BESSEMER TRUST

Quarterly Investment Perspective

Goldilocks or the Three Bears

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Executive Summary

- **2017 is ending on a happy note for the global economy and markets, with growth stronger than expected and most risks not materializing**
- **As we look at 2018, our base case is for another Goldilocks year, with solid global economic growth, only modestly rising inflation, and still-accommodative monetary policy — all suggesting further equity upside**
- **That said, we see bears lurking in the form of more-hawkish-than-expected central banks, an unexpectedly rapid slowdown in China, and politics/geopolitics**
- **We remain comfortable maintaining our equity exposure neutral to benchmarks, with some defensive exposures throughout the portfolio to guard against risks, especially given increasingly stretched valuations**

For many investors, 2017 seemed as much fairy tale as reality. There were villains lurking in the shadows — North Korea's Kim Jong Un and France's Marine Le Pen to name but two. But by the end of the year, the equity market came through all those challenges unscathed, aided by improving global growth and central banks that remained exceptionally accommodative — both feeding through to robust corporate earnings. The end-2017 consensus target for the S&P 500 index of 2,350 was reached by mid-February. By mid-December, U.S. equities were up by roughly 18% for the year, more than triple what the average forecast at the start of the year had implied.

While we began 2017 constructive on equities, we, like consensus, did not expect the magnitude of the rally that ensued. In particular, we were surprised by how low inflation remained throughout the year, and the impact that had on bond yields and central bank policy, which in turn acted like magic fairy dust on growth sentiment and cyclical assets (notably overseas equities).

In this edition of our *Quarterly Investment Perspective,* we consider 2018 and ask, will it be another Goldilocks year for investors, or will one or more of the Three Bears bring a negative surprise?

Our base case suggests another relatively happy story, albeit with equity gains more muted than those seen in 2017. That said, the bears we identify are not to be ignored. The possibility that U.S. Treasury yields rise more quickly than expected, that China's slowdown surpasses expectations, or that politics or geopolitics takes a sudden turn are all reasons to tread at least somewhat carefully, especially given already stretched market valuations (Exhibit 1). We start 2018 optimistic but comfortable being neutral rather than overweight equities versus our benchmark.

Exhibit 1: 2018 Base Case Supportive for Equities, But Risks Warrant Close Attention

Goldilocks Scenario for 2018

- Solid global growth
- Still-easy central banks
- Moderate inflation
- Politics/geopolitics on back burner

Or the Three Bears…

Hawkish Central Banks

- Inflation rises sharply
- Fixed income and credit investors face less liquid markets as they exit

Unexpected China Slowdown

- Stronger U.S. dollar fuels weaker renminbi worries
- Commodity prices fall
- Emerging equities hit

Politics/Geopolitics

- U.S. midterm elections
- Italian election
- "Brexit" challenges
- Mideast uncertainties
- North Korea
- Trade negotiations

Source: Bessemer Trust

This past year was the first in this economic expansion that truly felt like Goldilocks. Not only was the U.S. economy accelerating, but other major economies were also seeing growth momentum.

What Does Goldilocks Mean?

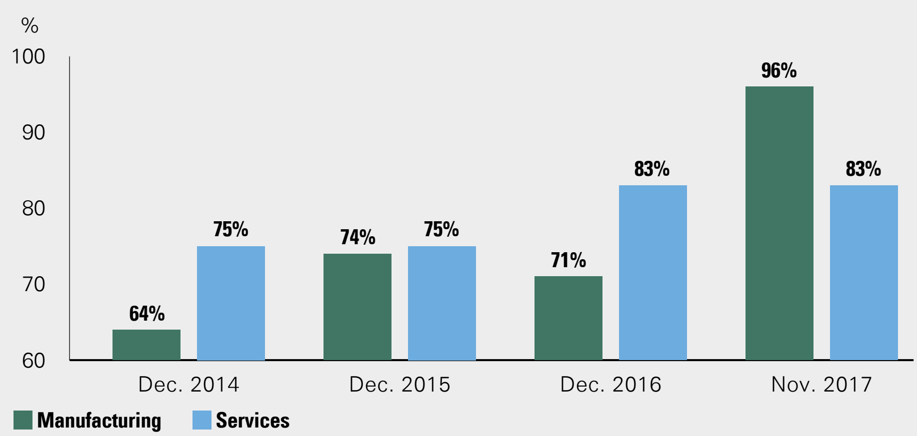
While most folks think of Goldilocks as a fictional little girl who appreciates a comfortable chair and warm bowl of porridge, the investment community hears that word and thinks of something else: a robust, growing economy with controlled inflation and a benign policy backdrop. Goldilocks is the "just right" macroeconomic setting for cyclical assets, including corporate debt markets and equities.

