Earnings, Opportunities, and Risks: The 2022 Outlook

BESSEMER TRUST

Holly H. MacDonald
Chief Investment Officer

Executive Summary

- **The economy has reopened, and economic growth has been strong. We do not believe inflation will put an end to the cycle as the Fed is likely to withdraw liquidity slowly; debt levels are high but unlikely to be addressed near term. We believe the U.S. economy will remain open and continue to grow in 2022.**
- **We are maintaining an overweight position in U.S. equities, and we are underweight emerging markets. Our portfolios are diversified with exposure to cyclically oriented companies and high-quality growth companies that are benefiting from innovation.**
- **We are underweight high-quality bonds, though they remain important for portfolio safety reasons. Our managers in private assets continue to identify early-stage growth opportunities.**
- **In this publication, we discuss our outlook and focus on five key themes that are shaping our investment approach and portfolio positioning.**

The tidal wave of changes spurred by the COVID-19 pandemic continued to cause ripple effects in 2021. Within investment markets, the striking figures highlighted in Exhibit 1 point to the magnitude of these trends, most of which started in 2020 and persisted during 2021. Just to name a few: massive stimulus from the Federal Reserve and the federal government, companies "reshoring" production to their domestic markets, an acceleration in digitalization, dollars flowing into sustainable strategies, and a jump in home ownership and move out of urban centers. We have discussed, debated, and published about many of these themes throughout the year, and our analysis has helped shape our outlook and positioning. Please see page 12 for a list of recent publications.

In this edition of our Quarterly Investment Perspective, we focus on the issues that are most crucial to our 2022 outlook. We believe the economy and markets have entered a new stage as 2022 is about to unfold. The economy has reopened, thanks to vaccines and a greater understanding of COVID-19, even as new strains threaten to dominate headlines for some time. There has been a recovery across sectors and a phenomenal level of economic growth, particularly in the U.S., which grew at nearly 6%, the highest since 1984, spurring continued gains in many of the "riskier" asset classes. Bessemer portfolios have benefited on an absolute and relative perspective in this context, which we discuss on page 4.

In 2022, we believe continued robust corporate earnings will drive further gains in equity markets, with economic growth and stimulus still ample enough to support this trend. At this stage of the recovery, earnings are the most important element from our perspective, as most of the broader macro uncertainty related to reopening and recovery has been resolved. We believe the U.S. economy will remain open and grow strongly in 2022. That said, growth is likely to slow from 2021's stellar speed, as we have already seen activity start to plateau at

Exhibit 1: Macro Trends in Figures

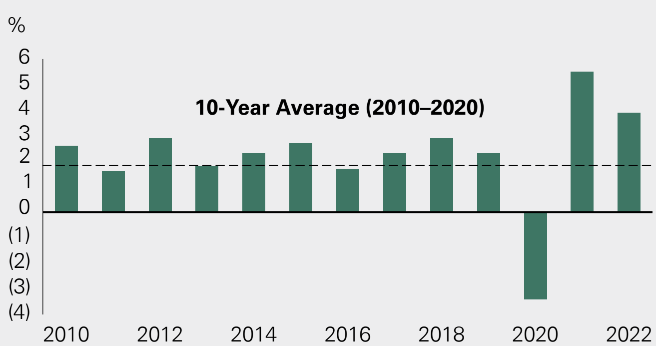
$850 billion	Federal government direct cash payments to American households in 2020 and 2021.
$4.23 trillion	Federal Reserve net purchases of securities in 2020 and 2021.
$3.9 trillion	Total global assets in sustainable funds, up from $1.7 trillion at the end of 2020.
1,060	Number of announcements of U.S. companies "reshoring" over past 12 months, as of September.
58%	Percentage of global customer interactions that were digital in 2020, up from 20% in 2018 (according to a McKinsey survey).
54%	Percentage of home buyers who are millennials, up from 33% in 2014.
24%	Peak of retail trading as a percentage of equity volume, up from 10% in 2010.

Source: Bloomberg, Corelogic, Economic Security Project, McKinsey survey, Morningstar, and UBS high levels as of the past summer. Specifically, we look for real GDP growth to remain meaningfully above trend at about 4% in 2022 (Exhibit 2).

An important assumption supporting our view is that stimulus will remain ample in 2022, which is indeed our strong base case. However, we do not expect significant additional fiscal spending from the federal government (following Senator Manchin's withdrawal of support for the Build Back Better legislation) given waning popular support for additional spending and the already charged political environment heading into the midterm elections in the fourth quarter. In fact, as prior spending falls off in early 2022, there is also a risk of a "fiscal cliff" becoming a market concern due to the year-over-year comparison. Accommodation from the Federal Reserve is most important, however, and there is enough stimulus from this avenue to allow the economic recovery to continue. We expect newly renominated Fed Chair Powell to continue the shift in rhetoric and action on inflation. The Fed has recently retired the word "transitory," started tapering bond purchases, and discussed interest rate hikes. Yet, we note that the environment will remain highly accommodative even assuming two to three rate hikes in 2022. Nonetheless, the risk that the Fed overtightens or otherwise commits a "policy error" cannot be dismissed given the tremendous challenge of normalizing policy into an altered economy post-COVID. As such, we flag this as a key risk to our outlook.

Exhibit 2: Historical and Forecasted Real GDP Growth (Year-Over-Year)

Key Takeaway: 2022 growth should decline from 2021 levels but remain well above the 10-year average.

