Investment Stewardship Guidance

InvestmentPerspectives

MARKET PREVIEW
JANUARY 2014

INTRODUCTION

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

Similar to previous years, we present our annual market preview newsletter. Each year presents new challenges to our clients, and 2014 is no different: We are coming off a banner year for U.S. equities, low interest rates continue to stymie fixed income investors, and while developed market equities enjoyed a strong 2013, emerging market stocks sputtered. In the alternative space, real estate and hedge funds proved accretive to portfolio returns, while growing dry powder in the private equity space is starting to raise a few eyebrows.

Each of the following articles contains insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classes covered. Recognizing that many of our clients may not have time to cover the following 24 pages of material, we offer you the primary conclusions for each asset class heading into 2014:

- U.S. economy: Expected to grow between 2.5 – 3% in 2014. Overall sentiment is positive and more optimistic now more than any other time since the great recession.
- Fixed income: Low rates continue to frustrate investors looking for yield; best sources are high yield and bank loans, which appear relatively attractive as yields are considerably higher than Treasuries and underlying defaults are low.
- U.S. equity: Though several sectors of the market are at or above full valuation, opportunity exists in large-cap and growth stocks. However, expectations should be modest after the massive run in 2013.
- International stocks: Emerging markets present a tremendous buying opportunity, while developed markets need to demonstrate earnings growth to withhold current valuation levels.
- Hedge funds: 2013 was a solid year for most hedge fund strategies and 2014 looks promising for strategies that employ short strategies. Managed futures may also be poised to post a solid year of returns as well. CONT...

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"...the following articles contain insightful analysis and key themes to monitor over the coming year, themes which will underlie the actual performance of the asset classess..."

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- Private equity: Dry powder is up and multiples are growing. Nonetheless, could be a strong year as many exits are expected, which could reward investors and return capital.
- Real estate: Returns will be primarily driven by income growth, as property appreciation has slowed. Returns should be in the 7 – 9% range for the year.
- Infrastructure: The tremendous need for infrastructure investments across the globe coupled with debt-saddled governments presents many opportunities for infrastructure investors. Institutional interest continues to grow, though a stronger U.S. dollar could pose challenges in the short-term.

We hope that this set of articles can assist you and your committees as you plan for 2014. Should you have any questions about any of the content, please feel free to contact any of us here at Marquette. We also have a webinar available on demand via our website if you would like to hear a high level presentation of the topics presented in these articles. Happy New Year!

U.S. ECONOMY:
Optimism Abounds

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

> "While not at the level it should be given the depth of the great recession, economic growth appears poised for its best year since 2005."

Ever since the financial crisis, our economic outlook has ranged from doom and gloom at worst to murky at best. For every reason to be optimistic, there seemed to be an offsetting argument that warranted pessimism. On top of that, discord in Washington – such as last year's near debacle with the fiscal cliff or this year's temporary government shutdown – further clouded the waters when trying to assemble guidance for economic expectations. Volatility and escalating debt levels - particularly in Europe - did not help the cause either.

But this year, things feel different. A bipartisan budget agreement was reached without going down to the 11th hour; there were no further rumblings of another government shutdown. The debt crisis in Europe appears to be receding. Perhaps most telling was the Federal Reserve's ("Fed") announcement in December that it will begin its taper of quantitative easing ("QE") this month, with a modest pullback of $10B in monthly asset purchases. The Fed has long stated that it would maintain an easy monetary policy until economic indicators – unemployment and inflation – approached either of their target levels (6.5% for unemployment, 2.5% for inflation). Given recent data points, the Fed seems warranted in its decision to begin tapering asset purchases, as early estimates for GDP growth during the second half of 2013 are in excess of 3%, and the December unemployment rate was 6.7%. Considering the absolute as well as directional valuable of these critical metrics, the economic outlook appears much brighter than it has the last seven years.

As mentioned above, the Fed is basing its taper decisions – how much and how quickly – on two primary economic variables, unemployment and inflation. Of course, the overarching goal is more formidable economic growth, so the Fed will also closely monitor GDP expansion, too. Looking at how each of these variables will evolve over the course of 2014 helps understand the positive outlook for the U.S. economy shared by many economists; we do so in the following sections.

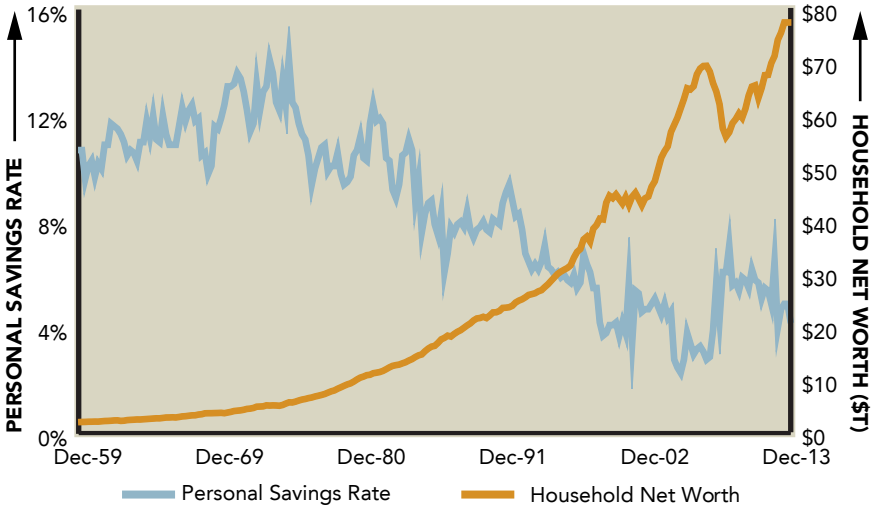
Recall that GDP is driven by four fundamental economic variables: consumption, investment, government spending, and net exports. We see the following trends for each in 2014:

- Consumption: As shown in Exhibit 1, the collective net worth of individuals has risen with the ongoing housing recovery and equity market run. This rise has been accompanied by a drop in the personal savings rate, an indication that consumers are beginning to spend more of their money, rather than save it (also shown in Exhibit 1). Couple these patterns with pent-up demand and more access to credit and it is relatively CONT...

straight forward to conclude that consumption – and by extension GDP – will expand in 2014.

- Investment: While there is not particularly strong evidence of a boom in investment over the last few years, this variable easily has the most upside potential of the four GDP equation constituents. Due to sub-par economic growth in past years and a continued lack of confidence, corporations have been content to sit on record high levels of cash instead of re-investing in their operations. However, with confidence starting to bloom, it is not unrealistic to think that companies may begin to update and/or expand their infrastructure in the near future.

Exhibit 1: Personal Wealth Up, Savings Down



Source: St. Louis Fed

- Government spending: Although the recent budget agreement removes some of the most severe reductions to spending, other cuts are still set to take hold for 2014, which ultimately limits the positive impact from federal government spending. Fortunately, spending by state and local governments appears to be on the mend, enough so that any drag stemming from cuts in federal spending are likely to be more than offset by spending from state and local governments. Overall, total government spending (aggregated across all levels) will likely be a small positive for GDP.

- Net exports: 2013 featured a strengthening dollar relative to other currencies, and the expectation is for this trend to continue in 2014. A stronger dollar combined with faster growth in the U.S. suggests that imports will rise more than exports, thus creating a larger trade deficit and drag on GDP. One potential offset to this drag is a reduction in oil imports as North America becomes more adept at extracting oil and natural gas from shale. While it will not completely reverse the negative direction of net exports on GDP, it is a meaningful contribution to the equation.

In total, we think these projections amount to a 2014 GDP growth between 2.5 – 3%, with a potential surprise to the upside (as opposed to downside). While not at the level it should be given the depth of the great recession, economic growth appears poised for its best year since 2005.

Moving onto the first of the Fed's explicit targets, unemployment, we find more of a juxtaposition than the headline unemployment rate would suggest. At first glance, December's unemployment figure of 6.7% is extremely encouraging and awfully close to the Fed's explicitly stated target of 6.5%. Peeling back the layers of the onion, though, reveals that the recent improvement in the unemployment rate is more of a "denominator effect" than that of truly remarkable job growth. Although the average number of new jobs created over the last year has averaged close to 200,000 (a figure widely accepted as meaningful progress for the unemployment challenge), in December only 74,000 net new jobs were created (see Exhibit 2 next page).

Instead, the driving force behind the apparent drop in unemployment continues to be the fall in participation rates, shown in Exhibit 3 (next page). There is no denying that the labor market has improved, but our hypothesis is that as the labor market shows further signs of improvement, more job seekers will return to the marketplace, CONT...

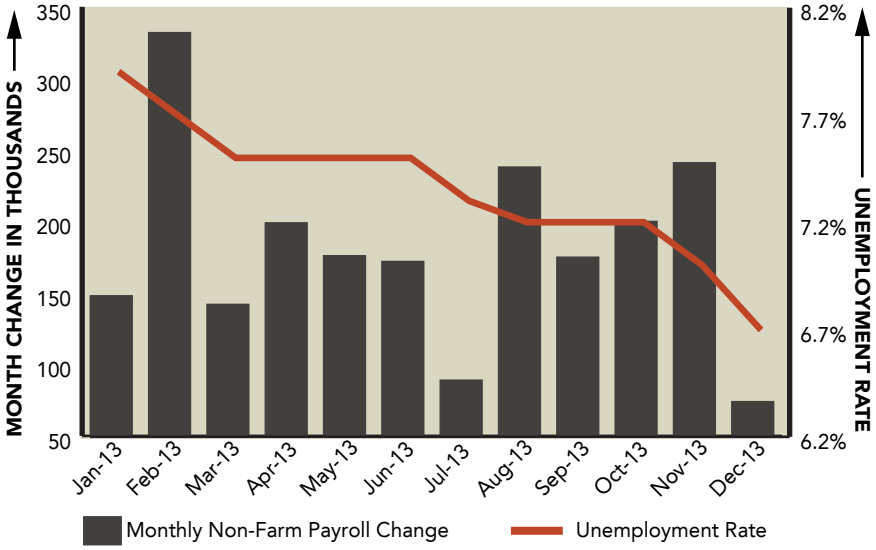
thus increasing the labor force participation rate, and by extension, the denominator of the unemployment rate equation.

Therefore, we would be surprised if the unemployment rate is below 6% by the end of 2014. This is not to say we do not expect more jobs to be created – we do – but we think progress as measured by the high level (and often misleading) headline unemployment rate will be slower than the previous 12 months.

In fact, some prognosticators have speculated that the Fed may continue some level of QE until unemployment drops all the way to 6%, as opposed to its publically stated target of 6.5%, so long as inflation remains in check. By just about any reasonable measure of inflation, it appears than the economy is comfortably (or perhaps too comfortably) below the Fed's tolerance level of 2.5%. A primary driver of low inflation has been stagnant wage growth over the last several years, shown in Exhibit 4. This pattern coupled with the ample slack in the labor force suggests that inflation is not likely to emerge as an economic worry in 2014.

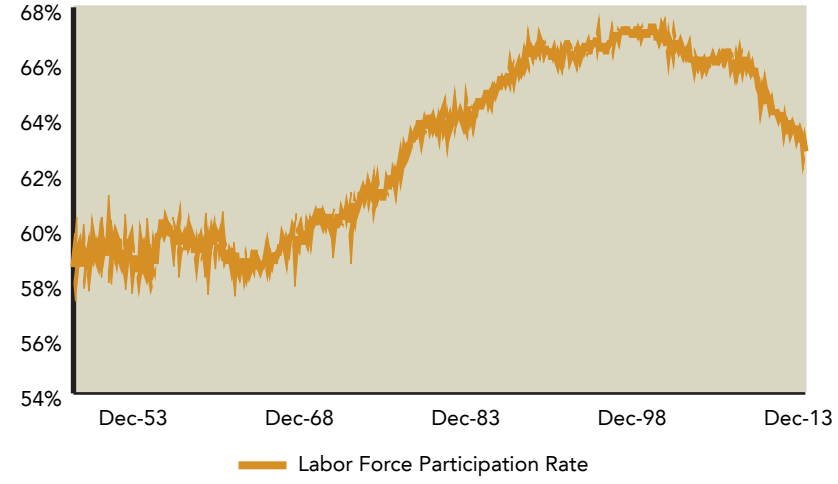
For 2014, we believe that the overall economic outlook circles back to the Federal Reserve: The Fed's decisions about how quickly to taper and ultimately eliminate its quantitative easing program will be the best indicator of economic health. Questions have been raised about the new chair, Janet Yellen, and her philosophy as it relates to QE. It would be surprising if she completely eliminates QE before tangible CONT...

