



EQUITIES: 2018 VIEWS AND IMPLEMENTATION

**Timothy R. Bruce, Partner,
Director of Traditional Research**

**Timothy P. O'Connell, CFA,
Research Consultant**



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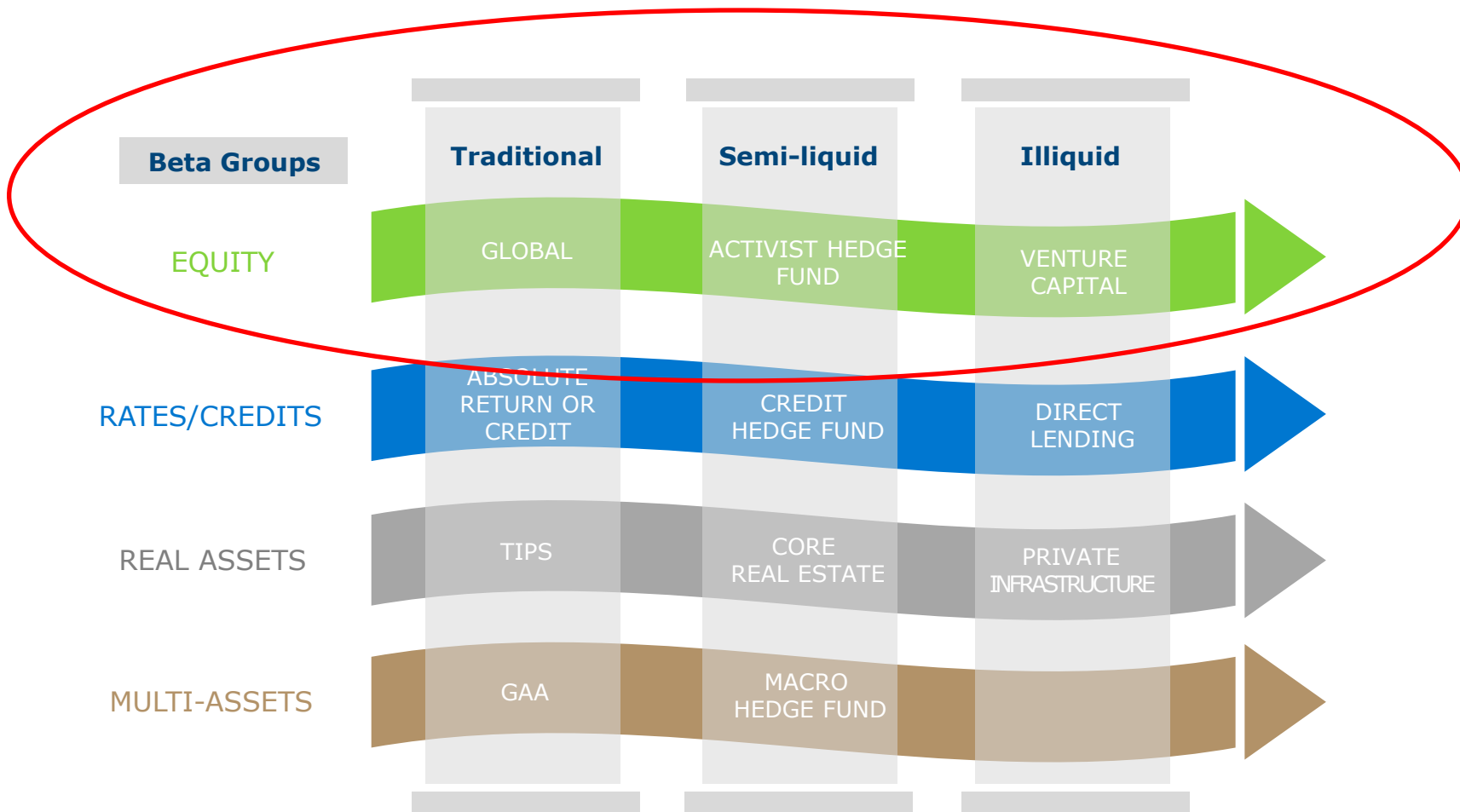
AGENDA

- 1. Beta Group Overview**
- 2. Equity Building Blocks**
- 3. 2018 Equity Beta Group Views**
- 4. Implementation Discussion**

BETA GROUP OVERVIEW

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BETA GROUPS



EQUITY BUILDING BLOCKS

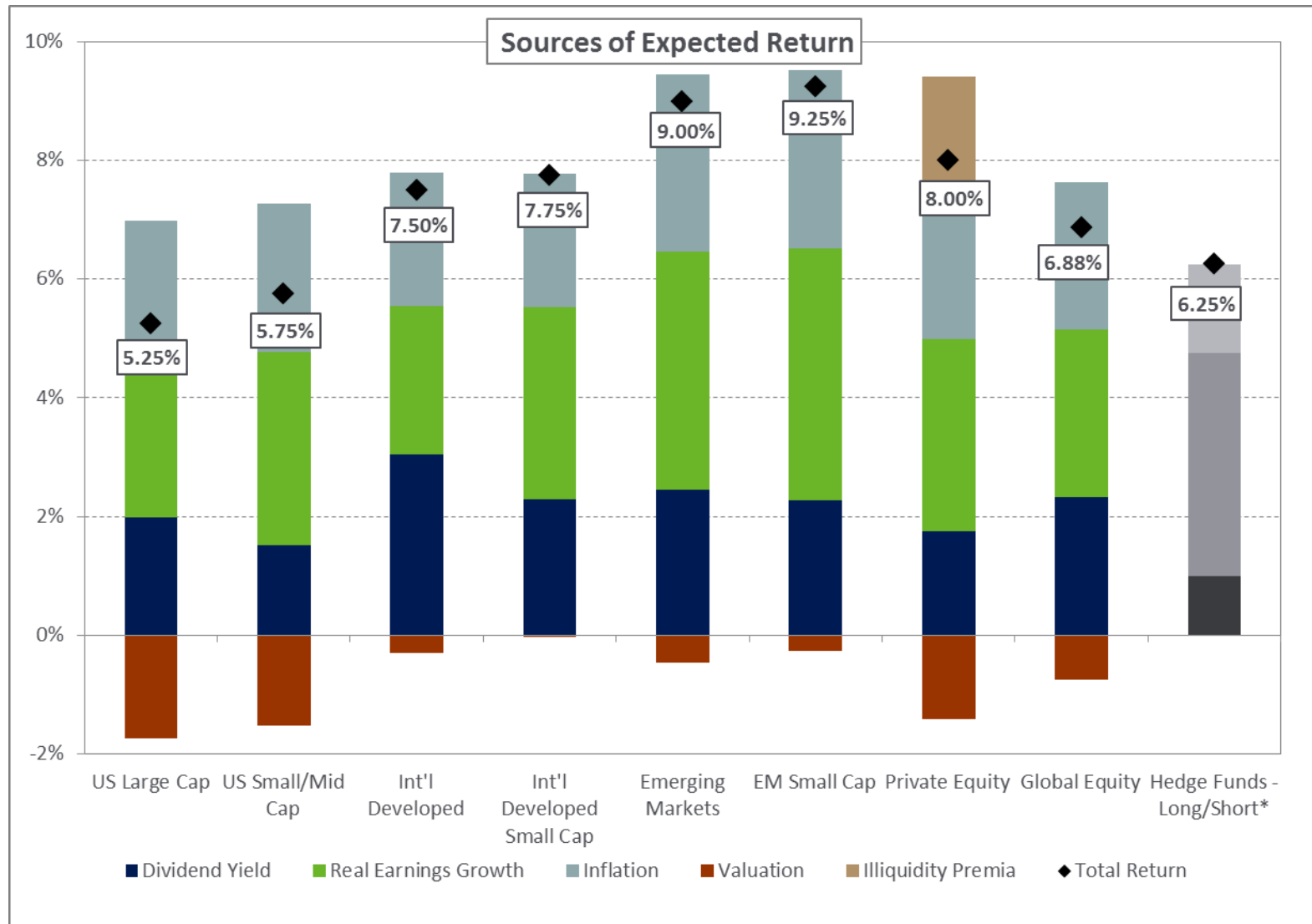
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EQUITY: ASSUMPTIONS

