MOVING IN DIFFERENT DIRECTIONS

NEPC's 2014 ASSET ALLOCATION LETTER

NEPC Asset Allocation Committee

In the five years since the financial crisis, investors have experienced a rising tide of returns that has been global, broad and powerful. Asset levels today are much higher than they were at the start of 2009, with most asset classes flowing generally upward in unison. Central banks have provided a strong undercurrent, supporting the housing market in the US and the banking sector in Europe, while buoying risky assets. These are times when diversification across markets may seem unresponsive to conditions.

Diversification always provides a reason to regret in the sense that it assures that the whole portfolio will underperform one of its components. This regret is particularly acute when US equities, often a significant allocation and a dominant source of volatility—and which some peers will always favor—shine the brightest. The corresponding feeling of doing relatively better during bad markets never seems to compensate. Yet, beyond this emotional ebb and flow, the smoother return stream of diversified portfolios leads to greater predictability, less second-guessing, and better risk-adjusted returns over market cycles.

With this in mind, we assess the recent divergence from the five-year trend of harmonized worldwide monetary and fiscal policies. In particular, the Federal Reserve's "taper" departs from the accommodative policies of other central banks, and its impact will be felt beyond the US economy. While other central banks in developed markets continue to ease, many emerging market countries face contradictory objectives for their economic growth, debt and currency. Shifting economic conditions and monetary policies fuel divergences in global investment markets that must be considered.

Diversified investors likely find themselves in a significantly better position than they could have imagined as recently as January 2009. This high ground offers an opportunity to re-confirm that their asset allocation and portfolio structure align with objectives. The recent robust performance of some markets, such as US equities, may tempt some to chase results. Investors, instead, must consider moving in a different direction. Performance gains in some markets create an opportunity to rebalance into those that lag. With volatility low and underpriced asset classes scarce, it is appropriate to consider a diversified and risk-aware stance, focused more on meeting predetermined long-term investment objectives than peer rankings.

With market divergence on the horizon, the sequence of actions by central bankers, countries, and investors sets the stage for distinctive events and conditions over the next several years. Investors able to provide patient long-term capital, or hold capital that may be readily deployed in the future, should expect to be compensated for their foresight. They are likely to benefit in the future as these divergences play out and opportunities emerge.

Economic Conditions Evolving

The outlook for economic growth has improved slightly. Yes, developed world growth remains stuck below historic averages, but there are signs of modest gains. Despite a meaningful fiscal drag in 2013, growth improved, in no small part, due to monetary authorities priming the pump and providing liquidity to markets. Conversely, emerging markets continued to cool, but collectively produced growth above the developed world.

Despite a theme of modest growth improvements across the developed world, many differences exist across countries. Those differences will likely intensify over the coming years and affect future economic growth, capital markets' performance, and yield levels. In the US, an aggressive and proactive approach to monetary policy has supported positive growth. Among other benefits, the stimulation of economic activity has allowed the US to withstand fiscal tightening and a ratings downgrade. Though planned deficit reduction should be less of a concern in 2014, further political grandstanding around the debt ceiling has the potential—yet again—to rattle markets during a mid-term election year.

Not much happened in Europe in 2013 – and that was both a relief and a disappointment. After withstanding the Cypriot bank restructuring early in the year, a period of relative tranquility was a welcome respite. Previous actions by the European Central Bank brought a measure of comfort to markets as did the continued healing of credit conditions globally.

In the short term, a bounce off of low levels could provide a further tailwind to European markets. On a more fundamental basis, illiquid debt and real estate opportunities appear interesting for investors willing to lock up long-term capital. Broadly, however, challenges remain for the region. The lack of news in Europe also represented a missed opportunity. Debt levels continue to build, particularly in the peripheral countries. Unemployment in Germany is contained at 5.5%, but joblessness remains unsustainably high in peripheral countries, according to the IMF. The unemployment rate is averaging almost 20% across Portugal, Ireland, Italy, Spain and Greece; even France appears challenged with unemployment approaching 11%.

