Investment Insights

Thinking About Corrections

BESSEMER TRUST

Rebecca Patterson
Chief Investment Officer

Highlights

- While the ongoing equity selloff has some differences, there are also worthwhile comparisons to the volatility experienced in 2011
- Like 2011, our base case remains that equities this year will recover; we continue to see reason to expect a positive calendar year return
- That said, we want to do everything we can to effectively manage through these pockets of volatility, including tactical asset-allocation shifts as well as using a philosophy of global, diversified investing

To say financial markets have had a rough start to 2016 is a clear understatement. After three years of below-average volatility in global equities, volatility has returned with a vengeance. The S&P 500 Index has suffered losses in more than half of the trading days so far this year, and the index is down almost 11%, with some other overseas markets losing even more (through February 11).

Many investors are wondering whether the market is telling us something and are left questioning their investment decisions. In our experience, the market usually does tell us something, but that something is not always correct. In fact, the market has predicted 16 of the last 10 recessions (depending on how you calculate it). The market is not always rational, which means it is not always right, but it still cannot be ignored.

Based on our analysis, it does not look as if the U.S. economy is entering recession. Personal consumption, which drives the lions' share of the economy, continues to hold firm; job growth is robust (even including energy-related layoffs), housing continues to improve and cheap oil is acting like a major tax cut. Indeed, we believe this could be one of those times when the market is sending us a false signal. In this publication, we compare today's environment to 2011, another period when the market was also sending a false signal. On a separate but related note, we also discuss why we believe a global, diversified approach to portfolio construction is still the best way to manage through these market roller coasters.

A Look Back to 2011

We cannot help but compare the ongoing equity selloff to volatility felt in 2011. Consider some of the issues at the forefront during that time:

- The U.S. was in political gridlock with Congress, stuck in a year-long game of chicken over the U.S. debt ceiling and the budget deficit;
- The Eurozone was in the midst of a sovereign debt crisis while inflation was rising and the European Central Bank (ECB) was tightening monetary policy;
- High-yield credit spreads versus U.S. Treasuries were widening to levels not seen since 2009 (though nowhere near the highs during the peak of the financial crisis); and

- The Federal Reserve had just ended its second quantitative easing program (QE2), and economic data were deteriorating after a negative GDP print in the first quarter of 2011 and an unemployment rate still above 9%. Moreover, economic growth forecasts for the year were cut in half, from a high of 3.2% in February 2011 to 1.6% by September.

All of these factors combined to spark recession concerns, and equities responded with a 19% correction between July and October. Eventually, sufficient doom and gloom was discounted in valuations. U.S. economic data started surprising positively again, U.S. earnings growth picked up, and a Greek bailout emerged: all together, these served to stabilize and then propel financial markets again. The S&P 500 Index bounced back 11% to end the year flat (before going on to return an annualized 16% over the next four years, Exhibit 1).

Fast forward to today: economic data is once again disappointing market expectations just as the Federal Reserve has entered its first tightening cycle in 11 years. As in 2011, investors perceive risks everywhere they look: slowing Chinese growth and questions over currency policy; plummeting oil prices and possible spillover to various related industries; and more recently, fear of another European banking crisis. Since the start of 2016, European bank stocks have lost over 25%, while banks in the U.S. and Asia are down 23% and 17%, respectively.

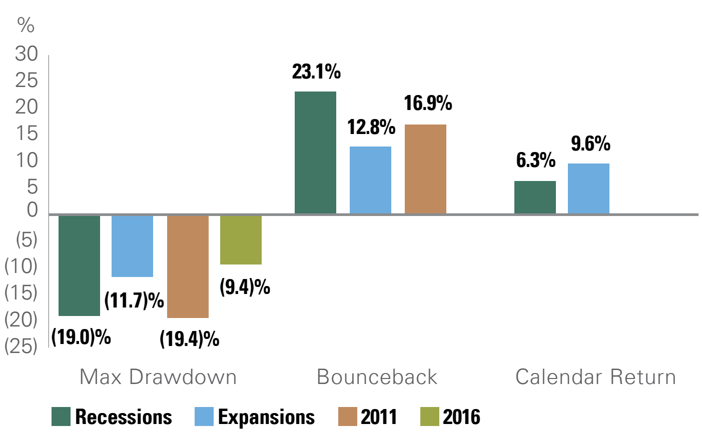
Today versus 2011: Similarities and Differences

Is this 2011 all over again? When volatility escalates and fear grips markets, it is more important than ever to look at what the data, not just what the market, is telling us. There are some key differences between today and five years ago.