Exhibit 2: Unemployment Rate Falls, But Job Creation Sluggish



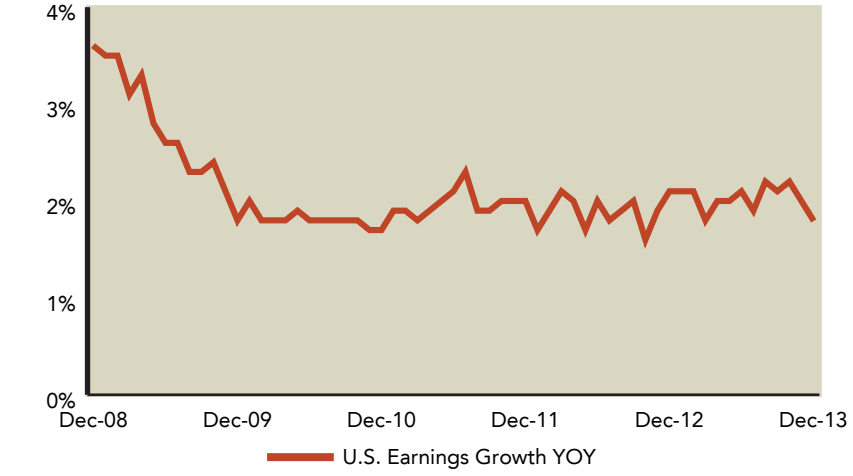
Source: Bureau of Labor Statistics

Exhibit 3: Labor Force Participation Rate Continues to Decline



Source: Bureau of Labor Statistics

Exhibit 4: Stagnant Wage Growth Contributes to Low Inflation Expectations



Source: Saint Louis Federal Reserve

evidence of economic momentum is evident through data readings, as she would rather err on the side of lower rates for longer than raising rates too quickly and putting a halt to forward progress. Overall, it is realistic to expect that QE will be wrapped up before the year closes, with sufficient growth to support the end of the program. The Fed will utilize other measures to maintain low interest rates for at least two more years, though a steepening of the yield curve is not out of the question as many expect longer rates to rise while the Fed maintains low shorter-term rates. While the upward movement in longer rates may put some brakes on the housing recovery, it will not be enough to slow the strongest economic growth since the onset of the great recession.

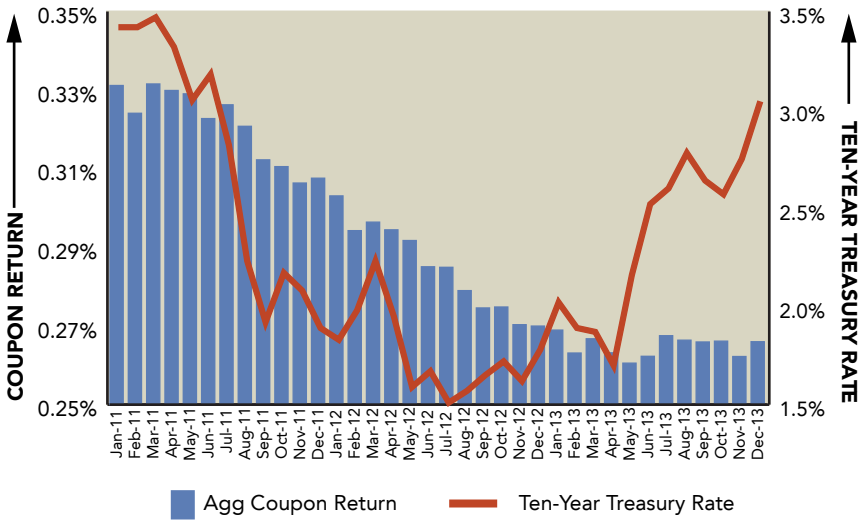
FIXED INCOME:
The Hunt for Yield Continues

DAVID HERNANDEZ, RESEARCH DATA ANALYST

> "Based on these conditions, the most attractive areas continue to be the top performers from 2013, high yield and bank loans..."

For the first time since 1999 and only the third time since index inception, core bonds, as represented by the Barclays Agg index, generated a negative calendar year return (-2.0%). This was driven by a price return of -4.6% and an income return of 2.6%. The Agg's performance is indicative of the unique environment fixed income investors faced in 2013, after three decades of favorable bond results. Markets experienced historically low yields across core bond sectors causing challenges to income seeking portfolios. Long term interest rates finally began moving up after a thirty year period of declines, causing appreciation losses to traditional bonds as prices fell. These market conditions, shown in Exhibit 1, forced investors to look outside of the core sectors to generate income and appreciation. Exhibit 2 (next page) charts the 2013 performance and year end yields of several fixed income asset classes.

Exhibit 1: Agg Coupon Return and Ten-Year Treasury Rate



Source: Barclays, St. Louis Fed

All core sectors with the exception of commercial mortgage backed securities ("CMBS") (0.2%) generated a negative return. In the spread sectors, the two bright spots were high yield and bank loans with performances of 7.4% and 6.1%, respectively.

On December 18th, the Federal Reserve ("Fed") formally announced its plan to begin tapering its asset purchases, with an initial scale back of $10B starting in January. As quantitative easing is wound down over the course of 2014, investors may react by scaling back risk. While the Fed has committed to keeping short term rates low, it has less control over the long end which is likely to continue its rise.[1]

This sets the backdrop for 2014 as investors contend with low yields, rising rates, and the ultimate elimination of quantitative easing. Though rates are expected to rise, the movement will likely be gradual, with the 10-year Treasury yield expected to rise 25 – 50 basis points over the course of 2014. As such, core bonds will be hurt by price depreciation, but such losses will at least be partly offset by higher coupons from underlying bond investments. Ultimately, though, it looks like a fairly flat year for core and intermediate bonds, leaving CONT...

[1] Ironically, short rates actually rose in early January, despite the Fed's stated intentions of keeping short rates at their extreme lows for the foreseeable future

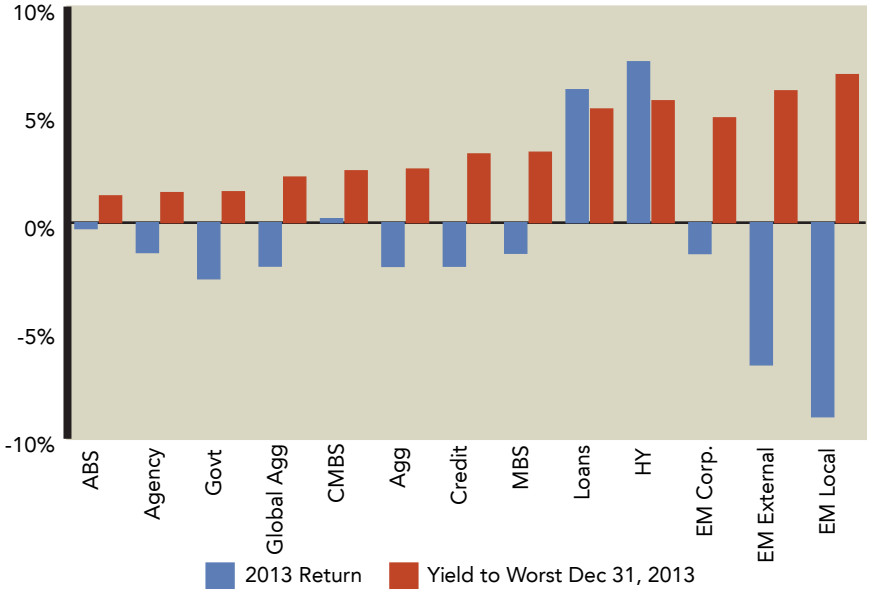
investors with the same question they have faced the last several years: Where's the yield?

Based on these conditions, the most attractive areas continue to be the top performers from 2013, high yield and bank loans, for the following reasons:

- Attractive levels of absolute and relative yield as compared to other fixed income instruments;
- Economic health of issuers and subsequent low default rates;
- Reasons for issuance (refinancing vs. new debt).

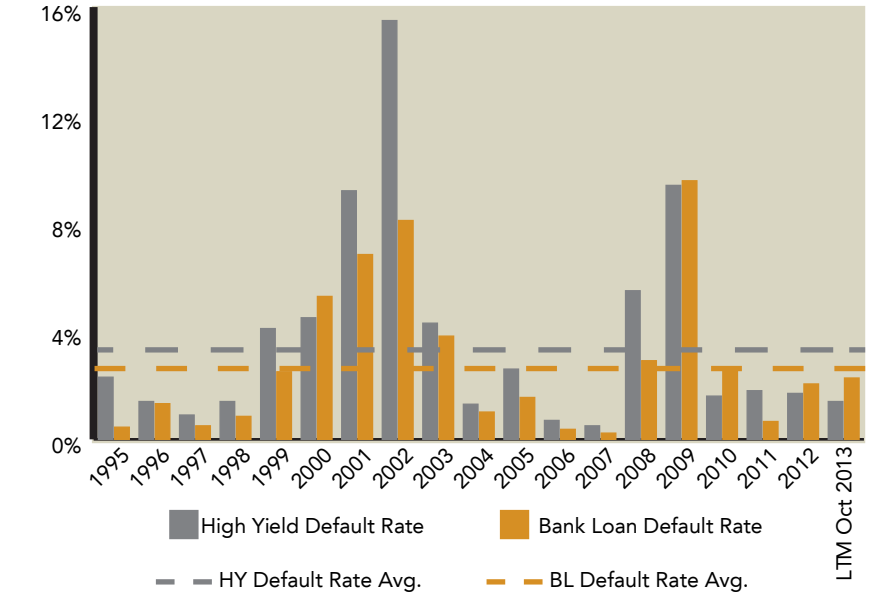
The current economic environment bodes well for these fixed income investments. Corporate balance sheets have remained healthy due to accessibility of low cost borrowing and relatively strong profit margins. With very little upward pressure on labor wages and moderately positive earnings growth estimates, the fiscal health of corporations should remain solid. Thus far these trends have translated into historically low default rates for both high yield bonds and bank loans as represented in Exhibit 3.

Exhibit 2: Core Sectors vs. Spread Sectors Performance and Yield



Source: Bloomberg, JP Morgan, Barclays

Exhibit 3: Annual Default Rates for High Yield and Bank Loans



Source: Credit Suisse

Considering the current default levels, investors are being fairly compensated with an attractive yield in both asset classes relative to other sectors (Exhibit 2). Default rates have been less than 2.5% the last three years for bank loans and less than 2.0% for high yield, both below their long term averages. Given the low default rates, it is not surprising that spreads have retreated, with the spread for high yield dropping from 511bps in December 2012 to 404bps as of November 2013, slightly below the long term median of 469bps (shown in Exhibit 4 next page). Nonetheless, the difference between current spreads and default rates has remained wide, indicating an opportunity for investors in high yield bonds.

Bank loans also remain attractive given their spreads which are represented in Exhibit 5 on the next page. While the 3-year discount margin (the spread over the reference rate) has tightened from 555bps at the end of 2012 to 494bps as of November 2013, it is still above the inception median of 396bps as well as the average of 454bps.

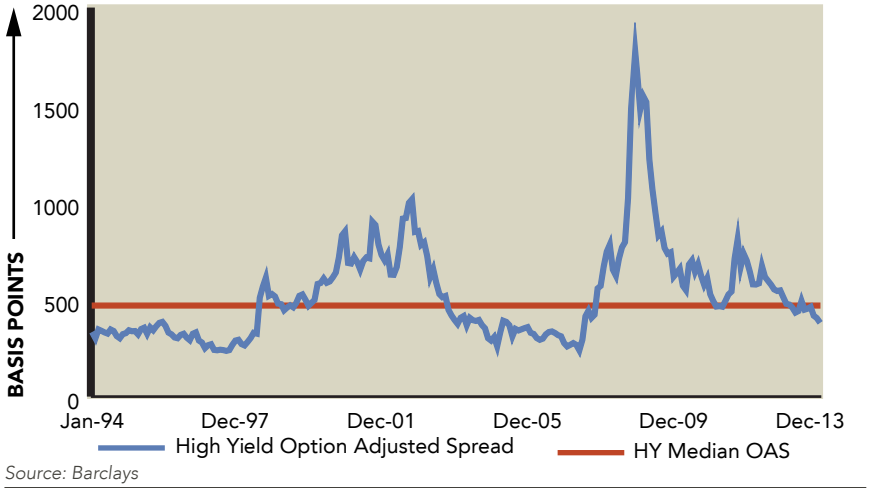
CONT...

