Rocaton

INSIGHTS

The Most Important Price in the World: *U.S. Interest Rates and the Impact on Asset Allocation*

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EXECUTIVE SUMMARY

* Central bank policies have encouraged many investors to take on more risk.
* Global financial markets have rallied in the last five years, due in part to easy monetary policies.
* As a result, future return expectations for many asset classes are modest given low starting interest rates and elevated equity market valuations.
* Investors who can tolerate the volatility may want to overweight non-U.S. developed and emerging market equities.
* Fixed income investors may want to shift some of their assets out of investment grade and high yield corporate bonds into U.S. Treasuries and bank loans, respectively.
* Investors of all types should be positioned at or possibly even below target risk levels and be prepared to deploy capital during the next market correction.

We recognize that markets may remain in a state of dis-equilibrium for a number of years and that taking risk may continue to be rewarded. However, we believe prudent risk management is likely to help investors achieve better outcomes over the long-term.

Introduction

Quantitative easing and monetary policy actions by central banks around the world have been discussed and dissected at length in the years following the global financial crisis. The necessity of these actions may be debated, but it can be unequivocally stated that easy monetary policy and quantitative easing has pushed up prices on virtually all financial assets. U.S. equity markets are at all-time highs just five years after the second worst recession in a century and interest rates across many developed markets are at historically low levels. This has created a difficult environment for investors of all types as expected returns on many asset classes appear to be low, encouraging greater risk taking to maintain target or desired rates of returns. Monetary policy is at least partly to blame for this environment. Broadly speaking, the following events have increased asset prices and potentially reduced future returns:

1. Short-term interest rates have been lowered to zero by many developed market central banks
2. In an effort to lower long-term interest rates, many central banks are purchasing longer dated bonds
3. Low interest rates have forced investors to move out on the "risk curve" to generate acceptable rates of return

Today, we are starting to see the unwinding of easy monetary policy as the Federal Reserve has begun tapering its bond purchase program. Ultimately, the Fed will increase short-term interest rates, with the first increase currently expected in 2015. Arguably, U.S. interest rates are the most important price in global financial markets as the U.S. fixed income markets are the largest financing markets in the world and are influential at setting prices for risk in all

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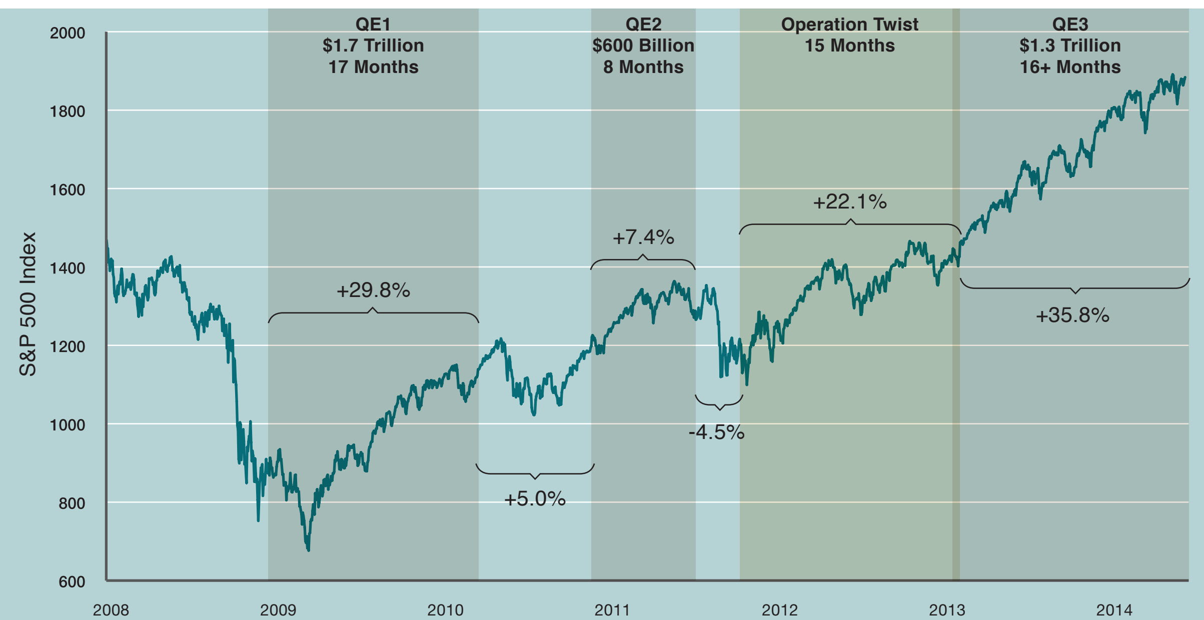
markets. The continued manipulation of this price is likely to have implications for all capital markets. The balance of this paper will focus on the events that have transpired in recent years and what the implications may be for investors' portfolios.

