CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"Global Markets Outlook and Strategy" by Jan Loeys, J.P. Morgan, December 1, 2010

Next year is likely to be characterized by growth acceleration, policy divergences, sovereign credit stress, and a continuation of the sport of bubble watching. As these themes take hold, investors will find strong returns in equities and commodities, and will be hard pressed to squeeze performance out of developed markets government bonds.

Investors should prepare for four themes to dominate markets in 2011, each of which has different tactical and long-term implications. Consistent with these themes, investors should be long equities and commodities, underweight bonds, and favor credit versus government debt. This positioning is supported by the first of these themes: that global growth will begin to accelerate again, boosted by monetary stimulus across developed economies. As growth forecasts are being revised up, markets are already taking their cue, and equities are outperforming bonds.

The second investment theme is the growing policy divergence between developed and emerging markets. Developed world economies are growing slowly and retain excess capacity. This limits inflationary pressures, with further quantitative easing programs also helping to keep interest rates down. In contrast, emerging economies are operating close to capacity, and increasingly will face a trade-off between growth and inflation. In the case of countries such as China, growth is likely to prevail. The implications for investors include overweighting real versus nominal assets; for example, favoring real estate and commodities over cash and bonds.

The third theme that will dominate markets in 2011 is sovereign credit stress. The European sovereign debt crisis has undermined the notion that developed world sovereign debt is risk free and this year led to a paradoxical flight to quality into emerging markets debt. In the near term, pressure on peripheral European nations is unlikely to abate, as monetary union without greater political and monetary agreement is untenable. Europe has several options in dealing with the crisis: allow the periphery to attempt to achieve their fiscal targets, increase the size of the European Financial Stability Facility (EFSF), or monetize the debt. Each of these options has different short-term investment implications.

If the periphery is able to deliver on their fiscal targets and prevent a bond market sell-off, the euro-to-U.S. dollar rate would rise. However, there remains little assurance that the European periphery will be able to successfully deliver. A second solution would be to increase the EFSF, since elevated bond yields are now at levels threatening the growth of too many sovereigns and the refinancing ability of their financial sectors. Tightening peripheral spreads may lead to euro appreciation; however, any delay in action would argue for a bond market sell-off and sharp currency decline. Finally, faced with the possible collapse of the European financial system, the European Central Bank (ECB) could respond as it has in the past: reinstate extraordinary liquidity measures and increase its purchases of peripheral debt. This solution will have offsetting impacts on the euro. The currency could rally initially since debt monetization would ease credit stress, but then retrace as expansion of the money supply weakens the euro.

In the intermediate term, how the sovereign debt crisis plays out will also have several significant implications. If the instability persists through 2011, Euro area asset prices are likely to remain depressed. How core countries view the crisis and how they are motivated to act are important. If core countries eventually become scared enough that their banking systems are threatened by losses on bond holdings, there may be a Troubled Asset Relief Program moment, triggering a more permanent resolution. Second, by raising the specter of a failed sovereign, credit risk has been introduced into sovereign bond pricing and should raise its cost going forward. Third, recent moves into emerging markets sovereign debt on the assumption that it is somehow safer than developed world debt may create an asset bubble. Finally, it is not far-fetched that some corporates will be able to borrow at lower prices than their sovereign counterparts going forward.

Tactically, investors should underweight Eurozone assets and reduce exposure to sovereign debt in general. In addition, corporate debt should be favored over sovereign debt. While it is a bit early, investors should also be prepared to reduce the duration of their emerging markets sovereign bond holdings.

A final theme in 2011 will be scouting for the next asset bubble. Telltale signs will include novice investors entering an asset class, stretched valuations, and increasing use of leverage. Scanning across asset classes at the moment, it seems too early to call a bubble in emerging markets equities and currencies. However, gold and U.S. Treasuries, both of which feature expensive valuations and face demand that incorporates leverage, are legitimate candidates. However, the main leveraged players in Treasuries are central banks, which have more capital to absorb potential losses than private sector equivalents.

Looking at the forecast for other asset classes in 2011, fixed income markets face an uncertain outlook as a result of the European sovereign debt crisis. However, the strong demand for high-yield products is keeping defaults low, and the asset class could perform even in a low-growth environment. The high-yield spread tightening that occurred during 2010 is expected to persist for 2011, providing a string value anchor. Similar to the high-yield story, emerging markets corporates should also benefit from a low default rate, and as the emerging markets corporates continue to enjoy robust inflows in 2011, they should be able to deliver strong returns as well.

Aside from growth and inflationary considerations, improving earnings expectations and attractive valuations have made it likely that equities will perform strongly. Within the developed markets versus emerging markets breakout, it is likely that emerging markets equities will continue to out-perform their developed counterparts in 2011 as the growth differential between emerging and developed markets widens and investor confidence in emerging markets increases. Across cap sizes, it is likely that more downside exists for small caps in both an equity rally scenario and an equity sell-off. If the equity sell-off continues in December, a flight to liquidity will likely force equity investors to start selling their more illiquid small-cap holdings, in a repeat of last May/June. If, on the other hand, equity markets go up in December, investors are more likely to buy large caps that were hit the worst over the past months.

