FEG INSIGHT

OCTOBER 2014

2014 FEG INVESTMENT FORUM

Fund Evaluation Group®
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Your Vision / Our Insight

Introduction

On September 23–24 Fund Evaluation Group, LLC (FEG) welcomed more than 500 attendees to the sixth FEG Investment Forum, *Game On: Producing Results in an Unpredictable World*. Held in downtown Cincinnati, the Forum featured six primary speakers who shared their insights on achieving results in an unpredictable economic environment.

In addition to the primary sessions, participants attended education sessions focused on global equity, fixed income, real assets, and diversifying strategies. The evening reception, held in Paul Brown Stadium, offered attendees the opportunity to connect with colleagues, and discuss trends and other emerging and critical issues affecting the investment landscape. Cincinnati Bengals Head Coach Marvin Lewis was the opening speaker and shared his views on leadership, overcoming adversity, and his charitable foundation.

Primary Forum speakers covered a broad range of topics spanning investment, economic, and philanthropic issues. While the following synopses may not reflect the entirety of each session, they attempt to highlight each speaker's primary thoughts and points of discussion.

Laurence Fink

Presented on global investment outlook and risk management in uncertain times

LAURENCE FINK
Chairman and CEO /
Blackrock, Inc.

Larry Fink and Scott Harsh, President and Chief Executive Officer of FEG, sat down for a Q&A-style conversation covering Mr. Fink's investment outlook, insight into governmental policy, and thoughts on risk management.

As part of Mr. Fink's global investment outlook, he offered views on China, Japan, the euro zone, and the United States. According to Mr. Fink:

- China's growth is slowing and the nation is experiencing escalating labor costs and increasing factory automation. Chinese society will have to adapt, as the economy shifts away from reliance on manufacturing toward a greater presence of the services sector. To address the nation's reputation for business corruption, the Chinese government is in the process of enacting monumental reforms that are dramatically changing how business is concluded in China.

- Japan needs to continue policy reform efforts to support growth after the Fukushima disaster and in the face of China's increasing geopolitical influence in the region. Mr. Fink believes that Japan has lost its way, making little to no material progress on the reforms promised by Prime Minister Shinzo Abe.

- The euro zone is suffering from increasing social tensions amid poor demographics, and given the structural issues of the euro zone and economic weakness, the situation could become worse. Peripheral European nations have struggled while being forced to address the same economic issues that most core nations, including France and Germany, have not themselves repaired. The European Central Bank (ECB) finally admitted that their toolbox is no longer full. They will have to turn to an easing program similar to those implemented in the U.S. and Japan.

- The U.S. Gross Domestic Product (GDP) is likely to grow at a rate of around 3% while experiencing a modest rise in interest rates, as the Federal Reserve concludes its bond purchasing program. Mr. Fink expects that rates will rise over the next year or so, but not significantly. A modest rise in rates would reflect the strength of the U.S. dollar, which has already risen in spite of the U.S. economic environment. The Federal Reserve does not want the U.S. dollar to be too strong in the face of global currency wars.

Primary session in the Westin Presidential Ballroom

Because of Mr. Fink's experience with Washington lawmakers, the conversation questions shifted to his insight into governmental policy. Regarding the domestic political and business environments, Mr. Fink believes the U.S. government is suffering from "short-termism" (i.e., constant campaigning) and a lack of community in Washington that result

Fink Continued

in finger pointing and a lack of problem solving. Short-termism also impacts the private sector through shorter CEO tenures and increasing pressure from activist shareholders, which prevents companies from investing for the long term. Companies, unlike Washington, have a common goal, which makes them successful in obtaining results. Mr. Fink noted that regulatory attitudes have shifted in the U.S. and regulators have started looking at the activities in which firms engage rather than the entirety of the firms themselves. More importantly, he believes working with regulators is necessary in order to create good effective policy.

Mr. Fink commented that globally, governmental policy will become more important than central bank behavior, as governments play an increasingly influential role in economies around the world. A global backlash against central bank activity could also be a future consequence if social tensions continue to rise across the world.

