CHRYSALIS
INVESTMENT MANAGEMENT LLC
8235 Forsyth Blvd., Suite 200
Clayton, MO 63105
(o) 314.726.5500
(f) 314.881.1868
www.chrysalisim.com

June 30, 2017 Quarterly Report

We hope your 4th of July celebration was safe and enjoyable and that your summer is going well.

We have certainly been intrigued (and happy) by the performance of our accounts over the last 9 months.

However, we would like to take this time to offer some cautionary tones to where we see the current and future investment outlook.

This past quarter has seen an ever larger divergence between the haves (Facebook, Amazon, Apple, Microsoft, Google) and the have-nots (most every remaining investment option). While these companies have provided an abundant amount of exceptional products and services to the world, we feel that the proportion of returns they have provided have masked the performance of most every other remaining publically traded company.

We have noted over the last few months a growing structural problem with how investing has been changing over the last few years and believe that this has increased the risk of a severe correction.

There are three main trends that we believe has led to a false sense of security (low volatility in an ever rising market):

- Rise of Quantitative Trading
- Rise of Index Investing
- Rise of Exchange Traded Funds

1) Rise of Quantitative Trading

Quantitative investing is based on computer formulas and trading by machines. It is estimated that fundamental traders account for only about 10 percent of trading volume in stocks. Passive and quantitative investing accounts for about 60 percent.

The trade most favored by these formulaic participants has lead to the rise in the Low Volatility and Growth, and the decline in the Value and High Volatility.

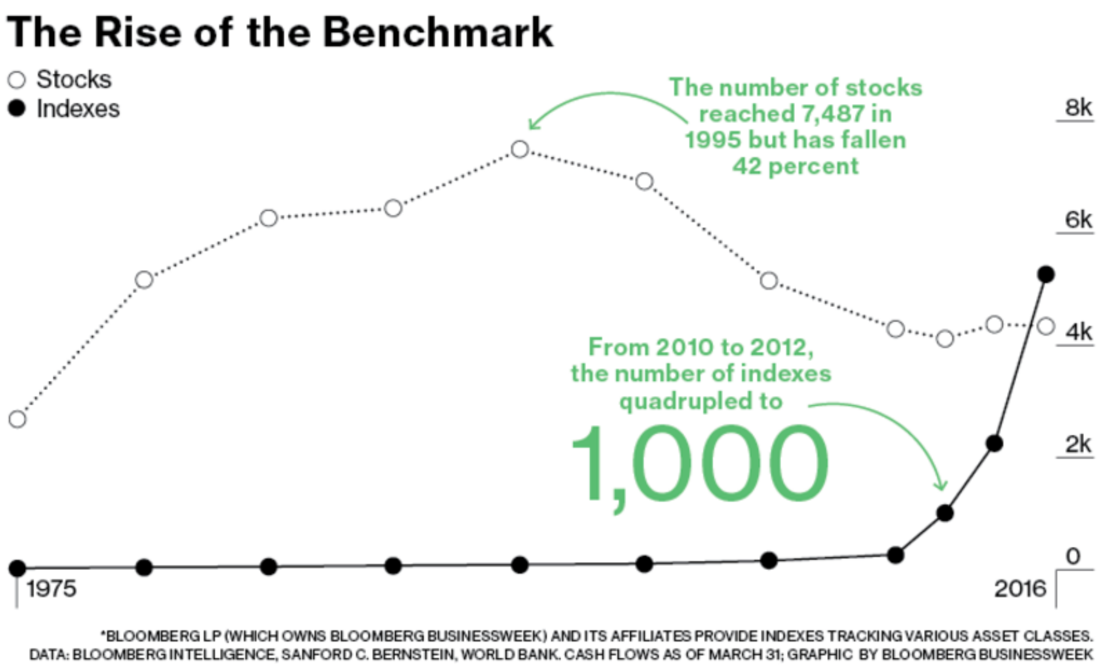
Derivatives, central bank policy and political developments have also contributed to low market volatility. These big data strategies are increasingly challenging traditional fundamental investing.

While the case can be made that these types of advancements in trading can be beneficial by providing additional liquidity, there is a certain critical mass that may be reached if too many participants are employing the same strategy. According to AllianceBernstein, artificial intelligence (machine trading) is unable to generate significantly different results because analyzing more and more data results in increasingly similar strategies.

The increase in computing power devoted to market trading has invariably brought about an increase in our next topic…Index Investing.

