Market and economic commentary

Great-West Profile Funds

To date, 2016 has been volatile in the financial markets. Despite the various ups and downs, however, the year has generally been a good one for both equities and fixed income, with the majority of asset classes posting positive returns. Although the heightened volatility has continued to drive headlines and drive a risk-on/risk-off type of environment, the underlying asset class return numbers have been relatively strong.

Economic growth continued at a slow pace in the second quarter, with the final estimate coming in at an annualized rate of 1.4% (which reflects an increase from 0.8% in the first quarter).[1] Slow economic growth remains a distinct headwind for the performance of financial markets. After some very inspiring jobs numbers in June and July (where the economy created 292,000 and 252,000 new jobs, respectively), the numbers slipped a bit in August and September and reflected only 167,000 and 156,000[2] new jobs, respectively. At this point, it is difficult to discern whether the slowing jobs market can be called a trend or simply reflects the natural volatility of month-by-month job creation. We are also beginning to see some signs of wage growth, as a result of a tight labor market. Wages increased 2.6% over the last 12 months versus an average of 2.3% in 2015. This trend may be bolstered by proposed minimum wage increases in many states.

In the third quarter of 2016, oil prices continued to stay in the $40-$50-per-barrel range. This represents a significant price increase from early this year when oil prices slipped below $34 per barrel in January as well as a dramatic decrease from where prices were several years ago. While more stable oil prices have helped the energy sector, prices in the current range are challenging for many energy producers. Commodities, at large, are having a relatively strong year after several consecutive years of significant declines. Gold prices had hovered in the $1,300-$1,375 range in terms of price per ounce before pulling back as we reached the end of September.[3]

The U.S. Federal Reserve (the "Fed") again passed on a rate increase at their most recent meeting in September, likely pushing any rate hikes beyond the date of the upcoming election. The market now predicts a rate increase at the December meeting. At the time of this writing, the likelihood of a Fed rate increase coming out of the December meeting as implied by the futures markets is now greater than 50%.[4] The Fed Funds rate currently remains targeted at 0.25%.

As we discussed last quarter, longer rates are still depressed. At the start of the year, the benchmark 10-year Treasury note was trading around 2.25%, and it declined nearly 0.90% in the period following the June "Brexit" vote. However, through Q3, the 10-year Treasury note slowly worked its way higher, briefly crossing 1.70% before closing the quarter near 1.60%.[5]

Impact of rising rates on stock market returns

As we continue to edge ever closer to the widely anticipated next Fed rate hike, it is worth analyzing what type of impact this may have on the future returns of equities. The markets remain jittery over the prospect of rising rates. A rising-rate climate is generally perceived by the market to have a dampening effect on economic growth, which, in turn, should impact the future performance of equity markets. Great-West Capital Management, LLC (GWCM) analyzed the annual returns of the S&P 500 Index and the three-month T-Bill Rate since 1937 (the first year data was available). We looked at the relationship between the change in T-Bill yields during each year opposite the return of the S&P 500® Index.

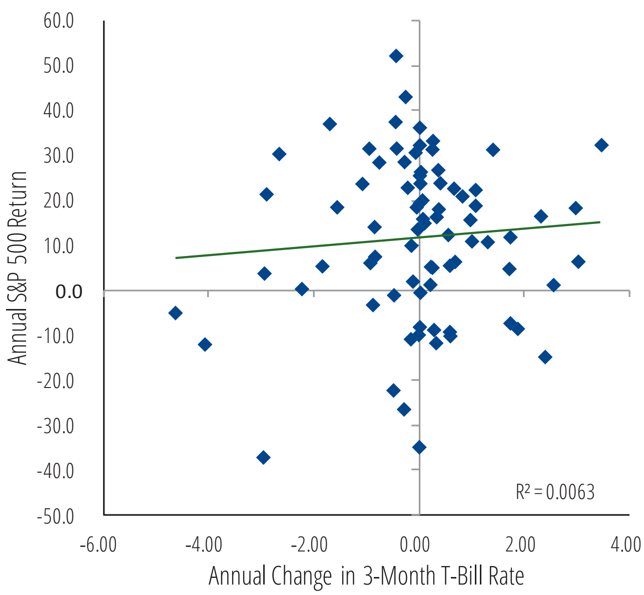
1 http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm
2 http://www.bls.gov/news.release/empsit.nr0.htm
3 http://www.wsj.com/articles/gold-prices-fall-to-new-four-month-low-1475765972
4 http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html. Accessed October 6, 2016
5 http://www.bloomberg.com/quote/USGG10YR:IND

