

Perspectives

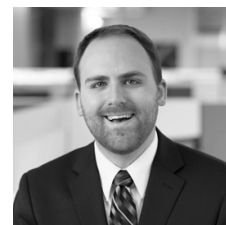
JULY
2018

A “Halftime” Review of Asset Allocation for 2018

As of June 30th, the Russell 3000 index was up only 3.2%, a far cry from its 10-year annualized return of almost 9%; the MSCI ACWI ex-U.S. — a broad proxy for international stocks — has been even more disappointing, down 3.8% compared to its 2017 return of 27%. Furthermore, most bond strategies are negative for the year, thus dispelling the notion of diversification. However, the year is only halfway complete and as we have seen repeatedly in the capital markets, fortunes can change rapidly and unpredictably. In an effort to formulate explanations and expectations, the following newsletter investigates the disappointing performance from the first half of the year, as well as potential outcomes for the remainder of 2018.

FIXED INCOME

Core bonds lost 1.6% in the first half of 2018 as rising inflation with lower unemployment led to a more hawkish Fed, which hiked rates in March and June. The yield curve rose and flattened to 2007 levels, putting downward pressure on core bond prices. Bank loans gained 2.4% due to spread-tightening driven by easing U.S.–North Korea tensions, strong inflows, and low repricings. High yield bond returns were almost flat at 0.2% due to spread-widening primarily driven by the rate hikes, outflows, and a longer relative duration versus bank loans.



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Exhibit 1: Fixed Income Returns as of June 30, 2018

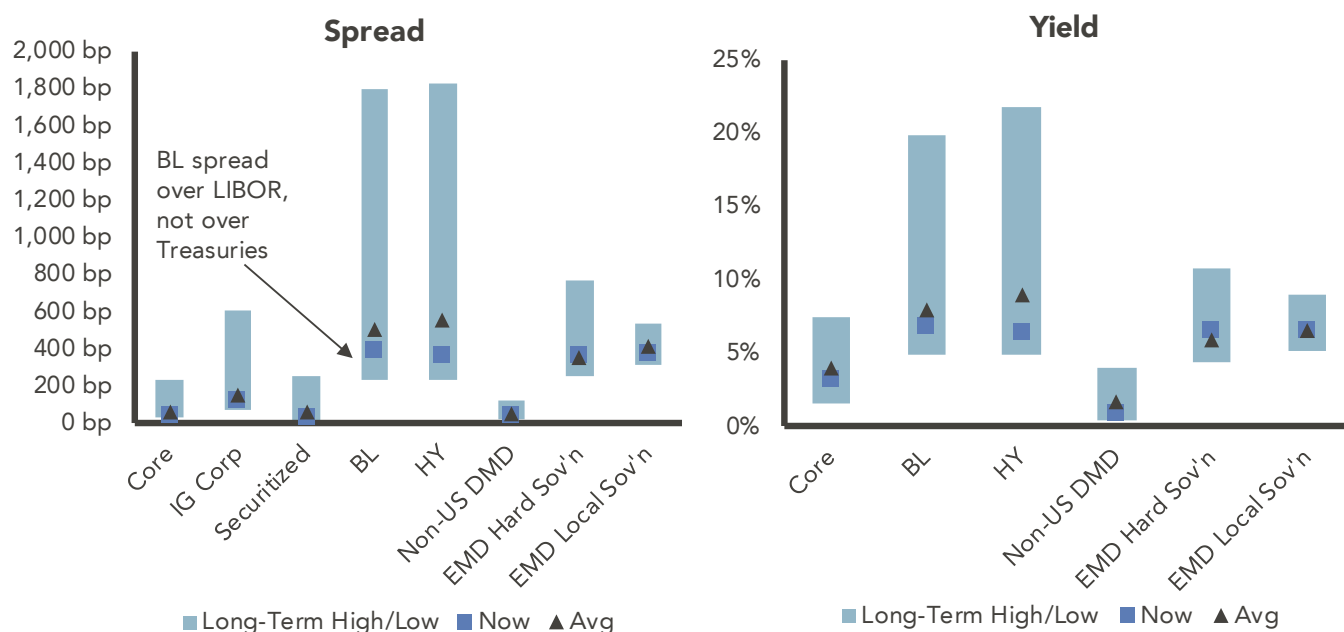
	Month (%)	3-Month (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
Broad Market Indices							
Blm BC Aggregate	-0.1	-0.2	-1.6	-0.4	1.7	2.3	3.7
Intermediate Indices							
Blm BC Int. Gov./Credit	-0.1	0.0	-1.0	-0.6	1.2	1.6	3.1
Government Only Indices							
Blm BC Long Gov.	0.2	0.3	-3.0	-0.1	3.4	4.6	6.0
Blm BC Int. Gov.	0.0	0.1	-0.7	-0.7	0.6	1.0	2.4
Blm BC 1-3 Year Gov.	0.0	0.2	0.1	0.0	0.4	0.6	1.3
Blm BC U.S. TIPS	0.4	0.8	0.0	2.1	1.9	1.7	3.0
Credit Indices							
Blm BC U.S. Long Credit	-1.2	-2.7	-6.4	-1.3	5.0	5.5	7.3
Blm BC High Yield	0.4	1.0	0.2	2.6	5.5	5.5	8.2
CS Leveraged Loan Index	0.1	0.8	2.4	4.7	4.3	4.2	5.0
Securitized Bond Indices							
Blm BC MBS	0.0	0.2	-1.0	0.1	1.5	2.3	3.5
Blm BC ABS	0.0	0.4	0.0	0.4	1.3	1.4	3.2
Blm BC CMBS	-0.1	0.0	-1.2	0.0	2.0	2.5	4.9
Non-US Indices							
Blm BC Global Aggregate Hedged	0.2	0.2	0.1	1.7	2.8	3.3	4.2
JPM EMBI Global Diversified	-1.2	-3.5	-5.2	-1.6	4.6	5.1	6.7
JPM GBI-EM Global Diversified	-0.8	-2.3	0.0	3.0	6.3	6.1	8.6
Municipal Indices							
Blm BC Municipal	0.1	0.9	-0.2	1.6	2.9	3.5	4.4
Blm BC HY Municipal	0.5	3.1	3.7	7.1	6.7	5.6	6.0

