BESSEMER TRUST

America the Beautiful

Rebecca Patterson
Chief Investment Officer

Executive Summary

- **After a welcome springtime recovery, financial markets were shaken again late in the second quarter, following the June 23 British decision to split from the European Union**
- **Investors are anxious heading into summer, given the combination of slow growth, a U.S. monetary tightening cycle, fully valued equities, and a host of event risks — all at the later stages of an economic expansion**
- **In this *Quarterly Investment Perspective*, we examine how different countries and regions have performed toward the end of an economic cycle and what may prove different this time around**
- **Our base case is that even with many homegrown risks, the U.S. is unlikely to underperform into the next recession. We remain overweight U.S. stocks and see medium-term risks skewed lower for longer-dated U.S. bond yields**

Summer, punctuated by the Fourth of July, is always a time of heightened patriotism in the United States. This year the focus on the nation is even greater, thanks to an unusually heated election season. Televised presidential primary debates have drawn unexpectedly large viewing audiences; Coca-Cola has launched "I'm proud to be an American" limited-edition red, white, and blue cans; and Anheuser-Busch InBev has gone so far as to change the name of the iconic Budweiser beer to perhaps an even more iconic "America" on 12-ounce bottles and cans through the November 8 polling day.

The U.S. is front and center for Bessemer's Investment Department as well. When we think about optimizing risk-adjusted portfolio returns, a critical part of our process is understanding where capital is going and why. Anticipating trends in capital flows is not just about asset classes; it's also about countries and regions, starting with the U.S., the largest economy in the world with the largest pool of investor capital in play.

In this edition of our *Quarterly Investment Perspective (QIP)*, we build on our last *QIP* note on asset-class performance across recoveries and recessions (*"R & R,"* April 1, 2016), this time examining country and regional performance through economic cycles. (As we have previously noted, we see a U.S. recession as an increasing probability in the coming years, but not an imminent risk.) Our conclusion is that for behavioral, market-structure, and policy reasons, the U.S. is likely to remain the place to be when recession or a severe market downturn unfolds. Our portfolios are overweight U.S. assets. The coming years could see us increase domestic U.S. exposure further — even if the next market downturn proves to be "made in America."

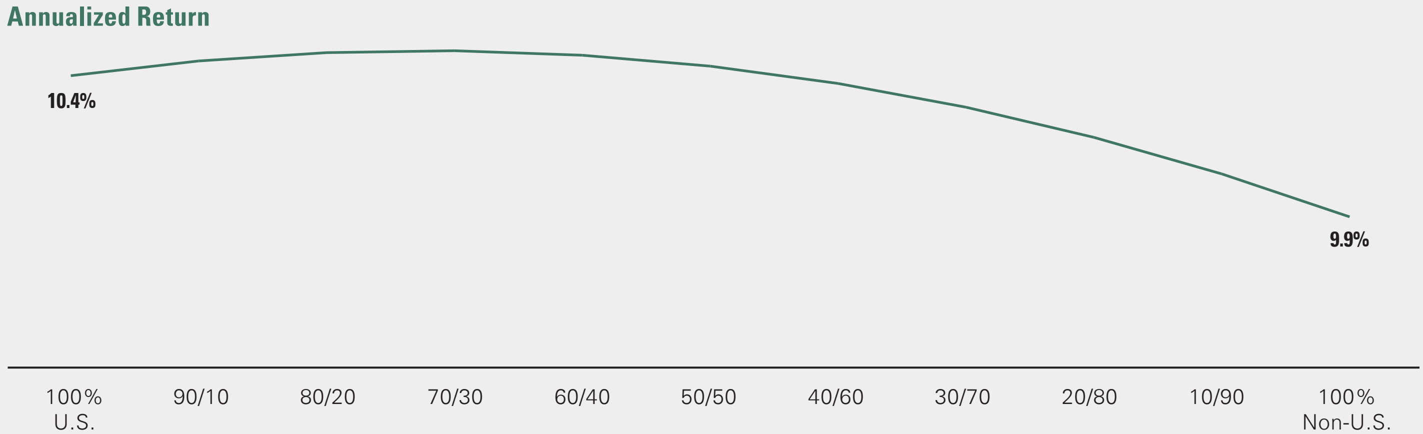
Should I Stay or Should I Go?

