BESSEMER TRUST

Quarterly Investment Perspective

The Defensive Playbook

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Chief Investment Officer

Executive Summary

- **We are frequently asked how long we believe this economic expansion and prolonged bull market will last**
- **While we do not see a U.S. recession or equity bear market as imminent, we must be ready to act when needed to protect our clients' capital**
- **We recommend an incremental approach to managing risk given uncertainty around timing the business cycle and equity market**
- **When recession probabilities sufficiently rise, we will consider aggressively lowering our equity allocation, focusing on non-U.S. and small-cap holdings**
- **Fixed income, opportunistic, and alternative assets together should help limit overall losses and allow portfolios to more successfully compound returns over the long term**

We are not surprised that clients are increasingly asking questions about the next extended equity bear market. Consider the following just from the last month or so:

- The U.S. expansion, running 108 months as of the end of June, is the second longest in modern history; over that period, the S&P 500 has returned a cumulative 255%, with cyclically adjusted price-earnings (CAPE) ratios for U.S. stocks near their highest level since May 2001.
- Three leading global investment banks in May forecast the next U.S. recession as early as 2019. Further, one firm additionally cautioned on the medium-term U.S. debt outlook: "The U.S. fiscal outlook is not good.... An expanding deficit and debt level is likely to put upward pressure on interest rates, expanding the deficit further."
- The ratings agency Moody's Investor Service said a "particularly large wave of defaults" seems likely when the next period of economic stress occurs, given the "record number of highly leveraged nonfinancial companies globally" (see Exhibit 1 on page 2).
- The world's largest hedge fund, putting some of these pieces together, announced that "2019 is setting up to be a dangerous period for the economy. Since asset markets lead the economy, for investors the danger is already here."

In a vacuum, those four bullet points might sufficiently scare some investors to "ring the bell" and run to cash — now. We do not share that view. While we know the economic expansion is mature and that the probability of a recession and an equity bear market over the coming years is rising, we still see enough supports near-term for corporate earnings and global growth that we believe a significant, further portfolio de-risking is premature. Recall that we already took initial steps to manage volatility, reducing our equity allocation to

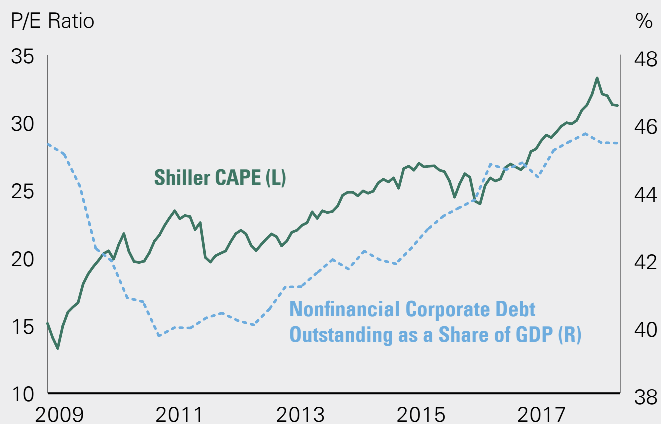
Defensive Playbook Overview*

Fixed Income	Public Equities	Opportunistic	Alternatives
Increase allocation, credit quality, and duration	Reduce exposure; focus selling on small-cap and non-U.S. stocks	Increase allocation to "safe haven" assets; use derivatives to limit downside	Tilt toward absolute return hedge fund strategies; hold private-markets allocation

*Assumes deflationary recession; Fed easing cycle.

Exhibit 1: Shiller CAPE Price to Earnings (P/E) and Nonfinancial Corporate Debt as a Share of GDP

Key Takeaway: U.S. P/E ratios are near their highest levels of the last decade while nonfinancial corporate debt levels have been steadily increasing.



As of May 31, 2018, for CAPE and March 31, 2018, for debt as a share of GDP.

Source: Bloomberg, Federal Reserve, U.S. Bureau of Economic Analysis, Yale University-Robert Shiller

neutral versus strategic benchmarks, and adding some defensive elements within equities. More recently, we further diversified our asset-class exposure by increasing commodity holdings.

