CAMBRIDGE C|A ASSOCIATES

VantagePoint

Second Quarter 2014

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VantagePoint is a new quarterly publication from our Chief Investment Strategist summarizing C|A's total portfolio advice.

Advice in Brief

- Review portfolios to prepare for the prospect of continued tapering and ultimate tightening of monetary policy. Income-oriented assets that benefitted the most from quantitative easing are likely to be hurt the worst as monetary policy normalizes, particularly those assets that remain expensive today.
- Exercise caution in credits by favoring other diversifying assets, such as low equity beta hedge funds.
- Pull back on US equities (if you have not done so already) and overweight cheaper markets, namely emerging markets and European equities.
- With regard to emerging markets equities, we would leave room to increase allocations on further weakness, which should be expected as China's economic growth slows.
- Stay neutral on Japanese equities for now absent adequate progress on structural reform and valuations that are neither demanding, nor particularly cheap.
- Substitute a portion of deflation-hedging and inflation-sensitive mandates today with cash, natural resources equities, and leveraged loans.
- At the same time, actively monitor sovereign bonds, commodities, and inflation-linked bonds for more attractive entry points to move back to policy allocations.

Published April 17, 2014

We have been focused on several key themes, most notably the difficulty in meeting return expectations given high starting-point valuations across the risk spectrum and the evolution of global monetary policy, particularly with the US Federal Reserve "tapering" and potentially tightening policy while other central banks (notably the European Central Bank and Bank of Japan) may be poised to further ease policy. Such divergent monetary policy will continue to impact global markets in various ways, as will asset class valuations.

This publication provides an update on our checklist of important investment considerations for 2014[1] and our views on where we find value with a focus on our current investment advice. In short, we continue to find very little that is deeply undervalued, causing us to focus on relative value. We continue to recommend underweighting US equities, the most expensive market today, and putting the capital to work in cheaper markets like emerging markets and European equities. We remain cautious on credit and continue to recommend substituting a portion of deflation-hedging and inflation-sensitive mandates today with cash, natural resources equities, and leveraged loans. Finally, we would actively monitor sovereign bonds, commodities, and inflation-linked bonds for more attractive entry points to move back to policy allocations.

Checking the Checklist

Review the portfolio to make sure it is not too heavily exposed to assets that would be vulnerable to a rise in interest rates

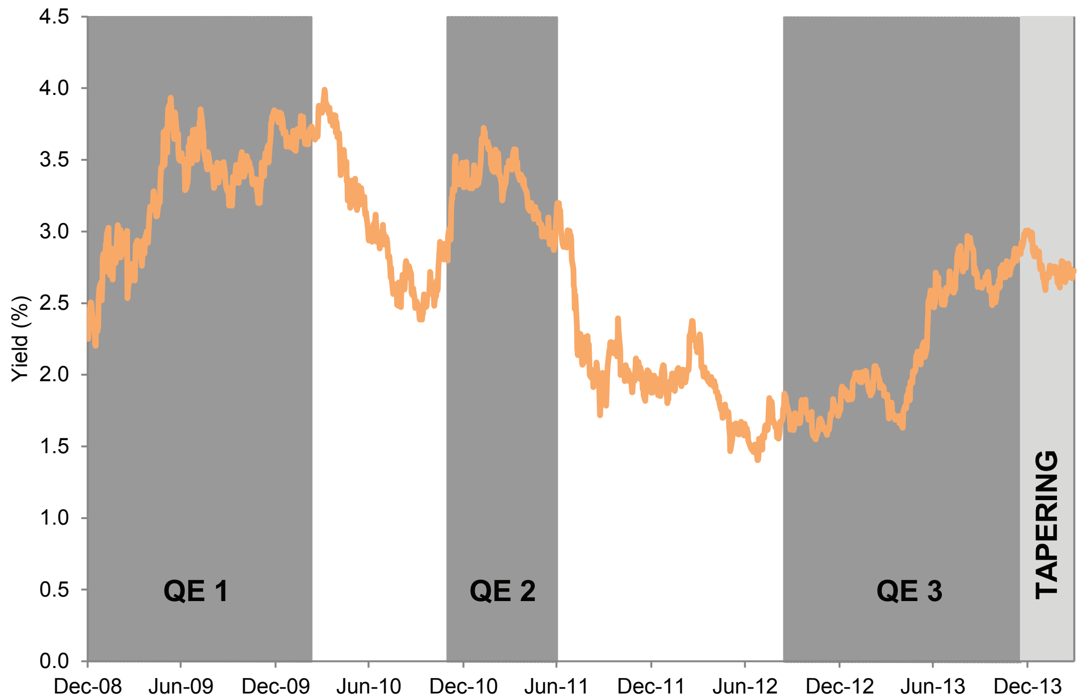
Continuing a familiar pattern, the benchmark US Treasury yield is down 30 bps year-to-date through the end of March. After each round of quantitative easing has come to a close in the United States, rates have fallen as the economy showed signs of softening (Figure 1). We are seeing the same phenomenon today as the Fed has been reducing asset purchases.