This past year was the first in this economic expansion that truly felt like Goldilocks. Not only was the U.S. economy accelerating, but other major economies were also seeing growth momentum. Indeed, using business confidence surveys (often reflected in "PMIs," or purchasing manager indices), 96% of 28 countries tracked suggested manufacturing sector expansion and 83% of the 12 for services sector expansion by late 2017, versus 71% for manufacturing and 83% for services a year earlier (Exhibit 2). Of those, critically important were China and the euro area (note that China, the euro area, and the U.S. together represent 55% of the global economy).

While globalization attracted a lot of bad press over the last year or so, we contend that linkages between different economies and markets were material in lifting corporate earnings in 2017. For U.S. firms in particular, earnings benefit directly from synchronized global growth, since about half of total sales come from overseas. Looking broadly, a FactSet index of more than 20,000 listed companies from around the world suggests earnings per share rose nearly 19% in 2017.

Exhibit 2: Percentage of Countries with Purchasing Manager Indices Above 50

Key Takeaway: Economic expansion has become more synchronized.

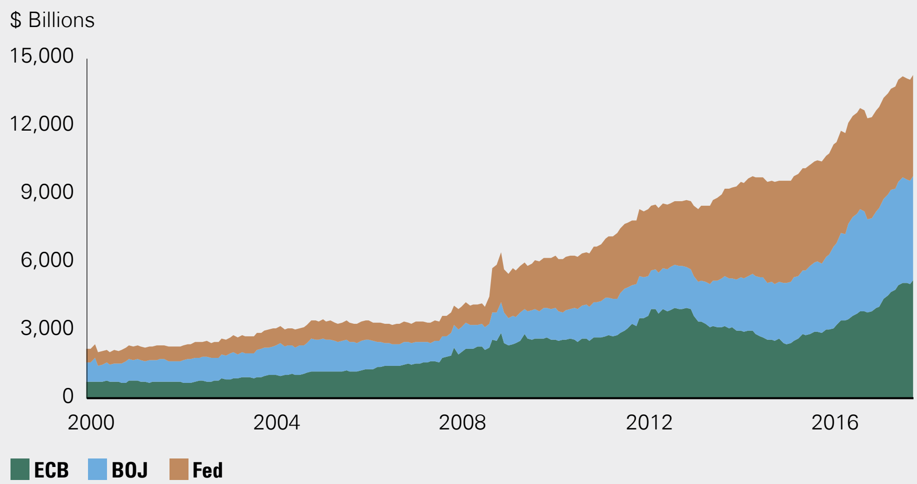


As of November 30, 2017. Sample sizes for Markit Manufacturing PMI are: 2014 (25 countries), 2015 (27), 2016 (28), 2017 (28). Sample size is 12 countries for each year for Markit Services PMI. A PMI reading above 50 indicates an expansion in business activity.

Source: Bloomberg, Markit

Exhibit 3: Total Assets of the Federal Reserve (Fed), Bank of Japan (BOJ), and European Central Bank (ECB)

Key Takeaway: Low inflation has allowed the world's central banks to maintain easy monetary policy, which includes asset purchases.



As of November 30, 2017.

Source: Bank of Japan, Bloomberg, European Central Bank, Federal Reserve

Central bank-fueled liquidity helped keep a lid on market volatility, which in turn reinforced corporate executive and investor confidence.

While improving global growth resulted in stronger earnings and tighter labor markets (the U.S. unemployment rate at 4.1% was the lowest recorded in 17 years, and the eurozone jobless rate at 8.8% was the lowest in nine years), it didn't translate into notably higher inflation. That, in turn, allowed policymakers to stay accommodative. Key short-term interest rates in the eurozone remained negative throughout 2017. Further, despite tapering of the Federal Reserve's balance sheet, total asset purchases by the Fed, European Central Bank (ECB), and Bank of Japan (BOJ) remained around $300 billion per quarter late in the year, bringing the stock of central bank assets to around $15 trillion (Exhibit 3). Central bank-fueled liquidity helped keep a lid on market volatility, which in turn reinforced corporate executive and investor confidence.

Further supporting this idyllic picture in 2017 was the relatively small number of worries turning into reality. Heading into France's presidential election, we, among many investors, lost sleep over the possibility that anti-Europe Marine Le Pen would ride a populist wave into office. At the end of the day, though, European equities benefited from a more business-friendly and eurocentric outcome in the form of Emmanuel Macron. Meanwhile, throughout the year, all investors grappled with the "what ifs" around possible military conflict in Korea or the Middle East and considered implications of more concentrated power in places like China and Turkey.

The global economy is on solid ground heading into 2018. Business and consumer confidence are strong — both tend to be decent leading indicators of actual economic activity.

