Investors Cautiously Optimistic On 2019 As Volatility Reemerges

Nonprofits Prepare For Dampening Of Equity & Fixed-Income Returns

Investors are less than bullish on the equity markets moving forward as 2018 saw volatility creep back into the picture.

Optimism investors held that some combination of strong global growth, earnings growth, low inflation and accommodative monetary policies would continue in 2018 and fuel the equity markets was all but lost as the Standard & Poor's 500 Index experienced 10% corrections in February and October after not having experienced a correction of 5% or more since June 2016. The markets have further suffered through the end of 2018 with the S&P 500 posting a -6.24% return for the year, the lowest return since the -38.49% return posted in 2008.

"What we started seeing in October and November are good examples of the times changing with the Fed on the course of normalization," said Deepak Puri, cio of Deutsche Bank Wealth Management, Americas. "We are going to see heightened volatility and frankly it's not as uncommon as people may think. It's not uncommon to see stock markets go down 5%. It's often down 5% three or more times per year and 10% or more every 14-15 months."

With volatility returning to the markets and anticipated to persist moving forward, investors' expectations on their equity allocations appears to be waning.

"I think a lot of institutions have been wrestling on the equity side," said Amy Falls, cio of Rockefeller University's $2.2 billion endowment. "In the next 12 to 18 months I don't see what pushes equities higher. Our long-term expectation for equities is 7% to 8%, and a little higher when including investments in private markets to pull it up, but I think this coming year is going to be below that."

That sentiment was echoed by Kristin Agatone, cio of Lehigh University's $1.3 billion endowment, who expects a mid-single digit return profile and noted, "We do not expect straight compounding for the next few years."

With investors carrying a more bearish sentiment on the equity markets for the next 12 to 18 months, now may be an opportune time for endowments, foundations and healthcare plans to take a look under the hood of their equity portfolios for any unintended bets, according to allocators.

"This has been a really long bull market in the U.S. and even if you're largely passive, you may have built up some exposure that you don't necessarily even think you have," said Greg Dowling, cio of investment consultant FEG Investment Advisors. "Now is the time to ask, do we have any unintended bets, did we get over our skis in terms of growth or momentum? Maybe now is the time to rebalance and become a little more diversified by factor exposure. It may be the time to have more exposure to quality and value and make sure you are well diversified."

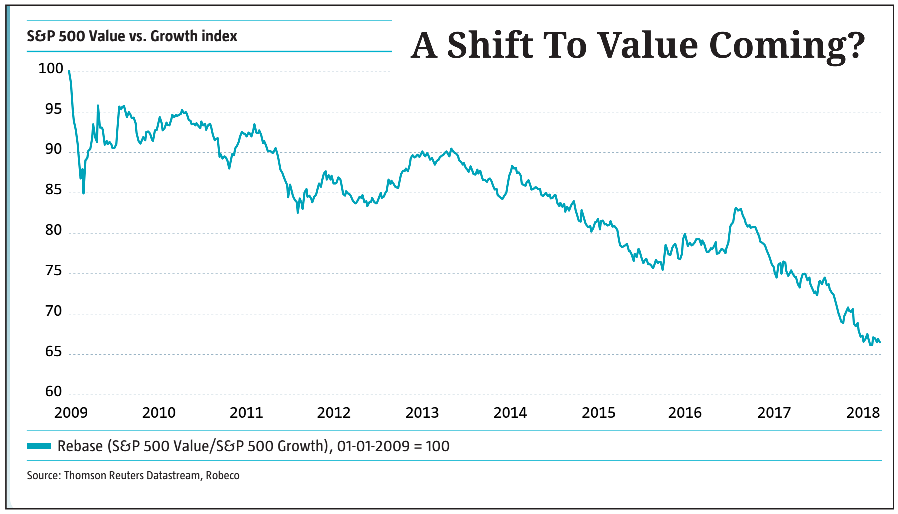
Beyond factor exposures, investors should also be aware of the drift in capitalization and style exposure within their portfolios, according to Tim Barron, cio of investment consultant Segal Marco Advisors.

"If you're finding your large cap portfolio has gotten out of balance relative to small-cap portfolio or finding your growth portfolio out of balance relative to value portfolio, this is probably a good time to exercise the discipline to move back towards your neutral positions," Barron said.

