Investment Insights

Building Our Defenses

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Highlights

- Medium-term cyclical considerations, coupled with critical near-term event risks, warrant a reduced underweight allocation to high-quality fixed income.
- Portfolios remain neutral equities with a tilt towards large-cap U.S. stocks.

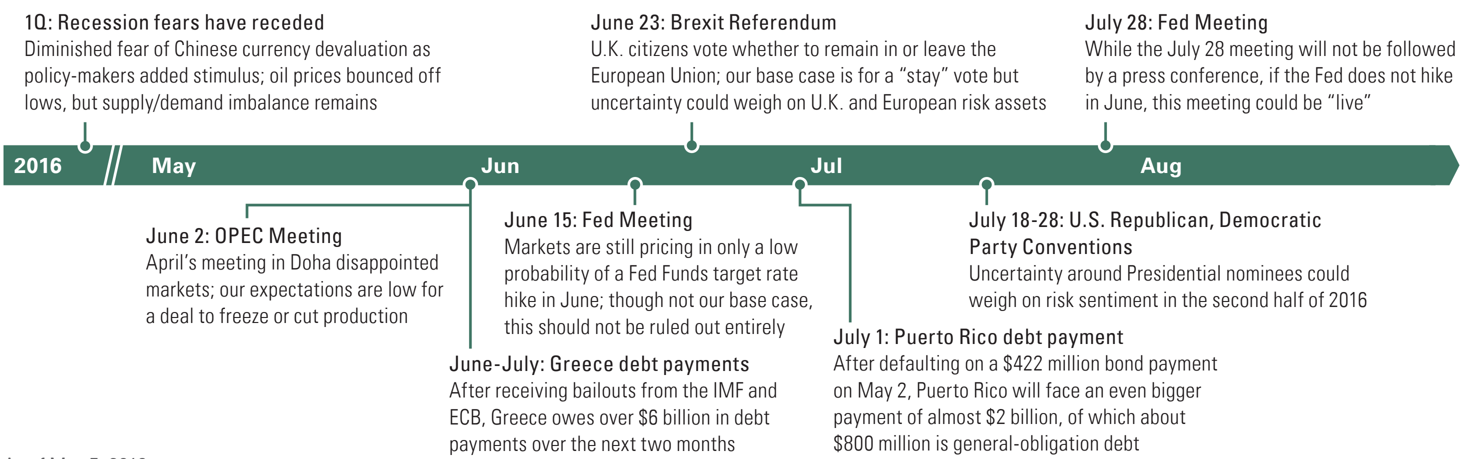
Like many of our clients, we in the investment world are looking forward to the summer for warmer weather, family vacations, and dining al fresco. But despite markets recovering from the first-quarter selloff, several events on the horizon could make the summer less sunny. A meeting of key oil producers, debt payments due by Greece, the U.S. Federal Reserve's next policy meeting, and the U.K.'s referendum on European Union membership all take place in June. July brings another key U.S. monetary policy decision and unusually high-profile presidential conventions. These are just some of the "known unknowns"; this year will undoubtedly serve up its usual share of "unknown unknowns" as well, all of which are likely to bring with them a degree of volatility in financial markets given fair or even rich equity valuations and an economic cycle getting longer in the tooth (Exhibit 1).

Earlier this year, our managers took steps to lower the volatility of Bessemer portfolios while retaining exposure to the equity markets, both by adding a "managed volatility" equity strategy and increasing cash above normal "frictional" levels. This was the first step in a broader plan to prepare portfolios for the end of the economic cycle. While we do not believe the U.S. is headed for a recession this year, we remain focused on incrementally positioning for the end of the cycle in order to better protect client capital. At this time, spurred by both medium-term cyclical factors and near-term event risks, we are taking another such step, specifically adding to our high-quality fixed income exposure.

How specifically will the portfolios be changing?

We are reducing the target allocation to the Strategic Opportunities mandate by 4% (within the Balanced Growth 70/30 Stock/Bond risk profile) to fund an increased allocation to high-quality fixed income

Exhibit 1: Monitoring Important Macro Risks on the Horizon



As of May 5, 2016.

Source: Bessemer Trust

(Exhibit 2). Strategic Opportunities is a multi-asset class mandate positioned to take advantage of opportunities and dislocations in the market while seeking equity-like returns over a cycle with notably less volatility. The manager is confident in the mandate's positioning; as such, Strategic Opportunities will trim across the board to maintain the mandate's current risk profile. These proceeds will be deployed across the various holdings managed by Bessemer's fixed income team — including high-quality corporate bonds, municipal bonds, U.S. Treasuries, and high-quality asset-backed securities — in a manner that is also consistent with the current strategy and according to individual client goals.

Separately, within the Large Cap Strategies equity mandate, exposure is rotating from some passive strategies into the Managed Volatility Equity (MVE) and the Bessemer Global strategies, which we expect will perform relatively better in potentially volatile markets.

