Negative Rates and the Need for Income

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Global Central Banks Continue to Ease

The impact of quantitative easing and low (and often negative) interest rate policies from central banks has caused investors to search for yield. Today, more than one-third of all sovereign debt is trading with a negative yield and according to Bloomberg, approximately 80% of German Bunds currently trade at yield below zero. In fact, just last month, Germany became the first Eurozone nation to issue 10-year debt with a negative interest rate.

Germany's negative yielding debt is partly a consequence of the European Central Bank (ECB) quantitative easing program, which includes buying ¬80 billion of European debt each month. While most of the ¬80 billion is sovereign-related, the ECB launched a program in June to purchase corporate bonds in attempt to spur inflation and lower financing costs. Currently, approximately $500 billion worth of European investment grade bonds are trading with a negative yield.

The Bank of England (BoE) was aggressive with its latest stimulus package during the August 4 meeting. The BoE's attempt to stimulate growth in the wake of Brexit included a 25 basis points (bps) rate cut, £60 billion of government asset purchases, £10 billion corporate debt purchases and a new Term Funding Scheme designed to provide direct credit to banks in support of their lending activity. The 25 bps interest rate cut was the first rate change since the financial crisis in March 2009. Further, similar to the Fed "dots" we see domestically, U.K. policy makers cut their economic forecasts and Mark Carney (governor of the Bank of England and chairman of the Monetary Policy Committee) suggested further rate cuts may continue, but he was "not a fan of negative interest rates."

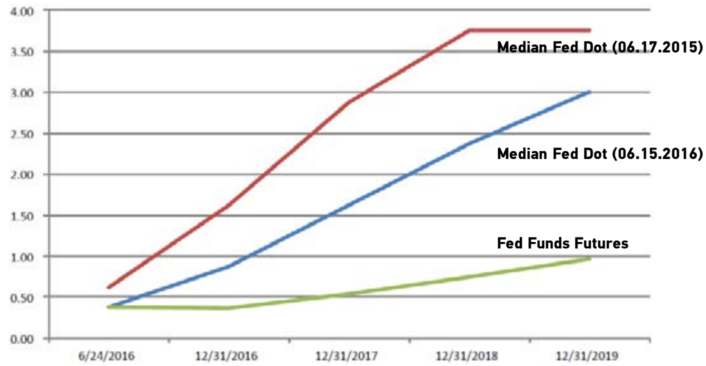
The Bank of Japan (BoJ) is also no stranger to stimulus packages. In fact, just last week, the BoJ put forth its latest effort providing both monetary and fiscal stimulus. On the monetary side, BoJ Governor Haruhiko Kuroda announced it will purchase $120 billion worth of ETFs over the upcoming two years. When that program is complete, the BoJ will reach approximately 4% of Japan's market capitalization. From a fiscal perspective, Governor Kuroda and Prime Minister Shinzo Abe will provide $40 billion in spending over the next eight months in the form of infrastructure spending, cash handouts to low-income households, lifting wages for nursing and childcare workers and a cut in employment insurance premiums.

While the Nikkei declined in the wake of the most recent BoJ announcement, suggesting the market was underwhelmed by the stimulus, the global markets continue to move higher. In fact, both the equity and credit markets are higher today than before Brexit. From the day prior to Brexit (06.22.2016) to 08.08.2016, the MSCI World Index, a proxy for international developed markets including the U.S., returned 3.24% while MSCI Emerging Markets was up 9.33%. Within fixed income, the Barclays High Yield Index was up 3.38% and the Barclays Long Treasury Index was up 3.54%.

As we conclude the around-the-world tour of central bank policy, we turn to the Federal Reserve. Yields continue to decline due to low inflation and tepid economic growth, but perhaps most notable is the demand from foreign investors. In a recent 30-year Treasury bond auction, demand continued to be strong, even with a record low yield of 2.172%. The largest source of demand (68.5%) came from indirect bidding, a proxy for foreign demand.

The Federal Reserve continues to be optimistic with its views on economic growth and upcoming interest rate increases. Based on the latest quarterly release of its Summary of Economic Projections ("dots"), the Fed anticipates one or two hikes in 2016 and three to four hikes in 2017. The market, however, continues to price in a much lower interest path and as of August 8, the market viewed the likelihood of one rate hike in 2016 as less than 50%.

The chart below illustrates the Fed's current anticipated rate trajectory (blue line), the expected path from the June 2015 Fed meeting (red line) and what the market anticipates (green line).