While many investors are not as optimistic on the domestic equity markets in the coming year as they expect a drop in earnings growth, a lower gross domestic product and stretched valuations even with the recent correction, others still believe there are returns to be wrung out of the markets.

"We are optimistic on equities for the next 12-18 months with return expectations north of 10% from current depressed levels," said Mary Jane Bobyock, managing director of the nonprofit advisory team at outsourced cio SEI Investments. “We’ve got a lot of transparency with the Fed, which helps, tax reform has helped, and there are still expectations that profit growth is going to be relatively high. It’s coming down a little, but we’re talking about 5% to 10% growth numbers, which is decent for profitability.”

Similarly, a cio from the Northeast region, who spoke on the condition of anonymity in order to speak freely on numerous topics, finds that despite U.S. equity markets appearing far along in their cycle there is still some room for the markets to run, albeit on a bumpier path.



Source: Robeco

“I think that tax reform may still have an impact because individuals don’t start seeing that in their refund until [2019],” the cio said. “That could be stimulative to the economy…Valuations are high, but not as high as they were. It’s a sentiment driven market and people seem to be concerned that it has gone on for too long, but it may have some more legs.”

Bobyock did note that there are a few wild cards that could serve as headwinds for the equity markets this year, including trade wars, tariff costs and increasing labor costs, all having the potential to squeeze profits.

Ultimately, the broad sentiment for investors and allocators shows positive returns for 2019 even with increased volatility expected.

J.P. Morgan Asset Management’s capital market assumptions peg domestic large-cap equity compound returns at 5.25% in 2019, down from 6.41% in 2018. Those returns also trail projections for domestic mid-cap at 5.75% and domestic small-cap at 6%, according to its 2019 return assumptions (https://am.jpmorgan.com/us/institutional/library/ltcma-2019-overview).

The firm’s assumptions project a slightly more favorable outcome for international and emerging markets equities as they peg compound returns for all country world equity at 6%, Euro area large-cap equity at 7%, emerging markets equity at 8.5% and all country Asia ex-Japan equity at 8.5%, according to its 2019 outlook report.

Amy Falls

Value Resurgence After 10-Year Growth Run

Within the domestic equity markets, growth stocks have provided almost 4% excess returns over value stocks over the last 10 years with some finding it to be a function of the Federal Reserve enticing riskier assets with lower interest rates. With investors and allocators acknowledging the cyclicality of growth and value stocks, many forecast a shifting of the guard to value from growth.

“The growth run has been pretty long compared to most growth cycles, which last more like two to five years, so this 10-year run has been the longest in duration and magnitude,” Bobyock said. “…Growth stocks and higher duration do better with lower interest rates, so it is not surprising how techs were helped, and financials were hurt a bit with their low margins over the course of the run. It’s been a long run for growth and we are thinking it is leaning a little bit more towards value stocks’ turn.”

Segal Marco’s Barron sees value and deep discount value stocks as attractive opportunities for investors as they tend to have more defensive characteristics, are less highly-correlated to the market and have a more absolute return orientation.

“Moving from a declining to rising rate environment, volatility and diminished return expectations does argue for a tilt to value and away from growth,” said Brian Arsenault, managing director and partner at outsourced cio Disciplina Group. “We might do some migrating out of growthier sectors or managers into more value type managers. This is a little bit more of a defensive approach in terms of our U.S. allocation, but it does not mean we are full risk off.”

Bobyock noted that investors should be conscious about factors within their equity portfolios as SEI has found that “momentum plays and price momentum and earning revisions are not just growth plays” as those factors can be found in “a value type of stock like a financial or industrial and some of the energy stocks.”

While investors see opportunities with value stocks and are hearing from value-oriented managers that there are pockets of opportunity to exploit, others are less optimistic the cycle is turning over as it may be abnormal due to the stimulus that it took to get the economy moving following the global financial crisis.

“I am not hugely optimistic for that [value stocks] in the near-term as I am more conscious of the equity markets. If you look at earnings as a percentage of GDP, they are pretty high, multiples are not low, and we’ve gotten used to a very low interest rate, which is not biblical,” Rockefeller’s Falls said.

In contrast, some investors view the cycle as closer to the beginning of the late-stage than the end of the stage with inflationary pressures potentially building, interest rates rising and investors shifting away from economically sensitive areas.