Additionally, in order to maintain a neutral exposure to equities overall, remaining excess cash in the other equity mandates (Small & Mid Cap, Large Cap Core) is being reduced to normal "transactional" levels; some of this cash was already put back to work in the first quarter. In all, in Balanced Growth portfolios, volatility will be slightly lower following these moves.

Exhibit 2: New Allocation Recommendation Decreases Strategic Opportunities to Fund Fixed Income

	Balanced Growth	
	Designed to generate meaningful long-term appreciation at moderate overall risk	
	70/30 Stock/Bond Profile	
	Old	New
Fixed Income	**17%**	**21%**
Fixed Income	17	21
Equities	**60%**	**60%**
Large Cap Core	16	16
Large Cap Strategies	32	32
Small & Mid Cap	12	12
Opportunistic Assets	**23%**	**19%**
Strategic Opportunities	13	9
Hedge Funds	10	10
Total	**100%**	**100%**

Source: Bessemer Trust

How do these moves fit into the broader views on the economic cycle?

We discussed this topic in great detail in the *Quarterly Investment Perspective: R&R*, released on April 1. During the first quarter, financial conditions (and market commentators) were suggesting that the U.S. was tipping into recession — a view we did not share. Certainly, the industrial and energy-related sectors of the economy were flashing warning signs, but housing, auto, and retail sales along with a robust labor market showed that the bulk of the U.S. economy was still expanding. We did, however, take an incremental step within portfolios to limit downside risk and reduce volatility into what we felt could continue to be a choppy year for financial markets. Though we still do not believe the U.S. will enter recession any time soon, the current asset allocation shift is one more step in a broader plan to prepare portfolios for heightened volatility as we head toward the end of the economic cycle — this time by chipping away at our underweight to high-quality fixed income (Exhibit 3).

Exhibit 3: Portfolio Construction for the End of the Cycle

Volatility Reduction	Equity/Cyclical Asset Reduction	Reinvestment for the Next Cycle
Late cycle: Take steps to reduce equity volatility and better manage rising-interest rate environment, with little or no reduction of overall risk assets.	**End cycle:** Incremental steps to reduce cyclical exposure (focused on equities); consideration around internal/external managers, style and geographies	**Recession:** Determine end-goal portfolio construction and possible steps to reinvest in risk assets.

Source: Bessemer Trust

What are the tactical considerations of these moves?

Year to date, Bessemer's underweight allocation to high-quality fixed income has been a modest drag on performance. We anticipate that range-bound bond yields can allow bonds to outperform cash in the near term and risk assets at the end of the economic cycle (i.e., recession). Meanwhile, Bessemer portfolios have had a neutral allocation to equities since early this year. Despite the likelihood of continued pockets of heightened volatility, our view that the U.S. would not enter recession this year argued against a more conservative, underweight stance to equities.

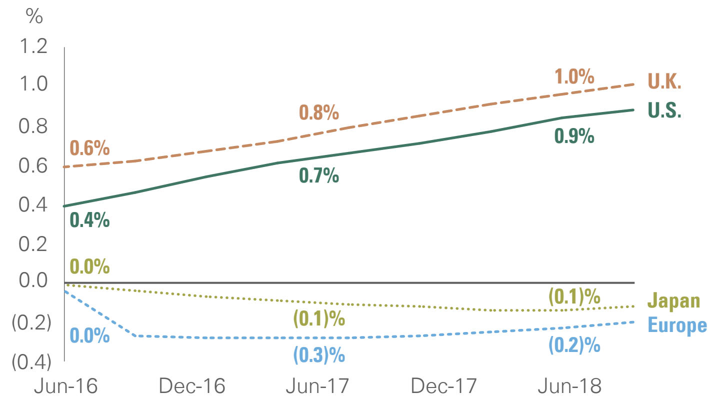
While our base case remains that recession is not imminent, a series of events in the coming months suggests volatility could increase again (refer back to Exhibit 1), perhaps not to the level that it reached at the start of this year, but enough to warrant a higher allocation to fixed income.

Historically, there has never been a bear market for stocks that has resulted in negative returns for bonds.[1] Said a different way, when stocks have sold off significantly, bonds have protected and, in many cases, delivered respectable (mid-single-digit or even double-digit) returns.

However, in today's environment it is admittedly difficult to love bonds. At roughly 1.8%, the yield on the 10-Year U.S. Treasury is still near its lowest level in decades, dragged down in part by negative-yielding bonds outside of the U.S. For reference, almost 30% of the Bank of America Merrill Lynch Global Government (Bond) Index is trading with a negative yield. In general, corporate bonds offer more attractive yield than Treasuries and should hold value better in a risk-on environment (when investors tend to sell Treasuries to buy stocks). And while we do expect bonds to continue acting as the protective cushion during difficult times and the negative yields of some non-U.S. bonds to generate demand for relatively higher-yielding U.S. bonds (Exhibit 4), the return prospects are not what they were years ago at higher nominal yields. For this reason, we are maintaining an underweight to fixed income at this time.