While Bessemer's Investment Department is always looking for opportunities to grow client capital, we are equally focused on managing risk. This edition of our *Quarterly Investment Perspective* opens the pages of our Defensive Playbook. We want to share our thoughts on questions such as the following: Do we think we can time the business cycle? How will we steward client capital in the next equity bear market? What assets, regions, or sectors can best protect in the next downturn? We know that reducing losses in such periods can materially contribute to superior long-term compounded returns — the ultimate goal for our clients.

Q: Is Bessemer trying to time the market?

A: In a word, no. Even with a crystal ball in my office, I do not think I or our team can time the top for equities or the exact start of the next recession. Indeed, history suggests that government, central bank, and financial-sector teams with dozens of accomplished Ph.D. economists rarely call the onset of recessions with any specificity; they, like us, think more in terms of probabilities. Even then, forecast errors can prove surprisingly large. Just looking at the last recession as one example, as of October 2007, the New York Federal Reserve forecast 2008 U.S. GDP growth of 2.6%; now, looking back, GDP in 2008 *contracted* by 3.3%.

This is not to say that we should just accept recessionary markets and stick with a fixed asset allocation. As we have written many times in the past, a portfolio that can reduce losses through tactical allocation shifts more successfully compounds long-term returns. In the simplified example in Exhibit 2, each portfolio gets an average 5% annual return. However, Portfolio A's total compounded return for the five-year period is notably higher by reducing losses in down markets, even if that means also giving up some gains in positive years. If a client invested $50 million in each portfolio, the difference between the two approaches at the end of the five years would be $1.4 million — managing risk can mean real money.

If one can't time the market but wants to minimize losses, what to do? We take an incrementalist approach. As we see more evidence pointing to a higher probability of recession, we take multiple small steps to de-risk. While these steps can limit performance relative to a benchmark in positive years (as was the case for us in 2016), they help avoid a portfolio being completely exposed if a shock suddenly changes the economic and market outlook: a Wile E. Coyote moment where the ground under your feet suddenly disappears.

In our April 2016 *Quarterly Investment Perspective,* "R&R," we discussed some of the ways we assess recession risks. They include global economic and financial market data as well as anecdotal information from corporate executives, policymakers, and industry experts.

The 2019 "recession calls" coming from some credible investors and economists today tend to hone in on a few such data points. Notably, the U.S. yield curve — the difference between short- and longer-term government bond yields — has inverted, with short yields relatively higher, ahead of all U.S. recessions since 1955, by between

Exhibit 2: Hypothetical Portfolios and the Power of Compounding

Key Takeaway: A smoother return stream allows more compounding to take effect when compared to choppier annual returns.

Year	1	2	3	4	5	Average Return	Cumulative	Portfolio Value After 5 Years
Portfolio A	5%	5%	5%	5%	5%	5.0%	27.6%	$63.8
Portfolio B	10%	0%	(10%)	20%	5%	5.0%	24.7%	$62.4

Initial portfolio value is $50 million.

Source: Bessemer Trust

six and 24 months before the recession began (using a one- to 10-year yield differential). That curve is expected by many to invert by next year. Separately, other investors worry that U.S. corporate profits will be increasingly squeezed by rising input costs, such as wages, at the same time that benefits from the late-2017 fiscal stimulus begin to fade.

While we would not disagree with the signaling impact of an inverted yield curve or the possibility of a downturn in profit margins, we think both should be seen in context of a number of other indicators, all of which (for now) still point to robust economic growth. Two in particular that historically have turned well before the onset of an equity bear market are confidence surveys (both for businesses and consumers) and U.S. unemployment claims. Claims today are at their lowest level since 1973 while consumers and businesses alike are reporting confidence levels that are near peaks for this economic cycle (Exhibit 3). No bell ringing yet here.

