BESSEMER TRUST

Quarterly Investment Perspective
"R & R"

Rebecca Patterson
Chief Investment Officer

Executive Summary

- **Financial markets were unusually volatile in the first quarter as sentiment whip-sawed between fears of imminent recession and hopes for recovery**
- **In this *Quarterly Investment Perspective*, we examine recessions and recoveries and why understanding them is critical for successful portfolio construction**
- **Our economic base case in the year ahead is no recession, but rather late-stage expansion, with corresponding portfolio positioning — our equity exposure is now neutral versus our benchmark**

Growing up with family members in the military, I quickly learned the term "R&R": soldier jargon for "Rest and Relaxation."

Fast forward to today, and many investors were longing for some R&R by the end of the first quarter, a period of unusually high intraday market volatility and bearish sentiment. The first six weeks of 2016 saw the *worst-ever* start of a year for U.S. stocks, with a cumulative decline larger than the same period in 2009. In the first two months of the year, U.S. equities posted negative daily returns more than half of the time; intraday S&P 500 price swings were the largest seen since 2009 and were double those recorded between 2010 and 2015. The same patterns held true overseas and across asset classes: Brent crude oil prices saw 5% daily trading swings in 42 of the first 49 trading days of the year.

Coincidentally, the first quarter's roller-coaster ride was driven by concerns over another sort of R&R: Recession and Recovery. Specifically, market volatility across geographies coincided with quickly changing sentiment around probabilities of an imminent global recession and the steps needed to spur recovery. A number of factors drove this fickle investment environment, but topping the list were oil prices, Chinese growth, and political developments in the U.S. and overseas.

In this edition of our *Quarterly Investment Perspective*, we examine recessions and recoveries in detail (focusing on the U.S. given the more robust data available). What causes a recession and can we see it coming? Why is the economic cycle so fundamental for portfolio construction? We also discuss what Bessemer's Investment Department is doing to ensure that we manage through these economic ups and downs as successfully as possible over the course of the economic cycle. Our base case for the year ahead is no recession but rather late-stage expansion. Our portfolios are positioned accordingly.

Economic Cycle 101

Much of investing comes down to understanding economic cycles, which in the simplest terms can be thought of in four phases (Exhibit 1).

1. **Early Expansion/Recovery**: These are the "green shoots" of economic growth that follow a contraction. In the early stages of the recovery, monetary and/or fiscal policy tends to be stimulative and helps stabilize sentiment. Consumer and business confidence starts to increase, followed by an improvement in labor markets and consumption. Cyclically sensitive equities, usually at attractive valuations, will often outperform and corporate profits frequently post strong gains. Smaller, more nimble companies frequently outpace their larger peers. In general, inflation is quite low at this time.

Not Your Typical Recession

The majority of recessions follow the economic cycle patterns described in this report. However, economies can also "slip" into recession: the cycle can end with a whimper instead of a bang. Such recessions usually occur when expansions are lackluster to begin with; growth is not running "on all cylinders." In such instances, economies are relatively more vulnerable to shocks that can easily take modest but positive growth to a slight contraction. Just in the last two years, the world has seen a number of these "whimper" recessions, including in Italy, Japan, France, and Canada. Indeed, since 2008 to 2009, Japan has experienced three such recessions, while the euro area as a whole repeatedly experienced contracting growth during 2011 and 2012. The takeaway here is that as investors, we have to appreciate that rising inflation and monetary tightening often foreshadow recessions, but that recessions do not require such conditions in order to occur.

2. **Mid Expansion**: Sentiment has now been improving for a while. Labor market strength is broadening across industries, helping to pull the unemployment rate down further. Economists sometimes refer to this as the economy "running on all cylinders." Growing household and company confidence results in more borrowing; in this period, we often see greater durable goods purchases. Inflation is often picking up and corporate profits are strengthening further.