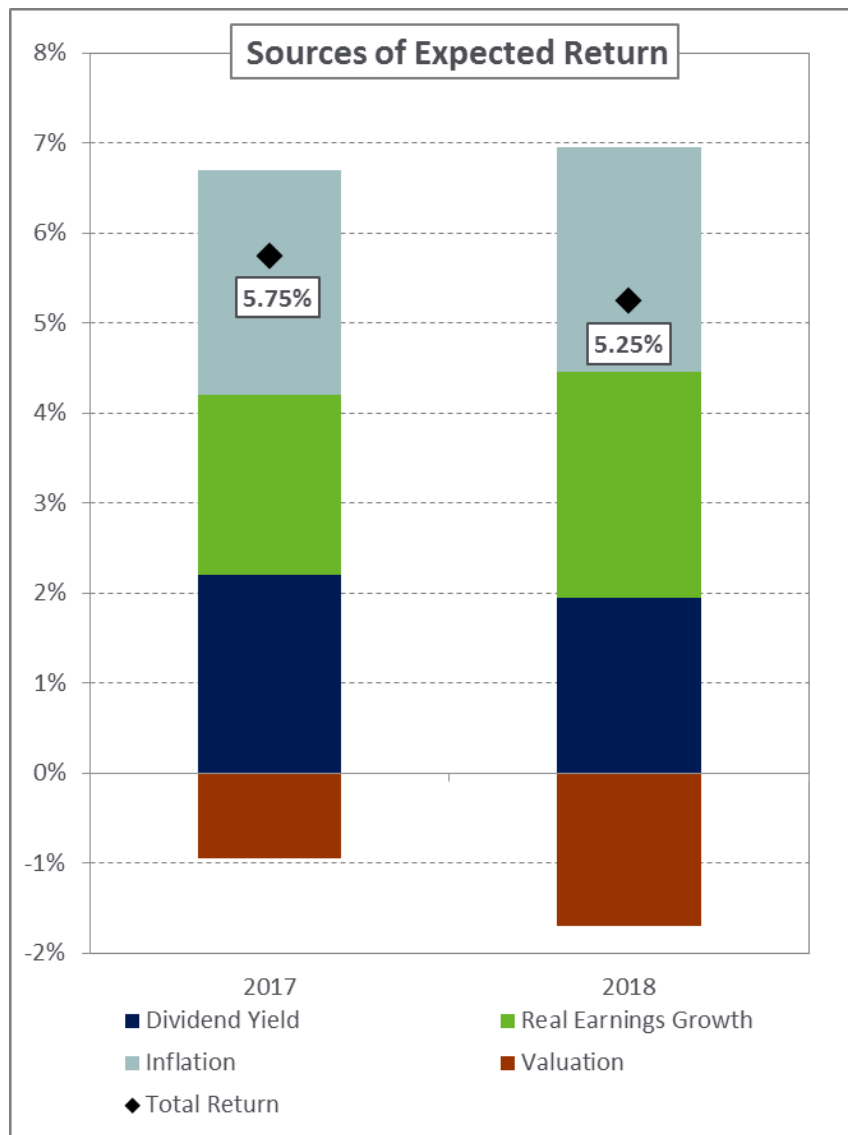
Equity Building Blocks	
Illiquidity Premium	The additional return expected for investments carrying liquidity risk
Valuation	An input representing P/E multiple contraction or expansion relative to long-term trend
Inflation	Represents market-specific inflation derived from index country revenue contribution and region-specific forecasted inflation
Real Earnings Growth	Reflects market-specific real growth for each equity asset class as a weighted-average derived from index country revenue contribution and forecasted GDP growth
Dividend Yield	Informed by current income distributed to shareholders with adjustments made to reflect market conditions and trends

Asset Class	5-7 Year Return	Change 2018-2017
US Large Cap	5.25%	-.50%
US Small/Mid-Cap	5.75%	-.25%
International (Unhedged)	7.50%	+.25%
International (Hedged)	7.82%	+.25%
International Small Cap	7.75%	+.25%
Emerging International	9.00%	-.50%
Emerging Intl. Small Cap	9.25%	-.75%
Private Equity	8.00%	-.25%
Hedge Funds – Long/Short	6.25%	-
Global Equity	6.88%	-.33%

EQUITY: BUILDING BLOCKS



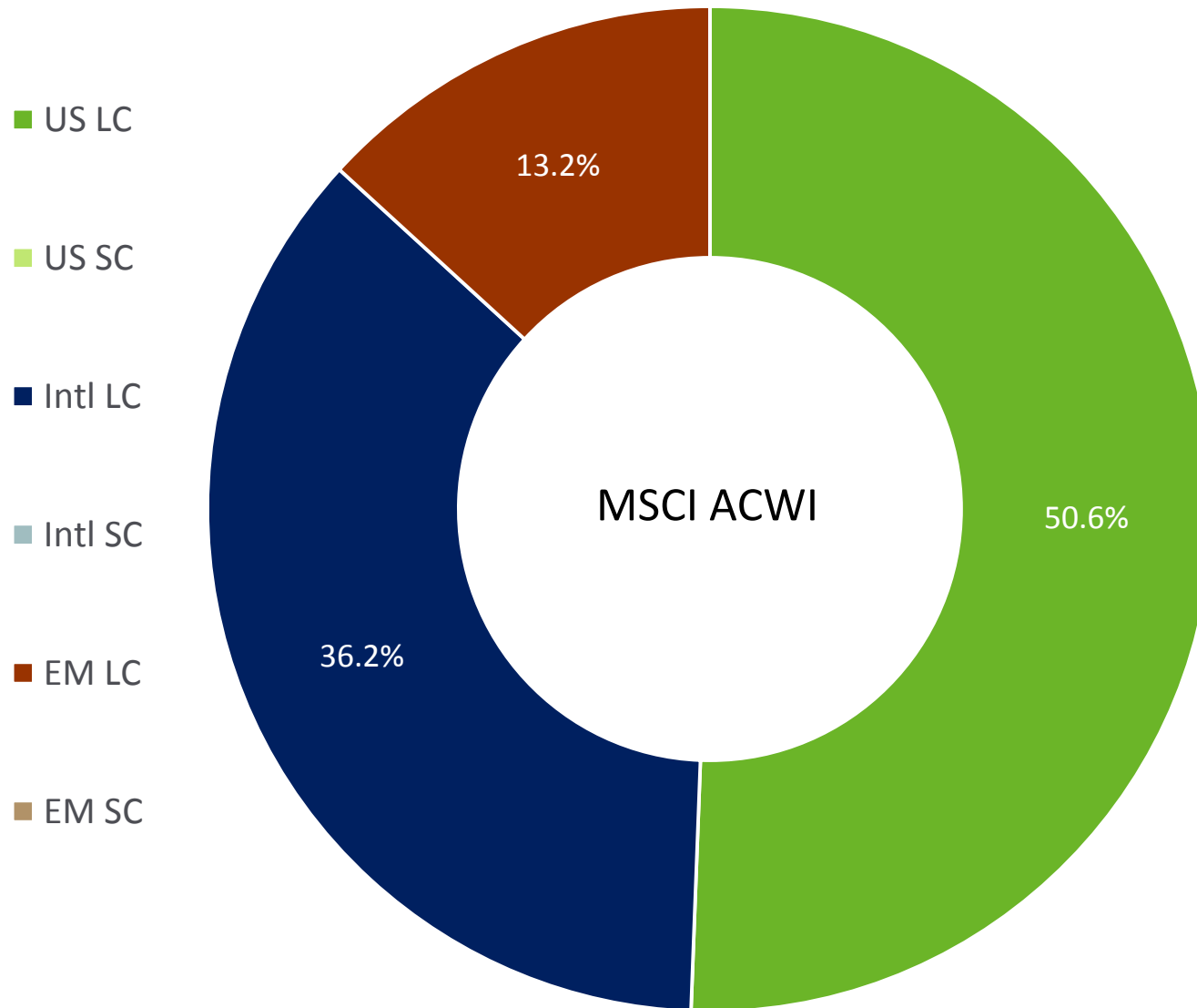
EQUITY EXAMPLE: LARGE CAP US EQUITY



- **Relative to 2017, the 2018 building blocks incorporate:**
 - Modestly higher growth to reflect strength in global growth
 - A more significant valuation adjustment to reflecting multiple expansion
- **Despite only a 50 basis point reduction in the 5-7 year outlook, more generous assumptions were applied:**
 - Profit margins are assumed to remain near current elevated levels
 - Assumed P/E multiple is expected to mean revert half way to the long-term average

OVERVIEW EQUITY MARKET

MSCI ACWI GLOBAL EXPOSURE



BETA GROUP THOUGHTS AND ACTIONS

Equity Beta Group Thoughts

- **US equities valuations remain elevated**
- **Europe earnings growth outpacing returns**
- **Emerging market economic divergence**