With their inherently low interest rate risk, current level of defaults, and attractive spreads, bank loans seem to offer a favorable value. Investors have taken notice and flocked to the asset class. Exhibit 6 shows the fund flows for both high yield and bank loans. Bank loans have seen consistently positive inflows since August of 2012, with a 2013 total of $56.6B through October. High yield flows were more volatile throughout 2013 as investors anticipated and responded to the Fed's spring hints of an earlier than anticipated taper, with June experiencing an outflow of $15.6B.

With increasing market appetite issuance was again strong for both high yield and bank loans in 2013. Investors may see the large number of issuances as a negative signal, fearing corporations are leveraging up and thus taking on more risk. However, the majority of issuance in both high yield and loans has been to refinance or redeem old debt (Exhibits 7 and 8 next page). Companies are taking advantage of low yields to decrease their borrowing costs, an action that is beneficial to investors.

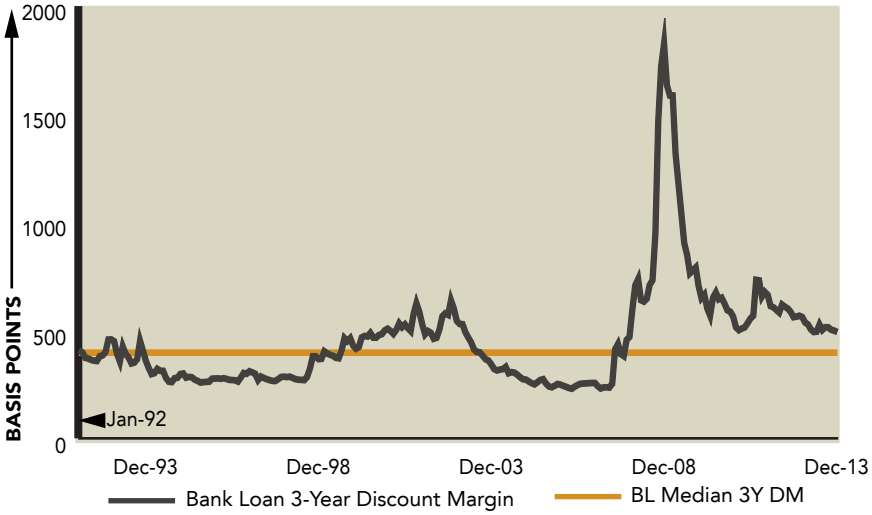
While these asset classes look attractive, there are some yellow caution signs investors should be aware of. For bank loans, the percentage of debts that are covenant lite has steadily ticked upward from 12.8% in January 2011 to 38.8% in November of 2013.[2] Typical covenants include liquidity, profitability, and leverage requirements. This is a CONT...

Exhibit 4: High Yield Option Adjusted Spread and Median



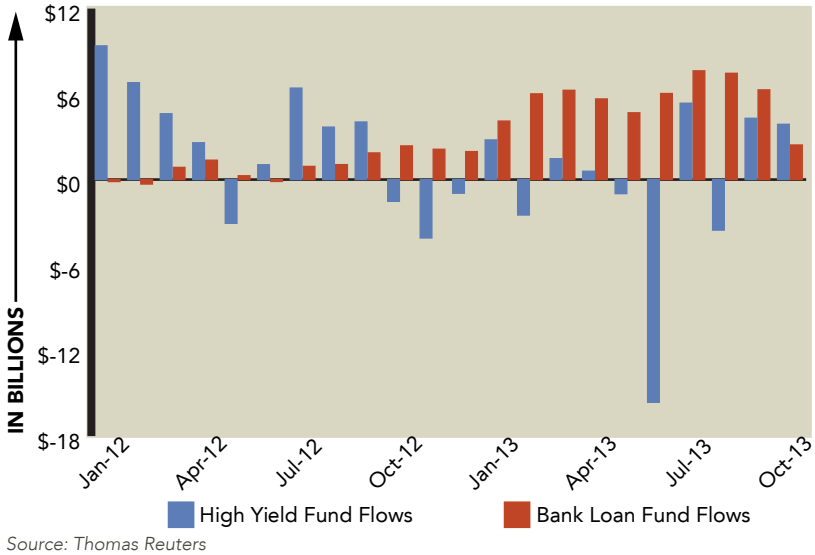
Source: Barclays

Exhibit 5: Bank Loan 3-Year Discount Margin and Median



Source: Credit Suisse

Exhibit 6: Fund of Flows of High Yield and Bank Loans



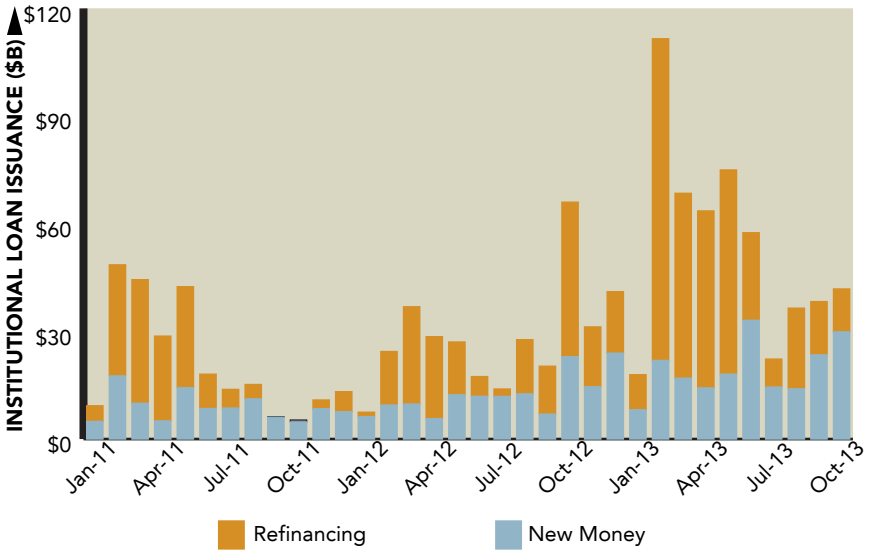
Source: Thomas Reuters

[2] Credit Suisse

noteworthy increase as borrowers have taken advantage of the strong demand by closing less restrictive loans and lenders have been willing to exchange extra yield for less protections. While not a full out red flag, it is something we will be closely monitoring as 2014 unfolds.

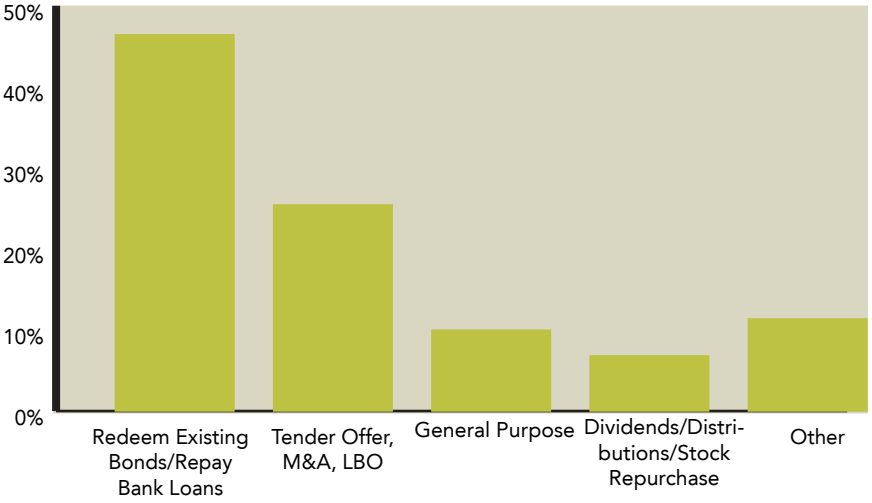
For high yield, the taper of the Fed's asset purchase program poses a threat to performance. In the second quarter of 2013 as the market anticipated a Fed taper, interest rates rose and investors sold off risk assets, including high yield bonds. This led to a loss of 2.6% in the month of June (Exhibit 9 next page) as well as a significant outflow in fund flows (Exhibit 6). High yield would go on to rebound as the central bank postponed the taper, but the tough period may foreshadow future volatility for investors if the taper is accelerated beyond the $10B monthly drawback currently in place. Over the longer term however, the stated Fed policy of maintaining low (short-term) interest rates coupled with moderate economic growth creates favorable conditions to own high yield bonds, as the asset class benefits from an economy that is neither too robust nor too weak.

Exhibit 7: Bank Loan Issuances, Refinancing vs. New Money



Source: Thomas Reuters

Exhibit 8: High Yield Reason for Issuance Jan 13 – Oct 13



Source: Thomas Reuters

Emerging market ("EM") debt also experienced a sell off amid taper talks causing acute declines in the second and third quarters. Since late May 2013 investors pulled $44B[3] out of EM fixed income funds as the market reacted to expected Fed policy and lack luster emerging market growth. While the yields in the asset appear relatively enticing (Exhibit 10 next page), investors should tread with caution. Long term, emerging markets look attractive with their growth potential, favorable demographics, and increases in consumer spending. Unfortunately, high inflation and debt levels in a few EM countries could make investments in a broad EM debt index bumpy, so short term expectations should include a tolerance for above average volatility. If EM debt experiences a sharp sell-off, this asset class could be an intriguing investment option once the dust has settled. Unlike EM equities, the level of yield does not make EM debt quite as attractive as its equity counterpart

CONT...

[3] JP Morgan

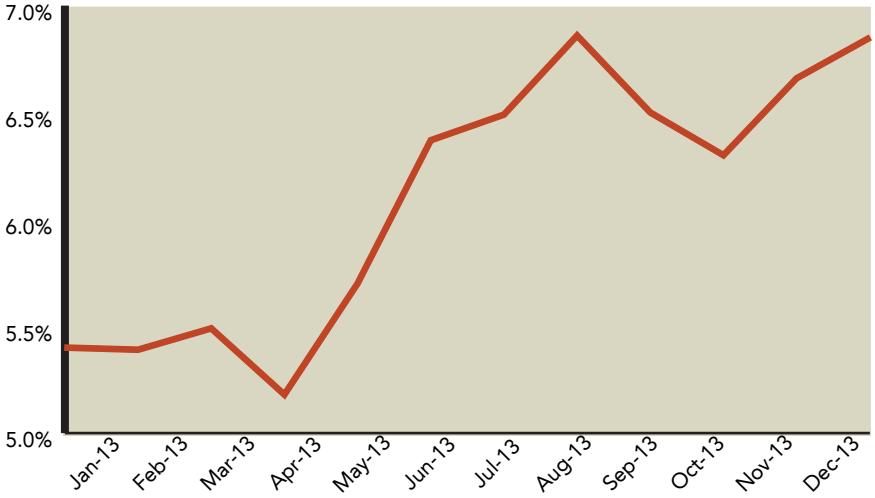
in today's market.

As fixed income investors adjust to recent trends of low yields, future rising rates, and Fed involvement in asset prices, many continue to look at spread sectors like bank loans and high yield. These asset classes performed well in 2013, and conditions remain favorable for solid returns in 2014. Both investments offer substantial yield to investors. Bank loans, a floating rate security, provide lower duration risk to portfolios, an attractive feature as rates rise. High yield stands to benefit from a continuation of moderate economic growth, where the risk of recession is low but the economy is not growing at a pace that would cause the Fed to increase rates in the near term. While there are cautionary factors for these asset classes, we believe they offer value given the current investment landscape and will continue to be accretive to otherwise low yielding fixed income portfolios.

Exhibit 9: High Yield Cumulative Return 2013

Source: Barclays

Exhibit 10: JP Morgan Global Bond Index Emerging Market Global Diversified Month End Yield



Source: JP Morgan

U.S. EQUITY:
Can We Go Up Any Further?

KELLI SCHRADE, CAIA, MANAGING PARTNER

> "...we would encourage clients who have experienced large gains in their domestic equity portoflios to consider rebalancing per their investment policies."