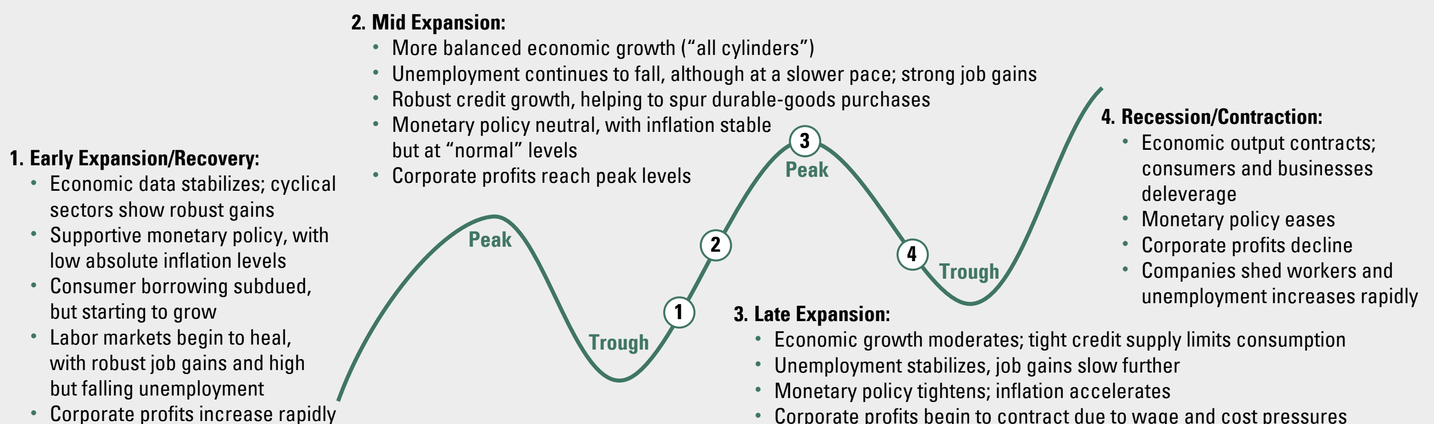
3. **Late Expansion**: By now, inflation is starting to feed through to companies, with wage gains weighing on corporate profits. The labor market continues to grow but often at a slower pace. The Federal Reserve may feel the need to start a monetary-tightening cycle in an effort to limit future inflation pressures; higher interest rates in turn slow the pace of borrowing. By this point, equity valuations are often at or above longer-term "fair values." Market volatility may increase alongside tightening liquidity conditions — in this environment, large-capitalization companies' share prices may be more stable relative to smaller firms' share prices.

4. **Recession/Contraction**: The end of the cycle sees tightening monetary and/or fiscal policy result in slowing and then contracting economic activity. Alongside declining corporate profits and often high valuations, this backdrop frequently leads investors to switch into more defensive investment vehicles such as cash or government bonds.

Looking at the post-World War II period, the U.S. has endured 11 recessions. While the average recession, defined after the event by the National Bureau of Economic Research (NBER), has lasted 11 months, each cycle and recession has been unique. Recessions, for instance, have been as quick as six months (1980) and as long as 18 months (the "Great Recession" of 2008 to 2009). On average, recessions have been associated with a GDP contraction of around two percent.

Exhibit 1: The Economic Cycle

Key Takeaway: Countries experience fluctuations in activity over time; this is known as the economic cycle, which goes through four phases.



As of March 31, 2016.

Source: Bessemer Trust, Bureau of Economic Analysis

Many market watchers are led to believe that a recession is always associated with two consecutive quarters of negative real GDP growth. In fact, the NBER's formula is much more subjective and detailed. While the U.S. has rarely experienced two consecutive quarters of negative economic growth and *not* been in recession (the last occurrence was in mid-1947), the economy has suffered many recessions without meeting this widely assumed rule, including in 1960, 1970, and most recently 2001.

End of the Cycle or Mid-Cycle Slowdown?