Let's start with European banks. The 2011 European banking crisis focused on liquidity, whereas we view today's European bank weakness as reflecting a crisis of confidence around earnings potential. During the 2011 crisis, banks held a substantial amount of sovereign debt on their balance sheets, which posed significant risks when yields on peripheral government debt increased (Exhibit 2).

Exhibit 1: S&P 500 Average Returns and Drawdowns, 1951 to 2016

Key Takeaway: Like other expansionary periods, 2011's correction was followed by a significant rally.

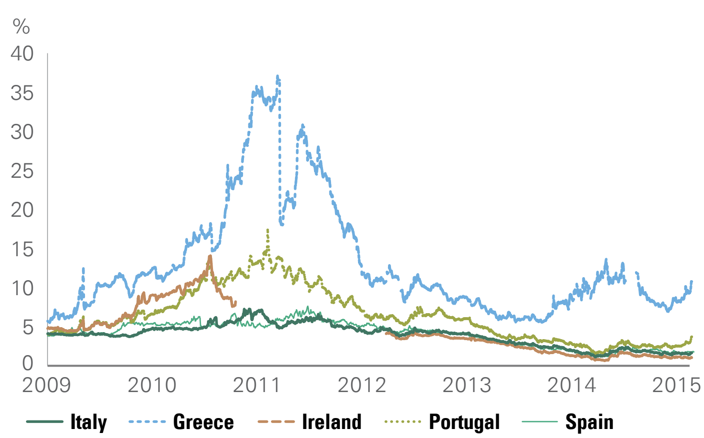


Data as of February 10, 2016. Reflects price return only. Max drawdown is calculated for each calendar year's largest peak to trough decline.

Source: Bloomberg, Standard & Poor's

Exhibit 2: European Sovereign Bond Yields

Key Takeaway: Bond yields in peripheral European countries spiked during the 2011 sovereign debt crisis, putting pressure on European bank balance sheets.



Data as of February 10, 2016. Reflects 10-year sovereign bond yields for each respective country.

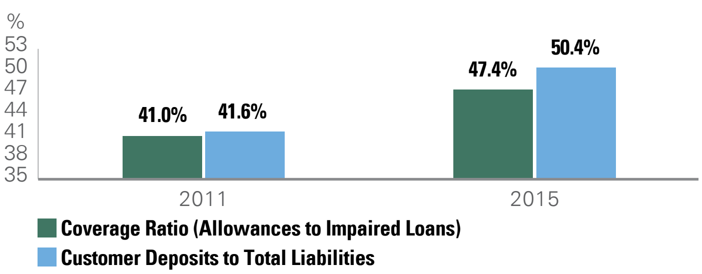
Source: Bloomberg

Banks today are much better capitalized than they were in 2011 (Exhibit 3), have little to no sovereign debt exposure, and have more than halved their reliance on ECB liquidity since 2012 peaks. Low growth and negative interest rates are leading investors to sharply discount the earnings potential of banks, but unlike a liquidity crisis that can seemingly escalate overnight, weaker bank earnings will be more of a slow drip that could easily turn around when growth re-accelerates and interest rates rise. (The question in our minds here is "when" — the fall in oil prices is keeping a lid on inflation, which in turn makes higher interest rates in Europe something that is getting pushed out in time.)

Exhibit 3: Health of European Banks

Key Takeaway: European banks are better capitalized today than they were in 2011.

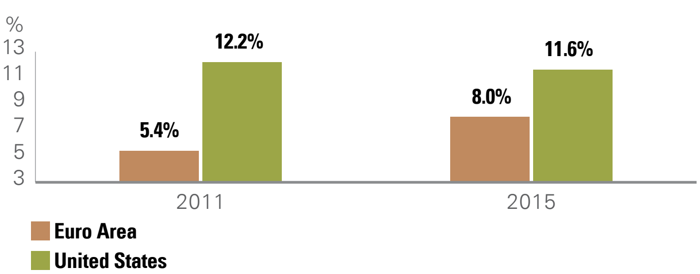
EU Bank Credit Risk and Balance Sheets



Data as of June 30, 2015. Data reflects the weighted average of 55 European banks.