2) Rise of Index Investing

At some point in 2016, according to Bloomberg, there were more indexes than there were stocks that could be traded. Indexes, which serve as benchmarks for both active and passive investors, have proliferated over the past 7 years as seen in the chart below.



The parabolic growth in benchmarks has coincided with the enormous growth in the number and amount of investing in Exchange Traded Funds. For every benchmark that is traded there are perhaps multiple ETF options available to mirror and track that benchmark.

3) Rise of Exchange Traded Funds

According to a report by Bank of America Merrill Lynch, the surge of ETFs is distorting the stock market and making it less efficient in the process.

The percentage of equity-fund assets has increased measurably since the last financial crisis, rising to 37% in 2017 from 19% in 2009, according to the report.

Leading this shift has been Vanguard, whose share of the S&P 500 market capitalization doubled from 2010 to 6.8% today. What is worrisome is that the number of S&P 500 stocks in which Vanguard holds more than a 5% stake totaled 491 recently, versus 116 in 2010. Only nine stocks in the S&P 500 are either not owned by Vanguard or have less than 5% Vanguard own

Passive investing may be distorting the true number of freely tradable shares available for the S&P 500.

This may have unexpected consequences for investors, as the average price volatility of stocks with large ownership by passive players has tripled in the past 12 months.

This also leads to a fewer number of stocks generating a larger crowd, which may lead to greater risk. The contrarian investor then should be better off focusing on shares that have been ignored.

Investor Socialism

With the rise of quantitative investing leading to more indexes created, and indexes leading to more ETF's, what we are witnessing is a shift to a type of Investor Socialism.

In an article titled "Stealth Socialism" that appeared in the September 17, 2016 print edition of The Economist, it points out that:

" Since 2008, about $600 billion in holdings of actively managed mutual funds (investments chosen based on fundamentals) have been sold off, while $1 trillion has flowed into passive funds. "

"Research by Jan Fichtner, Eelke Heemskerk and Javier Garcia-Bernardo from the University of Amsterdam tracks the holdings of the "Big Three" asset managers: BlackRock, Vanguard and State Street. Treated as a single entity, they would now be the largest shareholder in just over 40% of listed American firms, which, adjusting for market capitalization, account for nearly 80% of the market. The revolution is here, but it was not the workers who seized ownership of the means of production; it was the asset managers."

"A growing number of critics reckon this cannot be good for capitalism. Some argue that because such funds take investors out of the role of allocating capital the outcome does indeed resemble Marxism. In August analysts at Sanford C. Bernstein, a research firm, thundered: "A supposedly capitalist economy where the only investment is passive is worse than either a centrally planned economy or an economy with active market-led capital management."

Hyperbolic perhaps, but also tinged with a grain of truth.

So where to Invest?

I think the most prudent focus at this time should be following those ideas that are under followed and under owned. At this point in time the most opportunity to generate any outsize returns will arise from the sectors/industries/styles that have performed the worst over the last 3 years:

Energy, Financials and Telecommunications.

Additionally, there are no rules against holding cash when uncertainty arises. We are most likely to liquidate holdings as they approach our price targets and hold a larger amount of cash than normal until we see a better risk/return environment.

Index Returns

Index	Q2 2017	Q1 2017	Q4 2016	Q3 2016	5 Year Annualized
*MSCI ACWI ex-US	4.80%	7.21%	-1.61%	6.26%	4.26%
S&P 500	3.09%	6.07%	3.82%	3.85%	14.62%
Russell 2000 Value	0.67%	-0.13%	14.07%	8.87%	13.00%
Barclay's US Agg	1.45%	0.82%	-2.98%	0.46%	2.12%

Data provided by MorningStar Office
*MSCI ACWI ex-USA PR USD is the Price Return of the Morgan Stanley Capital International Index excluding US based companies

Summary

While we continue to receive technical confirmations that we are in the midst of a historically long run Bull Market, we are certainly becoming more cautious. Other than investments in oil and gas related industries, we are seeing fewer ideas that we consider to be attractive values.

The focus on Growth vs. Value over the last 3 years had led to market prices that we believe will make it difficult to realize above average gains from just holding the general indices.

We are of the opinion that taking a passive approach to these markets is not recommended given current market structure and fundamentals.

Should you have any questions please feel free to call me directly at 314-726-5500 or email at bgrunzinger@chrysalisim.com.

Sincerely,

Robert J. Grunzinger, CFA CPA (inactive)
President Chrysalis Investment Management, LLC