FEG INSIGHT

Fund Evaluation Group®
investment advisors

FEG 2017 INVESTMENT FORUM

CAROUSEL OF CHANGE:
Navigating the Ups and Downs of Market Cycles

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With a full room, FEG's Investment Outlook set the stage for the next two days.

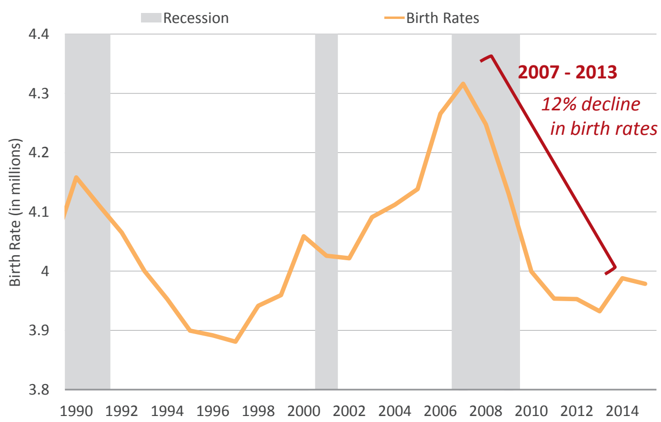
The Tuesday evening reception, held at the Anderson Pavilion, brought the Forum theme to life as guests had exclusive access to the Carol Ann Carousel. The evening offered attendees an opportunity to connect with colleagues to discuss trends and issues affecting their missions. As with previous Forum evening venues, Anderson Pavilion allowed FEG to showcase the city of Cincinnati.

INTRODUCTION

Fund Evaluation Group, LLC (FEG) welcomed more than 500 attendees to FEG's eighth Investment Forum, *Carousel of Change: Navigating the Ups and Downs of Market Cycles,* in late August. Held in downtown Cincinnati, the Forum featured three days of networking, seven keynote speakers, and numerous breakout sessions, all designed to help clients understand and navigate the markets in support of their organizations' missions.

Exemplifying the Forum's theme on market cycles, FEG President and CEO Scott Harsh kicked off FEG's 2017 Investment Forum by pointing out that there have been 10 bear markets over the past 70 years and highlighted that, in fact, the Great Financial Crisis prompted FEG's first Forum eight years ago. Understanding that these cycles occur is important, but what is more important is the impact these cycles have on an organization's ability to achieve its investment goals. For example, U.S. birth rates saw a 12% decline between 2007–2013 which may impact higher education institutions enrollment. Further, the cycles of inequality could impact community foundations in terms of both spending and fundraising.

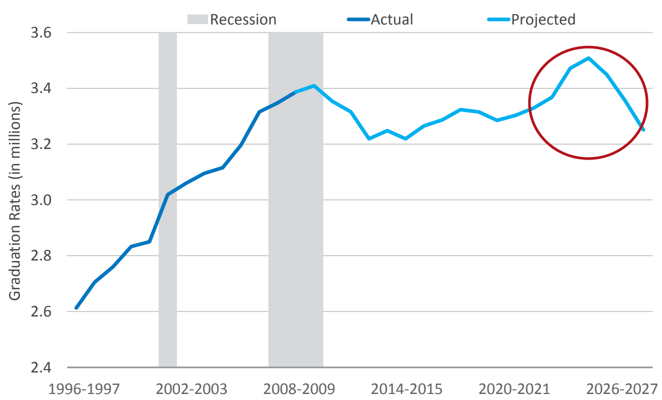
U.S. BIRTH RATES



Data sources: www.cdc.gov, NBER

U.S. HIGH SCHOOL GRADUATES

1996–1997 to 2027–2028



Note: Shows U.S. Public and Nonpublic graduates. 96-97 are actual and 09-10 to 27-28 are projected. Since the Private School Universe Survey (PSS) is biennial, alternate years include nonpublic graduate estimates based on data from the PSS
Source: http://files.eric.ed.gov/fulltext/ED540129.pdf

During the two days of sessions, primary Forum speakers covered a broad range of topics spanning investment and economic cycles, and philanthropic issues. While the following synopses do not reflect the entirety of each session, each highlights the speaker's most meaningful comments and points of discussion.

FEG INVESTMENT OUTLOOK

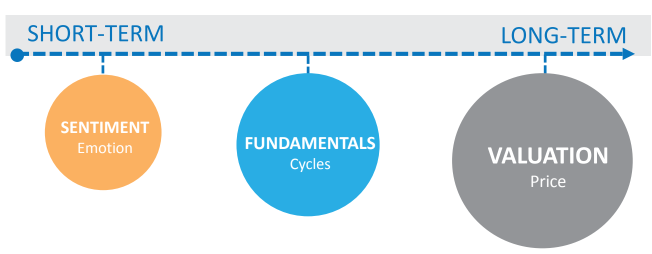
Presented by Gregory M. Dowling, CFA, CAIA, Chief Investment Officer / Head of Research at FEG and J. Alan Lenahan, CFA, CAIA, Chief Investment Officer / Head of Investments at FEG

Greg Dowling and Alan Lenahan opened the Forum by discussing FEG's framework for processing information and managing portfolios.

FEG'S FRAMEWORK FOR PROCESSING INFORMATION

Setting the stage for the next two days, Alan opened the session by explaining FEG's approach to organizing information through a valuation, fundamentals, and sentiment framework. We believe valuation, the price paid for an asset, is the primary determinant of an investment's success in the long-term. Fundamentals include components like GDP, earnings growth, and central bank policy, as well as other measures of market cyclicality that dominate valuation in the short-term. Another factor to keep in mind is sentiment, or momentum, which also influences short-term investment decisions, as trends tend to persist in the short-term.

ORGANIZING INFORMATION FRAMEWORK



Source: FEG

CURRENT MARKET ENVIRONMENT

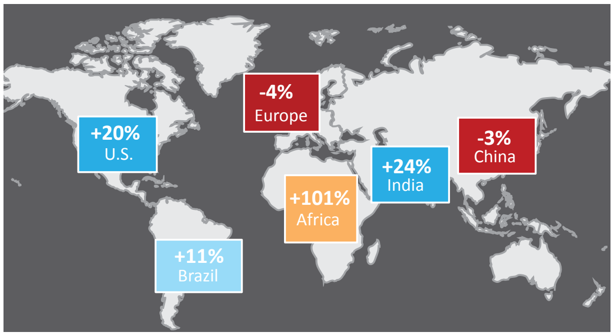
Alan highlighted four key market conditions that capture important fundamental considerations and investor sentiment.