Source: European Banking Authority

U.S. and Euro Area Bank Capital to Assets



Data as of June 30, 2015. Bank capital to assets is the ratio of bank capital and reserves to total assets. Capital and reserves include funds contributed by owners, retained earnings, general and special reserves, provisions, and valuation adjustments. Capital includes tier 1 capital (paid-up shares and common stock), which is a common feature in all countries' banking systems, and total regulatory capital, which includes several specified types of subordinated debt instruments that need not be repaid if the funds are required to maintain minimum capital levels (these comprise tier 2 and tier 3 capital). Total assets include all nonfinancial and financial assets.

Source: World Bank

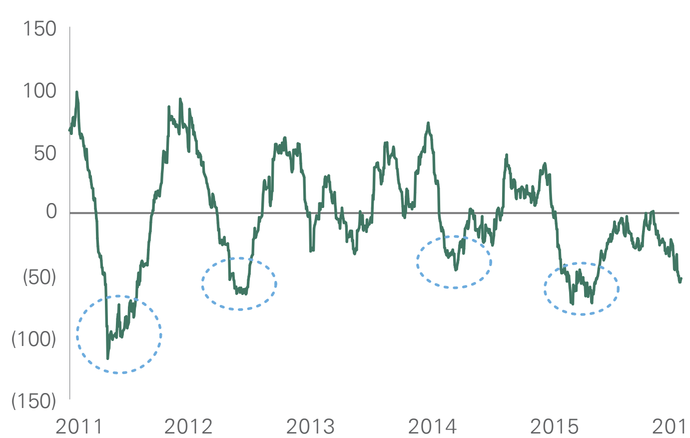
Another difference from 2011 is the global economic backdrop. While growth estimates have been lowered, consensus expectations for 2016 real U.S. GDP growth remain at 2.4%, down only 0.4% from six months ago. U.S. job growth is fairly robust while inflation is modest (consumer prices are rising by less than 1% and just over 2% when excluding food and energy), suggesting the Fed can afford to normalize monetary policy slowly. Beyond the Fed, central banks globally are actively easing monetary policy to support growth and fight deflation risks, going as far as to take policy rates into negative territory. Fiscal austerity in the Eurozone has been replaced with more accommodative policies and, although still polarized, U.S. policymakers are now providing more fiscal stimulus as well (with Congress passing a $1.1 trillion budget late last year). China's economy has slowed from 2011 levels, but at the same time the nominal economy has continued to grow.

The bottom line here: Economic momentum has slowed, dragged in part by lower commodity prices and a stronger dollar, but it remains nowhere near 2011's depressed levels (Exhibit 4).

While some elements of the global landscape look decidedly better than in 2011, there are still issues that warrant our consideration — and caution — today. We

Exhibit 4: Citigroup U.S. Economic Surprise Index

Key Takeaway: While economic momentum has slowed, it has not reached 2011's depressed levels.



Data as of February 9, 2016. The Citi Economic Surprise Index measures data surprises relative to market expectations. A positive (negative) reading means data releases have been stronger (weaker) than expected.

Source: Bloomberg, Citigroup

are in a later part of the economic cycle relative to 2011. Likewise, U.S. earnings growth does not look poised for 2011's double-digit growth rates, with increasing labor costs placing pressure on elevated profit margins for U.S. companies, and equity valuations somewhat higher (at least versus the market lows five years ago).

Although we feel that financial markets have "overpriced" recession risks in the near term and consumer momentum can lead equities to positive returns this year, we are cognizant of where we are in the economic cycle as well as anticipated volatility in the year and years ahead. We have taken steps in client portfolios to reduce risk and dampen some of the current equity volatility; we are actively considering if additional steps may be warranted despite our medium-term, more constructive view.