Dovish comments by new Fed Chair Janet Yellen suggest that rates could stay low for some time, with the labor market as a major concern. Unemployment has been falling, nearing the 6.5% target that the Fed had set as the point at which it would begin raising interest rates. However, as widely expected, the Fed revised this guidance, in large part because the labor force participation rate has also fallen. Forward guidance from the Fed is now more qualitative and subjective. Low inflation (1.5% year-over-year CPI in March) gives the Fed space to keep rates low for the time being. Fed funds futures price in a slow increase in rates consistent with FOMC member expectations—sub-1% rates for about two years.

Despite this dovish bias, markets may be volatile, as we saw when Yellen indicated that the first rate hike could be sooner than markets had been expecting—a position she later reversed. We don't have particular insights into how expectations for tight-

[1] First introduced in our Outlook 2014: *Our View on 2014: It's All Relative.*

Figure 1. US Ten-Year Treasury Yields During Periods of Quantitative Easing
December 31, 2008 – March 31, 2014



Source: Thomson Reuters Datastream.

ening will change over time and think it best that investors review portfolios in the near term and make appropriate adjustments.

Income-oriented assets that benefitted the most from quantitative easing are likely to be hurt the worst as monetary policy normalizes, particularly those assets that remain expensive today. Vulnerable assets include investment-grade and high-yield credits; REITs; utility-heavy, low-volatility equity funds; and some high–dividend yield equities. US high-quality equities (defined as equities with low leverage and stable profitability and earnings), while expensive, are more attractive.

While emerging markets equity, debt, and currencies may be vulnerable should liquidity dry up more or faster than currently anticipated, equity markets at least price in a heavy dose of skepticism, providing a margin of safety for long-term investors. In contrast, EM local currency debt and EM currencies as a whole are fairly valued. We are neutral on EM currencies as a whole as we view the "average" EM currency as fairly valued, though some countries with weaker fundamentals have fallen to undervalued levels. While EM currency fundamentals are stronger today than in the mid-1990s, we continue to view EM currencies as vulnerable in the near term. Similarly, while valuations for EM local currency bonds have improved, we are reluctant to recommend investors overweight exposure to index-like allocations (i.e., the GBI-EM GD) given the market is merely fairly valued and has significant exposure countries such as Brazil, South Africa, and Turkey that have currencies likely to adjust further to help close current account deficits.

