CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

September 2011

Copyright © 2011 by Cambridge Associates LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of U.S. and international copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, clients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. An authorized client may download this report and make one archival print copy. The information or material contained in this report may only be shared with those directors, officers, staff, and investment committee members or trustees having a need to know and with the understanding that these individuals will treat it confidentially. Violators of these confidentiality provisions may be subject to liability for substantial monetary damages, injunctive action, and all other remedies available at law or equity. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but clients are required to provide notice to CA reasonably in advance of such disclosure.

This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. This report is provided only to persons that CA believes are: (i) "Accredited Investors" as that term is defined in Regulation D under the U.S. Securities Act of 1933; (ii) "Qualified Purchasers," as defined in Section 2(a)(51) of the U.S. Investment Company Act of 1940; (iii) of a kind described in Article 19 or Article 49 of the Financial Services and Markets Act 2000; and (iv) able to meet the requirements for investors as defined in the offering documents. Potential investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Nothing contained in this report should be construed as the provision of tax or legal advice. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees) or both. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made.

Where referenced, the CA manager universe statistics, including medians, are derived from CA's proprietary database covering investment managers. These universe statistics and rankings exclude managers that exclude cash from their reported total returns, and for calculations including any years from 1998 to the present, those managers with less than US$50 million in product assets. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. CA does not necessarily endorse or recommend the managers in this universe.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Services Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

Investment Publications Highlights

Summarized by the Published Research Team

"What's the Difference Between Japan and the US" by Michael Gavin, Barclays Capital, August 31, 2011

As the economic backdrop in the United States continues to deteriorate, there is fear that it faces a lost decade or two similar to Japan. While there are clear parallels—a bursting of a real estate bubble followed by a financial crisis—there are also important differences, and to draw a direct comparison between the two countries and conclude that the United States will follow the path of Japan over the next two decades seems misplaced. However, the Japanese experience may prove helpful as a guideline for U.S. policymakers and investors.

As the economic backdrop in the United States continues to deteriorate, there is fear that the U.S. faces a lost decade or two similar to Japan. While there are clear parallels—a bursting of a real estate bubble followed by a financial crisis—there are also important differences, and to conclude that the United States will follow the path of Japan over the next two decades seems misplaced. Favorable demographics, an easier rebalancing process, and differentiated policy responses in the United States are key reasons why the two scenarios are not directly comparable. However, the Japanese experience may prove helpful as a guideline for U.S. policymakers and investors to help them avoid a Japan experience of their own.

After the real estate and equity markets crashed in Japan, GDP growth averaged just 0.9% per year for two decades, a dramatic slowdown from the 4.9% annual growth during the preceding 20 years. The situation in the United States certainly seems familiar. The U.S. housing bubble deflated in 2007 and led to a full-on financial crisis at the end of 2008. Since then, real GDP growth in the United States has been dismal and the level of real GDP has yet to reach its 2006 levels. As such, many market participants believe the United States is destined to follow Japan into 20 years of sluggish economic growth.

One of the key differences between Japan and the United States is demographics. Prior to the market crashes in Japan, the economy was already headed toward a reduction in its working-age population. By the middle of the 1990s, growth in the working-age population stalled and it has been on a steady decline ever since. The United States does not face such a scenario. As a more flexible and open economy, the United States still has a relatively young workforce and much lower dependency ratios. The U.S. working-age population is expected to grow around 1% in the next decade, compared to Japan's average growth of -0.4% over the last two decades. While U.S. real GDP/worker is expected to slow over the next decade, the decline is not expected to be as bad as that experienced by Japan over the last 20 years.

In terms of revitalizing its economy following the most recent crises, the United States faces a much more manageable road towards rebalancing than that faced by Japan. Japan's property bubble was widespread and far more excessive than that in the United States. The bubble in Japan also included excessive fixed investment spending, which at its peak exceeded 35% of GDP, roughly twice the peak in the United States. The troubles facing the United States have more to do with an excess of residential investment, which now

accounts for just 2.5% of GDP, less than half of its pre-bust level. As this normalizes and moves back toward sustainable levels, the subsequent investment should be supportive of growth. A decade of overconsumption and lower asset prices in the United States should also lead to higher levels of savings and investment, as consumers deleverage and look to rebuild their wealth. While the increase in savings may lead to lower trend growth, a rebalancing of the U.S. economy away from consumption and toward exports and investments will be much easier to orchestrate than a resolution to Japan's predicament of excessive investment over the last 20 years.

U.S. policymakers' response to the financial crisis is another key reason why the United States is unlikely to follow Japan into a lost decade. Japanese authorities are widely criticized for underestimating the size and scope of their real estate crises and its subsequent effects on the banking sector. As they were slow to react, the result was that many so-called "zombie" corporations were in effect bankrupt, but still allowed to carry on. By not purging the system of bad credits, the Japanese economy's credit creation slowed and capital flowed toward propping up unproductive assets rather than investing in new ventures that would have been supportive of growth. U.S. policymakers, in contrast, should be praised for their handling of their financial crisis. While controversial, by helping to recapitalize the banking sector and proactively providing liquidity, U.S. policymakers helped purge many of the problem credits and allowed the banking system to get back on its feet.