Yet even if geopolitical experts remained on edge, investors focused on the underlying economy, which seemed to be doing just fine despite the risks and headlines, and the increasingly upbeat comments from corporate executives.

Goldilocks 2, the Sequel?

The global economy is on solid ground heading into 2018. Business and consumer confidence are strong — both tend to be decent leading indicators of actual economic activity. Strengthening labor markets and rising wages, along with low borrowing costs, should continue to support consumer spending. Meanwhile, recent data suggest business spending is also starting to pick up. Still, economists are not looking for much inflation to come out of this late-cycle economic backdrop. In the U.S., core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, are expected to rise from roughly 1.5% now to 1.7% or 1.8% by the end of 2018, still under the Fed's 2% target. Inflation in the eurozone, meanwhile, is seen holding steady near 1.5% for the year ahead, and Japanese consumer price increases are expected to remain well under 1% in 2018.

Not surprisingly then, investors generally expect central banks to retreat from extraordinarily easy monetary policy very slowly. Borrowing costs should remain low and contribute to another potentially Goldilocks year. As of early December, markets only discounted two additional U.S. interest-rate hikes in 2018 (Fed officials are forecasting three 25-basis-point hikes for the year). Even more dovishly, the ECB isn't expected to stop buying assets for its balance sheet until late 2018, while deposit rates stay negative throughout the year. The BOJ is also seen building its balance sheet further, using asset purchases to keep its 10-year government bond yield at zero.

Introducing the Three Bears of 2018

Just because a view is consensus does not mean it will be wrong. That said, when most investors agree on a view, one can assume the market is skewed in a certain direction, leaving risks tilted the other way. Some soul searching into what one might be missing is warranted. With that in mind, we are comfortable heading into 2018 positioned for another constructive year for equities and broadly stable bond markets, but are intensely focused on the bears that could upset our Goldilocks.

Bear #1: Inflation and Central Bank Reactions

As noted earlier, most economists and investors heading into 2018 are looking for modestly rising inflation in key economies, suggesting only gradually rising bond yields and another year of economic and monetary policy support for equities.

We share that sanguine view but always ask, what if? What if inflation picks up faster than expected? This is the biggest worry we have looking at the year ahead, as faster inflation could trigger tighter monetary policy and destabilize corporate debt markets, with spillover to global equities.

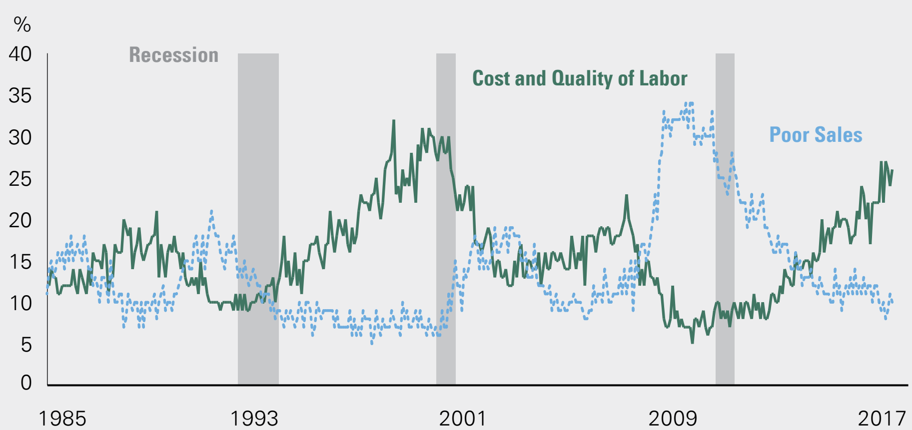
We have considered a number of potential inflation drivers as a way to back into different 2018 scenarios. And while we have focused mainly on the U.S. with this exercise, many of the same influences could impact inflation trends globally.

- **Wages pose an upside inflation risk.** Eight years into the economic recovery, with a U.S. jobless rate dropping to 4.1%, it has been surprising how little wages have reacted. Average hourly earnings growth has been stuck around 2.5% for the last few years, well below the pace of earnings gains seen in the last expansion. While one can point to structural elements such as globalization, automation, and reduced bargaining power for labor as reasons why wages might stay lower for longer today, there are increasing signs of building cyclical pressures. The National Federation of Independent Business (NFIB), representing the U.S. small business community, was reporting in late 2017 that many firms were unable to find qualified job candidates. The group's monthly index reading on labor tightness rose to its highest level since November 2000, suggesting growing risk that higher wages will be required to attract new employees (Exhibit 4). A separate Business Roundtable survey of 150 U.S. chief executive officers that was released in November showed that labor was the largest cost pressure facing companies.

What if inflation picks up faster than expected? This is the biggest worry we have looking at the year ahead, as faster inflation could trigger tighter monetary policy and destabilize corporate debt markets, with spillover to global equities.