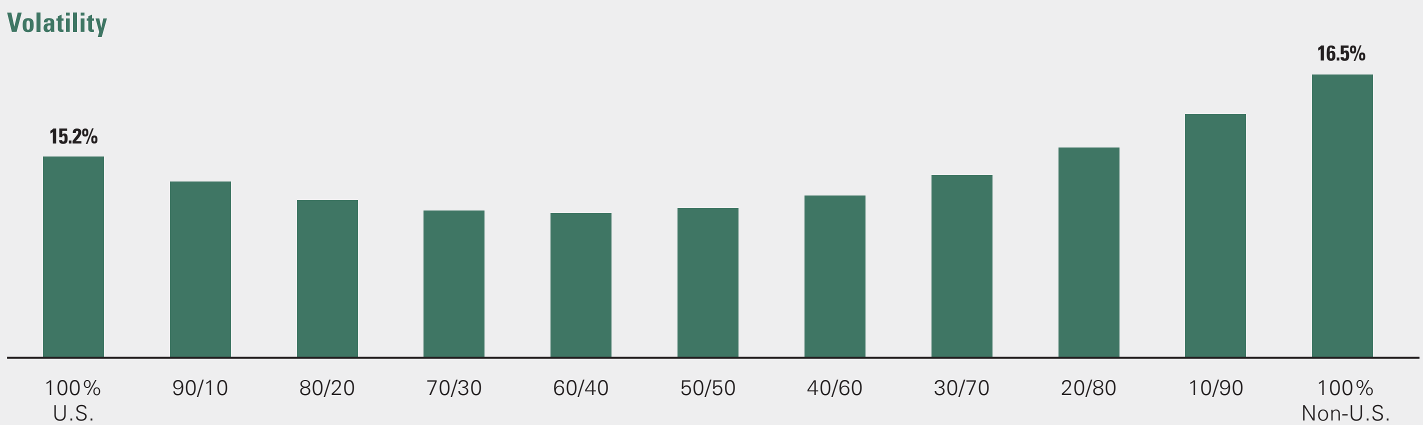
History shows us there is value in investing globally, especially in equity markets. Over time, a portfolio with a mix of U.S. and non-U.S. stocks has delivered slightly higher average annual returns, and with less volatility (which helps compound returns over time), than a U.S.-only equity portfolio (Exhibit 1). At Bessemer, our starting point is the MSCI All-Country World Index (ACWI), the leading global equity benchmark.

But are there better times than others to put more money overseas versus staying U.S. centric? What about now, given our views that (a) we are in the latter stages of the economic expansion, and (b) a recession is an increasing possibility in the next few years? (We note that our proprietary recession indicator gave a roughly 40% probability of a U.S. recession in the coming 12 months as of early June.)

Exhibit 1: Annualized Return and Volatility of Portfolios with Different Mixes of U.S. and Non-U.S. Stocks

Key Takeaway: A portfolio with a mix of U.S. and non-U.S. stocks has achieved a better risk/return profile than a portfolio with only U.S. equities.





As of May 31, 2016. Annualized return and volatility are calculated using monthly return data from January 31, 1971 to May 31, 2016. U.S. equities are measured using the S&P 500. Non-U.S. is measured using MSCI EAFE (80% of Non-U.S.) and S&P/IFC Emerging Markets Investable Composite (20% of Non-U.S.).

Source: FactSet, Global Financial Data, MSCI, Standard & Poor's

To answer these questions, we start by looking at history, although clearly noting that the past is an imperfect guide to the future. In particular, we highlight that equity investors' appetite to go outside the U.S. has changed materially over the last 20 years as technology, globalization, and lower regulatory barriers have allowed for more information and easier access to overseas opportunities. In contrast, earlier economic cycles saw a much greater and persistent U.S. home bias. As a result, the relevant data set for us to parse is frustratingly small.

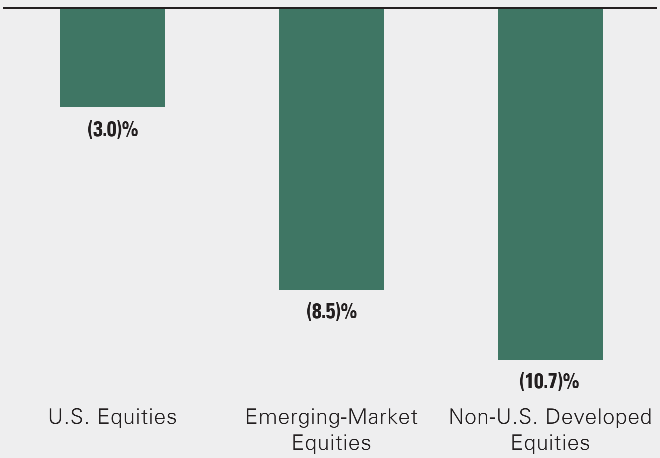
Still, history is a good place to start. Do we see any interesting patterns? Actually, yes.