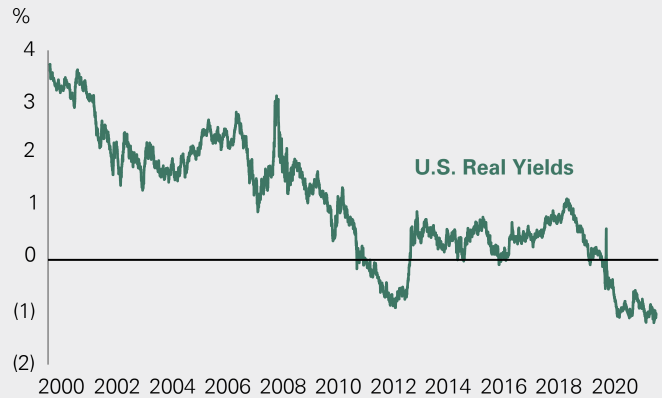


As of December 8, 2021. Pre-2021 reflects historical GDP growth; 2021 and 2022 reflect Bloomberg consensus estimates.

Source: Bloomberg

Exhibit 3: Real Yields Declined With Rising Inflation Expectations

Key Takeaway: Real yields remain in negative territory and look to remain negative in the near term despite hawkish central bank guidance.



As of December 8, 2021.

Source: Bloomberg

We think the correct way to look at the level of monetary policy stimulus is to account for current inflation levels in the context of interest rates. Zero rates with inflation running at 5% are much more stimulative than interest rates at 0% when inflation is running at 1%. Said another way, the penalty of holding cash is greater when inflation is higher and rates remain unchanged. From this perspective, the Fed's policy has essentially become much "easier" as inflation has picked up, and even with rate hikes, it will remain at a historically stimulative level next year (Exhibit 3). In such environments, it is better to be invested more heavily in equities, which offer greater potential for growth than cash or fixed income, which even at lower prevailing rates are still valuable for portfolio ballast and as defensive measures.

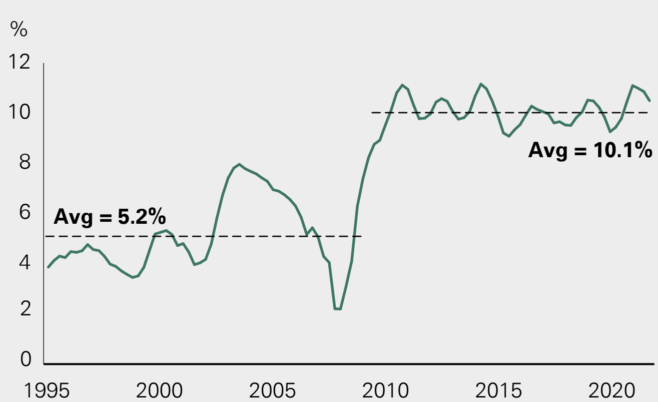
When we take a closer look at the current dynamics of the equity market, our enthusiasm for growth-oriented assets is greater. The abundance of companies, mainly in the U.S., that have not only navigated but thrived in the last two years is remarkable. There are different ways of considering how much of this good news is already baked into the prices of equities and whether they may be vulnerable to a significant sell-off as a result. In most years, there is at least one pullback of 10%, which has been the case even as equities have on average delivered

9% annualized over the past 40 years. So we are more concerned not about a temporary pullback, but rather a full-scale repricing of markets that would persist. That said, we are not particularly worried about valuations (the oft-cited price-to-earnings ratio of the S&P 500 is currently at 26.2x, 28% above historical averages). Innovation and advancement in U.S. companies have driven higher margins and higher cash generation (Exhibit 4). When valuations are seen in this light, they are only slightly above average (Exhibit 5). Indeed, improvements in business models should allow companies to grow earnings and essentially grow into their valuations, keeping valuations in check over time, as was the case in 2021, when P/Es declined as earnings advanced strongly. We note that the consensus expectation for earnings growth next year is 8.2% and that on average consensus has underestimated earnings growth by 0.6% over the past 30 years.

With this constructive backdrop in mind, we consider various opportunities and risks that abound in the pages that follow. Senior Strategist JP Coviello tackles the big one — inflation and debt. Will the recent surge in inflation, at least partially fueled by the experimental policy mix of massive debt fueled by lower interest rates, trigger an end to this economic cycle? Our assessment is no, not yet, as the details of the inflation debate will allow the Fed to only withdraw liquidity slowly and the

Exhibit 4: Free Cash Flow as a Percentage of Sales

Key Takeaway: Companies have increasingly adopted asset-light models over the past decade, almost doubling free cash flow generation as a percentage of sales to above 10% in recent years.

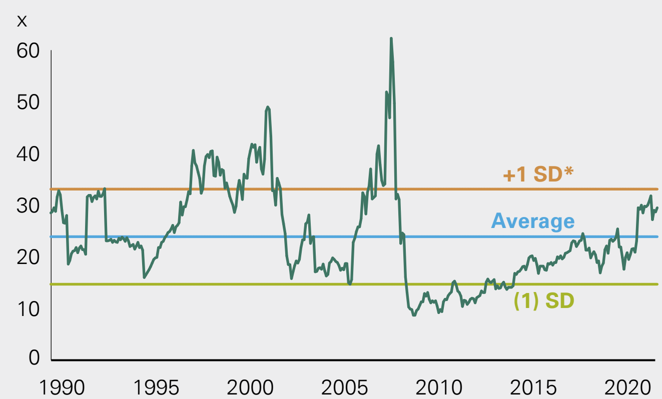


As of October 29, 2021.