Another asset class expected to offer strong performance in 2011 is commodities. The key risk to this view is if Chinese policy tightening results in an overly adverse impact on growth, which feeds through to commodity demand. Additionally, renewed fears of an escalation of the Euro area crisis to Spain pose a further threat to risky assets like commodities. Overall, however, the emerging markets growth story is expected to pave the way

for robust commodity demand, and tight supply conditions also should support commodities through next year.

"Don't Fight the Reflation Trade" by Larry Kantor, Barclays Capital, December 9, 2010

The combination of sustained economic recovery and increasing policy stimulus sets up a constructive near-term environment for risk assets. However, easy money–induced rallies can be unstable. Any sign that global central banks are going to pull back from reflationary policies could generate a significant market correction in the latter half of 2011. Reflecting these risks, investors should implement strategies to protect positions from heightened volatility and possible sharp reversals.

Just three months ago, investors were fretting over the possibility of a growth relapse. Recent economic data, however, have laid these worries to rest. Indeed, earlier softness in global economic activity was nothing more than a pause, as the cycle transitioned from the initial inventory- and stimulus-led surge in growth to a more sustainable expansion. The Chinese economy led the pickup in activity, with industrial production leaping at a double-digit pace in October. In Europe, sovereign debt concerns persist, but the debt problems of the larger economies are not nearly as intractable as those of the smaller peripherals. Growth on the Continent has held up quite well, especially in Germany. The U.S. economy, meanwhile, appears to be poised for a modest reacceleration from its mid-year slowdown, and recently proposed tax cuts suggest activity will pick up further into next year.

Even with the improved tone of economic data, monetary policy has become more accommodative. The Federal Reserve (Fed) announced its plan to purchase an additional $600 billion Treasuries through mid-2011. The ECB has decided to postpone its policy normalization, extend its liquidity facilities, and step up its purchases of government bonds. Further, while China has begun to tighten monetary policy, the scale has thus far been quite modest relative to recent economic strength, and authorities continue to resist currency appreciation.

The combination of sustained economic recovery and increasing policy stimulus sets up a constructive environment for equities, at least in the near term. The case is further bolstered by high profit margins, strong corporate balance sheets, and negligible financing costs. More generally, reflation favors business, as it initially widens profit margins (i.e., market-sensitive prices increase before labor costs). Thus, profits are positioned to move even higher in 2011 as income continues to be transferred from households to business. While these levels of profitability will ultimately prove unsustainable, equity prices may move considerably higher before valuations become a concern. The fact that the Fed is all but guaranteeing that investors receive negative real returns on their $8 trillion in cash and near-cash holdings also will boost demand for riskier assets.

Emerging markets should also fare well in an environment of improving growth and abundant liquidity, with the best-performing assets likely to be equities and higher-yielding bond markets that experience equity-like returns. However, given the potential for higher policy rates, fixed income returns are likely to come in much lower than the very strong performance of the past year and a half, although they should generally be positive.

U.S. Treasuries, on the other hand, are likely to perform poorly in 2011. Although Treasuries initially rallied on the news of QE2, they have since reversed as economic data improved. Further, the Fed's objectives of stronger growth and higher inflation are consistent with higher,

not lower, U.S. Treasury yields, despite increased purchases. With regard to credit, absolute returns may be undermined somewhat by a rise in interest rates. However, spreads are likely to remain stable or even narrow, benefitting from continued economic recovery, abundant liquidity, and strong corporate fundamentals.

Recent moves in the U.S. dollar, meanwhile, have not provided a useful guide to any future trend. For instance, news of QE2 pushed the dollar sharply lower. However, the sell-off set the stage for a major dollar rally when European debt concerns returned. Should these concerns persist in the near term, euro upside will be limited. Beyond the near term, however, a resolution of the European debt crisis will signal further dollar weakness. Other factors should pressure the greenback as well. First, monetary policy is likely to remain looser in the United States relative to other countries. Second, as European sovereign debt concerns fade, markets may begin to focus on other countries with extremely large fiscal debt burdens, such as Japan and the United States. It is likely that US$ depreciation will continue to be concentrated in European, commodity, and emerging markets currencies, given continued Chinese intransigence with regard to the *renminbi*.

Commodity prices are likely to perform well in the current environment. Estimates of demand from commodity end-users continue to be revised up in both emerging and developed markets. Further, a weaker dollar should also boost commodity prices. Regarding spot price volatility, the massive swings witnessed just before and after the financial crisis are unlikely to return anytime soon, barring an unforeseen major geopolitical event. Supply and demand factors are more balanced, and speculative flows have not returned to earlier levels.

Although the near-term environment (e.g., three-to-six months) is favorable for risk assets, it is unlikely to persist throughout 2011. Easy money–induced rallies can be unstable and sovereign debt problems are far from over. However, European debt pressures are not likely to trigger the end of the recovery in economic growth and financial markets. More likely, either stretched valuations or signs that central banks are pulling back from reflationary policies will signal the need for investors to exit the reflation trade. An important situation to monitor is the state of emerging markets economies. Indeed, monetary tightening has already begun and could advance enough in 2011 to generate a significant market correction. It is also worth keeping an eye on the United States. Any sign that the Fed is beginning to normalize policy could produce a large backup in bond yields and a significant market setback. Reflecting these risks, investors would be well advised to implement strategies to protect positions from heightened volatility and possible sharp reversals.

