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## Highlights

- Investors are increasingly focused on risks associated with a potential escalation of North Korean tensions.
- While we see that anxiety as reasonable, we do not believe related portfolio shifts are currently warranted.
- More often than not, negative shocks have historically proven to be good opportunities to buy risk assets; a prolonged bear market has been more likely only when the risk event drove the U.S. economy into recession.

Successful investing means constantly considering what could go right — and wrong — for the global economy and financial markets. One issue that is garnering increased attention on the extreme end of the “wrong” scale is North Korea. The focus on this isolated Asian country has come as missile launches have become more frequent, U.S. rhetoric around a potential response has intensified, and key North Korean event anniversaries have approached, leading some to fear that a military conflict centered on that country is a higher probability today.

In this *Investment Insights*, we review the threat from North Korea and why it is so difficult for global leaders to resolve. We also discuss how Bessemer views such so-called black swan risks and events — especially in terms of understanding implications for the global economy and financial markets. As we look ahead, we appreciate that North Korea is unlikely to — but could,

conceivably — transform from threat to actual crisis; diversified portfolios are held in part as defense against such a scenario.

## North Korea: Saber-Rattling or Real Threat?

Worries over a military conflict involving North Korea have regularly waxed and waned over the past decades, even well after the Korean War of the 1950s. U.S. President Richard Nixon considered tactical nuclear strikes after North Korea shot down a U.S. plane in 1969, according to documents published by the National Security Archive. Subsequent years saw North Korea focus on missile development. By the mid-2000s, North Korea was allegedly testing nuclear weapons (Exhibit 1). North Korea’s leaders have used this saber-rattling to help secure resources of various sorts for the country, as well as to attempt to underline the country’s importance as a key global player.

Over this period, the rest of the world focused on diplomacy to contain and restrain North Korea, as alternatives were never seen as preferable. Consider just a few of the puzzle pieces behind this “strategic patience.” South Korea, while appreciating the benefits of potential reunification with the North, also knew the costs in terms of assimilating millions of refugees following the potential dissolution of the country. China also feared a potential flood of North Korean refugees. In addition, China worried that a reunified Korea, allied with the U.S. and Japan, would create an unwanted, larger geopolitical counterweight. The U.S., Japan and South Korea did not want to unnecessarily antagonize China, nor did they want to incur large military and humanitarian costs that could come alongside a radical change in North Korea, especially if those costs were not backed by voters at home. All of these considerations assumed that North Korea’s dissolution or political transformation could occur relatively peacefully — a huge, and unfortunately unlikely assumption.

### Exhibit 1: North Korea Weapons Program Timeline

Time Period	North Korea Actions
1976 – 1981	Begins missile development
2003	Withdraws from Non-Proliferation Treaty, begins acquiring weapons-grade plutonium. First so-called six-party talks held, including China, Japan, Russia, South Korea and U.S.
2005	Announces possession of nuclear weapons; withdraws from six-party talks aimed at ending its atomic program
October 2006	Official Korean Central News Agency announces a “successful nuclear test”
May – July 2009	Carries out second nuclear test and test-fires missiles
December 2011	Leader Kim Jong Il dies; Kim Jong Un takes power
December 2012	Puts first satellite into space
February 2013	Conducts third underground nuclear test
May 2015	Claims to have tested submarine-launched missile
January 6, 2016	Claims successful test of hydrogen bomb
February 7, 2016	Launches long-range rocket that it says successfully put a satellite into orbit
August 24, 2016	Successfully launches a ballistic missile from submarine
September 5, 2016	Fires three ballistic missiles about 1,000 kilometers
September 9, 2016	Conducts fifth nuclear test
October 16, 2016	Fires ballistic missile; immediately explodes after launch
February 12, 2017	Fires intermediate-range ballistic missile into nearby seas
March 6, 2017	Fires four ballistic missiles; three fall into Japan’s exclusive economic zone
April 16, 2017	Fires unidentified ballistic missile; explodes shortly after launch

As of April 19, 2017.

Source: Bloomberg

Based on our research, we believe that diplomacy remains the most likely path forward — with the North Korean regime remaining intact. That said, we certainly acknowledge that the threat of military action has increased based on at least three developments:

- First, Kim Jong Un, grandson of North Korean founder Kim Il Sung, has displayed little predictability in policymaking since assuming power in 2011. He has reportedly had family members and top military aides killed for what seem to be fairly small perceived or real transgressions.
- Second, available data suggest that North Korea has materially increased its arsenal of nuclear warheads as well as chemical and conventional weapons. Reputable media have reported estimates of 10-25

nuclear weapons along with launch vehicles and supporting military now under North Korean control. There is growing anxiety that such weapons could reach Japan or even the United States.