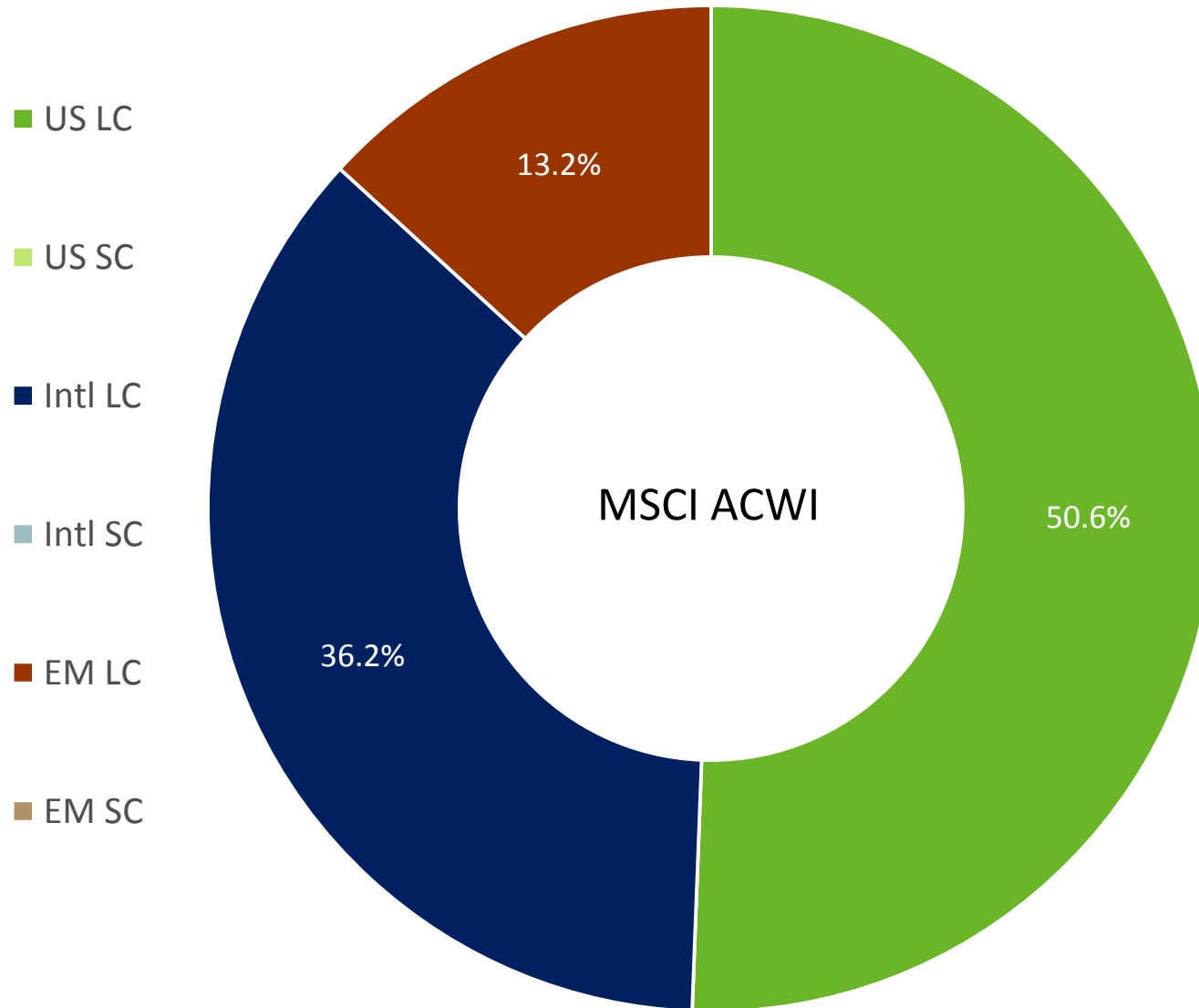
Equity Beta Group Actions

- **Trim US Equity Gains**
- **Small caps preferred implementation- Non-US and US**
- **Overweight small cap and consumer focused EM strategies**

US EQUITIES

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MSCI ACWI GLOBAL EXPOSURE



US EQUITIES

General Market Thoughts

- **US Equities Broadly**

- Valuations appear stretched based on a number of valuation metrics
- Earnings growth needed to continue rally; 2017 saw a recovery in earnings but can it be sustained?

- **Small Caps**

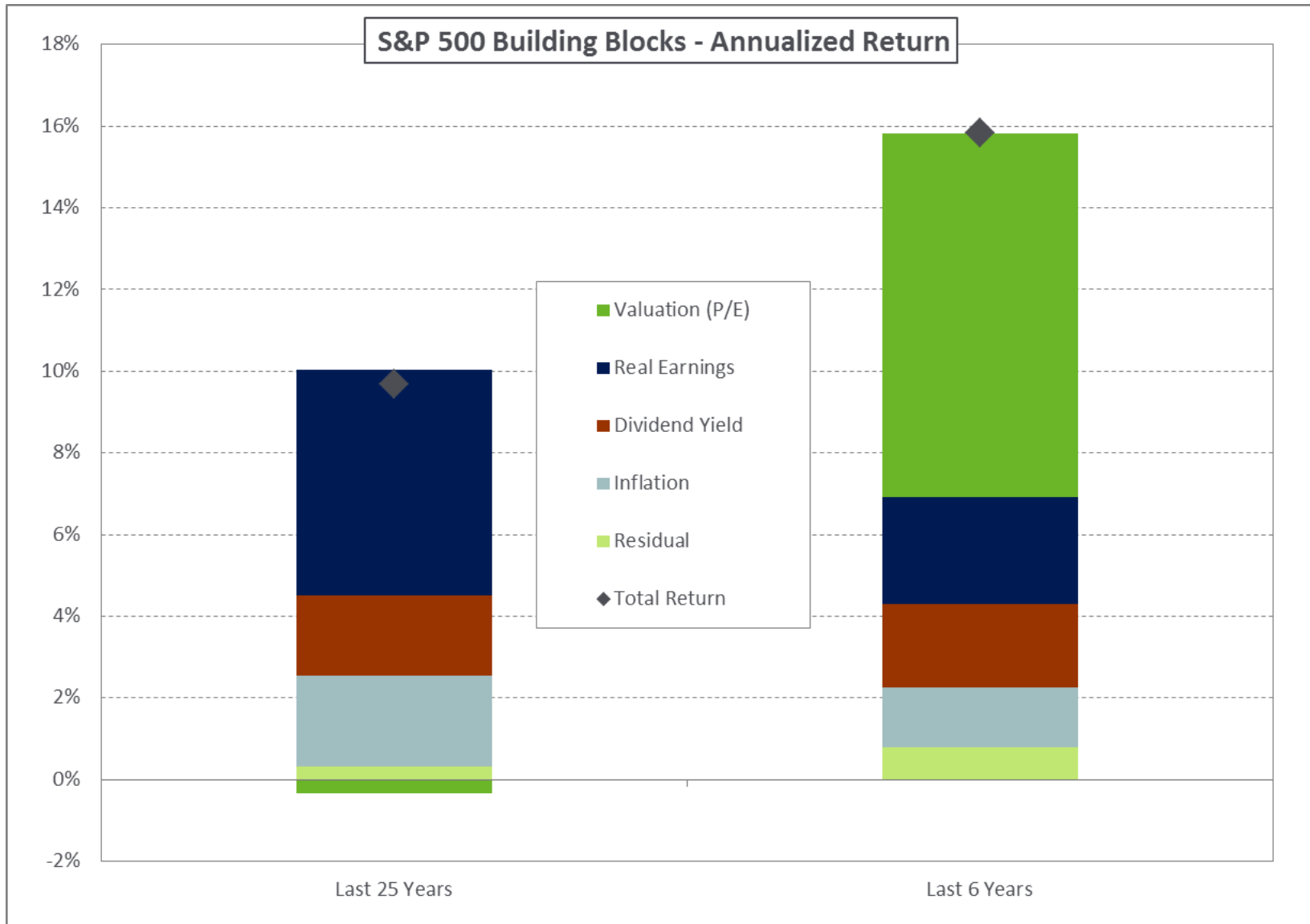
- Small caps should benefit from tax reform as effective rate drops from ~32% to 21%
- GDP surprise could be beneficial to smaller companies who are more domestically focused from a revenue standpoint