Sources: Bloomberg Barclays, Credit Suisse, JPMorgan

Emerging markets debt lost 5.2% for the hard currency index and was flat at 0.0% for the local currency index. Due to the growing U.S. deficit, the dollar weakened in the first quarter, a headwind for the hard currency index and tailwind for the local currency index. The strengthening of the dollar in the second quarter caused by the Fed hikes and ECB taper announcement led to softness across EMD, exacerbated by the U.S.–China tariff rhetoric and idiosyncratic shocks such as the Brazilian truckers' strike.

Going forward core bonds should benefit from stronger yields after seven post-recession rate hikes; in the event of a market correction, their duration should help offset equity losses as investors exchange risk for the safety of Treasuries. However, core bonds are expected to be flat for the second half of 2018 as we expect the Fed to hike twice more in 2018 plus three more times in 2019. Bank loans and high yield bonds are expected to provide a total return near coupon, at 6–7% annualized for both, absent any geopolitical shock or fraud that could cause major spread-widening. Spreads remain tight compared to historical levels and are supported by moderate fundamentals.

Exhibit 2: Limited Runway for Fixed Income Strategies



Note: Long-term high/low spans 20 years except for Non-US DMD and EMD, which span 10 years
 Sources: Bloomberg Barclays, Credit Suisse, Deutsche, JPMorgan as of June 30, 2018

Emerging markets debt is expected to remain volatile as the market prices in the remaining Fed hikes and the start of ECB tapering. Average spreads are still tighter than they've been historically. Nonetheless, fundamentals such as GDP growth, debt-to-GDP and current accounts remain strong. EMD yields are currently around 6–7%, but total returns could deviate significantly from current yields.

U.S. EQUITIES

After a strong start to the year, broad market indices have been on a tumultuous ride. As of June 30th, the S&P 500 had returned 2.6% year-to-date, recouping just under half of its gains from January. Similar to 2017, growth outperformed value across each market cap. Growth's outperformance was narrowest for small caps at 4.3% and widest for large caps at 9.0%. Technology was the best performing sector in the S&P 500, up 10.9% while Consumer Staples was the worst, down 8.6%.

