Investment Insights
What We Believe

BESSEMER TRUST

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Highlights

- While still constructive on risk assets, we want to use the latest equity market strength to marginally increase defensive holdings as part of our medium-term process to prepare portfolios for the next sustained downturn
- Within our equity holdings, we are incrementally tilting more toward U.S. and volatility-managed strategies

At Bessemer, we do not believe we can perfectly time the markets. We do not know on what day, or even what week or month, equities will peak and begin a sustained pullback, akin to 2001 or 2008, or at what index level a stock market has bottomed and should be bought aggressively. How many investors in early March 2009 were confident enough to dump all their cash and bonds and pile into stocks? Barring an incredibly large, unexpected shock that radically and suddenly changes the economic landscape, you won't see us suddenly go from all stocks to all cash and bonds, or vice versa. The world is — sadly — not that simple.

We do believe, however, that thoughtful economic and financial analysis can allow us to more effectively weigh the probabilities of various financial market outcomes. That, in turn, should help us adjust portfolios that appropriately balance risk and return for our individual clients' needs at different points in time.

Understanding Upside/Downside for Stocks and Bonds

What does our economic analysis say today? As we noted in our April 1 *Quarterly Investment Perspective*, "R & R," a sustained equity downturn usually comes into and/or during a recession. With that in mind, our proprietary recession indicator suggests only a 40% chance of a U.S. recession in the year ahead (as we've noted before, equities tend to post positive returns until recession probabilities head toward 80%). That forecast is helped in large part by resilient American consumers, in turn supported by low interest rates and housing-related wealth gains.

Further, we know that this economic cycle and equity rally, albeit in its eighth year and among the longest in modern history, could find additional, perhaps even new, growth catalysts. Extraordinarily easy monetary policy may keep pushing investors into equities (in part in a search for yield) and may encourage corporate and household borrowing. The potential for material fiscal stimulus — in the U.S. after the November election as well as globally — could also prolong the cycle.

While this analysis is encouraging, recession probabilities can change over a period of just a few months. Further, that growth outlook is only one tile in our analytical mosaic. We would add to that a number of other data points that suggest a slightly higher degree of caution on equities, including:

- Tightening U.S. labor markets and rising wages, which could lead to further interest-rate increases over the coming year or so;
- Signs that U.S. profit margins are starting to compress (in part because of greater wage expenses); and
- Equity valuations that are increasingly stretched. A 12-month forward price-earnings ratio (PE), a gauge of investor expectations for future corporate health, is now at an elevated 17.4x for global stocks, versus a 20-year median ratio of 15.7x[1].

[1] Empirical Research Partners

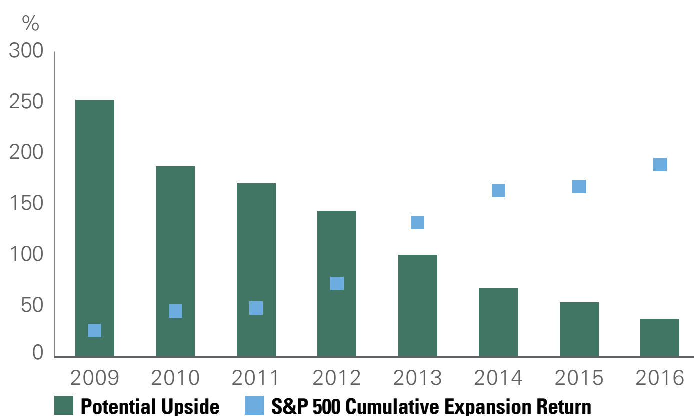
Pulling these threads together, our base case continues to be constructive for stocks. But how far can they rise from here? If we assume equity multiples (expectations for future earnings) expand from already elevated levels, helped by some of the economic forces discussed above, and profit margins (already near record highs) at least hold steady, we could see the S&P 500 gain another 20% to 40% before the next sustained equity downturn. (Exhibit 1).

Even in this optimistic scenario, our enthusiasm is tempered. Equities — in the U.S. but also broadly — have more than doubled in value since the 2009 trough, including a 20% rise since the dip early this year. Back in 2009 or 2010, multiples were less than half of current levels, and valuations and profit margins were severely depressed. You couldn't lose much back then because you were already near rock bottom; your potential opportunity was much greater. Today you have further to fall — you have climbed back up the ladder. At a minimum, the ladder could get shaky; the potential for regular bouts of market volatility has increased.

Our clients have different goals, to be sure, but the vast majority do have at least one thing in common: they want to keep what they and their families have worked so hard to create. Limiting potential portfolio losses is critical. Consider the last recession as an example. An investor who went into October 2007 with only equities suffered through the downturn, eventually recovering to "flat" in March 2013. If the same investor instead had been 60% equities, 40% bonds going into the recession, that recovery would have taken 29 months less. The difference is more than two years of potential portfolio gains forfeited by not reducing risk into the event (Exhibit 2).

With that in mind, and with a maturing economic cycle and relatively greater downside risk, we are using pockets of market strength to incrementally prepare for that next downturn, knowing we will never time it perfectly. We have taken two such steps so far this year, adding more "managed volatility" equities to our portfolios and modestly increasing our exposure to traditional fixed income.