Central Banks' Impact on Markets

As mentioned at the outset, the actions taken by central banks during the global financial crisis may have been a necessary evil.[1] It is hard to know how the crisis would have unfolded without the drastic actions taken by the Fed and other central banks. The longer-term impact of Fed actions is more easily understood. With interest rates at depressed levels for several years, there has been an ongoing transfer of wealth from lenders to borrowers. Companies, both high quality and below investment grade, have been able to issue debt at low rates while lenders have been forced to accept low yields. This relationship has led to a global "search for yield", pushing many investors to take on more risk in an effort to meet their return objectives. Insurance companies, for example, whose portfolios are dominated by fixed income assets, have, in some cases, turned to high yield bonds and emerging market debt as a way to keep their portfolio yields at acceptable levels. Many retired individuals living off their current portfolio income have been forced to make a somewhat similar choice. Further, defined benefit plans, who typically discount their liabilities at high quality corporate bond rates, have seen liability values soar as a result of declining interest rates.

The positive side of the story is that the massive increase in liquidity has pushed up asset prices in a meaningful way. Investors who moved out on the risk curve sooner rather than later were able to realize outsized returns. Over the five year period ending March 31, 2014, nearly all markets experienced positive total returns. Notable returns generated over this time period include U.S. equities (+21.1% annualized), high yield fixed income (+18.2%), non-US. de-

Figure 1:
S&P 500 Index and Federal Reserve Monetary Policy since 2008



Source: Bloomberg; Federal Reserve Open Market Committee

[1] It is worth noting that even opponents of today's continued monetary easing generally agree that easy money policies in 2008-2009 were essential for stabilizing financial markets.

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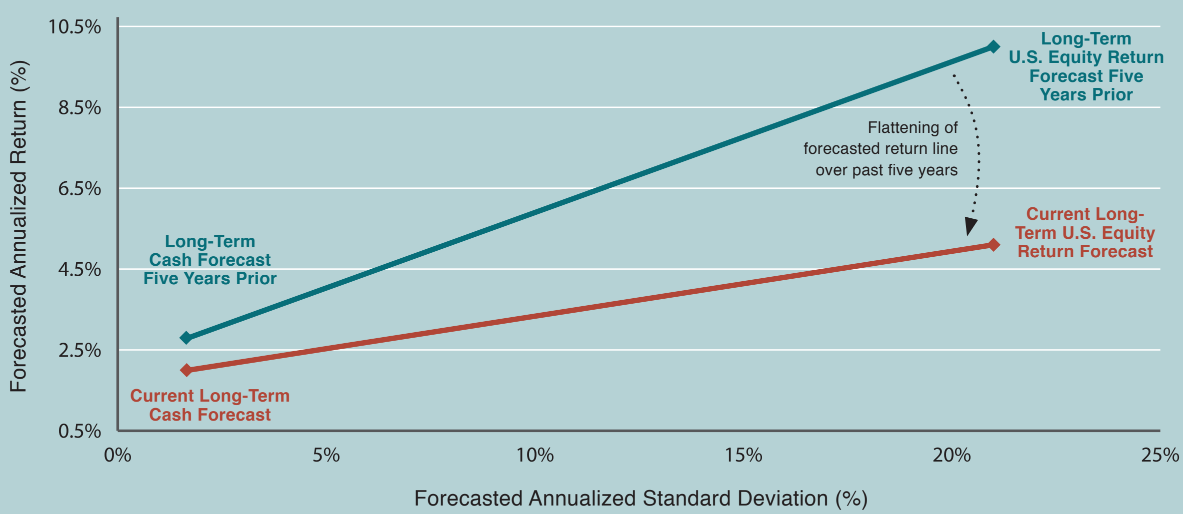
veloped equities (+16.6%), bank loans (+12.5%) and emerging market debt (+11.5%).[2] Even emerging market equities, which have struggled as of late, are up 14.8% annualized over the trailing five-year period ending March 31, 2014. As Figure 1 shows, the U.S. equity market was one of the primary beneficiaries of quantitative easing.

Interestingly, in recent years markets have reacted favorably to both positive and negative news. Investors have generally cheered good news as it often signals that markets are healing. Meanwhile, bad news has also been celebrated at times as it often indicates that central banks will continue to inject liquidity into the market. Recent market declines have been sparked by central banker commentary such as Ben Bernanke's "taper" comments in the summer of 2013 and, more recently, Janet Yellen's indication that the Fed would raise interest rates sooner than the market expected. Reactions like these increasingly suggest that a move away from easy monetary policy may be difficult.

Future Return Expectations

While investors have enjoyed recent returns in their portfolios given the run-up in equity markets and a general decline in interest rates, future return expectations may elicit a different reaction. The recent returns that have been realized were greater than even many of the most optimistic projections. By generating above expected returns, markets have borrowed from future returns. For fixed income markets, this is a fairly straightforward concept to understand. Lower yields today all but guarantee lower returns in the future, even without a meaningful rise in interest rates. For equity markets, however, there is the potential for valuations to remain at current levels or, potentially, to climb higher, as they did during the tech boom of the 2000s or fall lower, as they did during the global financial crisis. However, over longer periods of time, equity market valuations tend to revert towards equilibrium levels. The bottom line is that today's environment is characterized by a flat expected return curve. As investors have taken on more risk in recent years, the curve has flattened considerably. Based on Rocaton's (and other market participant) forecasts, U.S. equity return expectations are only modestly above those of bonds and cash (see Figure 2).