1. **Monetary vs. Fiscal Policy**
   Since the Great Financial Crisis, monetary policy has been in power—with quantitative easing and low policy rates. Policy rates are at historically low levels, and central banks globally are torn between spurring economic growth now by keeping the rates low or protecting against future economic downturns increasing rates now so that rates can be lowered during the next economic downturn. At the end of 2016, we expected to see a hand off to rising rates and fiscal policy; however, this has stalled in recent months.

2. **Trump Policies**
   Voters elected Donald Trump, the candidate who is expected to push against the status quo and disrupt political norms. The three main issues on his campaign platform were healthcare, tax reform, and infrastructure. What is yet to be determined is the degree of change that his policies and legislation with Congress will bring.

3. **Demographic Shift**
   A major consideration for investors is the changing demographic shift and the potential impact this can have on business and economic power. The most significant demographic shifts are occurring in the growing populations of Africa and India and the developing middle class across emerging market countries. Meanwhile, developed nations have fewer young workers than ever before.

A GLOBAL DEMOGRAPHIC SHIFT
Projected Population Change, 2017–2050



Source: United Nations Department of Economic and Social Affairs/Population Division World Population Prospects: The 2017 Revision, Key Findings and Advance Tables

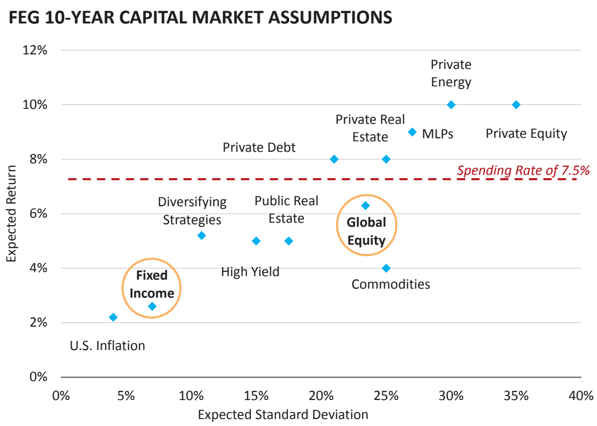
4. **Geopolitical Risks**
   Alan also cautioned investors to be aware of the risks that are starting to put pressure on equity markets. He asserted that there have been 27 instances of the volatility index (VIX) being under 10 since 1990, and 18 of these occurrences were in 2017 alone. Though investors cannot truly predict volatility, they can understand what risks might impact the sentiment of the market.

Outlook Continued

FEG'S OUTLOOK ON OPPORTUNITIES

Next, Greg took the stage to discuss asset categories and FEG's outlook on opportunities, which can be analyzed through the lenses of TINA and IKE.

TINA: "There Is No Alternative"



Source: FEG Data. As of December 31, 2016. FEG Capital Market Assumptions are hypothetical based on asset category.

TINA or "There Is No Alternative" reflects a current challenge for today's investor: equity markets are overvalued, but necessary in order to achieve returns close to a spending rate of 7.5%. To partially remedy this dilemma, investors can diversify by geography, style, and factor, as well as allocate across the active-passive spectrum.

IKE: "I KNOW IT'S EQUITY... And I Just Don't Care"

Source: FEG

With the understanding that equity is the only alternative, FEG has seen an increasing number of managers, using equity style investments within different asset categories. However, it is important to acknowledge and account for the equity risk that these investments contain. For example, REITS, which fall in the real assets domain, hinge on real estate exposure but trade in the equity markets; thus, they fail to do away with equity risk. To find higher return potential outside of equity, investors might turn to direct lending in the private fixed income space. Likewise, diversifying strategies can help mitigate equity risk, while providing returns that are more compelling than the low rates currently offered in fixed income.

Greg and Alan closed by detailing FEG's approach to categorizing assets: global equity, fixed income, real assets, private capital, and diversifying strategies, as well as FEG's current positioning.

Asset Category	Overall Strategy	Sub-Strategies
Equity	Neutral	Underweight U.S. Equity / Overweight Emerging Markets
Fixed Income	Neutral	Underweight credit sensitive / Overweight interest-rate sensitive
Real Assets	Underweight	Underweight commodities / Neutral position in REITs / Overweight MLPs and energy
Diversifying Strategies	Neutral	Underweight relative value / Neutral position in event-driven / Overweight macro strategies

HEALTH AND HEALTHCARE: A LOOK INTO THE CRYSTAL BALL

Presented by Bill Frist, MD, Former U.S. Senator and Partner at Cressey & Company

With a warm, inviting grin and years of multidisciplinary experience to offer, Bill Frist set the challenging goal of illuminating the murkiness of modern healthcare. Undertaking what many consider an Augean task, Dr. Frist proposed three vantage points from which to gain a comprehensive understanding of America's politically fraught healthcare arena: surgeon, senator, and investor. First, he recounted his tenure as an acclaimed transplant surgeon, who witnessed the challenges inherent to delivering superior care to patients. This professional expertise made his legislative agenda as U.S. Senate Majority Leader all the more relevant and impactful. Finally, Dr. Frist brought the audience to the present, where he drew upon his medical and political experiences to locate attractive healthcare investment opportunities.

LIFTING PEOPLE UP THROUGH MEDICINE

Hailing from a family of healthcare professionals, Dr. Frist proved he was no stranger to the medical field. He recounted his early exposure to the once controversial topic of transplant surgery, which many notable professionals deemed detrimental to medical innovation. However, after having performed over 150 heart and lung transplant procedures, he was confident in his assertion that "transplants do not stifle innovation; they are innovation." Improving quality of care through the advancement of medical techniques and technologies has been one of his most passionate missions throughout all aspects of his career.

"Then I lost my mind and went into the United States Senate."

WHAT'S HAPPENING IN HEALTHCARE WILL AFFECT EVERYONE

The audience enjoyed a hearty laugh as Dr. Frist segued into his outlook on the healthcare debate in Washington. Indeed, his experience as U.S. Senate Majority Leader gave him an interesting perspective on the political environment surrounding the hotly contested Affordable Care Act (ACA). Dr. Frist cautioned the current partisan climate in Washington has made it difficult to enact effective legislation that is built to last. The ACA was passed in a completely partisan fashion, with 60 Democrats and zero Republicans voting for the bill. This divisiveness, he said, sharply contrasts with the collaborative passage of Medicare Part D under Dr. Frist's leadership as Senate Majority Leader.