US EQUITIES

Implementation Views

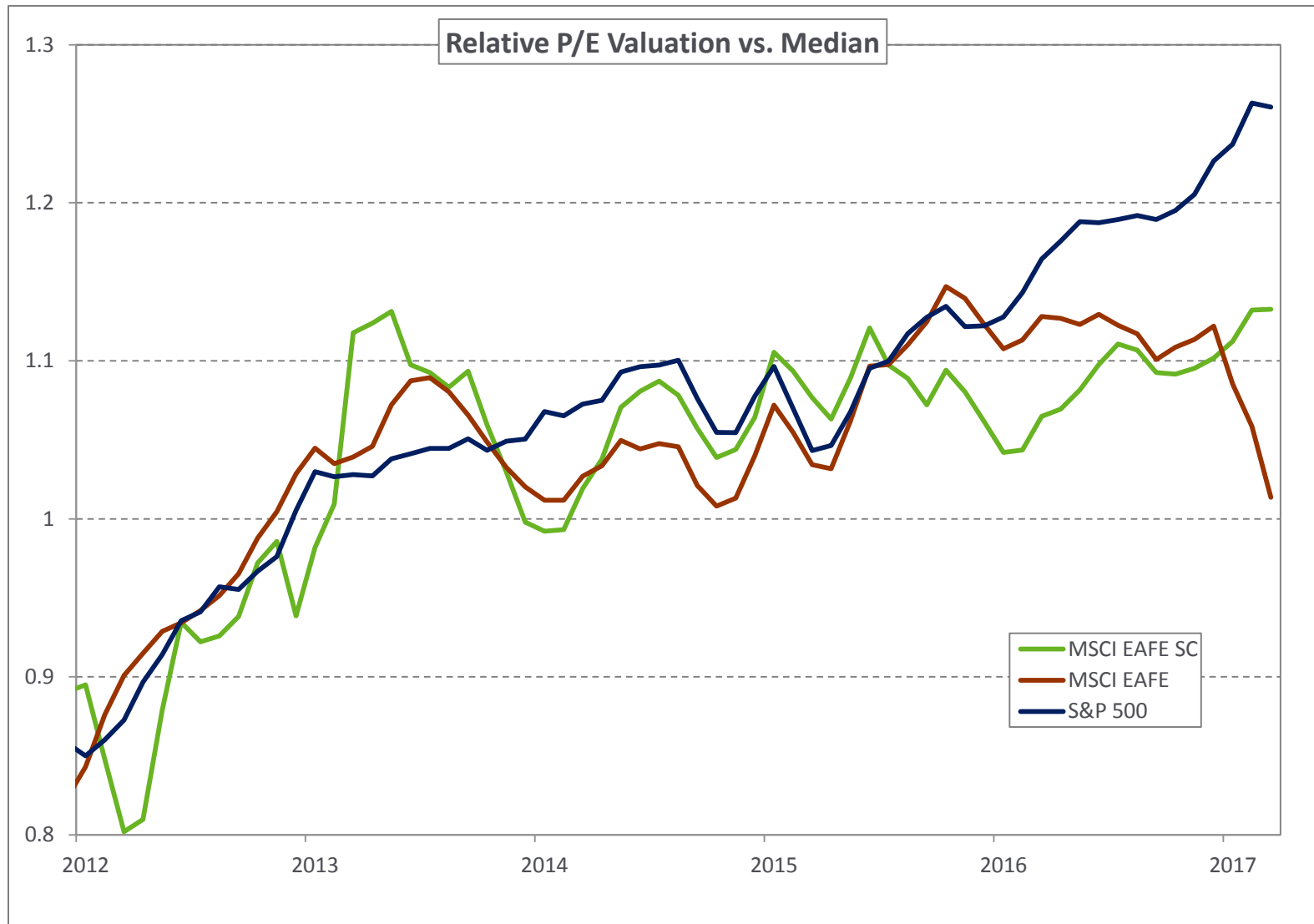
Strategy		Outlook
Public	Passive	Positive
	Large Cap	Neutral
	Small	Positive
Private	Venture	Neutral
	Growth Equity	Positive
	Buyouts	Neutral
	Special Situations	Positive

WHY DO WE TALK ABOUT VALUATIONS?



Source: Bloomberg

US EQUITY VALUATIONS REMAIN ELEVATED



Source: MSCI, Bloomberg, Standard & Poor's

TAX REFORM IMPACT ON US EQUITIES

Bull Case

- **Corporate tax cuts should be supportive of earnings**
- **The largest benefits will go to sectors with a domestic earnings focus that are currently paying higher average effective tax rates**
- **Reduction in individual tax rate spurs consumer spending**

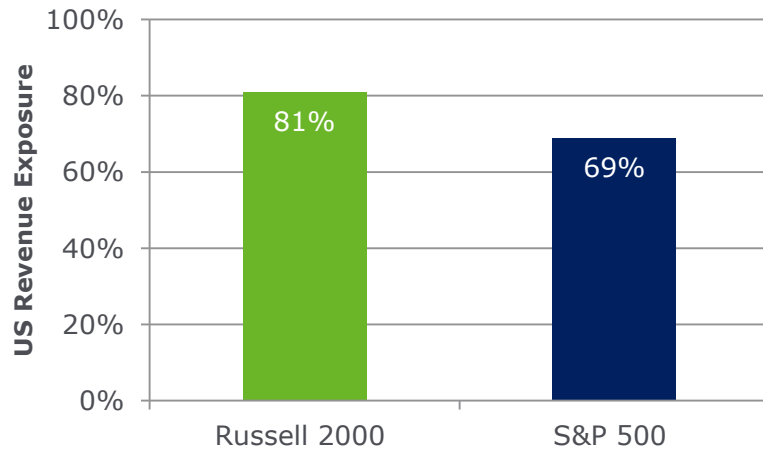
Bear Case

- **Impact to GDP may be limited due to a low fiscal multiplier**
- **Lower taxes and higher capital expenditures could cause the Fed to raise rates quicker than expected**
- **Tax cut impacts may already be priced in**