Source: Credit Suisse

Exhibit 5: S&P 500 Price to Free Cash Flow

Key Takeaway: Even though P/Es are elevated from an absolute standpoint, free cash flow generation remains very strong, enabling free cash flow valuations to remain slightly above average historical levels.



As of December 8, 2021. SD is the standard deviation of the multiple looking from January 1990 to December 2021.

Source: Bloomberg

federal government to punt concerns of fiscal deficits for some time. Related to this are the changes in the labor market, which Senior Investment Strategist Ken Grimes considers on page 6. Movement of workers, demographic changes, and a rethink of the traditional work model all complicate the picture — and we anticipate further recovery in employment as well as a higher aggregate wage picture in 2022. These factors suggest a higher premium in the share prices of companies that can absorb these costs and navigate the potential uncertainty, so we focus on security selection.

Regionally, we continue to find the best opportunities in the U.S., where we maintain a pronounced overweight. Given the relevance of non-U.S. growth, especially China's growth, to U.S.-domiciled multinationals, Investment Strategist Bree Sterne takes a deeper look at non-U.S. trends. We also are always checking our bias to the U.S. and evaluating other regions as part of the global opportunity set; our platform has the flexibility to ramp up our overseas exposure, largely through external managers, should we see a significant risk to the U.S. or the U.S. dollar, for example. At this stage, despite lower valuations outside of the U.S., we continue to find more risks than opportunities in aggregate beyond U.S. borders.

Monetary policy divergence, especially in response to supply-driven inflation, is increasingly apparent around the world. While most developed market central banks still maintain very low interest rates and have pushed back against the pricing of rate hikes in some cases, an emerging market hiking cycle has already commenced. Several emerging markets were spurred to action by high inflation or concerns surrounding policy credibility and government finances. Given generally lower vaccination rates, political volatility, the risk of inflation, and mixed policy backdrops, we maintain selective investments in certain emerging markets with more favorable trends but an overall underweight to the region.

A clear opportunity across markets, both in the public and private space, is continued digitalization of the economy. We frequently cover this topic given its prominence in our private and public holdings. On page 9, JP Coviello looks at the more extreme developments in this space, with the hyper speed of innovation in blockchain technology being a highlight. Unfortunately, nefarious actors have accelerated their approaches to hacking at a similar speed, putting an onus on the world to ramp up its cybersecurity defenses. This is the area where we see the biggest risks from a macro and geopolitical perspective; i.e., this is the answer we most frequently give when asked "what keeps us up at night" even considering we generally sleep quite well since key tenets of our investment philosophy include a long-term focus and diversified holdings. Perhaps ironically, the magnitude of the cybersecurity risk suggests there are equally sizeable opportunities to invest in companies that are helping others with their defenses to cyber threats. Senior Investment Strategist Calvin Huang explores these opportunities on page 8.

The speed of macroeconomic change and related innovation of companies and individuals mean that we have had to adjust our research efforts. At the same time, our portfolio teams have had more information to sift through to determine what is worthy of a position adjustment and what instead is noise that should be ignored in our process. Chief Portfolio Strategist Peter Langas details positioning across our platform headed into 2022 on page 10. The highlights are that we remain overweight equities, particularly in the U.S., with a consequent underweight to high-quality fixed income, and complimented by exposure to higher-yielding fixed income and a strong recommendation for an allocation to private assets where client liquidity needs allow for it.

A Note on Performance

A quick note on performance for 2021 before fully shifting focus to 2022. A representative Balanced Growth portfolio with a strategic allocation of 70% in equities and 30% in high-quality fixed income returned 12.5% over the course of 2021, outperforming its benchmark, which rose 12.1%. The overweight to equities, which was in place for most of the year, coupled with the allocation to the Credit Income Fund within fixed income, drove the outperformance.

Within public equities, a focus on quality names with a moderate emphasis on growth characteristics was additive in our large cap portfolios, notably Large Cap Core, which rose 28.8% over the year, with strong gains also seen in the internal Large Cap Global and U.S. Select portfolios. Quality and growth styles were a drag in the small and mid cap space, where volatility stemming from retail traders, short sellers, and violent reopening sentiment swings were more pronounced. In the first three months of 2021, low-quality small cap equities rose nearly twice as much as high-quality small cap equities and then maintained this performance margin for the remainder of the year. Despite the underperformance of our strategies in the small and mid cap space, we are comfortable with the longer-term performance and current positioning. Some of the richest active management opportunities are in this part of the market, and companies that are positioned to grow significantly in the years to come should see their share prices benefit on an absolute and relative basis.

An allocation to the Credit Income Fund, up 2.8% on the year, was helpful in light of essentially flat returns in municipal bonds over the year, with high-quality taxable bonds down about 1.4%. Absolute return hedge funds also fared better than high-quality bonds, though full-year marks are still being calculated. The private markets space saw a plethora of activity, and our program has seen returns in excess of historical averages in the past two years. Please speak with your client advisor regarding more specific performance as it can vary in individual cases.