Exhibit 3: U.S. Equity Returns as of June 30, 2018

	Month (%)	3-Month (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
Broad Market Indices							
Dow Jones	-0.5	1.3	-0.7	16.3	14.1	13.0	10.8
Wilshire 5000	0.6	3.8	3.0	14.7	11.9	13.4	10.2
Russell 3000	0.7	3.9	3.2	14.8	11.6	13.3	10.2
Large-Cap Market Indices							
S&P 500	0.6	3.4	2.6	14.4	11.9	13.4	10.2
Russell 1000	0.6	3.6	2.9	14.5	11.6	13.4	10.2
Russell 1000 Value	0.2	1.2	-1.7	6.8	8.3	10.3	8.5
Russell 1000 Growth	1.0	5.8	7.3	22.5	15.0	16.4	11.8
Mid-Cap Market Indices							
Russell MidCap	0.7	2.8	2.3	12.3	9.6	12.2	10.2
Russell MidCap Value	0.8	2.4	-0.2	7.6	8.8	11.3	10.1
Russell MidCap Growth	0.4	3.2	5.4	18.5	10.7	13.4	10.5
Small-Cap Market Indices							
Russell 2000	0.7	7.8	7.7	17.6	11.0	12.5	10.6
Russell 2000 Value	0.6	8.3	5.4	13.1	11.2	11.2	9.9
Russell 2000 Growth	0.8	7.2	9.7	21.9	10.6	13.6	11.2

Source: Morningstar Direct

So far 2018 has been volatile, with more than four times the amount of +/-1% days than we saw in all of 2017. However, volatility did turn lower as the second quarter progressed. First quarter earnings were strong on the back of tax reform and up 20% year-over-year; second quarter earnings are expected to be even stronger. This growth in earnings reduced price-to-earnings multiples to more moderate levels relative to the end of 2017.

During the first half the small cap Russell 2000 outperformed the large cap Russell 1000 by 4.8%, largely due to a re-risking into small caps starting around mid-March as the trade war / tariff talk began and we started to see deceleration in global economic data. This could continue as small caps should be more insulated from trade wars and global economic uncertainty given that their performance is more tied to the U.S. economy which has delivered stronger growth than its global peers. Another tailwind for small cap has been strong corporate earnings growth, a strengthening dollar (which hurts large caps relative to small), and the benefit of tax reform (benefits small caps more than larger caps).

Looking ahead to the second half of the year, the biggest concern is the renegotiation of trade pacts, which at a minimum could stoke market volatility and at the extreme dampen global growth along with consumer confidence. Additionally, mid-term elections are on the horizon and the S&P 500 is usually negative leading up to these elections. The second and third quarters of a mid-term year are usually the worst equity returns during the presidential cycle.

Strong earnings and economic growth is expected to support equity performance throughout 2018. However, corporate earnings growth is expected to moderate as we head into late 2018 and 2019. Finally, the performance spread between value and growth is still quite large. While this has been one of the longest periods of growth outperformance, it will not last forever and its eventual reversal bears watching.

Exhibit 4: Is Growth's Outperformance Peaking?



Source: eVestment as of June 30, 2018

NON-U.S. EQUITIES

The first half of 2018 was disappointing for international equities as all non-U.S. equity benchmarks produced negative returns. Developed markets (-2.8%) outperformed emerging markets (-6.7%), while developed small-cap stocks (-1.3%) was the best performing asset class while EM small-cap (-8.5%) underperformed the broader EM index. This underperformance is largely due to the U.S. dollar's strength, which detracted 1.8% from developed markets and 3.9% from emerging markets. 2013's so-called "fragile five" countries have been hit the hardest with Turkey suffering the most (-17.1%). Volatility has increased across equity asset classes compared to 2017 while value continues to underperform growth.

