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Decoding Volatile Equity, Fixed-Income Markets Key For 2015

In a year where strong equity returns boosted the market values of many endowments and foundations to their highest levels since 2007, the dethroning of a bond king stole the headlines during 2014.

Endowments produced an average of 15.8% in returns for the fiscal year ending June 30, 2014, according to preliminary data compiled by the *NACUBO-Commonfund Study of Endowments*. Operating charities, comprised of religious, cultural and social service organizations, were not far behind their endowment peers as they returned 15.1% for the calendar year ending December 31, 2013.

Overall returns were led by domestic equities, which gained an average of 22.6% for endowments, according to the preliminary data, in a year when the Standard & Poor's 500 Index returned 12.99% as of Dec. 31.

Yet is was the departure of PIMCO Co-Founder and CIO Bill Gross on Sept. 26 that turned the focus back to fixed-income for institutions, as investors pulled approximately $19.4 billion from the firm's flagship Total Return Fund in December, according to a statement this month. The Total Return strategy had $143.4 billion of assets at the end of December, down from its peak of $293 billion in 2013.

Institutional investors, including foundations, endowments, 529 plans and hospital funds, removed approximately $800 million in mandates from the firm, according to data compiled between Gross's departure on Sept. 26 and the year ending Dec. 31 by *NPNews*.

The past year also saw a rise in fossil fuel divestment discussions, as colleges throughout North America were faced with decisions regarding the risk and reward benefits of divestment versus engagement.

As 2015 gets underway, the volatility of the global equity markets and interest-sensitive concerns surrounding fixed-income are still in the forefront, as interviews with multiple institutional investors, consultants and money managers are indicating.

While investors are still favoring more volatile but opportunistic plays in emerging and frontier markets, further research continues to emerge on the pros and cons of smart beta strategies.

In fixed-income, investors said they are largely paring down or maintaining allocations as concerns regarding rising interest rates persist.

And overall, investors are erring on the side of caution and bracing themselves for a volatile, if not lower return environment, they said.

Bracing For A Lower Return Equity Environment

Institutional investors have rode the equity bull market over the past few years, but they are beginning to temper expectations for the asset class as they anticipate entering a low return environment in the coming years, according to interviews with allocators and investment consultants.

"Looking at the potential rate of return, one issue we're dealing with is a low interest, low inflation environment. The U.S. is doing better than the rest of the world at this point and the U.S. has been above expectations, but the rest of the world is decelerating, especially those countries dependent on high-oil price exports,"

said Jimmy Chang, chief equity strategist for Rockefeller & Co.

Jimmy Chang

The consensus for 2015 domestic equity earnings growth is 10%, Europe and emerging markets come in slightly higher at 11% and Japan a notch up from there at 12%, according to Celia Dallas, chief investment strategist with investment consultant Cambridge Associates.

Other projections shows similar numbers that are more conservative as the time period is extended to two years, with domestic equity returns driven by dividend yield, inflation and productivity improvements possibly landing in the 7% to 9% range, according to Tim Barron, senior v.p. and cio at investment consultant Segal Rogerscasey, adding that it will be "a bumpy road to get to that figure."

Over the course of the calendar year 2015, some investors expect domestic large-cap equity outperformance to persist over domestic small-cap equity. The ability of large-cap equities to be relatively defensive and offer better valuations than small-cap stocks will keep those companies attractive over the year.

Ryan Harvey

"Even in a market that is fully valued, we can still find opportunities in various sectors and geographies. I would say that looking at the efficiency of the market, data has proven that most U.S. large-cap managers have failed to outperform their benchmarks on a consistent basis. If you look globally, I believe there are still inefficiencies. Good active managers can capitalize on that and generate excess returns for their clients," Chang said.

The lower valuations of large-cap equities make the capitalization more attractive to investors than small-cap equities, with the relatively high valuations across the asset class due in large part to central bank support.

"The combination of persistently low interest rates and improving economic fundamentals have pushed market participants out on the risk curve, taking equity valuations higher," said Ryan Harvey, director at investment advisor Sellwood Consulting. "The question from here is whether those valuations can be justified by continued economic improvement. Good news is good news, but if it is already priced into the markets, it doesn't benefit the investor and leaves high valuations somewhat fragile and susceptible to drawdowns should fundamentals disappoint."

Lower equity valuations for markets outside of the U.S. have investors touting them as more attractive plays down the road.

European equities are attractive to some investors, with Dallas of Cambridge Associates noting that it is her highest conviction equity position for 2015 on a currency hedge basis.

