Rocaton

INSIGHTS

Opportunities in a Post-Brexit World

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EXECUTIVE SUMMARY

* "Brexit" has created uncertainty in the global economy and financial markets.
* Interest rates across the globe continue to fall with U.S. interest rates recently touching all-time lows. Today's low yield environment virtually guarantees that fixed income returns will be low for years to come.
* Equity markets potentially offer higher returns, but U.S. equity market valuations remain elevated and non-U.S. markets' attractive valuations are discounting a challenging political and macro-economic landscape.
* To the extent global economic growth underperforms already low expectations, capital market returns are likely to suffer.
* We believe conventional portfolio returns will be weak as successive rounds of quantitative easing across the globe have inflated many liquid asset class prices.
* To obtain higher expected risk-adjusted returns, investors may want to consider some of the limited opportunities that exist in markets that are less affected by large capital flows such as emerging market debt, preferred stock, commercial real estate debt, structured product and CLOs.
* Investors should also review their current portfolio positioning to determine if a reduction in risk is appropriate.

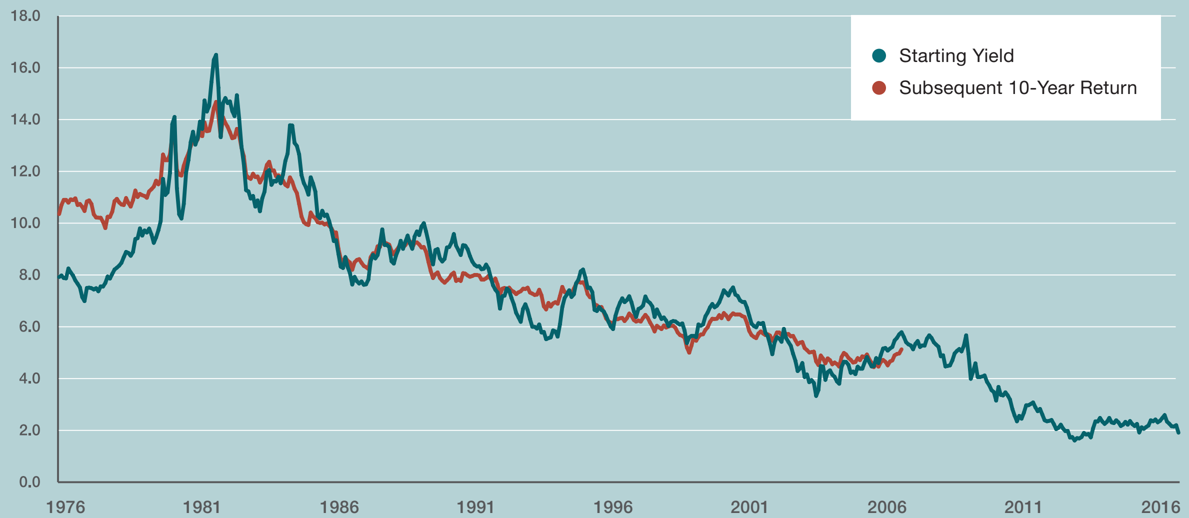
Introduction

The United Kingdom's ("U.K.") decision to leave the European Union ("EU") in late June was a surprise to most market participants, resulting in heightened market volatility. In our and many others' opinion, the vote to leave the EU has increased uncertainty and has not provided any resolutions. While market volatility has subsided in recent weeks, uncertainty remains. Given the high level of uncertainty and unattractive fixed income and equity market valuations, we believe it will be difficult for investors to generate attractive returns in the near term. Interest rates across the globe are at historically low levels and U.S. equity market valuations are elevated. While equity market valuations across non-U.S. developed and emerging markets are more attractive than those in the U.S., the potential for continued political instability and an uncertain economic outlook present challenges. The balance of this paper provides additional color on our capital market return forecasts and reviews potential investment opportunities which investors may wish to consider.

Return expectations are even lower following Brexit

The theme of low return expectations has been in place for several years as capital market return forecasts were generally modest prior to Brexit. Following the U.K.'s decision to leave the EU, we have an even more sober outlook for the next three years. For fixed income asset classes, long-term forward looking returns are heavily tied to starting interest rates. In the short term, it is possible for fixed income investments to generate attractive returns as yields have the potential to fall further. However, over the long-term, fixed income returns rarely deviate significantly from their starting yield (see Figure 1). This is true for both individual bonds held to maturity as well as portfolios of bonds with a constant maturity profile (e.g., the Barclays Aggregate Index). With a significant part of the developed world's bond markets offering negative yields[1] and the Barclays U.S. Aggregate yielding less than 2%, investors are virtually guaranteed to have low single digit returns from their fixed income portfolios.

Figure 1:
Barclays Aggregate Index Starting Yield and Subsequent 10-Year Return



Sources: Barclays. Based on monthly data through June 30, 2016.

Future equity market returns are much more difficult to estimate ex-ante. While valuation measures such as price/earnings ratio often have some predictive power for long-term returns, history has shown that valuations are not as reliable as a signal for short- or medium-term returns. As we have already pointed out, equity market valuations across Europe, Japan and most of the emerging markets are more attractive than they are in the U.S. However, these regions have a considerable amount of uncertainty which is exacerbated by the U.K. leaving the EU. Europe has struggled to generate positive economic growth and inflation for several years, despite easy monetary policy and a significant amount of quantitative easing from the European Central Bank ("ECB"). Similarly, the Bank of Japan ("BoJ") has tried numerous easing policies, yet growth and inflation remain weak. The recent strengthening of the Yen versus the U.S. dollar creates additional headwinds for the Japanese economy.