Exhibit 1: S&P 500 Potential* and Realized Total Return



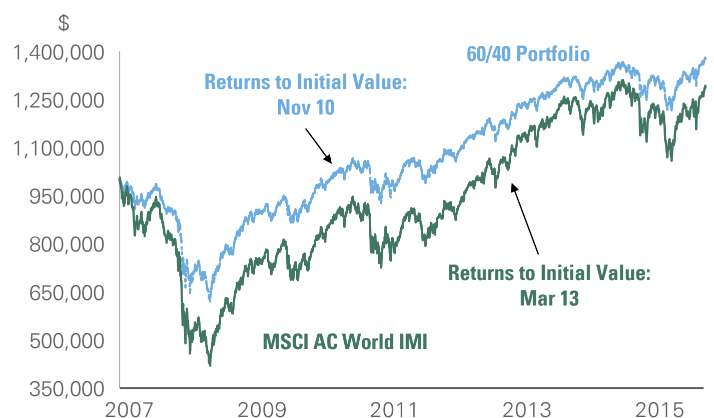
As of August 17, 2016.

* Potential returns reflect the cumulative return needed for the annual average of valuation multiples and profit margins to attain previous cyclical highs while also assuming the current expansion average of 3% revenue growth and 2.2% dividend yield. Per profit margins, a peak level of 10.1% is assumed while 22x trailing earnings is assumed for equity multiples. Importantly, while the latter level does not reflect a historic peak, the tech bubble is excluded from the data analysis and the resulting estimate reflects qualitative judgments while considering previous cyclical peak valuations.

Source: Bessemer Trust estimates, Bloomberg

Exhibit 2: The Importance of Protecting Capital

$1,000,000 Invested in October 2007 in a 60/40 Stock/Bond Portfolio versus Global Equities
Indexed to $1,000,000 on October 29, 2007

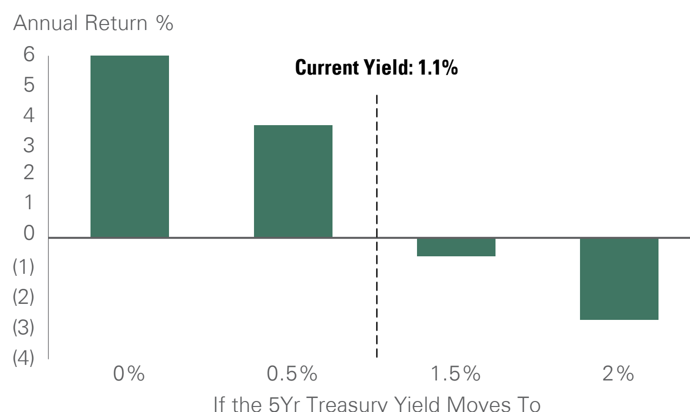


As of August 16, 2016. Returns are in USD and reflect the total return gross dividends. The 60/40 portfolio is 60% global equities (MSCI AC World IMI) and 40% bonds (Bank of American Merrill Lynch 1-10 Year AAA-A U.S. Corporate and Government Index). The 60/40 portfolio is rebalanced daily.

Source: Bank of America Merrill Lynch, Bloomberg, MSCI

Whenever we mention fixed income, with U.S. Treasury yields at staggeringly low levels, clients raise their eyebrows, nervous about a bond bubble bursting. We understand, but would go back to our upside-downside analysis. If the 5-year Treasury yield, currently around 1.1%, rose to 2% (a level last seen in early 2011), the loss on the investment would be roughly 3%. Not fun, but likely small potatoes compared to the scale of potential equity losses in a downturn. Meanwhile, if the 5-year yield fell further, say to 0.5%, that investment's gains would be nearly 4% (Exhibit 3).

Exhibit 3: 5-Year Treasury Return Scenarios by Ending Yield Level



As of August 17, 2016. Assumes a parallel shift in the yield curve and one-year holding period from current 5-year levels of 1.0%.

Source: Bessemer Trust estimates, Bloomberg

Balancing Participation and Protection

We believe the current environment presents another opportunity for an incremental risk reduction in portfolios. Specifically, the Small & Mid Cap mandate is reducing volatility by adding managed-volatility strategies. Further, throughout our equity holdings, our portfolio managers are also adding to our already overweight U.S. position, which we expect to be about 64% compared to the MSCI All-Country World Index "neutral" U.S. equity position of 53%. As we noted in our July 1 *Quarterly Investment Perspective*, "America the Beautiful," we believe that in a sustained equity downturn, U.S. stocks are likely to perform in line with, or somewhat better than, overseas peers. Our portfolios continue to hold a neutral exposure versus the MSCI ACWI in emerging-market stocks, and are underweight other developed-country equity markets.

Such incremental portfolio de-risking is not without risk — perhaps somewhat ironically. Should the economic expansion last a few more years and equities rise further and faster over that period than we expect, our portfolios will participate (that is, we will see higher absolute returns) but increasingly could lag our strategic, longer-term benchmarks. We certainly do not take the possibility of "underperforming" lightly, but weigh that scenario against not sufficiently protecting in the next downturn. As we regularly note to our clients, less exciting positive but steady returns and limited downside allows for greater compounded returns — greater wealth — over time versus riding the market fully up — and down (Exhibit 4).

Exhibit 4: Hypothetical Portfolio Returns

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Cumulative Return
Portfolio 1	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	62.9%
Portfolio 2	10.0%	0.0%	-10.0%	20.0%	5.0%	-10.0%	20.0%	10.0%	0.0%	5.0%	55.6%

For Illustrative purposes only. Both portfolio return streams result in an arithmetic average return of 5% over the 10 years shown. Cumulative return illustrates the compounding effect.

Source: Bessemer Trust

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