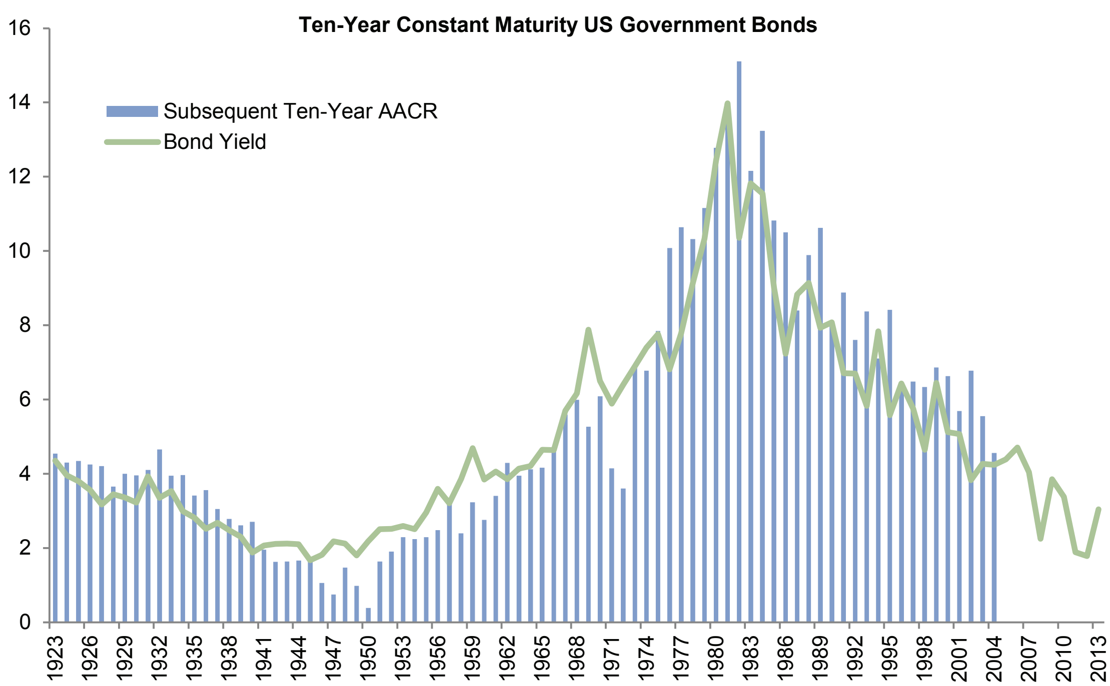
Be careful in credits

Low yields mean many assets with a fixed coupon are likely to provide subpar returns over the medium and long term. Beginning point yields are the most important determinants of subsequent returns (Figure 2). As of the end of the first quarter, yields on US investment-grade (3.1%) and high-yield bonds (5.2%) are at their lowest levels since our data begin in the 1970s and 1980s, respectively, while credit spreads are well below average. The case is even worse for euro-denominated credits, with slightly higher spreads, but lower base rates, for a yield to maturity of only 1.8%.

While 5.2% yields on high-yield bonds may seem appealing in a low-rate environment, it is important to remember that defaults can dampen returns meaningfully. Default rates actually fell last year as low rates and liquidity allowed issuers to refinance, pushing maturities out and improving interest coverage ratios. However, leverage is modestly rising and the share of new issuance for funding acquisitions and buyouts has picked up. Should this continue, credit quality is likely to eventually suffer. Investors are not being compensated for credit risk today.

Perhaps of more concern to investors that use credits as safe assets is the diminished liquidity in fixed income markets. Dealers have stepped back from making markets in fixed income given tighter bank regulations, capital constraints, and new approaches to risk management in recent years. Inventory is now nearly 70% lower than what was typical prior to the Global Financial Crisis and is focused on the most liquid/

Figure 2. Bond Yields and Subsequent Ten-Year AACRs
1923–2013



Sources: Federal Reserve, Global Financial Data, Inc., and Thomson Reuters Datastream.
Notes: Based on annual data. The last full ten-year period was from 2004 to 2013.

high-quality issues. Further, the potential for more selling under stress has risen given the sizeable run-up in credit holdings through more liquid and retail-oriented mutual funds and exchange-traded funds (ETFs) (Figure 3). Investors in solid credits that can buy and hold should be fine. The real question here is the fit between an investment mandate that requires high liquidity and relative stability and an asset that might show limited liquidity and mark-to-market risk in the near term under stress. It would be sensible for investors to reconsider if their assets would be better positioned in more liquid bonds or if they would be able to ride out mark-to-market volatility.

