A YEAR OF SURPRISES
Summary Report from the Investment Committee

After the first interest rate hike in nine years in December 2015, the selling in Chinese stocks caused a sharp decline in share prices around the globe and the US markets followed. The S&P 500 dropped by 11% over the first six weeks of the year.

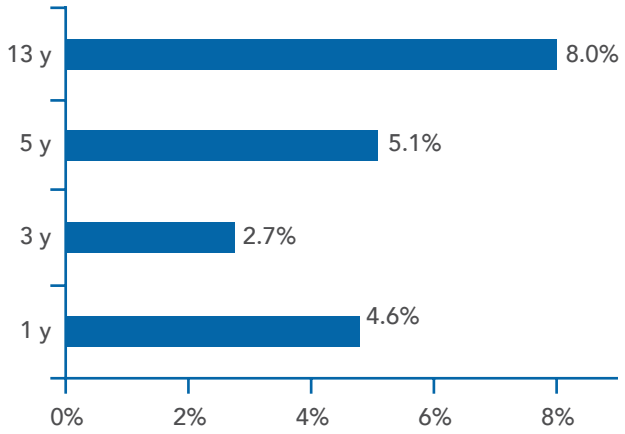
Although the Fed had promised three or four rate hikes in 2016, the selling in equities caused fears that the US economy would grind to a halt, so the central bank put any interest rate increase on hold.

By midyear, markets had recuperated losses and attention turned to Europe when, on June 23, another major surprise happened: The UK voted in favor of Brexit. Although this event triggered yet another market swoon, the sell-off was both more orderly and better contained this time around. The Bank of England stepped up monetary easing for support, and within several weeks, the markets had reversed their losses. Meanwhile, the 10-year treasury note yield bottomed.

After the shock of Brexit, the political focus shifted in earnest to the refugee crisis in Europe and the US elections. Although most of the polling surveys and prediction markets showed Hillary Clinton ahead, the perceived ebb and flow of voter preference periodically weighed upon markets. In what may seem odd to observers now, each time Clinton faltered or Trump gained momentum, markets traded lower and safe-haven assets rallied. The uncertainty in the lead-up to the presidential election was unprecedented. The result was shocking: Donald Trump took the world by surprise, defying pools, pundits, and much of the political press. The "Trump rally" that followed drove equity markets to new all-time highs and brought "safe-haven" assets down, as markets responded to expectations of higher growth and inflation.

In November OPEC, the world's oil cartel, did something unexpected: they cut oil production, compounding the "Trump rally." In December the Federal Reserve finally had enough faith in the US economy and raised rates by 25 basis points. Even though markets had anticipated the move, the Fed surprised them with a more hawkish outlook for interest rates, which again supported a deeper sell-off in bonds. The Fed's move was supported by economic data that generally pointed to healthier fundamentals.

AVERAGE YEARLY RETURN



Despite growth scares, populist risings, geopolitical events, electoral surprises, and uninspiring earnings growth, financial markets fared well in 2016. The KF portfolio was up 4.6%, in line with our long-term rate of return, led by our thorough fixed income management and disciplined equity strategy. At year end the total portfolio amounted to US$15.8 million.

FIXED INCOME

Our fixed income portfolio was up 11% in 2016. This positive return was based on good management of maturities and taking advantage of opportunities. We were also aided by our decision in 2015 to hold on to high coupon emerging market bonds denominated in Brazilian real. Those bonds were up on average 38% this year, compensating for the losses we had last year.

After touching an all-time low of 1.36% in early July in the aftermath of the Brexit vote, the 10-year US Treasury note yield started to move gradually higher before jolting upward (from 1.8% to 2.6%) in the two weeks following the presidential election, finishing the year flat, but a full 130 basis points higher from the bottom. Global fixed income markets shed more than US$1 trillion in value since the news broke of a Trump victory, with calls for the end of the 30 plus years bond rally. Asset allocations have shifted toward equities on hopes that higher government spending will raise growth and bring higher inflation.

Although we believe that higher US government spending by a new administration could lift inflation expectations further, the Fed's speed of policy normalization will also play an important role. That will be combined with the structural factors that have pushed rates lower over the past three decades (higher saving rates in emerging markets, weak productivity growth in advanced economies, and growing demand for "safe" fixed income assets as baby boomers retire). These factors are not likely to change in the next four years. Increased short-term volatility should be expected, but we continue to see value in fixed income as part of a diversified asset allocation.

FIXED INCOME OVERVIEW

Average Coupon	6.19%
Average Current Yield	6.01%
Average Yield to Maturity	7.84%
Average Modified Duration	6.8 yrs

Types	% Fixed Income
Foreign Notes & Bonds	58%
Non-US Corporates	2%
US Corporates	40%

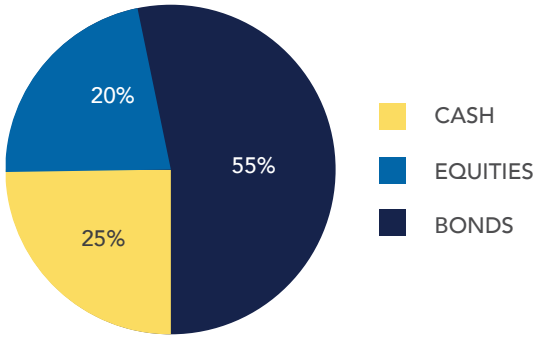
EQUITIES

In the first half of 2016, with the US dollar (USD) weakening against most currencies as the result of a growth scare, the United States and other developed markets — denominated in USD — were either negative or flat, while commodity-oriented countries like Brazil and Russia saw large gains. We sold investments in Brazil at the end of the first quarter, with gains of 17%.

Because most of KF's investments are hedged in US dollars, the returns in Japan and Europe were negatively influenced by the weaker currency. Following discipline, we closed investments in Europe with no gains and in Japan with small losses by midyear, when we believed that markets had topped. At that time we also took profits in selected US positions.

Markets in the United States then corrected slowly as the uncertainty about the presidential election loomed. But to our surprise — after having indicated the opposite — a Trump presidency gave US markets a sense of confidence, which resulted in a rally in the last two months of the year, bringing the S&P 500 to new highs, with a total return of almost 12%. Half of the gains were realized in the two weeks following the

election, and are largely attributed to expectations of deregulations that should positively affect financial and energy companies, combined with the belief that Trump's policies toward protectionism and a strong dollar will benefit small-cap companies.



The KF portfolio did not fully participate in the final rally, because we did not reinvest prior to the elections, so the total performance in 2016 was 3%, below our objective 5% return. The US portfolio was up 4.1%, while Hong Kong investments were up 5.1%.

As we enter 2017, we remain cautious. Markets seem to have concluded that Trump's policies will be meritorious, quickly passed into law, and successful. Even if these assumptions are true, progress is rarely linear. History says that sometimes the underlying momentum of the business cycle can temporarily overtake the best conceived of policies.

We continue to feel fortunate to be able to serve Rinpoche and to have the trust of our donors.

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