Mr. Fink believes geopolitical instability will increase, returning to more historic levels; however, he tempered his concerns by stating that many key players, such as Russian President Putin, are known and the associated risks should be containable.

The conversation shifted to the importance of risk management as Mr. Fink walked the audience through the development of BlackRock from a start-up in 1988 to one of the world's largest risk managers today. The capstone from his comments is that risk management should be thought of as a routinized process—not risk avoidance.

In closing, Mr. Fink answered a question from the audience about his thoughts on the next potential crisis. Mr. Fink replied that technology proliferation in the emerging world could be a potential "black swan" situation. In such a scenario, workers displaced by technology would face only "adequate" global GDP growth, which would fuel social tensions.

FEG'S INSIGHT

As Mr. Fink demonstrated, the world is always an unpredictable place that will offer many challenges for investors. Muted economic growth across the globe could dampen return expectations where recovery has already been priced into the market while concurrently presenting opportunities in other markets with a greater economic ambiguity. As a result, investors should maintain a broad understanding of the investment opportunity set and take a prudent approach to risk management.

Robert Gates

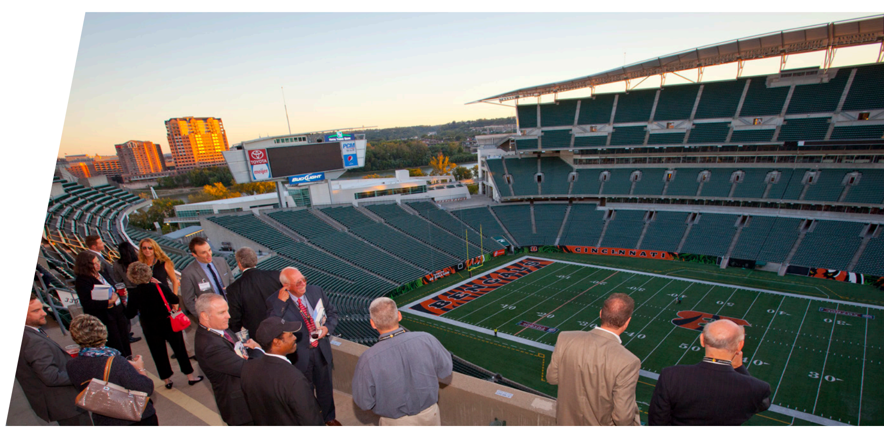
Presented on leadership issues and the current geopoliticalatmosphere

ROBERT GATES, PHD
Former U.S. Secretary of Defense

In a presentation illustrated by entertaining anecdotes and descriptions of the unique personalities of U.S. political leaders, former U.S. Secretary of Defense Robert Gates offered his perspective on four points on affecting change with leadership:

1. To implement long-term change, one should engender broad stakeholder partnership through open dialogue on the mission behind the initiative.
2. When attempting to fix a broken bureaucratic organization, senior leadership should have micro knowledge without micromanaging. A focus on increasing accountability at all levels of the organization is critical to success.
3. An open dialogue with all parties and a deliberate approach are essential to bringing together parties who have conflicting interests.
4. Best practices to lessen challenges faced when working with an oversight board, or similar stakeholders, include developing better knowledge and relationships, honest and transparent communication, giving access to one's best resources, and practicing active listening.

Dr. Gates then addressed questions from the audience, sharing his opinions on the current geopolitical environment. He commented that the West's initial reaction to the Crimea conflict was too weak; the weakness emboldened Putin in his mission to restore the former glory of the Soviet Union, which suffered painful disgrace when the nation was dismantled during the first Bush administration.



During the Opening Reception, guests explored Paul Brown Stadium including tours of the field and visiting team's locker room

Gates Continued

He views the situation in Syria as a microcosm of the consistent issues that underlie and encompass the broader Middle East region: sectarian conflicts that arise from varied interests and a long history of turmoil. The question for the U.S. is not whether to put boots on the ground—boots are already on the ground. Rather, the question for the U.S. is how involved it should be in the complexities of the Middle East after struggling to manage change in other countries in the region.

