THE DISEASE OF DOUBT

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Doubt can be a pesky thing. Once infected with it, it is hard to shake off. It makes you second guess what you thought you were sure of. It's contagious too. And there's no flu shot for it.

In investing, doubt takes hold whenever a portfolio position has not played out as expected. For NEPC and our clients, the last few years have naturally allowed some doubt to creep in. After watching US equities repeatedly outshine global markets, and witnessing the losses racked up by emerging markets and real assets, it is intuitive for investors to question their allocation and philosophy.

At NEPC, we have counseled our clients to embrace approaches that depart from average allocations. These range from a balanced structure with lower allocations to traditional long-only equity (generally globalized), a belief in emerging markets, exposure to real assets for long-term inflation protection, and unconstrained strategies.

This collective approach strongly outperformed ahead of the financial crisis and during the early years of recovery afterward. Yet, over the last few years, it has fallen short. Central bank policy shifted investors out on the risk curve, leading to outperformance in higher risk assets (equities) and assets domiciled in countries most proactive in monetary stimulation (United States). Concentration, not diversification, has been more favorable. Emerging markets have disappointed, unconstrained strategies have posted lackluster results, and inflation remains subdued. Faced with these disappointments, it is natural for investors to cast doubt on the validity of these approaches.

We believe the skepticism is appropriate. In fact, we think doubt is helpful. Through questioning, we learn. Through learning, we grow. And through growth, we expand horizons, identify new opportunities and become better investors.

To this end, after much deliberation, we think portfolios are now well-positioned to capitalize on opportunities even better than before. We are excited about long-term opportunities in emerging markets, the potential for distressed opportunities in certain areas of real assets, and the skill of unconstrained strategies to navigate across an increasingly complex investment landscape.

In this paper we briefly highlight each of these concepts, including how our views have evolved over time, and why we believe investors must combat the disease of doubt and confirm their conviction with their portfolio positioning.

Better Balance – A Structural Advantage

We believe a risk-based allocation, including comprehensive definitions of risk and recognition that different assets respond differently to core economic drivers, are critical to constructing long-term portfolios. The fact that we have experienced a market environment that has not validated exposure to most assets other than US equities does not diminish our conviction.

While there is a tendency to extrapolate recent performance into the future, periods of significant outperformance weaken the probability of a rally continuing as fundamentals may not keep pace with expectations. These periods—where only a narrow sliver of assets outperform—may disappoint diversified investors. But they also pave the way for future benefits of diversification. To this end, we counsel investors today to maintain, rather than abandon diversification.

We hope investors will employ a framework focused on long-term perspectives, recognizing there will be periods of underperformance and outperformance. Periods of underperformance will occur but long-term superior results are likely over time (Exhibit 1). A more risk-balanced and diversified portfolio using risk parity shows fairly modest annual outperformance, edging out a 60/40 portfolio 55% of the time on a rolling annual basis. Yet, over time, the regular accrual of

THE BENEFITS OF DIVERSIFICATION AND RISK BALANCE ARE EXPECTED TO ACCRUE OVER TIME BUT NOT ALL THE TIME.

more efficient performance piles up, leading to capital accumulation that exceeds the 60/40 model by 1.7 times during the 45-year simulation. We still believe a risk-balanced strategy trumps more concentrated approaches to earn the same or higher returns per unit of risk while withstanding various economic environments.

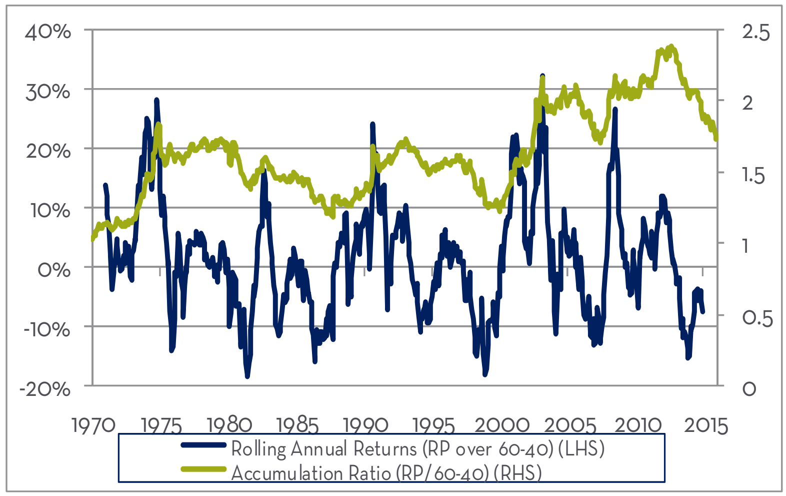
Will Emerging Markets Ever Emerge?