Though he admitted both programs were not initially well received, Medicare Part D has been largely successful due to a bipartisan willingness to fix its design flaws. Conversely, the source of the ACA's conflict is much deeper than design. He continued, the law is so intensely ideological it is difficult to bring Republicans and Democrats together for true collaboration.

Dr. Frist urged politicians, particularly President Trump and Congressional Republicans, to heed the lessons of legislative history: no bill passed in a partisan way can survive and thrive, and a commitment to dialogue and compromise is key to crafting successful, enduring legislation.

PRIVATE SECTOR SOLUTIONS TO HEALTHCARE PROBLEMS

Despite the partisan chaos plaguing healthcare in Washington, Dr. Frist reassured the audience that all hope is not lost. His current work with private investments at Cressey & Company has demonstrated the tremendous benefits possible through the integration of innovative ideas and sustainable business models in the private sector.

Following his remarks, Dr. Frist took questions from the audience that were moderated by FEG's Director of Private Equity Nathan Werner, CFA, CAIA.

Healthcare Continued

Moreover, improving pricing transparency has been a particularly important area of focus for him as an investor. As the healthcare industry progresses further away from fee-for-service pricing and towards fee-for-value pricing, consumers require ways to assess the true value of a service. In order to deliver that value, healthcare professionals must also be allowed to perform the services they are licensed to perform. To illustrate, Dr. Frist noted there are responsibilities a nurse is licensed to undertake that are being handled by doctors, creating a mismatch between patient needs, and services provided.

To rectify these inefficiencies, Dr. Frist turned to technological solutions for service price comparisons and telehealth consultations. Additionally, he espoused the potential of artificial intelligence to vastly improve the accuracy of diagnosis and medical imaging. For instance, in the case of the human eye, robotic systems like IBM's Watson can compile the knowledge of thousands of doctors into a single diagnosis, raising accuracy from 80% with a single doctor to 99.9% with a supercomputer. Coupled with technological innovation, private-sector home- and community-based services for palliative, life-prolonging care can vastly improve patients' quality of life by surrounding them with a team of healthcare professionals at a lower cost. Dr. Frist viewed these trends as viable investment opportunities to watch in the next five years.

CONCLUSION

Dr. Frist concluded his presentation by reiterating the importance of bipartisan efforts by President Trump, and Republicans and Democrats in Congress. By concentrating on building bipartisan support for comparably smaller initiatives such as corporate tax reform and infrastructure packages, Washington may have a chance to enact effective healthcare reform that is truly built to last.

FEG'S INSIGHT

Dr. Frist embodied a refreshing balance between ideological conviction and pragmatic flexibility. His advocacy of a multifaceted approach towards healthcare reflects the comprehensive understanding of a market that FEG values. In a gridlocked political arena dominated by partisanship, private investments in niche healthcare solutions are more important than ever to advance the availability of quality care for patients. We, like Dr. Frist, believe technology is a key driver of sustained innovation in all fields, especially in the complex, rapidly changing healthcare domain.

A FIRESIDE CHAT ON THE ENERGY MARKET

Presented by Lee Raymond, Former CEO of ExxonMobil, and Rob Raymond, Founding Member of RR Advisors, and moderated by Christian S. Busken, Senior Vice President / Director of Real Assets at FEG

With decades of dedicated experience in the energy sector between them, father-son duo, Lee and Rob Raymond, kept FEG's Christian Busken on his toes during a Q&A discussion that encompassed sundry topics related to energy. Given his tenure as CEO of ExxonMobil, Lee Raymond offered fascinating insights into the workings of an oil company, placing particular emphasis on how the industry represents itself to the public. He also recounted how cyclical swings in commodity prices affect both oil-dependent countries and competing energy sources. Additionally, Rob Raymond illuminated a particularly specialized subset of energy investment: the master limited partnership, or MLP. Not only did he discuss the connections between MLPs and commodity prices, but he also addressed the relevance of MLPs to the resource-rich Permian Basin of west Texas and southeast New Mexico.

MISCONCEPTIONS ABOUT OIL COMPANIES

As only the former CEO of a prolific company can do, Lee Raymond offered his opinion on how oil and gas companies craft and maintain their public faces. Most consumers, and even many investors, are only truly interacting with these companies through service stations, which in actuality represent a tiny portion of the firms' total business activity. Above all, people tend to measure a company's attractiveness based primarily upon the price of gas, an assessment technique derived from the service-station-moderated relationship between company and consumer. However, the bulk of an oil company's revenue stream stems from refineries and wells, though these operations are rarely discussed outside of the context of media reports on safety concerns. After stressing the high priority oil companies place on the safety of their employees, Lee Raymond urged the industry in aggregate to revitalize its public messaging in order to communicate the total concept of the industry in a more factually representative way.

OIL PRICES ARE A FUNCTION OF ECONOMIC GROWTH

Due to the industry's health being dependent upon the price of oil, how can these companies gauge oil prices, if at all? Lee Raymond suggested it all comes down to economic growth. History has provided multiple instances of the rapid rise and decline of commodity prices. He referenced a particularly telling example in 1985, when oil prices dropped from $28/barrel to $5/barrel in a mere six weeks. Such a sharp drop necessitated the reorganization of the entire oil and gas industry to heighten efficiencies and reduce expenditures, a process that took until the mid-1990s to see a notable, sustained elevation in prices. Lee Raymond argued the current situation, though perhaps not as dramatic, bears resemblance to this historic event. Economic growth must be considerable enough to warrant substantial demand for oil, which will support increased prices. However, as has been the case for the developed world, demand has not caught up with supply and oil prices remain lower.

Energy Continued

TECHNOLOGICAL ADVANCEMENTS UNLOCKING THE POTENTIAL IN THE PERMIAN

Mr. Busken directed the conversation towards Rob Raymond and his perspective on MLPs, an increasingly popular area for investor capital. Mr. Raymond immediately sought to clarify the fallacy of total correlation between commodity prices and MLPs. Notably, while commodity prices do influence the environment in which MLPs operate, the true drivers of MLP returns are throughputs, volumes, and cash flow durability. All of these provide the investor with an understanding of the fundamental framework underlying each MLP company. If an MLP efficiently conducts operations in favorable geological areas with high-quality assets, it has the ability to be profitable when oil prices are $40 per barrel or $80 per barrel.