JP Coviello, Senior Investment Strategist

Theme 1: Government Debt and Inflation Remain Higher for Longer

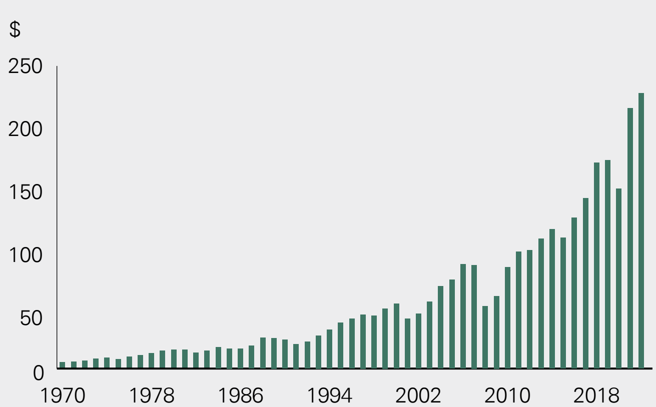
COVID-19 leaves in its wake a U.S. economy experiencing the lagged effects of tremendous fiscal and monetary stimulus. This flood of liquidity has pushed real government bond yields to historical lows, lifted equity prices to all-time highs, and driven interest-rate-sensitive real asset prices (homes and autos, for example) higher at the fastest pace ever recorded.[1] At the same time, we have a labor force participation rate unable to return to pre-COVID levels, supply chains working through unprecedented bottlenecks, and robust consumer demand.

As former Fed Governor Jeremy Stein famously said, monetary policy is extremely powerful because it "gets into all of the cracks." Combining monetary accommodation with fiscal stimulus generated a potent economic rescue package. However, the benefits are not without costs; debt levels on both corporate and government balance sheets rose tremendously since the initiation of government support in March of 2020.

Nonetheless, higher corporate debt levels have been accompanied by earnings that have vastly exceeded expectations, consumer free cash flow that stands nearly $2 trillion above pre-pandemic levels, and improved excess saving rates across all income quartiles.[2] Impressively, unlike prior economic crises, wage growth never rolled over during the pandemic, and household balance sheets have been de-levered, which provides additional consumer borrowing power.

Exhibit 6: S&P 500 Earnings per Share (EPS)

Key Takeaway: S&P 500 earnings are estimated to reach new highs in 2022, after a record year in 2021.



As of November 22, 2021. Earnings for years 2021 and 2022 are estimates.
Source: Empirical Research

We expect inflationary pressure to find some relief as goods prices fall along with supply chain improvements. Since the start of the pandemic, goods consumption has outpaced services 7:1, increasing 25% through October 2021. Severely exacerbated by supply bottlenecks, the robust demand has driven core goods prices to levels not seen since the early 1980s and is responsible for 150 bps of the current annualized rate of inflation. As these dynamics stabilize, or potentially reverse in the year ahead, they may mask a more important acceleration in service inflation, which tends to exhibit a stronger relationship with the labor market. For example, if core goods prices do not move higher in 2022, then they would fully reverse the 150 bps boost that they contributed to inflation in 2021. Furthermore, if core goods prices reversed half of their pandemic gains, they would exhibit a drag on inflation in excess of 2%.

We expect corporate and government debt levels to remain higher for longer as the Fed is unlikely to raise interest rates abruptly or withdraw liquidity in a manner that would catalyze abrupt deleveraging. After all, the Fed is responsible for global liquidity conditions, and we do not expect a sharp turn toward tighter policy without ample market pricing or communication from the FOMC.

We do expect headline inflation to exceed levels seen over the past decade due to the trends in wage growth, labor force participation, and housing, to name a few. Additionally, the Fed is targeting an average level of inflation over many years, not a predetermined level at a single point in time, as it has in the past, which leads to a different policy reaction function. Regardless, higher levels of inflation are manageable for equity markets amid an upbeat growth trajectory. As such, despite higher input costs, we expect businesses with scale to be able to maintain their margins as consumers in aggregate remain in a very strong position.

[1] Using S&P-CoreLogic-CS data back to 1975.
[2] Empirical Research Partners. "Where We Stand," November 22, 2021.

Ken Grimes, Senior Investment Strategist

Theme 2: Excess Labor Demand and Wage Pressures Haven't Impacted Earnings Growth

The U.S. and global labor markets were undergoing seismic changes even before the COVID-19 pandemic disrupted economies, took millions of lives, and exposed the fragility of supply chains and healthcare systems worldwide. The growth of gig economy opportunities, proliferation of tech-enabled mobile workforces, spikes in retirements, and curtailment of immigration were some of the factors driving the changing landscape. As we look ahead, accelerating trends in automation coupled with autonomous and untethered workers will continue to alter the workplace. How these dynamics have impacted — and continue to impact — wage growth, profit margins, and equity returns is important to understand.

Since much of 2020 data is greatly distorted by COVID-19, comparing 2019 to 2021 is useful. In the third quarter of 2019, according to the Bureau of Labor Statistics (BLS), the nation's full-time wage and salaried employees made $922 per week. Fast forward to 3Q 2021 and the BLS reported workers earned $1,003, an 8.7% gain from two years prior — a material jump in wages in a two-year period. Finally, recent survey data from the Conference Board points to continued future wage increases. Their most recent outlook forecasts that companies are expecting an average payroll increase of 3.9% in 2022. This would be the largest year-over-year gain since 2008.