Managing Through Anxious Times: Back to Basics

During times of market stress, when asset class correlations move toward one, it can be tempting to second-guess an investment plan. Investors fight the urge to sell out of losers and pile into the winners, or to sell everything and move to cash. Bessemer's investment philosophy, and a pivotal way in which we protect clients' capital to meet their long-term goals, is through a combination of tactical asset allocation decisions and diversification, the latter across asset classes and geographies.

Asset Class Leadership Rotates. Admittedly, diversification can be frustrating at times. When one particular asset class outperforms the others, investors can feel like throwing in the towel and just hopping on board with that "winner." As Exhibit 5 shows, however,

Exhibit 5: Calendar Year Returns of Major Asset Classes

Key Takeaway: Asset class performance rotates year-by-year; the best performer one year is often not the best performer the following year.

2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD
Non-U.S. Large 18.1%	Bonds 5.2%	Non-U.S. Small 63.5%	U.S. Small 28.0%	Bonds 7.8%	Non-U.S. Small 19.0%	U.S. Small 38.3%	U.S. Large 13.6%	Non-U.S. Small 3.0%	Bonds 1.4%
Commodities 16.2%	Cash 1.8%	Non-U.S. Mid 47.3%	U.S. Mid 26.1%	U.S. Large 2.6%	U.S. Small 18.2%	U.S. Mid 35.0%	U.S. Mid 12.4%	U.S. Large 1.9%	Cash 0.0%
Non-U.S. Mid 11.8%	Hedge Funds -18.7%	Non-U.S. Large 41.2%	Non-U.S. Small 25.6%	Cash 0.1%	Non-U.S. Mid 18.0%	U.S. Large 32.1%	U.S. Small 7.5%	Bonds 0.5%	Hedge Funds -1.1%
Non-U.S. Small 11.1%	Diversified Portfolio -26.7%	U.S. Small 39.7	Non-U.S. Mid 17.7%	U.S. Mid -0.8%	Non-U.S. Large 17.3%	Non-U.S. Small 20.1%	Bonds 6.0%	Cash 0.0%	Commodities -1.7%
Hedge Funds 11.0%	Commodities -35.6%	U.S. Mid 38.8%	Commodities 16.8%	Hedge Funds -2.0%	U.S. Mid 16.7%	Non-U.S. Mid 16.7%	Hedge Funds 4.3%	Hedge Funds -0.2%	Diversified Portfolio -4.0%
Diversified Portfolio 10.3%	U.S. Small -35.9%	Diversified Portfolio 26.6%	U.S. Large 13.5%	Diversified Portfolio -2.7%	U.S. Large 16.0%	Non-U.S. Large 15.6%	Diversified Portfolio 4.2%	Non-U.S. Mid -0.9%	U.S. Large -4.9%
Bonds 7.0%	U.S. Large -36.0%	U.S. Large 25.3%	Diversified Portfolio 12.3%	U.S. Small -3.0%	Diversified Portfolio 12.4%	Diversified Portfolio 14.8%	Cash 0.0%	U.S. Mid -1.6%	Non-U.S. Mid -6.7%
U.S. Large 6.4%	U.S. Mid -42.9%	Commodities 18.9%	Non-U.S. Large 10.4%	Non-U.S. Large -12.9%	Hedge Funds 4.4%	Hedge Funds 9.6%	Non-U.S. Mid -1.9%	Diversified Portfolio -1.7%	Non-U.S. Large -6.8%
Cash 4.8%	Non-U.S. Large -44.9%	Hedge Funds 18.6%	Hedge Funds 8.5%	Commodities -13.3%	Bonds 4.2%	Cash 0.1%	Non-U.S. Small -3.7%	U.S. Small -3.6%	U.S. Mid -7.4%
U.S. Mid 4.4%	Non-U.S. Mid -46.5%	Bonds 5.9%	Bonds 6.5%	Non-U.S. Mid -15.3%	Cash 0.1%	Bonds -2.0%	Non-U.S. Large -3.8%	Non-U.S. Large -6.2%	Non-U.S. Small -7.7%
U.S. Small -3.0%	Non-U.S. Small -50.0%	Cash 0.2%	Cash 0.1%	Non-U.S. Small -18.2%	Commodities -1.1%	Commodities -9.5%	Commodities -17.0%	Commodities -24.7%	U.S. Small -7.8%