- **In the year leading up to a U.S. recession** (as defined by the National Bureau of Economic Research, looking back to the late 1960s), **equity markets globally have tended to rise.** Regional patterns are not consistent, though emerging markets often posted average annualized returns notably above those recorded by U.S. and other developed markets.

Exhibit 2: Performance of U.S. Equities During Recessions

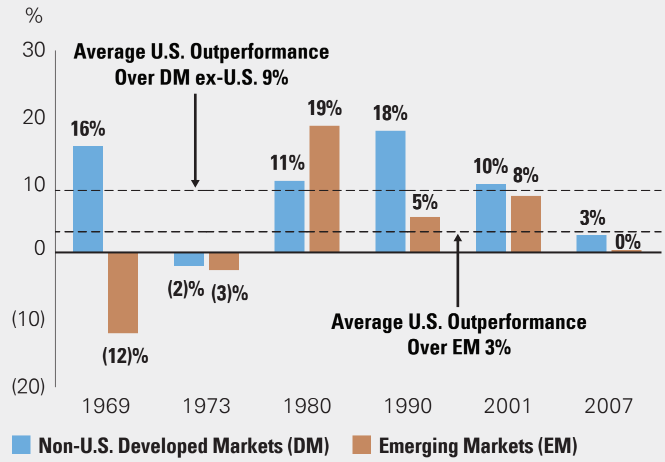
Key Takeaway: On average, during U.S. recessions, U.S. equities have lost less than emerging-market or non-U.S. developed-market equities. During the last six recessions, U.S. equities have outperformed non-U.S. developed-market equities by an average of 9% and emerging-market equities by an average of 3%.

a. Average Annualized Return During U.S. Recessions



As of June 30, 2016. Data set begins December 31, 1969. Includes all recessions according to NBER, with the 1980/1981 recessions combined. Represents MSCI World ex-U.S. (total return, USD), S&P 500 Total Return Index, and Global Financial Data's Emerging Market Index.

b. U.S. Outperformance During Recessions



As of February 29, 2016. Data set begins December 31, 1969. Includes all recessions according to NBER, with the 1980/1981 recessions combined. Represents MSCI World ex-U.S. (total return, USD), S&P 500 Total Return Index, and Global Financial Data's Emerging Market Index.

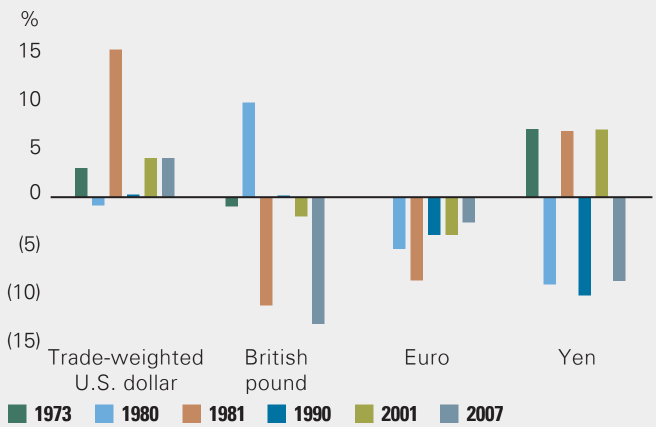
Source: FactSet, Global Financial Data, National Bureau of Economic Research, Standard & Poor's

- **The U.S. equity market fell less, on average, than other developed or emerging markets on an annualized basis during U.S. recessions** (Exhibit 2a). U.S. equities outperformed other developed markets by 9% and emerging markets by 3%, on average (Exhibit 2b).
- Looking at U.S. recessions in conjunction with equity-market corrections (so as to get a larger sample of data), emerging markets have underperformed U.S. stocks, on average, while other developed-market performance has been mixed.
- **During U.S. recessions, even if overseas countries were not in recession, the trade-weighted dollar usually strengthened.** While dollar performance during recessions against the British pound and Japanese yen was mixed, **the dollar consistently appreciated against the euro** (looking at six recessions going back to 1973 and using a synthetic euro before the 1999 launch of the European Monetary Union; see Exhibit 3).