Investors largely have been disappointed despite the promise developing economies hold as the future engine of global economic growth and their strong consumer and sovereign balance sheets. Depreciating currencies, plunging commodity prices and structural shifts have eroded initial post-crisis gains. Recent market results, notably higher commodity prices, have helped some troubled countries, for instance, Brazil and Russia, but a further continuation of a significant energy rally seems unlikely given global supply levels and muted demand. The uncertainty around China's growth also injects doubt. Yet, looking beyond the next year, we expect emerging markets to normalize, with potential currency appreciation and equity returns that reflect stable, higher-quality growth.

While recent currency depreciation has been painful for investors, lower currency values set the stage for improved competitiveness in manufacturing and exports. Emerging currencies, have moved from modestly overvalued to undervalued over the last four years. Undervalued currencies provide a potential double tailwind: unhedged investors may benefit directly through appreciation and indirectly through better economic growth dynamics, which may lead to renewed capital inflows.

Currency appreciation can be helpful but we expect core economic building blocks to drive asset class returns over the long-term. All asset class returns will be driven by income and change in price. For equities owners, your income is dividend yield. Change in price will occur due to earnings growth and changes in valuation. For emerging equities, recent performance has been driven by earnings contraction. Yet this compression sets a strong foundation for forward returns. In Exhibit 2, we compare forward five year performance with trailing fiver year earnings growth. Historical periods of earnings contraction have set the stage for future earnings growth and thus strong returns. Our expected return for EM equities is 9.50% based on building blocks of 3% dividend yield and 6.5% earnings growth. This easily trumps total return expectations for US equity returns of just 6%. While patience is required and periods of volatility is expected, we would expect future earnings growth to be a primary driver of strong long-term returns.

Exhibit 1: Risk Parity vs. Global 60-40



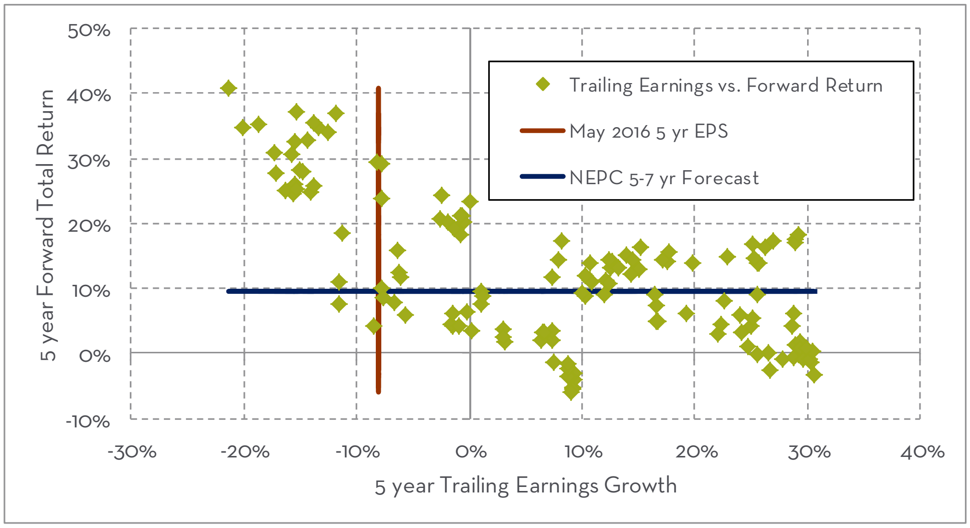
Source: Bloomberg

Do Real Assets Still Have a Role in Portfolios?

Investors facing the horizon management conundrum in emerging markets—structurally beneficial in the long-term but challenging in the short-term—will detect a similar theme in real assets. With high commodity production, tepid global growth, and spending constrained by debt levels, deflationary pressures have recently outweighed inflationary concerns.

That said, inflation can rear its head with a change in monetary policy, amid a strong spurt of global growth, or unforeseen commodity supply shocks. While these scenarios may seem unlikely in the near term, we cannot rule them out. In most cas-

Exhibit 2: Emerging Equities: Trailing Earnings vs. Forward Return



Source: Bloomberg

energy given falling prices; and the second order effect of relative increases in energy flowing through to non-energy sectors. While inflation pressures may remain subdued, some portfolio protection from inflation, either through TIPS, which would benefit directly from changes in CPI, or broader inflation hedging exposure remain a critical part of managing risk.

es, a portfolio of growth-centric assets (even if balanced with nominal bonds) would suffer meaningfully if inflation appeared.

The critical strategic decision for inflation protection is whether program objectives have an inflationary component. If they do, exposure to real assets should be considered a strategic imperative, even when suffering through losses.

