CAMBRIDGE C|A ASSOCIATES

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# VantagePoint

## Fourth Quarter 2014

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

### Advice in Brief

- Slower global economic growth and high valuations are likely to result in lower returns over the next five to ten years than experienced over the last five-and-a-half years. In addition, we anticipate that QE's ability to elevate asset prices is diminishing.
- Many investors reduced their equity allocations following the global financial crisis and are only now approaching pre-crisis allocations. For these investors in particular, we would strongly discourage raising equity risk today. Having not fully participated in the upside, seeking to chase a rally in equities that are now expensive is a surefire way to get whipsawed by the markets.
- Specific asset class advice:
  - Rebalance equity allocations to neutral levels/policy targets.
  - Within equities, maintain modest underweights to US equities, while overweighting more vulnerable but attractively priced emerging markets and European equities.
  - Begin to shift more capital into safer assets, more fundamentally driven hedge funds and high-quality sovereign bonds, as equity markets become more expensive.
  - In a low expected return environment, a number of strategies may improve investors' prospects for achieving investment objectives. For some, staying the course may be appropriate. For others, pushing to add more value from manager selection, opportunistic investments, and cost cutting will be more appropriate.

Published October 13, 2014

# Portfolio Tilts from C|A's Chief Investment Strategist

| | Overweights | Underweights | Pros/Cons of the Tilt |
|---|---|---|---|
| **Diversified Growth** | **US High-Quality Equities** | **US Small-Cap Growth** | **Pros:** Firms with historically stable profits and low leverage should be less vulnerable; small-cap growth is richly valued, and is vulnerable if risk appetite shifts downward<br>**Cons:** High quality no longer cheap; small caps have more robust manager universe than high-quality strategies |
| | **EM Equities** | | **Pro:** EM valuations are low relative to their history<br>**Cons:** Slower EM growth may put pressure on earnings; relatively defensive EM sectors are richly valued; macro head-winds hold potential for negative surprise over the near term |
| | | **US Equities** | **Pro:** US valuations are elevated<br>**Cons:** US economic growth is recovering; US stocks may benefit from EM volatility |
| | **European Equities** (currency hedged) | | **Pros:** Attractive relative valuations; earnings and profit margins relatively depressed and may rebound; currency hedging to US$ can be defensive in flight to quality<br>**Cons:** Macro risks have increased again; market has not been impressed with ECB action thus far |
| | **Low Equity Beta Diversifiers** (e.g., less equity- and credit-oriented hedge funds) | **Macro Protection** (particularly inflation resistant)<br>**Credit** | **Pros:** Real and nominal sovereign bonds remain overvalued; commodities unattractive (see below); credit markets are overvalued to very overvalued<br>**Cons:** Likely decreases inflation and deflation protection, but can still provide diversification in varied macro environments; may increase portfolio active risk |
| | **New Commitments to Private Investments in Less Expensive Areas*** | **New Commitments to Large US and European Buyouts** | **Pro:** Large buyouts are very overvalued<br>**Con:** Like equities generally, other segments of private equity are becoming more expensive<br>**Note:** Bottom-up manager selection remains paramount |
| **Deflation Hedge** | **Cash** | **Sovereign Bonds** | **Pros:** Return potential of bonds today not commensurate with interest rate risk; cash can be spending source for deflation or some *in*flationary periods<br>**Con:** Holding zero-yield cash for extended period would be challenging |
| **Inflation Resistant** | | **Commodities** | **Pros:** Somewhat elevated commodity spot prices, no cash yield, and negative one-month roll yield unappealing<br>**Con:** Few good substitutes for commodities in nasty inflation bout |
| | **Natural Resources Equities** | | **Pros:** Solid valuations and long-term return expectations for natural resources equities; inflation resistant<br>**Con:** Lack of performance pop in a high-inflation period |
| | **Gold** | | **Pro:** Gold should hedge against risk of currency debasement<br>**Cons:** Can't value gold, which has no cash flow; very vulnerable in central bank tightening |
| | **Cash** | | **Pros:** Cash held as substitute for sovereign bonds can be double counted as cash available as a liquidity reserve during inflation; "double counting" use of cash allows for higher allocation to diversified growth<br>**Con:** Holding zero-yield cash for extended period would be challenging |
| | | **Inflation-Linked Bonds** | **Pro:** Miniscule real yields offer ultra-low real returns<br>**Cons:** Contractual link to inflation can't be found elsewhere; sole survivor in stagflation |



* For example, small market buyouts, growth equity, early stage venture, and Asian private equity.

Since capital markets began their recovery from the ravages of the global financial crisis, investors have watched somewhat in disbelief as markets have continued to climb an obstacle course of wall after wall of worries. And climb they have: the MSCI ACWI has returned a cumulative 160.7% (18.7% AACR) since it bottomed on March 9, 2009, while the S&P 500 has returned 220.9% (23.2% AACR). This is strong progress against a backdrop of heavy debt levels across much of the developed world, stress in the Eurozone, and a rapid escalation in debt levels in China where political leaders have been seeking to wean the economy off its debt-fueled investment growth without sinking it and stirring up populist revolt. Economic growth across much of the developed world has been in secular decline, unemployment is high (but improving), and central banks are collectively engaged in the largest monetary policy experiment on record. Add to this geopolitical risk from Russia and the Ukraine, Syria and Iraq, Israel and Gaza, and the South China Sea, and it becomes easier to see why investors appear both complacent and nervous.