Our analysis uncovered a relationship that was a bit surprising. First, there is virtually no correlation between interest rate movements and stock market performance. The R-Squared Value (which measures the degree of statistical correlation between two sets of data) was virtually zero, suggesting there is very little relationship between the two outcomes. This suggests that rising rates do not directly impact future stock market returns. Intuitively, this makes sense. While rising rates indicate that the Fed may be attempting to slow growth to help prevent inflation, it also indicates that the economy is generally healthy enough to be absorb the rate hike. While interest rate changes may have some degree of influence on stock market performance, they are clearly not a critically important factor. Nor is it reasonable to believe that rising rates, in and of themselves, will be enough to derail the current stock market rally.

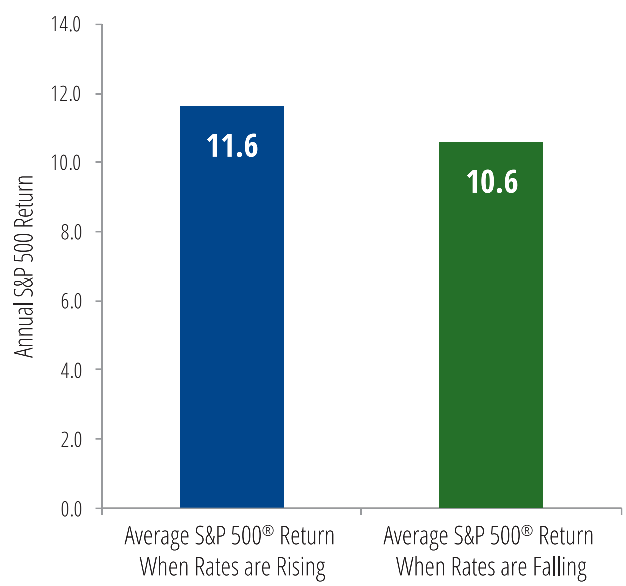
That said, when looking at sheer averages, the stock market appears to actually do marginally better during rising-rate environments, on average, than it does in falling-rate environments. On average, since 1937, when three-month T-Bill rates increased during a single quarter, the S&P 500® Index has returned 11.6% annually. However, during falling-rate environments, the index has returned, on average, only 10.6%.

This analysis should demonstrate that rising rates are not necessarily anything to fear for stock market investors in the near term.

Annual S&P 500 Returns vs. Annual Change in T-Bill Rate (1937-2015)



S&P 500 Returns Under Various Rate Conditions (1937-2015)



Asset class performance

A number of asset classes have produced strong, if not record-setting, returns so far into 2016. The slow yet positive economic growth has been enough for equities to chart an upward, albeit volatile, path. Much of this performance continues to be seen in the domestic equity markets, and international names continue to lag behind their domestic counterparts—a trend that we have witnessed for a number of years. As we'll see below, the year has also been kind to fixed-income investors.

The S&P 500® Index, a widely followed barometer of U.S. large-cap stock performance, closed the quarter with a gain of 3.9% on a total return basis, bringing the year-to-date return up to 7.8%. Over longer time periods, the returns for the index remained even stronger. While the three-year return for the index for the period the ended September 30, 2016, was 11.2% on an annualized basis, the five-year annualized number was an impressive 16.4%.