All of these factors lead to low return expectations for traditional asset classes over the coming years. Our current 10-year return expectation (as of June 30th) for core U.S. fixed income is 2.8% while our U.S. equity return forecast is 4.5% for the same period. Non-U.S. developed equity (8.2% return expectation) and emerging market equity (9.8%) return forecasts are higher over the next 10-years, but the range of potential outcomes is high.

1 As of July 15, 2016, 38% (by market value) of developed market sovereign bonds had negative yields.

Increased downside risks to economic growth

Adding to an already difficult investment environment, we believe the downside risks to economic growth have increased. Central banks across the globe have employed zero- and negative-interest rate policies for several years and monetary stimulus has been injected into financial markets with no end in sight. Even the U.S., which is supposedly in better economic health than most of the world, has increased interest rates only once since the global financial crisis. Given news of Brexit, further rate hikes seem to have been ruled out until at least late 2016 or possibly 2017. As a result, we believe central banks are running out of tools and will have fewer means available during the next economic downturn. Beyond central bank policies, political unrest is rising. Additional referendums in other EU countries are possible and another referendum on Scottish independence seems likely. The U.S. election has also occupied headlines for the last 12 months and represents an area of uncertainty for many investors. The rising economic uncertainty and growing political stress increases downside risks in financial markets.

We recognize that economic growth often has a weak statistical correlation to equity market returns and that a positive surprise in economic growth is possible. It is also fair to conclude that the U.S. economy is in relatively good health driven in part by strength in the consumer and housing sectors. However, U.S. GDP has expanded in 25 of the last 27 quarters, a span of more than seven years without a recession. Historically, the U.S. has experienced a recession every 4-5 years, on average, dating back to the early 1900's. Again, there are no immediate signs of a recession in the U.S., but as economic growth continues to expand uninterrupted, the probability of a recession increases. Naturally, a slowdown in U.S. economic growth would likely weigh on the global economy and capital market returns.

Post-Brexit investment opportunities

With a challenging outlook for traditional fixed income and equity investments, we believe investors should consider asset classes which are sometimes overlooked, provide attractive expected returns and by virtue of their more senior status (than equities) in capital structures are expected to hold up better in the event of a broad-based market sell-off. Examples of asset classes which we believe can offer more attractive returns with appropriate levels of risk are described below.

* *Emerging Market Debt* – We prefer hard currency (U.S. $) investments today over local currency mandates. Hard currency emerging market debt is currently offering spreads of approximately 4% over U.S. Treasuries and many emerging market economies have lower debt burdens relative to the developed world. Investors may also want to consider mandates that can allocate to emerging market corporate debt which can provide incremental yield.
* *Preferred Stock* – While preferreds are a smaller investment opportunity, they offer some of the highest yields in the investment grade universe (currently 5.2%). Floating-rate and fixed-to-floating rate securities can provide lower interest rate duration exposure and there

are opportunities for active managers to create a portfolio with a yield advantage and downside protection relative to the broad index. Investors should be aware that, despite the investment grade rating, subordination (relative to senior unsecured debt) in the capital structure can create periods of higher volatility although most sectors (the market has typically been dominated by issuance from financials) issuing preferreds today are relatively stable to improving on a fundamental basis.

* *Commercial Real Estate Debt* – The real estate credit markets are currently offering attractive risk-adjusted returns. In order to maximize the opportunity, we believe it's ideal to invest in a strategy that is adept at investing in all parts of the commercial real estate finance markets including private loans, public corporate bonds and CMBS. Investors should be prepared to accept illiquidity as these strategies often come with 3-7 year lock up periods.
* *Structured Product* – Structured product can broadly be broken out into four sub-sectors: Consumer ABS, Corporate ABS, Commercial ABS and Whole Business ABS. A dedicated structured product portfolio provides investors with diversification benefits relative to corporate credit and yield enhancement relative to core fixed income. Segments of the securitized market are small and fairly inefficient and skilled active managers should be able to add value. Additionally, a structured product portfolio may benefit from a rising rate environment given a portion of the market is floating rate. Some of the potential drawbacks include less liquidity (relative to traditional fixed income sectors), increased credit risk and a limited universe of high quality managers.
* *CLO Liabilities* – A CLO (Collateralized Loan Obligation) is a special purpose vehicle that issues debt and equity and uses the funds it raises to invest in a portfolio of loans. It distributes the cash flows from its asset portfolio to the holders of various liabilities in a prescribed way that takes into account the relative seniority of those liabilities. CLOs are attractive due to their nonrecourse term financing and high recovery rates (~70%). Additionally, during the reinvestment period if prices on bank loans fall, the manager will be able to invest in loans trading at higher spreads, potentially providing a more attractive return profile.

Conclusion

There is no question that we are in an uncertain investing environment. The outlook for fixed income investments is challenged given unprecedented interest rate levels. While equity markets potentially offer higher investment returns, there is the potential for much higher volatility. Further, the equity markets with the most attractive valuations (non-U.S. developed and emerging markets) continue to be plagued with uncertain political and economic outlooks consistent with what markets are currently discounting. To the extent economies underperform market expectations, market returns are likely to suffer. Investors should consider more attractive risk-adjusted opportunities that exist, including emerging market debt, preferred stock and commercial real estate debt. Investors should also reexamine their current risk profile and determine if a reduction in risk is appropriate.

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