Complacency has been fueled by the belief that central banks will come to the rescue every time the economy or stock market stumbles, as has been reinforced over and over again in recent decades, from the collapse of Long-Term Capital Management in 1998 to the ongoing rounds of quantitative easing in recent years. Fear has been fueled by the uncertainty surrounding many unknowns. While history provides centuries of data on the resolution of debt-fueled crises, the severity of the pain meted out has varied. Global crises have been both more severe and required more time to heal than more localized crises. Of particular concern is the ability of central banks, many of which have already brought interest rates to the zero bound, to manage through the *next* recession. Will governments be willing and able to use fiscal policy given already high debt levels? Will governments and societies be willing to take hard medicine to resolve economic imbalances (e.g., China, the Eurozone) and finance massively underfunded commitments (e.g., US Medicare, Medicaid, Social Security, state and local pensions) as their populations age? These issues are difficult for investors to deal with as markets (and, unfortunately, policymakers) tend not to discount their importance until the issues come to a head, often making them more costly to resolve, but providing policymakers cover for making tough choices.

This is the context in which investors must navigate today. As introduced in last quarter's *VantagePoint*, we now place a greater emphasis on diversification given the markets are at a more advanced stage of the economic and market cycle and risks are beginning to rise. However, we would not underweight equities today and recommend sticking closely to policy/neutral allocations and tilting modestly to what is relatively cheap. At the same time, risks are beginning to rise, so in preparation for the inevitable next market correction, now is the time to evaluate how you will navigate through. Where will you seek the liquidity for rebalancing, making opportunistic investments, and meeting spending and capital call liquidity requirements? Will the diversification you have put in place provide protection against the risk of deflation or economic contraction—the primary tail risk as the credit cycle advances?

We would seek to increase exposure to longer-term US Treasuries as yields rise, and would beware of creeping credit exposure, particularly in mandates intended to be defensive.

In this publication, we review the case for rebalancing equity allocations to policy targets or neutral allocations and resisting the temptation to chase the US equity rally, should it resume. We discuss prospects for slower global economic growth and high valuations to result in lower capital market returns over the next five to ten years than experienced over the last five-and-a-half years. Globally, monetary policy appears set to remain accommodative, even as the Federal Reserve completes its tapering in October. However, we anticipate that QE's ability to elevate asset prices is diminishing. None of this means that a sharp decline in risky assets is imminent. Rather, it suggests returns from risky assets are likely to moderate, while returns from safer assets are likely to stay low, absent any market disruption that causes a reversal. Finally, in the face of lower expected returns we consider what choices investors have to increase the likelihood of meeting their return objectives.

## Keep Disciplined

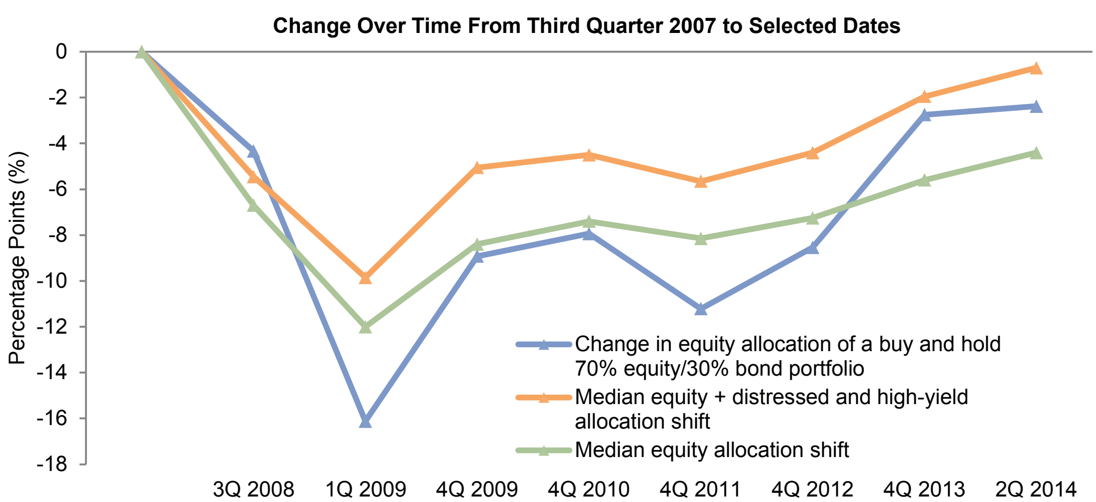
Today, we would seek to balance between greed and fear, which means rebalancing equity allocations (if you have not done so already) back to policy targets. Understandably, we find that many investors are increasingly attracted to the irresistible lure of risky assets, particularly US equities, having been beaten into submission by central banks enticing them to take more risk. Monetary policy has helped prop up asset prices thus far in the market cycle, but there are legitimate reasons to doubt this will be as supportive in markets where valuations are elevated and risk premiums have narrowed. Prospective benefits from investing in risky assets have diminished. At the same time, as the economic cycle, credit cycle, and market cycle advance, risks of market setbacks typically rise. As such, taking a disciplined approach to investing today is appropriate. Today, this means rebalancing equity allocations to neutral levels and expensive US equities to underweight positions in favor of less expensive equities, and maintaining your investment strategy. The temptation to follow momentum and chase equities up to new heights may be strong—and momentum is not a force to be ignored—but as valuations rise, appropriate caution is necessary to lock in gains and continue to participate in the markets at more neutral allocations.

The global financial crisis was a very difficult period and in many ways investors are still feeling the aftereffects, and will for some time. It is human nature to be fearful after such a significant market decline, followed by large government interventions, unprecedented levels of monetary stimulus, and increased regulation of the financial sector. Further, liquidity dried up rapidly and investors with large unfunded capital commitments and inflexible liabilities to be funded from portfolios were appropriately more conservative in their asset allocation post-crisis to preserve limited liquidity in the event that liquid assets declined further and/or private investment funds called down capital rapidly. As a result of these varied factors, many investors adopted a more defensive strategy in the aftermath of 2008, incorporating less equity risk either by allocating less capital to public and private equities or by using more defensive managers that take less equity risk (i.e., lower equity beta managers and strategies). Indeed, we recommended overweighing more defensive managers with lower equity risk and more flexible mandates for a time after the initial recovery, which in hind-sight was too conservative.