2013: A Banner Year

The U.S. stock market ended 2013 with tremendous gains, as all U.S. equity asset classes returned at least 32%. The best performing asset class was small-cap growth, which gained more than 43%. An improving IPO market and a surge in internet-related stocks propelled small-cap growth, especially during the second half of the year. In a reversal from prior years, growth stocks outperformed their value counterparts. Strong performance in health care, consumer discretionary, technology and industrials - large portions of most growth portfolios - gave growth stocks an edge in 2013.

Similar to 2012, the market did not experience any large or prolonged swings of negative volatility. News of a potential Fed taper in the second quarter and the government shutdown in the third quarter provided CONT...

short-lived down days for equities. At the closing bell on December 31, the S&P 500 reached an all-time high at 1848, and its 2013 performance is the best absolute return since 1997. With another double-digit showing in 2013, the S&P 500 has returned more than 203% since the market low in March 2009.

Exhibit 1: 2013 Performance[1]

	Value	Core	Growth
Large	32.5%	32.4%	33.5%
Mid	33.5%	34.8%	35.7%
Small	34.5%	38.8%	43.3%

Source: JP Morgan

Opportunities: Large Caps and Growth Stocks

Using traditional valuation metrics, several asset classes of the U.S. equity market are overvalued, while others are nearing fair value. Given the stock market's outsized returns in 2013, small value, small core, and mid value are now trading well above historical valuation levels, and appear overvalued. The table below depicts each broad asset classes' current price-to-earnings ratio as a percentage of its 20-year average price-to-earnings ratio.

Based on these metrics, the biggest opportunities in the market lie in growth stocks, which are trading 10-15% cheaper than their historical averages. Large-cap core stocks are also trading below historical valuation levels, 5% less than their 20-year averages.

Exhibit 2: Current P/E Ratio as a Percentage of the 20-Year Avearge

	Value	Core	Growth
Large	101.6%	95.1%	85.7%
Mid	110.5%	106.8%	89.4%
Small	117.3%	112.2%	102.9%

Source: JP Morgan

Potential 2014 Roadblocks: Tapering and Rising Interest Rates

There are two big unknowns facing investors going into 2014, which may impact the meteoric rise of U.S. stocks:

1) The pace at which the Federal Reserve tapers its stimulus program.

2) If and when the Fed will begin raising short-term interest rates.

The Fed's current bond-buying program is unprecedented, with no historical data as a guide to help fully anticipate the potential impact of tapering. Earlier in the year, we saw the U.S stock market react negatively to the Fed even "hinting" at tapering. From May 22nd through June 24th, after Fed Chairman Ben Bernanke first discussed reducing the bond buying program, the S&P 500 fell a precipitous 5%. However, on December 18th, when the Fed formally announced its intention to buy $10B less of bonds and mortgages each month (thus commencing the long-awaited and expected taper), the market was up nearly 2% in reaction to the announcement. Ultimately, the Fed is unlikely to completely eliminate the stimulus program without solid economic conditions, including lower unemployment. A stronger overall economy may lessen investor fears; therefore, the Fed taper may ultimately have little to zero negative long-term effect on the U.S. equity market.

Conversely, rising interest rates – an expected long-term result of eliminating quantitative easing - could have a negative effect on the small cap segment of the U.S. equity market. CONT...

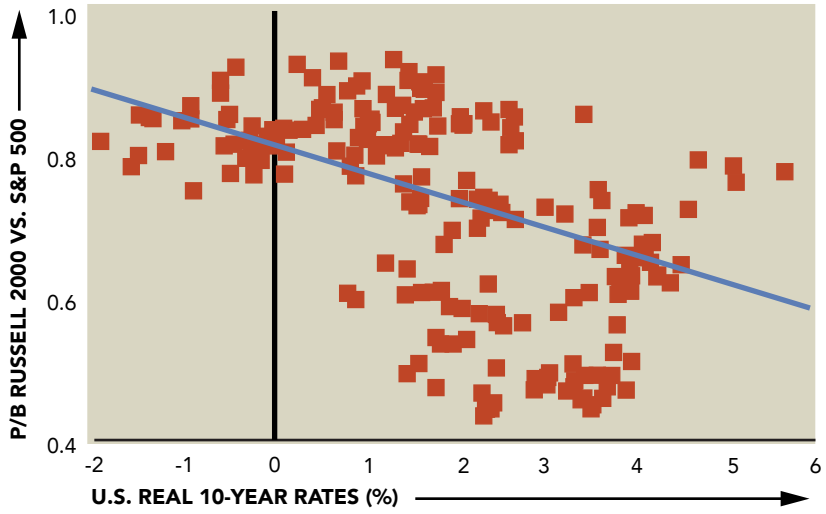
[1] Russell-style indexes with the exception of large core, which is reflected by the S&P 500 index

As shown in Exhibit 3, the price-to-book ratio of the Russell 2000 trades at a premium versus the S&P 500 during accommodative periods when real rates are low and the money supply is plentiful. As we have seen during the current stock market run - especially in 2013 - small cap stocks tend to benefit tremendously in such a low real rate environment. As rates rise, though, the trend reverses and valuations for small caps relative to large caps fall. This historical data suggests that large cap stocks stand poised to outperform small caps when real rates increase.

Interest rates are still low, with the 10-year Treasury hovering around 3.0%. Based on historical data, the equity market should remain largely unaffected by rising interest rates[2] until rates hit 5%.

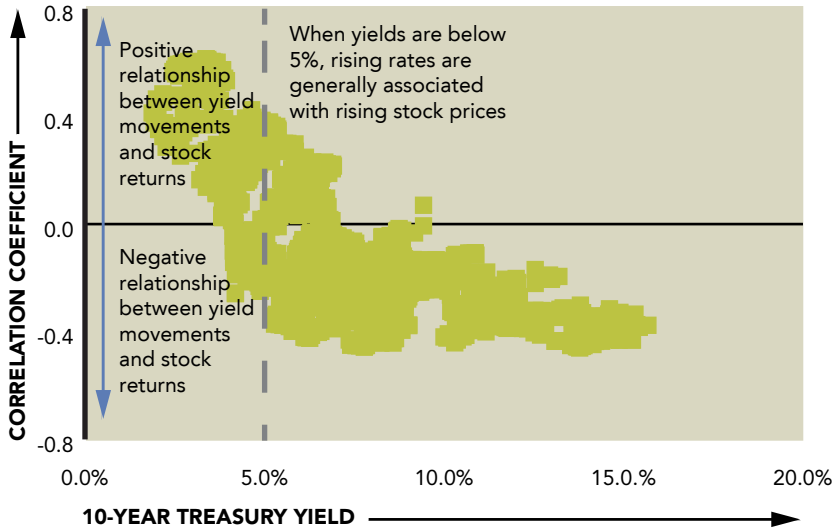
As this Exhibit 4 demonstrates, when yields are below 5%, rising rates are generally associated with rising stock prices. Looking ahead to 2014, it is highly unlikely the 10-year Treasury will hit 5% in the next 12 months, which bodes well for continued positive equity returns.

Exhibit 3: Real Rates and Small Cap Relative Valuation (Jan 1997 to Nov 2013)



Source: Blackrock, Bloomberg

Exhibit 4: Correlations Between Weekly Stock Returns and Interest Rate Movements



Source: JP Morgan, Bloomberg

What Lies Ahead: 2014 Earnings Estimates

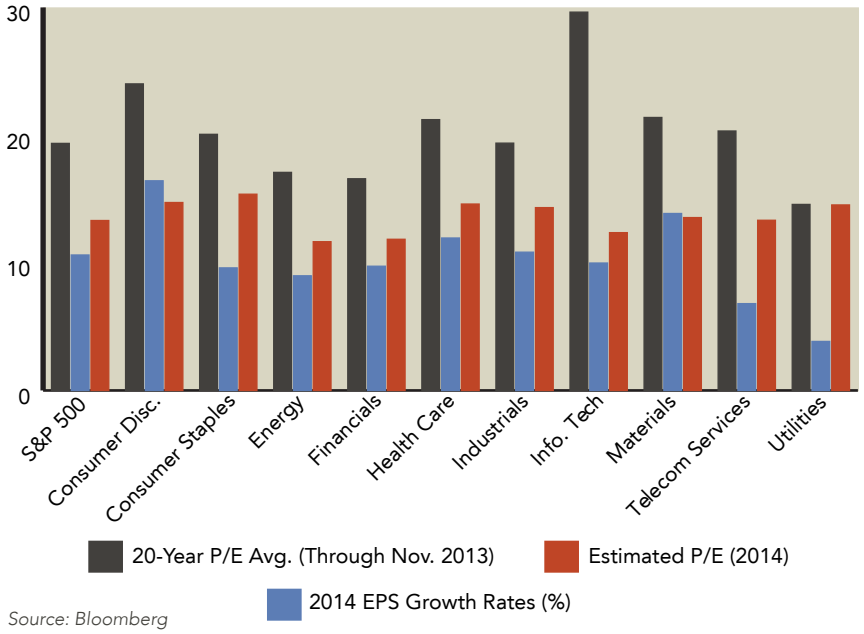
While monetary and fiscal policies play an important role in the U.S. equity market, fundamental factors, particularly earnings and cash flow generation, ultimately drive stocks. Currently, earnings expectations among the S&P 500 sectors reflect a growth rate of about 10% for 2014. Materials and consumer discretionary have the highest expected earnings growth estimates, while utilities have the lowest.

Excluding utilities, each of the S&P 500 sectors have estimated price-to-earnings ratios below that of their 20-year averages. This indicates the U.S. equity market, particularly in large-cap stocks, could continue its positive rise in the year ahead. CONT...

[2] As measured by the 10-year Treasury

Caution is still warranted, though. Given the large run up in stocks this year, tepid economic growth, as well as uncertainty surrounding monetary policy, we would urge moderate expectations for 2014. With current valuation levels, especially in small cap, we do not expect another outsized double-digit gain in the U.S. equity market. While a solid year of single digits returns from the U.S. equity market is quite possible, we would encourage clients who have experienced large gains in their domestic equity portfolios to consider rebalancing per their investment policies.

Exhibit 5: S&P 500/Sector P/E Ratios & 2014 Earnings Per Share (EPS) Growth Estimates



Source: Bloomberg

NON-U.S. EQUITY:
Turning Attention Towards Growth

TOM SALEMY, CFA, CAIA, ASSISTANT VICE PRESIDENT

> "Despite these short-term pressures, we believe emerging markets are an attractive asset class... undervalued on both an absolute and relative basis..."

2013: Developed stocks outpaced emerging market counterparts

2013 was a divergent year for international equity returns, with developed stock indices delivering positive returns while emerging markets struggled. For the second year in a row, non-U.S. developed stock market indices were in positive double-digit territory, with the EAFE index up 23.3%. A primary reason for the strong year was the eurozone emerging from its 18 month recession as GDP growth turned (slightly) positive for the region. Additional good news out of the eurozone included the smaller number of bailouts (the only one was for Cyprus) as well as the significant progress shown by peripheral European countries with respect to their budget and fiscal imbalances. Further tailwinds for international developed markets came from the aggressive monetary policy enacted in Japan – dubbed "Abenomics" – that propelled the Japanese stock market to significant gains.

Unfortunately, the story for emerging markets was vastly different in 2013, as slow growth and high inflation plagued the majority of emerging market countries, with the MSCI EM index returning -2.3%. Though slow growth was troublesome for many emerging market countries, the most problematic was that of China, whose GDP growth rate has fell from 9.5% in 2011 to approximately 7.5%. Perhaps more troubling, the People's Bank of China stated that it had no plans to stimulate the economy, thus creating a more bearish growth scenario for China in the coming years. A slowing China translates to lower demand for natural resources and additional exports from other emerging market countries, further weighing on future return prospects. Outside of slowing Chinese growth, 2013 saw inflation touch 9% in India, 7% in South Africa, while growth in Brazil and Russia dropped below 2%. CONT...