The United States faces tremendous challenges stemming from its housing bubble and financial crisis. The rebound in economic growth following the most recent recession has been considerably weaker than many previous recoveries. Even so, supportive monetary and fiscal policies, as well as economic imbalances that are much easier to resolve, point to the United States having a period of below-trend growth, and not necessarily a lost decade. While the United States may take another two to three years to resolve some of its balance sheet issues, relatively favorable demographics, accommodative and proactive policymakers, and a more flexible economy all point to the United States being able to avoid Japan's lost decades.

"Absolute Zero" by A. Gary Shilling, A. Gary Shilling's INSIGHT, September 2011

Zero interest rates and economic weakness in the United States are causing market participants to wonder if the United States is headed for a Japan-type future. While there are notable differences between the two, bond markets are telling investors that the United States is likely to witness a similar period of slow growth and deflation as the economy delevers, despite unprecedented monetary and fiscal stimulus. For those that accept such a premise, further gains in the bond market lie ahead, as the 30-year bond will likely test the 2.6% yield reached during the global financial crisis.

The last monetary policy statement from the Federal Open Market Committee (FOMC) was unusual because of its specificity—namely, the FOMC pledged to keep federal funds rate at current low levels through at least 2013. The decision was also significant as rates will have been near the zero bound for roughly five years by that point. Zero interest rates and related issues are relatively new in the United States. However, Japan has been mired in such an environment for roughly two decades, leaving many market participants to wonder if the United States is headed for a similar outcome.

There are a number of similarities that suggest America will experience a long period of economic malaise. The most pertinent relate to the actions (and inability) of policymakers to reverse the tide of economic weakness. For instance, Japan has spent large sums of money, much of it politically motivated, on economically questionable projects to try and reverse its slump (e.g., building bridges to nowhere). Similarly, the United States spent $814 billion in a 2009 stimulus package, while the administration is currently proposing another package of roughly $447 billion. This spending has led to big government deficits and rising debt levels for both countries. Although Japan is in a league of its own, with net government debt of more than 120% of GDP, the ratio in the United States is projected to reach similar levels in the not-too-distant future. In turn, these debt levels have led to actions by rating agencies. Here, the recent U.S. downgrade by Standard & Poor's parallels the first cut in Japanese bond ratings in 1998. Monetary policy, meanwhile, has been equally ineffectual, despite zero interest rates and quantitative easing measures. Indeed, these actions have proven impotent in an environment where banks do not want to lend and creditworthy borrowers do not wish to borrow. Put differently, both central banks find themselves in a classic liquidity trap.

Of course, there are also considerable differences between conditions in the United States and Japan that makes the latter's experience a questionable model for the former. Culturally, for instance, the two are very different. The Japanese are an extremely homogeneous population, with little immigration and low fertility rates. Its declining population lacks the innovation and dynamism of its U.S. counterpart, which enjoys a more youthful, diverse, and growing population.

Economic conditions between the two also attest to dissimilarities. For instance, post–World War II Japan has been an export-led economy where perennial current account surpluses, coupled with earlier high saving by households, and now by businesses, financed huge government deficits. Indeed, foreigners own just 5% of Japanese government debt. In contrast, the United States runs chronic current account deficits, relying on foreigners to finance the shortfall. As a result, foreigners now own roughly 50% of outstanding U.S. government debt. Thus, Treasury yields are much more controlled by global forces.

While the differences between the United States and Japan are too great to use the Japanese experience as a precise template for the future of the U.S. economy, the United States is likely to witness a similar period of slow growth and deflation as the economy delevers. Policymakers, meanwhile, will be unable to forestall this outlook, as evidenced by their attempts thus far. Like QEI, QE2 put money in the hands of investors, but had no follow-on economic effects, as these actions require the cooperation of banks and creditworthy borrowers to turn excess reserves into loans and money. However, both parties have been reluctant to do so. Nonfinancial businesses, for instance, already have high levels of cash, while creditworthy individuals would rather pay down mortgages and other debts than request new loans. Similarly, QE2 did not achieve the Federal Reserve's goal of reducing mortgage rates further to aid distressed homeowners, as rates actually rose after the program was announced in November 2010.

More recently, other options for further easing have been discussed—for example, the Fed could lengthen the duration of its Treasury holdings (i.e., sell short-term securities and buy longer-term debt instruments), attempting to reduce long-term interest rates even further. Importantly, however, banks (i.e., lenders) are already hurting from the narrow spreads between near-zero cost deposits and low lending rates. Thus, a flatter

yield curve would exacerbate such problems. Another potential option is for the Fed to cut the interest paid on excess reserves, which is currently at 0.25%. However, this plan seems unlikely to spur lending in a meaningful way and may actually do more harm than good by adding further stress to money markets.

The ineffectiveness of these actions is reflected in the bond market. Indeed, current Treasury yields are near historic lows, despite unprecedented monetary and fiscal stimulus. Thus, while many investors fret over inflation, higher yields, and subsequent losses on bonds, the bond market is telling a much different tale—namely, a sluggish U.S. economy and deleveraging are here to stay for the foreseeable future. For those that accept such a premise, further gains in the bond market await, as the 30-year bond will likely test the 2.6% yield reached in the global financial crisis. ■

These monthly investment perspectives are intended to provide analysis of recently published articles on a wide range of investment topics, focusing on insights from publications not as widely available as *The Wall Street Journal* and *Business Week*, for example. We regret that due to copyright restrictions, Cambridge Associates cannot provide the articles cited above.