For investors that have taken this approach in particular, we would strongly discourage raising equity risk today—five years into an equity bull market. With all of the risks facing investors today, perhaps the most significant is permanent capital impairment through loss of investment discipline. Having not fully participated in the upside, seeking to chase a rally in equities that are now expensive is a surefire way to get whipsawed by the markets.

In fact, investors on average meaningfully decreased their equity exposure after 2007, only getting back near prior equity levels in the last couple of years. We looked at the 260 institutions that have completed our quarterly asset allocation surveys since 2007 and found that the median decline in institutions' allocation to equities (traditional long-only equities, venture capital, and private equity) fell 12 ppts from the peak in third quarter 2007 through the market bottom at first quarter 2009 and appears to have increased largely in sync with market appreciation over the following five years (Figure 1). In fact, the average change in equities looks similar to what an investor would have experienced from buying and holding a portfolio indexed to 70% global equities and 30% bonds with no rebalancing.

Figure 1. Median of Surveyed Institutions' Change in Equity Allocation Post–Global Financial Crisis
Third Quarter 2007 – Second Quarter 2014



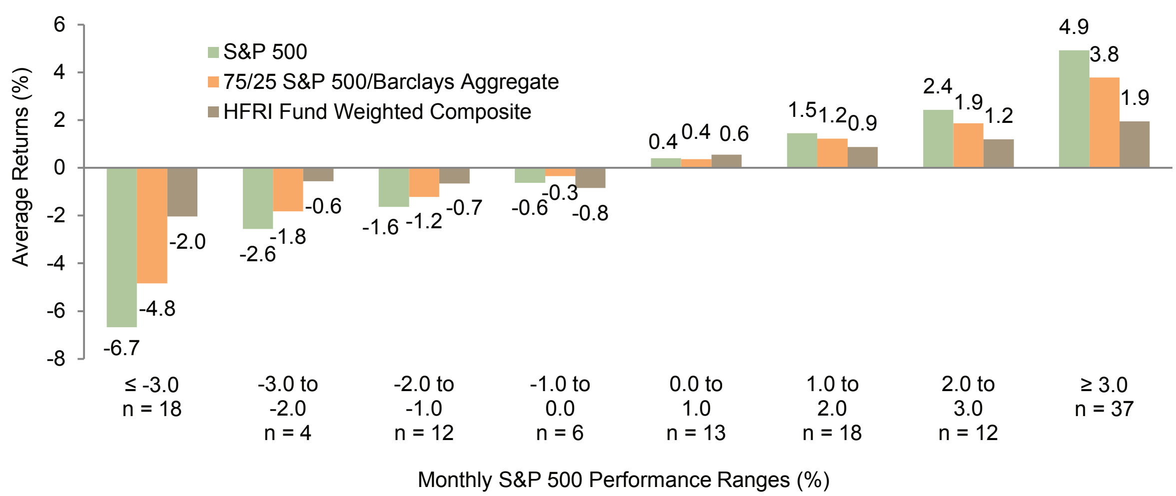

Sources: Barclays, Cambridge Associates LLC, and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Notes: Historical allocations based on data from 260 institutions. June 2014 allocations represent data from 256 institutions.

Where did the capital go? Initially to cash and fixed income, but pretty quickly it flowed into other investment strategies, most notably those run by hedge funds. By the end of 2011, the median investor in our survey had experienced a 3 ppt increase in hedge fund investments[1] relative to third quarter 2007 allocations. In an environment in which defensive assets (e.g., sovereign bonds) are very expensive, increasing use of hedge funds (while recognizing they participate in market downside, just typically not fully) as a substitute for some equity and fixed income allocations makes sense given their ability to provide some downside protection in exchange for giving up some market upside. Further, carefully selected hedge funds offer the potential to add diversifying return sources, including adding alpha. Even as hedge funds initially disappointed many investors during the global financial crisis by declining more than they had historically, the value of their asymmetric performance was clear. The S&P 500 fell 51% over a 16-month period starting in November 2007 and took 37 months to recover, while hedge funds declined 21% over the same period, but recovered in about half the time.

The tendency of hedge funds to lag equities at an increasing rate as equity performance strengthens, and to outperform at an increasing rate in down markets as market performance weakens heightens behavioral risk (Figure 2). Hedge funds tend to underperform by the greatest margins in roaring bull markets, often right before markets reverse, and outperform meaningfully in down equity markets when equities are more likely to recover. We would be patient and stick with hedge funds today, but note that manager selection has become vastly more important over time. The

[1] Hedge funds here refer to the wide array of strategies that are in the hedge fund legal structure. Performance is represented by the HFRI Fund Weighted Composite Index unless otherwise noted.

Figure 2. Hedge Fund Performance Relative to US Equities and a Simple Stock/Bond Portfolio
October 31, 2004 – September 30, 2014




Sources: Barclays, Hedge Fund Research, Inc., and Standard & Poor's.
Notes: Graph shows average returns, bucketed by monthly performance of S&P 500. Hedge Fund Research data are preliminary for the preceding five months.

dispersion of hedge fund performance has widened, and the return profile has been dampened as the market has matured and the number of managers proliferated. Investors need to dedicate adequate resources to evaluating and monitoring managers that serve this role in portfolios.