“We have a favorable view of what I call late-cycle cyclicals, parts of the markets that are more growthier-oriented like the tech sector and some telecommunications services, which have seen some migration from tech,” Deutsche’s Puri said. “We also like healthcare, financials and consumer discretionary sectors. What we are avoiding are the ones that are considered to be like bond-proxies such as utilities, MLPs and REITs. We expect yields to go up, so those plays could come under pressure in 2019.”

Ultimately it will be tough for investors to time the changing of the guard, with Barron saying, “At some point in time it will turn and if I knew when that was going to happen, I am not sure I would put it in the paper."

Agatone believes that for investors examining their growth and value leanings, they should spend more time focused on underlying companies, geographies and sectors more so than factors.

"What somebody can define as value could be someone else's growth stock, and some people are growth managers but are buying at a deep discount to what they believe is intrinsic value. It's a little too blurry for us to have a view on at that level," Agatone said. "What we look at is more company specific like how protected are the underlying revenue and earnings growth. The more a company can drive market share, enter new markets or find growth through ways that are independent of GDP growth, the better."

Expected Increase In Volatility Paving Way For Defensive Strategies, Active Management

With investors viewing the domestic equity markets in some point of its late-cycle stage and volatility increasing, defensive equity plays and shifts toward active management are expected to be a frequent topic for investment offices and investment committees to discuss.

Defensive equity options run the gamut from multi-asset class strategies that give managers the ability to be nimble about where they are participating in the markets to low volatility strategies that have value and income characteristics and may incorporate stable companies or "blue-chip stocks."

Other options for investors include moving away from some of their S&P 500 Index exposure to more factor-weighted portfolios that are less concentrated in the top ten names or FANG stocks (Facebook, Amazon, Netflix and Google).

Others view the strategies as a substitute to more absolute return-type strategies that can have less correlation.

"In the E&F world, we have never really been as supportive or accepting of some of the defensive or low vol strategies, it's something we've seen more on the public pension side," FEG's Dowling said. "To some degree it's a poor-man's proxy for other absolute return strategies that some of the E&F's may do. The concept is valid, we just may enact it a little differently."

Active management appears more attractive to investors as 2018 brought four interest rate increases and an unwinding of balance sheets, which has led to lower correlations and wider dispersions, investors and allocators said. The case for active management has been furthered by the increased differences in stock performances as well as takedowns to some of the largest stocks.

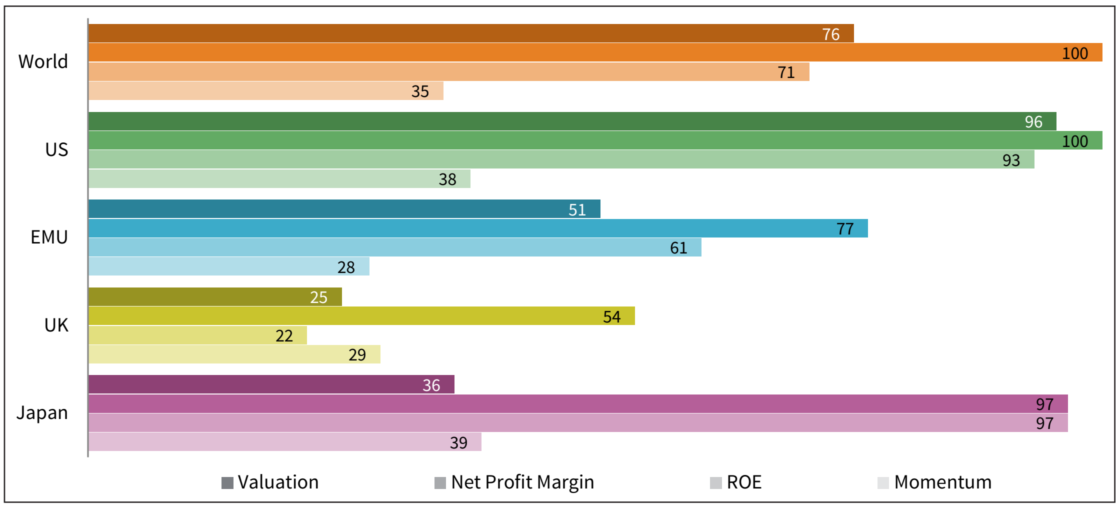
The Northeast cio noted that smart beta or factor-based strategies could also be of interest to investors as the strategies fall somewhere in between passive and active management and can dynamically tilt or shift a portfolio toward targeted weights or factors to capture a risk premium, while having the potential for lower volatility.