Looking Forward to 2014:

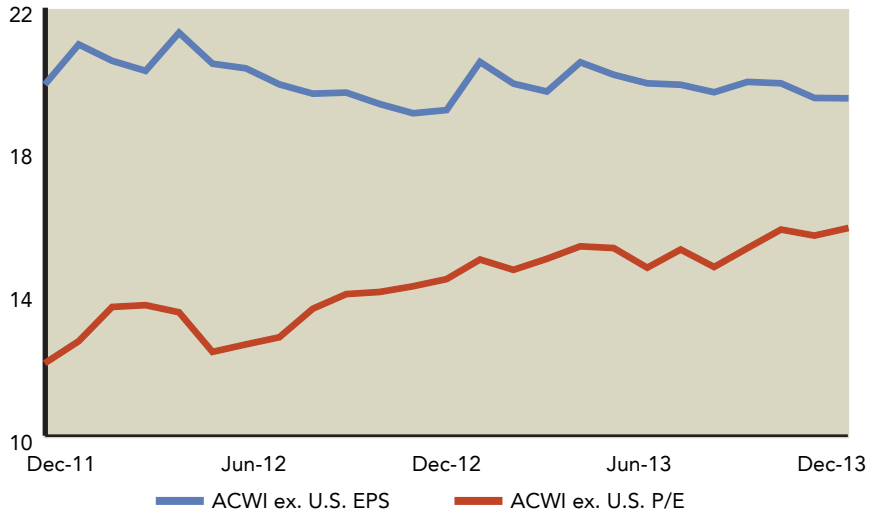
Across much of the international developed world, 2014 will likely be characterized by extremely accommodative monetary policies in order to stimulate growth. While the eurozone crisis - as defined by ongoing volatility and bailouts - appears to have passed, there is still much work to be done. Structural reforms have been implemented across the region which has reduced deficits and overall debt levels. However, growth - which remains dismal within the region - must be addressed. It seems that the most natural way to foster economic growth is through the utilization of easy monetary policy, which should provide ample liquidity and low interest rates.

In regard to Japan, the country is likely to continue its quantitative easing program known as Abenomics through 2014, with the ultimate goal of ending its decade-long battle with deflation while simultaneously spurring growth. At this point, the program has positively impacted the country's stock market (up 27.3% in 2013) while repercussions for the yen (-17.7% YTD return vs. the dollar) have been dire. Directionally, we expect 2014 to be similar to 2013 in terms of ramifications for the stock market and yen, but forecast the absolute level of change to be smaller, since the most radical adjustments to monetary policy have already been enacted.

As we have witnessed over the past few years, the macro environment, specifically quantitative easing, can actively drive investor demand for equities; this has been evident in both the United States and abroad. However, the two-year rally for international developed equity markets has not been accompanied by equivalent growth in company earnings. This has created valuation levels that most investors would consider fair at best. As of year-end, the MSCI ACWI ex U.S. index, the EAFE index, and the EM index featured price-to earnings ("P/E") ratios of 15.8, 17.1, and 12.1, respectively.

Ultimately, though, international equity returns should be driven primarily by company earnings. With both market valuations and company margins at high levels, many believe that earnings growth will be the primary engine that drives future returns in the international equity space. Regrettably, a closer look at earnings growth of international equities reveals a potentially significant headwind for returns in 2014, as shown below in Exhibit 1. While valuation levels have increased, international company earnings have remained stagnant over the past two years. For example, the ACWI ex U.S. companies' earnings per share[1] ("EPS") on 12/31/2012 was 19.1, while one year later on 12/31/2013 the EPS had increased to 19.46, a 1.7 percent increase. Over that same time period, the P/E ratio increased 25%. It seems unlikely that international markets – most especially developed countries – will deliver impressive equity marketreturns without earnings growth in 2014.

Exhibit 1: ACWI ex U.S. Company Earnings vs. P/E ratio



Source: Bloomberg

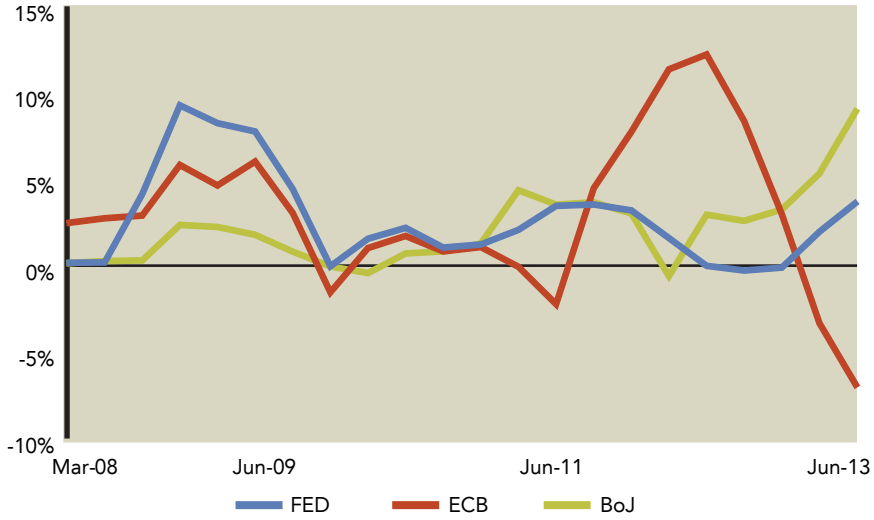
Of course, a fundamental source of earnings growth is underlying economic growth across the globe. While the U.S. and more recently

CONT...

[1] EPS defined as trailing 12 month earnings per share

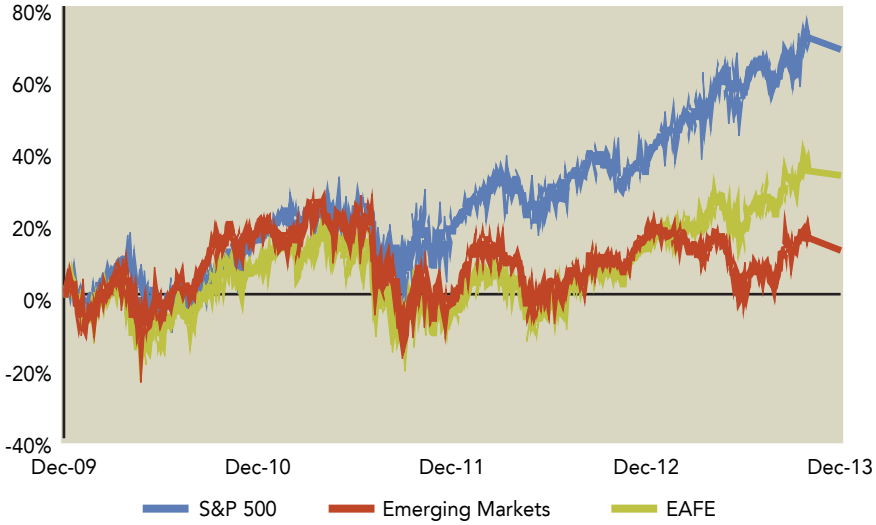
Japan have refined their monetary policies to encourage growth, the European Central Bank ("ECB") has not been as aggressive. Exhibit 2 illustrates this trend, showcasing central bank balance sheet expansion/ contraction as a percentage of GDP for the U.S., Japan, and the eurozone. While both the U.S. and Japan have continued to provide monetary stimulus to their respective economies, the ECB has continued to contract its balance sheet. Going forward, we would expect the ECB to begin some type of monetary stimulus program (in addition to the lowering of its key interest rate in 2013) to stimulate growth and reduce unemployment. The success or lack thereof by the ECB to promote growth in its native countries should be a key driver of international developed stock market returns in 2014.

Exhibit 2: Central Bank Balance Sheets (Expansion/Contraction in % of GDP)



Source: Bloomberg

Exhibit 3: S&P 500 vs. Emerging Markets



Source: Bloomberg

Lastly, emerging market countries as a whole struggled relative to their developed market counterparts in 2013. Exhibit 3 illustrates the dramatic outperformance of the S&P 500 compared to the MSCI EM index. Since the beginning of 2010, the S&P 500 has returned a cumulative 71%, while the EM index has returned just 15.7%, a 56% disparity.

In 2014, look for relative outperformance from emerging markets compared to developed markets. Emerging markets are favorable from both an absolute and relative basis. Currently, the MSCI index has a P/E ratio of 12.2 vs. 16.9 for the S&P 500 which equates to a 38% discount. Historically, emerging markets trade at a 20% discount to the S&P 500. Rather than a broad-based recovery, outperformance is likely to be driven by financially healthier countries and companies. Consequently, we expect performance across managers and strategies to demonstrate significant divergence, therefore reinforcing the importance of manager selection and due diligence in this space.

Conclusion

Emerging markets will continue to face short-term headwinds, especially with the Fed taper set to begin in January. Despite these short-term pressures, though, we believe emerging markets are an attractive asset class. They are undervalued on both an absolute and relative basis and should regain some of the CONT...

underperformance witnessed over the past few years as growth resumes and inflation subsides.

Overall, the international landscape appears to be on much more stable footing than just a year ago. Specifically, many of the peripheral eurozone countries have made solid progress reducing their deficits and fiscal imbalances. However, growth or lack thereof still remains the region's foremost issue. To combat the slow growth, we expect the ECB to pursue an easier monetary policy and expand its balance sheet, similar to what the U.S. and Japan have done in recent years. The Bank of Japan will likely continue its quantitative easing program for the foreseeable future until there are clear signs of growth and inflation within the Japanese economy. While this ongoing monetary stimulus will continue to put downward pressure on the Yen, it should also be accretive to the Japanese stock market.

In terms of expected returns, it is unrealistic to expect developed markets to deliver a third consecutive year of 15+% returns, though a strong single digit return figure is not out of the question. Although issues do remain for developed countries – most especially generating more impressive economic growth and subsequent earnings growth – there seems to be sufficient commitment and supply of stimulus across the representative regions to drive positive returns. For emerging markets, the long-term reasons for making an allocation are still present, and coupled with current valuation levels, offer compelling value and opportunity which should ultimately translate into investor profits.

HEDGE FUNDS:
Alpha Opportunities On the Short-Side Return in 2014

"...most asset classes seem fairly priced, at best, and expensive at worst..."

NAT KELLOGG, CFA,
ASSOCIATE DIRECTOR OF RESEARCH

For the second time in as many years, hedge funds posted solid returns during 2013. While most hedge fund strategies trailed the broader equity markets, the hedge fund industry handily outperformed all sectors of the fixed income market. The distressed cycle that emanated from the 2008 credit crisis is now mostly played out, but two widely held distressed issues (Lehman Brothers and AMR Corp) posted strong returns in 2013. These positions were widely held and were sizeable issues that helped drive returns for a significant number of funds.

2013 proved to be the year of the activist investor. Companies entered the year with record levels of cash on their balance sheets. As economic and market data gradually improved throughout the year, activist hedge fund managers increasingly pushed for board seats and cajoled firms into more aggressive share buybacks, increased dividend payouts, and spin-offs of non-core businesses. Most of these campaigns proved to be very successful, driving share prices of target companies higher. CONT...

Exhibit 1: The Year of the Activist

United States			Rest of World		
Target Firm	**Date**	**Activist**	**Target Firm**	**Date**	**Activist**
Dupont	Aug 2013	Trian	EADS	Aug 2013	TCI
Apple	Aug 2013	Greenlight/Ichan	Sony	May 2013	Third Point
Microsoft	Jul 2013	ValueAct	Transocean	Jan 2013	Ichan
P&G	Sep 2012	Pershing Square	Danone	Nov 2012	Trian

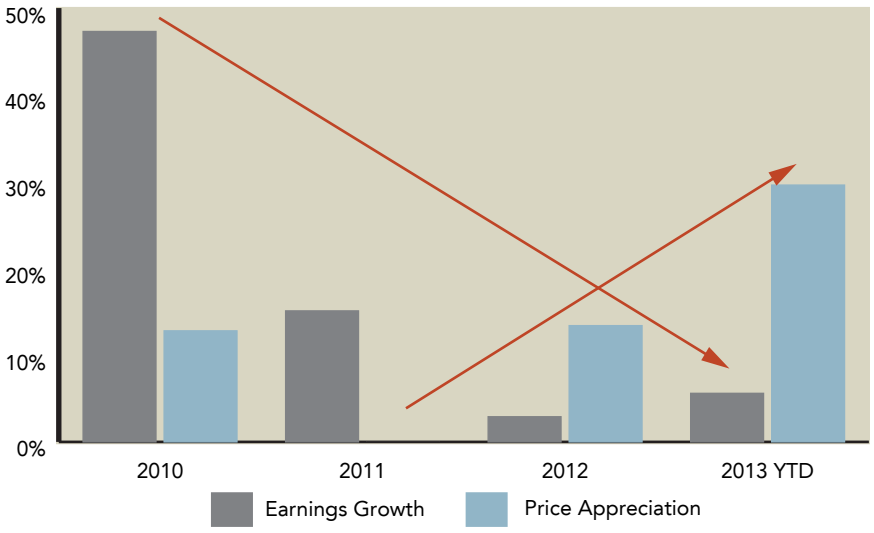
Source: ISS, Citi, Arden

In the credit markets CLOs (collateralized loan obligations) came roaring back in 2013 after a few quiet years following the credit crisis. This was driven by a universal search for yield, and fairly attractive pricing in the bank loan market early in 2013. CLOs are one of the few "structured products" that survived the credit crisis and have become widely used by large credit focused hedge funds.