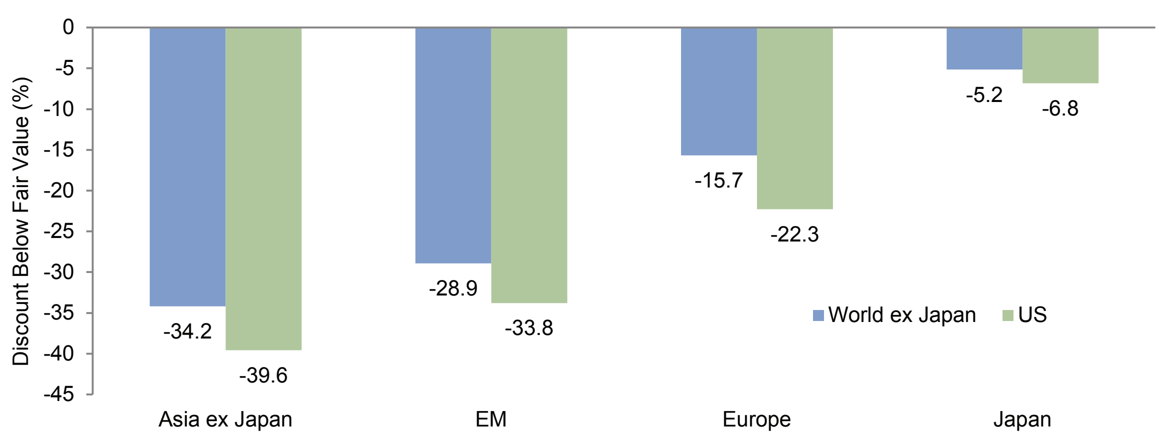
## US Equities Pose the Most Price Risk

While we would rebalance equities in aggregate to target today, we would seek to modestly underweight US equities relative to more vulnerable but attractively priced European and emerging markets equities (Figure 3). US equities may continue to appreciate strongly, but we expect performance to moderate with markets now in the later stages of the cycle and prices well ahead of earnings. Further, we continue to recommend underweighting US small caps, particularly small-cap growth, relative to higher-quality US equities. Even as they have already experienced a meaningful setback, small caps remain very overvalued with poor earnings growth and negative momentum.[2]

Consider the following: while it has been well reported that US equity indexes have been setting new highs, the latest of which was reached on September 18 for the S&P 500, somewhat less recognized is that the market on that date got very close to breaking through its inflation-adjusted high set in March 2000—just 6.0% shy of that record. This may somewhat explain why the index has struggled to remain above 2,000. The last major nominal index peak in October 2007 failed to break through the

[2] See Jason Leibel et al., "US Size Effect: How Long Will it Defy Gravity?," Cambridge Associates Research Note, May 2014.

Figure 3. Excess Discounts vs World ex Japan and US Equities
As of September 30, 2014




Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Excess discount refers to the current discount minus the implied "fair value" discount for each region.

March 2000 high in inflation-adjusted terms, lagging by nearly 17%, despite setting new nominal highs.

The S&P 500 certainly could push to new inflation-adjusted highs, but from a historical standpoint, 14 years would be a fast recovery. Looking at the S&P 500 dating back to 1926, it has taken much longer for the index to retrace prior inflation-adjusted secular highs. The September 1929 high was not surpassed again for nearly 30 years (November 1958), and the December 1968 secular high held for 24 years (December 1992). If the S&P breaks decisively through the March 2000 bogey, history suggests that this bull market has significantly more room to run. Looking at these two long secular bull markets, after breaking out to new highs in 1958, the S&P 500 increased another 66% in real terms before peaking nearly a decade later in 1968; after retracing 1968's inflation-adjusted high in December 1992, the index increased another 180% through the next peak in March 2000[3].

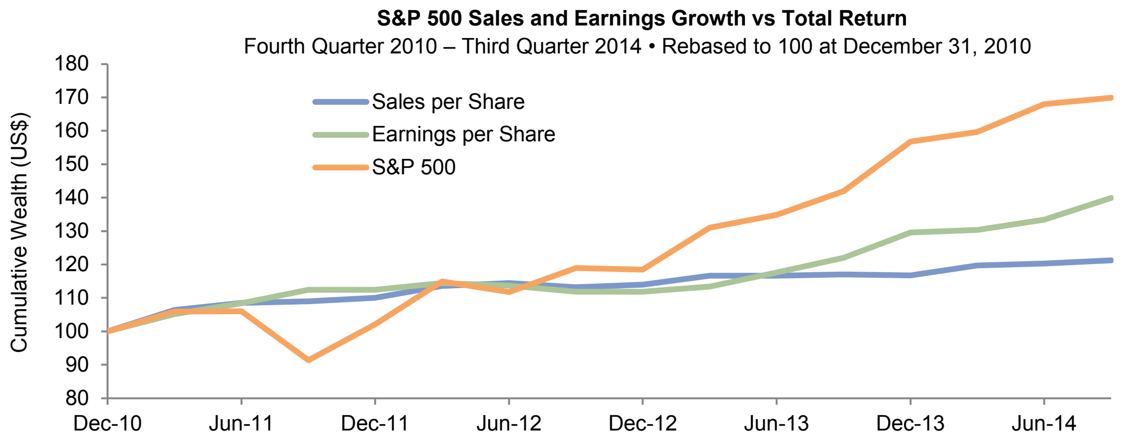
Even if the S&P 500 heads to new highs, that doesn't preclude the market from experiencing a correction on the way up. As many commentators have indicated, a correction seems to be well overdue. For example, the S&P had five declines in the teens between 1958 and 1968 and suffered a 22% decline in 1966. During the 1990s the market corrected nearly 20% in 1998 and suffered two declines in the low teens in 1998 and 1999.