- Third, the new U.S. administration has struck — at least so far — a more aggressive military stance, in general and specifically vis-à-vis North Korea. After an April meeting with Chinese President Xi Jinping, for instance, U.S. President Trump tweeted: “I explained to the president of China that a trade deal with the U.S. will be far better for them if they solve the North Korean problem! If China decides to help, that would be great. If not, we will solve the problem without them!” In addition to such rhetoric, the Pentagon ordered the USS Carl Vinson to head toward Korean waters.

It's worth noting that April 25 marks the 85th anniversary of the founding of the Korean People's Army and Kim Jong Un could use the event as reason to launch or test weapons. Any policy misstep from his side, or from the U.S. and/or Asia in reaction to such a launch or test, could inadvertently escalate into a larger crisis. It's important to remember that the South Korean capital, Seoul, with 10 million residents, is just 35 miles south of the North Korean border. North Korea could easily inflict immeasurable damage against its southern neighbor.

## Negative Shocks and Investing

In general, we believe a diversified portfolio of stocks, bonds, credit, and alternative investments (the latter only for appropriate clients) is the best defense against a shock that reverberates in financial markets. While we have sometimes seen drawdowns in the stock market around similar crises, when these drawdowns occur, they tend to (a) be short lived unless accompanied by a broader recession, and (b) coincide with solid returns in bonds, making bonds consistently one of the best hedges against these risks (Exhibit 2).

Indeed, throughout history, capital markets have proven to be incredibly resilient to exogenous events such as wars/conflicts and natural disasters. Even during the height of World War II and the Vietnam War, both of which were pivotal conflicts during the 20th century, the S&P 500 still had many good years.

We would also note that moderate stock market pullbacks have historically been the rule rather than the exception during bull markets. Taking U.S. large cap stocks as an example, over the past 30 years we have seen a minimum pullback in the S&P 500 during the course of any given calendar year of 3%. That means the stock market in any given year falls at least 3%, and often more. Even more striking, the average pullback in years when stocks end the calendar year with positive returns is 11% (Exhibit 3). Pulling all this together, we conclude that aside from a recession or a fundamental paradigm shift that dramatically affects both domestic and global growth expectations, equity pullbacks triggered by negative shocks including military tensions or events tend to be buying opportunities.

### Exhibit 2: Asset Class Performance During Crises

**Key Takeaway:** Stock market drawdowns during crises tend to coincide with solid returns in bonds; the performance of gold has varied in times of crisis.

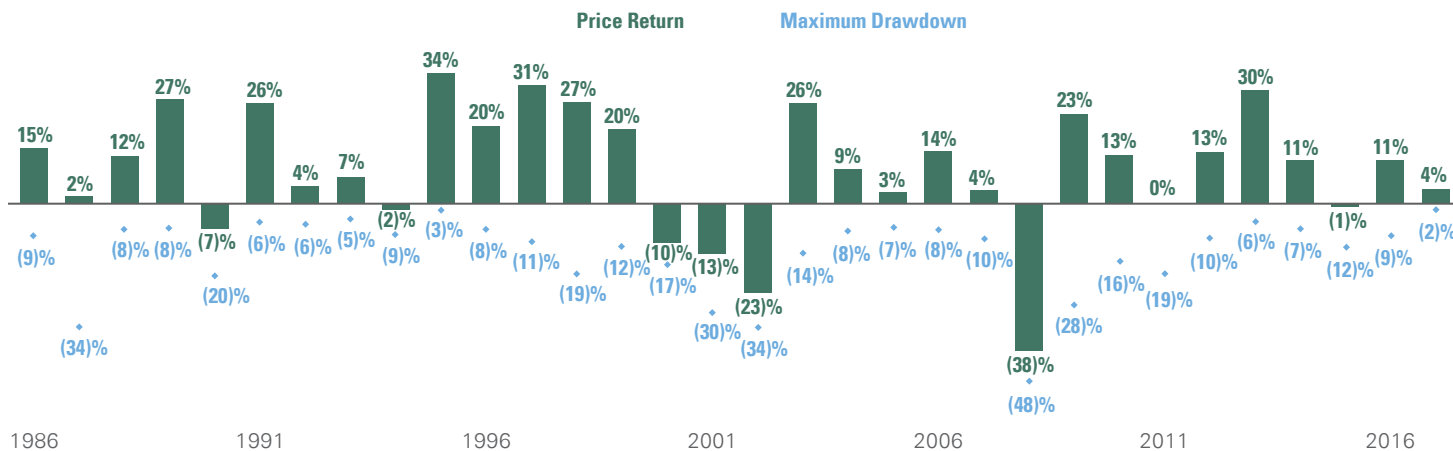
Event	Start Date	S&P 500 Maximum Drawdown	Total Return During Event	
			Gold	U.S. 10-Year Treasury
Gulf War I	Aug 90	(19.9)%	6.8%	(1.1)%
Mexican Crisis	Dec 94	(3.6)%	(1.5)%	(2.1)%
Asian Financial Crisis	Jul 97	(3.0)%	(6.1)%	5.9%
LTCM Collapse	Sep 98	(19.2)%	2.2%	8.9%
Sept. 11 Attack	Sep 01	(26.4)%	0.4%	7.5%
Operation Iraqi Freedom/Gulf War 2	Mar 03	(9.7)%	5.4%	4.9%
Lehman Collapse	Sep 08	(47.3)%	(18.6)%	8.3%
Euro Area Crisis	Mar 10	(5.6)%	(1.0)%	0.1%
Debt Ceiling and Government Shutdown	Oct 13	(4.1)%	2.2%	0.4%
Crimean Invasion	Feb 14	(1.8)%	6.6%	3.0%
<b>Median</b>		<b>(7.7)%</b>	<b>1.3%</b>	<b>4.0%</b>