"If you want to get active exposure and you know what you want your portfolio to look like, it could be an easier and cheaper way than finding an active manager," the Northeast cio said.

The strategies are not without risks as they can be susceptible to overcrowding and rebalancing as well as taking on exposure to particular risk factors.

Ultimately, the increased interest in defensive equity plays means that investors and allocators are keen to the notion that the domestic equity market is in the late stage and volatility is heightening, with Segal Marco's Barron borrowing an anecdote from Bridgewater Associates Partner and Co-CIO Robert Prince, "It's not time to leave the party yet, but you might want to be standing close to the door."

% Ranking of Valuation, Profit Margin, Return on Equity & Price Momentum



Source: Cambridge Associates, As of Nov. 30

Investors And Allocators Look Abroad In Search Of Higher Returns, Focus On Emerging Markets

As sentiment for domestic equity hovers somewhere between cautiously optimistic and bearish, investors are looking globally as valuations are more attractive with emerging markets equity and Eurozone stocks being down more than 10% in 2018, according to allocators and investors.

"If the Fed isn't going to move as aggressively as people think, that coupled with less upward pressure on the dollar is more favorable for emerging markets' outlook, where you have more attractive valuations that have gotten beat up in 2018," Disciplina's Arsenault said. "The same can probably be said for Europe as there is a lot going on in terms of Brexit negotiations and discussions between Italy and the EU. Sure, some risk factors have been priced in, but there is negativity in the market, and deservedly so. However, we like to zig when everyone else is zagging. Valuations are more attractive and negative sentiment argues to increase allocations in some of the beaten-up asset classes."

The Northeast cio amplified the optimistic sentiment for emerging markets saying, "I think emerging markets is the place to look, not just now, but for the next ten to 20 years and beyond. We're actually thinking of increasing our target and allocation to it next time we review our investment policy."

SEI's Bobyock sees emerging markets equity as one of the few levers that can be used by institutions to get their return assumptions north of 6.5% to 7%.

"Our developed international forecast is not far from it either and because of lower valuations, there is room to grow on the developed side with less volatility," Bobyock said. "We favor the smaller companies, smaller country kind of implementation in the emerging markets space because it gets us a little bit more of a return that way."

Barron, who finds that generally investors are underweight emerging markets relative to their long-term potential, sees the space as particularly attractive for strategies that actively select countries and companies that will benefit from long-term growth and improvements of technology. Barron noted that China is still an attractive area, despite its slow down in growth as it remains roughly twice the rate as the rest of the world.

"When thinking about what the world will look like in five to 10 years, China will have its bumps, economies always do, but an upward sloping trajectory seems likely," he said.

Deutsche's Puri carries a bias to Asian emerging markets as some investors' more negative sentiment does not reflect the actual situation of high earnings expectations and lower valuations coupled with growth potential in some sectors.

Rockefeller's Falls is also drawn to China as the country has focused less "on brute GDP" and seen an increase in individuals' income.

"What I've been hearing from a lot of equity managers is a focus on return on capital and companies with good margins," Falls said. "It also looks like there's a renewed sense of strategic leadership and low cost companies. Of course, there have been pockets of overvaluation and frothy value, but I think in general it has sold off a fair amount and there are some good companies that increasingly good money managers can take part in."

Falls also made the case for opportunities in Japan, noting that "it's not a badly-performing market recently, but it has corrected and corrected from a pretty low state."

That correction has provided opportunity from a valuation standpoint, which is also bolstered by the country's "focus on better utilization of balance sheets and corporate governance."

FEG's Dowling finds that emerging markets' attractiveness "is going to be contingent somewhat on trade and the dollar. If we do have a pause in the Fed raising rates after March, perhaps the dollar stabilizes sometime in 2019 or declines and that would be a tailwind for emerging markets as long as there is not an all-out trade war. You have to watch dollar strength and watch trade wars."

Dowling notes that while the asset class is not without risk and timing can be difficult, he expects the latter half of 2019 might be when emerging markets experience positive momentum.

Deepak Puri

"The forecast for emerging markets is never going to be mid-single digits, it is an all or nothing asset class," Arsenault said. "It's an asset class that argues for making some tactical moves and while we're still long-term investors, given where valuations are and negativity that's been absorbed, valuations can be a bit better in 2019 than where they are now."