In closing, Dr. Gates spoke of the binds that form between those that experience difficult decisions and stressful events, referencing the mission to eliminate Osama Bin Laden, and concluded by telling the group that no matter what challenges you face, you should maintain a sense of humor—even in the situation room.

Illustrating the importance of keeping the Osama Bin Laden raid photos confidential, Dr. Gates referenced this retouched Situation Room photo featuring him as the Green Lantern.

FEG'S INSIGHT

Offering an alternative to the other investment-focused sessions, Dr. Gates gave an insider viewpoint on current political issues that resonated with the audience. Answering questions ranging from serious – global issues such as ISIS, Ukraine and Washington political gridlock – to trivial – "are there really aliens in area 51?" – Dr. Gates was refreshingly candid in his replies; he indicated that the aliens were in D.C.

Daniel Och

Presented on the evolution of the alternative investment industry

DANIEL OCH
Founder and CEO / Och-Ziff Capital Management Group

Danny Och began his presentation with what he believes are the foundations for a successful team. Mr. Och stated that he does not subscribe to the "Michael Jordan" model of building a team around one star player. Instead, he feels that teams should rely on the collaborative ideas of many strong participants. Further, the most critical element to creating a strong team is alignment of interest. To align a team around a shared goal, Mr. Och believes that incentives should be based on team performance, not personal accomplishments of individual investment professionals. This would ensure that capital is allocated to the asset class that presents the best opportunity set and avoids personal claims on what should be done for client benefit.

Mr. Och next delved into his views on current macroeconomic conditions. He believes that economic links the financial industry used to take for granted no longer exist. For example, one might consider that emerging markets are positioned for better growth without consideration of increased risk versus developed markets. Additionally, investors should no longer group all emerging markets, or even all Asian countries, together when considering investment decisions, as each country has a unique story. While on the topic of Asian countries, he commented that China seemed to be working to change the behavior of the nation's consumers. Whether this strategy will successfully transform the Chinese economy remains unclear.

Mr. Och stated that as a financial professional, he believes one of his primary roles is to anticipate and adapt to the ever-changing market. Although certain metrics may not have correlated in the past, there may be increased correlations in the future; therefore reevaluating correlations is important for risk management.

Because of the ever-changing investment landscape, Mr. Och believes that even if one had next year's newspaper, making money would be difficult. For example, if one knew for certain the economic growth of the euro zone, clearly predicting the market's reaction would remain difficult. That being said, he believes there will be a lot of opportunities in Europe in the future. While the U.S. has stabilized, there is still much work to be done in Europe.

FEG'S INSIGHT

Mr. Och provided keen insight relevant to all institutional investors regarding the importance of alignment of interests. Alignment of interests is a primary element of FEG's investment philosophy and a consideration we take to heart in our recommendations and our assessment of investment managers. His view on the broader economy unearthed a thesis consistent with many of the speakers' presentations: we live in a new investment environment, one that favors those who can adapt to and identify new themes.

Saumil Parikh

Presented on the U.S. investment over the next three to five years, and "the New Neutral"

SAUMIL PARIKH
Managing Director / PIMCO

Saumil Parikh began by first highlighting the fact that PIMCO takes a three- to five-year outlook on interest rates rather than a shorter-term view. This long-term view allows PIMCO to avoid being distracted by the business cycle. While many investors have a stock answer for what will happen in the near term, few have a concrete answer to what will happen over the long term.

Mr. Parikh believes there are three macro drivers of what he terms "the New Neutral:"

1. The rate of growth for the economy, which has a positive correlation to interest rates,
2. The use of leverage, which has a negative correlation to interest rates, and
3. Inflation expectations, which have a positive correlation to interest rates.

In the U.S., one of the few economies not scarred by war on home soil, the 120-year annualized return on cash is just over half of one percent in real terms. While the Fed claims that the neutral rate is 2% real, PIMCO believes that the new neutral rate is 0% real and 2% nominal.

