refined to more accurately reflect the criteria used to determine membership. No membership changes resulted from the revision.

For comparison purposes the Gateway Index/RA Composite is measured against two indexes, the S&P 500® Index (a popular indicator of the performance of the large capitalization sector of the U. S. stock market) and the Bloomberg Barclays U. S. Aggregate Bond Index (an unmanaged index of investment-grade bonds with one- to ten-year maturities issued by the U. S. government, its agencies and U. S. corporations). Prior to April 2008, the Lehman Brothers U. S. Intermediate Government/Credit Bond Index was utilized for comparison. The bond index change was made as the Bloomberg Barclays U. S. Aggregate Bond Index is widely viewed as more broadly representative of the fixed income markets and was considered to be more in line with the historical volatility associated with the Composite's investment strategy.

Performance results are based on fully discretionary accounts under management, including accounts that may no longer be with the firm, and are expressed in U.S. dollars. Performance returns are presented gross and net of management fees and include the reinvestment of all income. Past performance is not indicative of future results. The annual Composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the Composite the entire year.

Net of fee performance was calculated using actual management fees. The current investment management fee schedule is as follows: 0.85% on the first $5 million; 0.65% on the next $5 million; 0.50% on the next $40 million; and 0.45% on assets in excess of $50 million. Actual investment management fees incurred by composite accounts may vary.

Gateway Investment Advisers, LLC (Gateway) is an independent registered investment adviser and a successor in interest to Gateway Investment Advisers, L.P. as of February 15, 2008. Gateway claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Gateway has been independently verified for the periods January 1, 1993 through September 30, 2016.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The Gateway Index/RA Composite has been examined for the periods January 1, 1993 through September 30, 2016. The verification and performance examination reports are available upon request.

Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request. A list of composite descriptions is also available upon request.