Boiling these points down, we are left noting that the U.S. equity market has held up better in most U.S. recessions and equity-market corrections than counterparts overseas, with a material amount of that relative performance coming from U.S. dollar strength (remember that for dollar-based investors, total return includes both local equity market performance and currency translation).

Exhibit 3: Currency Performance During Recessions

Key Takeaway: The trade-weighted U.S. dollar has usually strengthened during U.S. recessions.



As of June 30, 2016. If the 1980 and 1981 recessions are combined from the start of the 1980 recession to the end of the 1981 recession, the USD strengthened 4% versus the yen. The strength of the dollar versus the yen in 2001 could be partially attributed to rapid, sound policy response following the 9/11 terrorist attacks. (The dollar weakened about 4% versus the yen in the two weeks immediately following the attacks.)

Source: Bloomberg, Federal Reserve

Why Does Stress Make America So Beautiful?

Understanding why these historical patterns exist, in our view, is important before we tackle how markets may evolve in the coming years. We think past relative U.S. strength in times of stress has been the result of three main factors:

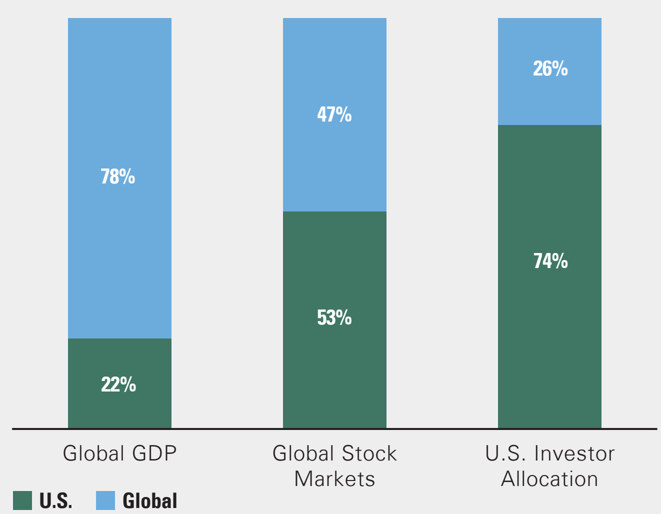
1. **Home bias.** U.S. investors have always favored domestic stocks, and for good reason. These tend to be securities of firms they know well. In addition, at least broadly speaking, there is transparency around these companies' accounting practices and management competency. U.S. investors' allocation to domestic stocks was 74% as of 2014, despite U.S. equity markets representing only 53% of global equity capitalization and the U.S. making up only 22% of the global economy (Exhibit 4).

Historically, in times of improving investor confidence and wealth, U.S. home bias has diminished, at least at the margin. Americans were more willing to take risk in portfolios — in part in the form of foreign assets — in search of stronger returns. Indeed, we believe this is one key reason why the U.S. dollar often weakened during past economic expansions: Americans were selling dollars to buy foreign currency in order to purchase foreign stocks and bonds.

At the end of a cycle and into a recession, though, American investors often repatriated capital. They sold their foreign assets for the familiarity of a U.S. security and in the process needed to buy dollars again. This capital flow, alongside a stronger dollar, helps explain the relatively good U.S. market performance in periods of U.S. stress (even when that stress was not occurring at the same level overseas).

Exhibit 4: U.S. GDP and Assets as a % of World

Key Takeaway: U.S. investors tend to favor U.S. stocks despite the U.S. making up a much smaller share of global stock markets and GDP.

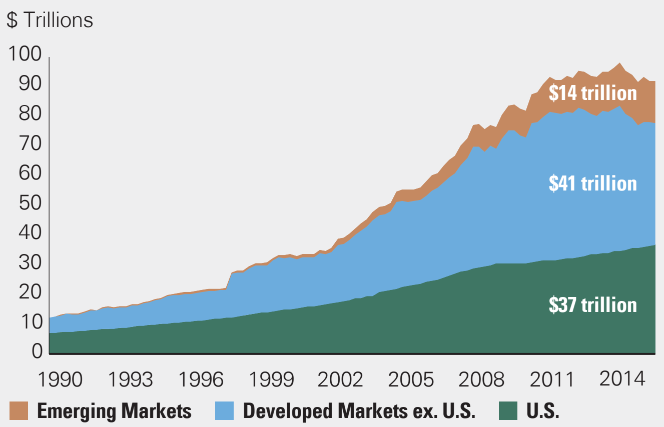


As of June 30, 2016. Global GDP and U.S. investor allocations as of 2014. U.S. investor allocation is the total value of investments in global or domestic equity mutual funds and ETFs.