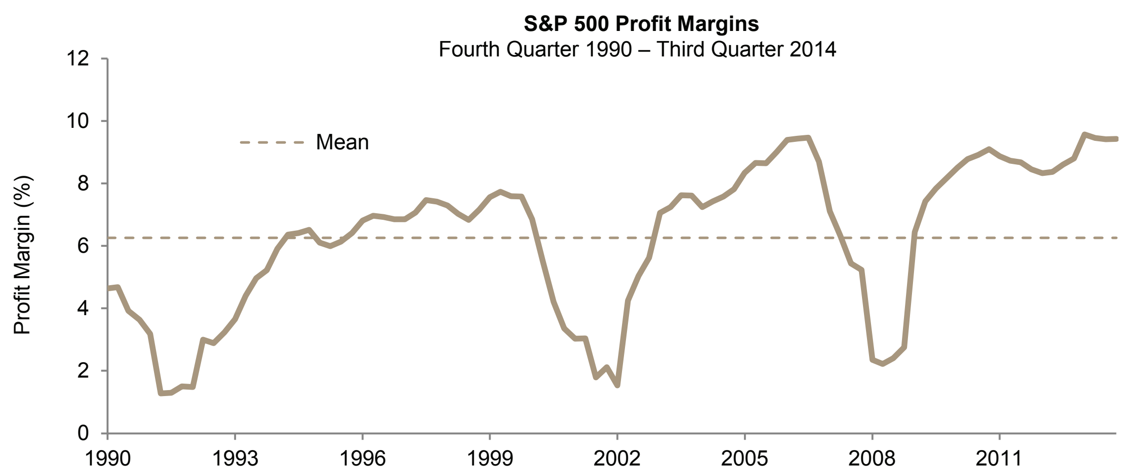
The most likely case is that US equity prices grow in sync with earnings, which we expect will be more modest looking ahead than they have been over recent years. US earnings are becoming more vulnerable. Earnings growth has been boosted by peak profit margins that have been hovering around 9.5% and escalating share buybacks (Figure 4).[4] One of the major drivers of high margins has been robust growth in revenues from outside the United States, as such revenues are subject to lower taxes (provided they are not repatriated). According to analysis by Barclays, the median corporate tax rate for S&P 500 companies has decreased from 32% four years ago to 29% today. Other analyses suggest even lower effective rates, as low as 13% for a broader group of companies analyzed by the US Government Accountability Office. Amid weakening global growth, this boost to margins may be diminished. If the US economic recovery continues, profit margins should come under some pressure from rising wages, rising interest rates, and a stronger US dollar, making revenue growth increasingly important in supporting earnings. Over the last few years, revenue growth has been sluggish compared to earnings growth—in 2013, S&P sales increased 2%, compared to earnings per share (EPS) growth of 16%. Year-to-date, EPS have increased at twice the rate of sales growth. In fact, US equities are already very overvalued on the basis of price-to-sales (P/S) ratios. This ratio stands at 1.8

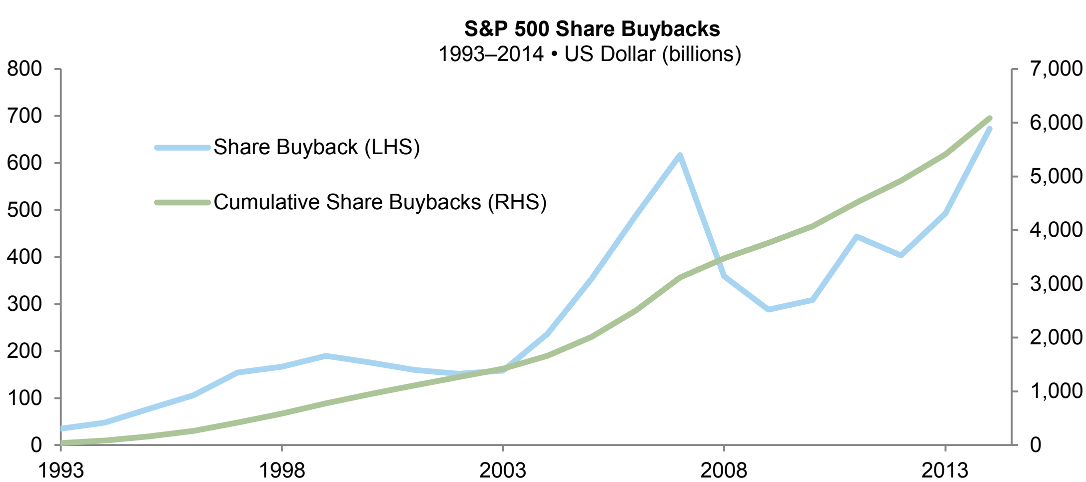
[3] March 2000 marked the nominal peak. The inflation-adjusted peak was in August 2000. The S&P increased 185% in real terms from December 1992 through that date.

[4] For more on these topics, see Bob Sincerbeaux, "Have Lofty US Corporate Profit Margins Finally Turned a Corner?," Cambridge Associates Research Brief, October 13, 2014 and Alex Jones, "Yakety Yak, Just Buyback," Cambridge Associates Research Brief, September 12, 2014.

Figure 4. S&P 500 Earnings Growth, Profit Margins, and Buybacks




Sources: Bloomberg L.P., Standard & Poor's, and Thomson Reuters Datastream.
Notes: For the top graph, EPS for third quarter 2014 are estimated. For the bottom graph, S&P 500 share buybacks data are annual except for the most recent figure, which is annualized based on 2014 data through September 30.

today, 73% above its post-1960 median and just below the 2.1 peak reached in 2000. Adjusting for market capitalization by looking at the median stock's P/S ratio, valuations are the highest on record.