Turning the page on 2013 and looking ahead to 2014 most asset classes seem fairly priced, at best, and expensive at worst. While this may not be a great environment for generating high nominal returns, hedge funds appear likely to do well compared to other asset classes because of their ability to short. Shorting stocks over the last few years has been extremely difficult as the Federal Reserve's Quantitative Easing program pushed all investors into riskier asset classes (i.e. stocks). However, equity market valuations ended 2013 at their highest point since 2008, and with the Fed taper set to start in 2014, the opportunity to add value on the short side seems better than at any time since the onset of the credit crisis.

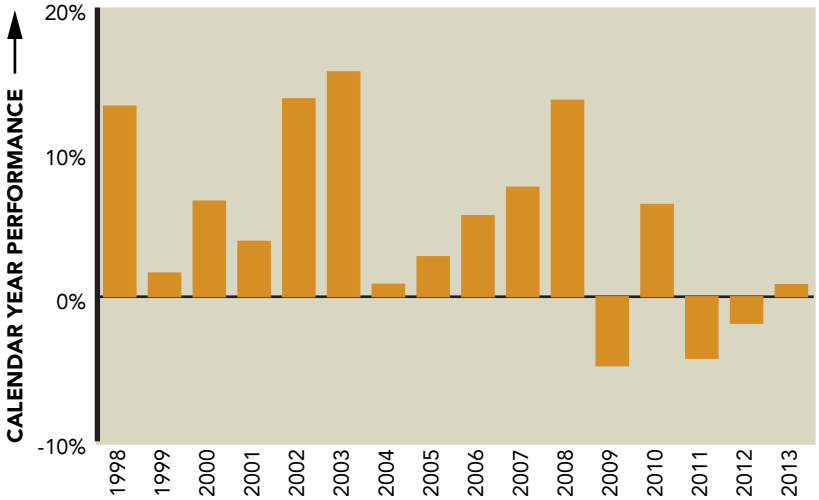
Lastly, for the contrarian investor, managed futures look interesting. Despite strong trends in the equity markets the bumpy ride in commodities, currencies, and interest rates led to poor returns for most trend following strategies. For the second year in a row, managed futures was the worst performing hedge fund strategy. There is no guarantee that 2014 will bring more favorable market conditions for trend following strategies, however, managed futures often have their best years after periods of poor relative performance. Interestingly, these periods of strong performance have also historically tended to be during bumpy years in the equity markets.

Exhibit 2: Equity Markets are Booming but Earnings Growth is Slowing



Source: Standard & Poors

Exhibit 3: Barclays Hedge Top 50 CTA Index ("BTOP 50"); Due for Bounce?



Source: Bloomberg

REAL ESTATE:
Will 2014 Be a "Real" Suprise?

> "...an accretive component to portfolio returns in 2013, and we expect similiar results from the asset class in 2014 as well."

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

Introduction

Real estate continued to exceed performance expectations throughout 2013. Trailing one-year returns through September 30, 2013 were 11.0% for the NCREIF Property Index ("NPI") and 13.0% for the NCREIF Fund Index ("NFI"). Real estate provided a consistent, positive return each and every quarter albeit with a slightly decreasing income distribution. Four factors contributed to the positive returns:

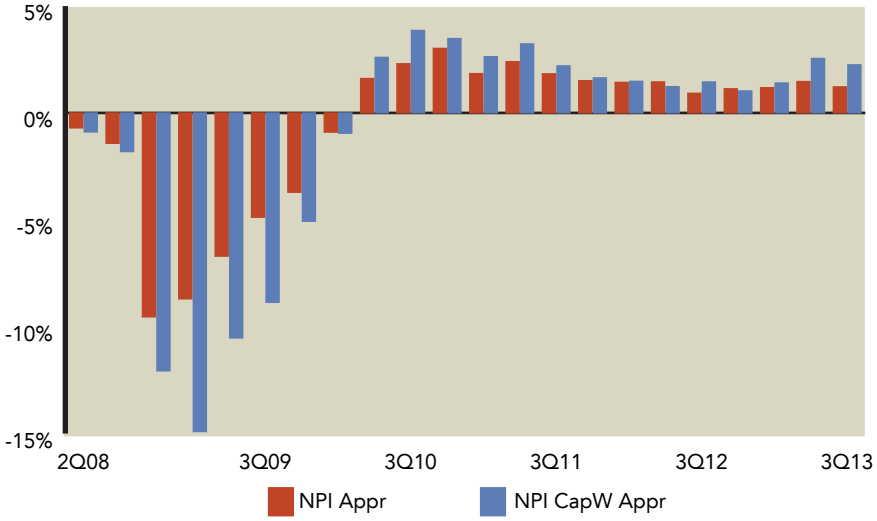
- Increased transaction volumes;
- Institutional demand for the inherent stability of real assets;
- The pricing rebound since the market trough, and;
- Diminished debt expense.

Appraisal values for properties continued to improve, but have begun to level off. As property values have stabilized, the cap rate compression story is naturally coming to an end. Exhibit 1 illustrates how appreciation has slowed, accompanied by a leveling of underlying cap rates (shown in Exhibit 2). Going forward, real estate funds will focus on income growth through improved occupancy, absorption, and expense management. The expectations for 2014 are returns in the normal historic range of 7.0 - 9.0%, with income providing about 5.5% of the total return, and property appreciation fulfilling the balance.

An influential factor of real estate returns is the use of leverage. As investors have come to understand, leverage magnifies returns – it helps in an up-market and hurts in adown-market. The median core fund has a 22% leverage position as of September 30, 2013. With interest

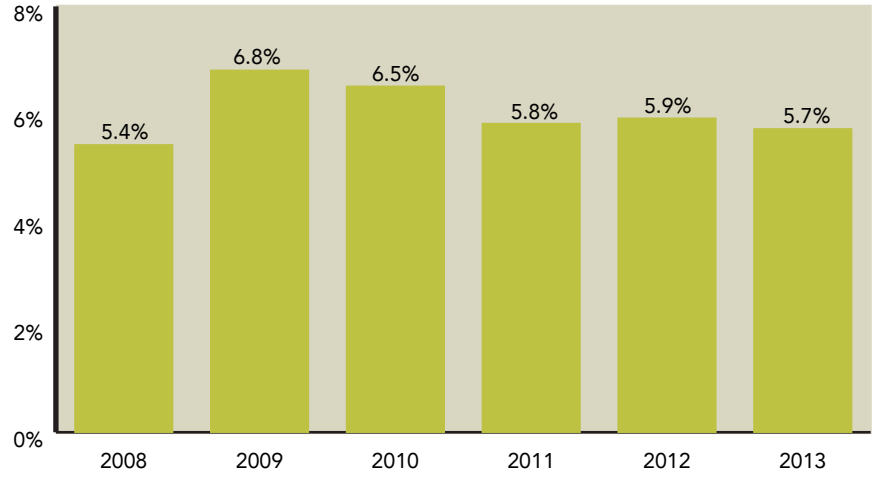
CONT...

Exhibit 1: Capital Appreciation Slows as Cap Rates Flatten



Source: NCREIF

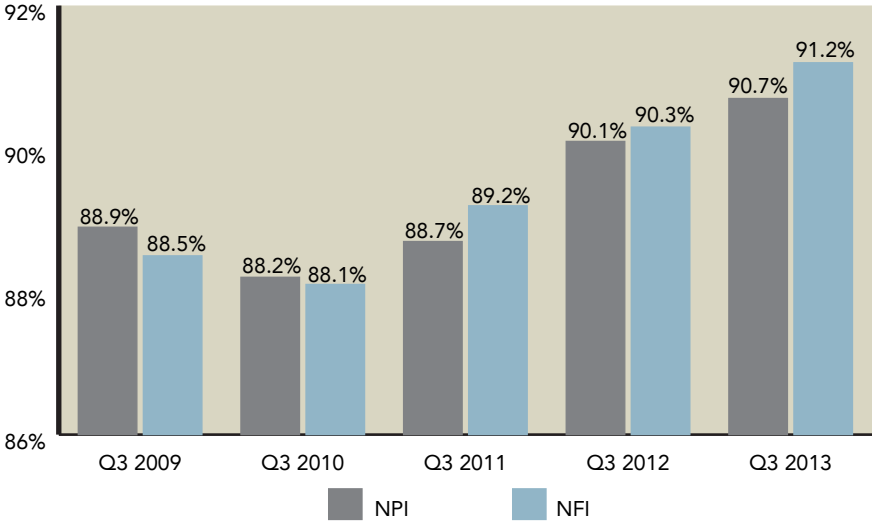
Exhibit 2: Trailing Four Quarter Implied Appraisal Cap Rate



Source: Third Quarter 2013 NCREIF Indices Review

rates/debt expenses expected to remain low until at least mid-2015, in theory, the use of leverage should be accretive to those funds employing leverage. Of course, this will only be possible if occupancy remains strong, and occupancy levels can increase only as fast as job, income, and household growth. The occupancy trend has been improving, as Exhibit 3 demonstrates.

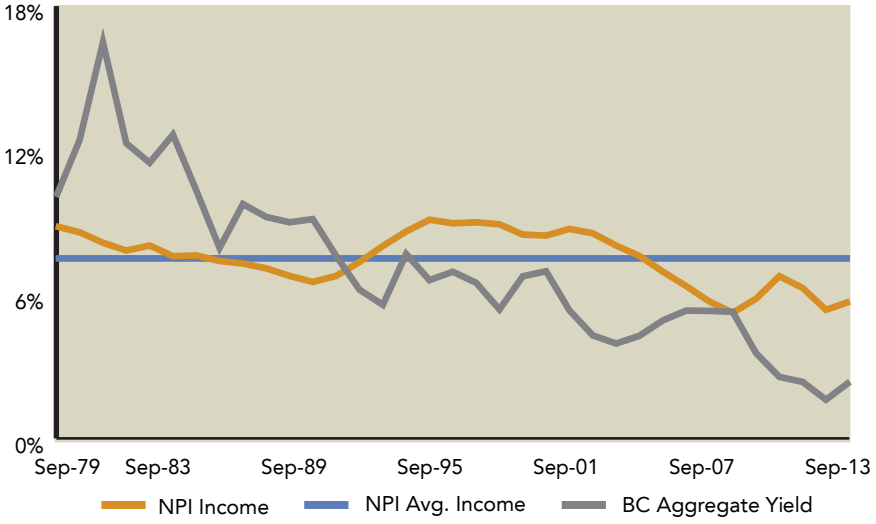
Exhibit 3: NPI and NFI Occupancy Levels



Source: Third Quarter 2013 NCREIF Indices Review

A property's value fluctuates from quarter to quarter or year to year depending on occupancy levels, rents, and maintenance costs. If occupancy remains constant or increases, it makes sense that the value would stay the same or slightly rise. If the occupancy level decreases, the corresponding income level will decrease. This change to the property's cash flows will affect the valuation. Analyzing the quarterly, since-inception (March 1979) data of the NPI, the income return has averaged 7.5% per year, while the appreciation component has averaged 1.8% per year. The consistency of the income stream is the reason we recommend an investment in real estate. It should be noted that although the quarterly income return has decreased over time, it continues to provide a better coupon than traditional fixed income (Exhibit 4).

Exhibit 4: Historic Annual and Average Income Level of the NPI vs. BarCap Aggregate Yield



Source: Encorr and NCREIF

Sectors

Although one can invest in various real estate sectors, below we highlight the established core sectors. Note that not all sectors have rebounded with the same velocity, as property sectors do not perform in lockstep.