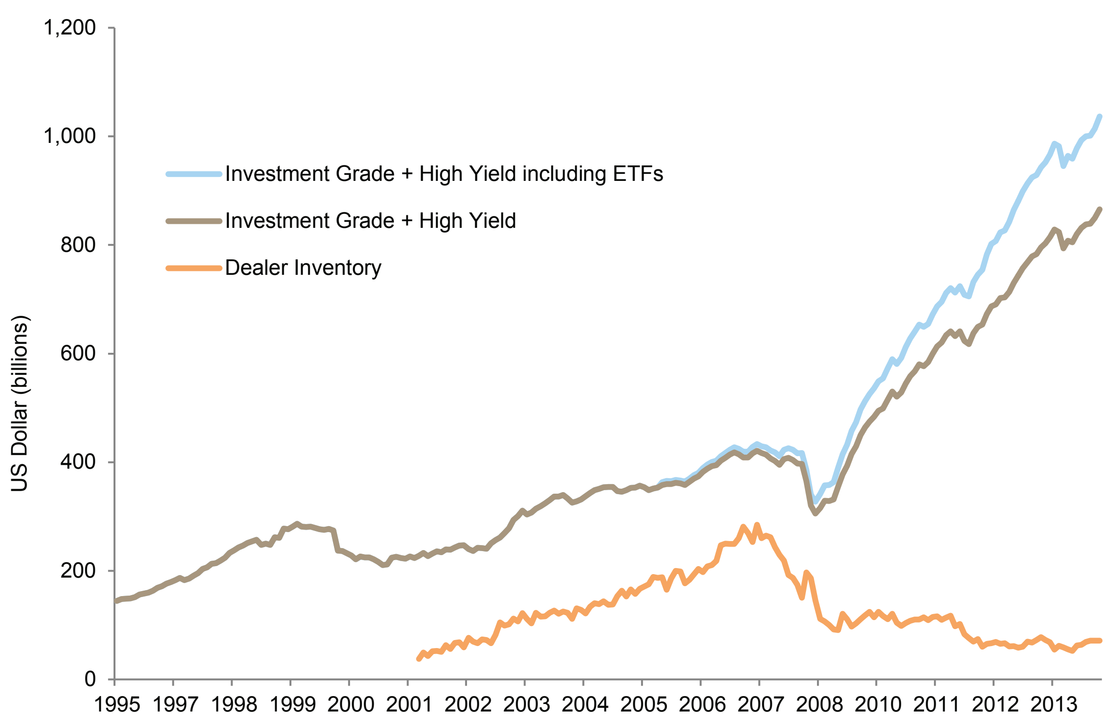
In general, we prefer keeping more defensive, deflation-hedging mandates in high-quality sovereign bonds and cash. And we prefer diversifying exposures such as US high-quality equities, long/short hedge funds, and certain other lower-equity beta, less-credit-dependent hedge fund strategies to credits today.

Put US equities on a valuation watch list

US equities are the most expensive equity market and remain vulnerable to disappointment. The composite normalized price-earnings (P/E) ratio is now 21.6, which is 33% or 1 standard deviation above fair value.[2] Relative to other developed markets, the US market trades at a 46% premium, an extreme level compared to the average

[2] The composite normalized P/E ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings.

Figure 3. Credit Mutual Fund Assets vs Dealer Inventory
January 31, 1995 – February 28, 2014



Sources: Barclays, Federal Reserve, Moody's Investor Services, and Thomson Reuters Datastream.