Source: International Monetary Fund, Investment Company Institute, J.P. Morgan Asset Management, Openfolio

Exhibit 5: Global Bond Markets

Key Takeaway: The U.S. is still the largest single bond market globally, despite recent growth in emerging markets and non-U.S. developed markets.



As of December 31, 2015. The totals reflect the sums in the last time period (December 31, 2015). The market composites are based on MSCI Emerging Markets and MSCI World indices. Emerging Markets include: Brazil, Chile, China, Colombia, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates (Czech Republic is excluded due to lack of data). Developed Markets ex. U.S. include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the U.K.

Source: Bank for International Settlements (BIS), MSCI

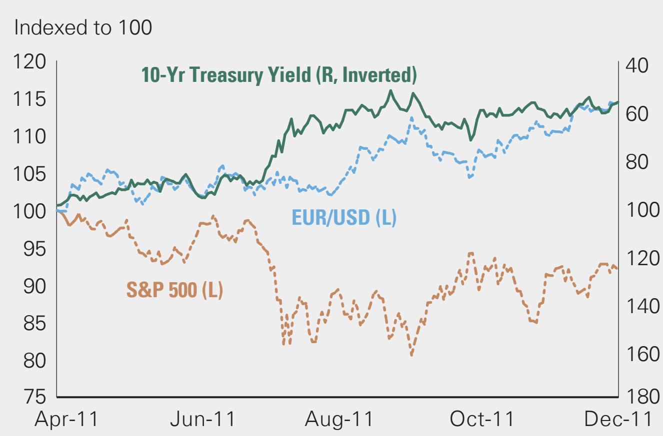
2. **Market structure.** For now at least, the U.S. remains the world's largest economy, with the world's largest stock and bond markets (the latter by market capitalization). Deeper, more developed markets are particularly favored during recessions or substantial market corrections as they will normally offer greater liquidity; that is, investors can buy or sell what they want, when they want, at a reasonable price. As noted in Exhibit 5, even with rapid growth in issuance of emerging and developed-market bonds in recent years, the U.S. has remained the largest single market, representing nearly 40% of the global total as of year-end 2016. During crises, investors put a premium on such liquidity, as the ability to get in and out of investments in such a period provides flexibility for whatever comes next.

Beyond the equity repatriation that often occurs during recessions and sustained corrections, history shows that global investors have been biased to hold U.S. government bonds with greater liquidity than their counterparts overseas. Importantly, this premium on liquidity and ease of trade has been on display even when the trigger for the market stress emanated from the United States.

Consider 2011: In the summer that year, investors became increasingly anxious that the U.S. could not meet its debt payments. While default was avoided, Standard & Poor's announced on August 5 that it was downgrading the U.S. sovereign debt rating for the first time, from AAA to AA+. During the months leading up to the rating decision, U.S. equities tumbled, but bond prices and the U.S. dollar rallied (Exhibit 6). (We acknowledge that some of the flight to U.S. assets at this time may have been fueled by increased uncertainty in Europe.)

Exhibit 6: Performance Prior to the U.S. Credit Rating Downgrade in 2011

Key Takeaway: In the months leading up to Standard & Poor's credit rating downgrade, U.S. equities tumbled, but bond prices and the U.S. dollar rallied.



As of June 30, 2016.

Source: Bloomberg

3. **Policy reaction.** While secondary to home bias and market structure, another reason investors may lean toward U.S. assets (especially equities and currency) in times of crisis could be a sense that U.S. policymakers react more quickly and aggressively to growth slowdowns and stress events than their foreign peers. Significant fiscal or monetary stimulus, for instance, could support perceptions that U.S. growth will rebound faster. While the 2008 global financial crisis is only one data point, and an exceptional period, it was certainly noteworthy that the U.S. central bank started easing monetary policy in September 2007; the European Central Bank was still tightening policy at that point, and only began easing in October 2008 (Exhibit 7). Similarly, aggressive easing by the Bank of Japan only began in earnest in late 2008.