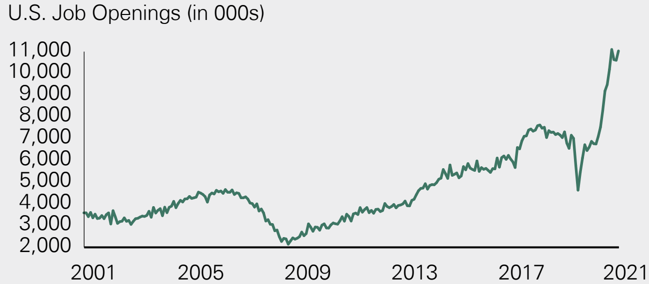
Fortunately for equity investors, the jump in labor costs appears to have had minimal impact on S&P 500 earnings and the near-term outlook. Current consensus estimates for 2022 earnings are $222. Should these earnings materialize, it would also be a record. Despite the highest wage increases in 13 years, the latest and recently forecast corporate profits haven't eroded. In fact, a growing body of economic research shows that in many industries higher wages actually lead to reduced turnover and boosts in productivity that offset margin reductions.

Many small private businesses lack the operating leverage to absorb wage cost shocks that large, globally scaled public corporations are better able to withstand. The levers available to the local pizza shop or lawn care company versus those available to multinational consumer brands or high-margin software companies can be vastly different. But what's not different is the profit imperative that fuels the desire for earnings growth and returns of capital to shareholders. Business leaders of both types of firms need to effectively manage employment costs and efficiently procure required labor resources to keep employees and shareholders satisfied.

Exhibit 7: Labor Constraints and Wage Growth

Key Takeaway: At the end of October 2021, there were a record 11 million U.S. job openings. That's 1.7 openings for every unemployed person. Excess labor demand is contributing to the highest annual growth in wages since 2007.[3]

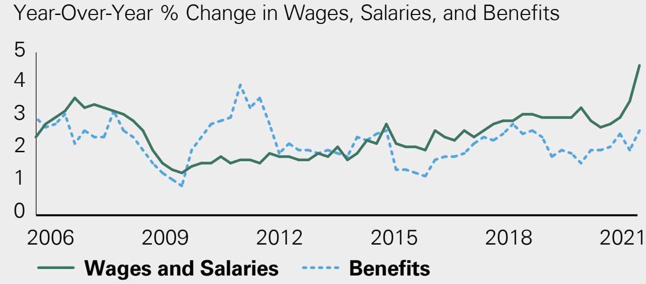
Monthly U.S. Job Openings From December 2001 Through October 2021



As of October 31, 2021.

Source: U.S. Bureau of Labor Statistics

Wages, Salaries, and Benefits in Private Industry, 12-Month Percentage Change (Not Seasonally Adjusted)



As of September 30, 2021.

Source: U.S. Bureau of Labor Statistics

[3] U.S. Bureau of Labor Statistics.

Bree Sterne, Investment Strategist

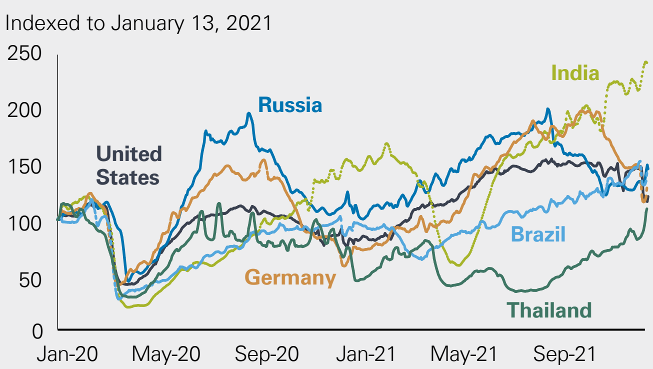
Theme 3: Reopening Progress More Mixed Outside of the U.S.

Ongoing endemic waves, vaccine and therapeutic access, and varied approaches to restrictions will continue to drive different rates of economic reopening among regions. While the Omicron variant could delay progress, we are seeing signs that pandemic-induced supply chain disruptions may soon peak. The path to supply chain normalization is likely to be uneven and take time, but the fading of constraints should bolster growth, dampen goods inflation, and benefit multinational companies navigating these disruptions.

With European economies generally more sensitive to the virus given their leverage to retail and hospitality, alongside governments more willing to impose restrictions, a winter COVID wave is likely to create a relatively larger drag on European growth.

Exhibit 8: Apple Mobility Data by Country

Key Takeaway: Reopening varies by country.



Notes: Data represents 7-day moving average.

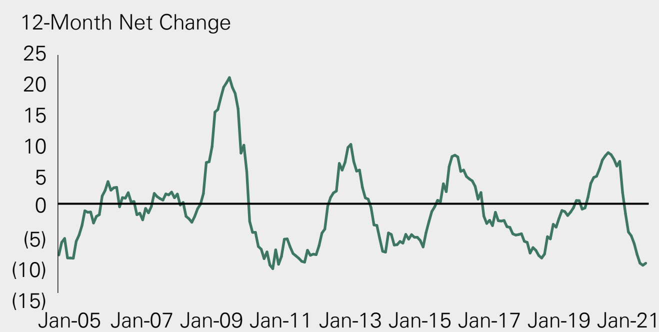
Source: Apple

Already, high-frequency data is indicating that the virus resurgence is restricting mobility measures in parts of Europe (Exhibit 8). We remain underweight European equities given the economic sensitivity to COVID and an index bias toward lower-growth companies.

While the U.S. and Europe largely reopened early in 2021, other countries are only now starting to emerge from lockdowns and are poised to see growth accelerate during 2022. Several countries in the Asia-Pacific region saw their economies hurt by their COVID-zero policies and have since begun to transition toward living with COVID. Indonesia, Malaysia, and Thailand have had some of the world's harshest lockdowns, and countries such as Japan, Korea, Australia, and New Zealand are all looking to abandon their COVID-zero strategies. High-frequency data supports the notion that some Asia-Pacific economies are beginning to accelerate as mobility has moved higher along with vaccination rates. In addition to increased regulatory scrutiny, Chinese equity markets have been challenged by slowing economic growth as China remains one of the few countries doubling down on its COVID-zero approach. We continue to monitor the evolution of policy accommodation, which appears to be loosening at the margin. At the same time, it appears China is starting to ease economic policies more broadly, which is supportive of risk assets (Exhibit 9).