Exhibit 4: NFIB Small Business Survey — Single Most Important Problem

Key Takeaway: Small businesses are increasingly worried about increasing wages and finding quality workers.



As of October 31, 2017. Cost of labor and quality of labor is a sum of the percent reported. Recession dates are based on National Bureau of Economic Research business cycle dates.

Source: Bloomberg, National Bureau of Economic Research, National Federation of Independent Business

One upside risk in 2018 for growth and inflation is U.S. fiscal policy. While still being negotiated at the time of this writing and complicated by a lot of different provisions, the proposed tax reform overall seems likely, in our view, to lift inflation, in part via tighter labor markets and subsequently higher wages. Using the Fed's own models and the Senate tax proposal, the U.S. unemployment rate could fall by an additional quarter percentage point after three years — that's beyond what could happen without new stimulus.

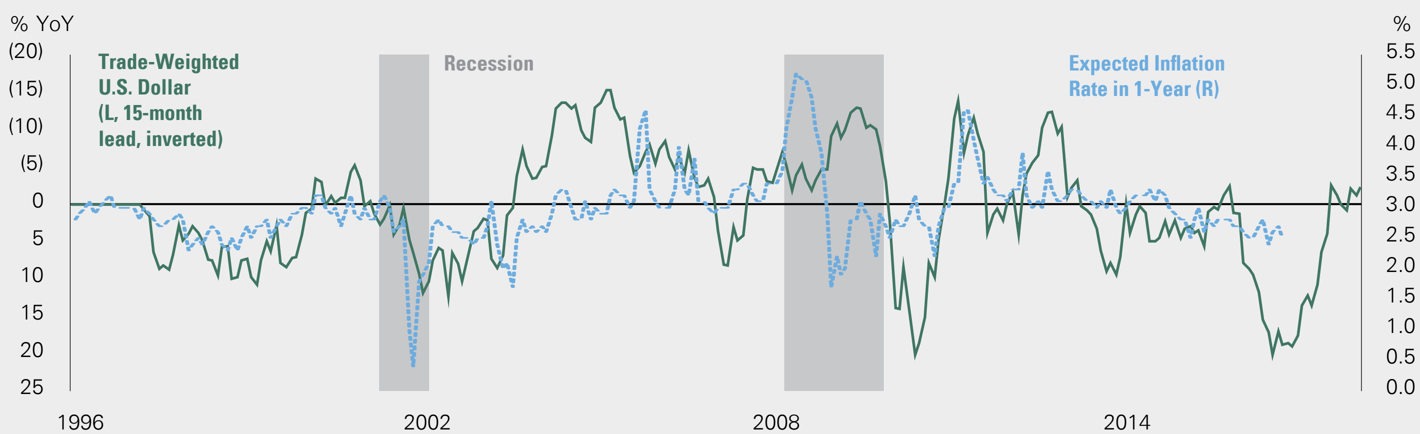
- **The U.S. dollar seems less of an inflation risk for 2018.** As we wrote in our November *A Closer Look,* "The Dollar Under President Trump, Revisited," the dollar came under unexpected pressure in 2017, thanks in large part to differentials in government bond yields between the U.S. and the rest of the world. Dollar weakness can fuel inflation expectations and actual inflation with a lag, in part via import prices (Exhibit 5). Specifically, as the dollar falls relative to other currencies, the dollar prices of foreign goods increase relative to goods made in the U.S. Since imports are part of the basket of goods purchased by U.S. consumers, measures of inflation based on that basket will rise.

  The transmission from dollar to inflation is not immediate, so pass-through from 2017 dollar weakness (the trade-weighted dollar lost roughly 7% for the year overall) could still support U.S. inflation into 2018. That said, as we look ahead, our view is that the dollar is more likely to stay range-bound or strengthen modestly in the coming year. This suggests less risk of a prolonged upside inflation surprise, at least from this source.

- **Oil prices face two-way risks — a question mark for 2018 inflation trends.** What happens to the dollar in the year ahead can influence commodity prices, another key inflation driver. A weaker dollar can boost oil prices since most countries price and trade oil in dollars. If an overseas producer "loses" on the exchange rate, it can try to lift oil prices to compensate and keep its local currency revenues stable. While the dollar is just one of many factors driving oil prices, it is still noteworthy that, in 2017, alongside dollar weakness, Brent crude oil prices rose around 11%. (We note that since oil markets are globally integrated, U.S.-produced and imported oil prices will generally follow each other closely.)

Exhibit 5: Trade-Weighted U.S. Dollar versus Expected Inflation Rate

Key Takeaway: A drop in the value of the U.S. dollar can result in higher inflation via higher prices on imported goods. In our view, the dollar is likely to stabilize in 2018.