Share repurchases are also a major factor boosting earnings growth, accounting for as much as 25% by some measures. As of June 30, S&P 500 companies had bought back nearly $540 billion of stock on a trailing 12-month basis, and more than $2 trillion since 2009. As buybacks currently account for 80% of free cash flow after dividends are paid out, the sustainability of their continued support to earnings is questionable. Low interest rates have also been supportive of buybacks, as much buyback activity is debt financed despite high levels of cash on corporate balance sheets. Corporate leverage, at 51%, remains at post-1998 lows and well below its prior cycle peak of 70%, and interest rate coverage ratios remain at historic highs. Still, rising rates could easily slow down this train, making revenue growth central to earnings growth once again.

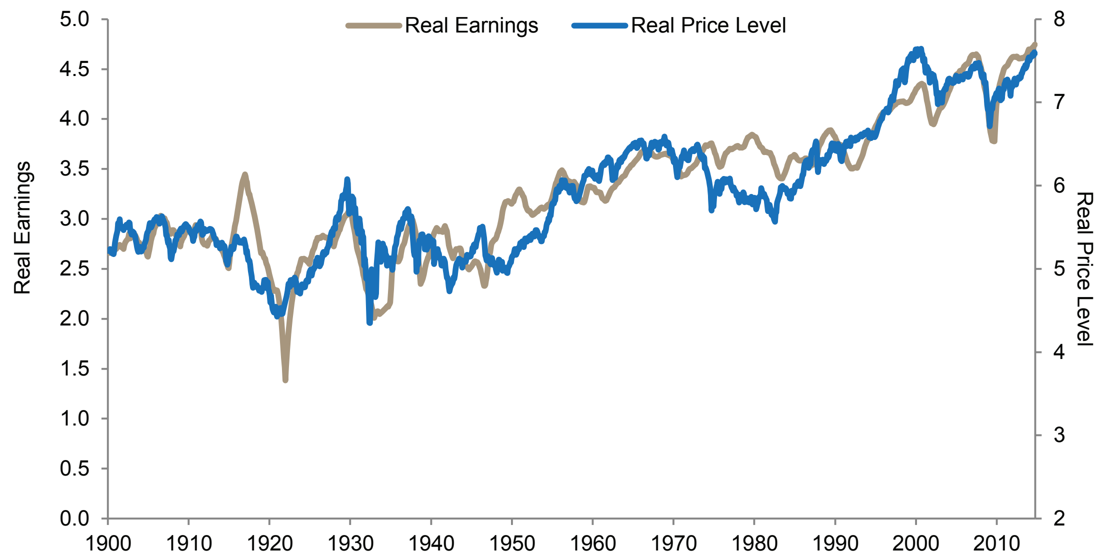
## Lower Your Expectations

Over the long term, equity returns have two strong anchors: underlying fundamentals and the prices investors are willing to pay for them. Ultimately, equity investments are claims on future earnings growth. The more investors pay for future earnings today, the less return they will generate as earnings grow. At the same time, earnings growth is constrained by economic growth over time. As markets have become more globally oriented, global economic growth, rather than local growth, has been more central to earnings potential (Figures 5 and 6).

Since the 1960s, economic expansion has seen lower real growth rates (Figure 7). This trend has prevailed in Western Europe as well as the United States. The Congressional Budget Office has downgraded potential US GDP growth expectations to 2.1% for the next decade, a full percentage point below growth experienced from 1980 to 2007. According to analysis by the Council of Economic Advisors, two-thirds of the decline in US growth potential is from secular trends taking place before the global financial crisis, the most important of which is a decline in the growth of the working population. In addition, Chinese growth has slowed as authorities seek to rein in credit growth and implement structural reforms. From a near-term perspective, the International Monetary Fund has once again lowered global economic growth expectations for this year and next.

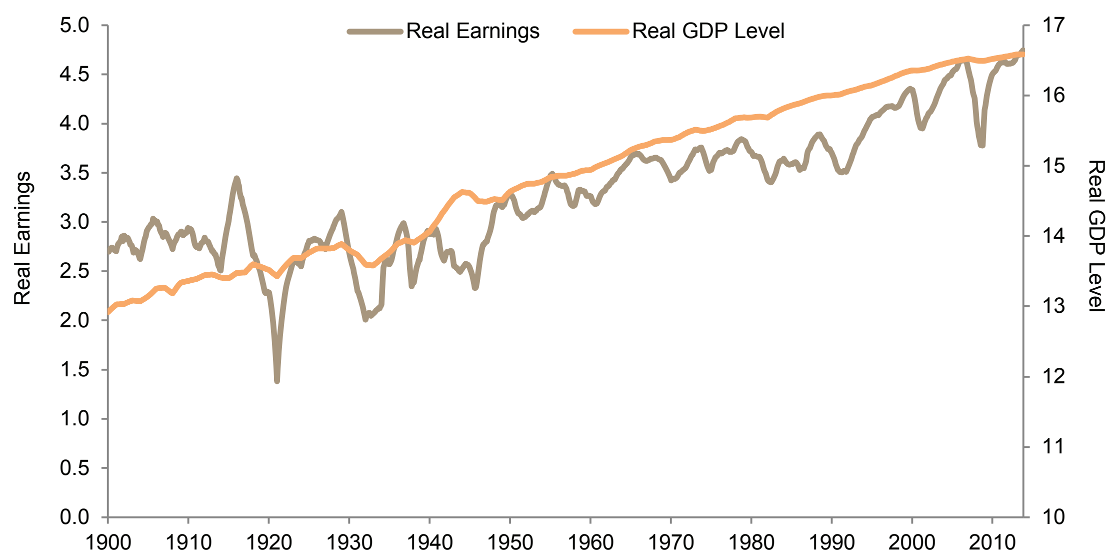
Lower global economic growth not only suggests earnings growth may be more constrained than in recent decades, but that interest rates will remain subdued for some time. As economic growth in the United States has slowed, the average Fed Funds rate that prevailed during economic expansions has declined. Relatedly, much of the developed world has become dependent on low rates to support highly lever-