Exhibit 9: Credit Impulse to Bottom

Key Takeaway: Chinese policymakers are easing policy, supporting the economy and equities.



As of November 30, 2021.

Source: Bloomberg

Some emerging markets, especially in Latin America, are facing numerous headwinds, including political instability, dollar strength, higher oil prices, stronger inflation, and higher policy rates. Additionally, strength in the U.S. dollar has led to weaker emerging market currencies, and higher oil prices and stronger inflation have led to higher policy rates, which could slow some emerging market economies.

Calvin Huang, Senior Investment Strategist

Theme 4: Cybersecurity Industry Poised for Growth Given Increasing Risks

Cybercrime damages are estimated to cost the global economy $6 trillion in 2021, and total damages are projected to reach $10.5 trillion by 2025.[4] The core driver of cybercrime growth has been the general shift in economic activity from offline to online across many sectors, including ecommerce, gaming, and banking. This already-strong trend was then further accelerated by the COVID-19 pandemic.

In response, the cybersecurity industry has also grown rapidly at 9% per year, twice as fast as total IT spending growth. Cybersecurity revenues are now expected to exceed $150 billion in 2021 (Exhibit 10). Traditionally, cybersecurity has been a top priority for financial companies. However, with the recent proliferation of ransomware attacks, such as the WannaCry attacks in 2017, major corporations in all industries are now placing a strong emphasis on cybersecurity. For example, the airline industry has become a prime target for cyber criminals due to its collection of vast amounts of customer data. According to McKinsey, the number of data breaches in the airline industry has doubled over the past five years to 1.6 billion.

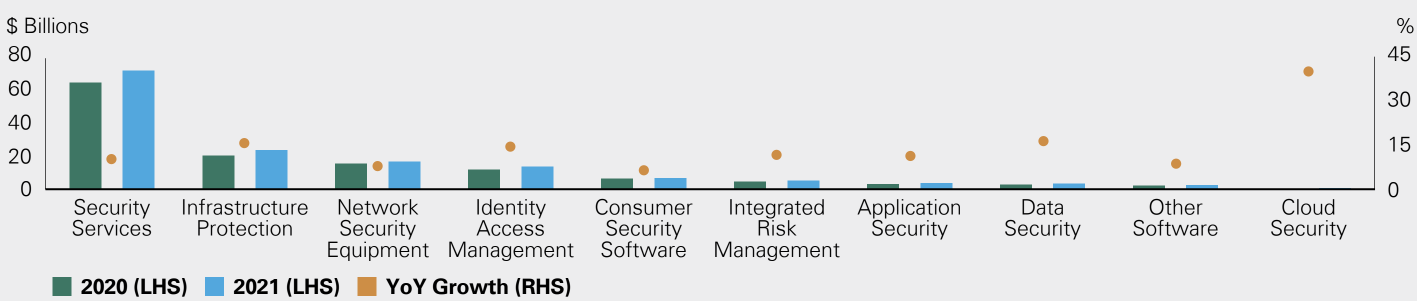
A key trend in the industry has been an increasing number of organizations shifting to a zero trust architecture. Traditional security models make it difficult for attackers to get inside a network, but once attackers get in they usually have a wide range of access. Zero trust security continuously monitors users inside a network, which significantly limits the potential damage that can be caused by insiders of an organization.

In our portfolios, we see many opportunities in cybersecurity in both private and public markets. In private markets, our managers have backed innovative companies that are defining the new frontiers of cybersecurity. For example, Netskope is a young company that builds software that continuously follows enterprise data across cloud applications and personal devices at the edge of the network, protecting users wherever they are with “always-on” security within a zero trust framework. With more than 25% of Fortune 100 companies as customers, Netskope is likely to continue building a leadership position in the cybersecurity industry.

In public markets, we prefer companies that offer an ecosystem of products rather than just a single solution. A notable example is Fortinet (FTNT). The company is well positioned to benefit from the robust cybersecurity spending environment, with an addressable market of $65 billion that is expected to grow at 10% annually over the next four years. Fortinet’s approach of bundling its proprietary hardware and software into a comprehensive offering is a strong competitive advantage that has helped the company gain market share. As the cybersecurity industry evolves, we plan to add more companies with strong technological capabilities and demonstrated track records of innovation.

Exhibit 10: Cybersecurity Revenues by Market Segment

Key Takeaway: Security services represent the largest category of cybersecurity spending, while cloud security has experienced the fastest growth.[5]



As of May 17, 2021.

Source: Gartner, https://www.gartner.com/en/newsroom/press-releases/2021-05-17-gartner-forecasts-worldwide-security-and-risk-managem

[4] Source: Cybersecurity Ventures. The total damage cost estimate includes destruction of data, stolen money, lost productivity, theft of intellectual property and personal data, and reputational harm.

[5] Security services include consulting, hardware support, implementation, and outsourced services.