Source: Morningstar Direct; U.S. Federal Reserve; GWCM Analysis. Three years where there was no change to the 3-month T-Bill rates were omitted from the analysis (1943, 1944, 1945, 1946, and 2013).

Small-cap stocks, as measured by the S&P SmallCap 600® Index, again had a stronger quarter than the large-cap stocks, and longer-term numbers are catching up to the returns of the domestic large-cap names. For the quarter, the S&P SmallCap 600® posted an impressive return of 7.2%, bringing the year-to-date number for the index up to 13.9%. The one-year number for the period that ended September 30, 2016, was 18.1%, and the annualized five-year number as of September 30, 2016, was 17.9%. The three-year number reflects some more choppiness than we've seen in recent years and reflects a more muted 9.0% on an annualized basis.

International equities

Outside the U.S., equity markets were very strong in the quarter, although longer-term numbers lagged domestic equities. The MSCI EAFE® Index, which measures the performance of developed equity markets outside the U.S. and Canada (primarily in Western Europe and developed Asia), realized a total return of 6.4% on the quarter, dragging the year-to-date return into positive territory at 1.7%. The MSCI Emerging Markets® Index was even more impressive, generating a total return of 9.0% for Q3. Year to date, emerging markets have generally been a encouraging, generating a total return of 16.0% and outperforming developed-world equities both in the U.S. and globally. Emerging markets could finally be shaking off a long-term rough patch in which the three-year return has been an annualized loss of 0.6%.

Returns on commodities slipped again in Q3. The Bloomberg Commodity® Index, which tracks a broad-based basket of various commodities, realized a positive return of -3.9% for the third quarter, dragging the year-to-date number down to, a still formidable 8.9%. Despite the strong recent returns so far in 2016, however, commodities have performed very poorly over longer-term periods, posting annualized losses of 12.3% and 9.4% annualized over the three-year and five-year trailing periods, respectively.

Growth names outperformed value names, on average, in the quarter (reflecting a recent resurgence in growth stocks). The Russell 1000 Growth Index has realized a return of 4.6% for the quarter, relative to 3.5% for the Russell 1000 Value Index. A similar relationship held in small caps where the Russell 2000 Growth Index, which measures the performance of U.S. small-cap growth names returned 9.2% relative to 8.9% for its value-oriented counterpart (the Russell 2000 Value) in a strong quarter for small caps all around.

Fixed-income markets

The third quarter was generally a good time for fixed-income investors despite a marginally rising-rate environment. The yield on the benchmark 10-year Treasury note increased from 1.49% at the end of the second quarter to 1.60% by the end of the third quarter. Despite the increase in rates on the quarter, fixed-income returns were generally positive and remain well into positive territory for the year-to-date period. While the Barclays U.S. Aggregate Bond® Index posted a return of 0.5% for the quarter, the year-to-date return on the index now stands at 5.8%. High-yield bonds were strong in the quarter, as they have been for the year so far. The Barclays U.S. Corporate High Yield Index®, which tracks the returns of the non-investment-grade bond market, posted a return of 5.6% for the quarter and was up 15.1% in the first nine months of the year.

Real estate

Finally, the domestic real estate market as measured by the performance of the FTSE NAREIT All Equity REITs® Index was the one blight on asset class returns in the quarter, with the Index posting a loss of 1.2%. Despite the poor showing in the quarter, the index remains in positive territory to the tune of 12.3% for the year-to-date period and an impressive 20.9% in the one-year period, which reflects a very strong quarter for real estate in the fourth quarter of 2015.

Performance of the Great-West Profile Funds[6]

The Great-West Profile Funds each closed out the quarter with positive returns ranging from 2.0% to 4.8%. The returns at the fund level largely reflect the weighted returns of the underlying funds. Each fund, by design, is broadly diversified across global equity and fixed income asset classes. In general, the performance of each of the funds is influenced, overall, by the performance of the various equity and fixed income asset classes in which the funds invest.

