



PARKER GLOBAL STRATEGIES, LLC

MLPS: THE OPPORTUNITIES AND THE CHALLENGES MARCH 2016

EXECUTIVE SUMMARY

Defensive MLPs Present an Attractive Current Investment Opportunity

- **Defensive MLPs have underperformed Q1 2016**
 - MLPs currently represent the most conservative way to participate in the energy market.
 - Riskier commodity sensitive MLPs along with E&Ps have had strong outperformance for the quarter.
 - Defensive MLPs are best positioned for the year and for the long term.
 - Yields are attractive and growing; firms have access to capital markets; we do not anticipate distribution cuts.
 - Many of these defensive MLPs are “farther from the well head” and less exposed to declines in volume.
- **Defensive MLPs are more attractive than integrated oil companies and E&Ps**
 - Defensive MLPs have a higher current yield, a higher 3 year CAGR.
 - Defensive MLPs have a higher potential upside than integrated oil companies when considering percent recovery to 52 week highs and cycle highs.
 - PGS believes that refining margins will not be as attractive in 2016 as they were in 2015 which would impact earnings for integrated oil companies.
 - E&Ps have the highest potential should they recover to 52 week highs or cycle highs, but a number face ratings downgrades, equity issuance and/or the threat of bankruptcy.
 - E&Ps valuations are currently reflecting \$60-\$70/Bbl WTI, whereas the current spot is ~\$40 and the one year forward is ~\$45. By investing in E&Ps now, one is wagering that the WTI futures curve is mispriced and that it will experience a material upward shift from today’s level.
- **MLPs were hurt by negative fund flows during 2015. In 2016, we are seeing positive fund flows**
 - Significant investors like Oklahoma Pension are increasing their exposure.
 - Discretionary open-ended funds had inflows of \$533 mm for February 2016.¹
 - We have completed earnings’ season, and many of the defensive MLPs beat or met estimates.

¹ Source J.P. Morgan Markets

Metric	MLPs²	MLP GPs/ C-corps	Integrated Oils Cos.	E&Ps
Current Yield	7.1%	7.1%	4.6%	0.6%
2015-18 CAGR	8.7%	7.4%	-4.9%³	-8.4%
Recovery to 52 Week High (%)	71.1%	153.7%	28.9%	82.9%
Recovery to Cycle High (%)	90.4%	178.7%	58.2%	153.9%

- **Midstream MLPs are a “safer” way to play a rebound in oil prices.**
 - Over the course of 2015, WTI fell 30% and MLPs currently owned (as of Mar 18) in the PGS portfolio fell 29%. The cash flows of MLPs owned in the PGS portfolio (as measured by EBITDA) declined just 5% YoY over this span. Meanwhile, E&P EBITDA declined 193% in 2015 vs 2014’s levels (as measured by 46 publicly traded US E&Ps in the XOP ETF).
 - We believe the disparity between MLP and E&P cash flow performance underscores that the drawdown in MLPs has been driven more by technical factors and concerns over E&P counterparty risk than material fundamental weaknesses in the fee-based nature of midstream MLP business models.
 - Given that MLPs equities have been penalized during the oil price downdraft, one may surmise to reason that defensive MLPs should benefit substantially when technical factors and E&P counterparty concerns are alleviated.
 - Meanwhile, investors are paid healthy yields (AMZ yield = 8.8%, as of March 18; 7.1% for the PGS focus list of defensive/opportunistic MLPs) to wait for this commodity price recovery. Notably, the few E&Ps that even pay a dividend are all yielding <3%. We would argue that MLPs are a better way to play an oil price rebound than E&Ps.
 - Similar to Defensive MLPs, a core group of MLP GPs and C-corps also present an attractive current opportunity.

² PGS’ MLP Focus list of 35 MLPs that we believe are best positioned for the next 12 months.

³ 2.1% including only those integrated oil companies with a positive expected CAGR for 2015-2018.