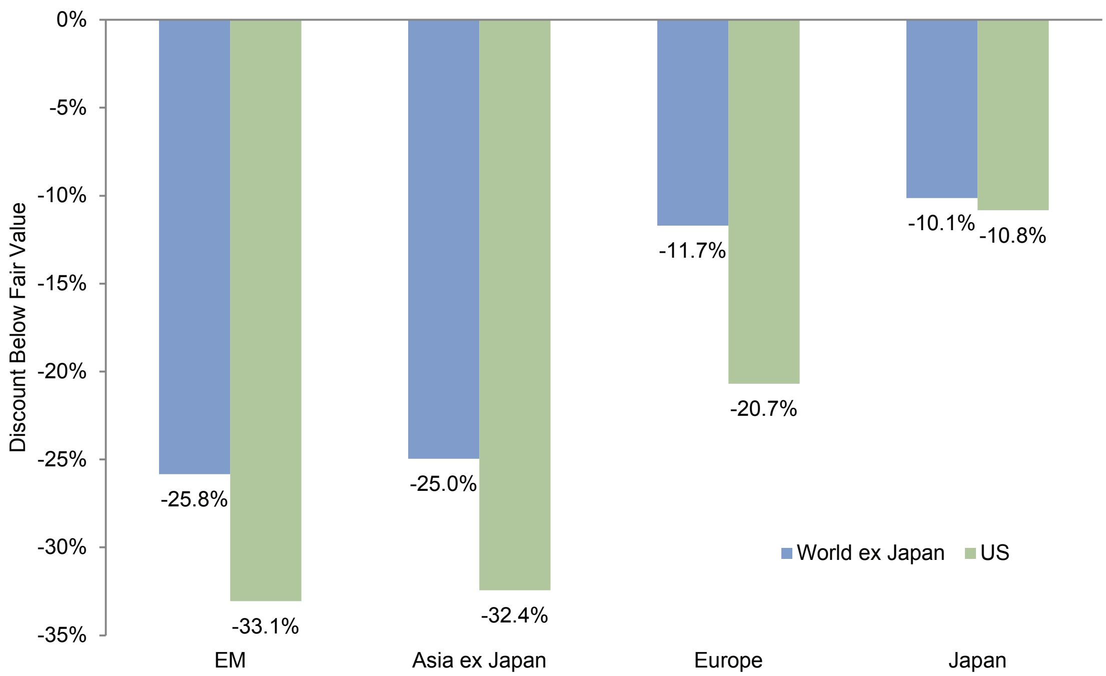
post-1972 premium of 10%. US equities have benefitted from relatively healthy economic conditions and strong earnings growth compared to other markets. Indeed, as interest in emerging markets waned last year, US equities have been the biggest beneficiaries. Since the start of 2013, investors have placed over $300 billion into ETFs and mutual funds invested in developed world equities while pulling out around $100 billion from emerging markets funds and ETFs. Nearly half of the flows ($152 billion) went to US-dedicated vehicles.

Will US equities continue to benefit from safe-haven status? If January serves as a guide, we have some doubts. US equities often outperform in down markets, partly thanks to a countercyclical US dollar. US equities dropped more than European equities during the January sell-off, losing 3.4% compared to 2.2% for the MSCI Europe Index. We are seeing the same pattern as we go to press in the March/early April market sell-off. The underperformance of the US market, despite more solid domestic economic conditions, highlights that US equities have reached valuations that leave them especially vulnerable to disappointing news. A swath of "new" technology and health care companies that dramatically outperformed the market overall for the last several years sold off sharply in late March. For example, from September 30, 2011, through February 28, 2014, the S&P 500 appreciated 65%, while the S&P Biotech Index soared 175%. This context sheds some light on the sector's sharp decline of 28% in just over one month (from the February 27 high through April 14). Stretched valuations made the sector more vulnerable to bad news.

Equity returns come from earnings growth, dividend yields, and multiple expansion or contraction. While dividends presumably could increase from here, they are right at their average over the last 20 years and leave little room for boosting returns. Further, earnings are at all-time highs, nearly 20% above peak levels seen in 2007 during the last market cycle. Profit margins are also at historical peaks. In fact, with earnings up 16% for the S&P 500 last year, multiple expansion drove 12 ppts of the 30% rise in S&P prices. With earnings at historical highs, interest rates near historical lows, and already-stretched valuations, it is difficult to come up with a thesis for continued multiple expansion. Of course, in the short term, markets don't need a solid thesis. They can continue to run on momentum and optimism, but ultimately the gravitational pull of valuations will prevail. At five years, this bull market is getting long in the tooth.

Today we recommend an underweight to US equities versus both European and EM equities, which currently have wide relative valuation gaps (Figure 4). Within US equities, we recommend underweighting small caps, and maintaining tilts to quality equities. Should US equities reach very overvalued levels, defined as 1.5 standard deviations above fair value, or about 12% higher than current valuations, we would recommend a more meaningful reduction in US equity exposure as well as further tilts toward cheaper, more defensive sectors within the US equity market.

Figure 4. Excess Discounts vs World ex Japan and US Equities
As of March 31, 2014



Source: Thomson Reuters Datastream.
Notes: Excess discount refers to the current discount minus the implied "fair value" discount for each region. Japan discount based on P/B ratio.

Monitor Japanese equities for cheapness and watch for progress on structural reform

Japanese equities have had a rough start to 2014, cheapening valuations. Despite this, we remain neutral on the equity market.

From late 2012 through the middle of last year, hopes ran high that Abenomics would finally serve as a catalyst for a new dawn in Japan, reviving inflation, economic growth, and corporate profitability. Indeed, propelled by quantitative easing, the yen weakened considerably in 2013 on a trade-weighted basis. CPI increased 1.6% year-over-year (its strongest showing since 2008) and earnings grew 81%, albeit from a low base.