In the longer term, the funds have continued to perform in line with GWCM's expectations. Given the relatively strong performance of the equity markets (relative to fixed income) over longer-term periods, we have seen the funds with greater equity exposure (the Aggressive and Moderately Aggressive Profile Funds) generate outperformance relative to the more conservative funds (the Conservative Profile and Moderately Conservative Funds). The Moderate Profile Fund has generated returns in between those of the other funds.

One positive driver of relative performance for the funds was their investment in the Great-West MFS International Value Fund.[7] This Fund has been a consistent high-performer in the space and has been regularly cited as a reason for outperformance of the funds over recent years. This fund deploys a compelling stock selection process to non-U.S. (primary large-cap, developed-market) names. The managers of the fund have consistently been able to generate outperformance for fund investors. While the fund's return of only 5.4% in the third quarter was not particularly impressive, relative to other funds in the category, longer-term results have been very strong. The fund returned 16.3% and 7.8%[8] on an annualized basis over the one and three-year periods, respectively, which rank in the top 2% and 1% of all funds in the Morningstar® category, respectively.[9]

Another positive driver of fund performance for the quarter was the Great-West Putnam High Yield Bond Fund[10] This strategy leverages Putnam's deep capabilities in high-yield fixed income to identify names in the space that they expect to outperform. The fund has had an impressive run over the past several years, despite a more conservative tilt versus many other funds in the high-yield space. Year to date, the fund has posted a return of 13.9%, which ranks among the top quarter of all funds in the Morningstar high-yield bond category. Over the last five years, the fund has returned an average of 7.9% annually.[11,12]

6 The Great-West Profile Funds are managed by Great-West Capital Management, LLC (GWCM) and may invest in other funds advised by GWCM, funds that are sub-advised by affiliated and unaffiliated sub-advisers retained by GWCM, funds that are advised by affiliated and unaffiliated investment advisers of GWCM, and in a fixed interest contract issued and guaranteed by Great-West Life & Annuity Insurance Company. All comments reflect the Initial Share Class of each fund. Asset allocation funds are subject to the risks of the underlying funds, which can be a mix of equity funds and fixed income funds. For more information, see the prospectus.

7 Foreign investments involve special risks, including currency fluctuations, taxation differences and political developments.

8 Great-West MFS International Value Fund Institutional Class performance as of September 30, 2016, performance for the one-, three-, five- and 10-year and since inception periods was 16.3%, 7.8%, 13.1%, 3.3% and 5.6%, respectively. The date of inception for the fund was May 1, 2015. The gross expense ratio as of September 30, 2016, is 0.72%. Performance for Institutional Class shares before their inception is derived from the historical performance of Initial Class shares, which has not been adjusted for the lower expenses; had it, returns would have been higher.

9 The Great-West MFS International Value Fund Institutional Shares ranked 684 of 910 funds in the Morningstar foreign large-blend category for the three-month period, 34 of 884 funds in the year-to-date period, 8 of 715 funds in the three-year period, and 5 of 634 funds in the five-year period. The three-year and five-year rankings reflect the Initial Class Shares, because the Institutional class shares were incepted on May 1, 2015.

10 Great-West MFS International Value Fund Institutional Class performance as of September 30, 2016, performance for the one-, three-, five- and 10-year and since inception periods was 16.3%, 7.8%, 13.1%, 3.3% and 5.6%, respectively. The date of inception for the fund was May 1, 2015. The gross expense ratio as of September 30, 2016, is 0.72%. Performance for Institutional Class shares before their inception is derived from the historical performance of Initial Class shares, which has not been adjusted for the lower expenses; had it, returns would have been higher.

11 Great-West Putnam High Yield Fund Institutional Class performance as of September 30, 2016, performance for the one-, three-, five- and 10-year and since inception periods was 11.9%, 4.8%, 7.9%, 5.5% and 5.9%, respectively. The date of inception for the fund was May 1, 2015. The gross expense ratio as of June 30, 2016, is 0.75%. Performance for Institutional Class shares before their inception is derived from the historical performance of Initial Class shares, which has not been adjusted for the lower expenses; had it, returns would have been higher.