Source: Federal Reserve, Bloomberg

Achieving Income Through a Risk-Controlled Approach

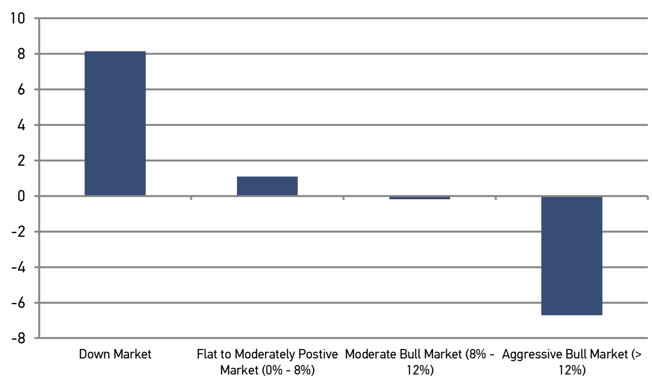
With interest rates at or near record lows throughout much of the world, investors have been forced to assume greater levels of credit, duration, liquidity and valuation risk in an effort to achieve desired yield targets. In this environment, a diversified and risk-managed approach to income generation has never been more important.

The Sterling Capital Diversified Income Fund's risk-first approach to asset allocation and security selection can provide an effective solution for income-focused investors. The fund seeks income and capital appreciation by investing in a broad range of income-generating asset classes and strategies. The fund utilizes both active and passive management, and a disciplined asset allocation approach is employed to maximize risk-adjusted yield.

From an equity perspective, the fund balances exposure to high dividend yield, consistent dividend growth, real estate investment trusts (REITs), master limited partnerships (MLPs) and option writing strategies. When utilized in a risk-controlled manner, these strategies present appealing risk/return opportunities.

Option writing strategies, for example, may help provide downside protection as option premiums, which generate income, can provide a cushion against downward movements in the equity market. These strategies have historically generated positive excess returns relative to the broad equity market, with the only exception being in aggressive bull markets, as shown on the chart below.

Option Strategy Excess Returns in Different Market Environments
07.01.1986 - 06.30.2016

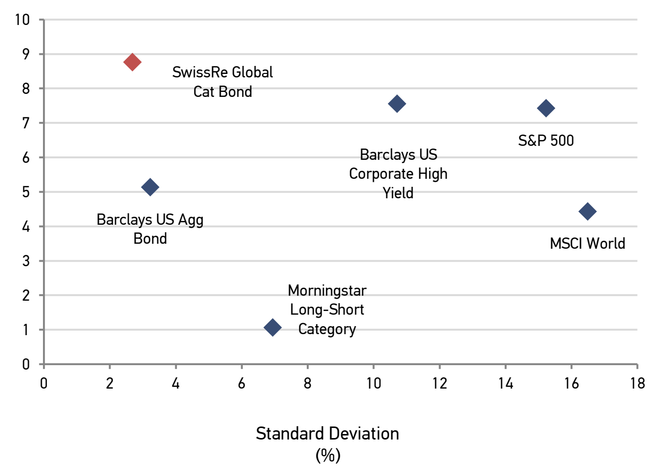


Source: Morningstar Direct. Rolling 1-year periods re-calculated quarterly. Median return differential of the CBOE S&P 500 BuyWrite BXM Index above the S&P 500. Past performance is no guarantee of future results. It is not possible to invest in an index.

Within the fixed income opportunity set, the fund allocates to income-generating asset classes including high yield, floating rate, investment grade, MBS and emerging market debt. Further, it aims to maintain substantial downside protection, the fund provides exposure to long Treasuries as well as municipal bonds. The most unique asset class, however, is insurance-linked securities, which offer attractive risk/return opportunities and characteristics.

These securities are issued by property/casualty insurers and reinsurers to transfer major risks on their books (such as for hurricanes and earthquakes) to capital market investors, reducing their overall reinsurance costs while freeing up capital to underwrite new insurance business. Insurance-linked securities, as represented by the SwissRe Cat Bond Index, have historically provided returns above the S&P 500 and Barclays High Yield Index while maintaining a risk profile comparable to the Barclays Aggregate Index.

Trailing 10-Year Risk & Return as of 06.30.2016



Source: Morningstar Direct. Past performance is no guarantee of future results. Indices and categories are unmanaged and used as a benchmark to judge relative performance. It is not possible to invest directly in an index or category.

Investors can only maintain and grow an income stream if their income-generating asset base is not being eroded during periods of elevated market volatility. The Sterling Capital Diversified Income Fund's investment process is focused on maximizing and growing income for investors while attempting to reduce the probability of significant capital loss.

Investment Considerations

The fund is primarily concentrated in underlying funds and is therefore subject to the same risks the funds are invested in and may entail higher expenses. The fund is also subject to valuation risk which is the risk the Fund has valued certain securities that won't appreciate as anticipated or remain undervalued for a long period of time.

The underlying funds may be invested in equity securities including more aggressive investments that engage in short selling, options, exchange-traded funds (ETFs), Master limited partnerships (MLPs – affected by the natural resources sector of the economy and regulation) and real estate investment trusts (REITS - affected by economic factors related to the real estate industry). The fund's volatility may be amplified by its use of short sales and derivatives. Investments in fixed income and debt type securities are subject to credit risk, call risk, prepayment and interest rate risk so that as interest rates rise the value of bond prices will decline. Investing in high-yield debt (junk) securities involve greater risks and less liquidity than investment grade bonds.

Standard Deviation: statistical measurement showing how widely returns varied over a certain period of time; high standard deviation, may imply greater volatility.