OUTLOOK FOR THE REMAINDER OF 2016

The first quarter has witnessed a continuation of the volatility that weighed on MLP equities in 2015. As of 2/29/16, the Alerian MLP Index is down -11.5% year-to-date. Recent performance of MLP equities has primarily been driven by concerns governing three main issues:

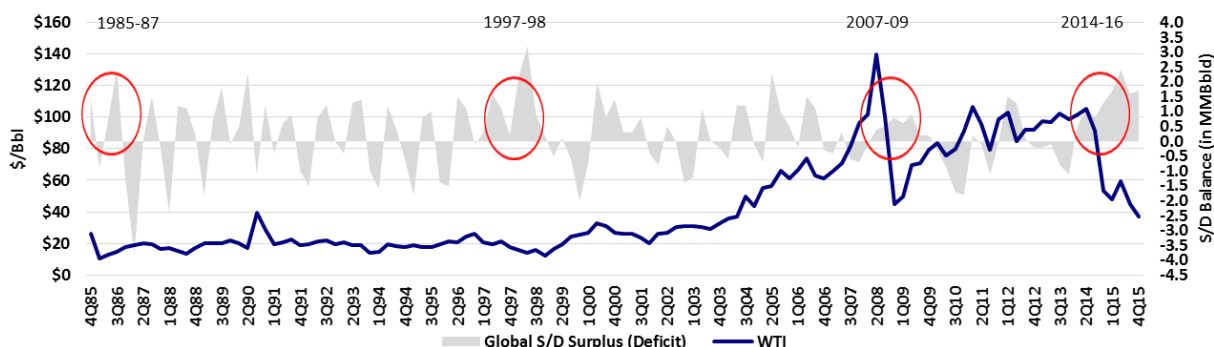
- Global oversupply of crude oil
- Volumetric risks posed by potentially declining volumes in the US
- MLP growth financing needs

Each of these concerns has called into question the continued viability of the MLP business model. In order to see a sustained recovery in MLPs, MLPs must alleviate these concerns. Our note examines each of these concerns and why the industry is nearing an inflection point that should drive a historical recovery in MLP equity prices.

Global Oversupply of Crude Oil

A primary driver of the decline in the price of oil and MLP equities continues to be the overhang of too much oil supply in the global market. Data released from the International Energy Agency (IEA) in mid-January showed that global oil production exceeded demand by an average of 1.7 million barrels per day (MMBbld) in the fourth quarter of 2015. While this imbalance is moderately wider than the third quarter's 1.6 MMBbld surplus, it is *tighter* than the peak imbalance of 2.3 MMBbld in the second quarter.

Figure 1: Four Major "Oil Recessions" in Last 30 Years



Source: IEA, Bloomberg

The fourth quarter imbalance of 1.7 MMBbld represents 1.8% of demand, a relatively small amount when viewed in the context of global demand. Historically, we have actually observed more pronounced imbalances when looking amongst the three other major oil price "recessions" of the past thirty years: the 2007-09 crash in oil prices saw global the global supply surplus peak at 0.9 MMBbld (1.1% of global demand), while the 1997-98 crash correlated with a peak supply surplus of 3.2 MMBbld (4.4% of global demand), and the 1985-87 crash correlated with a peak supply surplus of 2.4 MMBbld (4.0% of global demand).

The current oil market imbalance is differentiated by its duration and causality. At nearly nine quarters and counting, this surplus will likely go down as one of the longest in modern record. Three of the past "oil price recessions" have been cleared up in one to two years. This is also the first *supply*-led oil market

imbalance since 1985-87. Between the depths of the Great Financial Crisis in 3Q08 and the peak of the global supply surplus in 2Q15, global oil production increased by 10.1 MMBbld. This compares to an increase in global demand of just 8.2 MMBbld over this span. Much of the supply increase can be pinned on US shale producers. US oil production increases are responsible for 4.8 MMBbld (47%) of the 10.1 MMBbld increase in global production over 3Q08 to 2Q15.

The current global supply/demand imbalance is marked by the absence of a swing producer. Historically, OPEC has filled this role, utilizing semi-coordinated supply cuts or increases to right-size global oil supply with demand. This time is different. The cartel effectively abandoned an output ceiling in November, 2014, instead allowing member countries to produce as they see fit. Thus, the role of swing producer has been thrust on the collective group of non-OPEC producers.