As of November 30, 2017. Trade-weighted dollar is measured using the Federal Reserve Trade-Weighted Major Currencies Dollar Index. Expected inflation rate is measured using the University of Michigan expected change in prices during the next year median estimate. Recession dates are based on National Bureau of Economic Research business cycle dates.

Source: Bloomberg, Federal Reserve, National Bureau of Economic Research, University of Michigan

What else could impact oil in 2018? Beyond the dollar, we always consider supply and demand. A solid global backdrop (assuming only modestly slowing Chinese growth) is supportive for prices, as is a pledge by major oil producers late in 2017 to maintain oil production levels until the end of 2018. Potential tensions in the Middle East create an upside oil-price risk via worries over key supply channels. So too does the potential for the U.S. to sanction oil exports from Iran. At the same time, however, more U.S. drilling (made more attractive as prices rise) could add unexpectedly to supply, creating a negative price risk. Our base case is for oil prices to hold in a range not far from current levels (Brent crude was trading around $63 per barrel in mid-December) in 2018, suggesting limited impact on inflation trends. However, we acknowledge that risks are not immaterial and could change our inflation view as the year progresses.

Will Higher Inflation = Tighter Monetary Policy?

For now, let's assume inflation does rise by as much, or more, than consensus currently forecasts (core PCE to 1.8% year-on-year by late 2018). From an investment perspective, the next question should be, "What is the Fed's reaction?"

Even in normal times, this is not the easiest question to answer, but 2018 could prove particularly challenging given the unusual amount of change occurring and still to occur within the Fed's decision-making ranks. Every year, the regional Fed presidents who vote on policy rotate: For 2018, Cleveland Fed President Loretta Mester and San Francisco Fed President John Williams will move into the voting group. Other new voters will include Atlanta Fed President Raphael Bostic and Richmond Fed President Thomas Barkin. Although the voting rotation process is well known by investors, both Bostic's and Barkin's policy views are less well understood. Additionally, New York Fed President William Dudley is set to retire in mid-2018, which will open up another seat on the Fed's Open Market Committee (FOMC).

President Trump will also be able to appoint three Fed board members (in addition to Randal Quarles), including the Fed's vice chair. In late November, he proposed economist Marvin Goodfriend for one of those seats. Goodfriend has been a vocal advocate for the adoption of a more rules-based approach to monetary policy, as well as greater congressional oversight of the central bank.

Trump already appointed a new chair to replace Janet Yellen in February. Incoming Fed Chairman Jerome Powell, in remarks to Congress in November, suggested he had supported recent years' ultra-easy monetary policy: "We've been patient in removing accommodation, and I think that patience has served us well." He added, looking ahead, that "there is no indication in wages that the labor market is overheating or even hot." Overall, his remarks suggest little change in direction from Yellen — steady but gradual tightening. A no-surprises approach would please the administration since voters tend to reward incumbents for strong economies and stock markets. (We are not suggesting that Fed officials would pander to any particular administration. We do believe, however, that a slower tightening cycle would be more likely to elicit praise from this White House.)

While the chair of the Fed, in our view, is "first among equals" and can direct policy at least at the margin, the shift in the overall Fed ranks suggests more two-way risk for policy interest rates in the year and years ahead.

Fed Tightening a Threat via Corporate Debt

How inflation evolves and how the Fed reacts to any inflation surprise are critical to how we invest. Indeed, probably the biggest risk on our radar as we look at 2018 and beyond is a more-hawkish-than-expected Fed that raises borrowing costs for the economy and potentially — eventually — inverts the yield curve (in other words, short-term interest rates rise more than longer-term interest rates, to a point where short-term rates are higher). While the yield curve is only one "recession indicator" we follow, it is one that definitely impacts investor sentiment. Each of the last seven U.S. recessions was preceded by an inverted U.S. government yield curve; on a related note, U.S. equities never peaked before the curve inverted, at least looking back to the late 1960s.

The outlook for interest rates matters so much to us because that is where we see the greatest market vulnerability at this point in this cycle. Consider the backdrop:

- **"Crowded trade."** Since 2009, more than $4.6 billion of capital has gone into global bond mutual funds and exchange-traded funds (ETFs). That's more than 50% greater than the cumulative flows that have gone into equity funds over the same period. As investors have searched for yield, in our view, they have taken more and more risk for less return: Witness European "junk" bond yields now lower than similar-maturity U.S. Treasury yields, or a 100-year Argentina government bond yielding 7.9% being oversubscribed by 3.5 times. Bonds, including credit, appear more at risk of a sudden bout of profit-taking than equities, in our view.