While 2013 started off with strong GDP growth, by the fourth quarter it sank to 0.7%, and this includes strong personal consumption as households frontloaded their purchases in advance of the consumption tax increase effective on April 1. Further, fiscal policy should drag on growth given the government's goal to cut the budget deficit in half by 2015. At the same time, Japan's current account position has deteriorated, as the increase in imports and weak exports have put pressure on Japan's trade balance. Should deterioration continue (whether through trade or capital net outflows), interest rates could come under pressure as the country would become dependent on foreign investors to finance its country's huge debt burden.

We believe the Bank of Japan will ultimately do more to support growth, possibly changing the mix of QE down the road by purchasing more equities. There are also some possible positive technical forces, like increased equity purchases by the $1.2 trillion public pension fund, GPIF. Domestic households and corporations, also underinvested in equities, may follow suit. Structural reforms have been coming, but are the most difficult policies, as seeking to influence behavior is difficult and takes time. There is much to be gained from unlocking value in Japanese companies that have suffered from persistently low returns on equity compared to emerging markets peers.

On balance, we see better opportunities in emerging markets and European equities and prefer to wait and see if earnings growth persists and ROE continues to improve. To date, we have not seen enough progress on structural reform to act at current valuations, which are neither demanding, nor particularly cheap. Should we see signs of such progress along with inexpensive equities relative to the improved outlook, we would become more constructive. Today, we remain neutral on equities. However, we are more constructive on global or international equity managers that maintain an overweight based on bottom-up stock selection.

Monitor deflation-hedging and inflation-sensitive allocations that serve as liquidity or spending reserves

Protecting against such macro risks remains expensive today, leaving investors to consider the least bad options for implementation. As a result, we continue to recommend minimizing holdings to the lowest acceptable level of protection today (roughly two years depending on investor circumstances).

High-quality sovereign bonds remain overvalued, supporting our recommendation to hold some cash as a part of the sovereign bond allocation and monitor yields to dial up and down the cash allocation as bonds become richer and cheapen, respectively. As investors are on watch for tightening in a number of developed markets—most notably the United States and the United Kingdom—should growth surprise to the upside or unemployment to the downside, yields could easily spike, providing an opportunity to overweight exposures at more attractive prices. We recommend setting up a process to quickly move should bonds reach fair value, as markets may move quickly. We regard the ten-year US Treasury as fairly valued at 3.7%, but would begin reducing cash positions at yields of roughly 3%, the low end of our fair value range. For US taxable investors, we would maintain allocations to muni bonds, even as they have become slightly rich this year. Ten-year muni yields ended the first quarter at 2.55%, right at the bottom of our fair value range.

Similarly, implementation of liquid inflation-sensitive assets has been challenging. Commodities and inflation-linked bonds remain expensive. Commodity spot prices are elevated, and cash collateral yields are paltry, although the yield from rolling futures has improved, turning positive on a trailing 12-month basis for the first time in a decade. We continue to favor natural resources equities and leveraged loans to more inflation-sensitive assets like commodities and inflation-linked bonds since valuations are far more compelling. However, we are watchful of credit quality on leveraged loans. Record new issuance levels ($176 billion in the first quarter, the third-highest quarterly total ever) suggest markets are becoming less discriminating, although nearly two-thirds of this was used for refinancing, keeping default rates low for now. While the United States has begun tapering, central bank balance sheets remain bloated. As such, we continue to recommend holding a small allocation to gold, in place of a broader commodity allocation. Should policy rates rise faster than currently expected, gold would be vulnerable, as has consistently been the case. Finally, the cash used as a sovereign bond substitute can serve double duty as a source to support spending and other liquidity needs in the event of inflation. This could allow for a reduction of the combined deflation and inflation protection allocation. We would reallocate such capital to diversifying positions (e.g., hedge funds with low equity beta).

Where's the Relative Value Today?