A substantial number of non-OPEC producers is comprised of publicly traded E&P and integrated oil companies, whose principle mandate is to maximize profits for shareholders. As a result, these producers will act in their own best interests to produce hydrocarbons to generate maximum cash flow. This routine will persist until oil prices fall to the breakeven level of production. At the breakeven level, either cost concessions are obtained from oilfield service companies, allowing the breakeven cost of production to fall further—and allowing for further drilling—or upstream investment is slashed in the interest of preserving liquidity in order to remain a viable economic entity. The net result of this dynamic is a transitory period of overproduction from the upstream industry.

What is the Path to Recovery?

Many signs have materialized that we are nearing the end of this transitory period of overproduction. WTI and Brent oil prices briefly broke through \$30/Bbl and presently sit in the mid-\$30s—a level where most non-OPEC production is sub-breakeven. The upstream industry has responded by lowering growth capex by 25% globally in 2015 and by another 25% in 2016 (as per UBS). In the US, capex was slashed by an even greater 41% in 2015 and is expected to fall another 53% in 2016. As a result, the US oil rig count has fallen from a peak of 1,609 in the fall of 2014 to a 2015 average of 750, and a current level of ~386 (March 11). For perspective, UBS estimates that 720 rigs are required to hold US oil production flat in 2016.

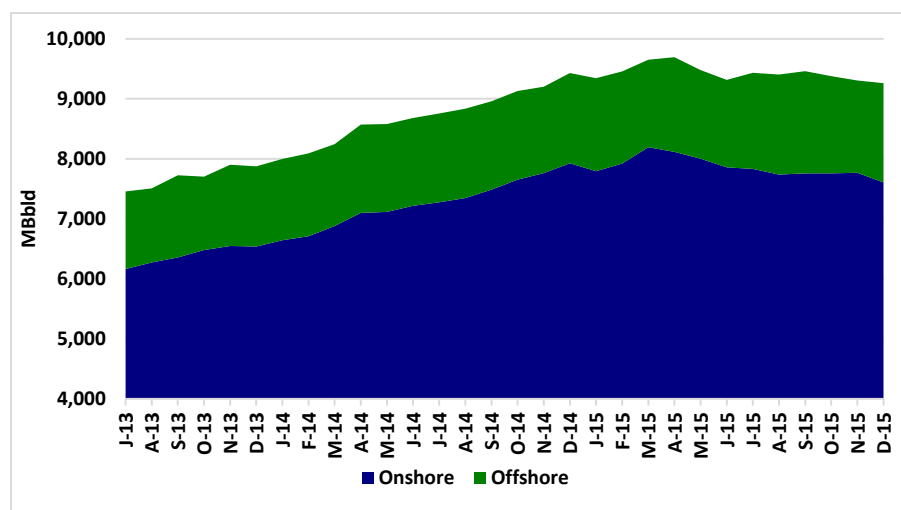
During 2015, the economics of lower oil prices have forced 42 smaller, less capitalized North American E&Ps to file for bankruptcy. The prospect of large free cash flow deficits, low cash positions, and limited borrowing capacity on revolving credit facilities have pushed a number of other high profile, publicly traded E&Ps to the verge of insolvency. Investment in growth, at the expense of near-term liquidity, is no longer an option for these E&Ps; they must cut capex or risk insolvency. Global upstream spending is estimated to fall by 44% over 2014-16. The culmination of spending cuts and reduced drilling activity will result in a decline in US and other non-OPEC volumes.

So when will a more balanced global oil market materialize? There is no question that the decline in oil prices has begun to take hold on US production. Monthly data from the Energy Information Agency (EIA) shows US onshore production peaked in March, 2015 and has declined 586 MBbld through December, 2015 (Figure 2). Meanwhile domestic offshore production has increased 195 MBbld over this same



period. Six large, offshore Gulf of Mexico (GoM) deepwater fields have been brought online in 2015 and five more are expected to start producing by mid-2016. Overall US volumes may decline only slightly over the next few months, until all of the GoM fields are online. Once these new fields are online and are no longer offsetting onshore production declines, overall US volumes will likely *decline sharply*. Evidence of this may start surfacing in weekly EIA data around mid-year. Our expectation is that US volumes will decline ~700 MBbld (~7.4%) year-on-year in 2016, in line with projections made by the EIA. This should take a serious bite out of the global supply imbalance.