Mr. Parikh says that this rate is a result of the U.S. growing steadily at 2.0% to 2.5% on inflation expectations of 2.0% to 2.25%, and relatively constant leverage levels. This level is lower than what investors witnessed in recent decades. The real return on cash in 1980s was 4%, in the 1990s it was 3% and in the 2000s it was 1%. The rate of economic growth has been slowing for the last 35 years, leverage has been rising, and inflation expectations have been dropping, thus reducing expectations to the new neutral.

The investment implications of the new neutral are that most assets in the U.S. are priced for low single-digit returns and volatility should be muted in the future. Although the investment environment is perfectly designed for the use of leverage, investors must feel comfortable that central bankers will not make a hawkish mistake that leads to a recession before investors will accept leverage.

The Minsky Moment in the last financial crisis was precipitated by the pyramid scheme-like manner in which leverage was employed. Mr. Parikh is not afraid of a similar situation in the current cycle. Credit standards have meaningfully improved, financial leverage in portfolios is restrained at this point, and the use of leverage in the economy is not as risky.

Finally, because the ECB announced an intention to buy government bonds, he sees an opportunity in European equities similar to that found in the U.S. equity market in 2012. By implementing such a program, the ECB will support the markets, leading European equities to outperform over the next few years.

FEG'S INSIGHT

FEG agrees with Mr. Parikh's statement that U.S. assets are priced for single-digit long-term returns and as a result, investors must assess not only their portfolios, but also their investment objectives in concert with the level of risk the investor can accept to ensure that risk is not accepted blindly in pursuit of return. We believe that planning for the potential of low returns makes low returns tolerable and high returns a pleasure, while simply planning for high returns is setting oneself up for disappointment.

LaVaughn Henry

Presented on the current status and outlook of the U.S. Economy

LAVAUGHN HENRY, PHD
Vice President and Senior Regional Officer / Federal Reserve Bank of Cleveland

When one envisions a presentation by a member of the Federal Reserve, the expectation resembles an opaque economics lesson delivered at a press conference. In stark contrast, Dr. Henry's presentation was an entertaining showcase of the recent initiative at the Fed to focus on greater transparency and engagement. This included good-natured retorts directed at the prior presenter, Saumil Parikh of PIMCO, who delivered his "new neutral" view of the world, a less optimistic alternative to that envisioned by the Fed.

The foremost message Dr. Henry conveyed was that the Fed believes the economic recovery is accelerating; the next three years should see 2.5% real annual GDP growth. Beginning with veiled hints of a rate change, this idea evolved into a clear message over the course of the presentation. As a result of GDP growth, short-term rates could move up sooner than expected.

Dr. Henry went on to discuss how technology productivity impacts the U.S. economy. Due to this increased productivity, the U.S. is building more with less labor. As a result, in aggregate the U.S. has regained the total number of jobs lost during the financial crisis. Importantly, however, these jobs came back in the professional and business services sector, but not the goods producing sector, where many jobs were lost. Members of the population with the highest education levels have witnessed the return of job opportunities, while those in sectors with lower education requirements have struggled. This remains a significant headwind for the economy. Consequently, growth in real disposable income is far below the level necessary to motivate more consumption. The gap created by the changes in the economy requires education and training of the labor force, both of which take long periods of time.

On another positive note, the Federal Reserve sees an opportunity for the housing market to reclaim its former status as a driver of the economy. Since the financial crisis, the housing market has only built at a level to replace aggregate stock lost (due to natural disaster, fire, condemnation, etc.). Only now is additional housing stock being produced, aiding the housing market recovery.

Finally, Dr. Henry indicated that the Fed's plan for managing a reduction in the size of their balance sheet is one of gradual normalization. The Fed will manage the short end of the curve first by managing down the principal instead of re-investing proceeds of mortgage-backed securities.