Figure 5. S&P 500 Real Earnings and Real Price Levels Since 1900
January 31, 1900 – September 30, 2014



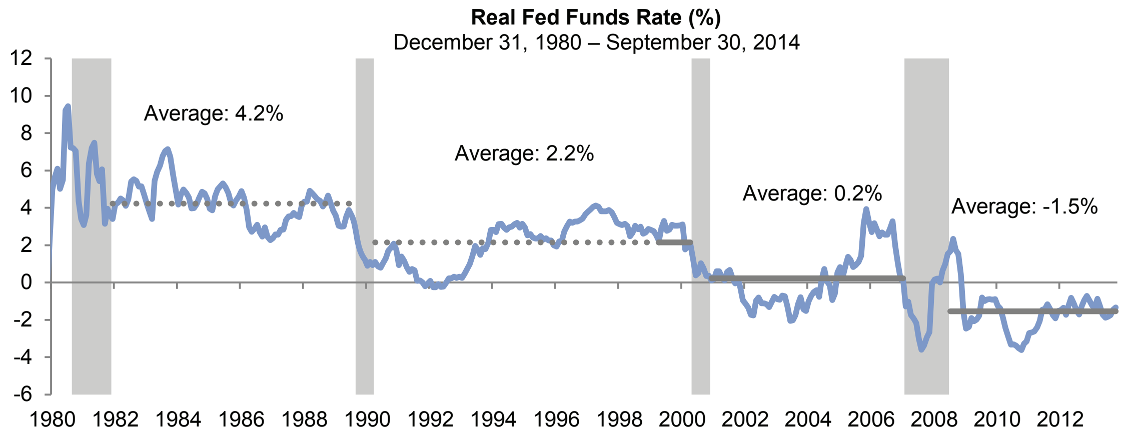

Sources: Robert J. Shiller, Standard & Poor's, and Thomson Reuters Datastream.
Notes: Real earnings and real price levels are shown in logarithmic terms. From 1900 through 1984, earnings are based on reported earnings per share (EPS). From 1985 through present, EPS are based on operating earnings. Monthly earnings are interpolated from actual quarterly EPS. Real price levels and earnings are deflated in terms of August 31, 2014, dollars. Current earnings are based on third quarter 2014 estimate from Standard & Poor's. Historical data before 1936 provided by Professor Robert Shiller.

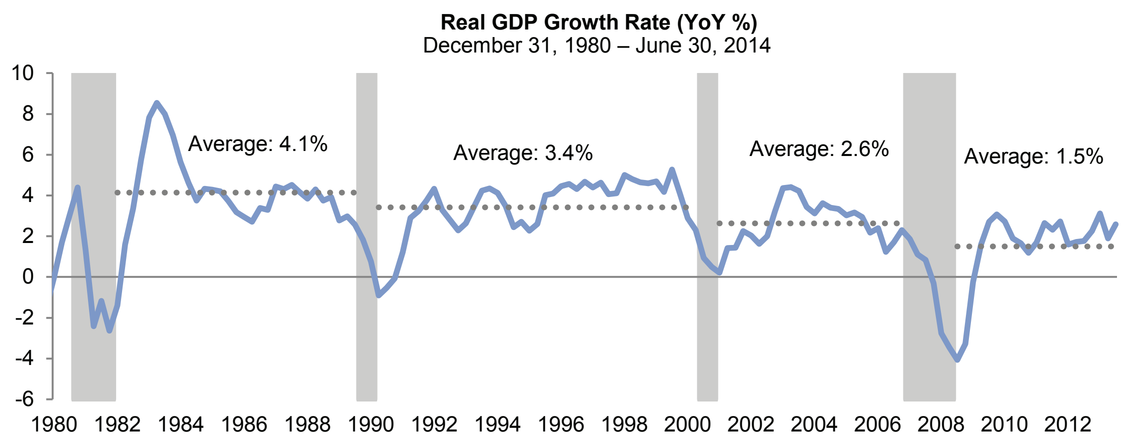
Figure 6. S&P 500 Real Earnings and Real GDP Levels Since 1900
January 31, 1900 – September 30, 2014




Sources: Global Financial Data, Inc., Robert J. Shiller, Standard & Poor's, and Thomson Reuters Datastream.
Notes: Real earnings and real GDP levels are shown in logarithmic terms. From 1900 through 1984, earnings are based on reported earnings per share (EPS). From 1985 through present, EPS are based on operating earnings. Monthly earnings are interpolated from actual quarterly EPS. Real GDP levels are interpolated from actual annual data and are deflated in terms of August 31, 2014, dollars. Current earnings are based on third quarter 2014 estimate from Standard & Poor's. Historical data before 1936 provided by Professor Robert Shiller.

Figure 7. Real Fed Funds Rate and Real GDP Growth Rate




Sources: National Bureau of Economic Research, J.P. Morgan Securities, Inc., and Thomson Reuters Datastream.
Notes: CPI data are as of August 31, 2014. Shaded areas represent US recessionary periods as defined by NBER.

aged economies. For debt burdens to remain sustainable, interest rates must stay below growth rates.[5] Given these constraints, we believe the Fed is likely to be very cautious in raising rates. Even if policy rates do rise, if growth remains moderate as we expect, low interest rates could be sustained as deflationary pressures from the Eurozone and China could dampen inflation.

