# EMBRACE OPPORTUNITIES AMIDST UNCERTAINTY: NEPC'S 2016 ASSET ALLOCATION LETTER

NEPC's Asset Allocation Committee

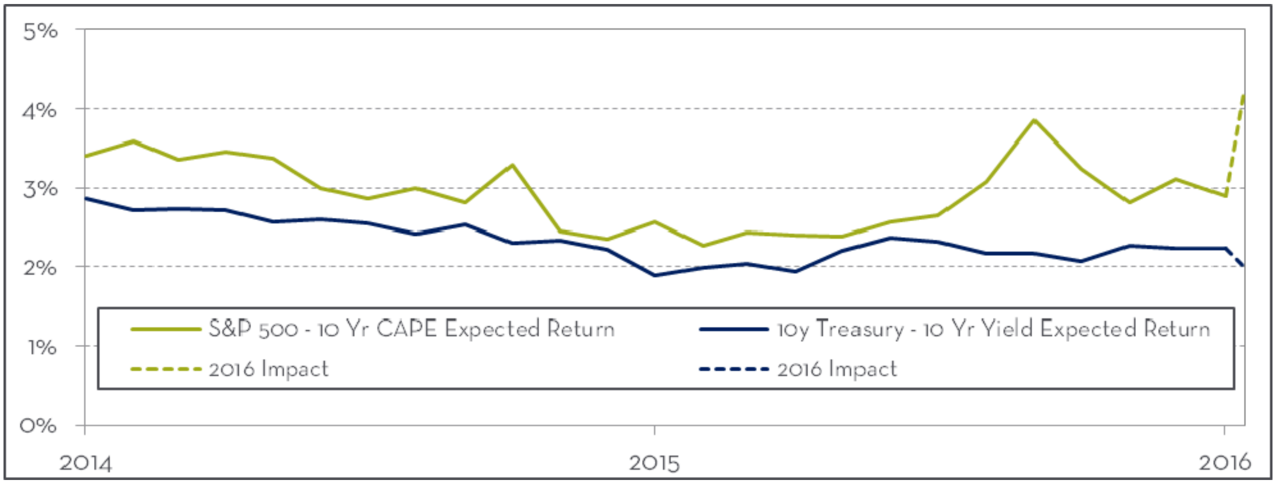
**Take Advantage of Current Pricing – Rebalance and Assess Targets**

At NEPC, we go through a robust and comprehensive process to set our capital markets outlook and asset class assumptions. As we finalized this process at the end of 2015, we saw reasons global economies could continue to expand in the near term, providing support to risky assets. That said, we also saw a muted return environment and dynamics that suggest a renewed focus on risk management and diversification. Market dynamics have certainly changed as we kick off 2016. With the recent ~10% sell-off in equities and over a year of negligible total portfolio returns, we think the balance is shifting towards seeking returns. We note little that has changed in the underlying fundamentals driving our outlook and, thus, see this volatile environment as an opportunity to rebalance and even selectively increase exposure to assets that have fallen in price.

## INVESTORS SHOULD ACTIVELY SEEK OPPORTUNITIES TO REBALANCE TOWARD HIGHER RETURN-SEEKING INVESTMENTS

We think investors should actively seek opportunities to rebalance toward higher return-seeking investments, including long-only equities and credit. We believe rebalancing is appropriate since, as Exhibit 1 shows, the compensation for holding equities has increased over the last few weeks. However, there is increased market risk and investors should prepare for a more volatile ride. If the markets continue to drop, we encourage investors to consider increasing their overall strategic weight to equities and credit.[1] We think it is very hard to identify the best buying opportunity (i.e., "call the bottom"). Instead, we seek to identify attractive entry points within the frame-

**Exhibit 1: 10-Year Expected Returns**




*Source: Yale/Shiller Data, Bloomberg, NEPC*

[1] *Investors have different portfolio goals and risk tolerance and our recommendations should be viewed in the context of each investor's unique situation.*

work of long-term focused investment portfolios. With the recent sell-off, we think this environment represents a good buying opportunity. Investors with safe haven exposures, for instance, Treasuries or core bonds, have a ready funding source for a reallocation to equity.[2] Some investors may want to, more boldly, tilt toward risk assets by lowering exposure to select diversifiers such as hedge funds, other absolute return-oriented strategies, or inflation-sensitive assets.

Rebalancing and seeking to take advantage of attractive pricing present an opportunity to capitalize on higher return expectations, especially as most portfolios have started the year in the red. Investors with June 30 fiscal dates likely have negative returns more than halfway through their fiscal year. Given this gap relative to targets, this will be a challenging year to meet long-term return targets. Attempting to take advantage of appealing market entry points may also help to potentially close or narrow this return gap.