Exhibit 5: Non-U.S. Equity Returns as of June 30, 2018

	Month (%)	3-Month (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
MSCI ACWI ex. U.S.	-1.9	-2.6	-3.8	7.3	5.1	6.0	2.5
MSCI EAFE	-1.2	-1.2	-2.8	6.8	4.9	6.4	2.8
MSCI EAFE Local	-0.3	3.5	-1.0	6.1	5.2	8.9	5.0
MSCI Emerging Markets	-4.2	-8.0	-6.7	8.2	5.6	5.0	2.3
MSCI EM Local	-2.5	-3.5	-2.8	10.5	7.5	8.5	5.2
MSCI EAFE Small-Cap	-2.0	-1.6	-1.3	12.5	10.0	11.3	6.8
MSCI EM Small-Cap	-6.6	-8.6	-8.5	5.6	2.9	4.3	4.4
MSCI Frontier	-3.5	-15.2	-10.9	1.7	2.2	4.6	-2.5

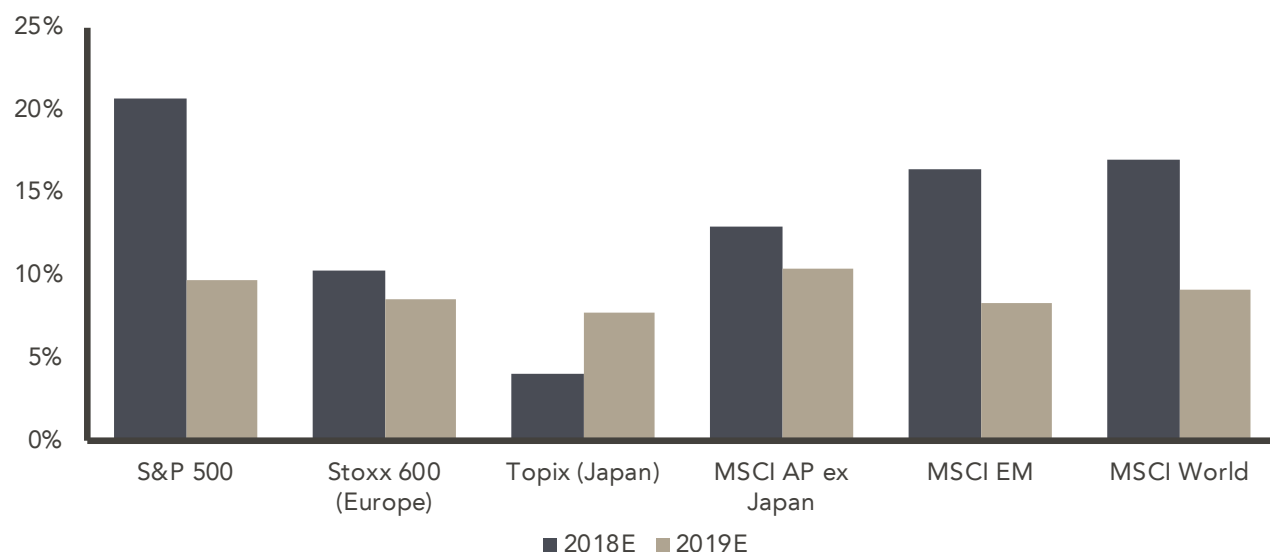
Source: Bloomberg

Going forward expect ongoing volatility due to Brexit negotiations, the new Italian government and currency losses in select EM countries. But most notably the further escalation in trade conflicts promises to increase volatility. All parties figure to lose something in a trade conflict, but some will lose more than others. Given that China's exports to the U.S. constitute a larger portion of its GDP than the U.S.' exports to China, a

tariff exchange would hurt China's growth prospects more. However, China has other means by which it can retaliate including restrictions on U.S. businesses in China and selling their massive holdings of U.S. Treasuries. In addition, the U.S. runs the risk of isolating itself from global trade as well as a rise in inflation due to increased prices stemming from the tariffs. The key takeaway is that trade tensions are a source of volatility in capital markets and pose a risk to the entire global economy.

While there are certainly issues that could lead to a bumpy second half the overall fundamentals in the non-U.S. space remain on solid footing. Earnings growth is positive along with economic growth. In addition, due to recent price declines and stable earnings growth, valuations have become more attractive.