As is typical, markets with the most macroeconomic risk are the least expensive today—European and EM equities. With regard to Europe, as the Eurozone has exited recession and UK GDP growth has strengthened, macro concerns have remained in check. At the same time, European equities are fairly valued, but cheap relative to expensive US equities. At a 31% discount compared to the average discount of 11%, European equities are at their cheapest level in relative terms since the 1970s. Our suggested overweight to Europe also applies to the United Kingdom, where relative valuations are comparable.

Low relative valuations are even more attractive in the context of the relative earnings environment. European earnings remain 30% below their high in the previous market cycle in 2007, while US earnings are 18% above prior peaks. Further, profit margins in Europe remain depressed at roughly half of those in the United States. We are likely reaching a point at which European earnings must deliver to prevent investors from de-rating equities after a third year of earnings contraction. We are closely monitoring whether European profits can rebound this year, which could be challenging if EM growth remains slow. (Emerging markets account for roughly 30% of European corporate revenues.) Further, non-euro investors should hedge euro exposures, as deflation pressures may push the ECB into action at a time when the Fed and Bank of England are moving toward normalization of policy rates. Hedging would also provide some protection if the large wave of capital that has flowed into European assets were to reverse. We believe expensive European sovereigns and credits are more vulnerable to capital outflows from offshore investors than are equities.

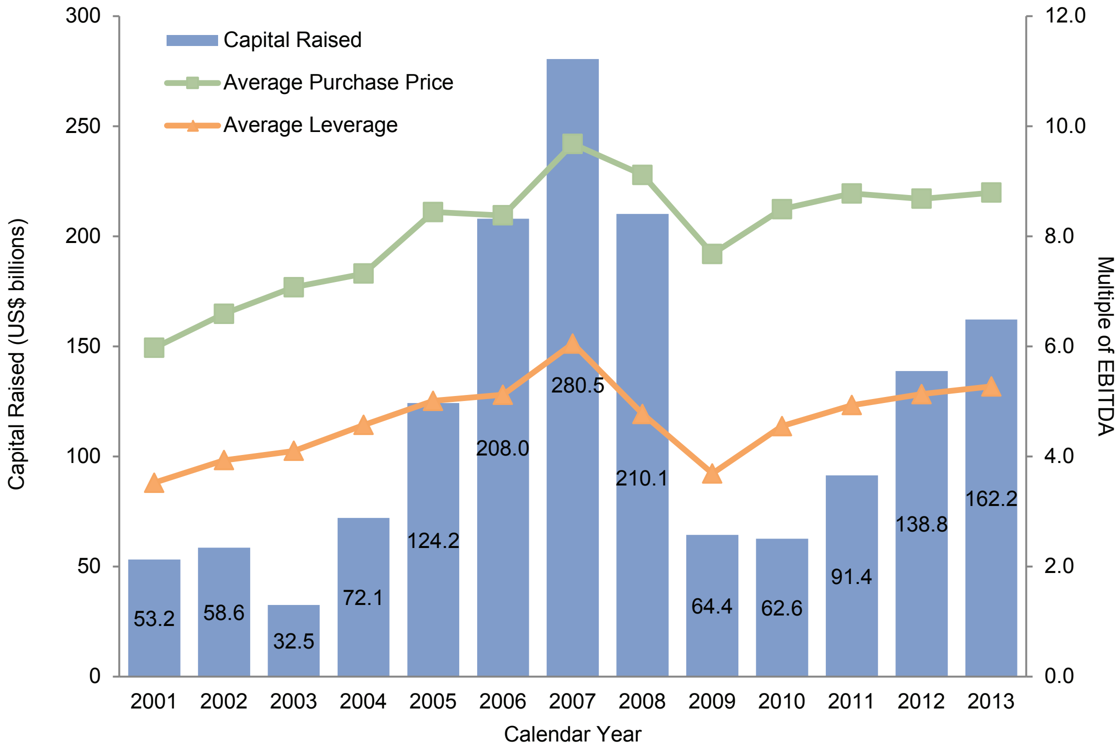
EM equities are the most undervalued equity market today. Normalized valuation metrics fall below our fair value range and relative valuations offer a discount of 37% to developed markets equities and a 43% discount to US equities (compared to a fair value discount of 10%). However, macro headwinds continue to give us pause. Using managers that consider country risk as part of their investment process can be helpful in navigating the environment. In particular, the EM landscape has become increasingly divergent. The possibility of dislocation in Asia, particularly given the potential for rising rates in the region, as well as China's focus on slowing growth by reining in fixed investing, suggests potential stresses on the horizon. Over the intermediate to long term, we expect emerging markets will benefit, but along the way, having managers that can offset the risk in any emerging markets value play by capitalizing on such disruptions should provide helpful diversification. Examples include distressed credit funds that can benefit from "special situations" and private equity managers that will be disciplined in investing over any potential economic downturn to reap the benefit of the eventual recovery.[3]