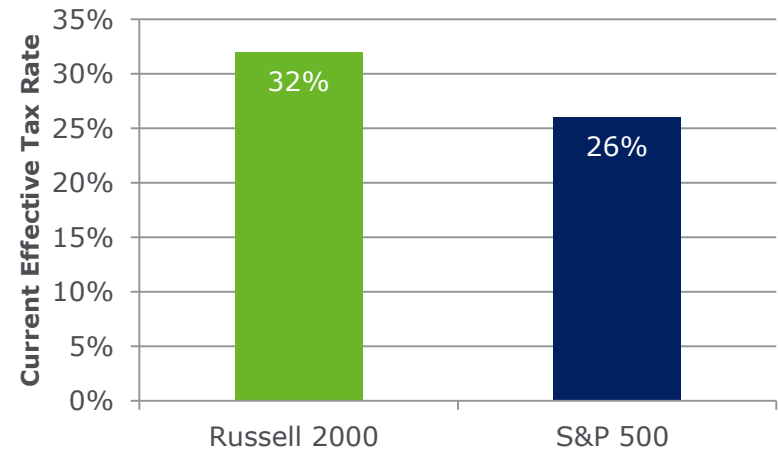
Source: Morgan Stanley

TAX REFORM: SMALL VS LARGE CAPS

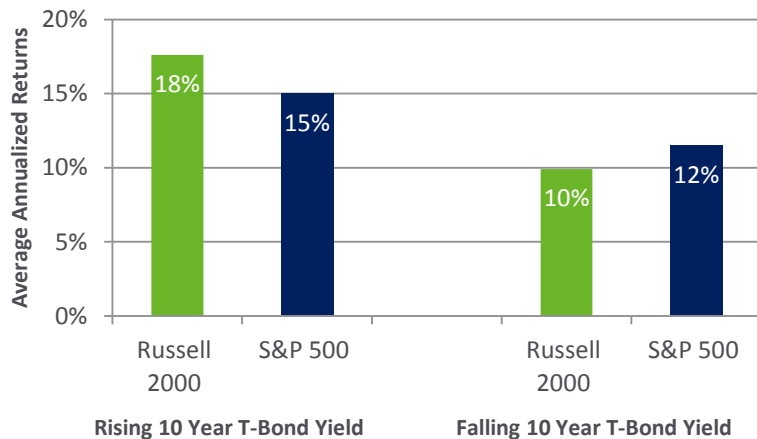
% of Revenue Sourced Domestically



Effective Tax Rate



Performance in Rising/Falling Rate Environment



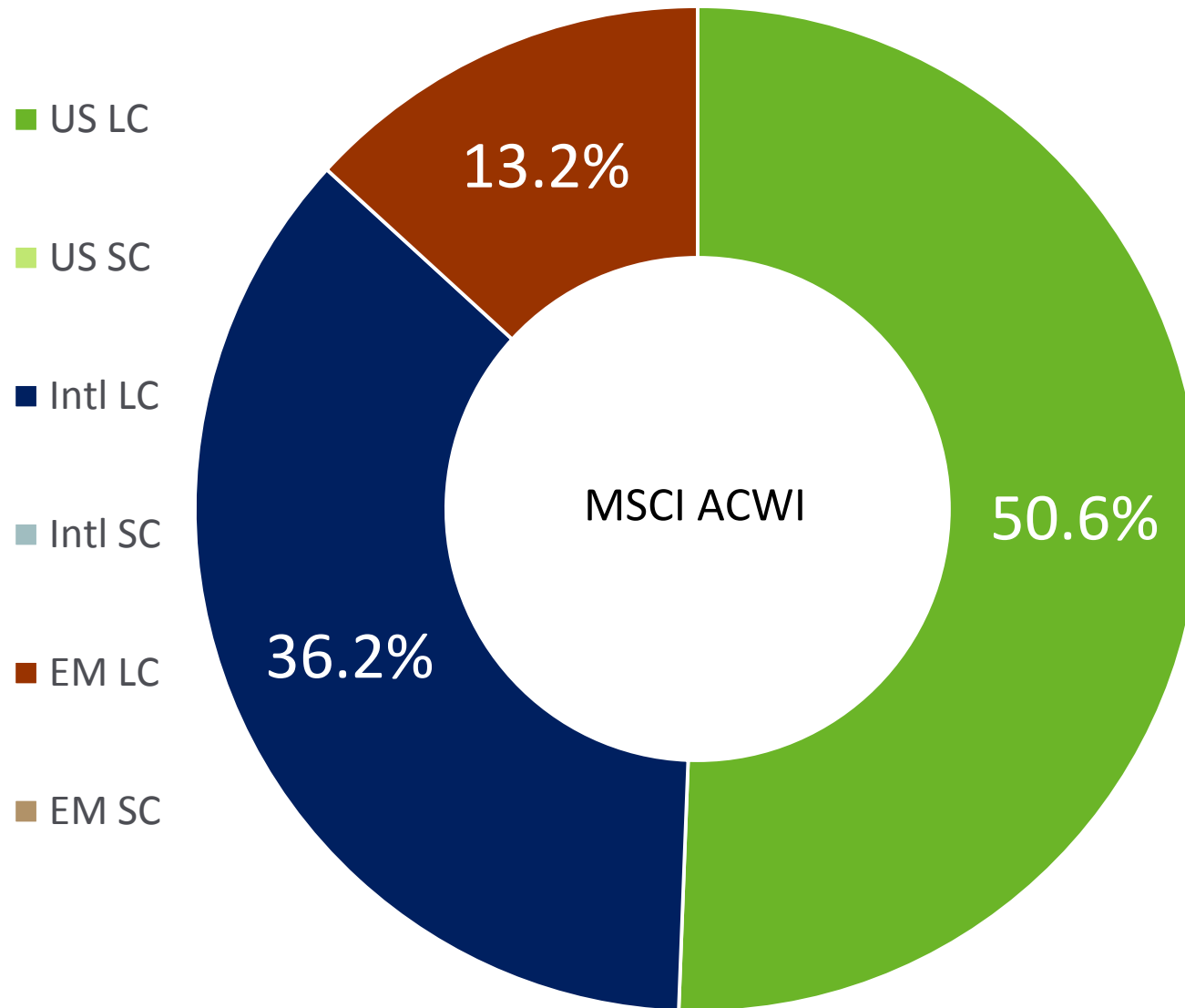
Commentary

- **Tax reform should be more beneficial for small caps than large caps:**
 - Small caps have a larger portion of revenue domestically sourced than large caps
 - Small caps currently pay a higher effective tax rate than large caps

INTERNATIONAL EQUITIES

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MSCI ACWI GLOBAL EXPOSURE



BETA GROUP SUMMARY SLIDE- INT'L

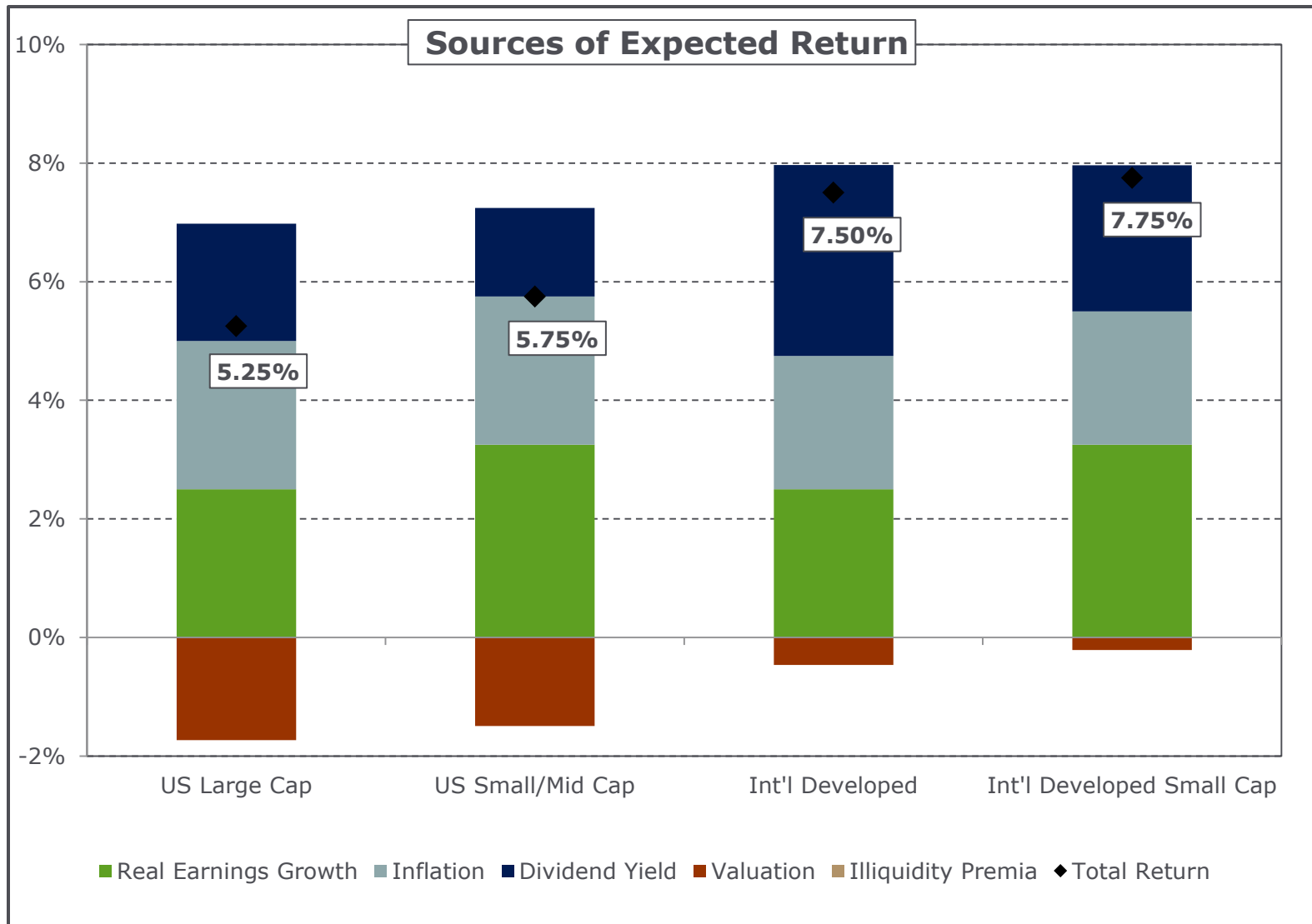
General Market Thoughts

- **Europe and Japan carry risks but offer a meaningful return opportunity even after recent strong performance**
 - Earnings growth has outpaced multiple expansion in Europe
 - Catalysts for outperformance are present with shareholder friendly actions in Japan and macroeconomic improvement in Europe
- **Small-cap equity and global equity are preferred implementation approaches**
 - These strategies offer the best opportunity to exploit valuation discrepancies among stocks across countries and sectors
 - Hedging a portion of non-US developed currency exposure remains a strategic goal

BETA GROUP SUMMARY SLIDE- INT'L

General Market Thoughts		
Strategy		Outlook
Public	Passive	Positive
	Large Cap	Positive
	Small Cap	Positive
	Europe	Positive
Private	Venture	Positive
	Buyouts	Positive