Exhibit 6: Earnings Growth Expected in 2018 and 2019



Source: Goldman Sachs Global Investment Research as of July 9, 2018

HEDGE FUNDS

Event-driven and merger arbitrage were the best performing hedge fund strategies during the first half of 2018, up 2.4% and 2.6%, respectively. Through June 30th, there were 79 deals above \$5 billion and 35 deals above \$10 billion, which provided ample investment opportunities for these types of funds. Globally, \$2.35 trillion of M&A deals were announced in the first half, up 57% from a year ago, according to dealogic. Equity hedge funds finished in positive territory for the first half of the year, as managers battled negative dispersion and short positions moving against them in June, causing second quarter performance to suffer. Macro strategies were the worst performers during the first half, as trend following strategies declined during the first half.

Exhibit 7: First Half Performance for Hedge Funds

	Month (%)	3-Month (%)	YTD (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
HFRX Global	-0.2	0.2	-0.8	2.5	0.8	1.3	-0.4
HFRX Hedged Equity	-0.7	-0.9	0.2	6.3	1.7	3.0	-0.4
HFRI Composite	-0.5	0.9	0.8	5.7	3.6	4.4	3.4
HFRI Fund of Funds	-0.2	0.9	1.1	5.6	2.1	3.6	1.4
HFRI Convertible Arbitrage	-0.3	-0.2	0.5	3.2	4.3	4.3	5.5
HFRI Equity Hedge	-0.9	0.8	1.2	8.2	4.8	5.8	3.7
HFRI Event-Driven	0.8	2.3	2.4	5.9	4.7	4.8	4.7
HFRI Macro	-0.3	-0.2	-1.8	1.1	0.2	1.2	1.1
HFRI Merger Arbitrage	1.2	2.5	2.6	3.5	3.6	3.8	3.6
HFRI Relative Value	-0.1	1.2	1.6	4.0	3.8	4.4	5.1

Source: Hedge Fund Research as of June 30, 2018

Following the approval of the AT&T/Time Warner deal, it is likely we will see more M&A in the media space. Event-driven and merger arbitrage funds should see performance gains off this increased deal activity in the second half. Finally, leverage levels have come off sharply over the last few weeks while weighted gross leverage has been on a more steady and gradual decline since April, per Morgan Stanley Prime Brokerage. This implies managers are lowering risk going into the second half, becoming more defensive.