JP Coviello, Senior Investment Strategist

Theme 5: Crises Spur Innovation in Digitalization, Blockchain, and Cryptocurrencies

The aftermath of the Global Financial Crisis led to the launch of Bitcoin in 2009, a technological feat due to its groundbreaking blockchain roots. It is important to note that blockchain-related investments span a far larger universe than Bitcoin alone and the possible use cases for this technology are likely to far exceed present-day expectations and forecasts. As such, we consider the development of blockchain technology to be one of the most exciting innovations in many years, sparking the exponential growth of cryptocurrencies, utility tokens, and stablecoins. Today, some of the most heavily traded cryptocurrencies have market caps that rival those of major publicly traded businesses. Nonetheless, the overwhelming majority of the 13,000 cryptocurrencies in existence[6] do not possess characteristics or fundamental use cases that could incite a structural disruption of traditional industries.

While online banking and digital money transfers have existed prior to the development of the blockchain, Bitcoin and other "Layer One" blockchain protocols like it (Ethereum, Avalanche, and Solana, to name a few) represent a potential paradigm shift in the way financial transactions could be processed and settled in the future.

In some cases, the transaction speeds far exceed those available on payment rails within the traditional financial system.[7] Faster transaction speeds mean quicker payment and trade settlement times. Consider the fact that the Depository Trust and Clearing Corporation (DTCC) only upgraded settlement time for securities from three days to two days in 2017. On the other hand, the Solana blockchain can process up to 50,000 transactions per second and achieve block settlement finality in milliseconds. As a result, there is a compelling case for a decentralized — without explicit human intervention or coordination — approach to payment and trade settlement via blockchains in the future. Over time, we could envision a transition from what has been the norm in traditional financial markets to more decentralized markets, or at least markets that utilize the cutting-edge technology created by some of the fastest and most secure blockchains.

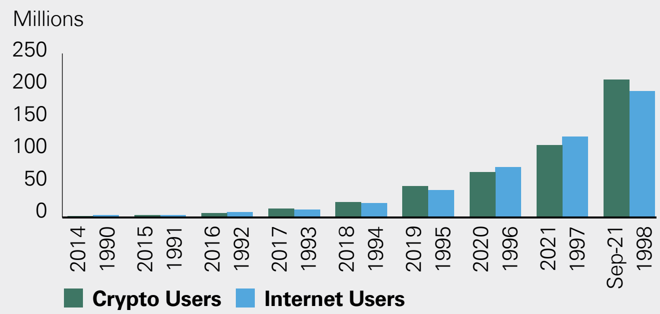
Regulation

Regulation of the crypto universe is on the minds of many as the speed of technology development to date has been unrivaled and the returns garnered by some rival the early days of what would become the internet bubble. The recent approval of a Bitcoin ETF in the U.S. suggests that the U.S. regulatory bodies are accepting of blockchain and cryptocurrency development; however, this is only one small piece of the overall landscape. The U.S. government, in sharp contrast to China, has not banned cryptocurrencies, in a nod to the innovation potential that can be seen via expanding blockchain use case developments from industries such as ecommerce and finance to gaming and the creative economy. Nonetheless, within any new technological development that is seeing rapid adoption (Exhibit 11), there will be bad actors, and they will likely be targeted by regulators. Given our ability to select top-tier managers in any asset class or specialty, we would expect to partner with managers who have exceptional regulatory visibility and regularly interact with regulatory agencies over time.

A special thank you to Stone Y. Cao for his contributions to this theme.

Exhibit 11: Global Crypto Users (2014–21) vs Internet Users (1990–98)

Key Takeaway: It took nine months for the number of crypto users to increase from 65MM to 100MM, but only four months to grow from 100MM to 200MM. Simple compounding suggests almost half a billion users in 2025.



As of September 21, 2021. Estimates crypto users by aggregating known wallet numbers and users within custodial wallets held by the 24 major crypto exchanges.

Source: crypto.com

[6] As of 11/16/2021.

[7] The Solana blockchain boasts transaction speeds of 50,000 transactions per second (TPS).

Peter Langas, Chief Portfolio Strategist

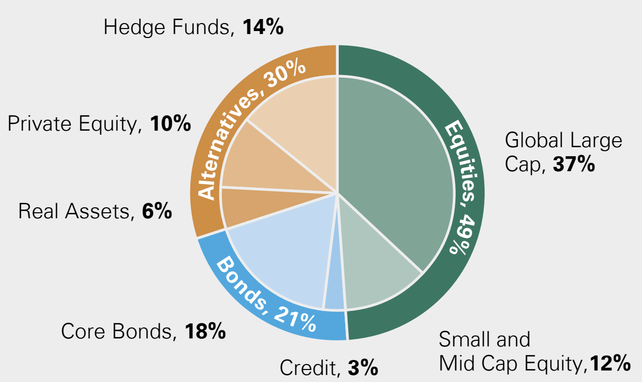
Portfolios Positioned to Combat Inflation and Capture Innovation

Maintain Tactical Overweight to Equities

We continually monitor the macroeconomic conditions and assess a range of possible outcomes. What if we're wrong and inflation turns out to be higher for longer? This is where the importance of diversification comes in. When building portfolios, we assemble a diversified balance of asset classes and strategies tilting toward areas that we believe represent the best set of opportunities but not positioning for a singular outcome.

The most important aspect of asset allocation is the weight of risky assets, such as equities, which provide opportunities for growth versus safer, stable assets, such as bonds. Our research has shown that regardless of whether inflation is high or low or rising or falling, stocks have historically delivered solid returns and provide a good "hedge" against inflation as long as the economy is growing. Stocks tend to have trouble when the economy is contracting. There are likely to be corrections and volatility in the coming months. But with the odds of recession low for the foreseeable future, we are comfortable leaning more toward equities to provide growth that exceeds even an elevated level of inflation.