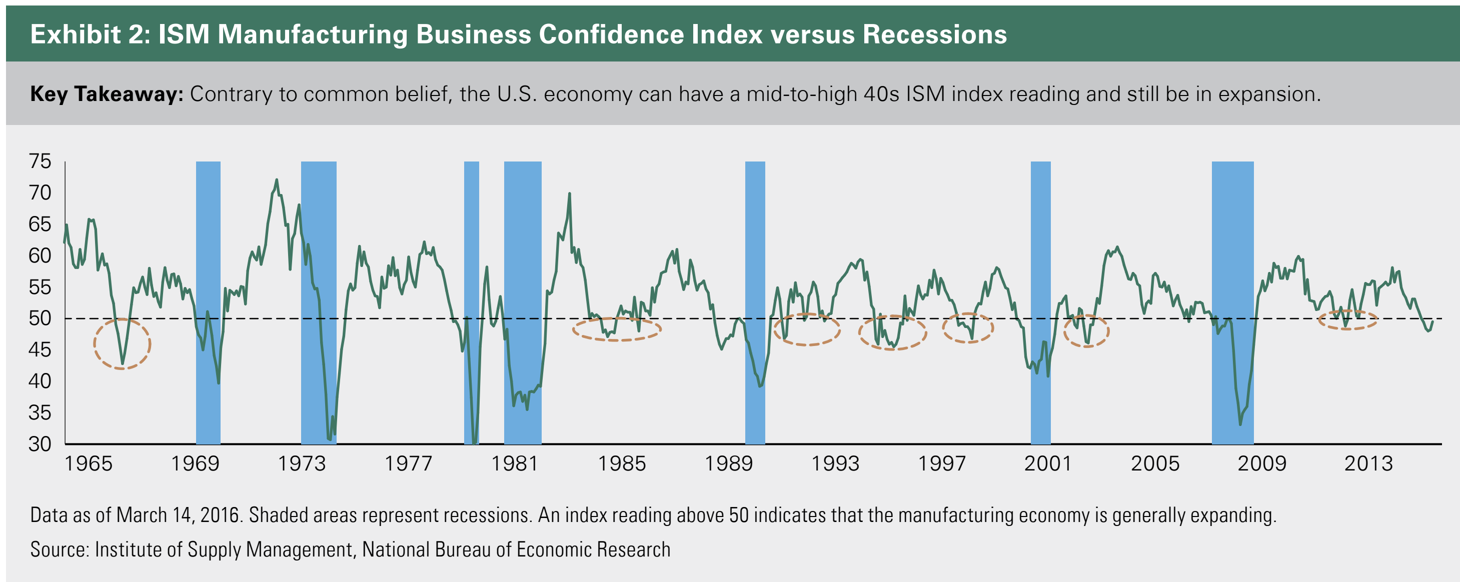
While painful, recessions are fortunately a short part of the overall cycle. On average, U.S. expansionary periods since World War II have lasted 5.3 years; as a result, the economy has grown 85% of the time and contracted the other 15% of the time. That is not to say that expansionary periods are not without ups and downs. Some cycles have pronounced "mid-cycle slowdowns" that do not meet the NBER's recession definition but clearly show deterioration in economic momentum. Consider the mid-1990s. A stronger economy and rising inflation led the Federal Reserve to raise interest rates from 3% to 6% between late 1993 and mid-1995. U.S. growth slowed materially from 1994 to 1995, partially as a result of the Fed hikes, but then regained momentum in the subsequent years. An official recession did not occur until 2001.

The current expansion, starting in mid-2009, is in its seventh year and looks more and more vulnerable to recession (though we would quickly note that history never has to repeat). Certainly, the market consensus view in January and early February was that a U.S. recession was imminent — or indeed had already started. Many pointed to U.S. industrial production, which contracted on a year-on-year basis in November, December and January. The last 11 U.S. recessions all saw industrial production contracting for two months or more. On a similar note, manufacturing business confidence (the "ISM" survey is often used here) implied contracting growth between October and February. Historically, such confidence levels have occurred alongside recessions (although not always; Exhibit 2).

On average, U.S. expansionary periods since World War II have lasted 5.3 years; as a result, the economy has grown 85% of the time and contracted the other 15% of the time.

Exhibit 2: ISM Manufacturing Business Confidence Index versus Recessions

Key Takeaway: Contrary to common belief, the U.S. economy can have a mid-to-high 40s ISM index reading and still be in expansion.



Data as of March 14, 2016. Shaded areas represent recessions. An index reading above 50 indicates that the manufacturing economy is generally expanding.

Source: Institute of Supply Management, National Bureau of Economic Research

Rather than signaling a recession, we viewed recent months in the U.S. economy as reflecting another mid-cycle slowdown — caused not only by spillover from the unexpected collapse in energy prices, but also by a significantly slower pace of growth in China and a stronger U.S. dollar. Within that slowdown, we viewed certain sectors of the economy — particularly related to manufacturing and energy — as having contracted outright. However, the bulk of the economy continued to expand. Home and auto sales remained robust, retail sales held firm, and perhaps most importantly, the labor market continued to improve, even accounting for energy and manufacturing-related job losses. Over the last six months, the U.S. produced 235,000 jobs per month on average. That kind of job creation simply does not align with the idea of recession, in our view.

