Fund Manager Commentary
William Blair SICAV Dynamic Diversified Allocation Fund

Performance Summary

The Dynamic Diversified Allocation strategy completed the quarter with negative performance, with both aggregate market and currency exposures detracting and security selection adding. Within markets, the portfolio benefitted from long exposures to European equities like U.K., France, and Spain. Negative contributors to performance in the market strategy were long exposures to emerging market equities and short exposure to Canadian equity. Within currencies, short exposures added value, particularly the New Zealand dollar, Thai baht, euro, and Czech koruna while long exposures in the Turkish lira, South African rand, and Great Britain pound detracted. Security selection also contributed positively, driven by International Leaders.

Fund Positioning

Market strategy remains long of equities, with effective exposure of +29%, with exposures generally unchanged during the quarter. The strategy remains long of U.S., developed Europe, U.K., and emerging equities. Market strategy is modestly long of fixed income with a net exposure of +14%.

Within currencies, strategy remains long of emerging currencies such as the Turkish lira, Philippine peso, and Indian rupee with the largest short positions in the Thai baht, Swiss franc, and New Zealand dollar.

Fund Exposures (%) as of 30.06.2018

Equity	**29.3**
Europe (ex-U.K.)	9.4%
U.K.	6.0%
Asia Developed	0.9%
U.S.	4.4%
Canada	-2.8%
Emerging	11.4%
Fixed Income	**13.5**
U.S. Treasury and Credit (10-Year)*	3.3%
Non-U.S. Developed (10-Year)	8.2%
Emerging	2.0%
Unencumbered[1]	**30.6**
Active Currency	**USD Based**
Euro (EUR)	-7.0%
Switzerland Franc (CHF)	-6.0%
Great Britain Pound (GBP)	6.0%
Other Europe	-0.4%
Australia Dollar (AUD)	-3.4%
New Zealand Dollar (NZD)	-7.8%
U.S. Dollar (USD)	-6.3%
Canada Dollar (CAD)	0.0%
Other Americas	10.8%
Japan Yen (JPY)	5.2%
China Yuan (CNY)	-1.4%
Asia (ex-JPY and CNY)**	0.0%
Other	10.3%
Net Currency	**0.0**

Fund Review and Outlook

Global equities made modest gains in the second quarter and did not revisit the year's low point, which coincided with the end of a volatile first quarter of 2018. In currency-hedged terms, the MSCI All Countries World index (hedged into U.S. dollars) rose by 2.9%. Developed country markets were up 3.8%, though hedged emerging equities lagged and returned -3.6%. Bond yields moved higher (again) in the United States and in some European markets (Italy, Spain), but not for the eurozone as a whole and not in Japan. Against a basket of developed currencies, the U.S .dollar strengthened, reversing its fall in the first quarter and some of its decline in 2017. The dollar also climbed relative to emerging market currencies, in some cases (Turkey, Mexico) particularly steeply. Other emerging currencies (India, Indonesia) were more resilient, particularly when their "carry" (nominal interest rate premium) is included.

Growth in the second quarter was mostly slower in advanced economies: both the United States and the eurozone posted weaker real GDP gains than in late 2017. In the United Kingdom, growth fell almost flat (partly attributable to bad weather). The larger developing economies, China and India, continued to expand relatively rapidly but India was not able to repeat its 2017 achievement of exceeding China. Among the slower-growing emerging economies, there was some acceleration in growth (from a low base) in Mexico and Brazil, while South Africa experienced a surprising slump. The International Monetary Fund, in its most recent update of its World Economic Outlook (in April), has become more optimistic about growth in 2018-19, though the IMF warned that risks to this improvement could come from trade tensions, asset market vulnerability, and geopolitical risks.