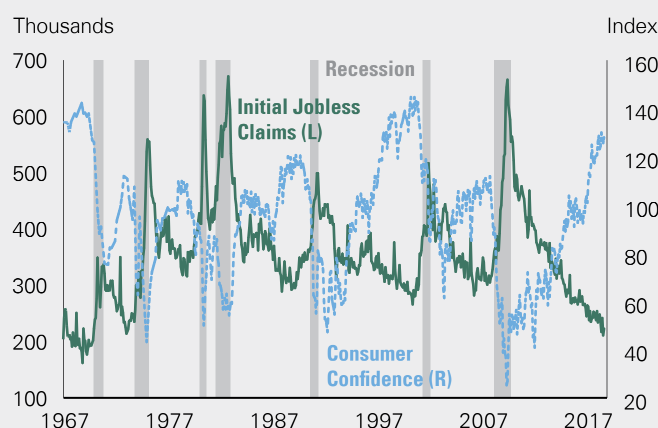
Further, we cannot rule out that investors are underestimating a scenario in which economic growth lasts longer than expected, supporting equities and other cyclical assets in turn. What if:

- U.S. fiscal stimulus supports growth for longer and by more than consensus expects. Note that this year's government spending bill will inject some $300 billion into the economy during 2018 and 2019. That's beyond stimulus achieved through last year's tax bill.
- Global inflation remains modest, kept in check in part by technological advances that hold down wage and many price gains.
- Central banks tighten monetary policy only very gradually, keeping borrowing and debt-servicing costs controlled.

The possibility that this cycle becomes the longest in modern history, and that the next bear market remains a ways off, comes back to why we have an incremental approach. Investing is about probabilities and confidence levels, not absolute certainty.

Exhibit 3: U.S. Initial Jobless Claims and Consumer Confidence

Key Takeaway: Employment and sentiment data continue to point to robust U.S. economic growth.



As of May 31, 2018.

Source: Bloomberg, Conference Board, U.S. Department of Labor

Q: When Bessemer decides risks have sufficiently grown to position for an extended equity selloff, how specifically will it protect client capital?

A: We have two answers here, a short and a longer one. The short answer first: A higher recession probability will lead the Investment Department to significantly cut equity exposure in client portfolios, with that capital going to more defensive assets, such as government bonds, derivatives, precious metals, and for appropriate clients, alternative assets. (Of course, the type of defensive assets used will depend in large part on the characteristics of the recession — a deflationary slowdown, for instance, would lead to a starkly different allocation shift compared with a stagflationary one.)

Perhaps the more interesting answer here, though, is the longer one — some of the details in the Defensive Playbook. De-risking a portfolio requires a lot more thought than simply selling stocks. We need to consider how much to sell from certain managers, what types of stocks to sell, and what countries' equities might prove most at risk. Below we discuss each of these factors.

1. **Internal versus external strategies.** For strategies and asset classes Bessemer believes can be strong performers over the cycle and will likely play a perennial role in portfolios (such as government bonds or large-cap equities), we prefer to manage capital internally. However, for more tactical opportunities or for strategies where we believe our clients would benefit more from an external manager, we often partner with carefully selected outside sub-advisors, as is the case today for emerging-market equities and opportunistic credit, among other mandates.

   Internal management provides several benefits, including seeing daily market flows and conditions, and gaining access to corporate executives and industry leaders regularly, the latter useful not only for security selection but also to consider macroeconomic trends. A third and critical reason for internal management is flexibility. We can shift portfolios very quickly when needed, tilting between countries or sectors — but also simply getting into or out of the market.

   Today, in a portfolio with 70% equity and 30% bond risk (what we call Balanced Growth), more than two-thirds of the equity exposure is managed internally. We believe this will be a notable advantage when we want to meaningfully reduce risk in portfolios. Our portfolio managers are compensated on medium-term performance, not on the amount of assets they hold; there is no resistance when they are told to sell, as might occur at firms with different incentive structures. In addition, external managers will have multiple clients — in volatile periods, any selling they do for one client will have to be considered alongside the impact to other invested clients. This complication can potentially slow the process of de-risking.

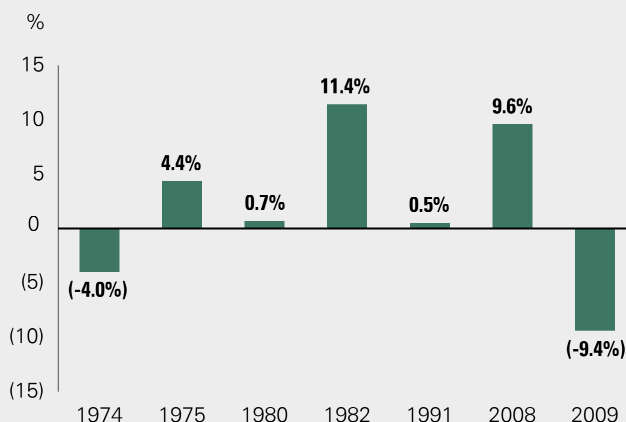
   Successful, popular external managers may create another complication: capacity constraints. Strong managers may have investors waiting for an opportunity to work with them. If we exit such an external manager to lower a certain portfolio exposure, even if we have a robust, long-term relationship, we cannot be guaranteed that we can reinvest with that manager when we want.