FEG'S INSIGHT

This presentation was successful in making the Federal Reserve more transparent and relatable to investors. Dr. Henry could have easily presented for twice his allotted time, as he wished to have each member of the audience leave with a clear understanding of the Fed's outlook and positioning on interest rates. One should note, as Dr. Henry did, that the pace of Fed action and overall attitude is dependent on economic data, which is subject to change. Therefore, investors should be cognizant of the fact that the Fed's language and activity is one thing and the market's reaction could be another.

James Paulsen

Presented on the U.S. economy and six driving factors for growth in the U.S.

JAMES PAULSEN, PHD
Chief Investment Strategist / Wells Capital Management

As the final speaker of the 2014 FEG Forum, Jim Paulsen delivered his optimistic outlook on improvement in the U.S. economy from dire levels with the same energy one would expect from an opening speaker.

According to Mr. Paulsen, the new normal state of the economy (only a 3% growth environment) is the result of long-term demographic trends. While initially underwhelming to most economically-aware investors, this moderate environment is likely to result in less volatile business cycles as a result of slower and longer recoveries. Mr. Paulsen proposed the idea that this recovery might not be exciting, but still could be profitable for investors.

Mr. Paulsen believes there are six driving factors for growth in the U.S. that are:

1. Credit creation
2. An improved financial situation for Main Street
3. A capital spending backlog
4. Catch-up production in new housing
5. Improvement in the trade balance for the U.S., and
6. A return to pre-crisis confidence levels for businesses and consumers.

Noting that technology spending has been largely absent from the recovery thus far, Mr. Paulsen believes it is a likely focus of the capital-spending backlog as an emphasis on productivity continues through the recovery. Mr. Paulsen detailed his views on the changing demographics in the U.S. and abroad, namely in the emerging markets. Past consumption by the Baby Boomer generation has been recreated in emerging market consumers, who will help fill the gap created by the demographic shift in the U.S. This demographic shift will allow emerging markets to grow at a greater pace than developed markets.

When discussing the next market downturn, Mr. Paulsen indicated he does not see a collapse in the next five years, because market participants are still on their best financial behavior and unlikely to cause another recession. The likelihood for recession increases when participants become overconfident and take excessive risks, but a slow growth environment means a longer time period is required for the excesses that precede a collapse to develop. Further, he sees runaway inflation as the biggest risk, but not a probable risk, to economic recovery in the U.S.

Concluding his presentation, Mr. Paulsen believes that investors should consider that there are three widely held views on the market that are unlikely to hold: that the U.S. is the place to be, that the dollar will continue to strengthen, and that yields will stay low for a long time.

FEG'S INSIGHT

Mr. Paulsen offered one of the most positive outlooks at the Forum, and he delivered it in an entertaining fashion. FEG agrees that emerging markets offer a long-term advantage over developed markets in terms of growth rate and investment opportunity, especially given current valuations. Likewise, FEG agrees that investors should realize the valuation opportunities that exist abroad and consider decreasing their weights to the U.S. equity market in favor of international opportunities. Finally, investors should consider the impacts of developed market currencies and the potential for a new rate regime on their portfolios.

Conclusion

As reflected in the FEG Investment Forum theme, *Game On: Producing Results in an Unpredictable World,* there is always uncertainty in investing. Achieving long-term investment success requires strategy, discipline, and expertise. FEG believes that the spectrum of viewpoints presented at the Forum helped attendees interpret the complexities of the financial and geopolitical landscape.

The world is an unpredictable place. Mr. Och's statement, "Even if one had next year's newspaper, making money would be difficult," drives home this point. Other speakers had varying expectations for the future, as seen in Mr. Parikh and Dr. Henry's presentations. Nevertheless, with the right strategy one can produce results in an unpredictable world. For successful investing one must employ a disciplined approach that takes a long-term view, allowing valuation criteria to drive investment decisions, diversifying by global sources of risk, and accessing skillful active managers in areas where they can add value.

2016 FEG INVESTMENT FORUM

CINCINNATI, OHIO · MARCH 2016

The next FEG Investment Forum will be in March 2016. To accommodate guests' preferences, the event will alternate between March and September on an 18-month rotation. We will send a save the date when the dates are confirmed.

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