"A Radical Approach to Asset Allocation" by Byron Wien, The Blackstone Group, December 2010

Few institutional portfolios are positioned appropriately to perform well in today's investment world. Investment committees have failed to reflect on past drivers of returns and to realize that current asset allocation decisions should recognize that future drivers of returns will be different.

The author has seen few institutional portfolios that he regards as positioned appropriately to perform well in today's investment world. Many institutional portfolios have an asset allocation tilted toward long-only exposures to developed markets, and lack diversified allocations to alternatives such as hedge funds, which can help smooth returns during periods of volatility. While some portfolios have trimmed fixed income allocations, most are underweight higher-yielding

fixed income securities and instead retain over-valued U.S. Treasuries. Portfolios are underweight exposure to emerging markets, which will drive world economic growth in the decade ahead. Further, portfolios are susceptible to what is likely to be an extended period of volatility.

Investment committees use a policy portfolio approach and assign an expected return and anticipated volatility for each asset class, defining a risk-reward trade-off for the total portfolio that allows them to meet their objectives. The problem with this approach is that as economic power has shifted from the developed to the developing world, the return potential for developed world equities has reduced. In addition, volatility is likely to be higher going forward, given macro risks for the developed world such as excess leverage. Investors anticipating a return to the mean for their developed world equity returns, and a redo of the 1982–99 period, thus may have a long time to wait. The volatility of the last decade may be indicative of the risks for the future.

Investors should not ignore the developed world completely. Large-cap, multinational growth stocks in developed markets offer an attractive opportunity given their reasonable valuations. The asset class deserves a 10% allocation in a portfolio, as many are high-quality companies with great products that have strong growth prospects. Substantial exposure to hedge funds across a wide variety of strategies should also provide satisfactory returns to investors, and skilled hedge fund managers have demonstrated the ability in the past to de-risk and protect portfolios during times of increasing volatility. A 20% exposure is likely to provide investors with exposure to some of the high-quality companies mentioned above, as well as gain exposure to arbitrage and distressed opportunities unavailable to traditional, long-only managers.

Given these secular changes in growth dynamics, one of the largest exposures a portfolio should have is to emerging markets equities. Allocating more assets to emerging markets has become a common theme, yet very few institutional investors have actually done it. Although the developing world accounts for 35% of the world's GDP, it accounts for less than 20% of the world's market capitalization and less than 10% of a typical institutional portfolio. As institutional investors seek to take advantage of the relative health of emerging markets economies and their strong outlooks for growth, they should allocate up to 20% of their portfolios to these markets. There are potential risks. Brazil, China, and India all face significant headwinds to increase the living standards of their populations and will need to become more accountable for the impact they have on the world. These concerns aside, emerging markets equities will be the place many investors look to for growth in the future.

With respect to a fixed income allocation, investors should invest up to 20% of their portfolios in high-yielding fixed income securities and have no exposure to U.S. Treasuries. Treasuries offer little value at current prices and are likely to see their yields move higher going forward, which will almost guarantee mark-to-market losses large enough to offset current income. High-yield bonds carry more default risk, but over the last two years defaults have been low. Given that this is unlikely to change, current yields offer relatively attractive high-single-digit return prospects. Other high-yielding fixed income securities such as bank loans and certain types of mortgage securities also offer attractive yields and should be considered when building out a fixed income allocation. These types of securities should hold up relatively well assuming that the United States is able to avoid another recession and the housing sector does not fall much further.

Real estate has bounced back following the 2008–09 recession and high-quality properties are available at or below replacement cost. Current cap rates are attractive enough to provide positive capital gains. Real estate deserves a 10% allocation, as does private equity. Private equity funds have shown over time that the premium paid to lock up capital has been rewarded. Even in what is likely to be a slower growth environment, opportunities are created as large companies continuously want to divest of noncore subsidiaries and entrepreneurs want to cash out and move on to new challenges. Thus, while stock picking may be difficult in the years ahead, there are always opportunities for private equity investors that take a long-term, patient approach to investing.

Investors should also have a 5% exposure to commodities in their portfolios. As the developing world's standard of living continues to rise, diets will improve and demand for higher-quality clothing will increase. As such, the demand for agricultural commodities should continue to increase faster than the ability to increase production; corn, cotton, soybean, and wheat prices should all rise. Commodities tend to be more volatile than most financial assets, but with the growing importance of emerging markets development, there is a legitimate case to be made for having exposure to real assets in a portfolio. Finally, gold deserves a 5% allocation as a form of insurance against severe dislocation or disaster in the markets for financial assets. Given the developed world's large debt obligations, expansive monetary policies, and declining currencies, investors will seek alternative stores of wealth; historically, gold has been a great benefactor during such times. Gold should not be in a portfolio as a protection against inflation, as this risk should be contained over the next few years. ■

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