- **Liquidity.** In the aftermath of the 2008–2009 financial crisis, a swath of regulation was put in place to reduce risks around large investment banks, including provisions that limited fixed income inventories and forced banks to look more closely at day-to-day balance-sheet risks. Those measures appear to have contributed to a drop in bond and credit market liquidity. A New York Federal Reserve note out in June estimated that fixed income dealers' assets had fallen to $3 trillion at the end of 2016 from about $5 trillion in early 2008. While still a deep market, the change in trading behavior and new rules suggest that if investors wanted to exit quickly from bond-related funds or other instruments, a sell-off could be exacerbated by the reduced liquidity backdrop.

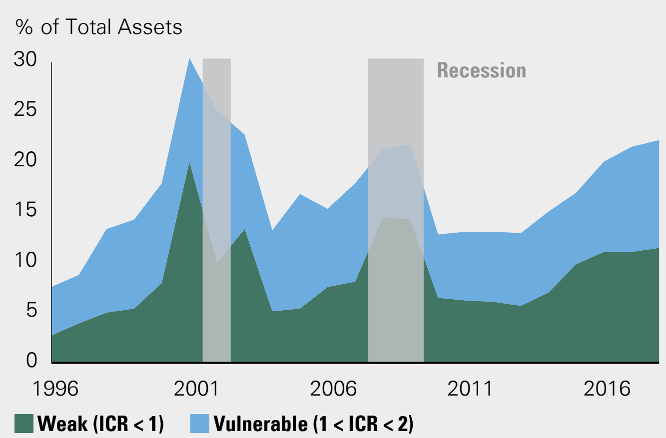
- **Corporate leverage.** Outside of financial firms, U.S. corporations today are back to pre-crisis levels in terms of leverage, leaving them vulnerable should interest rates rise quickly and more sharply than expected. According to data from the International Monetary Fund (IMF), U.S. corporations have issued $7.8 trillion in debt and other liabilities since 2010 — firms have taken advantage of low interest rates to grow via debt financing and to refinance existing debt to reduce debt-servicing costs. Over the same period, credit quality has started to deteriorate with weaker covenants to protect bondholders. Further, an increasing portion of companies (particularly in the energy, real estate, and utility sectors) are finding themselves not able to meet interest expenses with current earnings. Many of these corporate bonds mature over the next few years; firms will need to lock in refinancing quickly or potentially find themselves in a stressed situation (Exhibit 6). As we were repeatedly reminded over the last decade, stress in one asset class can spill over immediately to other asset classes (see our April 2014 *Quarterly Investment Perspective*, "Islands in a Storm," for more of our research on contagion).

Bear #2: Misstep for Chinese Economy

During the second half of 2017, China was largely focused on the successful completion of its 19th Communist Party congress, which marked a successful consolidation of power by President Xi Jinping. Leading up to this event, it was no secret that Chinese policymakers went out of their way to ensure a stable economy and calm financial markets, in turn supported by credit growth. Now that the party congress is in the rear view mirror, there may be less of an incentive for China to continue protecting financial markets and overleveraged parts

Exhibit 6: More U.S. Firms Challenged to Cover Interest Expense

Key Takeaway: An unexpected rise in yields could hit U.S. corporate debt.



As of 2016. ICR stands for interest coverage ratio. Figure 1.10 in IMF Global Financial Stability Report, April 2017.

Source: International Monetary Fund

of the economy. Consistent with this, various Chinese policymakers have issued warnings over the past several months that suggest a somewhat more assertive regulatory stance; mainland Chinese equities have fallen 5% from their early November high.

While China represents roughly 15% of global GDP, it makes up 35% of global GDP *growth*, and thus this is a key risk to watch in the year ahead. A policy misstep in China can easily have global implications: Recall the modest renminbi (RMB) devaluation (3%) in August 2015 that resulted in global equities tumbling some 11% in subsequent weeks.

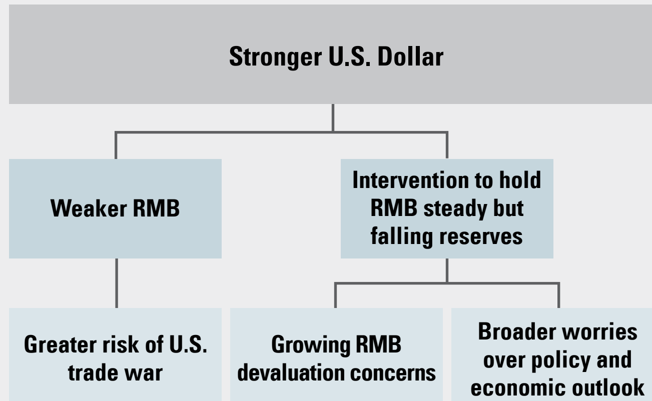
Consensus forecasts suggest China will continue to successfully manage its economy in 2018, with GDP growth moderating from roughly 6.8% in 2017 to 6.5%. If that forecast proves roughly correct, it would provide a level of support for the global economy via trade and commodity prices, among other channels.