   All of this leads us to think about de-risking in a multidimensional way. Once we decide how much we want to sell and what kind of final equity exposure (for instance) we want to have in a bear market, we examine how much we should sell internally and externally to reach our goals, ideally without limiting our options to re-enter the market when we deem such a step appropriate. When it is time to get truly defensive, much of that equity selling, we expect, will come from our internal managers.

2. **U.S. versus overseas equities.** Historically, U.S. equities have tended to perform in line with, or better than, overseas markets into and during recessions — importantly, even if the recession emanated from the U.S. (as was the case in 2008–2009). We believe this pattern occurs for two main reasons. First, the U.S. equity market has greater liquidity than foreign peers; that liquidity means shocks can be more easily absorbed. As of last year, for instance, the S&P 500 had a market capitalization around $23 trillion while Japan's TOPIX index market cap was only around $5 trillion.

Exhibit 4: Trade-Weighted U.S. Dollar Performance (Annual Percent Change)

Key Takeaway: The U.S. dollar has tended to appreciate during economic contractions.



Reflects annual percent change in the U.S. Trade-Weighted Major Currency Dollar Index during years when GDP growth was negative.

Source: Bloomberg, Federal Reserve

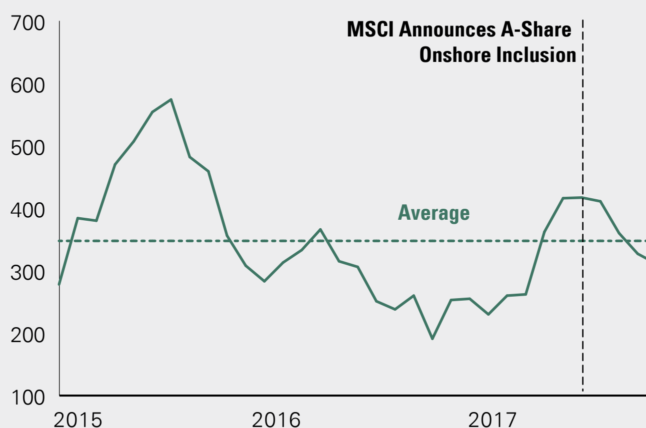
The second reason for "less bad" U.S. performance in a bear market centers on home bias. The American (dollar-denominated) investor base is the largest in the world. During periods of improving global growth and positive sentiment, U.S. investors will tend to be comfortable taking more overseas risk; as we saw in 2017, for instance, the trade-weighted dollar weakened by some 9% in part as U.S. investors sold dollars to buy foreign currency in order to buy more foreign assets (mainly equities). The greater that capital outflow during an expansion, the greater the potential for a reversal into and during a recession. Those same U.S. investors repatriate capital to increase defensive holdings and just to have the security of domestic American assets.

The dollar gains triggered by capital repatriation exacerbate the total-return difference between U.S. and foreign securities for investors whose portfolios are denominated in dollars. As discussed in our July 2014 *Quarterly Investment Perspective, "Common Cents — All About the Dollar,"* since 1972, when annual U.S. GDP growth was positive, annual changes in the trade-weighted dollar were negative more than half the time. However, when annual GDP growth was negative, dollar currency returns were positive more than 70% of the time (Exhibit 4). To give a specific example of how flows and currencies can impact returns, in the 2008–2009 financial crisis, the U.S. S&P 500 fell (peak to trough) by 57%, Japan's TOPIX fell 61%, and China's CSI300 Index fell 72% (the latter both in dollar terms). Clearly, investors were notably better off in U.S. stocks, even though economic strains were centered in the U.S.