Muted Returns Expected For Fixed-Income

Investors' optimism for fixed-income is increasing with return projections slightly up as investors and allocators identify the need for downside protection in the face of volatility in the economic cycle's later-stages.

"In 2019, the 10-year treasury is probably at the best starting point in terms of yield that we have seen in the last five years, since the taper tantrum in 2013," Arsenault said. "With the higher starting point, you could argue treasuries could do a little bit better of a job as a shock absorber in portfolios."

Beyond a more positive starting point for treasuries this year, investors see room for yields to increase.

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"I think that with the 10-year and 30-year treasury around 3%, and especially if they get closer to 4%, I actually don't think that's a bad trade," Falls said. "I could see treasury type bonds go up a little more from here. Unless we get really unexpected news on the inflation side, I think we're sort of heading towards a place where treasury bonds look not bad to me."

A similar sentiment was echoed by Deutsche's Puri, who sees treasury bills as additive for investors' portfolios, particularly in the short-term.

"Over [the] last 10 years, it was pretty much the worst time to be a saver," Puri said. "Investors weren't making any money in their savings accounts. All of a sudden, a three-month T-bill is paying a 2% handle and after a bit more time, an investor could get 2.5% to 3%, which is really not bad. If an investor's return expectation is 6% and he or she can get 3% in a very low volatility fixed-income allocation, that should be a good thing."

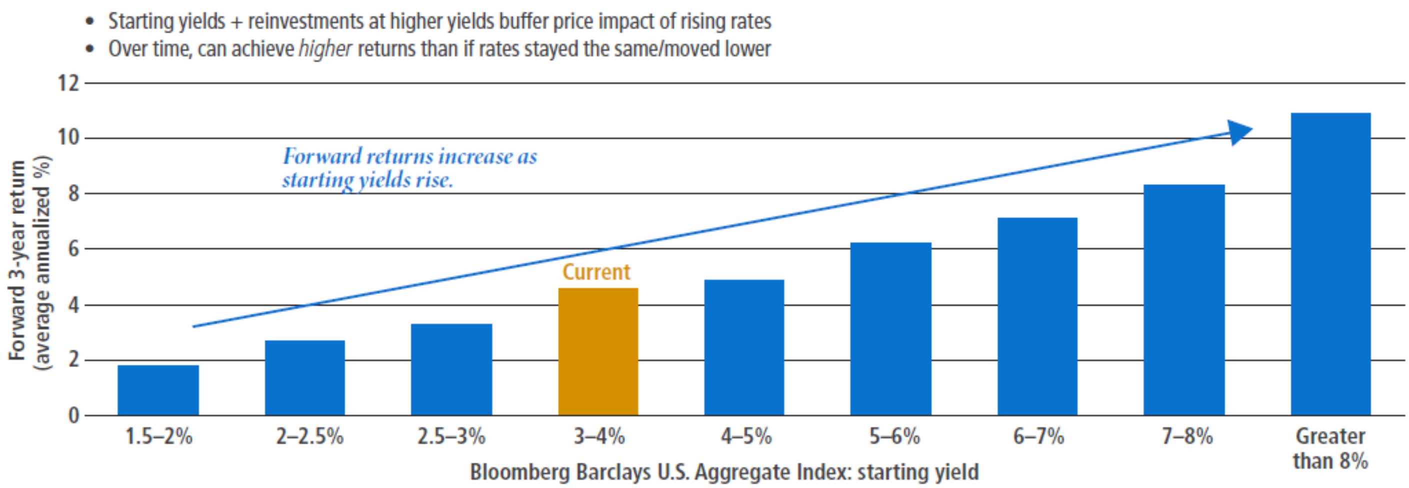
Dowling suggests taking a bar bell approach with simple and liquid strategies, such as treasuries or an aggregate strategy on one side and more complex and private strategies on the other.

"Because of our debt issues in the U.S, we have seen a significant increase in treasury issuance and the percentage of treasuries in the Agg has gone way up," Dowling said. "If you have a skillful manager who can be nimble, they should be able to add a few basis points over the Agg by taking prudent risk. It makes a lot of sense right now to be active, but still keep it simple. Institutions should not try and swing for the fences, rather try and add some incremental alpha through active management."