Figure 2: US Onshore vs Offshore Production



Source: EIA

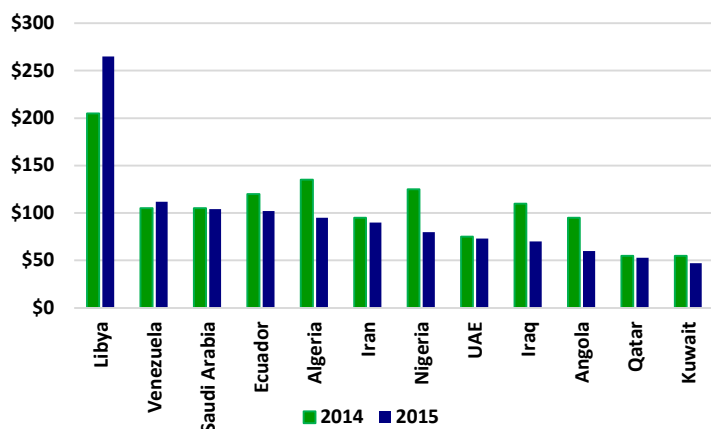
Non-OPEC production outside of the US was widely expected to come under pressure in a lower oil price environment. So far, this has not been the case. Final figures for North Sea volumes are expected to be up 100 MBbld in 2015, with Canada up a similar magnitude, and Russia up ~140 MBbld. The resilience of mature non-OPEC (non-US) production can be attributed to a number of items. First, the decline in oil prices has not impacted long-dated projects that were slated to come online in 2015. Second, some producers have focused efforts on *reducing unit costs*; one way to achieve this is by actually *producing more*. Finally, production costs have fallen with the decline in the value of local currencies in Russia, Canada, Brazil, Australia, and Norway as a result of the collapse in oil prices. For these reasons, we expect the US to shoulder the bulk of production declines in 2016.

As for OPEC, the decision to relinquish the role of swing producer has resulted in an interesting test of member countries' financial stress thresholds. A closely watched data point has historically been the oil price required for OPEC producers to balance domestic spending needs. Fiscal breakevens vary widely by country (see Figure 3). Lower oil revenues have led the majority of producers to implement social budget cuts. These cuts should lower breakevens over 2016-17. Nonetheless, short term financial shortfalls have led some countries to produce more volumes to maximize revenue, even in a dramatically lower oil price environment. Understandably, there has been discord amongst OPEC members about whether an orchestrated production cut or ceiling should be implemented to stem the oil price slide. The more financially distressed states (Venezuela, Libya) have been proponents of this



measure. However, de facto OPEC ring leader, Saudi Arabia, has repeatedly quashed the probability of such a move. Consequently, we expect OPEC volumes to remain near historical highs in 2016, placing the burden of “swing producer” collectively on US shale and non-OPEC producers.

Figure 3: Break-even Oil Price for OPEC (\$/Bbl)



Source: IMF, Bloomberg, UBS

Looking beyond 2016, the massive reduction in upstream capex should have longer-dated consequences for the oil supply/demand balance. UBS estimates that in a normal year, the global upstream industry approves 5-5.5 million barrels of oil equivalent (MMBoed) of peak production through large projects. In 2015, just 1.3 MMBoed reached final approval. A similar level of project approvals is expected in 2016. The shortfall in project approvals over 2015-16 more than equals the current supply surplus (1.7 MMBbld) and could result in a production shortfall of ~4 MMBbld in the 2018-20 horizon.