EQUITY: BUILDING BLOCKS



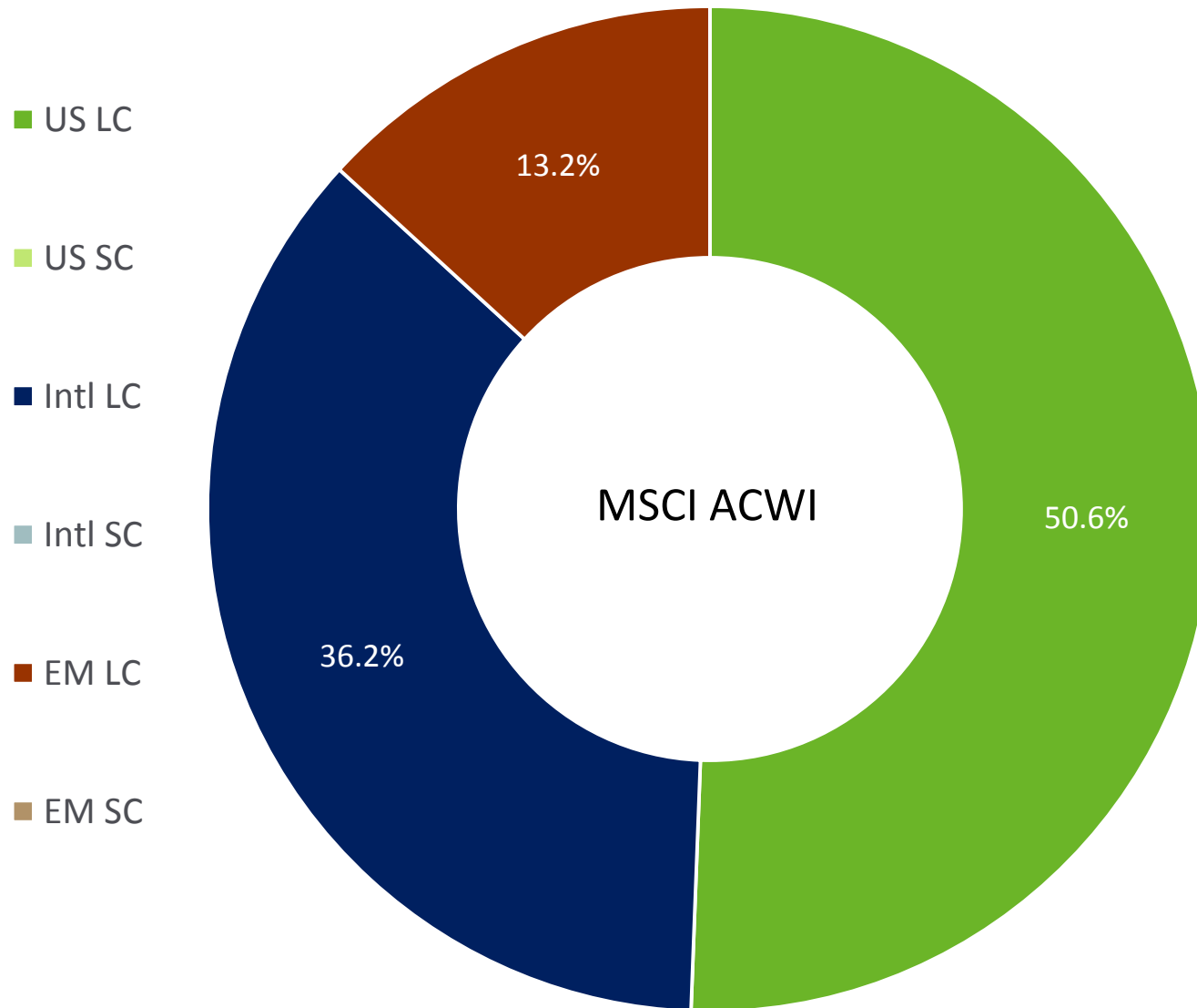
Source: NEPC

*Hedge Funds are discussed in detail in the Multi-Asset section

EMERGING MARKET EQUITIES

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MSCI ACWI GLOBAL EXPOSURE



EMERGING MARKETS

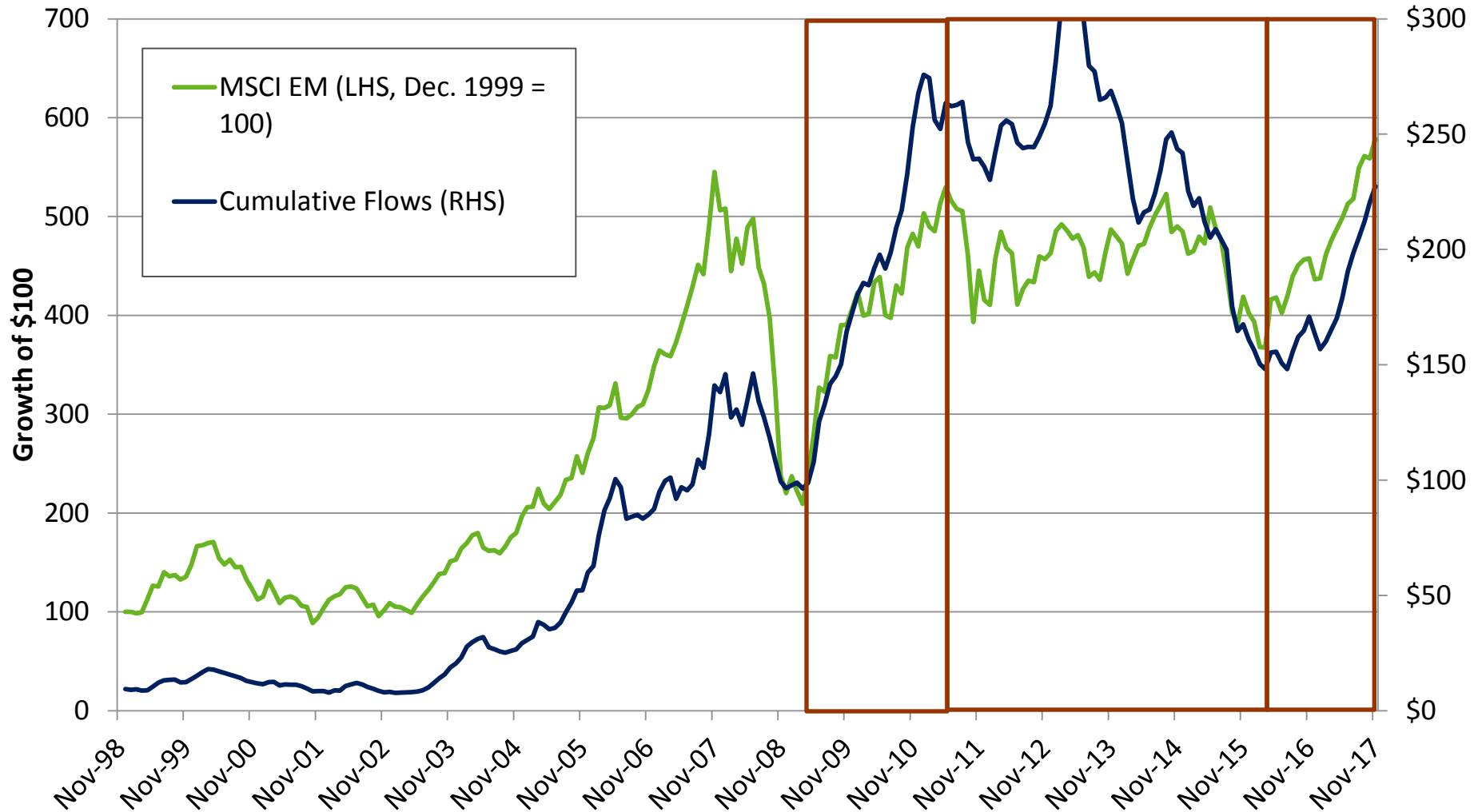
General Market Thoughts

- **Emerging equities offer the highest total return potential for investors**
 - Valuation levels and long-term fundamentals suggest an overweight relative to global market cap weights (e.g. 15% to 20%)
 - China's depreciating currency, broad US dollar strength and US-Asia trade policy concerns temper our excitement
 - Growth premium relative to the developed world is advancing as emerging market economic conditions improve off fiscal and currency adjustments of recent years
- **Overweight small-cap and consumer focused strategies relative to broad benchmark mandates**
 - Small-cap and emerging market consumer strategies offer a structural bias away from commodity exposures and state owned enterprises

EMERGING MARKETS

Equity Implementation Views		
Strategy		Outlook
EM	Passive	Negative
	Large Cap	Positive
	Small Cap	Positive
	Asia Private Equity	Positive