Furthermore, the energy sector is seeing a huge resource infrastructure opportunity being unlocked in the Permian Basin, which has the largest deposits of Permian-age rock in the world. As such, competitive desire to unlock the 300 billion barrels of oil trapped there is spurring technological advancement, particularly in horizontal drilling technologies. According to Rob Raymond, development in the energy sector is driven by increasingly sophisticated methods of harnessing energy.

FEG'S INSIGHT

Lee Raymond astutely declared "the oil and gas industry is the lifeblood of the world economy." FEG values the conviction the Raymonds revealed in the energy sector and appreciates their identification of viable opportunities within the energy space. In particular, FEG affirms the potential embedded within the U.S. energy revolution and believes energy plays a crucial role in a well-diversified portfolio. The audience departed the session with a renewed take on this important diversifying sector, contemplating the holistic view from which the Raymonds approach energy.

WACKO-O SEASON

Presented by Jeffrey Gundlach, CEO of DoubleLine Capital

The audience was captivated as Jeffrey Gundlach shared his belief that we are currently immersed in a "Wack-o Season" of investment behavior, characterized by bizarre trends in the market.

MARKET TRENDS & ABSURDITIES: A BLOODLESS VERDICT OF THE MARKETS

Mr. Gundlach addressed a number of topics related to the global and U.S. economy, jumping from one interesting observation to the next. He demonstrated the absurdity he noticed in the markets by pointing out that at present, there is no high yield return in high yield. European high yield bonds are currently on par with U.S. 10-year Treasuries, while U.S. high yield provides little compensation for default risks. He also asserted incredibly high price-to-sales in equities should be a red flag to investors, as there is no signal that strong sales growth will support valuations.

Resolute in his judgement of the current trends seen in the market, Mr. Gundlach declared, "In this business, when you hear the word 'never,' it means imminent." As an example, he referenced the crazy popularity of short VIX strategies, which may lead to a tremendous short squeeze, an outcome many invested in such strategies consider unthinkable. Moreover, he commented on the overvalued equity market and investors' fascination with mega stocks like Amazon, pointing out "A guy on TV said Amazon is a no risk investment."

Mr. Gundlach paused dramatically as the audience laughed, before alleging the stock price of the e-commerce giant was sure to fall in the coming years. At the same time, Mr. Gundlach warned investors to beware of the "value trap" or the belief that just because something is considered cheap, the price will increase in the future.

He further spoke about the concept of an "outside day," which is a day in the markets when the high is higher than that of the day before, and where the low is lower than the low of the day before. In the Wack-O season we find ourselves in at present, he said, the U.S. dollar has seen an atypical "outside year," moving both lower and higher than it has in previous years.

FED POLICY

Mr. Gundlach pointed out that March of this year was one of the rare times when the Fed and the markets agreed on a rate hike, although it seems the markets are not buying the Fed's intention of raising rates three times this year. He supports the Fed's plans to decrease the size of their balance sheet, a development the Fed has been more vocal about in recent months. According to his projections, the balance sheet run-off will tighten financial conditions in late 2017, as the Fed's reinvestments lag the redemptions of securities, and he considers the upcoming quantitative tightening a possible catalyst that could drive prices down.

> *"In this business, when you hear the word 'never,' it means imminent."*

Wack-o Season Continued

AUTOMATION & CRYPTOCURRENCY

Investors in the audience were cautioned by Mr. Gundlach against blindly following the herd, especially with the integration of automation, making such behavior more extreme than it has ever been in the past. He claimed this "robo-activity" has led to everyone having the same mindset and being in the similar trades, and thus has rendered them unable to take advantage of the opportunities in the markets.

Mr. Gundlach recounted a conversation with his 86-year-old mother, who sent him a link about Bitcoin and asked for his opinion, saying she thought it sounded a little too good to be true. Agreeing with this sentiment, Mr. Gundlach declared he does not philosophically agree with the cryptocurrency hype and believes it cannot feasibly function as legitimate currency with "standard deviations of 25 million."

THE RECESSION IS NOT COMING

Despite these observations, Mr. Gundlach shared he does not foresee a U.S. recession in the near future. While auto sales and credit spreads bear watching, he pointed to a chart showing ISM Manufacturing and Services PMI to assuage concerns. The ISM Manufacturing PMI as well as Non-manufacturing PMI continue to be at healthy levels, far from the negative values that have accompanied recessions in the past.

FEG'S INSIGHT

Mr. Gundlach was consistently candid in his take on the wacky market environment we are currently in, expressing his incredulity at certain persisting trends and comments made by other leaders in the industry. He urged the audience not to confuse "brains with a bull market" and to watch indicators of the health of the economy instead of getting caught up in short-term value traps and popular trades that have done well. FEG encourages clients to take a long-term perspective when investing and to avoid reacting to short-term market movements. In addition, FEG shares Mr. Gundlach's perspective that many areas of the market are priced such that risks are not commensurate with potential rewards. While Wack-O season drives many off the edge in search of investment opportunities, FEG believes patience in building a portfolio that can withstand market craziness can help investors weather such storms.

THE DEATH OF VALUE... AND OTHER RECENT INVESTMENT MYTHS

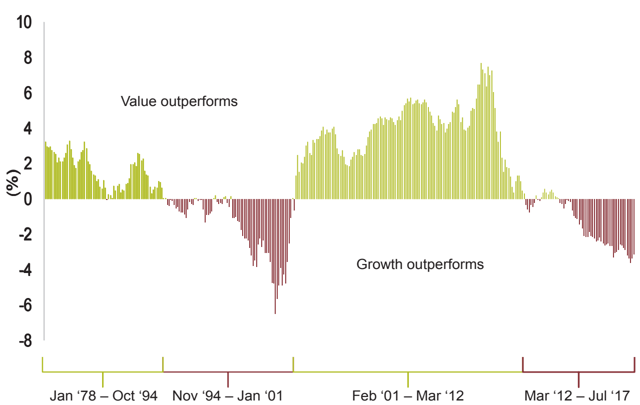
Presented by Steven Romick, CFA, Managing Partner of First Pacific Advisors

"Value investing: dead again?" This ironic headline from *Investors Chronicle* set the tone for Steven Romick's presentation. As a managing principal for First Pacific, a firm whose central component of its investment philosophy is value investing, Mr. Romick was surprised he was invited to speak, given the strategy is currently out of favor. However, he remains convicted in this strategy as was evident through his presentation of five related investment myths.