Within the US, as the industry emerges from this oil price correction, there is a risk that a snap-back in upstream investment will be somewhat delayed. Focus will center on improving balance sheets and liquidity that were destroyed during this downdraft. An extended period of rising oil prices may be required before rampant growth investment is stimulated. We believe the US industry may refrain from material drilling activity until oil prices exceed \$60/Bbl and managements become confident that prices will stay above these levels. Hiring and training (or re-training) rig crews that were laid off across various basins where shale drilling activity was once prolific may take time. Both of these factors increase the risk of global *undersupply* in years ahead and a robust price recovery.

Demand is also a key variable that will help rebalance global oil markets. Lower oil prices have resulted in lower gasoline prices, translating into a significant *demand pull* effect from consumers. The income effect of lower costs associated with transportation fuels has led to change in consumer behavior. US vehicle miles travelled increased 3.4% year-on-year in 2015 through October. Sales of gas guzzling SUVs in the US and China rose 8% and 53%, respectively, in 2015. Per IEA data, global oil demand grew by 1.7 MMBbld (1.9%) in 2015, representing the highest annual growth rate since 2010, when the global economy was emerging from the depths of the Great Financial Crisis. The IEA projects global oil demand to increase 1.3% in 2016.



In summary, we expect to see a gradual, but volatile, recovery in oil prices beginning in mid-2016. A resumption of upstream spending will occur—but likely after some stability in oil is reached at prices north of \$60/Bbl (timing 2017). This will eventually spawn another investment cycle for midstream infrastructure (2017-20 timeframe). Finally, underinvestment in longer-dated upstream growth projects will drive a potential price spike in oil prices in later years (2018-20).

Volumetric Risks to MLPs

The process of rebalancing the global oil supply overhang rests heavily on US production declining in 2016. As such, the market is grappling with concerns over how a short-term decline in US volumes will impact MLPs. The maturation of contracts between midstream and E&P counterparties will likely present volumetric risk for some MLPs. Unfortunately, precise clarity on volumetric risk is not available for all MLPs. This is mainly due to competitive reasons, as midstream operators refrain from disclosing which contracts are up for renewal.

Consequently, we have positioned our portfolio around MLPs that have high leverage to the volumetric “demand pull” created by the price induced demand response created by lower energy prices. We have also positioned our portfolio around MLPs with diversified operational footprints, to mitigate counterparty risk and potential unfavorable contract renewals created by the roll-off of maturing contracts or E&P bankruptcies. A prime example of the benefit of operational diversification is Enterprise Product Partners’ (EPD) 4Q results, which were released on January 28th. We were encouraged to see total system volumes climb 6% year-on-year despite today’s difficult commodity environment.

The potential for E&P bankruptcies poses additional risks for MLPs. The April redetermination period, where banks will review credit lines that have been extended to E&Ps, will be a telling sign. These credit lines have been a valuable lifeline to this point for E&P companies. Given the further weakness in oil price since the last broad round of redeterminations in the spring of 2015, we would expect most E&Ps to see a reduction in the borrowing bases extended by financial institutions. Such redeterminations may trigger defaults amongst E&Ps, as producers face a shortage of capital required to meet debt maturities or other financial obligations (some of which include contractual obligations with MLPs). As a reaction balance sheet liquidity constraints, many E&Ps have attempted to issue equity to temporarily fill cash flow short falls: there have been 12 E&Ps that have issued equity during Q1 2016, raising approximately \$8.3 billion in proceeds.

Nonetheless, bankruptcy risk with E&Ps exists. We have framed this risk by focusing on how midstream contracts are honored during the bankruptcy process. In short, we feel confident that E&P bankruptcy events will have a muted impact on most MLPs.

In the event of an E&P bankruptcy, the E&P is not required to pay unsecured debts, which typically include the midstream contracts. But these contracts are often critical for generating revenues, so the E&P may choose to maintain these payments in order to maintain the operations of the company and thereby protect the interests of the stakeholders. In this situation, the E&P is usually able to pick and choose contracts that it would like to maintain, rejecting those that are not critical to the function of its



business. Bankruptcy proceedings typically require that contracts be honored as is. For example, gathering and processing commitments are often maintained, as this piece of the midstream chain allows the E&P's products to be taken from the wellhead to a terminal and processed, in order to be taken to market, generating revenues and thereby allowing the business to remain operational.