Tying the Cycle to Markets

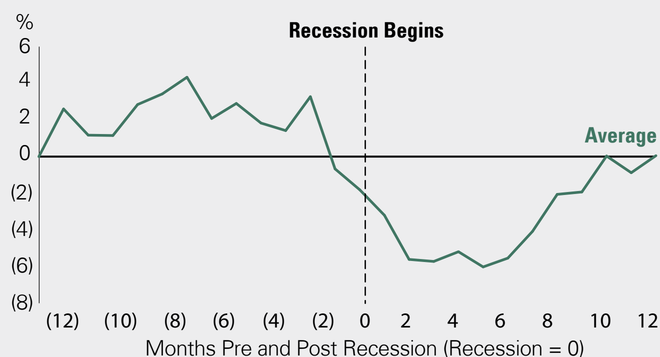
Why is it so critical to distinguish between a mid-cycle slowdown within an expansion and a recession? The two scenarios, in our view, have meaningfully different implications for portfolio construction. During economic expansions, equities will tend to have positive returns, although as we've clearly seen during this cycle, some years are a lot better than others (more than 30% for the S&P 500 in 2013 versus effectively flat in 2015). In contrast, equities are more likely to suffer serious losses into and during recessions (Exhibit 3). As Exhibit 4 shows, there is a lot of market performance variability around recessions, but in general, equities fall into and during the start of a recession and recover as the recession comes to a close.

This is not to say that stocks must fall sharply during a recession or that they cannot lose value during expansions. However, more than 70% of the sustained equity bear markets over the last six decades have occurred before or during recessions. This is intuitive: equity valuations should reflect prospects for and actual changes in customer demand, a company's pricing power and ability to generate profits as well as investor risk appetite. Knowing where one is in the economic cycle and when a recession might unfold provides a valuable framework. While we are honing in on equities versus fixed income here (as the largest traditional building blocks of a portfolio), one's position within the cycle also has important implications for a range of asset and sub-asset classes.

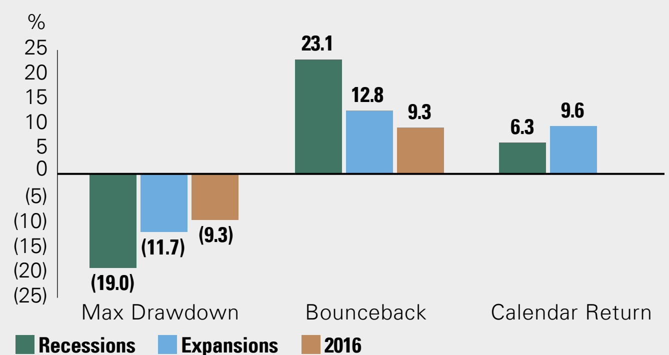
Exhibit 3: U.S. Equity Returns During Recessions and Expansions

Key Takeaway: Equities are more likely to suffer steep losses prior to and during recessions.

A) Cumulative S&P 500 Performance Pre and Post Recessions
1948-2008, 11 Recessions



B) S&P 500 Average Returns and Drawdowns
1951-2016



Data as of March 14, 2016. Stock returns are price only and reflect the S&P 500 Index.
Source: National Bureau of Economic Research, Standard & Poor's

Exhibit 4: Performance of U.S. Equities Before, During, and After Recessions

Key Takeaway: Returns are highly variable before and during recessionary periods; U.S. equities have posted losses in 8 of 11 pre-recession periods.

Start Date	End Date	Duration (Months)	Decline in Real GDP	Stock Returns 6-months Pre	Stock Returns 6-months In	Stock Returns 6-months Post
Dec-48	Oct-49	10	(1.5)%	(9.2)%	(6.8)%	12.0%
Aug-53	May-54	9	(1.9)%	(10.0)%	12.1%	17.3%
Sep-57	Apr-58	7	(3.0)%	(3.8)%	(0.8)%	18.2%
May-60	Feb-61	9	(0.3)%	(4.2)%	(0.5)%	7.3%
Jan-70	Nov-70	10	0.0%	(7.4)%	(8.2)%	14.3%
Dec-73	Mar-75	15	(3.1)%	(6.4)%	(11.8)%	0.6%
Jan-80	Jul-80	6	(2.2)%	10.0%	6.6%	6.5%
Jul-81	Nov-82	16	(2.5)%	1.1%	(8.0)%	17.2%
Jul-90	Mar-91	8	(1.3)%	8.2%	(3.4)%	3.4%
Mar-01	Nov-01	8	0.5%	(19.2)%	(10.3)%	(6.3)%
Dec-07	Jun-09	18	(4.2)%	(2.3)%	(12.8)%	21.3%

Data as of March 14, 2016. Stock returns are price only and reflect the S&P 500 Index.