In the emerging world, like developed countries, there is a commonality in the direction of economic growth but stark divergences across nations. In general, the growth forecast for emerging markets has been trimmed, but the pace of growth will likely consistently exceed the developed world. Emerging countries can be divided into two groups: the financially healthy ones, and then those facing challenging balances of payments with the associated potential for continued currency weakness and economic contraction.

Though not without issues, the largest emerging market—China—appears better positioned than most emerging countries. Growth remains strong even as expectations move towards the 7% mark, replacing last decade's 8%-10% range. Recent announcements of reform, at least as described, appear to promote growth and further integration into the global economy.

Countries with vulnerable balances of payments—Brazil, India, Indonesia, South Africa and Turkey—are challenged by funding the shortage of capital flows that have dried up over the last year. The reasons each country faces a shortfall in its balance of payments are unique, and their ongoing response to these challenges will likely be unique too. These regions remain fragile though it is unclear whether any of these situations could morph into a crisis. These countries will need to implement monetary policies that effectively address their internal challenges, policies that will likely differ from those of the developed world and other emerging markets.

Diverging Monetary Policy

Easy monetary policies have been a critical part of the global economic recovery since the financial crisis. Broad and coordinated actions to provide liquidity to markets in the depths of the crisis, in addition to multiple rounds of bond-purchasing programs by central banks, have collectively fueled economic growth, facilitating a transition through global deleveraging. While the intention and direction of these policies were almost all accommodative, the magnitude of each country's intervention has been quite different over time. Certain countries have done more (US, UK); others have done less (Europe and until recently, Japan).

In particular, the proactive policies of the Fed have propelled the US economy to a better position than most of the developed world. To be sure, too many Americans are still out of work, and the debt overhang from the financial crisis has been merely transferred to the Fed's balance sheet. Yet, with the US economy on relatively stable footing, we can now expect a methodical shift in policy to monetary tightening, diverging from the easy money policies in most of the developed world. In December, the Fed announced a planned reduction, that is, a so-called taper, in monthly purchases to $75 billion from $85 billion; further reductions are expected throughout 2014.

This modest tightening underscores the improvement in economic conditions in the US relative to its peers. That said, the tightening—though still accommodative with short-term rates likely to remain near 0% well into 2015—has implications far beyond the US economy. Tighter monetary policy will tend to cool the US economy, which will likely spill over to the rest of the world as demand for exports from other markets subsides and the dollar rallies.

The potential for higher US interest rates creates challenges for other global markets. As the baseline for lending markets, higher US rates increase the global cost of borrowing. This is potentially challenging for debt-strained peripheral European countries which, so far, have withstood last year's uptick in interest rates, but remain at risk if growth does not improve and/or borrowing costs increase. Additionally, increased yields make the US a stronger competitor for global capital, thus capital flows into emerging markets could continue to weaken as those markets become relatively less attractive to investors. As noted above, this is very challenging for countries facing balance of payments issues.

In addition to Fed announcements moving markets, US monetary policy impacts the global economy over the long term. The taper affects not only prospects for global economic growth and inflation, but also expectations for capital market performance.

Outlook Shifting for Stocks and Bonds

The performance between different asset classes diverged in 2013. The spread between US equities (+32%) and long US Treasuries (-13%) was the largest it has been since 2008, when bonds were positive and equities experienced a painful drawdown. This stark difference reflects stocks benefitting from economic growth, a sharp contrast to losses from rising bond yields.

This contrast in performance, combined with divergences in economic conditions and a pivot in US monetary policy, lead to 5-7 year assumptions moving in different directions. A broader divergence may exist in assessing capital markets over different time horizons. While an investment horizon of 5-7 years may prove appropriate to allow fundamentals to play out, we may see further momentum of recent trends in the short term, including a strong showing by US equities or continued challenges in certain emerging markets.

The outperformance of equities in developed markets, combined with low dividend yields and valuations above historical averages, lead to subdued expectations in those markets. The challenge in sustaining recent performance is a theme throughout developed equity markets. Expectations for all developed equity asset classes are lower than a year ago.