With low sovereign yields across most of the globe, and still-low credit spreads (despite their recent widening), expected returns from bonds remain uninspiring. Equity returns look better by comparison. However, as discussed earlier, valuations look stretched for US equities, which have remained a few hairs shy of very over-

[5] Please see Stephen Saint-Leger et al., "How Far Will US Rates Rise in the Next Cycle?," Cambridge Associates Research Note, September 2014 for more discussion.

valued since the start of this year, while European and Japanese equities remain fairly valued, and emerging markets equities undervalued, albeit with meaningful dispersion across countries and sectors.

## Stacking the Odds in Your Favor

Given our expectation of low returns, is there anything investors can or should do to increase the likelihood of meeting portfolio objectives? There are a number of considerations for investors, all of which involve different trade-offs. They include:

- Increase market risk;
- Take a long-term approach and accept lower near-term returns;
- Take more active management risk in pursuit of manager alpha or value added returns;
- Look for opportunistic investments;
- Raise cash or other defensive positions; and
- Lower costs.

Of all the options on this list, the first item, take more market risk, is the only option that seems unappealing as the market cycle is well advanced. Increasing equity or credit risk at this stage, particularly into assets where risk premiums have narrowed, is not a good idea. All of the other options are reasonable to consider and elements of all should be adopted.

As investors, we strive to build efficient portfolios to meet our return objectives, working hard to construct portfolios that will meet objectives while taking risk tolerance into account. We are always looking to find managers with the ability to add value and take advantage of market opportunities as they develop. Therefore, for many investors, the best course of action may be to stay the course and focus on the long term. However, as we suspect capital market returns generally will be below their long-term historical averages over the next five years or so, and expect that pursuit of value-added returns will continue to help, it is important to consider the possibility that investors may fail to earn what they spend. Educating stakeholders to this possibility and evaluating potential changes in operations, reserve funds, or spending rates seems appropriate and worthwhile.

To the degree that you have capacity to take more active management risk with skilled managers, we believe you should do so. Private investments are an important part of this strategy, as are hedge funds, as discussed earlier. Of course, we are not the only ones seeking to add value in this manner, so an increasing amount of capital continues to search out additional returns from manager value added. Valuations on many strategies have become more expensive, most notably US and European private equity, which we now regard as very overvalued. We continue (as always) to maintain a high bar in selecting managers and prefer those with an investment pace that favors selling in rich markets and more aggressively buying when valuations improve. While we tend to take a bottom-up approach in private investments, today we favor growth equity and smaller funds that operate in the sub $500 million enterprise value segment of the market and have an established approach to creating value. Sector funds can also provide investors with an edge.[6] We would caution against scaling commitment sizes with manager fund sizes.

We see limited candidates for opportunistic investments today, and much of what we do see are somewhat niche. Private investments in metals and mining and royalty funds that have attractive return profiles with short lock-up periods are examples. Cash or other defensive positions could be used as dry powder to pursue opportunities later, in the event of market turbulence. For those considering raising cash, we would caution that the opportunity cost of doing so is high, as cash yields virtually nothing. Instead, today we would seek to increase the quality of defensive positions by moving from credits to sovereigns and/or hiring skilled managers that have a proven track record of successfully capitalizing on opportunistic investments as they arise.

An often overlooked means of adding value is by lowering costs. If you can find alpha, you should be willing to pay for it, as the goal of active management is to outperform the market on a net-of-fee basis. However, you should only pay high fees for managers you are confident have skill. This is particularly the case in a low expected return environment. Indexing and less expensive alternative beta/smart beta strategies[7] are reasonable alternatives for rounding out portfolios where adequately skilled active managers are difficult to identify. This does not mean firing managers that have underperformed recently, but rather performing careful analysis of the drivers of managers' performance to understand if their ability to outperform the market is based on a sustainable edge.

## Conclusion

As markets get more advanced, investors should shift more toward fear than greed. It is difficult, but important, to stay disciplined at this stage in the market cycle. The biggest risk to investors that have taken a lower equity approach post–global financial crisis is to change strategies today and risk getting whipsawed. This discipline includes rebalancing equity allocations to policy targets or neutral levels and resisting the urge to chase a rally, particularly in US equities. Within equities, maintain overweights to more vulnerable but attractively priced emerging markets and European equities. We would stick with hedge funds and lower equity-beta managers, again with careful manager selection.

[6] Please see Josh Zweig et al., "Declaring a Major: Sector-Focused Private Investment Funds," Cambridge Associates Research Note, September 2014.

[7] For more on this topic, see Sean McLaughlin and Deborah Christie, "Alternative Beta Strategies: A 'Smarter' Way to Invest in Equities?," Cambridge Associates Research Report, 2014.

As discussed in the last edition of *VantagePoint*, we would seek to increase allocations to Treasuries should yields move back to our fair value range, which currently starts at a yield of 2.9% on the ten-year, and would reduce exposures to credit risk, which we do not regard as attractive given narrow credit spreads on top of low sovereign yields, particularly as lending standards are getting more lax. In general, we would prepare to shift more capital into safer assets, more fundamentally driven hedge funds and Treasuries, should equity markets become more expensive. As markets become more extended, it is particularly important to understand what you own and how investments might react in different types of down markets to make sure you can live with your portfolio in the next major sell-off. If not, now is the time to plan how to get there.

Finally, in a low expected return environment, a number of strategies may improve investors' prospects for achieving investment objectives. Staying the course may be appropriate for some investors, while pushing to add more value from manager selection, opportunistic investments, and cost cutting will be more appropriate for others. ■