CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Investment Strategy Research Team

"Equity Valuations Laid BARE*"

Dennis Jose, Edmund Shing, Yu-chieh Chiang,
and Joao Toniato, Barclays, June 6, 2012

Looking ahead, investors are struggling with the difficult question of where to find real returns. Today, risk-free government bonds offer near-zero or negative yields, while credits yields are among all-time lows. Equities offer an attractive entry point, and despite numerous risks, are poised to deliver above-average real returns.

As investors attempt to navigate their way through financial repression to generate robust real returns, they find themselves wondering how to achieve their ultimate goals. Yields on developed markets sovereigns range from the barely positive to negative, while credit yields are near historical lows. Surprisingly, equities are the menu item today that may satisfy investor cravings for robust real returns going forward.

Future equity returns will be driven by a combination of earnings growth, dividends, and valuations changes. Over the long run, valuations have shown to be mean reverting, and equity return forecasts should reflect this by assuming that cyclically adjusted price-earnings (P/Es) or trailing dividend yields revert to historical averages. Earnings growth is driven by revenue growth (assumed to be linked to GDP growth), and margins, which can be assumed to be either mean or trend reverting. For equity markets like those in the United States and United Kingdom with a high percentage of foreign earnings, GDP and thus revenue growth forecasts should use a blended global proxy.

One common error when forecasting equity returns is using the forward P/E. The problem with this metric is that it assumes that earnings are held constant in perpetuity, which will have little correlation to actual earnings growth. This is partially because historical evidence suggests that margins trend (or mean) revert. With current margins at peak levels across markets, forward P/Es may be overly optimistic and show that equities offer much greater value than if using a normalized metric. While normalized metrics offer a less optimistic outlook than forward P/Es, the question remains, do equities look attractive today?

Over the last century, real returns on developed markets equities have averaged between 5% and 7%. Today, Japanese and developed Europe ex financials appear most attractive, developed Europe and the United Kingdom are modestly attractive (all are priced to return in excess of their historical averages), and U.S. equities appear expensive relative to both their longer-term history and other asset classes. Even as the aforementioned regions appear attractive today, they could still fall further in the face of exogenous risks. Further, equity prices have not quite reached levels that historically denote the beginning of a secular bull market. Historically, secular buying opportunities arise when U.K. and European (ex financials) equities are priced to offer five-year annualized real returns in excess of 15%, whereas today's valuations suggest returns of 9% to 11%. U.S. Equities, which are even less attractive, should offer returns of 4%, both below their historical average and that of other markets.

* BARE is an acronym for the Barclays Return Estimates model.

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While the previous decade was one to forget for equity investors, the coming decade is one that will offer better prospects. Current valuations do offer attractive entry points, but not without risks as the European sovereign debt crisis, increased volatility, and a global growth slowdown all hang over markets. However, investors can help mitigate these risks through lower volatility strategies like high-dividend paying stocks. But, with negative real returns coming from safer sovereigns, and lower expected returns from credits, it is likely that a brighter future awaits equity investors, and that may just be the meal that satisfies investors' craving for real returns going forward.

"Investing in a Low Return World: In Search of Cheap Assets"

Martin H. Barnes, BCA, June 18, 2012

In today's market environment, popular asset classes (bonds, equities, and real assets) are simultaneously unattractive. For the most part, they are not cheap (especially bonds and real assets) and macro risks provide an uncertain future. However, there are pockets of cheap assets and for buy-and-hold investors, a focus on quality and stable returns is more important than looking for capital gains as economic uncertainties are likely to persist.

In today's market environment, popular asset classes (bonds, equities, and real assets) are simultaneously unattractive. They are not cheap (especially bonds and real assets) and macro risks provide an uncertain future. However, there are pockets of cheap assets such as euro-periphery bonds and European equities, which could become superb buying opportunities if conditions improve. For buy-and-hold investors, a focus on quality and assets with stable returns is more important than looking for capital gains as economic uncertainties are likely to persist.

Bond yields in developed markets are near their lowest points in modern history. At this point, yields cannot fall much further and as such, there is limited upside to bond prices. The only exception is bonds issued by troubled Eurozone countries such as Greece, Italy, and Spain. Clearly there are risks involved when investing in these countries, but if the current crisis is resolved, then those bonds have the potential to provide exceptional returns.

Relative to bonds, equities look only slightly better. Most developed markets are undervalued compared to their historical averages, with Spain being the most undervalued and the United States being the least. Despite the undervaluation, there are other factors that cloud the outlook for equities. U.S. profit margins are at cyclical highs and likely to fall, while a worsening of the euro crisis could pull down prices even more.