MYTH #1: VALUE INVESTING IS DEAD

Mr. Romick quickly dispelled this myth through two arguments. Value investing, or buying something for less than its intrinsic value, is always a sound approach. Additionally, value vs. growth goes in and out of favor. He pointed out that if investors look at these factors on a rolling 10-year basis, they will identify the trend. Mr. Romick surmised the current reigning champion of this cycle, growth, was soon to be overturned. While he could not speculate exactly when this might occur, Mr. Romick claimed growth is expensive relative to value today, as evident through the Russell Value Index.

VALUE AND GROWTH MOVE IN & OUT OF FAVOR



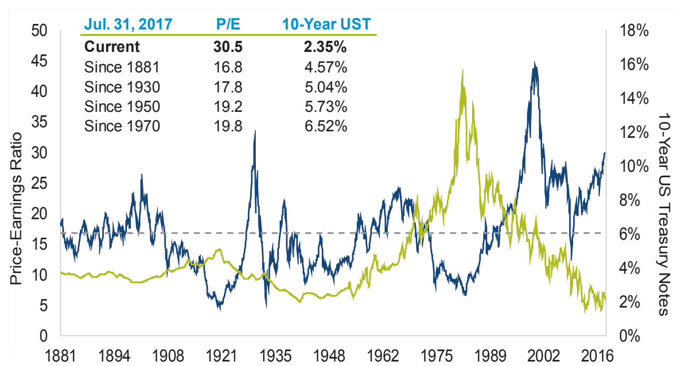
Source: Morningstar. As of July 31, 2017. Value and Growth are represented by the Russell 1000 Value TR USD and Russell 1000 Growth TR USD Indices on a rolling 10-yr basis.

MYTH #2: INTEREST RATES AND THE STOCK MARKET ARE NOT LIKELY TO DISAPPOINT

Mr. Romick stated that we are in the third longest economic expansion on record, with the potential to become the first. Low interest rates are contributing to the success of levered companies and the current bull market.

However, upon closer examination, Mr. Romick postulated the current expansion is "anemic," citing declining interest rates as the cause behind decades of slow (less than 2%) GDP growth. He further pointed to the lack of opportunities in both the bond and stock markets, with high yield options not providing high yield returns, and high equity valuations (as determined by a higher CAPE and higher P/E ratio) In fact, the CAPE ratio has only been higher than it is today 4% of the time since 1881.

HISTORIC P/E USING 10-YEAR AVERAGE EARNINGS



Source: Shiller, Robert J. Online Data, www.econ.yale.edu/~shiller/data.htm. Data as of July 31, 2017. Please see appendix for full disclosures.

After setting the stage of the current market environment, Mr. Romick posed the question, "What happens next?" Although he did not claim to know the answer, he suggested that it was a good bet to say rates will go down and this economic expansion will soon come to an end.

Death of Value Continued

MYTH #3: PASSIVE IS ALWAYS BETTER THAN ACTIVE

Passive investing continues to gain share. Mr. Romick claimed index funds currently account for 40% of the U.S. equity fund industry. Driving this popularity is the belief that it is nearly impossible to pick winning active managers, with some studies suggesting only the top 4% of managers outperform.

Mr. Romick suggested that the premise of the argument is off and proposed that active investing should not be about picking the winners but instead avoiding the losers. Notably, the top 10 winners in the S&P added 13%, while the bottom 10 performers took away 13%. Moreover, the average company lifespan is currently about 27 years, but that measure is expected to decline to about 15 years. Thus, shorter corporate lifespans and indiscriminate buying of indices will make it harder for investors to ascertain when to leave an investment, essentially tying capital to weak firms.

For the long-term Mr. Romick believes active investing opportunities are attractive; however, he conceded value investing is difficult today, primarily because the pricing between securities is too narrow.

MYTH #4: CASH IS TRASH

In general, investor propensity is to put money to work, but Mr. Romick warns investors to use caution because U.S. stocks do not always outperform cash. To illustrate, in times where price-to-book ratios are high, cash will outperform.

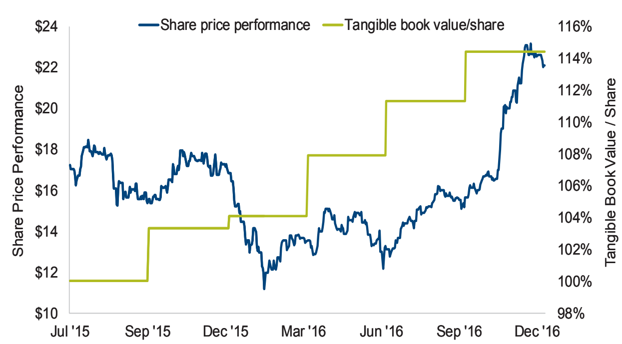
Instead of viewing cash as a drag on returns, Mr. Romick proposed cash should be viewed instead as a by-product of a research process and available for attractive opportunities. Nevertheless, if no perceived opportunities exist, then cash should be kept on hand until they do.

MYTH #5: LARGE CAP STOCKS ARE EFFICIENTLY PRICED

Although large cap stocks are more efficient than other styles (i.e., small cap), they are not fully efficient. For example, in 2015-16 Bank of America's share price plummeted, while the tangible book value/share increased. Nonetheless, the market took close to a year to catch up before the bank was priced appropriately. During that time, there was the opportunity for savvy investors to earn alpha.

BANK OF AMERICA: EVIDENCE OF AN EFFICIENT MARKET?

Share Price vs. Tangible Book Value Performance



Source: Morningstar. As of December 31, 2016.

FEG'S INSIGHT

This year, we received a large number of FEG client questions regarding active vs. passive investing. FEG often reinforces the greatest determinant of an investment's success is the price paid. Further as a proponent of diversification, we recommend our clients construct portfolios along the value–growth and active–passive continuums in a manner reflective of their risk tolerance and return goals. While FEG perceives the greatest opportunity for active management to add value to be in less efficient and opaque markets, such as venture capital and buyout strategies, there remain, as Mr. Romick proposed, opportunities in U.S. equities.