- Apartment – new supply remains muted as apartment construction is moving back to 1% of stock (pre-crisis, stock growth averaged 1.5 - 2.0% per year). Supply/demand is in balance for the majority of markets. Move-outs to ownership still low. Rent growth is decelerating, but still strong. Markets with higher barriers to entry provide short-term development and long-term hold opportunities. Core apartment product remains pricey and higher yields have be realized in development.

- Hotel – demand is healthy, but normalizing as demand growth has been tied more to corporate strength (i.e. profits) during the current recovery. Corporate sector demand accounts for nearly 75% of

CONT...

upper-end demand. Positively, leisure travel demand is looking better as housing and wealth factors improve while corporate profit growth moderates.

- Industrial – demand drivers of the housing recovery and promising growth in retail sales, auto sales, and internet commerce are suggestive of increasing absorption of space. Space demand is expected to outpace new supply over the next two years. Valuations are starting to accelerate, and the sector is experiencing the highest transaction levels since 2007. Prime markets are priced with lower cap rates.

- Office – office employment is increasing thus steadying net absorption. Energy and technology markets experiencing the strongest gains with financial services lagging. Rent growth is expected to be slower in this recovery cycle than in prior cycles and broader recovery in office NOI will not occur for twelve to twenty-four months.

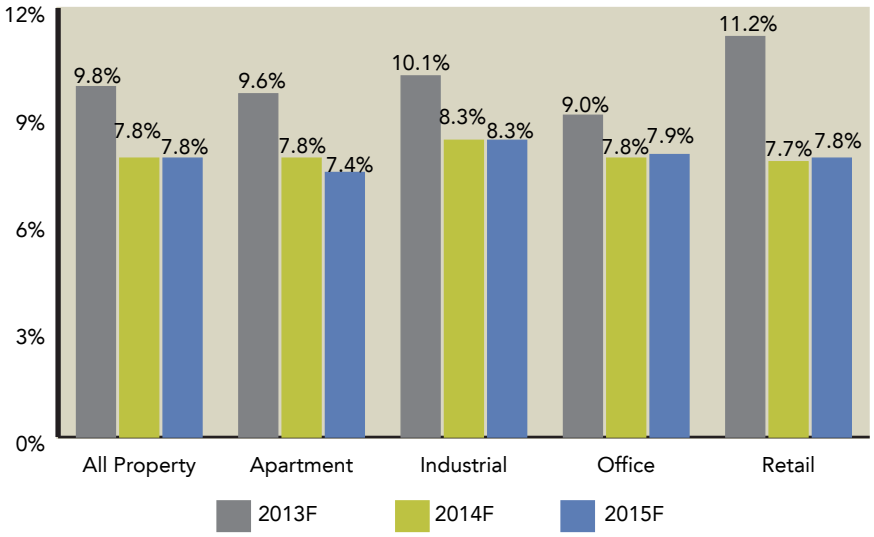
- Retail – store closings are down and openings are up for the first time in years. Vacancies are improving with very limited development. Consumers' spending habits continue to increase at a moderate rate with confidence at its highest levels since early 2008. Mall pricing is expected to head higher, but scope of the recovery should extend to power centers and other retail formats as well.

- Total – in aggregate, real estate is expected to produce healthy normalized returns in 2014. Experts are projecting the following returns: 7.8% overall, 7.8% for apartments, 8.3% for industrial, 7.8% for office, and 7.7% for retail. There is not much dispersion among the sectors. Of note, previous consensus forecasts of late have under-promised and over-delivered on performance; thus projections may be cautiously modest.

Conclusion

Real estate was an accretive component to portfolio returns in 2013, and we expect similar results from the asset class in 2014 as well. With improving occupancies, expense management, absorption, and limited construction starts, income levels should remain steady, if not slightly rise. It seems highly likely that the income level of real estate will exceed that of fixed income alternatives in 2014. With debt financing relatively inexpensive and job growth improving, property appreciation may surprise to the upside as well.

Exhibit 5: Return Forecasts



Source: Pension Real Estate Association

PRIVATE EQUITY:
Is 2014 "The Year of the Exit"?

NAT KELLOGG, CFA,
ASSOCIATE DIRECTOR OF RESEARCH

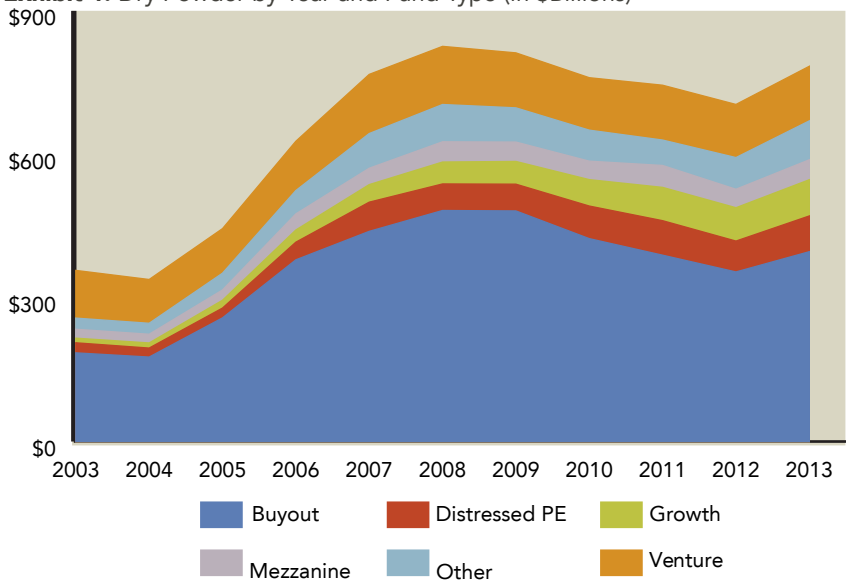
"All of these forces should combine to make 2014 a record year for exits and distributions."

For four straight years after the credit crisis (2009 through 2012) the global private equity industry made steady progress reducing the overhang of dry powder built up from the boom years of 2006

CONT...

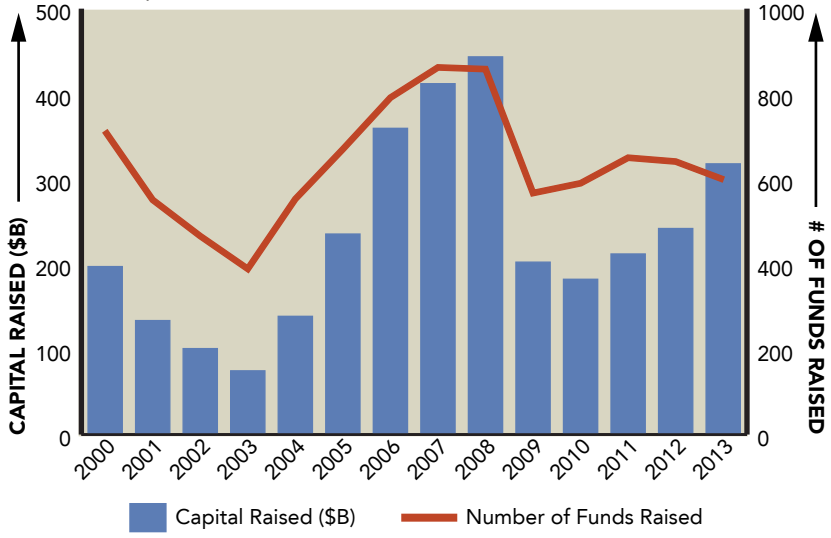
through 2008. Fundraising remained at levels significantly below the pre-crisis highs, private equity funds diligently put money to work buying new portfolio companies, and more capital was invested and returned to limited partners than raised by new funds. This led to a steady normalization of deal activity, exit activity, valuation multiples, and led many investors to develop a constructive view on the prospect for private equity returns. Sadly, these positive trends reversed in 2013. Fundraising reached a new post-crisis high in 2013 (although it admittedly still remains comfortably below the 2008 peak), and relatively little deal activity fueled the first year-over-year increase in global dry powder since 2008. The increase in dry powder and ebullient equity markets, particularly in the United States, are driving multiples higher. Average purchase price multiples in 2013 exceeded 10x EV/EBITDA according to Pitchbook. These are valuation levels that were only briefly exceeded during the peak of the last buyout boom.

Exhibit 1: Dry Powder by Year and Fund Type (in $Billions)



Source: Preqin

Exhibit 2: Capital Raised and Number of Funds Raised



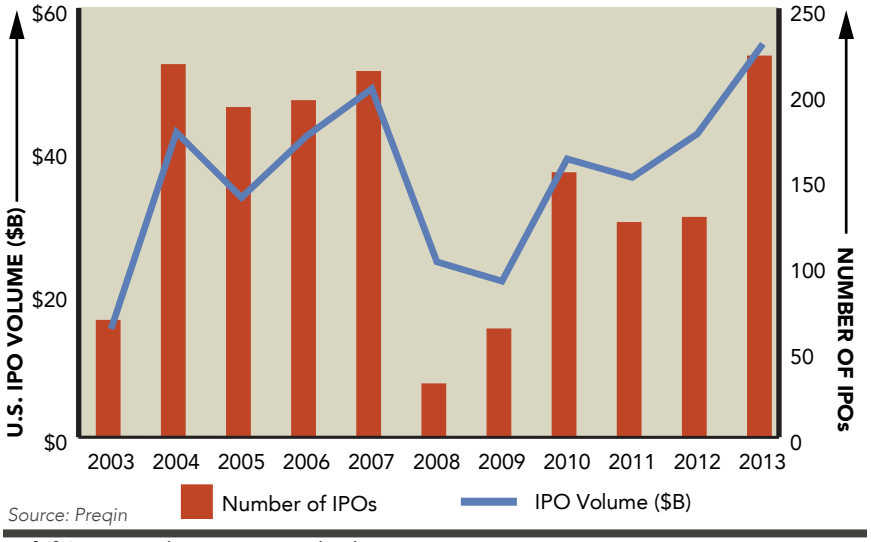
Source: Preqin

Some of the creep in multiples was driven by very accommodative credit markets. The credit markets are wide open, particularly for larger transactions, and financing is cheap given the low interest rate environment. Sponsor backed issues of loans and high yield bonds hit new highs in 2013. Abundant cheap financing lowers a firm's cost of capital and should lead to higher returns for private equity investors. The concern is that with valuation multiples creeping up, the benefits of cheap debt are accruing to sellers of businesses more than the buyers.

Looking ahead we expect 2014 to be the year of the exit. The buyout funds raised from 2005 through 2008 are now through their investment period and solely focused on realizations. Financing is cheap, equity market activity and valuations are back to robust levels, and an improved economic outlook makes positioning portfolio companies for exit significantly easier. All of these forces should combine to make 2014 a record year for exits and distributions. CONT...

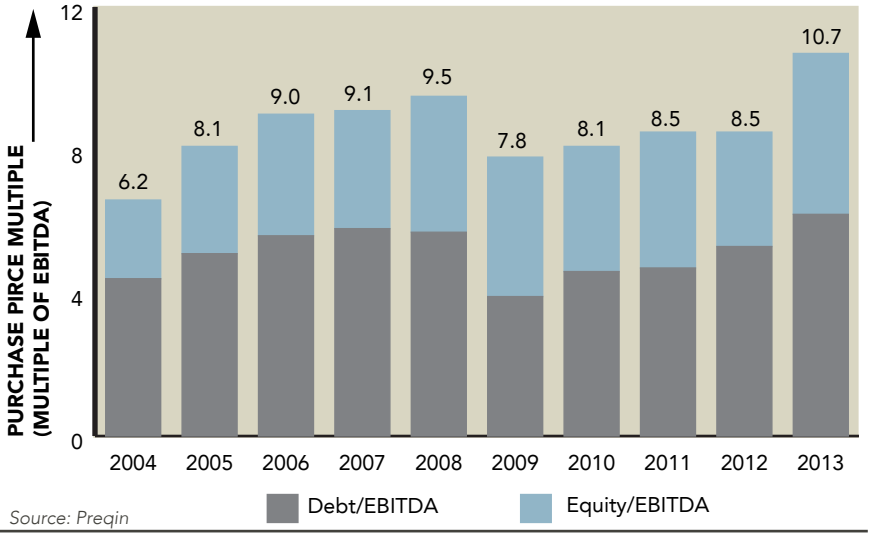
Related to the health of the public equity markets is the significant improvement in the IPO market in 2013. In last year's market preview we highlighted the disappointing performance of a number of high profile venture backed IPOs including Facebook and Zynga. There were no such problems this year as Twitter, the highest profile venture backed IPO of 2013, jumped 72.6% on the first day of trading and subsequently held on to most of those gains. Overall IPO activity looks likely to set new highs in 2014 based on both the number of companies coming to market and the amount of capital being raised. Private equity and venture capital funds will likely be lining up to tap into the IPO market if demand from the public markets remains robust. This is just another tailwind for general partners looking to sell their portfolio companies and will simply add to the amount of realizations in 2014.