With all this in mind, our Defensive Playbook favors reducing foreign equities more than domestic stocks. That said, when we think about the details here, we are mindful that history does not have to repeat. Recent years have seen a shift, with much greater public-sector intervention to support public stocks in Japan and China. In Japan's case, the central bank has routinely bought local equity exchange-traded funds (ETFs), while China has regularly suspended struggling shares, sometimes hundreds at a time (Exhibit 5). We cannot rule out that the next crisis sees these countries' equity markets performing

Exhibit 5: Chinese A-Share Suspensions

Key Takeaway: China regularly intervenes to support public equities by suspending selling of struggling shares.



As of October 31, 2017.

Source: Acadian, Bloomberg

We want to balance limiting downside into a recession against capital gains-related taxes and still having enough equity exposure that we do not miss the initial stage of a recovery when it ensues.

relatively better — liquidity would still be a drag, but government intervention, in currency and equity markets directly, could provide an important measure of support.

3. **Large- versus small-cap equities.** We know from history that investors seek liquidity during crises. Not only does that pattern favor U.S. markets and the dollar; it also favors large-cap companies versus smaller ones. In addition, larger firms tend to have higher dividend yields that investors see as a buffer against falling prices. As of mid-June, the S&P 500 had a dividend yield of nearly 1.9% versus a Russell 2000 small-cap index dividend yield of 1.24%. Our playbook suggests that we want to have a significant tilt toward large-cap stocks into a recession. (To note, Bessemer portfolios already started moving more toward large-cap equities as an early incremental step to manage late-cycle market volatility.)

Q: Would Bessemer ever sell out of all its equity holdings? How low would equity exposure go?

A: We would never recommend clients sell all their equity exposure into a recession, but we do believe there are benefits to reducing exposure tactically. We want to balance limiting downside into a recession against capital gains-related taxes and still having enough equity exposure that we do not miss the initial stage of a recovery when it ensues.

With that context in mind, we can think about the degree to which we want to outperform equities in a bear market. Consider just as an example a 70/30 "Balanced Growth" portfolio. If we want that diversified portfolio to see half or less of the equity bear market, as a first step we could consider reducing our equity risk from 70% to 50% of capital. That relative protection would not just reflect a top-down allocation decision. Indeed, we would expect our internal and external active managers to take additional steps within respective mandates to become more defensive, through position adjustments and/or sector tilts. In equities, that might mean more defensive sectors, such as healthcare or utilities; in fixed income, it would likely mean more duration and less credit risk. Further, for clients using Bessemer's Strategic Opportunities mandate, derivatives would likely focus more on limiting downside and/or benefiting from flows into perceived "safe haven" assets, such as the Japanese yen, Swiss franc, or even precious metals.

We will plan to publish a deep dive into our "Offensive Playbook" in time, but for now we want to at least share brief thoughts on why we would not de-risk even further into a recession. Historically, the first few months of market recovery toward the end of a recession have seen some of the largest percentage gains for equities of the entire cycle. Between early March and mid-June 2009, for instance, the S&P 500 rose more than 40%, while the MSCI All-Country World Index (ACWI) rose more than 51%. A portfolio

with no or very little equity exposure during the recession would risk missing those early gains. Indeed, just as we take an incremental approach into a recession, we would do the same during the recession — starting to average back into the market as a combination of fiscal and monetary response, valuations, and flows suggested that a bounce was growing more likely.

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Q: Has Bessemer successfully protected in the past?

A: Yes. In 2008, for instance, a 70/30 Balanced Growth portfolio lost 21.7% versus the portfolio benchmark, which was down 25.8%; the S&P 500, which was down 37%; and the MSCI ACWI, which was down 42%. In the last 20 years, in calendar years where S&P 500 performance was negative (2000, 2001, 2002, and 2008), a 70/30 portfolio had an average loss of 10.3% versus an S&P 500 loss that was effectively double: 20.8%.

Q: Would Bessemer recommend putting cash into the market now?

A: Yes, but with a caveat. As noted earlier, we do not think we can time the turn in the business cycle or the top in equities. Sitting in cash for an extended period of time if the business cycle extends and equities continue to appreciate is a potentially large opportunity cost. Recall 2006 and 2007: Even as signs were building that the cycle could be turning, the S&P 500 posted a return over those two years exceeding 20%!