As of January 31, 2016. The asset class performance is measured using the following indices: MSCI USA Large Cap (U.S. Large), MSCI USA Mid Cap (U.S. Mid), MSCI USA Small Cap (U.S. Small Cap), MSCI AC World ex. USA Large Cap (Non-U.S. Large), MSCI AC World ex. USA Mid Cap (Non-U.S. Mid), MSCI AC World ex. USA Small Cap (Non-U.S. Small), Barclays US Short Treasury 1-3 months (Cash), Barclays US Aggregate (Bonds), HFRI Fund Weighted Composite (USD) (Hedge Funds), Bloomberg Commodity Index (Commodities). Diversified portfolio is 65% equities (MSCI AC World IMI), 32% bonds, 3% commodities through 2015 and 70% equities (MSCI AC World IMI) and 30% bonds thereafter.

Source: FactSet, MSCI

asset class leadership rotates, and often quickly and without warning. Great performance one year does not necessarily mean a repeat performance the following year. Even though during periods of extreme volatility asset classes become more correlated and all seem to move down together, over time, a diversified portfolio offers a steadier return stream — which is important as it allows for the compounding of returns to take effect more consistently.

Global Investing Expands the Opportunity Set. In recent years one portfolio "winner" has been U.S. large cap equities. Through January 31, 2016, the S&P 500 Index has returned 11% on an annualized basis over the last five years, compared with global equities, measured by the MSCI ACWI index, which has returned 5%.

While we have been overweight the U.S., we are sometimes asked why invest outside the U.S. at all. Limiting oneself to just U.S. investments ignores an open landscape of opportunities in foreign countries. The U.S makes up over 50% of the total market capitalization of world stock markets (Exhibit 6). Of the sheer number of stocks held globally (8,703 as of January 29, 2016), 71% are listed outside of the U.S. All of these metrics point to ample sources of return in non-U.S. regions and countries; there is clearly tremendous room for growth as populations grow, emerging economies become more advanced, and developed economies adapt and change in order to generate positive growth.

Further, geographic borders have become increasingly blurred. Many U.S. companies derive substantial revenues and profits outside the U.S., and the same is true for non-U.S. multinational companies. For example, technology giant Apple derives just 35% of revenues inside the U.S., and vice versa, Taiwan-based Taiwan Semiconductor gets 67% of its revenues from the U.S. Manufacturing is spread across countries as well; for example, Switzerland-based Nestle has operations in 47 states in the U.S. and employs over 44,000 U.S. workers.

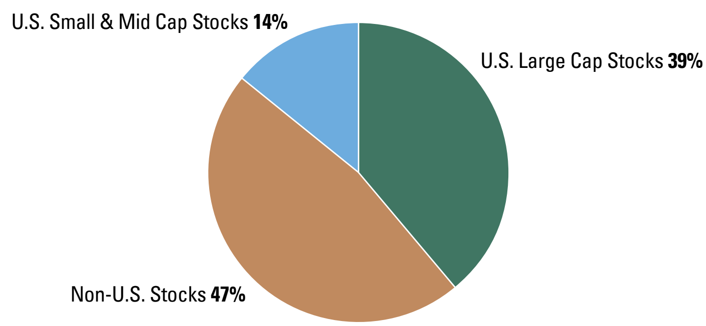
An important part of our equity investing philosophy is to own high quality, world-class companies; there are many such companies headquartered outside the U.S. To limit oneself solely to the U.S. would mean not analyzing companies that are leaders in their respective industries — names such as Unilever, Nestle, AstraZeneca, Sky, L'Oreal, and Baidu.

Global Investing Can Enhance Return and Reduce Volatility. A mix of U.S. and non-U.S. stocks has historically generated a superior risk/return profile

Exhibit 6: Composition of Global Equities

Key Takeaway: Non-U.S. markets offer ample investment opportunities.