Exhibit 4: Negative Yields Overseas May Keep Downward Pressure on U.S. Rates

Market Expectations for Policy Rates



As of April 30, 2016.

Source: Bloomberg, J.P. Morgan

What are the regional implications of the changes?

The allocation changes mentioned above will allow portfolios to retain an overweight to the U.S. (broadly across asset classes and specifically within equities). This is the strongest view expressed across portfolios, with approximately 41% of Balanced Growth 70/30 (including those in the Strategic Opportunities mandate) held in U.S. equities versus the benchmark weighting of 37%.

Portfolios are slightly underweight Japanese and European equities versus the benchmark (about 1% each) and neutral emerging markets following the increase in exposure in mid-March (*Investment Insights: Boosting Emerging Markets Exposure to Neutral on Improved Outlook*). Europe and Japan continue to struggle against low inflation and weak demand — domestically and globally. It is not for lack of trying: Both the European Central Bank and Bank of Japan have exercised significant monetary policy muscle, most recently taking target policy rates into negative territory. At this point, with monetary policy likely delivering diminishing marginal benefit and region-specific challenges

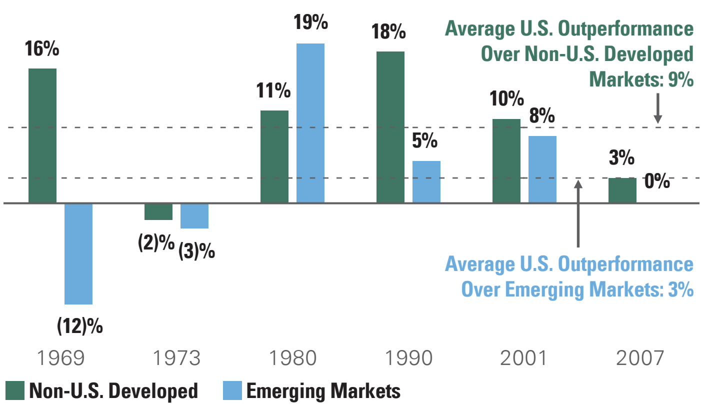
[1] Bear market refers to a decline of 15% or greater for the S&P 500 Index. Bonds refer to the 5-Year Treasury Note, and data goes back to 1929.

with implementing fiscal stimulus, we think the balance of risks calls for a slight underweight to these markets.

We are comfortable with a higher weighting to the U.S., even in light of the U.S. being further ahead in the business cycle than other regions. Looking over the last six U.S. recessions, the U.S. has outperformed the rest of the developed world in five of them by an annualized average of 9% (and emerging markets in four by an average of 3%, Exhibit 5). That is in part because the U.S. dollar is a safe-haven currency, even during U.S.-centric risk-off periods. While each case is different and data is limited, the above-mentioned tactical considerations combined with evidence that the U.S. does not tend to underperform other regions during U.S. recessions makes the case for an above-benchmark weight to U.S. equities.

Exhibit 5: A U.S. Recession Does Not Mean U.S. Underperformance

U.S. Outperformance During Recessions



As of April 30, 2016. Includes all recessions according to NBER, with the 1980/1981 recessions combined. Represents MSCI World ex-US (total return, USD), 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

Looking Ahead

With the U.S. undoubtedly in the later stages of the economic cycle, our investment strategy has become increasingly focused on preparing for recession. We are humble enough to know that it is impossible to perfectly time a recession and any accompanying pullback in risk assets; that's why we believe in taking a measured approach to reducing risk in portfolios while, for now, remaining neutral equities versus our benchmark. After some reduction in volatility within equity holdings, this latest step will serve to increase our exposure to the protective part of the portfolio: high-quality fixed income. Though we still believe the U.S. economy will continue to expand through this year, providing equities the opportunity to generate positive returns, we are mindful of potholes in the road ahead. We hope markets can swerve around some of these (e.g., it is now looking like the Republican Party will avoid a protracted, contested convention), but some will be unavoidable, and we are intent on protecting our clients' capital as much as possible through these periods.

Our Recent Insights

"R & R" — Quarterly Investment Perspective (Second Quarter 2016, Video Available)

Boosting Emerging Markets Exposure to Neutral on Improved Outlook — Investment Insights (March 2016)

Coordinated Currency Policy is Back — Investment Insights (March 2016)

A Briefing on Brexit: Evaluating the Risks of the U.K. Leaving the EU — A Closer Look (March 2016)

Will Negative Interest Rates Come to the U.S.? — Investment Insights (March 2016, Video Available)

Thinking About Corrections — Investment Insights (February 2016, Video Available)

Navigating Underfunded Pensions — Investment Insights (February 2016)

Addressing Recent Market Weakness — Investment Insights (January 2016, Video Available)

Inflation Checkpoint — Investment Insights (January 2016)

Managed Volatility Equities — Q&A — Investment Insights (January 2016)

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