Emerging equities present a murkier picture. Performance has been disappointing over the last several years. Uncertainty is elevated, particularly in balance of payments challenged countries. Yet growth in the emerging world, especially from the burgeoning middle class, is still expected to be well above that of the developed world. Over an investment horizon of 5-7 years, we expect emerging market equities to outperform relative to the developed world. Recent relative underperformance presents an opportunity to take gains from developed markets and build positions in emerging equities, especially for investors who remain under-allocated.

We believe the balance of payments challenge facing certain emerging countries highlights the importance of flexibility and adaptability within allocations. These countries are meaningful parts of the global economy, suggesting the potential for large-scale implications. They are also significant parts of indices of emerging equity (28%) and local country debt (38%), underscoring the importance of active management across these asset classes.

In bond markets, an uptick in yields undercut performance in 2013, but this also creates more constructive expectations going forward. Sovereign bonds still have low yields relative to long-term history but much higher yields (and thus, expected returns) than in recent memory. Importantly, while many worry about rising interest rates, there are three reasons that increasing yields are less likely to erode bond returns:

- The yield curve remains steep, which makes further increases in long-term rates less likely since the short end has historically served as an anchor for the longer end of the curve. Each section of the yield curve has distinct buyers and sellers providing supply/demand pricing. US short-term rates remain near zero as the Fed navigates the taper (absent negative rates, this is "pushing on a string"), while intermediate- and long-term rates especially involve global central banks, insurance companies, and increasingly, US corporate pension funds.

- Bond yields and economic activity have a symbiotic relationship. Increases in yields must be absorbed by the economy as lending costs increase. If rates rise too quickly, the economy will slow down, leading to Fed action to decrease rates. Also, higher rates for long-term bonds would likely increase the demand from corporate pension plans.

INVESTORS SHOULD CONSIDER CHANGES BASED ON WHAT LIES AHEAD, AND NOT WHAT IS LEFT BEHIND.

- A yield curve is a collection of current interest rates and future rate expectations. The current yield curve already incorporates 125-150 basis points of increases over 5-7 years. Bond returns only erode if yield increases exceed this level.

Credit markets appear less appealing despite the improved attractiveness of sovereign bonds. Tightening of credit spreads served to offset the increase in sovereign yields in varying degrees. While favorable for returns last year, this spread compression hurts future credit expectations. Less overall liquidity in bond markets and a general deterioration of credit protection in new issues create an environment of concern for credit markets. For instance, half of all new loans issued in 2013 were classified as "covenant-lite" with less protection for lenders than traditional loans. This is in striking contrast to the last few years, where credit has been one of the most attractive sources of risk-adjusted returns.

One exception where credit markets remain favorable: private direct lending. Here, providers of capital can continue to replace traditional lenders as banks reduce leverage and comply with new regulations. The return profile for private debt has shifted downward relative to a year ago, but remains one of the more compelling ways to allocate capital in a low-return world.

The Challenge for Investors

History informs how investors interpret markets and take action. Recent history tells us that equities have outperformed tremendously, credit spreads have tightened, and volatility has subsided. We also cannot ignore the behavioral aspects of investing. These emotional influences likely have an investor's inner voice screaming "Don't miss out! Everyone is making money!"

Yet, at these times, investors are best served if they consider a different direction than simply chasing the recent past. They should re-affirm investment objectives, and consider changes based on what lies ahead, and not what is left behind. Peer rankings can be an important yardstick for performance, but peer allocations concentrated in US stocks have the makings of a volatile ride. Hindsight is 20/20 and foresight starts out at 50/50, but can be improved. NEPC believes that successful investing has entailed and will entail being:

- Diversified – having broad exposure to multiple sources of return
- Disciplined – following a plan consistent with objectives
- Contrarian – rebalancing while others chase returns
- Risk-aware – understanding and managing the chance of poor outcomes
- Forward-looking – a focus on what can be, not what has been
- Unconstrained – willing to give greater flexibility
- Opportunistic – able to look for new markets, ideas and structures

These traits have served investors well, especially through challenging markets. These successful long-term attributes can be more challenging to embrace when market performance is strong, but it is especially in these times that investors must consider a different direction than what has worked recently. By moving in that different direction, while tapping the wisdom of time-honored investment principles, investors can look to the future with confidence.