Like their public market brethren, US private markets are among the most expensive on the whole, while Asian markets offer the best value. Of course, active management is paramount regardless of geography. Large buyouts are particularly expensive across the globe. In the US market, small-cap buyouts, with enterprise values below $500 million, offer the best value. Total capital raised has increased over the last five years, while easy access to cheap debt has pushed leverage multiples and deal volume higher with the expected result is that purchase price multiples are above average across the spectrum (Figure 5). Further, the discount has narrowed between the lower middle market and large-cap buyouts. S&P reports that in the United States, the nine deals with enterprise values between $250 million and $499 million had an average purchase price multiple (PPM) of 8.1 times EBITDA, compared to 9.6 times for the 26 deals above that range (these data are somewhat thin). With a lack of very large transactions that were common at the peak of the last cycle, more capital is searching for deals in the mid- and large-cap sectors, pushing up PPMs across the spectrum. We would continue to selectively commit to top-quality managers that possess the ability to improve value through operating skill, while resisting the temptation to scale commitment size with manager fund size.

Late-stage and expansion-stage US venture is also overvalued. Disclosed median pre-money valuations for later-stage deals finished 2013 at historic highs, while expansion-stage valuations have steadily increased since 2010. The good news is that capital already in the ground has had a ripe exit environment, with first quarter 2014 venture-backed IPOs (36 IPOs raised $3.3 billion) reaching their highest level in nearly 15 years. However, the sharp decline in some segments of technology and health care in recent weeks raises questions about the continued strength of IPO exits.

[3] For a more detailed overview of our thoughts on emerging markets investing, please see our February 2014 report *Emerging Markets: Navigating Through Rough Waters*. And for thoughts on Chinese credits, please see our April 8, 2014, Research Brief *Chinese Credit Problems Arise*.

Figure 5. US PE Commitments, EBITDA Purchase Price, and Leverage Multiples
2001–13



Sources: Cambridge Associates LLC, Dow Jones & Company, Inc., and Standard & Poor's LCD.
Notes: Data are as of December 31, 2013. Purchase price multiple is defined as enterprise value over EBITDA and leverage multiple is defined as net debt over EBITDA.

Within hard assets, real estate and private energy remain fairly valued and continue to offer opportunities for investment with best-in-class managers. Within real estate, private investments in non-core real estate offer the least worst valuations. As has been the case for some time now, the lure of cash-flowing core assets in major markets has kept them richly bid, resulting in substantial yield compression. As economic activity has improved, momentum has been building farther up the risk spectrum, with capital increasingly flowing to secondary markets where the recovery of asset prices lags relative to core properties. Overall, the best long-term opportunities may be found by managers with the ability to address physical or capital structure deficiencies and rebuild a cash flow stream.

In US private energy, we continue to see opportunities across the value chain; however, we would caution that dedicated private equity energy managers are proliferating, which will increase competition for both oil & gas assets and experienced management teams. At the same time, the demand for capital to extract, develop, and transport unconventional upstream resources is significant, providing opportunities for adept managers to add value.

Conclusion

The market environment remains challenging. Valuations are elevated across the risk spectrum and the economic and credit cycles are getting extended. We recommend exercising caution by pulling back on US equities and overweighting cheaper markets, namely emerging markets and European equities. However, we would leave room to overweight emerging markets allocations on further weakness, which should be expected as China's economic growth slows. We would also pull back on credit exposure in favor of other diversifying assets, such as low equity beta hedge funds. And finally, we would minimize allocations to deflation and traditional liquid inflation-sensitive assets today and incorporate cash, natural resources equities, leveraged loans, and gold. We would prepare to move back into intermediate to long duration sovereign bonds, inflation-linked bonds, and commodities should they approach fair value. ■