Exhibit 12: Bessemer Portfolio Positioning



Positioning as of December 30, 2021. 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.

Focus on Quality Equities

We expect the tug of war between value and growth stocks to continue. Our equity portfolios are diversified with some exposure to cyclically oriented companies in sectors — such as commodities, materials, energy, railroads, and banks — that may benefit in a higher inflation environment and have good drivers of growth. That said, over the long term, we favor high-quality growth companies with overweight exposure to technology, communication services, and healthcare comprising almost 50% of our equity portfolios (Exhibit 13).

Our equity teams continue to conduct diligent research on key investment themes such as ecommerce, social media, cloud computing, electric vehicles, and cybersecurity, as well as consumer and healthcare trends. Moreover, we believe quality companies are equipped to navigate today's complex environment. For example, quality companies with scale are exhibiting pricing power and maintaining healthy margins despite inflationary pressure and supply chain bottlenecks.

Meta Platforms (formerly Facebook), Amazon, Alphabet, Apple, and Microsoft are among our equity portfolios' largest holdings. Other notable holdings include KLA Corp, which dominates process control systems for semiconductors, and Cadence Design, which makes semiconductor design software. Among our software holdings, Service Now is a provider of digital transformation systems for businesses, and PayCom is a leading cloud software vendor for payroll and human resources systems. We also are finding quality compounders in niche businesses such as animal medicine supplier Zoetis, contact lens manufacturer Cooper Companies, and Avantor, which provides chemicals and supplies to biopharma research labs. All of these companies have solid growth drivers and unique advantages in their businesses.

Exhibit 13: Bessemer Portfolio Positioning: All Equity Portfolio Sector Weights

	All Equity 100/0	Equity Benchmark	Difference
Communication Services	10%	8%	2%
Consumer Discretionary	14	13	1
Consumer Staples	4	6	(2)
Energy	3	3	(1)
Financials	12	14	(2)
Healthcare	13	11	1
Industrials	10	11	(0.2)
Information Technology	25	22	3
Materials	4	5	(1)
Utilities	1	3	(2)
Real Estate	2	4	(2)
Cash & Equivalents	3	–	3

■ Overweight ■ Underweight
■ Under 1% Difference in Bessemer Allocation and Benchmark Weights

Source: Bessemer Trust, MSCI All Country World IMI

Capturing Opportunities in Innovation

Innovation at its earliest stages is where we see some of the greatest opportunities. Over the last year, exits from private assets were at a record high as many young companies with promising futures went public or were acquired. Our managers in private assets continue to see more early-stage growth opportunities as innovation proliferates in areas such as quantum computing, healthcare therapeutics using artificial intelligence, telehealth, and ecommerce in emerging markets, to name a few. By aligning our private assets investments with disciplined top-tier managers, our portfolios are well positioned to capture opportunities in these exciting industries of the future.

Bonds Over Cash

Yields on bonds are higher than they were a year ago but are still low by historical standards. With interest rates likely to move gradually higher from here, why invest in high-quality bonds at all? Bonds provide safety and ballast to portfolios in case of a market downturn. Regardless of the level of interest, high-quality bonds are a source of safety and in times of stress have historically delivered positive returns.

Our outlook for high-quality bond returns is modest, which is reflected in our underweight position. Even in a rising rate environment, the total return potential is greater than the alternative of moving to cash. Why? Returns on cash will remain close to zero until the Federal Reserve starts raising short-term rates. Even then, they are likely to raise rates very slowly. There is a misconception that rising rates mean negative returns for bonds, but it depends on how rates go up, which bonds you own, and how they are managed. A single long-term Treasury bond could go down in price as rates go up. On the other hand, we actively manage *portfolios* of core bonds with a target duration currently just over four years, which means the yield is higher than cash but the sensitivity to rising rates is much less than say a 10-year Treasury bond. If rates rise rapidly in a short period of time, it could lead to negative returns in the short run, particularly for longer-term bonds. Our core bond portfolios are diversified across maturities, so as long-term rates increase, we can reinvest shorter-term bonds that have matured into longer-term bonds at higher rates thereby increasing the overall yield of the portfolio, enhancing the total return potential and with high odds of beating cash.

To further enhance yields, the Credit Income mandate provides exposure to higher-yielding credit instruments. We expect continued strength in the housing market to provide a favorable backdrop for non-agency mortgage-backed securities. Likewise, a strong economy and low default rates support yields for high yield corporate bonds and other higher-yielding credit instruments.

Conclusion

Thank you for reading our 2022 Outlook, and we look forward to engaging with you further as earnings, opportunities, and risks unfold. All the best to you and your loved ones for a happy, healthy, and prosperous year ahead.

Our Recent Insights

Go Big and Go Home? Corporate Spending and the Economic Expansion — Quarterly Investment Perspective (Fourth Quarter 2021)

Electric Vehicles: Rising Demand and Relevance — Investment Insights (September 2021)

Investment Deep Dive: A Roundtable Discussion With Bessemer's Fixed Income Portfolio Managers — Investment Insights (July 2021)

China: The Investment Landscape — Investment Insights (June 2021)

Reopening, Recovery, and Growth: Not Yet Too Much of a Good Thing — Quarterly Investment Perspective (Third Quarter 2021)

The Future of Money — Quarterly Investment Perspective (Second Quarter 2021)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

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