He noted that for that idea to be unsuccessful, it would take a "a tremendous flight to quality because the treasury issuance and because of the extension of duration."

J.P. Morgan's compound return assumptions for U.S. Long treasuries have increased to 3.25% in 2019 from 2.5% in 2018, according to its 2019 outlook report. Projections for U.S. Aggregate bonds are slightly higher with

Do Higher Starting Yields = Higher Potential Returns?



Source: PIMCO

a projected compound return of 4%. Leading the firm's assumptions domestically are high-yield bonds with a 5.5% compound return, while internationally emerging markets local currency debt is pegged at a 6.75% compound return.

While many investors and allocators interviewed utilize U.S. treasuries as an insurance policy and cushion, some have moved more of their fixed-income portfolios to cash as an area to gain positive yield and capitalize on the markets' recent shifts.

"What we've been looking at in the last six months to a year is viewing cash from a better return perspective than treasuries, so we were more overweight cash than treasuries in that category," Agatone said. "That has come in handy now that volatility has returned, which is what we were hoping to use it for. Seeing volatility and market declines starting in October and November has allowed us to put money to work at attractive valuations and entry points."

Kristin Agatone

FEG's Dowling sees cash and liquidity as particularly useful in the coming years, saying, "I think there are some great opportunities to use liquidity coming up in 2019 or 2020. Maybe there is an opportunity in high-yield or distressed, there isn't now, but maybe you can deploy that capital to those opportunities down the line…Having some dry powder, earning some yield, and when you can take some illiquidity, take it to maybe do some private debt or lending types of strategies."

While treasuries can be viewed as ballast for institutions' portfolios and cash as an opportunity to enter downtrodden or stressed segments of the market, institutions must concentrate efforts on determining what role fixed-income plays in their portfolio and what strategies fit that agenda.

"For a lot of people, fixed-income is used as their base through some of the aggregate index in the U.S. or globally and it behooves investors to ask the big question, 'why do I own it,' and build a portfolio that is designed to do what is needed as opposed to trying to outperform an index," Barron said.

Honing in on fixed-income's purpose in an institutional portfolio is crucial to ensuring that the strategies are not dilutive to the goals of providing grants and support for public agencies and charities, particularly in a rising rate environment.

The Federal Reserve announced on Dec. 19 that it increased the interest rate to a range of 2.25% to 2.5%, from its previous level of 2% to 2.25%. The move marked the fourth increase of 2018 and the ninth since it began normalizing rates in December 2015.

"The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook," the Federal Open Market Committee said, in a statement (https://www.federalreserve.gov/monetarypolicy/files/monetary20181219a1.pdf).

Outside of core fixed-income approaches investors and allocators have identified emerging markets debt as particularly attractive.

"We really like emerging markets debt as a return diversifier for equities. We have about a 6% return expectation for EMD with 25% less volatility," Bobyock said.

For institutions to truly excel in the emerging markets, they need to have strong manager selection, security selection and country selection, according to Bobyock, who strongly recommends active strategies in the space as an opportunity to gain more control of the investment and manage risks.

Disciplina's Arsenault finds that many investors find emerging market debt as an attractive space driven primarily by the credit valuations, which took a further hit as volatility picked up in the last few months.

"We would have a slot nod to emerging market debt. We think you'll get paid back and having the higher yields is a great thing from that regard," Barron said, adding that due to the difference in currency performance, preference to the strategies goes to U.S.-denominated exposure at this time.

Barron noted that higher yields and valuations are not the end all be all, providing high-yield fixed-income as an example.

"We think now is not the time to be too risky there," Barron said. "You don't want to stretch the envelope in any risk asset given how late we are in the cycle."

Lehigh's Agatone expressed similar caution saying that the corporate credit and high-yield markets are being priced so tightly that the risk-return profile is not attractive at present.

Despite the negative sentiment toward high-yield, Arsenault sees the high-yield bond market as in good shape, particularly from a composition standpoint, with around 50% of the market being BB rated and around 12% CCC rated.

"The credit quality is as good as it has been in quite some time," Arsenault said. "Now the reason for that is because the garbage is going to the bank loan market due to the insatiable demand from structured credit buyers and financial advisers. A lot of money has been flocking to the asset class and forcing managers to put capital to work. As that happens, underwriting standards tend to deteriorate."