THE CAROUSEL OF ECONOMIC AND MARKET CYCLICALITY

Presented by Michael Oyster, CFA, FEG

Recounting sparkling anecdotes from the prior evening's festivities at Carol Ann's Carousel, FEG's own Michael Oyster drew insightful parallels between the sensation of riding a carousel and investing in a financial market. Just as one who partakes in a merry-go-round subjects himself to the whims of the ride, bobbing up and down as the carousel spins in circles, so too does the market participant subject himself to the whims of the market and its cycles.

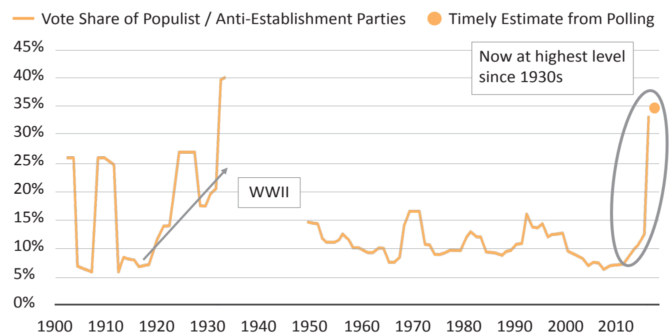
Indeed, market cyclicality, with all of its exciting ups and frustrating downs, is an inevitable investment reality, particularly for those with long-term missions. Though the sensation of helplessness the investor might experience is admittedly graver than that of the carousel rider, there are certain tools the investor can use to better understand the many factors influencing the market. Michael focused on a particularly powerful technique for identifying the political, economic, social, and technological forces that move portfolios: the PEST framework, derived from Harvard professor Francis Aguilar's foundational framework.

Source: FEG

POLITICAL FORCES

He first recognized the profound shift in political sentiment across many nations in the developed world. Most significant has been the rise in populism in the United States and around the world, a phenomenon that rallied the common man around political candidates like Donald Trump and Bernie Sanders to demand rights and recognition from the institutions that govern society. However, nationalistic activity, such as imposing trade and immigration restrictions, tends to accompany populism. As a result, reduced diffusion of capital and technology across industries and geographies could hinder economic growth. Michael, nevertheless, believes meaningful corporate tax reform, infrastructure spending, and deregulation could support a "bull market in capitalism," a "we the markets" escalation of favorable financial conditions that promotes economic expansion.

DEVELOPED WORLD POPULISM INDEX



The latest point includes cases like Trump, UKIP in the UK, AfD in Germany, National Front in France, Podemos in Spain, and Five Star Movement in Italy. It doesn't include major emerging country populists, like Erdogan in Turkey or Duterte in the Philippines. In the rest of the study, we look at populists of the past rather than those now in office in order to study the phenomenon because the stories of ones in power or possibly coming to power are still being written. For example, while we consider Donald Trump to be populist, we have more questions than answers about him and are using these other cases to assess him against by seeing if he follows a more archetypical path or if he deviates from it significantly.
Source: Bridgewater Associates

ECONOMIC FORCES

The influence of monetary policy on markets is more prevalent than ever before. Since 2008, investors have witnessed accommodative central bank activity move markets dramatically, though not always in the right direction. Although low interest rates have supported the economy and propped up the stock market, they also have allowed "zombie" companies that would otherwise go bankrupt to obtain cheap financing and stay afloat, dragging down national productivity. Michael pointed out the subsequent

Cyclicality Continued

disparity between rapid asset price inflation and low-wage inflation, inciting populist rhetoric and the consequential constraints on economic growth.

Conversely, he reiterated the potential of effective fiscal policy to spur meaningful economic advancement in the face of nonviable monetary policy.

SOCIAL FORCES

Just as macroeconomic forces dictate the market's ups and downs, consumer preferences also play a role in the market landscape. Additionally, demographics help investors understand these preferences and explain demand shifts over time. He specifically highlighted the demand discrepancy between the United States and emerging market economies. America's relatively older consumer base is demanding fewer goods and services and therefore driving inflation lower.

In contrast, emerging economies are proliferating with young consumers, so much so that "over the next five years, there will be one million Indian citizens turning eighteen each month."[1] This remarkable statistic substantiated his prediction that youth-dominated emerging markets, including India, stand to experience higher demand and inflation.

TECHNOLOGICAL FORCES

Innovations in technology are putting downward pressure on prices and disrupting segments of the labor market. Michael provided multiple examples of the inflation-dampening effects of technological advancement, including fracking in the energy sector and smartphones in the entertainment sector. Companies turn to more efficient modern technologies to replace human labor, displacing entire industries and lines of work. However, though certain jobs and industries struggle, he firmly asserted, technological change improves and advances society as a whole and is thus a beneficial agent of economic growth.

"History doesn't repeat, but it does rhyme."

— Mark Twain

FEG'S INSIGHT

While we as investors can never truly predict every which way the market will move us, we can utilize analytical tools like the PEST framework to understand the political, economic, social, and technological factors that have historically influenced market movements. Accordingly, investors can more confidently grasp how, when, and why we move the way we do, and how to prepare our portfolios to weather the cyclical changes to come.

[1] https://www.nytimes.com/2016/03/20/books/review/the-end-of-karma-by-somini-sengupta.html

A TALE OF TWO CHINA'S

Presented by Kyle Bass, Founder and CIO of Hayman Capital Management, L.P.

Introducing Kyle Bass, FEG's Greg Dowling asked attendees through a poll question whether they considered China an opportunity or a risk. Approximately 64% of the audience responded in favor of the former. As Mr. Bass took the stage, he commented there should be a third option for guests: both. It is his belief that China poses a risk first, followed by an opportunity.

CHINA: CURRENT ENVIRONMENT

Mr. Bass explained what we see on the surface today regarding China's economic conditions is overwhelmingly positive; GDP is growing, Chinese equities are rallying, there is apparent foreign exchange stability, and foreign exchange drawdowns are lower. Also, the country has sustained a low level of non-performing loans in their banking system, which has grown at over 1000% in the past decade alone. Nonetheless, he pointed out as we dig deeper into these numbers, we discover some noteworthy changes that will affect China's financial health in the future.

While headline numbers often look reasonable, individual metrics taken together can show a more robust picture of an economy. Mr. Bass explained China today is faced with the onset of an election cycle, with the Communist Party attempting to crack down on corruption and create financial stability in the system to ensure control of the country. The political climate of increased regulation and restrictions has wealthy Chinese investors scrambling to take advantage of opportunities outside the country. Over recent years, China has imposed capital controls on multinational corporations as well as individuals, shutting down capital outflows from the country.