Figure 2:
Long-Term Return Forecasts – Current & Five Years Prior



These are long-term, forward looking expectations and there is no guarantee these will be realized.

Based on Rocaton's Capital Market Assumptions

[2] Source: Bloomberg

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As already stated, return expectations for all fixed income asset classes are depressed given low starting yields and tight corporate bond spreads. Expectations that rates will rise over the next several years have further compressed fixed income return forecasts, at least in the medium term[3]. Rocaton's March 31st 10-year compound return forecast is 3.5% for core U.S. fixed income and 4.0% for high yield bonds. Our U.S. equity market 10-year return forecast of 5.1% is only modestly higher. This assumption is driven by elevated price/earnings ratios which are more than 25% above long-term average levels. Non-U.S. equity market return forecasts, both developed (7.7% next 10-year return forecast) and emerging (10.9%), are higher, but these markets remain plagued with structural challenges and have the potential for high volatility.

Asset Allocation Implications

With an unenthusiastic outlook for most asset classes, investors may ask themselves where to allocate capital. Naturally, cash may seem like one of the few safe places at this point. Market timing, however, has proven to be extremely difficult as 1) markets can remain in a state of dis-equilibrium for many years and 2) investors must correctly time both their market exit and subsequent re-entry. Investors may also feel tempted to abandon their fixed income allocations given the prospect for rising interest rates. We would caution against this strategy as fixed income asset classes often play roles other than generating total return in portfolios such as hedging liabilities, having low correlations to risk assets, deflation protection and providing liquidity. Investors may instead want to focus on relative value ideas within their equity and fixed income portfolios.

Equities

As previously stated, return expectations for U.S. equities are well below long-term averages. Although return forecasts for non-U.S. equity markets are higher, there are fundamental and structural challenges that remain in those markets which might contribute to greater volatility in the years to come. Investors who are willing to take a long-term view and who can tolerate volatility, however, may want to take this opportunity to at least rebalance their portfolios back to their equity targets in the event that they are overweight U.S. equities and possibly even consider modest overweights to non-U.S. developed and emerging equities. Certain lower beta strategies such as low volatility equity, long/short equity and possibly even convertible bonds might also be worth considering as part of a "U.S. Equity" allocation.

Fixed Income

Given the manipulation of interest rates, fixed income markets have, arguably, been the most impacted by central bank policies. Below investment grade borrowers, in particular, have been able to take advantage of low interest rates by issuing record amounts of debt. Record borrowing, which has been met with increasing investor demand, led yields on high yield bonds to

[3] It is worth noting that in the current environment the primary way to get attractive long-term returns from investment grade fixed income investments is for interest rates to rise. Rising interest rates is a worry in the short- and medium-term but essential for the long-term health of financial markets and investors' portfolios.

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briefly fall below 5% in mid-2013. More recently, the yield on below investment grade bonds was only slightly above 5%. To put this in context, prior to 2013, the yield-to-worst on the Barclays High Yield Index had never dropped below 6% in its more than 27-year history. In aggregate, valuations are stretched in the high yield market, particularly in the lower credit quality segment of high yield. While also not cheap, the floating rate and senior secured nature of bank loans has made them less susceptible to rising interest rates and likely to provide higher recovery rates in the event of defaults. Historically, bank loans have also proven to be less volatile than high yield fixed income. For these reasons, investors might want to consider shifting some portion of their high yield portfolio into bank loans. As mentioned, investors should be aware that bank loan valuations are not particularly attractive. The average price on bank loans is near par ($98.72 as of March 31, 2014) and the current yield of 4.7% is below the long-term average of 6.6%.[4] Nonetheless, substituting bank loans for high yield fixed income may make sense in today's environment.

Investors may also want to reexamine their investment grade corporate bond allocations. Defined benefit plans implementing a liability driven investing strategy may want to favor government bonds over corporate bonds given the relative tight spread levels in the corporate market with the spread on the Barclays Corporate Index tightening to 106 basis points as of March 31, 2014. This level is below both the long-term average of 134 basis points and Rocaton's equilibrium expectation of 150 basis points. As corporate bond spreads have tightened, investors are being compensated below average amounts for taking on credit risk. Other investors with the flexibility to allocate between corporate and government bonds may also want to make similar adjustments. In the short-term, this decision is likely to lower both portfolio yield and return expectations, but the downside protection provided by Treasuries historically might again prove to more than compensate investors for the give up in yield.

Conclusion

Monetary policy decisions in recent years likely helped avoid an even more prolonged and deeper recession. Asset prices have responded and risen significantly across many markets. It should come as no surprise that future expected returns across markets are relatively low. In our opinion, investors should be aware that the compensation for taking risk in many markets today is diminished. Instead, investors should reposition portfolios in order to exploit some of the limited market opportunities that exist, generally be positioned at or possibly even below target risk levels and be prepared to deploy capital during the next market correction.

[4] Unlike other fixed income markets, bank loans rarely trade above par due to the fact that many are callable at par.

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