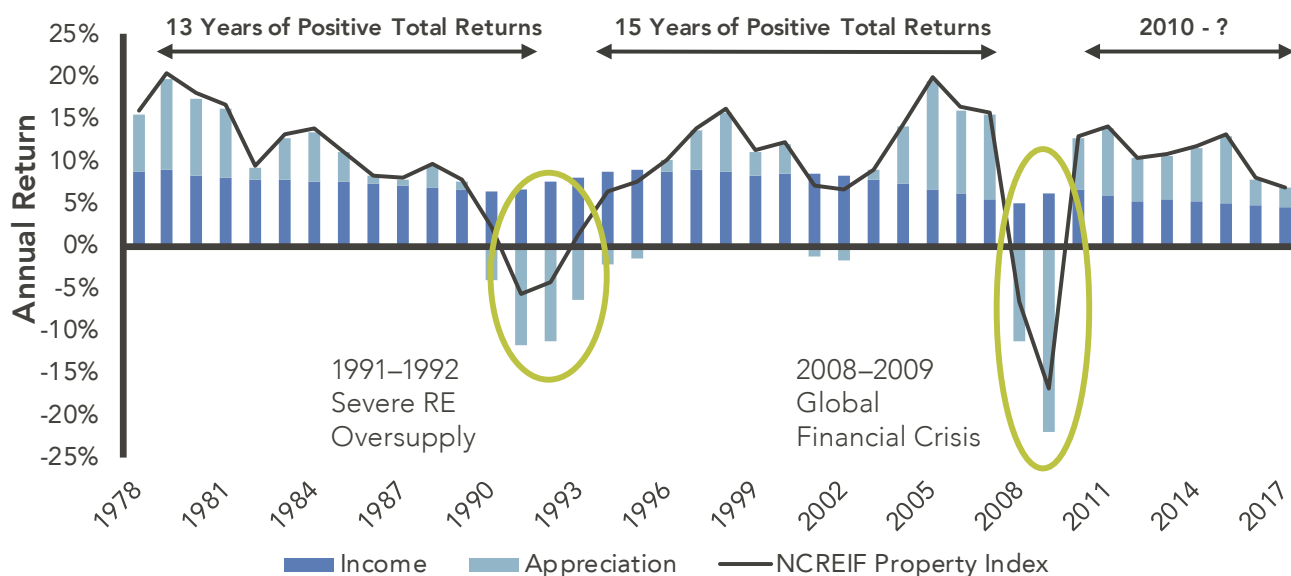
REAL ESTATE

Real estate investments have flourished since the financial crisis. While overall returns are moderating, the relatively lower returns in the mid-to-high single-digits are consistent with our longer-term expectations for the asset class and real estate remains an attractive investment relative to other asset classes. Real estate valuations based on the Moody's/RCA Commercial Property Price Index have fully recovered from their drawdowns during the financial crisis, with all major sectors rebounding from their lows. Apartment properties have experienced the strongest recoveries and now reside above their prior pricing peak followed by office, industrial and retail.

From an income perspective low cap rates suggest a lower yielding investment than what was available seven years ago. Nonetheless, real estate continues to offer a modest spread above the 10-year Treasury yield so while the absolute yield is lower, it is still favorable to low Treasury yields. All property cap rates are at 4.9% relative to a 2.8% 10-year U.S. Treasury yield as of mid-2018. Going forward, we expect this spread between cap rates and Treasuries to provide a measure of cushion that will allow long-term interest rates to rise without impacting core real estate.

In terms of price returns (i.e. property appreciation), all property cap rates have been normalizing over the past several quarters. As cap rates continue to slow their decline and eventually turn upwards, the appreciation component of real estate returns will have less of an impact on positive total returns. However, despite the decline in cap rates, net operating income ("NOI") growth has become an increasingly important component of total return and likely a key driver of appreciation returns going forward.

Exhibit 8: Real Estate Returns Are Still Positive, but Moderating



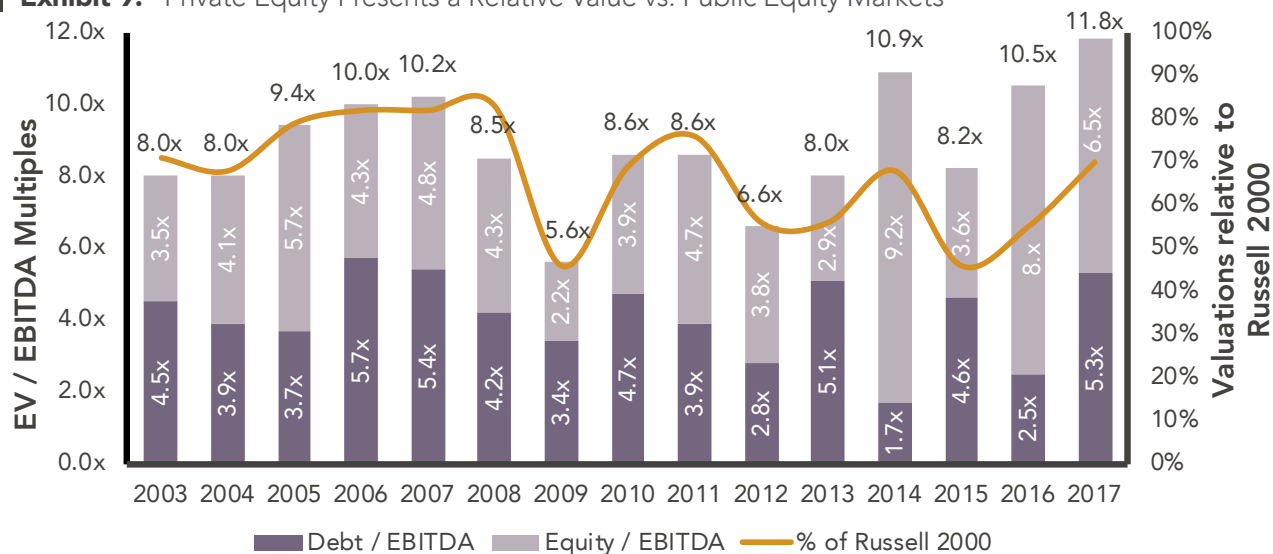
Sources: NCREIF, Bloomberg, Clarion Partners

The PREA consensus survey calls for a 5.2% unlevered total return over the next five years for core real estate. Applying these estimates as a reference point along with the current mature phase in the real estate cycle, we expect value-added real estate investment strategies to deliver higher levered total returns in the low-to-mid double-digit return range depending on the investment strategy. Many value-added real estate strategies invest in secondary and tertiary markets with higher cap rates and growth which should translate to higher returns vs. core real estate, albeit it with higher expected volatility.