Cross-border merger and acquisition activity with companies in western countries has essentially been stopped, those corporations currently in China are restricted from moving cash out of the borders, and the transactions made by Chinese individuals currently residing abroad are being monitored by China's State Administration of Foreign Exchange. Mr. Bass showed in spite of strict monitoring and current account accruals, cash was staying out of the country. While capital controls have succeeded in stopping outflows, they have not had an impact on trading volumes.

These restrictions have other impacts on the financial strength of China as well. According to Mr. Bass, China is underweight in international assets; only about 18% of the country's GDP consists of gross FX assets. Additionally, in the Chinese real estate market, land prices continue to grow at a rapid pace, but this increase is not accompanied by increasing transaction volumes. Mr. Bass referenced an ancient Chinese proverb to explain the land price situation, which translates roughly to "the dough now costs more than the bread." Further, China's equivalent of the Federal Reserve in the U.S., the China Banking Regulatory Commission, admitted to massive losses observed in the banking system over the past few years. In fact, risks arising from slower growth and higher leverage led to Moody's downgrading of China's credit rating earlier this year.

Overall, Mr. Bass presented a myriad of factors to consider when looking at the risks and opportunities investors face when investing in China. The key risks and opportunities are summarized on the following page.

Guests attending one of the breakout sessions during Forum.

Two China's Continued

RISKS

- Upcoming elections always pose the threat of political disruption, and the primary goal of the party is to remain in power. Thus, any disruption could present risks in a crackdown on dissidents.
- Capital controls prevent individuals and multinational corporations from withdrawing their Chinese investments, and wealthy Chinese see value in having assets offshore.
- Rising rates are paralyzing the economy and causing a slowdown in credit availability.
- Asset-liability mismatches and the underlying risks of wealth management products have the potential to create financial instability.

OPPORTUNITIES

- Chinese GDP continues to grow at a pace that exceeds the progression of the developed world.
- Chinese equities are rallying, and overall foreign exchange reserves are ample.

While Mr. Bass is not optimistic about China's current economic situation and foresees a period of decline, he does not believe this will trigger contagion in the global economy. Rather, this is a temporary situation where a centrally controlled government wants to stay in power and is pushing for capital controls as a means of showcasing its regulatory capabilities.

FEG'S INSIGHT

In an emerging market gaining investors' interest, due in part to the rebound from the lull in current high growth in recent years, Mr. Bass showed incredible restraint from following the herd.

FEG values Mr. Bass' ability to break away from the crowd and be aware of both the risks and opportunities presented when investing in emerging markets. FEG has long advocated building a diversified portfolio by investing globally, and although emerging markets provide an enticing opportunity today, it is important to be aware of the nuances that differ one such investment from another.

DATA MINING, PERFORMANCE CHASING, & THE QUEST FOR REAL RETURNS

Presented by Robert Arnott, Founder and Chairman of Research Affiliates

While all investors want their portfolios to generate real returns, Robert Arnott warned while it is tempting to follow the path of least resistance and assume the same high future returns as we had in the past, the assumption is without merit and does not lead to success. In fact, Mr. Arnott finds it highly unlikely these returns will continue.

PAST IS NOT A PROLOGUE

As an illustration, over the past 30 years, stocks have given investors nearly 10% returns, while bonds have delivered 7%. However, if investors look at the subsequent 10-year real return vs. the prior 10-year real return, they will see a correlation of -0.37, suggesting prior strong performance will be succeeded by somewhat weak negative performance. In the case of bonds, starting yield is highly predictive of subsequent 10-year nominal returns, with a correlation of 0.92. Given that current yields on 10-year Treasuries are 2.2%, investors can expect these lower yields to provide subdued returns in the years to come.

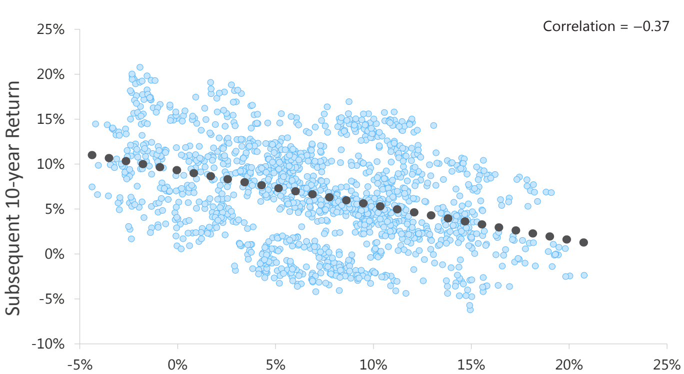
PATH TO IMPROVING RETURNS

What does this mean for investors? Mr. Arnott joked with the audience that "we didn't survive the African valley by running towards a lion and away from a field of food." While he is not suggesting investors should shift their stance away from joy and profit to pain and loss, he is suggesting investors consider other asset classes, unlock excess returns within asset classes, and rebalance across asset classes.

CONSIDER OTHER ASSET CLASSES

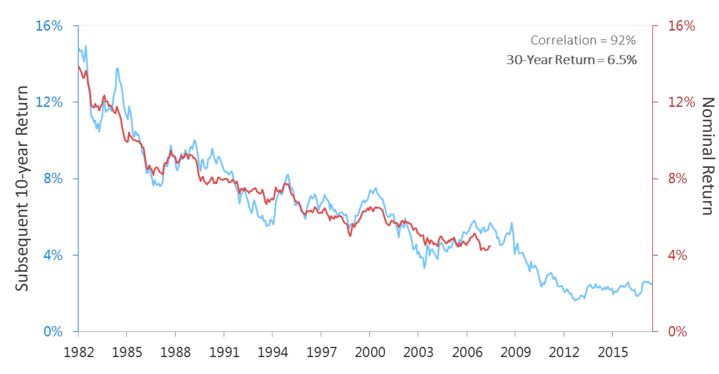
Mainstream stocks and bonds are not the only choices, and uncomfortable assets can be priced to offer better returns. Furthermore, some assets, which Mr. Arnott deems Third Pillar assets, can provide inflation protection stocks and bonds lack.

U.S. EQUITIES / January 1871—2016



Source: Research Affiliates, LLC, based on data from Shiller, Ibbotson, and Bloomberg.