Source: Bureau of Economic Analysis, National Bureau of Economic Research, Standard & Poor's

There is No Useful Crystal Ball, But…

I have a crystal ball in my office — a crystal globe, to be exact. It's pretty, but has never given me or the team an edge in predicting financial markets. We view recession modeling the same way. We are humble enough to know we are unlikely to build a perfect model, or frankly anything that tells us something about the future that is significantly ahead of every other investor in the world. In addition, the small size of the data set (only 11 recessions to study) limits the meaningfulness of any model focused on the U.S. economic cycle. (Creating a global model is even more challenging with even less data to parse.)

That said, we believe that having a robust framework, alongside other analysis, can help us build a mosaic that gives us a greater degree of confidence in our planning and portfolio construction. Our recession modeling effort, led by our colleague Anthony Wile, begins with history. As we noted earlier, history is not always a great guide to the future, but is a reasonable starting point. What economic and financial market variables have most accurately and consistently "predicted" U.S. recessions in the past? There are dozens of variables we considered, though in the end, we settled on 14 we believed were the most meaningful and captured different transmission vehicles that could foreshadow a recession. Consider a basic one: U.S. jobless claims. This weekly data series has tended to show a rising number of people applying for unemployment benefits, on average, starting 14 months ahead of a recession. Such a pattern is intuitive, and has occurred in every cycle going back to World War II.

While watching trends in individual variables is important, we also want to think about the linkages among variables. After all, different parts of the economy can move in different directions and impact each other, just as we have seen in recent months with the fall in oil prices. While cheaper oil has weighed indirectly on industrial production (less demand for related equipment), it has helped consumers directly via lower energy prices but also indirectly by weighing on inflation and in turn, U.S. interest rates. Lower interest rates have supported borrowing (including mortgages for new homes). Our model is able to consider how trends in all 14 variables impact each other in both positive and negative ways, albeit based on historical relationships (which we know can change over time).

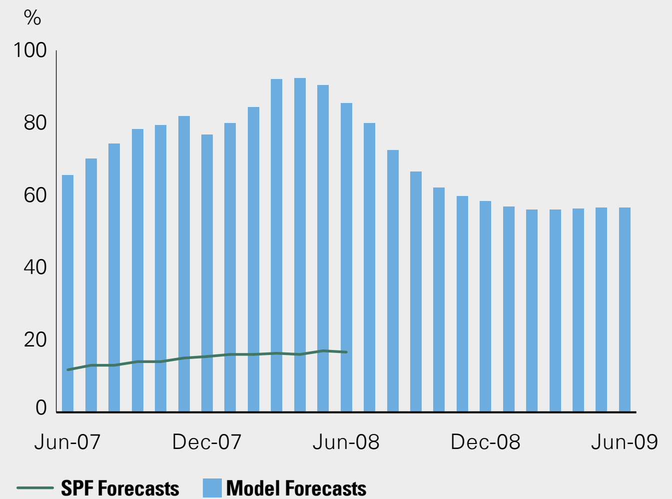
Finally, the model uses these linkages and recent trends in the variables to forecast the coming year's economic data. Just as any economist would search the current economic environment for clues of future weakness, our framework attempts to extrapolate future economic data given the historic relationships between each variable we measure. For instance, using the previous example, if jobless claims begin to rise at the end of the cycle, what has this historically meant for labor markets in the following months? If we expect additional layoffs, how has an increase in joblessness affected consumer confidence measures, and in turn consumption over the following year? By providing an educated guess to some of these questions, our recession framework attempts to give early signals of a deteriorating economy.

The outcome for our model is a probability: a percent chance that a U.S. recession will begin over the coming year. Looking back, the average probability outside of actual recessions has been 38%. Further and importantly, the model did accurately see increased probabilities of recession during the last three cycles (using out-of-sample data). For instance, while admittedly containing biases[1], Exhibit 5 plots recession probabilities generated from our model in June 2007. Notably, the model would have assigned an 80% to 90% probability of entering recession by late 2007 and early 2008, detecting elevated recession risks as early as one year in advance. However, it is important to stress the model is not perfect — while the framework indeed captured deteriorating economic fundamentals, it did not forecast the severity of the Great Recession, missing estimates in many key variables (housing in particular). In this instance, we invite complexity: using an expansive list of economic and financial variables provides a large "safety net" for catching signs of economic weakness from different sources, as was the case in this example.