Such costs have to be weighed against the risk that the 2019 recession forecasts could actually prove correct, that something occurs to hasten the end of the cycle. With those two contrasting scenarios in mind, our best advice is to average in. Whatever one's appropriate longer-term allocation, consider getting part of the way there today, and using the inevitable pullback as an opportunity to complete the longer-term investment strategy at more attractive levels.

Q: What kind of returns will bonds provide in this next recession versus the past given how low yields are today?

A: Probably better than you think. From a macroeconomic perspective, today's level of interest rates, in the U.S. but also globally, is certainly cause for worry. At the moment, central banks simply do not have much room to ease to hasten a recovery — and in the U.S., at a time when fiscal room may prove more limited as well (due to the large and growing budget deficit). Over the last six economic cycles, the Federal Reserve cut interest rates by an average of 7.9 percentage points around a recession. As of end-June, the effective fed funds policy rate was only at 1.9%. Meanwhile, as of late June, the 5-year U.S. Treasury was trading just below 3.0%, versus an average yield going back to 1990 of 4.0%. We expect the next recession will see central banks re-embrace asset purchases (so-called quantitative easing), and in some cases, negative short-term interest rates as well.

From a portfolio perspective, however, we believe high-quality government bonds should still play an important role in our Defensive Playbook in most scenarios (we would likely see things differently in a stagflationary crisis). In a recession more akin to what has occurred in recent decades, a slowdown in growth and selloff in equities should lead to central bank easing (reducing short-term interest rates) and investors buying bonds for liquidity and relative safety (pushing down yields and lifting prices along the yield curve). From June 2007 to the depths of the last crisis in December 2008, the 5-year Treasury yield fell from 5.2% to 1.3%: 390 basis points. Although current levels of just under 3% reduce the magnitude of potential bond returns over the medium term, we would not be surprised to see the 5-year yield fall to, or even below, 1%. To put that in a portfolio perspective, a fall in the 5-year yield to 1.0% over the next year would provide a total return of 10%. Additional factors that could impact returns include the degree to which municipal bond yields behave differently, changes in inflation expectations, and a continuation of the elevated level of Treasury issuance. While insufficient to completely offset equity losses, bonds should significantly help manage risk, especially if portfolios extend duration.

Q: How do alternative assets fit into the Defensive Playbook?

A: For appropriate clients, we believe both absolute return-focused hedge funds and private-market investments (private equities and real assets) can help limit downside in a recessionary market in a number of ways. Hedge funds, as their name implies, generally try to hedge risks via an array of different strategies. When successfully employed, these hedges help the funds outperform in bear equity markets. In 2008, for instance, as the S&P fell some 37% and the global ACWI index fell some 42%, an HFRI hedge fund of funds composite index lost about 21%; meanwhile, the fund-of-funds volatility during this year was 9.1% versus the equity market volatility of more than 20%.

Hedge fund portfolios constructed by Bessemer aim to achieve high Sharpe ratios; that is, attractive returns relative to risk taken. Perhaps more importantly for our playbook, Bessemer seeks managers, especially for our more defensive Absolute Return mandate, where returns have only modest correlations with broader public equity markets as well as low correlations with bond markets. The idea is to have a defensive strategy to complement, not duplicate, the role of fixed income in a recession. While we have historically seen, and have to expect, that correlations between different asset classes will rise during the next extended crisis, we believe the notably defensive starting point and actively managed nature of the hedge funds used in Bessemer portfolios should help protect client capital relative to public markets.

Private equities and real assets are similar to hedge funds in two important ways. First, they are very active. A manager, heading into a recession, can slow down putting committed client capital to work — opting instead to hold extra cash. He or she can also take steps with portfolio companies to reduce expenses as needed to help those underlying investments' returns. Bessemer also seeks private-market managers who do not employ significant leverage; while nice to amplify returns in good times, such leverage can quickly erode returns into recessionary markets. Second, private markets are illiquid investments — indeed, much more so than hedge funds. This illiquid nature can be advantageous to investors in periods of market stress when the temptation to sell is high. At the same time, investors must be comfortable that these funds will generally not be available in times of crisis.

Private markets are different from many (though not all) hedge funds in another sense, however. In general, they will have higher correlations with public equity markets. The forces of the economic cycle impact private just as they do public companies. When Bessemer constructs client portfolios, even if private markets are actively managed and volatility is optically masked by less frequent valuations (quarterly rather than daily), we consider public and private markets to represent comparable equity risk.