As of April 19, 2017. Maximum drawdown represents the peak to trough drawdown three months preceding and following the cited event.

Source: BCA Research

**Exhibit 3: S&P 500 Maximum Drawdown and Price Return by Calendar Year**

**Key Takeaway:** Stock pullbacks are the rule, not the exception.



**Minimum pullback in any calendar year = (3)%**  
**Average pullback in an up year = (11)%**

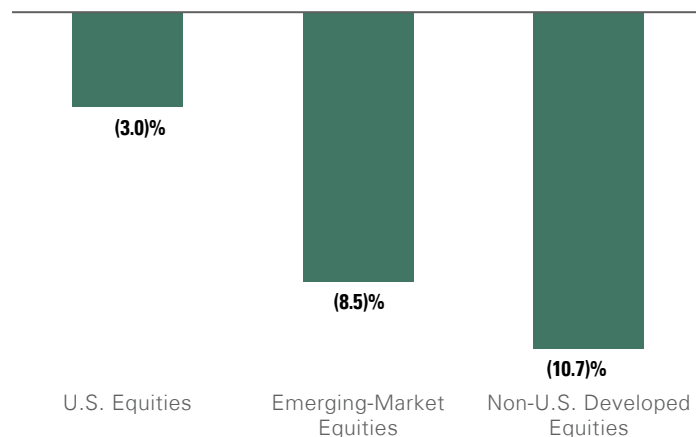
As of April 19, 2017.  
 Source: Bloomberg

**So What Now?**

Today, as we view the U.S. economy as being in the later stages of a growth cycle and equity valuations as fair or even stretched, incremental equity returns become harder to achieve. Heading into 2017, with this backdrop alongside several “known unknowns” on the horizon (including European elections and geopolitical hot spots) that have the potential to fundamentally alter the economic and financial landscape of major economies, we feel it is prudent for our equity mandates to maintain some more defensive, managed-volatility equity strategies. We also hold fixed income exposure to help protect against downside risk. Further, within equities, we maintain a healthy overweight to the U.S. and, as a result, the U.S. dollar. Given the liquidity of U.S. financial markets and the safe-haven status of the dollar, U.S. equities tend to experience quicker recoveries than non-U.S. counterparts, all else being equal. We view this country tilt as a defensive measure as much as anything (Exhibit 4; see *“America the Beautiful, October 2016”* for more detail).

**Exhibit 4: Average Annualized Return During U.S. Recessions**

**Key Takeaway:** On average, during U.S. recessions, U.S. equities have lost less than emerging-market or non-U.S. developed-market equities.



As of April 19, 2017. Data set begins December 31, 1969. Includes all recessions according to NBER, with the 1980/1981 recessions combined. Represents MSCI World ex-U.S. (total return, US), S&P 500 Total Return Index, and Global Financial Data’s Emerging Market Index. Source: FactSet, Global Financial Data, National Bureau of Economic Research, Standard & Poor’s

Should negative shocks such as a North Korean military conflict *not* emerge — our base case — we believe Bessemer portfolios have sufficient equity and other cyclical-asset exposure to still generate attractive returns. Tactical asset-allocation shifts can also help fine-tune portfolios as risk probabilities change. In the meantime, we believe our role as investors means continually thinking about what could go right and wrong, researching and questioning our portfolios to make sure we are positioned appropriately.

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