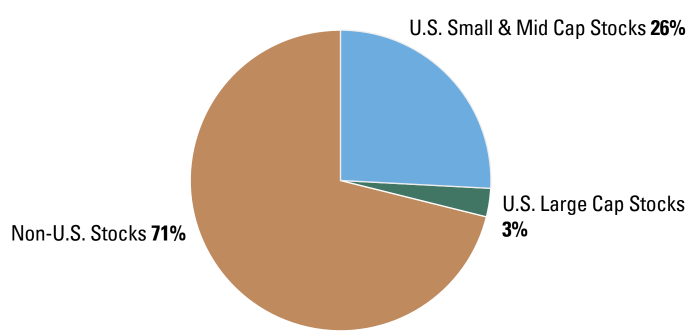
Global Equity Market Cap ($37 Trillion)



Market capitalization data is as of February 11, 2016. Index's constituent data is as of January 29, 2016. U.S. Small & Mid Cap Stocks is represented by MSCI USA Small Mid Index. U.S. Large Cap Stocks is represented by MSCI USA Large Cap. Non-U.S. Stocks is represented by MSCI AC World ex USA IMI.

Source: FactSet, MSCI

Number of Stocks Globally (8,703)



As of January 29, 2016. U.S. Small & Mid Cap Stocks is represented by MSCI USA Small Mid Index. U.S. Large Cap Stocks is represented by MSCI USA Large Cap. Non-U.S. Stocks is represented by MSCI AC World ex USA IMI.

Source: FactSet, MSCI

when compared to a 100% U.S. equity portfolio or a 100% non-U.S. portfolio. As Exhibit 7 shows, the optimal mix between the two has historically been in the 70% U.S./30% non-U.S. to 50% U.S./50% non-U.S. range. At this allocation range, annualized return is highest, while volatility, as measured by standard deviation, is lowest.

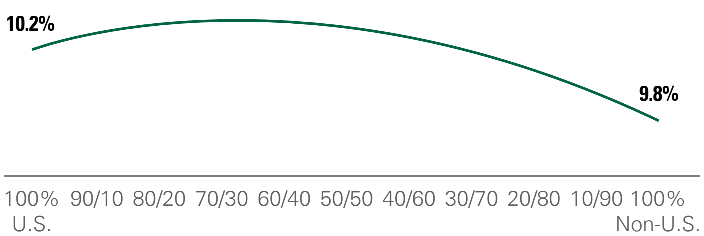
Concluding Thoughts

The selloff in financial markets so far this year has been humbling. Some of the current fears in the market are reminiscent of 2011, and as we know, at that time it paid to generally stay the course and ride the wave back up. We acknowledge that right now we are in a different part of the economic cycle, but we still do not believe we are facing an imminent recession. Our regional and sector tilts, focus on high-quality companies, and recent portfolio shifts (including an equity sleeve dedicated to managing volatility and increased cash in equity mandates) have reduced our expected portfolio volatility. As we watch the markets, but also study the data and look ahead at how the world may unfold, we will not hesitate to take additional tactical steps to manage through this current down-market but also allow ourselves the potential to benefit from what we believe will be a recovery later this year.

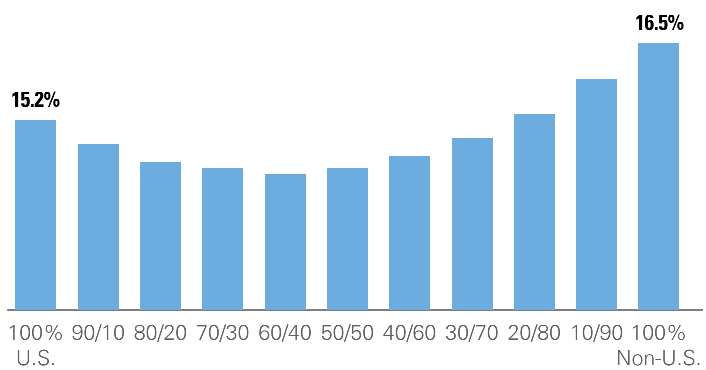
Exhibit 7: Combining U.S. and Non-U.S. Equities

Key Takeaway: Over time, a mix of U.S. and non-U.S. stocks can provide higher return with less risk than either 100% U.S. or 100% non-U.S.

Annualized Return



Volatility



Data as of January 31, 2016. Reflects monthly data between December 1970 and January 2016. U.S. equities reflect the S&P 500 and non-U.S. equities reflect MSCI EAFE and S&P/IFC Emerging Markets Investable Composite.

Source: FactSet, MSCI, Standard & Poor's

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