12 The Great-West Putnam High Yield Bond Fund Institutional Shares ranked 90 of 796 funds in the Morningstar high-yield bond category for the three-month period, 44 0f 765 funds in the year-to-date period, 189 of 659 funds in the three-year period, and 116 of 524 funds in the five-year period. The three-year and five-year rankings reflect the Initial Class Shares, because the Institutional class shares were incepted on May 1, 2015.

Fund performance and Morningstar ratings as of September 30, 2016

				MORNINGSTAR RATING/ TOTAL # OF FUNDS			TOTAL RET. RANK CATEGORY*/ # OF FUNDS		
FUND NAME	TICKER	INCEPTION DATE	CATEGORY	OVERALL	3-YEAR	5-YEAR	1-YEAR	3-YEAR	5-YEAR
Great-West Aggressive Profile II Instl	MXGTX	5/1/15	Allocation—85%+ Equity	★★★★★/150	★★★★★/150	★★★★★/134	9/178	—	—
Great-West Moderately Agg Prfl II Instl	MXHRX	5/1/15	Allocation—70% to 85% Equity	★★★★/382	★★★★/382	★★★★/309	141/453	—	—
Great-West Moderate Profile II Instl	MXITX	5/1/15	Allocation—50% to 70% Equity	★★★★/826	★★★★/826	★★★/716	316/926	—	—
Great-West Moderately Cnsrv Pfl II Instl	MXJUX	5/1/15	Allocation—30% to 50% Equity	★★★★/481	★★★★/481	★★★★/421	217/589	—	—
Great-West Conservative Profile II Instl	MXKVX	5/1/15	Allocation—15% to 30% Equity	★★★★/202	★★★★/202	★★★★/165	77/237	—	—
Great-West Aggressive Profile I Init	MXPPX	9/11/97	Allocation—85%+ Equity	★★★★/150	★★★★★/150	★★★★/134	20/178	6/150	5/134
Great-West Moderately Agg Prfl I Init	MXRPX	9/11/97	Allocation—70% to 85% Equity	★★★★/382	★★★★/382	★★★★/309	181/453	110/382	90/309
Great-West Moderate Profile I Init	MXOPX	9/11/97	Allocation—50% to 70% Equity	★★★/826	★★★/826	★★★/716	423/926	395/826	369/716
Great-West Moderately Cnsrv Prfl I Init	MXTPX	9/11/97	Allocation—30% to 50% Equity	★★★★/481	★★★★/481	★★★★/421	285/589	139/481	100/421
Great-West Conservative Profile I Init	MXVPX	9/11/97	Allocation—15% to 30% Equity	★★★★/202	★★★★/202	★★★★/165	114/237	67/202	39/165

* A lower percentile ranking is more favorable (higher relative returns).

GREAT-WEST FINANCIAL™

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The S&P 500® Index is an unmanaged index considered indicative of the domestic large-cap equity market. The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity performance of developed markets, excluding the U.S. and Canada. As of December 31, 2014, the MSCI EAFE® Index consisted of 22 developed market country indices. The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade bond market. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The FTSE NAREIT U.S. Real Estate Index Series is to present investors with a comprehensive U.S. REIT performance index. The FTSE EPRA/NAREIT Developed ex-U.S. Index is a subset of the FTSE EPRA/NAREIT Developed Index and is designed to track the performance of listed real estate companies and REITs outside of the U.S. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Barclays U.S. Corporate High Yield Index is designed to measure the performance of the non-investment-grade (i.e., high yield) segment of the U.S. corporate fixed income market. The Barclays U.S. Government/Credit Long Duration is designed to measure the performance of long duration government and corporate and other credit bonds. S&P 500® Index is a registered trademark of Standard & Poor's Financial Services, LLC. Russell 2000® Index is a registered trademark of Russell Investments. MSCI EAFE® is a registered trademark of MSCI Inc.

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