Institutions Continue To Look Beyond Traditional Fixed-Income Strategies

Some institutions may choose to take risk elsewhere in their portfolios in search of higher returns, with private credit receiving attention because it tends to have cash yield, a shorter duration, floating rates and attractive risk-adjusted returns, investors and allocators said.

Rockefeller's Falls sees near term risks for credit with a possible "significant downside event in credit potentially in the next 6 to 12 months" especially as fewer banks are lending and more direct lending has occurred.

"When credit spreads widen, that's when you see bankruptcies increase," Falls said. "If everyone can refinance, then no one goes bankrupt. If you can't refinance, then the weaker credit starts to go and that injects more risk premium in the market and it becomes a more self-amplifying trend until you get to a point where you really get good prices and compensation for those weaker credits. That's a good time to invest."

Falls finds the real opportunity may come in smaller and middle-market companies, as there appears to be a lot of leverage in the companies.

"I think they may have trouble rolling over and then you'll start seeing bankruptcies go up and credit spreads widen, and we want to be ready to step in," Falls said. "I wouldn't be doing it now, but I see opportunity sooner than later."

The Northeast cio does not expect the credit downturn to happen as quickly, but is "looking forward" to stress in the credit market to allocate more capital and add real return to the portfolio.

The cio has no concerns with it being the end of the cycle as the potential investments are "senior secured, top of the capital structure" with "a nice coupon." The cio noted that many of the managers they would like to invest with aren't raising money at the moment.

"There is going to be good outcomes and bad outcomes. If it's a good loan or a good company that will come back eventually, that's a technical market issue," the cio said. "There are companies out there that have gotten too much leverage and because people haven given more senior leverage to a company doesn't mean it is okay because it's senior. How far down does that attachment fully go and where is your risk of loss?"

Lehigh's Agatone also advocates for institutions to look at alternative credit or illiquid credit as the strategies can provide a yield component to help de-risk a portfolio in unfavorable periods. On the private credit side, she has focused in on niche credit plays that are highly secured.

"It is a very narrow market where there is a lot of underlying collateral and you are not necessarily as exposed to corporate default rates," she said.

Credit quality cannot be understated in the late-stage of the cycle, according to Puri.

"For years, we were going lower on the credit spectrum to get higher yields. It was advantageous to be short duration and buy high-yield or emerging market bonds. Quality was not something that the average client was differentiating, as there wasn't a big difference between a BBB and an A minus rating. Returns were pretty close, so no one bothered to pay close attention to underlying credit quality. That has changed and quality names are really coming back," he said.

Dowling contends that now is not the time for investors to go with a first-time fund, with the better option being a team of expert providers who have been through multiple market cycles and have experience working out of downturns.

Greg Dowling

"You're going to earn extra yield and maybe you get low to mid-single digits on your liquid side and maybe high single digits to low-teens on your private side," he said. "You average those together and you have a pretty good return."

While private credit appears to be an attractive area for investors when they can partner with the right manager, others warn of the danger the strategies may hold as investors crowd the opportunities.

"In an environment where it has been a while since we've had to worry about risk, even if you get paid less, you're still getting paid to take a moderate amount of risk," Barron said. "That doesn't continue forever and one of the reasons why you take the risks is to be reasonably rewarded. An important lesson is to look to the reasonableness of the reward that you're getting relative to the additional risk you're putting in a portfolio for private investments."

Arsenault has found that with private strategies like direct lending, "Performance chasing has caused people to flock to the space where you have new lending mandates popping up every day. I think a lot of that has been driven by underfunded public pension plans that are looking for income in different ways to fill in returns and sort of grasping at straws."

While he views the returns of the strategies as asymmetric, he finds that with all of the money flocking to the space, "underwriting standards and pricing terms" cannot be nearly as robust as they were previously when coming out of the global financial crisis.

Being in the later stages of the credit cycle proves to be an opportune time for investors to stress test their portfolio allocations and make sure they are not overweight credit, as it can creep into a portfolio , according to Bobyock. She suggested institutions look at their directional hedge funds, long/only, high yield, structured credit, private investments and short-term fixed-income areas.

Ultimately, investor and allocator expectations for the public equity and fixed-income markets leave them short of their spending needs. Adding private equity and credit and other fixed-income surrogates may help them along the way, but there may still be gaps in the portfolio, which is "where alternatives come into play," according to Bobyock.