Exhibit 5: Recession Probability Forecasts at Varying Intervals

Key Takeaway: A variety of economic and financial data indicated increasing probabilities of recession prior to the Great Recession of 2008 to 2009.

Out-of-Sample Estimates*



Data as of March 14, 2016. *SPF forecasts reflect the Survey of Professional Forecasters Anxious Index, which measures the probability of recession as forecasted from professional forecasters by quarter. All forecasts are made as of June 30, 2007.

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Conference Board, Department of Labor, Federal Reserve Board, Institute of Supply Management, Moody's, National Bureau of Economic Research, University of Michigan, U.S. Treasury

Looking back to 1979, the model has shown a consistent link between equity performance and recession probabilities

Putting the Model to Work: Recession Planning

Acknowledging the limitations of our model and the need to combine it with other analysis, we still believe it provides a solid jumping-off point from which to think about constructing portfolios. Looking back to 1979, the model has shown a consistent link between equity performance and recession probabilities. Specifically, when the probability of a recession rose to 80% or higher, the S&P 500 returned an annualized -5.8% on average. Importantly, the pattern is reliable, with generally lower equity returns as recession odds increase.

[1] Out-of-sample refers to using data outside of the data used to create the model. In statistics, out-of-sample testing allows researchers to examine the efficacy of their model, given the model itself does not contain any inherent knowledge of the future. When mentioning biases, we refer to the fact that back testing suffers from limited history, revised data and, to some extent, hindsight bias.

In contrast, when the recession probability was at or below 40%, average S&P 500 returns were positive at 12.8% (Exhibit 6).

One might reasonably ask how we incorporate this model with analysis on overseas markets. As noted earlier, historical economic and market data for many foreign countries is quite limited, leaving models less effective. Fortunately, U.S. recession probabilities can tell us something useful about equities outside the U.S. There is something to the old adage: "When the U.S. sneezes, the rest of the world catches a cold." With the deepest equity and bond markets in the world, and (for now) the largest economy, what occurs in the U.S. tends to lead what happens overseas. There may be lags and differences in magnitude, but a recession "red flag" in the U.S. that gives us cause to reduce U.S. equity risk in portfolios would almost certainly also lead us to want to reduce equity risk globally, barring some development in the future that allows overseas economies to meaningfully decouple from the U.S. Importantly, we see significantly more country differentiation during expansions.

Exhibit 6: Average S&P 500 Returns by Recession Probability

Key Takeaway: Bessemer's model has shown a relatively consistent link between recession probabilities and equity returns.

Average Annualized Monthly Return

Data as of March 14, 2016. Recession probabilities reflect in sample estimates.

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Conference Board, Department of Labor, Federal Reserve Board, Institute of Supply Management, Moody's, National Bureau of Economic Research, Standard & Poor's, University of Michigan, U.S. Treasury

What about today? Importantly, our recession model helped us avoid overreacting to market stress and bearish sentiment at the start of this year. The extreme equity selling pressure that kicked off 2016, and potential for oil prices to slide even lower and take equities along for the ride, led us to reduce risk in mid-January. We cut our equity exposure from overweight to neutral and acted to lower the overall volatility of our equity holdings — both steps to ensure that our portfolios would more effectively manage through what we feared could be an extended period of volatility. That said, we felt only an incremental move was warranted, in large part because our recession model continued to telegraph in January and February that the overall U.S. economy was expanding, with only a slightly elevated recession probability — mainly driven by financial market volatility as opposed to hard economic data.

As we look to the months and quarters ahead, we believe that some of the headwinds that prompted the early 2016 recession fears will fade further. China still faces huge challenges over the medium term, but for now appears set on managing its growth slowdown and not letting capital flight undermine its evolving currency policy. In addition, oil prices seem closer to finding a bottom, even if a sustained price recovery feels unlikely anytime soon. Finally, tighter liquidity conditions tied to a hawkish Federal Reserve appear less likely this year given the more volatile global backdrop and pass-through to both the Fed's growth and inflation mandates. Barring much brighter growth prospects and/or a faster-than-expected rise in inflation, we are now looking for one or two U.S. interest rate hikes this year. Global monetary policy, in other words, should remain exceptionally loose.