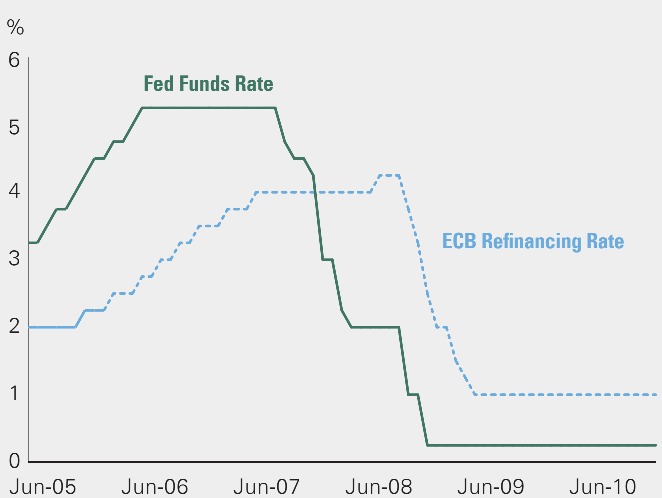
Is This Time Different?

As we take stock of the economy and financial markets today and consider the future, we believe that some of the underpinnings of past U.S. asset strength in times of stress — home bias and market structure — are likely to remain. Beyond that, however, "this time is different" rings as loudly in our ears as July 4th fireworks. Four issues stand out:

1. **Global monetary policy.** To say global monetary policy is different today is an understatement. With growth sluggish and inflation nonexistent across much of Europe and Japan, respective central banks have embraced negative interest rate policy, or NIRP. Those policies are dragging yields of longer-dated bonds into uncharted territory — in mid-June, 10-year German bund yields dipped into negative territory for the first time. Japanese 10-year government bond yields now regularly dip below zero (Exhibit 8). As we look ahead, our base case is that NIRP is likely to linger, potentially for years to come, and may be accompanied by looser fiscal policy and/or other creative stimulus efforts (such as aggressive Japanese buying of local equity exchange-traded funds) in an effort to boost growth and encourage higher inflation.

Exhibit 7: Central Bank Policy Rates

Key Takeaway: The U.S. central bank reacted more quickly to the global financial crisis than the European Central Bank.

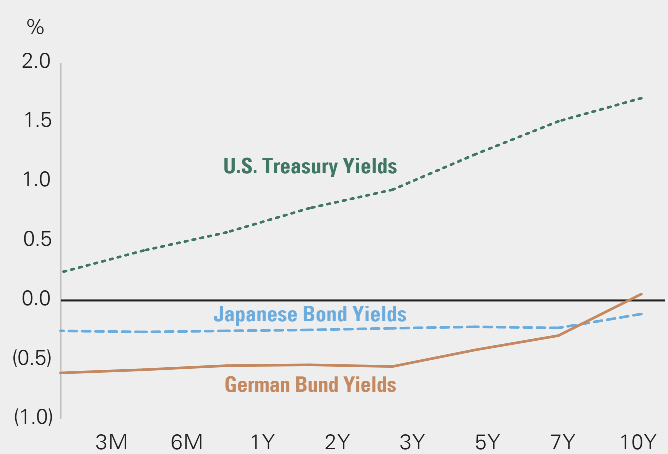


As of June 30, 2016.

Source: Bloomberg

Exhibit 8: Global Sovereign Bond Yields

Key Takeaway: U.S. government bond yields exceed those of other developed-market sovereign bonds where central banks have embraced negative interest rate policies.



As of June 10, 2016.