PRIVATE EQUITY

For private equity there are not yet benchmark performance numbers for 2018. However, fundamentals continue to improve as growth has been strong and the tax cut has provided higher levels of cash generation for many small U.S.-focused private equity owned businesses. The pace of fundraising has slowed from the record level in 2017 as dry powder continues to accumulate since competition for assets is intense and the overall deal volume continues to remain modest. Valuations have fallen slightly from 2017, with the average middle market transaction at 9.1x EBITDA, representing a 30% discount to public markets. The emergence of mega funds in both buyouts and venture capital continues to drive a lot of the headlines as managers have responded to robust investor interest. While we expect industry returns to decelerate to low double digits, we believe the strong fundamentals and discounted valuation multiples to public markets presents a relatively attractive investment opportunity for investors.

Exhibit 9: Private Equity Presents a Relative Value vs. Public Equity Markets



Sources: Pitchbook, Bloomberg as of December 31, 2017

CONCLUSION

Although the first half of the year has been frustrating for investors, not all hope should be lost for the remainder of the year. While returns may not repeat 2017's fortunes, positive returns for the second half of the year — as well as 2018 as a whole — are not out of the question. As the chart below illustrates, it is not unusual for the best and worst performing asset classes to significantly vary from year to year, so if nothing else investors are encouraged to appropriately diversify their portfolios and rebalance per policy guidelines. Over time, a diversified portfolio that adheres to a disciplined rebalancing policy should deliver its expected return over longer-term investment horizons, despite year-to-year volatility. ■