It's not unreasonable to think China's leaders can thread this needle, at least for another year. Even with an uncomfortably (and unsustainably) large credit overhang (total Chinese debt stands at nearly 260% of GDP), policymakers have a lot on their side. The vast majority of the Chinese banking sector is run by the government, China's currency is managed, and officials can fine-tune housing policy as needed to rein in or stimulate consumer confidence and spending.

But what if there is a policy error or an external shock that slows Chinese growth faster than expected? In the year ahead, risks could emerge from a variety of sources, including a North Korean military event, a U.S.-China trade war, or a rapidly rising dollar. Regarding the latter, it's worth remembering that since currencies trade in pairs, broad dollar strength would push the RMB lower, putting Chinese policymakers in a difficult position (Exhibit 7). The central bank could allow market dynamics to play out, but that could increase risks of retaliatory trade measures by the U.S., especially ahead of midterm U.S. elections and given the White House's pledges to ensure a level playing field for domestic companies. Alternatively, China could intervene to support the RMB, drawing down central bank reserves. As we saw in late 2015 and into 2016, a rapid fall in reserves (even if from a comfortable starting point — today around $3.1 trillion) can generate a negative feedback loop, with investors fearing a one-off, material RMB devaluation and local Chinese trying to diversify their wealth by finding ways to move assets outside the country, further pressuring the currency. Such pressures, at least in recent years, have led to broader concerns over China's economic outlook and the ability of policymakers to successfully steer the country.

Bottom line: While a sharp Chinese slowdown or heightened policy worries in the year ahead are low-probability events, in our view, the implications of such scenarios could be large given Chinese economic and market linkages today with the rest of the world.

Exhibit 7: China's Challenge in Strong U.S. Dollar Scenario



Source: Bessemer Trust

Bear #3: A Swath of Political and Geopolitical Events

Every year faces political and geopolitical risk, but more often than not, such risks — even if they turn into reality — have only short-lived market and economic implications, either because leaders respond to shocks with looser policy that in turn stabilizes economic outlooks, or because market participants realize that the broader economic backdrop is not sustainably impacted by the event at hand, even if the event is troubling from other perspectives.

The year ahead is no different in that it is full of both political and geopolitical risks, some of which would impact markets if realized.

- **Italy**, the eurozone's third-largest economy, is due to have a parliamentary election in the spring. Polls suggest that the populist, anti-Europe Five Star Movement is level with the ruling center-left Democratic Party of Prime Minister Paolo Gentiloni, with both parties trailing a coalition including the Forza Italia party of former Prime Minister Silvio Berlusconi, the euro-skeptic Northern League, and the far-right Brothers of Italy. While an outcome that triggers a major policy shift seems unlikely, the size of Italy's economy and fickle sentiment in recent years toward the region make this race worth watching, in our view.
- Other elections of note in the year ahead include **Russia** (March), **Sweden** (September), **Brazil** (October) and **Mexico** (July). The Mexican presidential election could well impact NAFTA trade negotiations with the U.S. and Canada, at least tactically.
- **U.K. "Brexit" talks:** The coming year should see important decisions made as the U.K. deadline to exit the European Union (EU) gets closer (March 2019). One of the key risks we see here, especially if negotiations do not sufficiently progress, is that companies using the U.K. as their European headquarters move to an EU member country to ensure regulatory continuity, a trend that would likely weigh on growth and the British pound.
- **U.S. midterm elections** (November 6): Historically, the opposition party almost always has gained seats in midterm congressional elections. In the 18 midterm elections since World War II, the president's party has lost an average of 25 House seats and four Senate seats. We can reasonably assume that November 2018 will be no different. The question we ask is, could Democrats pick up enough seats in the House and Senate that investors start to discount a material possibility that impeachment proceedings against the president move forward? On one hand, history suggests the president's current low approval rating could result in more seats moving to the opposition. However, the building strength of the U.S. economy could put more voters in forgiving moods into November — incumbents are usually rewarded if voters are happy with their wallets. The biggest risk here would be a swing to the Democrats for both houses of Congress, as the uncertainty around policy could weigh on sentiment, at least tactically.
- **Middle East:** Over the past year, there have been several notable developments in the Middle East, each of which has incrementally raised the tail risk we believe the region represents. Most notably, the change in Saudi Arabia's leadership structure, which propelled Mohammad bin Salman to power, is a potential source of instability in the world's largest oil producer. The prince, who is just 32 years old, sidelined a large cross section of the Saudi elite on his path to power and is now confronted with an economy that is running a consistent budget deficit and a resurgent Iran that has prevailed in the various proxy conflicts across the region, most notably in Syria and Yemen. Add the ongoing embargo of Qatar, the Trump administration's decision to move the U.S. embassy to Jerusalem, and the ultimate fate of the Iran nuclear deal, and it's easy to see why the region represents a 2018 risk that we believe warrants careful monitoring.
- **North Korea:** President Kim Jong Un has said he intends to build a nuclear and ballistic missile program to have "equilibrium" with U.S. forces and to protect his regime. The last two years have seen an increase in nuclear and missile tests that support this goal. To us, the risk in 2018 is that either Kim or another party miscalculates and saber-rattling turns into a real military conflict (see our April 20, 2017 *Investment Insights,* "Escalating Tensions with North Korea"). While certainly possible, we