The *Where* stage of our investment process, which compares our estimate of fundamental value to current prices, suggests a medium amount of investment risk is currently appropriate in our portfolios. This applies to all of our risk budgets: systematic market (beta), unsystematic market (relative value), and currency. From a systematic market risk perspective, the *Where* stage informs us that equities in Europe (Italy, Spain, the United Kingdom, Greece) and select equity markets in the developing world are attractive while bonds are generally unattractive. From an unsystematic market risk view, unattractive equity markets in the Canada, Japan, South Africa, and Mexico provide us opportunities to be short. Looking across our currency universe, we see a mix of attractive and unattractive currencies in both developed and developing areas, a marked difference from the opportunity set we saw just a few years ago when we were generally long emerging currencies and short developed ones.

However, all three items mentioned in the IMF update (trade, market vulnerability, and geopolitics) also provide reasons why the risk taken in our strategies is lower than the “untainted” or pure valuation opportunity would warrant. This is not to ignore valuation altogether, but to take into account headwinds in our *Why* stage that, in most cases, are currently blowing in the opposite direction to the gradual pull of value. These headwinds are more prominent than was the case in 2017. Put simply, a widening opportunity set (price moving away from value) presents a challenging environment for fundamental investors. In such an environment, we do not necessarily avoid risk altogether, but rather we are more deliberate in accumulating active risk. We are then armed with ample dry “risk” powder so that we may appropriately take on more risk after such headwinds have created larger opportunities than were present before. We can take each of the three categories of investment headwind in turn.

Reductions in the volume of global trade, brought on by higher barriers to trade such as tariffs, are generally a growth-hampering impulse. Higher trade barriers have been both implemented and threatened in recent months, mostly led by the U.S. administration’s more protectionist stance under President Trump, and involving Canada and Mexico (via the North America Free Trade Agreement or NAFTA), China, and recently Europe. The geopolitical dynamic of trade disputes is best appreciated by analysis of the incentives facing the governments that are involved. “Nobody wants a trade war” is a truism deriving from the assumption that, in aggregate, all parties suffer a negative growth outcome the more free trade is impaired, but at the same time it is well understood that in game-theoretical terms, one player’s best reply to another’s raised trade barrier is to reciprocate, leading to a pattern known as “tit-for-tat.” Therefore, uncertainty and risk is increased by the deliberate actions of the players, even though their encompassing best interests would be better served by not escalating and indeed de-escalating the situation. For these reasons, we are negative on trade-sensitive markets and have reflected this in our portfolios—we are less long of Chinese equities and the Mexican peso than fundamentals suggest, and we are more short of Canadian equities than we would be without this elevated risk. We do not, however, expect a dramatic and negative trade war as a base case, and this is due to the encompassing best interest noted above. In this vein, dialing down of trade threats (U.S.-China) and/or delaying their implementation have also been features of political maneuvers in recent months. But the bottom line is that this aspect of global policy is producing increased uncertainty (a headwind) that was not present in recent years.

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We share the IMF's concern about market vulnerability for reasons outlined in our first-quarter letter. The experience of 2017, when we saw little-to-no volatility and high equity returns, still renders market prices fragile, we believe. This is especially the case because of the large growth of passive, or rule-following, strategies, and the corollary of potentially significantly lower discretionary liquidity being available (an evolution also driven by market regulation of recent years) should the market conditions that have rewarded passive strategies end, or reverse. This vulnerability had already become more visible in the first quarter of 2018. But, notwithstanding market events in February and March, this situation (much rules-based trading, less room for liquidity expansion) has not yet been stressed, making its potential impact substantially unknowable. Although we find reason to be concerned about market fragility, it is costly, over time, to protect against adversity by buying options (which for a premium can automatically reduce long exposure to markets that fall). Our approach to the vulnerability concern has been (i) to carry less systematic risk in portfolios than valuation justifies, and (ii) to hold long option protection against a large adverse market move, that would not particularly change portfolio behavior in the case of moderate or normal downside volatility, and which, therefore, does not cost so much in option premium. Our option positions are dispersed across asset classes: protection on small-cap eurozone equity, on three emerging currencies (Chinese yuan, Philippine peso, Indian rupee), and long optionality to the spread of high yield over investment grade fixed income. In each case, our analysis anticipates that "risk-off" market behavior would result in all three effectively reducing portfolio downside beta (sensitivity to falling equities).