U.S. BONDS / As of June 30, 2017



Source: Research Affiliates, LLC, based on data from Barclays. The yield-to-worst and total returns are of the Barclays Aggregate Index

Data Mining Continued

UNLOCK EXCESS RETURNS WITHIN ASSET CLASSES

Mr. Arnott eschews the traditional approach of seeking alpha through active managers and advocates fundamental indexing, a strategy in which weighting is determined by any measure of company size except market capitalization, as well as select other smart beta strategies, to add value in a sample, transparent, low-cost way.

While there are many approaches to fundamental indexing, Mr. Arnott discussed at length the opportunity in value stocks, citing numerous analyses that showed factor valuations are predictive of future returns. For instance, when investors look at the valuation cycle for the value factor from 1968-2016, the data shows stocks with higher relative valuation metrics demonstrate higher performance.

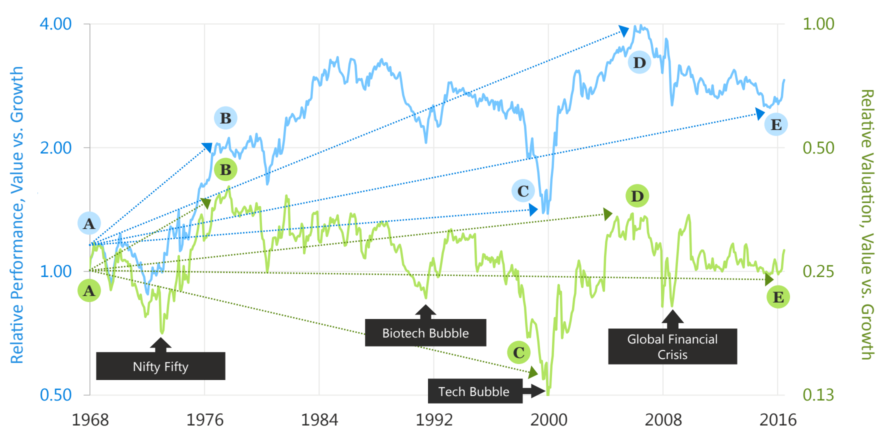
REBALANCE ACROSS ASSET CLASSES

Mr. Arnott discussed how buy-and-hold approaches led to overweighting recent winners. These strategies result in investors purchasing overpriced stocks and selling underpriced stocks. As prices rise in popularity, they become overpriced and are more likely to underperform, and vice versa. As an example, Mr. Arnott referenced the performance of average U.S. Long-Only Equity funds from 1990-2016, in which the lowest performers (based on prior three-year returns) generated the highest subsequent three-year average annualized returns. Therefore, tactical over-rebalancing can profit from extremes of valuation.

CONCLUSION

According to Mr. Arnott, pursuing diversification and rebalancing both within and across asset classes can generate up to 200 points in alpha, although the path to improving returns is uncomfortable.

VALUATION CYCLE FOR VALUE FACTOR
Value vs. Growth July 1968—December 2016



*Source: *Based on a blend of four valuation metrics: Price/Book, Price/5yrSales, Price/5yrEarnings, Price/5yrDividendsSource: Research Affiliates, LLC, using data from CRSP and Compustat.*

Data Mining Continued

Hence, Mr. Arnott advises investors to:

- Reign in the expectations gap.
  - Do not extrapolate the past to predict the future.
  - Recognize that 3% real economic growth is part of the past, not the future.
  - Do not expect U.S. stocks to give much more than 5% in coming years.

- Consider three paths to improving returns.
  - Invest in diversifiers like hedge funds, as many are now cheap.
  - Break the link between price and portfolio weights; stop chasing the most expensive stocks.
  - Rebalance within and across asset classes.

- Prepare to stay on course.
  - Do not chase performance, as that is a proven path to disaster.
  - Embrace discomfort; capital markets do not reward comfort.

FEG'S INSIGHT

FEG's capital market assumptions support Mr. Arnott's statements that investors cannot expect the returns of the past. We agree with many of the solutions he advocated, including diversifying, avoiding the assumption that the recent past will repeat, and focusing on the long-term perspective.

Taking a long-term perspective can help investors avoid performance chasing and focus more on the long-term strategy vs. short-term returns. FEG believes the measurement of our recommended managers should be based on a number of qualitative and quantitative factors, including consistency in executing strategy and advisement against putting too much weight on short-term performance.

Conclusion

FEG believes the spectrum of viewpoints presented at the Forum were vital in assisting attendees to interpret the complexities of the financial and geopolitical landscape. As reflected in the FEG Investment Forum theme, *Carousel of Change: Navigating the Ups and Downs of Market Cycles,* there are a myriad of cycles—political, economic, sector, investment, and social—which our speakers covered.

As evidenced by some of our speakers, social and political issues such as healthcare and partisan politics can greatly affect individuals, but also ultimately have an impact on the ability to fulfill your organization's mission.

A theme among the speakers was that investors cannot expect the returns of the past but there are ways to still achieve returns. We believe that in the future, investors will have to take a global perspective, continue to diversify, utilize selective additions of active managers, and think differently about their investments. This also means staying calm and maintaining a long-term focus as Mr. Gundlach, Mr. Romick, and Mr. Arnott illuminated.

FEG believes a disciplined approach that takes a long-term view and utilizes the framework of valuation, fundamentals, and sentiment to drive investment decisions is critical for successful investing.

Looking Ahead

FEG President and CEO Scott Harsh brought the event to a close in the Pavilion room just before lunch. As he mentioned in his opening speech, the FEG Forum will move to a two-year schedule to allow for more regional and international events in the non-Forum year. FEG promotes global diversification, and in order to provide better exposure, we have developed a new event—FEG CIO Corner—which will give attendees the opportunity to learn about international markets. Our inaugural international event will be in Hong Kong and focus on the theme, *An Approachable Asia.* We hope to see some of you there!

APPENDIX

Page 12: Historic P/E chart. Monthly dividend and earnings data are computed from the S&P four-quarter totals for the quarter since 1926, with linear interpolation to monthly figures. Dividend and earnings data before 1926 are from Cowles and associates (Common Stock Indexes, 2nd ed. [Bloomington, Ind.: Principia Press, 1939]), interpolated from annual data. CAPE stands for Cyclically Adjusted P/E. P/E or price-to-earnings is a valuation ratio of a company's current share price compared to its per-share earnings.

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