Source: Bloomberg

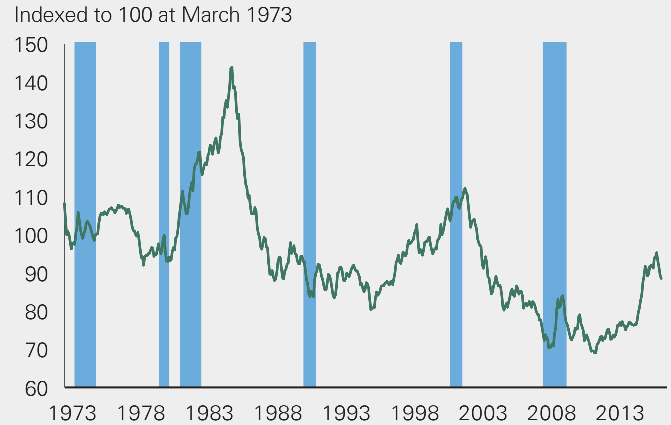
This overseas backdrop has several implications for U.S. assets at the end of the cycle. Should overseas stimulus measures succeed (this is a maybe, not a given), we could see a recession in the U.S. but not overseas. Such divergence would not guarantee that non-U.S. cyclical assets do better, but it could at least suggest that any U.S. outperformance may be less stark than in the past. (In 2001, the U.S. entered recession, but the euro area did not; U.S. equities still held up better over this period, helped in part by dollar strength versus the euro.)

What about NIRP? Should negative rates intensify and/or linger, we would expect foreign investors to continue moving into U.S. fixed income in the search for higher yields. That capital flow, all else equal, should support longer-dated U.S. bond prices as well as the dollar. NIRP could also help support higher-dividend equities, both in the U.S. and generally. Dollar strength in turn, as noted earlier, will help the total return of all USD-denominated assets.

A final word on the dollar. Historically, the dollar has often been weak toward the end of a U.S. cycle, thanks in part to U.S. capital going overseas but also to U.S. purchases of foreign goods (a wider trade deficit). This time around, though, the dollar started climbing (albeit off record lows) in 2011. On a trade-weighted basis, the dollar today is some 30% above mid-2011 levels and by many measures is seen as at least somewhat overvalued (Exhibit 9). Many investors are already long the dollar, meaning that further upside for the currency could prove a bit more limited into and during the next recession. A separate but related potential dollar headwind: Should NIRP linger overseas but the Fed continues to slowly raise U.S. interest rates, the eventual recession could see dollar gains limited by a narrowing interest-rate differential between the U.S. and major trading partners as the Fed could lower interest rates more than foreign central banks.

Exhibit 9: U.S. Trade-Weighted Dollar

Key Takeaway: The trade-weighted dollar has risen nearly 30% since mid-2011; further upside may be limited into and during the next recession.



As of May 31, 2016.

Source: Bloomberg

2. **U.S. politics.** The ongoing election season is unusually heated and uncertain; we plan to write more on the topic this fall when (hopefully) we know more about possible policy implications of the next administration and Congress. For now, we would just say that major policy change could impact both the likelihood of the next U.S. recession as well as the timing of the end of the cycle. Substantial policy changes could also alter our thinking on capital flows to or away from the U.S. This degree of uncertainty makes historical patterns marginally less useful.

3. **Oil.** At least compared with recent decades, the U.S. will enter its next recession in a very different position when it comes to commodities. Even with the recent (and ongoing) reduction in U.S. production, the U.S. is still one of the top crude oil producers in the world. A recession that presumably would bring a sharp slowdown in demand would likely weigh on oil prices. We could reasonably expect spillover from oil to related industries (such as transportation and industrials) and sub-asset classes (such as high-yield debt, since such debt funded a lot of

recent growth in the energy sector). While there could be a drag on broader U.S. equities via weakness in oil-sensitive equity sectors, the fall in oil prices might also help lift the U.S. dollar given the frequent inverse relationship between oil and the dollar over time.

4. **China.** At the end of the last U.S. economic cycle, China had nominal GDP of less than $4 trillion. Today that GDP is nearly $11 trillion. In 2007, according to data from the Bank for International Settlements (BIS), the Chinese renminbi was the 20th most traded currency in the world; today it is ninth, above the currencies of New Zealand, Sweden, Hong Kong, and Norway, among many others.

   China's greater size (the second largest in the global economy) and integration with global trade and finance suggest that feedback loops between the U.S. and China are likely to matter more — possibly a lot more — when we see the next U.S. recession. Consider one sequence of events for a moment:

   a. A shallow U.S. recession is reflected in weak demand for goods, including Chinese imports. The U.S. is China's second-largest export destination; exports still represent some 26% of China's overall GDP.

   b. The hit to China directly via trade and indirectly via likely lower equities and a stronger dollar results in a weaker Chinese renminbi. That in turn rekindles Chinese capital outflows and worries over the country's foreign-exchange reserves.

   c. Heightened fears about Chinese growth (alongside what is already a clear slowdown for the U.S.) cause more selling of assets of countries with China ties. Commodities and China, and/or commodity-related emerging markets, take a particularly hard hit.

   d. The shallow U.S. recession grows more severe thanks to these global feedback loops. A flight to traditional U.S. bonds pushes down yields and lifts the dollar (see *"Bonds and Late-Cycle Investing — A Closer Look,"* May 2016).