Thirdly, geopolitical risk remains pronounced across our investment universe. In particular, politics has added to investor uncertainty in the most recent quarter and contributed to price weakness in both Italy and Turkey. In Italy's case, a general election in March that produced a hung parliament led to almost three months of negotiations before a government comprising Italy's two largest populist parties was finally formed. During this negotiation period, fears were raised both about Italy remaining in the eurozone (to which the new government committed, but not until early June), and likely fiscal expansion by the government breaching the zone's deficit limits and adding to the country's very high public debt load. Italian government bond yields jumped higher, and equities, which had performed well until early May, dropped. We cut our long exposure to Italian equity before the sell-off (having increased it in the prior quarter and benefiting from market strength at the time), such that Italy becomes another market in which we have dampened risk relative to the opportunity, this time owing to geopolitics. In Turkey, President Erdogan called a snap election in April (one year early), and while campaigning in May stated that he would seek to influence the central bank to lower interest rates despite high inflation caused in part by depreciation of the Turkish lira. This frightened market participants and gave the lira a further sharp fall, with the consequence that the central bank stepped in to increase interest rates, twice, quite probably by more than would have been the case absent Mr. Erdogan's verbal interference. We made two increases to the strategy's long lira exposure through this episode, and at quarter end, it was our largest long exposure. Looking forward, substantial political risk remains in respect of Turkey, but we believe that May's experience with the lira largely reduces the danger of renewed rhetoric that would compromise monetary policy. Put bluntly, Mr. Erdogan "played chicken" with the currency market and lost. Hence we are content to increase our exposure to a now very large divergence between currency value and price.

In the United Kingdom, negotiations with the European Union about the United Kingdom's departure ("Brexit") became dominated by a near-unanimous political imperative to avoid re-establishment of a customs border between Northern Ireland (part of the United Kingdom) and Ireland, which was removed when the EU's "single market" was created in 1993 and would need to be reinstated if the United Kingdom exited the single market, as is official government policy. The reason almost all parties are distinctly unwilling to countenance a new border is that it would echo (in sentiment) a military border that divided the countries during the Northern Ireland "Troubles" (ethno-nationalist conflict involving paramilitary groups),

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which have been over since a 1998 peace accord was reached. The interest in the objective of no border appears to have greater compulsion across political "players" than the coalition that favors what is known as "Hard Brexit," involving the United Kingdom leaving with nothing similar to the single market, or existing customs union, in place. The political outturn from this has been general delay since a solution is not apparent that reconciles both interests; we also conclude that the likelihood of "Soft Brexit" has risen. The latter is preferable to the former from a market perspective, both as it relates to U.K. equity and the British pound (both of which we regard as attractive relative to fundamental value). We maintain both of our long exposures.

In the larger picture, our longer-term investment objective is to deliver positive investment returns above inflation through a market cycle. We remain grounded in fundamental valuation as our first step—we strive to only take compensated risk and are unwilling to extend exposures unduly in a reach-for-yield that would be dictated not by opportunities and risks but by very low real interest rates. There will be environments in which we conclude that macro markets do not provide returns and risks compatible with portfolio objectives alongside other periods where compensation is abnormally high. During the last decade, the challenge of navigating these evolving environments has remained a significant component in the investment landscape, but we find our investment process, dialogue, and decision-making well-equipped to meet this challenge in an appropriate way. We remain vigilant as we assess new and relevant information to capture future investment opportunities in a timely manner and will continue balancing the relationship between risk taken and compensation expected.

FOOTNOTES TO FUND EXPOSURE TABLE

***Credit Detail**	
European Investment Grade Spread	3.5
U.S. Investment Grade Spread	7.4
U.S. High Yield Spread	-1.2
****Select Exposures**	
India Rupee (INR)	6.3
Philippine Peso (PHP)	9.0
Singapore Dollar (SGD)	5.6

[1]Unencumbered cash is residual cash and equivalents.

Fund exposures are as of 30 June 2018.

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