On the other hand, the E&P might reject a contract for a long-haul pipeline if there are other midstream counterparties that could offer more beneficial terms to the E&P. This would mean that the counterparty could assert a damage claim. If the E&P were to reject a contract with a counterparty and renegotiate a more favorable contract with that same midstream counterparty, the difference between the old and new contracts would still create a damage claim that the counterparty would be able to assert against the E&P on an unsecured basis.

Figure 4: PGS Preference for “Demand-Pull” and “Long-Haul” Midstream Themes

Ticker	Sub-sector	Supply- push	Demand- pull	Middle	Supply- push	Demand- pull	Middle	Total
APU	Propane and Fuel Distribution					100%		100%
CLMT	Refinery	10%	90%					100%
CPPL	Natural Gas Midstream				39%		61%	100%
CQP	LNG					100%		100%
DM	Natural Gas Midstream				46%		54%	100%
EPD	Diversified Large Cap		8%	18%	40%	8%	27%	100%
EQGP	General Partners				50%	50%		100%
EQM	Natural Gas Midstream				50%	50%		100%
ETE	General Partners	0%	13%	43%	19%	5%	20%	100%
ETP	Diversified Large Cap			58%	21%	9%	13%	100%
GEL	Liquids Midstream	6%	13%	79%			2%	100%
GLP	Refined Products Midstream	10%	90%					100%
HEP	Liquids Midstream	19%	73%	8%				100%
MMP	Liquids Midstream	18%	41%	41%				100%
MPLX	Liquids Midstream		48%		52%			100%
NGLS	Natural Gas G&P				42%	50%	8%	100%
PAA	Diversified Large Cap	3%	3%	48%			46%	100%
PAGP	General Partners	3%	3%	48%			46%	100%
PBFX	Liquids Midstream		100%					100%
PSXP	Liquids Midstream		50%	13%	25%	13%		100%
SHLX	Liquids Midstream		11%	89%				100%
SUN	Refined Products Midstream		100%					100%
SXL	Liquids Midstream		2%	92%			5%	100%
TEGP	General Partners				41%	26%	33%	100%
TLLP	Liquids Midstream	15%			39%	45%		100%
VLP	Liquids Midstream		100%					100%
VTTI	Liquids Midstream		50%	50%				100%
WES	Natural Gas G&P				100%			100%
WGP	General Partners				100%			100%
AM	Natural Gas G&P				100%			100%
SEMG	C-Corp	1%	14%	42%	44%			100%
SEP	Natural Gas Midstream			15%			85%	100%
OKS	Diversified Large Cap				59%	37%	4%	100%
BPL	Liquids Midstream		82%	18%				100%
EEP	Diversified Large Cap			41%	59%			100%
ENLK	Natural Gas G&P			28%	68%	4%		100%
WNRL	Liquids Midstream		100%					100%
WPZ	Diversified Large Cap		7%		36%		56%	100%
Avg		1%	11%	22%	31%	18%	16%	100%

Note: The MLP universe shown above does not represent the current PGS portfolio.

Source: Company documents and PGS estimates



Concentration risk is important for measuring the potential impact of an E&P customer's bankruptcy on an MLP. An MLP that is reliant on a small number of E&P customers to generate revenue on any given asset inherently faces greater counterparty risk. Part of our investment thesis for each MLP that we own rests on the principle of diversification. We have surveyed the names that we hold in our portfolios to gain a sense of the general diversity of each MLP's customer base. We strive to avoid MLPs with highly concentrated customer bases, but make exceptions for sponsored or dropdown-oriented MLPs. While these MLPs have significant operational leverage to a single counterparty (the sponsor), the sponsor's business strength is underpinned by a strong balance sheet.