Implementation considerations are critical. Given the low-rate environment, and continued negative commodity roll yield, we are concerned about dedicated long-only commodity futures exposure. There may be further upside to commodity prices given the depth of the drawdown, but we do not expect an uptick in spot prices to meaningfully offset the drag of rolling futures contracts. Instead, we expect there will be opportunities for patient investors to provide capital to parts of the commodity market, particularly energy, experiencing low prices. These opportunities will likely be best accessed in private vehicles with long lock-ups. We believe it is appropriate for managers to allow distress to play out and then benefit from providing capital and facilitating recoveries for quality businesses.

In particular, we see some specter of higher inflation emerging in the near term based on the calculus of Consumer Price Inflation. Over the second half of 2014 and in 2015, energy dragged down rolling 12-month CPI by 1.0%-1.5% each month. Inflation will likely calculate higher for several reasons: the base effect, that is, current and future energy prices will be compared to a much lower number as one year ago sits fully in the energy downturn; a smaller net contribution from

Will Unconstrained Approaches Deliver on Their Promise?

A core investment belief at NEPC is: When you identify managers with skill, grant them appropriate flexibility to implement their approach to generate the highest information ratio they can deliver. That conviction led us to investment strategies not constrained by traditional benchmarks or style boxes. These include global asset allocation, unconstrained fixed income and, more broadly defined, even hedge funds with their flexibility to go long or short or employ leverage. Generally, these approaches have delivered relatively disappointing results over the last several years.

This is because many of these strategies are valuation oriented. A valuation-based approach can be a sound investment philosophy capable of delivering excess returns over time. It can require a long-term horizon as value-oriented assets can become even more attractive as they fall in price. Tactical trading with a value or mean reversion foundation has not worked recently as asset classes exhibiting value characteristics generally fell further (developed non-US equities, emerging markets equity/ debt/ currencies, and energy-related assets). While still early, it is encouraging to see signs of a turnaround in these markets and we expect these types of strategies to benefit.

Another cause of disappointment stems from the structure of these strategies and requires setting appropriate expectations. These strategies are designed to be more diversified than traditional allocations, whether it is a GAA manager relative to a balanced (60/40) allocation or an unconstrained fixed-income strategy relative to the Barclays Aggregate Bond Index. This structural diversification is expected to lead to stronger returns over the long term. Unfortunately, when certain asset classes, like US equities, outperform almost all other categories over a multi-year period, it should be expected that a more diversified strategy will lag.

We believe in strategic exposure to unconstrained strategies to capitalize on manager skill. We are in the early stages of a market environment defined by divergences. Shifting monetary policy should lead to increased volatility and attractive opportunities for skilled GAA and unconstrained managers to exploit. Despite recent challenges, these managers should be well positioned to capture alpha in this shifting policy environment.

What Have We Learned?

We believe it is not only rational to doubt our investment philosophy after a period of underperformance, but also healthy to question it. What would be irrational is to skip the critical next step of evaluating investment positioning through each forward-looking investment thesis, and prematurely reach the conclusion of abandoning positions that didn't work. If the original thesis is still compelling, we must resist the temptation to conform to convention.

At NEPC, we have learned the following through our experiences so far:

- Unconventional and unprecedented monetary policy can have a dominating (if uncertain in the moment) influence on capital markets. In particular, relative monetary conditions can lead to a wide dispersion in capital market outcomes. As we face a continued period of negative rates and reliance on central banks, interpreting future policies and effectiveness across regions will be critical.

- Asset classes can experience extended periods of unexpectedly high correlations to each other. Standard allocation analysis may suggest adding or increasing several asset class allocations on their own merits. Yet, the layering of several of these positions can contain embedded themes that we must recognize, such as the close tie between real asset prices and conditions in emerging markets. A factor-based approach or thematic understanding of the portfolio can be an important lens to aid in understanding portfolio risks.

- While unconstrained strategies operate independently, falling prices make some assets attractive to many different types of unconstrained investors. This reinforcement of views should result in outsized returns for all strategies over time, but the imprecise timing of "buying low" means that it can often result in reinforced losses and overlapping positions across strategies and at the portfolio level. A look-through analysis of all exposures can reveal linkages across a portfolio. Investors need to either accept that aligned views increase short-term risk, or limit their exposure to tactical mandates.

We believe it is a time to recognize and acknowledge doubts we may all have about current positioning. It is a time to reflect on the decisions that led to that positioning, learning and growing as investors through that reflection. But it is not a time for capitulation in the face of doubt. Instead, it is a time for resiliency. We expect investors able to battle through the disease of doubt and maintain or even add to themes like balance, emerging markets, and high conviction tactical strategies are poised to outperform traditional allocations. Could a conventional allocation biased toward US equities continue to shine in the near term? Of course. But over the long-term, we doubt it.

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