Final Thoughts: Second-Quarter Performance and Positioning

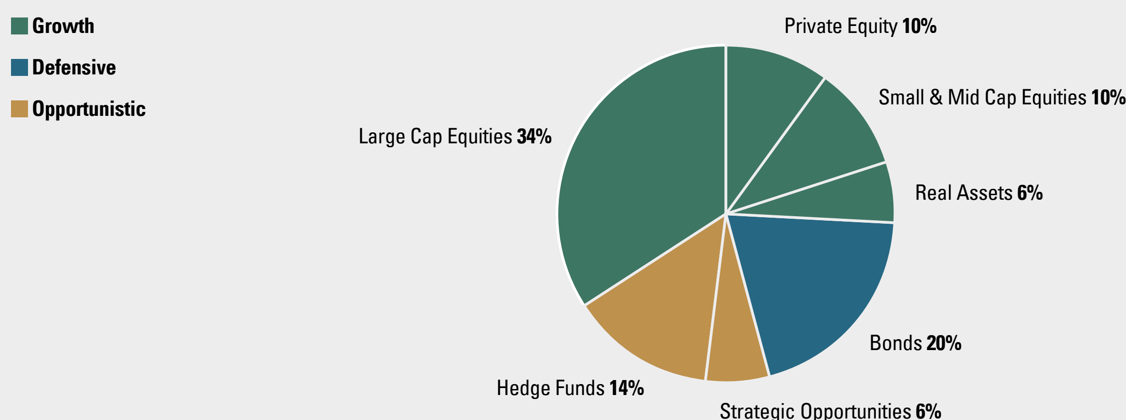
The second quarter ended with investors on edge as volatility picked up in the final trading days. For the quarter, global equities eked out a slight gain of just under 1%, bringing the year-to-date result to essentially flat. Political uncertainty in the U.S. and abroad,

particularly with regard to trade, continued to be a headwind — especially as rhetoric escalated late in the quarter. However, robust growth data provided a counterbalance. The economic narrative, meanwhile, shifted from one of a synchronized global recovery to one of U.S. outperformance. Relatively better U.S. growth and earnings data helped the S&P 500 to gain over 3%, and the broad U.S. dollar was up over 5% in the second quarter, reversing the trend seen for much of 2017. Developed European and Japanese equities fell 1%–3%, with Europe plagued by a downtick in economic activity from last year and renewed questions about the resilience of the European Monetary Union (EMU) following a populist shift in Italy (and, to a lesser extent, Spain). Emerging markets faced their own idiosyncratic challenges, with outflows from Turkey and Argentina most notable but tensions in Brazil and South Africa also reemerging. As a block, emerging market equities declined almost 8%, with Latin America underperforming significantly.

A representative Balanced Growth portfolio (70/30 equity/ bond risk) preliminarily finished the quarter with a return of 1.7%, ahead of the benchmark return of 0.6%. For the year-to-date period, a Balanced Growth portfolio returned 1.6% versus -0.3% for the benchmark. At a high level, an underweight to high-quality fixed income, an overweight bias to the U.S., as well as some defensive elements within equity portfolios helped amid the continued volatility. An overweight to information technology and energy sectors within portfolios also helped, as those sectors outperformed on a global basis, up 10.2% and 3.9%, respectively, over the quarter. More generally, pieces of equity portfolios with a "growth" style dominated despite the higher volatility. Bonds were range-bound, with municipal bonds earning approximately 0.7% on the quarter but still posting small losses for the year to date.

Bessemer mandates enter the second half of 2018 poised for volatility to remain high, as the tug-of-war between policy uncertainty and economic strength persists. With overall equity risk at a "neutral" level versus strategic benchmarks and several defensive strategies incorporated, we believe portfolios are well positioned for a continuation of the current late-cycle environment. Portfolio managers are constantly analyzing different ways to adjust positioning as opportunities arise, with an eye toward long-term risk-adjusted returns for clients, and prepared for whenever the Defensive Playbook needs to be implemented.

Bessemer's Positioning (70/30 Risk Profile with Alternatives)



Positioning as of July 2, 2018. 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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