Foundational elements of NEPC's investment approach include diversification, contrarian thinking, and a long-term focus. We believe diversified investors have weathered this current storm better than those employing more concentrated equity-focused approaches. Further, a willingness to be contrarian, look past short-term noise and evaluate markets over long-term horizons suggest rebalancing and even increasing risk can benefit patient and dynamic investors.

**The Backdrop – NEPC's 2016 Capital Market Outlook**

Last year marked the first pause in four years in the US equity market rally. Dollar strength, expectations for tighter US monetary policy, and slowing emerging market growth all contributed to lackluster market performance across most asset classes. Disappointing total portfolio returns after such dramatic strength from 2012-2014 may feel especially unsatisfying as forward prospects look dim in a low-growth, rising-rate environment.

However, we see numerous potential positives that may persist over the coming years: US consumer health can extend the domestic economic recovery, accommodative monetary policy in non-US developed markets is encouraging growth in Europe and Japan, and a lower starting point for emerging markets compensates investors more handsomely going forward. All these factors support a tilt towards equity and away from other diversifiers to help achieve targeted returns.

Beyond the immediate opportunity, we are also focused on three potential turning points currently dominating the medium-term investment landscape:

1) The US economy is in mid recovery – will it continue to accelerate or slow from external pressures and the start of a tightening cycle by the Federal Reserve?

2) Global central bank policies are finally showing initial signs of divergence – will this continue or will the Fed need to reverse course?

3) Emerging market growth expectations are unexpectedly low amid dollar strength, energy volatility, and shrinking investment flows – will the environment worsen (and for how long) or will the recent currency adjustments prove sufficient to revive growth?

A healthier American consumer can spur continued US growth. Wage pressures have not yet materialized. A slower pace of US dollar strength should provide some relief for multi-nationals. It is a delicate balance but one we believe will support mid-to-single digit returns for domestic equities.

The Fed remains cautious and adaptive on its path to reduced monetary support. Meanwhile, the European Central Bank and the Bank of Japan press forward with additional easing and some expectation of more stimulation if necessary. Against this backdrop, risk assets should receive some degree of support and non-US developed equity markets look particularly attractive. Even if the Fed keeps rates lower for longer, we think the relative differential versus the other major central banks' policy rates will still favor dollar strength, albeit at a slower pace than the last 18 months; therefore, we still recommend a partial USD currency hedge as part of the non-US developed equity overweight.

Emerging markets have seen losses, outflows, currency devaluation and slowing growth. These adjustments have been severe and forward-return expectations today appear to compensate inves-

[2] *We continue to believe exposure to duration provides a diversification benefit; but, in general, we see a modest trimming of duration as a reasonable tradeoff of defensiveness to fund potentially higher-returning assets.*

tors well relative to developed markets. China remains behind peers in significant currency devaluation but recent actions indicate more adjustments are around the corner. We remain supporters of the long-term fundamental story in emerging markets and favor consumer-oriented strategies as many key regions shift from an export-focused economy to a consumer-driven one. Near term, however, we see greater volatility so investors need to re-affirm their commitment levels to emerging markets and rebalance accordingly to capitalize on attractive entry points.

Despite the heightened attractiveness of risky assets, we still think returns will be challenged going forward given the muted backdrop for growth and inflation. Therefore, we encourage clients to evaluate ideas outside the traditional stock/ bond framework. We think clients should continue to look to capitalize on dislocations in capital markets with private market strategies focused on direct lending, and opportunities created by stress in energy markets. We also like strategies such as global macro hedge funds, which can benefit from divergent trends across global markets and others that are seeking to gain from credit volatility such as multi-sector fixed-income and hedged-credit strategies.

**Summary**

We remain committed to diversified investment programs and believe investors must attempt to capture quickly-evolving opportunities when they present themselves. We believe the market dynamics of these early days of 2016 offer a compelling opportunity to rebalance to targets to capitalize on volatility. Then, overall return/ risk objectives should be re-examined to assess how best to embrace the more positive backdrop for risk assets resulting from the decline in prices. Next, we counsel clients to seek strategies which will provide a return premium for complexity, illiquidity or skill to support return objectives as traditional stocks and bonds are unlikely to generate required results by themselves. Finally, we remind investors of the advantage a long-term time horizon can provide to liquidity providers in difficult markets. As always, we stand ready to provide proactive advice to our investors through this challenging investment environment.





255 STATE STREET, BOSTON, MA 02109 | TEL: 617.374.1300 | FAX: 617.374.1313 | www.nepc.com

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