This is not to say that other shocks couldn't change our recession model inputs. The U.K.'s vote on European Union membership, due June 23, could impact the U.S. via spillover from lower European growth prospects. The U.S. election season is clearly an exceptional one; sustained, heightened uncertainty here, or actual policy change, also could affect business and consumer behavior.

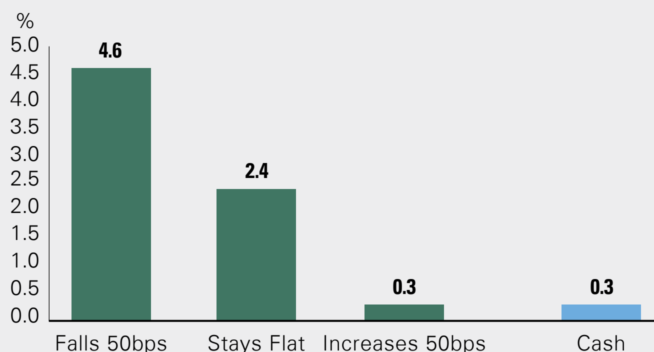
Barring such shocks, however, our base case is that we are likely finishing a mid-cycle slowdown within the latter stages of an economic expansion. A modest acceleration of growth into 2017, alongside a continued rise in inflation, could well lead us to a "typical" end of a cycle in the year or years ahead, with stretched valuations on equities and rising borrowing costs leading to an ultimate turn lower for equities and an economic contraction.

We can't pinpoint a starting date for the next recession. The world is dynamic and increasingly interconnected, as recent years have so vividly demonstrated. However, with an eye on our model, together with bottom-up corporate research and top-down global macro analysis, we are planning how to best manage the end of the cycle. We have already taken a first step, by moving equity exposure to neutral (versus a benchmark weighting), and our portfolio managers have reduced the volatility of the equities held in client portfolios. While it is difficult to love traditional government bonds at these low yields and high prices, we know that late-cycle planning necessitates reducing our bond underweight (and understanding the pros and cons of holding cash versus bonds as a defensive asset). For now, given our view that U.S. interest rates will rise slowly, we continue to expect the total bond return will exceed the value of holding cash (Exhibit 7). For clients where hedge funds are appropriate, increasing allocations to defensive hedge fund strategies also makes sense, not as a replacement but as a complement to fixed income. Beyond these blunt tools, some of the other portfolio changes that the investment team would consider for later stages of the expansion include:

- Further reducing small- and mid-cap equities that tend to be less liquid and are relatively more vulnerable to wage pressures;
- Holding more floating-rate debt to better manage through a rising interest rate environment;
- Reducing underweights to commodity-related equity sectors (such as materials and industrials) and emerging markets, assuming China sentiment does not deteriorate further, energy prices stabilize, and inflation rises; and
- Holding overall portfolio volatility in check; offsetting any additional (higher volatility) emerging-market and/or commodity exposure with more "managed volatility" equity vehicles and/or an increase to fixed income.

Exhibit 7: Five-Year U.S. Treasury Return by Yield Scenario

Key Takeaway: With cash yields still resting at historically low levels, traditional fixed income may provide a better return profile going forward.



Data as of March 15, 2016. Total returns assume the 5-year Treasury yield equals 1.5% and moves to 1.0% and 2.0% respectively one year from today.