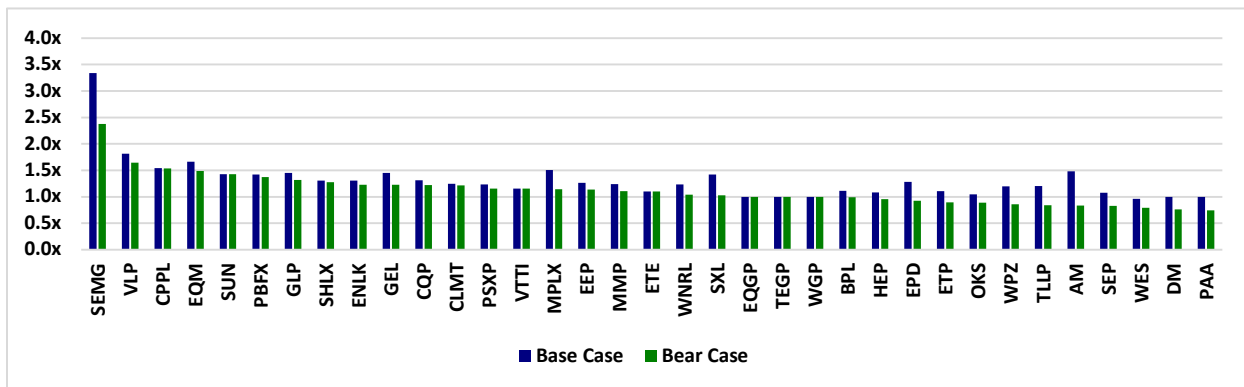
MLP Growth Financing Needs

MLPs have traditionally funded organic development through public equity and debt offerings. Access to capital via traditional channels has become less desirable for management teams in today's environment. The drop in MLP equity prices have pushed public equity yields to historically high levels. As of February 29th, the Alerian MLP Index yielded 9.5%. By comparison, typical midstream growth projects target a 10-15% return on invested capital. As such, the public equity markets are now an unappealing financing route for many MLPs; although some of the sponsored MLPs and general partners still have relatively low yields of 5% or less. Debt markets have similarly become a less attractive source of capital, with bond yields for many MLPs also widening to historic levels.

The increase of equity and debt costs has raised serious questions about how MLPs will finance their near term growth plans. MLPs with strong balance sheets, diversified operational footprints, minimal counterparty risk, and demand-pull oriented business models tend to have the most flexibility for financing. These MLPs can still tap equity and debt markets at competitive cost levels that allow for accretive investment in growth projects or acquisitions. Other MLPs have the optionality of utilizing alternative financing structures. This includes private investment in public equity (PIPE) deals with key shareholders, convertible preferred equity, or unit exchanges with strategic sponsors (as is the case with many dropdown-oriented MLPs). Alternatively, MLPs with healthy distribution coverage ratios (>1.2x) may elect to partly fund growth with organic cash flow. MLPs with lower coverage ratios (<1.1x) and higher debt positions (debt-to-EBITDA >5.0x) may elect to moderate distribution growth or cut their distributions until equity market conditions improve. Our portfolio emphasizes MLPs with distribution coverage ratios of 1.1x or better and with relatively low or manageable debt levels (debt-to-EBITDA <5.0x). These metrics should allow the MLPs in our portfolio to avoid distribution cuts.



Figure 5: Changes to Distribution Coverage with Sustained Low Oil Prices



Note: Bear case assumes 6% decline in volumes in 2016 and 5% decline in tariffs. The MLP universe shown above does not represent the current PGS portfolio.

Source: Bloomberg, PGS estimates

On the flip side, MLPs with greater direct commodity price exposure or overly concentrated customer bases have more constrained access to capital. Oilfield services, E&P, and some Gathering & Processing MLPs fall into this category of being financially constrained. These MLPs face declining volumes, gross margins, lower cash flows, and consequently have much higher equity and debt costs. For these MLPs, distribution cuts are a potential reality. PGS has avoided investing in these MLPs.

Currently, most MLPs are priced for little to no distribution growth in 2016. We base this estimate on the comparison of MLP yields today vs. periods when concern over volumetric and commodity price risks was much less elevated. Our analysis suggests many MLPs will grow distributions, and our strategy focuses on those that still have attractive growth expectations.