This is just a single scenario; it's not necessarily our forecast. If the U.S. recession is shallow enough and China has made more progress by this time to strengthen local consumption and reduce trade dependency, the contagion that could ensue may not be as severe. Further, in the event of a contraction, the U.S., Europe, and Japan could respond with stimulative policies that could provide offsets and lessen the risks described above. We could also end up being happily surprised by other factors — even U.S. policy after the November vote — that provide an unexpected support to investor sentiment.

A Quick Word on Second-Quarter Performance

Despite taking equity exposure to neutral versus our benchmark in January, our portfolios have performed relatively well in the second quarter, during what was (until the "Brexit" vote) a more constructive market environment, modestly beating respective benchmarks and helping year-to-date 2016 performance. Our internally managed equity mandates have also outperformed benchmarks for the quarter, even with a lingering underweight exposure to commodity companies. Looking top-down, our U.S. bias helped equity returns, as did our underweight position in European equities.

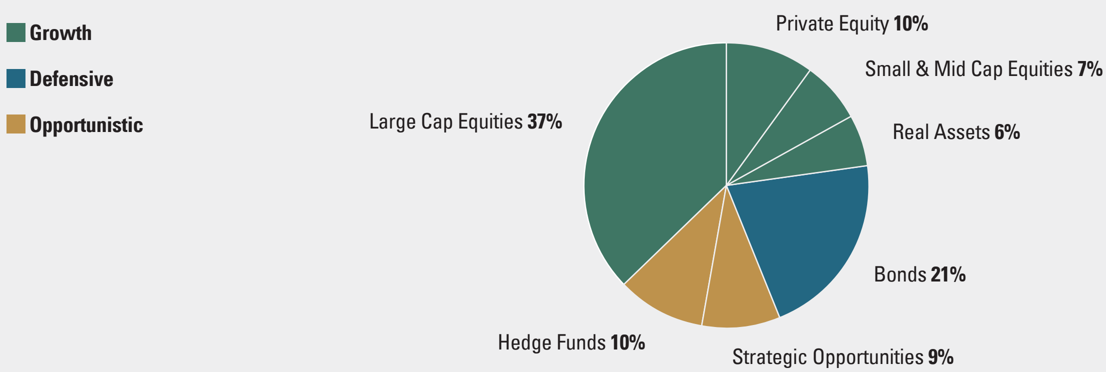
Portfolio Implications: Past, Present, and Future

As of June, our portfolios were positioned for a late-cycle economic environment and a decent amount of two-way event risk (including but not limited to the U.S. election, central bank decisions, and geopolitical uncertainties). We are neutral equities versus benchmarks and, within equities, tilted toward large-cap stocks and the U.S. Indeed, our U.S. equity exposure is 58% versus the MSCI ACWI benchmark weight of 53%. For the portfolio overall, our USD-denominated exposure is 76%.

Should the coming months prove more benign than feared, our equities and other cyclical investments should help generate solid returns. We do not dismiss the possibility that the current anxiety around a host of market and economic issues proves unfounded this year. However, the shifts in recent months to include more managed-volatility equity strategies and slightly more traditional U.S. bonds should provide a greater cushion against bouts of volatility, which we also cannot rule out. Simply put, without a huge amount of conviction near term about how these event risks will shake out, and acknowledging the late-cycle backdrop, we prefer to play it down the middle of the fairway in terms of portfolio positioning.

Further out, as we see more signs that the late cycle is tilting more toward recession, we would expect to further reduce equity and other cyclical exposure and increase defensive assets (traditional bonds, cash, and possibly gold). Within countries, we will constantly assess what is different, but in general we expect that we'll likely reduce our emerging-market equity exposure and potentially increase the U.S. bias of our portfolio. Timing all these shifts perfectly is simply not possible. As a result, our approach is likely to remain incremental — using periods of strength in cyclical assets to slowly and methodically prepare for the next recession. As we frequently state, we view our clients' capital as irreplaceable. Planning ahead is critical to successfully protecting, as well as growing, that capital.

Bessemer's Positioning



Positioning as of June 30, 2016. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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