Compared to developed markets equities, emerging markets equities have a wider dispersion of valuations. Strong performers like Mexico are overvalued, while the much more unstable and volatile Argentina is undervalued. Scanning the globe, there is no overarching theme as to why there is such divergence in valuations within emerging markets. When the current level of valuation is plotted against economic growth, only three countries (Poland, Russia, and South Africa) have both low valuation and high expected improvement in economic growth.

If both bonds and equities are unattractive at current valuations, should investors "hide" in real assets? The current environment of extremely low short-term interest rates and aggressive monetary policy by central banks has historically provided a positive signal for real assets. However, prices of most real assets are at all-time highs and long-term returns for assets such as commodities, farmland, and gold are likely to disappoint at current valuations. Certain real estate assets are

priced more reasonably and managers with skill to uncover them may prove to be winners.

All in all, the outlook for most asset classes is bleak. A world of low interest rates and slow GDP growth will not be conducive to high investment returns. Bonds are likely to disappoint when interest rates eventually rise, and while equities may provide reasonable returns from current levels, there are still considerable near-term risks. An indexed balanced portfolio is not expected to return more than 5% a year over the next decade.

In terms of strategies, investors may need to be more active in their portfolio management than they have been in recent years and adept at tilting toward the right geographic, sector, and stock selections. European assets may seem very cheap, but investors will be forgiven for passing if they weaken further. At a minimum, they should build a watch list of European assets and move in if the crisis looks to be easing. For investors with a buy-and-hold strategy, a focus on quality and assets with stable returns will be needed as volatility from macro uncertainties will continue to plague the markets.

"Profits for the Long Run: Affirming the Case for Quality"

Chuck Joyce and Kimball Mayer, GMO, June 2012

Investors systematically undervalue high-quality companies (i.e., those that have high and stable profits) enhancing the attraction of these stable firms with profits. Equity investors should focus more on corporate profitability as an investment consideration, as it is the ultimate source of investment returns. By focusing on "quality" companies, investors can do a better job of controlling the price "risk" in their portfolios.

"Low-risk" investment strategies have been gaining a lot of attention recently as their benefits have started to become widely accepted. However, too many investors continue to rely on risk measures that are based on historical market data like stock price movements, co-movements, and cross movements, which—while easy to quantify—can be misleading. Investors are better served recognizing risk as a multifaceted concept with no single measure truly capturing its essence. A key risk factor for equity investors is profitability. As defined by Ben Graham, risk is "the danger of a loss of quality and earnings power through economic changes or deterioration in management." By focusing on "quality" companies that have high and stable profits, investors can do a better job of controlling the price "risk" in their portfolios.

The return earned by a stock investor (equity holder) is ultimately a function of the underlying profits earned by the companies held in a portfolio. For investors with long-term time horizons, as long as a company has a history of consistently delivering profits, any stock price volatility will ultimately wash out and the return to the stock investor will be a function of the earnings and dividends that accrue over time. Risk should be defined as deterioration in the underlying profitability of a company, and portfolios that are constructed to consist of companies with high and stable profits will be rewarded. Companies that are exceptionally profitable can generate strong returns over long periods of time while companies that do not often end up failing or bankrupt.

There are many factors that can contribute to a company's ability to generate consistent profits. Intangible assets such as brands and franchise values, as well as human and intellectual capital, can protect a company from competitive pressures. Contrary to competitive equilibrium theories, many companies have demonstrated the ability to persistently deliver high returns on equity and

consistently strong profits and dividends largely as a result of their intangible assets, which are not easily re-created and eroded away by competition.

When thinking about how most investors "price" risk, most academic theories and corporate finance actually get risk and reward backwards. One of the central tendencies of modern portfolio theory is that risk and reward are positively related, so taking on risk, as defined by past price movements and co-movements with market indices, is necessary for outperformance. The recent history and outperformance of low-beta strategies are clear examples of how the market misprices price-based risk factors. The persistence and outperformance of high-quality stocks demonstrates that the market mis-prices fundamental risk as well. The difference between high-quality strategies and other low-volatility strategies like high-yield bonds or quantitatively driven low-volatility strategies is that the performance of the latter will depend not on fundamentals but rather on the future stability of past price performance. High-quality equities are appealing relative to these strategies because attempting to predict and estimate the future profitability of high-quality companies is much easier, as it does not depend on unstable variables and past relationships that may or may not persist in the future.

As investors systematically undervalue high-quality companies, the stability and persistence of profits they generate makes them attractive. Ultimately, profitability is what matters for equity investors as it is the source of investment returns. When thinking about ways to minimize risk, investors are best served by focusing on real economic risk of the underlying companies they are investing in with a fundamental focus on profitability. ■