We have stress-tested our financial models for MLPs in our portfolio, assuming a lower-for-longer oil price environment, and continue to view distributions as secure. In a bear case where we assume a 6% decline in volumes in 2016 (roughly equivalent to the EIA’s 2016 oil production forecast), held flat thereafter and a 5% decline in tariffs in 2016, held flat thereafter, we expect average coverage in 2016, 2017, and 2018 to be 1.13x, 1.07x, and 1.02x respectively. PGS has positioned its portfolio around names that can weather a lower-for-longer commodity price environment (WTI <\$45/Bbl).

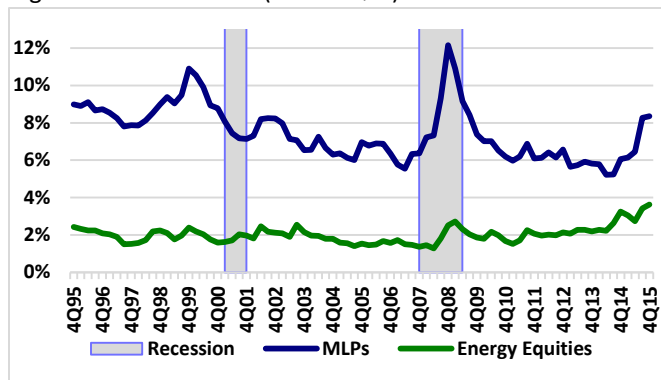
VALUATION

MLP equities currently trade at compelling valuations relative to historical levels. As at February 29, 2016 the yield of the Alerian MLP Index is 9.5% vs the 20 year average of 7.5%. This represents the highest yield since the Great Financial Crisis. Importantly, a significant component of the index (~26%) is weighted towards dropdown-oriented MLPs that trade at much lower yields due to their secure, visible growth profile. These “hyper” distribution growers did not exist during periods of prior selloffs. Because of this, historical peak MLP yields look comparatively wider than the present dislocation.



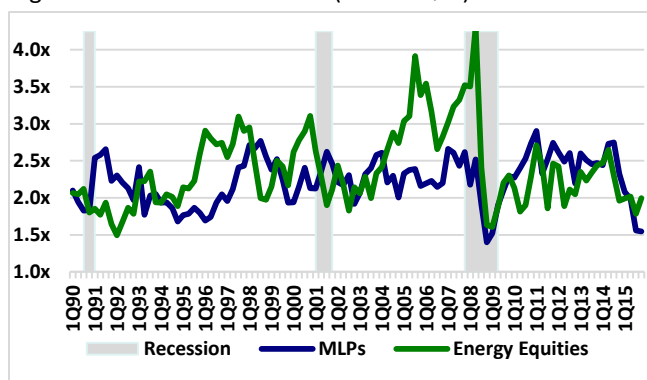
The price-to-book (P/B) ratio of the Alerian was ~1.4x at the end of February, which compares to the 20 year average of 2.3x. The present P/B level represents the lowest valuation since the Great Financial Crisis.

Figure 6: Alerian Yields (1995-4Q15)



Source: Bloomberg

Figure 7: Price to Book Ratios (1990-4Q15)



Source: Bloomberg

SUMMARY

We are currently near the trough of the present oil price “recession,” as data from the International Energy Agency shows that the global oil supply surplus peaked at 2.4% of global demand in the second quarter of 2015 and has contracted since. In response to the lower oil price environment, global producers have substantially cut investment in drilling programs. **Oil prices will be volatile over 2016, but the table has been set for a potentially dramatic recovery in oil prices as demand eventually outstrips supply.**

We believe that defensive MLPs are positioned to capitalize on this change better than both integrated oil companies and E&P companies. We are seeing positive funds flow into the sector over the last quarter. The defensive mid-stream MLPs continue to beat or meet estimates. Integrated oil companies are likely to move slower and E&P valuations have run up dramatically in recent weeks, primarily driven by short covering. Currently E&P valuations reflect a crude oil price of \$60 - \$70 which is significantly higher than is expected through the end of 2018, based upon the current strip. With the attractive yields, valuations and safety of strong balance sheets, defensive mid-stream MLPs along with a selective group of MLP GPs and C-corps are a more conservative way to play the rebound in oil prices.





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