Source: Bloomberg

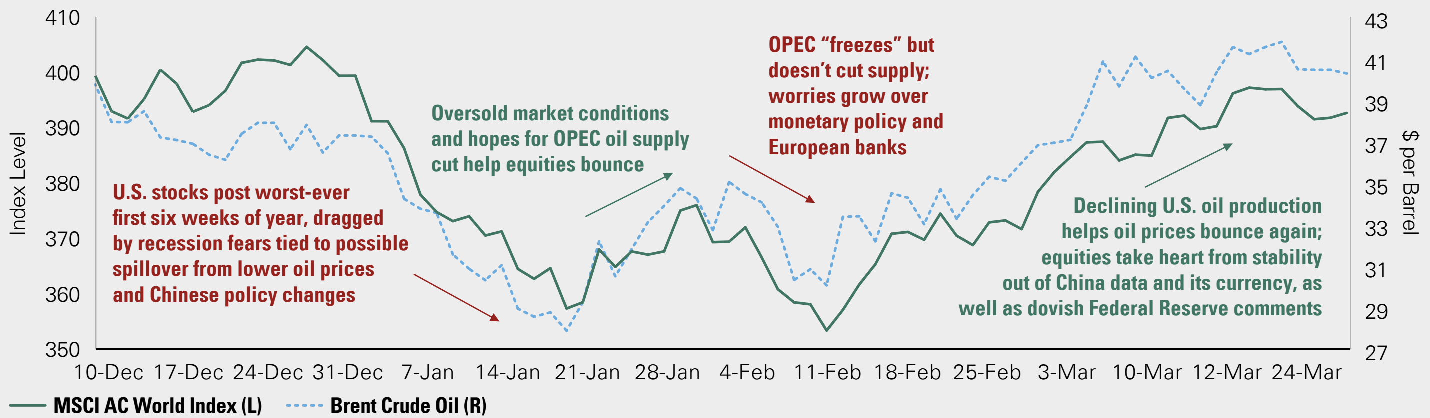
We would reinforce that any plan, including the details shared above, is subject to change, at least at the margin as the world evolves (and often surprises). However, by at least thinking ahead of the cycle and considering scenarios — both in terms of potential asset-allocation steps and sizing of moves, we hope to improve our risk-adjusted returns not only short-term but throughout the cycle.

Final Word: First Quarter Performance

I expect many investors, and clients, will be happy to see the first quarter behind us. As noted earlier, it was an exceptionally uncertain time, with market volatility to match. Overall, what we call our "Balanced Growth" portfolio (effectively a 70% global equity, 30% U.S. bond risk profile) underperformed its benchmark modestly, ending the first quarter effectively flat.

We began the quarter overweight equities, which clearly worked against us in those first weeks as global equities (using the MSCI All-Country World Index, or

Exhibit 8: First Quarter Recap — Global Equities and Oil Prices



Data as of March 28, 2016.

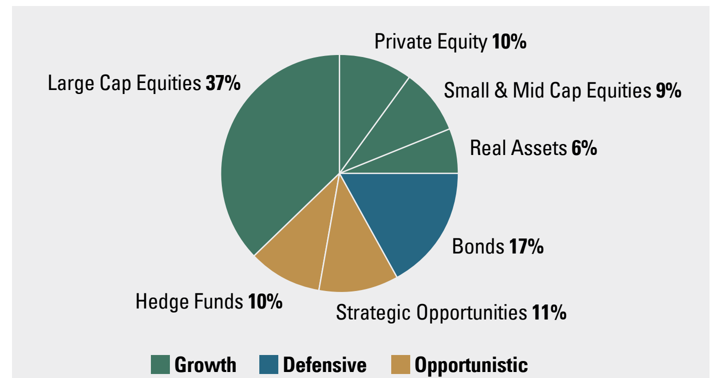
Source: Bessemer Trust, Bloomberg, MSCI

ACWI) dropped by more than 10% (Exhibit 8). This volatility was led by an unexpected, 25% plunge in crude oil prices (both Brent and WTI crude dove below $30/barrel for the first time in 13 years) as well as worries over Chinese growth (policymakers let the renminbi weaken into the new year and then reported that central bank reserves were declining at an alarming rate, suggesting potentially destabilizing capital flight).

Particularly given the prospects for even lower near-term oil prices and spillover to equities, we decided to reduce equity exposure to neutral mid-January, raising some cash and allocating to a large-cap managed volatility equity strategy to help better navigate through further market turmoil. As of the end of the quarter, the managed volatility effort has been additive to performance, while cash has acted as a modest drag (since markets overall have risen from those January levels). Overall, we were pleased we didn't "give in" to investor emotions during the quarter and reduce equities further. We benefited from our overweight to large-cap versus small-cap equities, and our overweight to U.S. equities versus non-U.S. We also had strong security selection helping returns, particularly in some of our internally managed equity mandates.

While we do not take lightly the underwhelming start to the year, we continue to see reason for positive calendar year portfolio returns — especially if the global economy can successfully manage through potential catalysts ahead, including the June U.K. vote and the ongoing U.S. election campaign. We plan to publish more on these political issues in the months ahead, with U.S. analysis after the July party conventions. We always strive to achieve the best risk-adjusted returns we can for clients. In-depth research and planning are critical for that success.

Bessemer's Positioning



Positioning as of March 31, 2016. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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