continue to see this as a low-probability risk, as the costs of conflict are large for all parties involved. South Korea, while appreciating the benefits of reunification with the North, also knows the costs in terms of assimilating millions of refugees. China also fears a potential flood of North Korean refugees, as well as the possibility that a reunified Korea, allied with the U.S. and Japan, would create an unwanted, larger geopolitical counterweight. The U.S., Japan, and South Korea do not want to unnecessarily antagonize China, nor do they want to incur large military and humanitarian costs that could come alongside a radical change in North Korea, especially if those costs are not backed by voters at home. All of these considerations are not even taking into account the possible loss of life during the transition from the current regime to something new.

Final Chapter: Positioning for a Cautious Goldilocks

At Bessemer, we always try to construct portfolios to participate as much as possible on the upside but also to limit risk in the event of a negative shock. While such a posture can make it more challenging for us to outperform, we know that reducing portfolio volatility will let us compound returns more successfully, which allows our clients to achieve greater total returns over the longer term. As a simple hypothetical example in Exhibit 8, Portfolio 1 makes 5% a year over 10 years, for an average annual 5% return and a cumulative return of 63%. Portfolio 2 also has an average annual 5% return. However, it has greater volatility (up 20% in some years but down 10% in others) — one could picture this as riding along with the market without any tactical allocation shifts. Because of that volatility, the cumulative return is notably less at 56%. For a $30 million account, the difference in those returns over a decade is $2.1 million. In our minds, that is a sufficiently meaningful difference to warrant our team's focus on the year ahead as well as the long term.

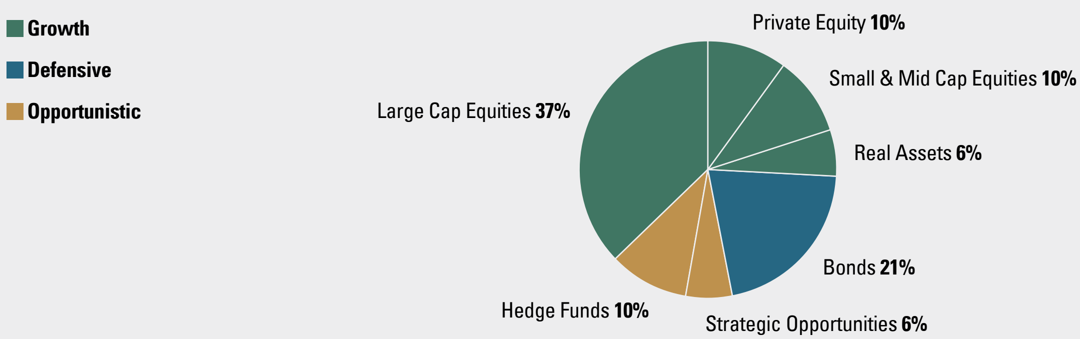
As we close the books on 2017, our neutral-equity exposure and diversified holdings meant we lagged our benchmark modestly but still achieved attractive double-digit returns for clients. And as we consider the year ahead, we want to maintain that posture. We do see risks — ranging from stretched valuations to a possible upside surprise on inflation, a downside surprise on China growth, or any number of political/geopolitical shocks. However, our base case — what we think is most likely — is still constructive, thanks to what we expect will be a still-strong global economy and easy central banks, both contributing to solid corporate earnings. Even eight years into the expansion, we want to stay invested. As we see more signs that the cycle is nearing an end, we will take additional, incremental steps to reduce portfolio risk, focusing on limiting downside and ensuring we can compound returns over time. We want to make sure our story ends happily ever after for clients.

Exhibit 8: Hypothetical Lower-Volatility Portfolio Pays Off Over Time

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Average Annual Return	Cumulative Return
Portfolio 1	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	**63%**
Portfolio 2	10%	0%	-10%	20%	5%	-10%	20%	10%	0%	5%	5%	**56%**

Source: Bessemer Trust

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



Positioning as of December 12, 2017. 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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