EMERGING MARKET FLOWS

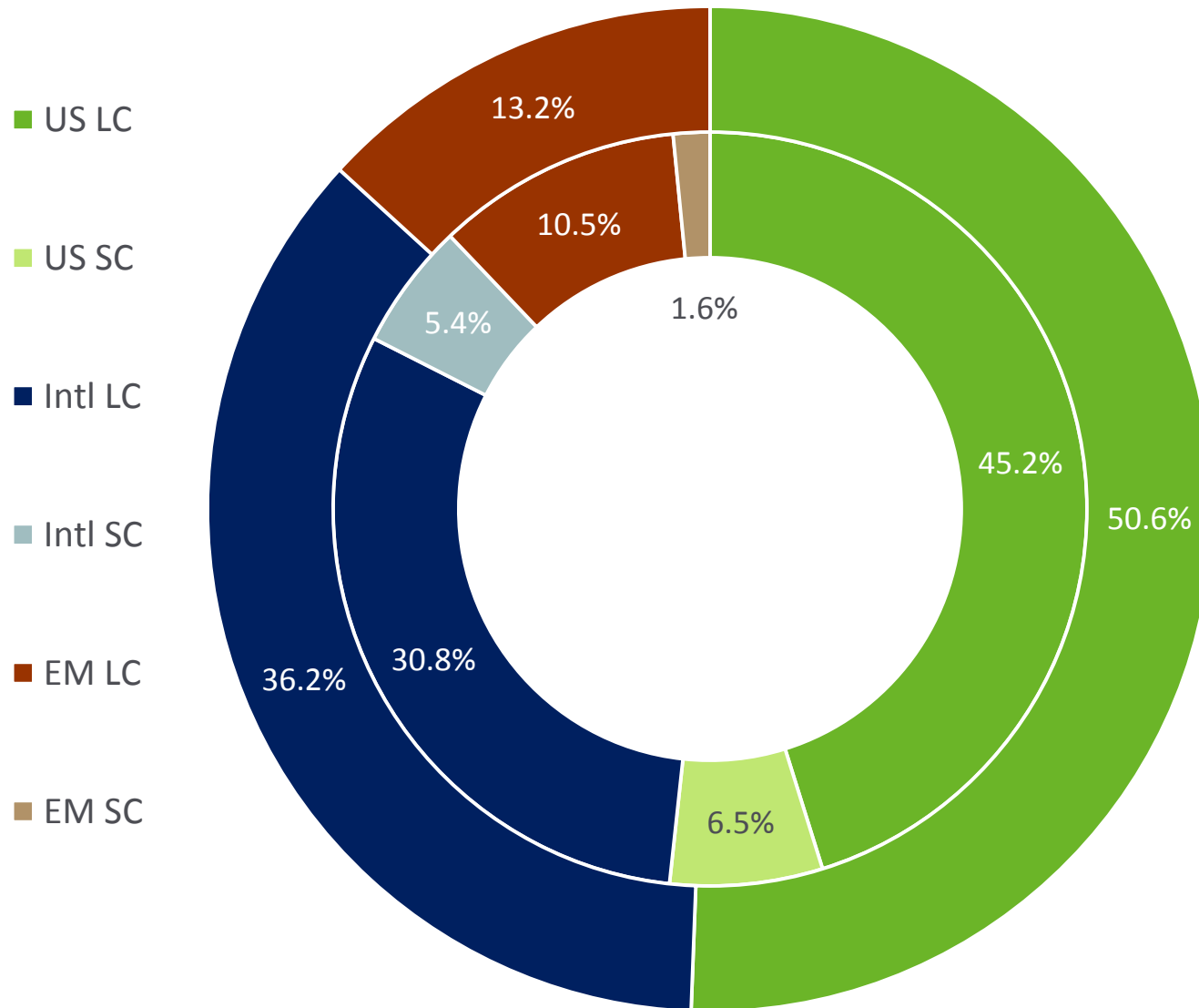


Source: EPFR, Bloomberg

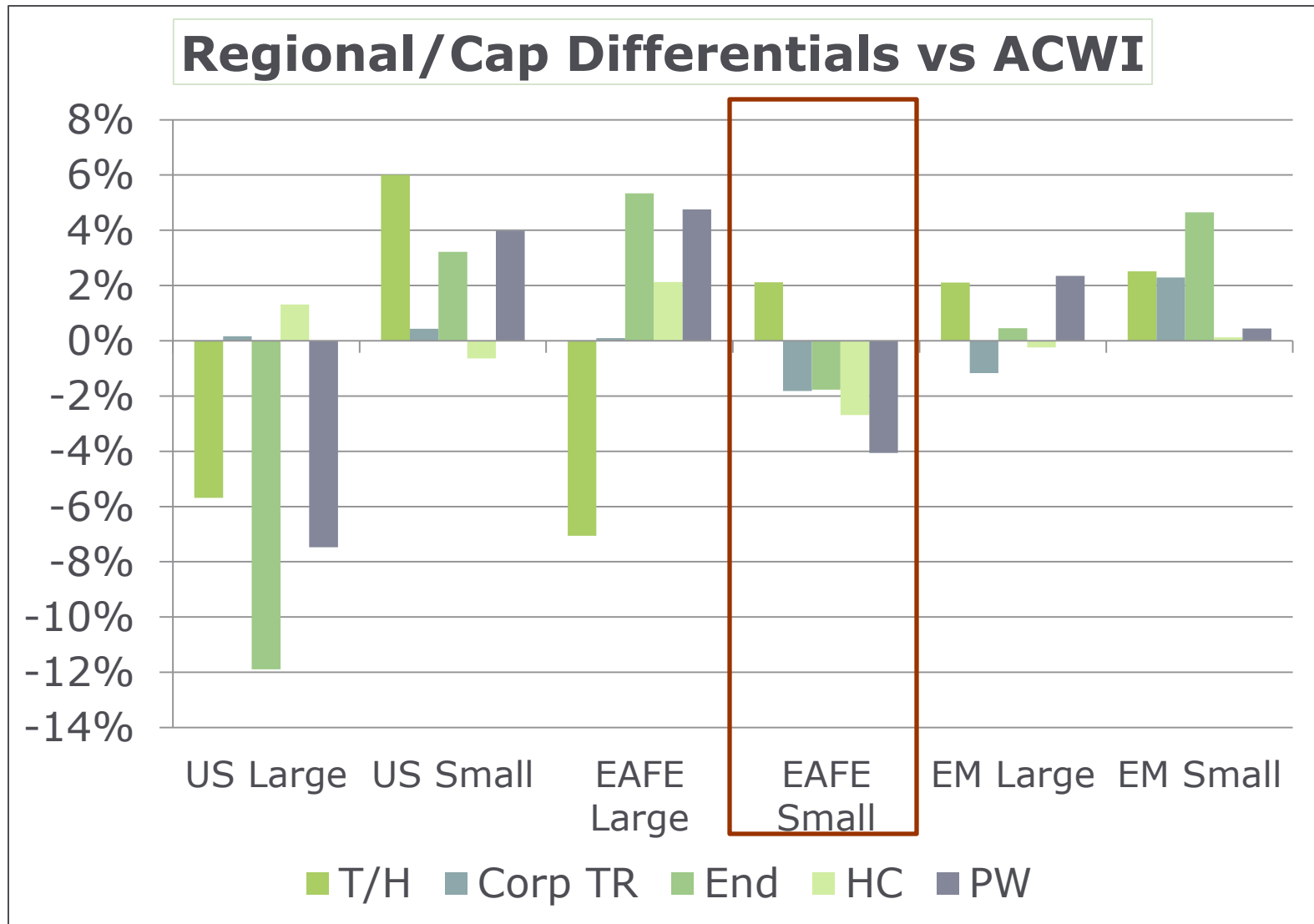
IMPLEMENTATION

IMPLEMENTATION: INTERNATIONAL SMALL CAP

MSCI ACWI VS. MSCI ACWI IMI



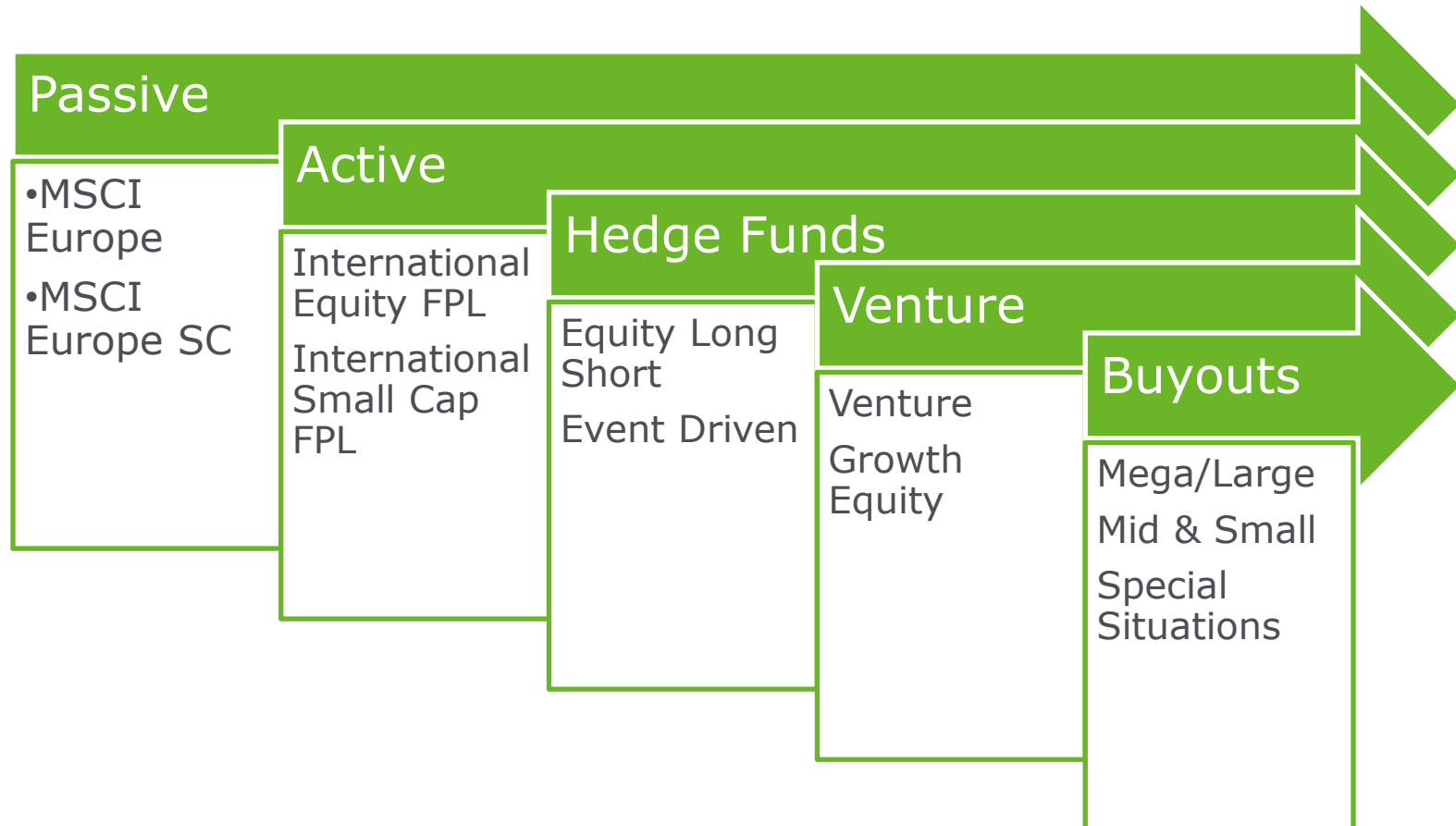
EAFE SMALL CAP UNDERWEIGHTS



Source: InvestorForce, Spotfire

IMPLEMENTATION: ACROSS LIQUIDITY SPECTRUM

EUROPEAN EQUITY LIQUIDITY OPTIONS



BETA GROUP SUMMARY SLIDE

General Market Thoughts

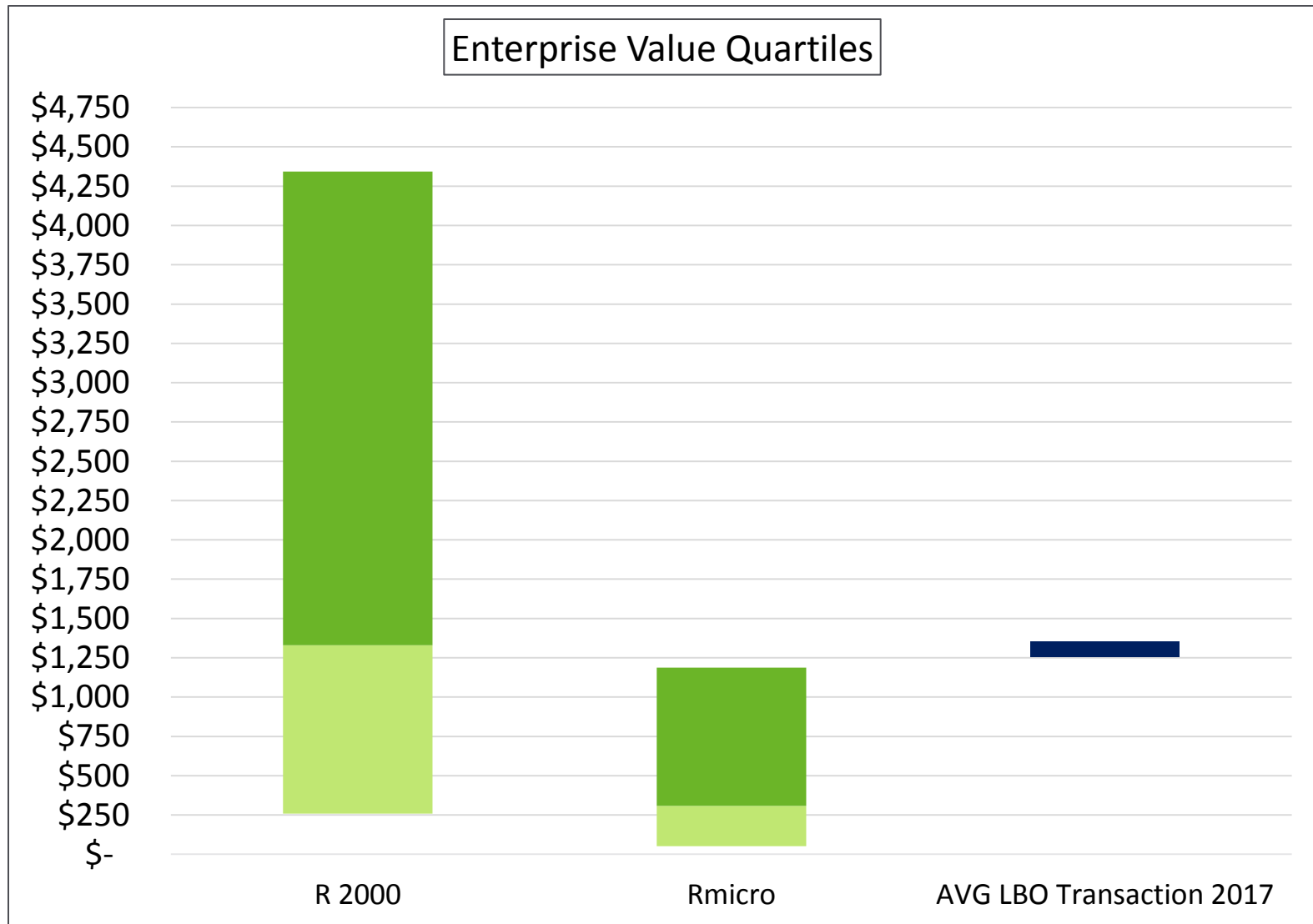
- **Europe may offer a meaningful return opportunity even after recent strong performance**
 - Earnings growth has outpaced multiple expansion in Europe in public markets
 - macroeconomic improvement in Europe
- **Venture Capital**
 - More segmented market with penetration far below that of the US
 - Confluences of circumstances has resulted in a fundamental mind shift towards entrepreneurship as a career path
- **Private market buyouts**
 - Occurring at more favorable purchase price multiples, with less leverage, than US

Equity Implementation Views

Strategy		Outlook	Commentary
Europe	Passive	Positive	MSCI Europe and Europe SC offer cheap tactical exposure
	Active	Positive	Implementation through international small cap is current preferred method
	HF	Positive	With valuations close to long term averages long short equity managers may find winners and losers
	Venture	Positive	In Europe, target managers with strong networks and ample deal flow.
	Buyouts& Special Situations	Positive	Middle market biased; seek managers that have experience turning local, regional businesses into Pan-European or global businesses

IMPLEMENTATION: PRIVATE EQUITY AND MICRO/SMALL

RUSSELL 2000 AND RUSSELL MICRO CAP



CONCLUSION

CONCLUSION

- **Consider evaluating portfolio through Beta group lens**
- **In US we are constructive on small and microcap**
- **Negative on passive EM implementation**
- **Opportunities in Europe particularly in European Venture**

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