Exhibit 10: Why Diversification is Important

2018 YTD*	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	5yr	10yr
Commodities 10.4%	Emerging Mkts. 37.3%	Small Cap 21.3%	Real Estate 13.3%	Large Cap 13.7%	Small Cap 38.8%	Intl Small Cap 20.0%	Real Estate 14.3%	Small Cap 26.9%	Emerging Mkts. 78.5%	Core Bond 5.2%	Large Cap 13.4%	Small Cap 10.6%
Small Cap 7.7%	Intl Small Cap 33.0%	High Yield 17.1%	Intl Small Cap 9.6%	Mid Cap 13.2%	Mid Cap 34.8%	Emerging Mkts. 18.2%	Core Bond 7.8%	Mid Cap 25.5%	High Yield 58.2%	Real Estate -6.5%	Broad U.S. Eqy 13.3%	Mid Cap 10.2%
Broad U.S. Eqy 3.2%	Broad Intl Eqy 27.2%	Mid Cap 13.8%	Large Cap 1.4%	Broad U.S. Eqy 12.6%	Broad U.S. Eqy 33.6%	Intl Large Cap 17.3%	High Yield 5.0%	Intl Small Cap 22.0%	Intl Small Cap 46.8%	Hedge Funds -21.4%	Small Cap 12.5%	Broad U.S. Eqy 10.2%
Large Cap 2.6%	Intl Large Cap 25.0%	Broad U.S. Eqy 12.7%	Core Bond 0.5%	Real Estate 11.8%	Large Cap 32.4%	Mid Cap 17.3%	Large Cap 2.1%	Emerging Mkts. 18.9%	Bank Loans 44.9%	High Yield -26.2%	Mid Cap 12.2%	Large Cap 10.2%
Bank Loans 2.4%	Large Cap 21.8%	Large Cap 12.0%	Broad U.S. Eqy 0.5%	Core Bond 6.0%	Intl Small Cap 29.3%	Broad Intl Eqy 16.8%	Bank Loans 1.8%	Broad U.S. Eqy 16.9%	Broad Intl Eqy 41.4%	Bank Loans -28.8%	Intl Small Cap 11.3%	High Yield 8.2%
Mid Cap 2.3%	Broad U.S. Eqy 21.1%	Commodities 11.4%	Hedge Funds -0.3%	Small Cap 4.9%	Intl Large Cap 22.8%	Broad U.S. Eqy 16.4%	Broad U.S. Eqy 1.0%	High Yield 15.1%	Mid Cap 40.5%	Small Cap -33.8%	Real Estate 10.0%	Intl Small Cap 6.8%
Real Estate 1.7%	Mid Cap 18.5%	Emerging Mkts. 11.2%	Bank Loans -0.4%	Hedge Funds 3.4%	Broad Intl Eqy 15.3%	Small Cap 16.3%	Commodities -1.2%	Large Cap 15.1%	Intl Large Cap 31.8%	Large Cap -37.0%	Intl Large Cap 6.4%	Real Estate 6.1%
Hedge Funds 1.3%	Small Cap 14.6%	Bank Loans 9.9%	Intl Large Cap -0.8%	High Yield 2.5%	Real Estate 11.0%	Large Cap 16.0%	Mid Cap -1.5%	Real Estate 13.1%	Broad U.S. Eqy 28.3%	Broad U.S. Eqy -37.3%	Broad Intl Eqy 6.0%	Bank Loans 5.0%
High Yield 0.2%	Hedge Funds 7.8%	Real Estate 8.0%	Mid Cap -2.4%	Bank Loans 2.1%	Hedge Funds 9.0%	High Yield 15.8%	Small Cap -4.2%	Broad Intl Eqy 11.2%	Small Cap 27.2%	Mid Cap -41.5%	High Yield 5.5%	Core Bond 3.7%
Intl Small Cap -1.3%	High Yield 7.5%	Broad Intl Eqy 4.5%	Small Cap -4.4%	Emerging Mkts. -2.2%	High Yield 7.4%	Real Estate 10.5%	Hedge Funds -5.7%	Bank Loans 10.0%	Large Cap 26.5%	Intl Large Cap -43.4%	Emerging Mkts. 5.0%	Intl Large Cap 2.8%
Core Bond -1.6%	Real Estate 7.0%	Core Bond 2.6%	High Yield -4.5%	Broad Intl Eqy -3.9%	Bank Loans 6.2%	Bank Loans 9.4%	Intl Large Cap -12.1%	Commodities 9.0%	Commodities 13.5%	Broad Intl Eqy -45.5%	Bank Loans 4.2%	Broad Intl Eqy 2.5%
Intl Large Cap -2.7%	Commodities 5.8%	Intl Small Cap 2.2%	Broad Intl Eqy -5.7%	Intl Large Cap -4.9%	Commodities -1.2%	Hedge Funds 4.8%	Broad Intl Eqy -13.7%	Intl Large Cap 7.8%	Hedge Funds 11.5%	Commodities -46.5%	Hedge Funds 3.3%	Emerging Mkts. 2.3%
Broad Intl Eqy -3.8%	Bank Loans 4.2%	Intl Large Cap 1.0%	Emerging Mkts. -14.9%	Intl Small Cap -4.9%	Core Bond -2.0%	Core Bond 4.2%	Intl Small Cap -15.9%	Core Bond 6.5%	Core Bond 5.9%	Intl Small Cap -47.0%	Core Bond 2.3%	Hedge Funds 1.4%
Emerging Mkts. -6.7%	Core Bond 3.5%	Hedge Funds 0.5%	Commodities -32.9%	Commodities -33.1%	Emerging Mkts. -2.6%	Commodities 0.1%	Emerging Mkts. -18.4%	Hedge Funds 5.7%	Real Estate -16.9%	Emerging Mkts. -53.3%	Commodities -9.4%	Commodities -12.4%

List of benchmarks on following page

List of Benchmarks

Core Bond - Barclays Aggregate	Broad U.S. Equities - Russell 3000	Broad Intl Equities - ACWI ex-U.S.	Commodities - S&P GSCI
High Yield - Barclays High Yield	Large Cap - S&P 500	Intl Large Cap - EAFE	Hedge Funds - HFRI FoFs
Bank Loans - CS Leverage Loan	Mid Cap - Russell Mid Cap	Intl Small Cap - EAFE Small Cap	Real Estate - NCREIF
	Small Cap - Russell 2000	Emerging Markets - MSCI EM	

*Hedge Fund returns through 5/31/18

*Real Estate returns through 3/31/18

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