Exhibit 3: IPO Market



Source: Preqin

Exhibit 4: Purchase Price Multiples



Source: Preqin

INFRASTRUCTURE:
Opportunities on the Rise

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH

> "...growth in fundraising and global deal activity suggests that momentum is building behind broad acceptance of the asset class..."

Current View

Demand for infrastructure development and maintenance continues as a worldwide theme. With developed economies reeling under debt burdens and unsubstantial GDP growth, private investors are filling in the gaps to fulfill infrastructure financing needs. Data from a Preqin study revealed that 63% of surveyed investors plan to make an infrastructure investment within the next twelve months, primarily in unlisted funds (as opposed to listed funds). It should be noted that last year, only 58% of investors were planning to increase their allocations to infrastructure, thus a slight improvement. However, when evaluating the "maintain" and "decrease" categories, a different picture emerges. Only 27% will maintain a current allocation compared to 40% last year, and 10% will look to decrease exposure to infrastructure compared to 2% last year. Overall, exposure is expected to increase, but not with the same velocity as seen in previous years. CONT...

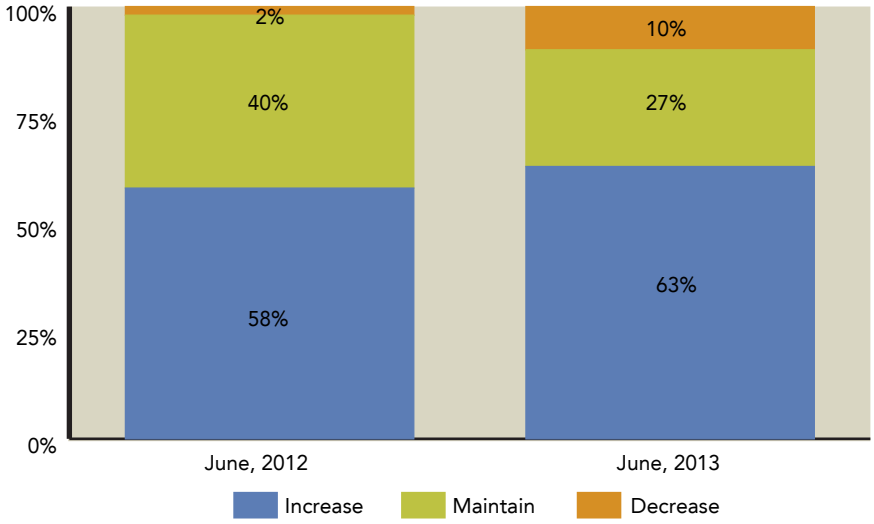
As a result of the growing commitment to infrastructure, large fundraises are occurring. The top five largest funds holding final closes during 2013 are listed in Exhibit 2.

Exhibit 3 demonstrates the health of the fundraising market. Infrastructure funds raised $39.4 billion dollars over the course of 2013. This represents a 35% increase over 2012, and is the strongest year for fundraising since 2008, and the third best year in the history of the asset class.

Exhibit 4 (next page) evaluates where deals have occurred by region. Europe has long been the leader in both infrastructure privatizations and investment, so it is not surprising that the bulk of deals are clustered there. North America has gradually increased its market share. Globally, European and North American deals are increasing at the expense of the rest of the world.

Year-to-date in 2013, energy deals have comprised the majority of deals done at 174 or 43%. This trend is not new as throughout time, energy deals have been the bulk of activity at 35%. In 2013, transportation has been a noteworthy area of activity with 71 deals completed, followed by healthcare at 39, utilities at 54, and education at 33. Exhibit 5 shows this activity.

Exhibit 1: Investor Plans for Future Infrastructure Exposure



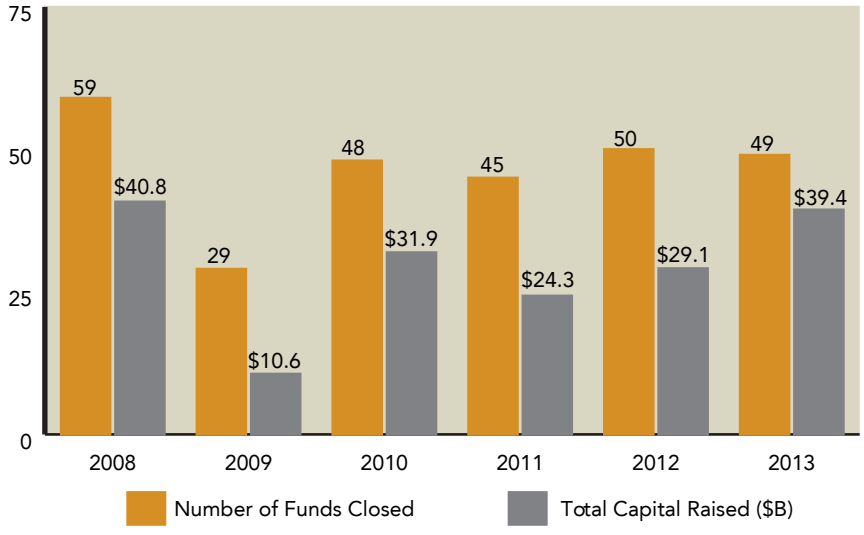
Source: Infrastructure Spotlight, Preqin, September 2013, p. 2

Exhibit 2: Top Five Final Closes 2013

Fund	Size (M)	Fund Focus
Brookfield Infrastructure Fund II	7,000 USD	North America
Macquarie European IV	2,750 EUR	Europe
EQT Infrastructure II	1,925 EUR	Europe, North America
AXA Infrastructure Generation III	1,450 EU	Europe
Urban Construction Fund	10,000 CNY	China

Source: Preqin

Exhibit 3: Total Capital Raised ($B) and Number of Funds Closed



Source: Preqin

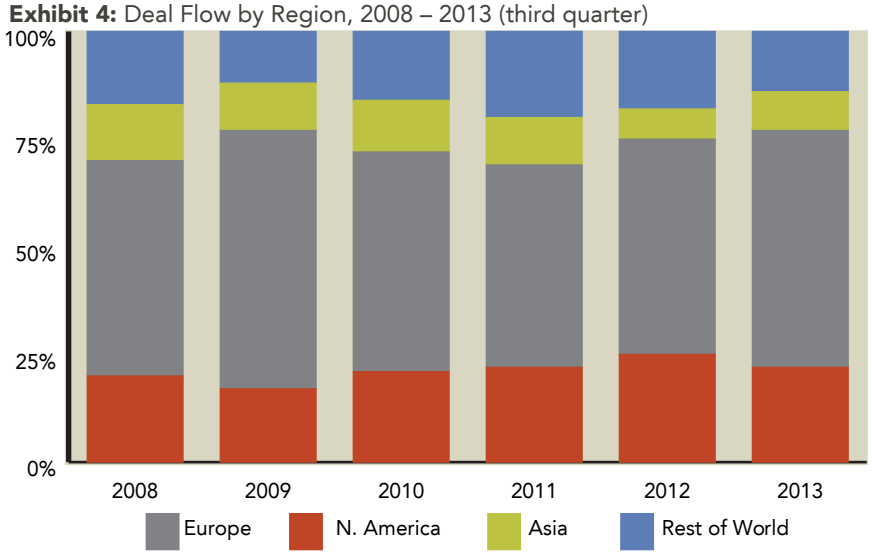
On the next page are examples highlighting the more notable transactions that occurred in 2013:[1] CONT...

[1] Preqin

- American Midstream Partners ("AMP") – In April, ArcLight Partners via its portfolio company, High Point Infrastructure Partners, acquired a 90% stake in AMP for about $90M. AMP is a growth-oriented company engaged in gathering, treating, processing, and transporting natural gas.

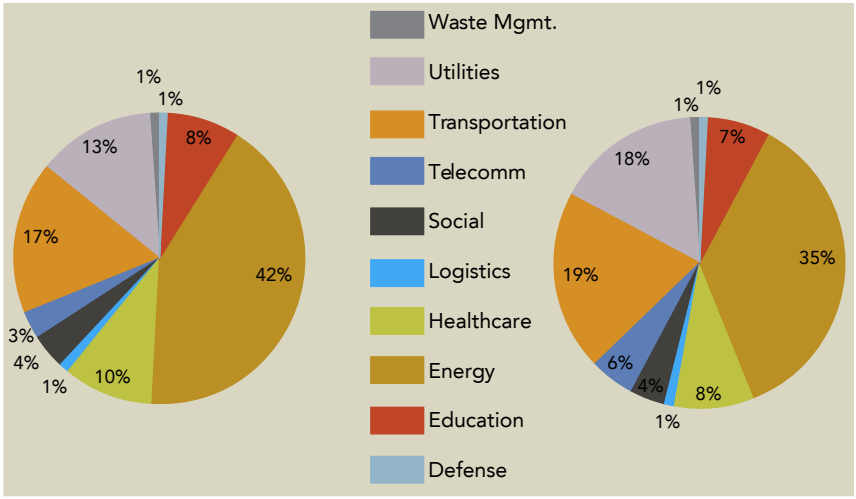
- South Staffordshire Water ("South Staffs") – In May, KKR acquired 100% of South Staffs from Alinda Fund I. South Staffs is a UK-based water company that supplies water to approximately 1.25 million customers and provides specialist technical services of flow monitoring, leak detection, sewer relining, water hygiene, and billing services to government agencies throughout the UK.

Exhibit 4: Deal Flow by Region, 2008 – 2013 (third quarter)



Source: Preqin, Global Infrastructure Trends in 2013 "Mid-Term" Infrastructure Market Review, Sep 2013, p. 10

Exhibit 5: Number of Investments by Industry, 2013 and All Time



Source: Preqin

- Midway Airport – In August, Chicago's Mayor Rahm Emanuel essentially removed the privatization option of Midway Airport infinitum when one of the two bidders dropped out of the race. When Industry Funds Management ("IFM") removed itself from the bidding process, only the consortium of Macquarie and Ferrovial remained. Mayor Emanuel stated the privatization would not move forward with only one bidder.

- Global Tower Partners ("GTP") – in September, GTP, a holding in the Macquarie family of funds, was sold to publicly traded American Tower Corporation for $4.8B. GTP owns and operates cellular towers and sites for wireless communication throughout the United States. The realization of this asset was a great success for Macquarie.

Concerns

Perhaps the most significant risk facing infrastructure investors is currency fluctuation. While currency volatility has always been a risk, 2014 seems especially notable in this regard as most prognosticators are predicting a strengthening of the dollar, which given the international scope of most infrastructure funds, could be a forceful headwind for U.S.-based infrastructure investors. Of course, a stronger dollar means higher interest CONT...

rates, which could also weigh on a fund's ability to meet interest costs for underlying deals in the portfolio. While not a deal-breaker, higher interest costs could slow deal activity as financing becomes more expensive. Funds with more cash to infuse into deals are likely better positioned for success should we see a sudden rise in rates.

Conclusion

Ultimately, despite the risks outlined above, well-positioned purchasers should be able to negotiate better terms or prices for the assets as it is a buyer's market, not a seller's market. For investors, this is certainly good news and helps to paint a more optimistic picture of opportunities in infrastructure, as the previous years have been characterized by fits and starts as it relates to institutional interest. New products and assets will be coming to market, and we may see more asset divestments from funds coming to the end of their investment lives either to the public markets (GTP example above) or a strategic buyer (South Staffs example). Sales of assets by governmental agencies in the United States appear to be at a standstill as acceptance by the public has been stymied due to lack of education, disclosure, and perceived conflicts. The non-deal of the Midway Airport privatization reflects that sentiment well. However, the growth in fundraising and global deal activity suggests that momentum is building behind broad acceptance of the asset class by pension funds, endowments, and foundations. Such a trend will bolster the asset class as these groups look to infrastructure for diversification, inflation hedging, income, stability, and long-term appreciation.

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