"The economy is struggling, but investors should consider that Europe gets more than 50% of its revenue from outside of the region," Dallas said. "Europe's exports should see improvement from a weaker Euro, their finan-

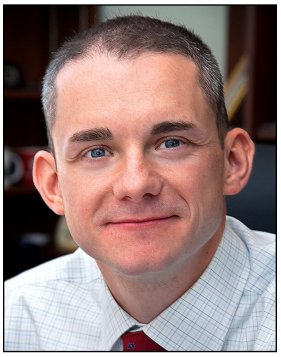
Asset Class	2013	2014
Domestic equities	20.60%	22.60%
Fixed income	1.70%	5.40%
International equities	14.60%	19.60%
Alternative strategies	8.30%	12.80%
Short-term/Cash/Other	1.20%	2.70%

**Average Return by Asset Class for Fiscal Years 2013 and 2014 from 2014 NACUBO-Commonfund Study of Endowments*

cials have seen recovering earnings through less provisioning for nonperforming loans. Risks still remain for earnings, but the pricing is relatively attractive."

Other investors are not as bullish on the European equity markets.

"Europe has the potential for positive surprise, but it is likely to have a long, slow road ahead. Europe has more attractive valuations when compared to the U.S., but many questions persist relative to its banking system and economic direction in general," Barron said.



Tim Jarry

With investors agreeing in interviews that concerns about domestic equities are further down the road coupled with valuations and the general notion that Europe is still a risky play, they will look to emerging and frontier markets in 2015 and beyond.

"Domestic equities have performed better than emerging markets equities in the last five years, but we do not expect that trend to continue long-term," said CIO Tim Jarry of the College of the Holy Cross. "We are slightly underweight U.S. equities in favor of emerging markets and European equities."

The pockets of the emerging markets that investors may find attractive for 2015 are those areas with ties to natural resources like materials, energy and financials, anything viewed as vulnerable to a slowdown in global growth, and particularly growth in China, according to Dallas. She added that emerging markets are a "value play that will ultimately benefit from normalization of relative valuations; however macro headwinds continue to give us pause. We are comfortable with modest overweights today, especially against richly valued U.S. equities, for investors with a long-term time horizon and some tolerance for volatility."

Holy Cross' Jarry said he has seen a lot of investors begin to move capital back into emerging markets after getting out five or six years ago. He thinks that the more attractive emerging markets will be the countries that are not tied to or driven by commodity prices, where there has been volatility as of late as evidenced by the drop in oil prices in October. Jarry said in the emerging markets, he will continue to focus on companies that derive their revenue from the local consumers in the country.

Frontier and emerging markets represent interesting opportunities for investors because they are undervalued, however they are also riskier plays because of volatility and the fact that much of the markets are not "institutionalized," resulting in the costs of investment remaining high.

Barron said that as long as global developed economic growth is muted, it will be tough for many emerging markets to show robust growth, particularly in the more export-driven economies.

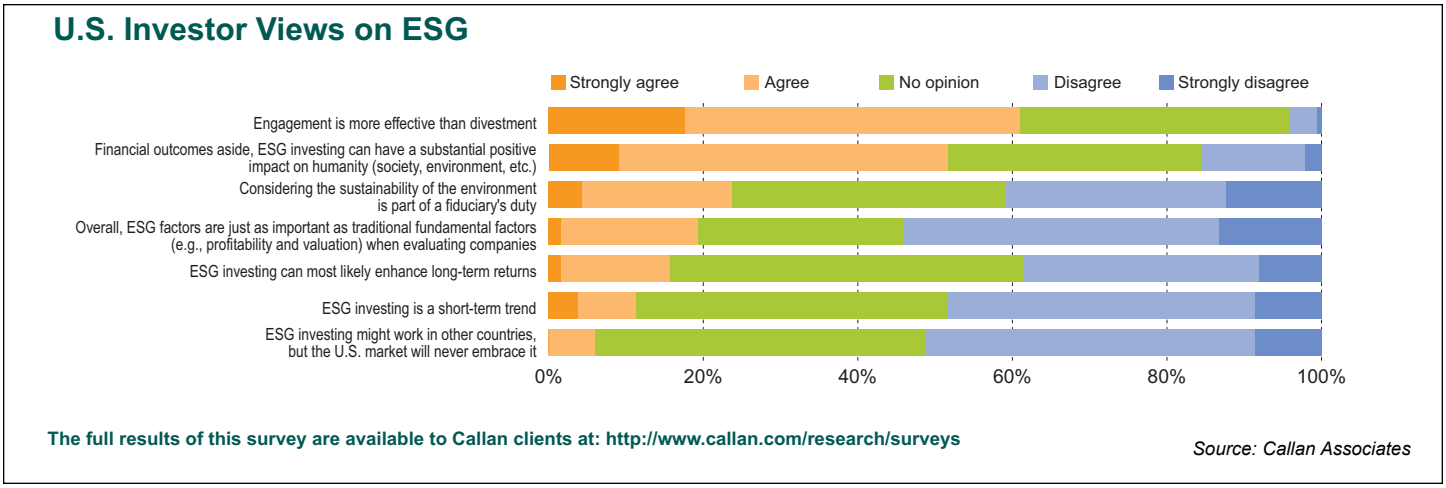
"The fact that most institutions overlook the frontier markets makes them interesting, but the costs make them unattractive," Sellwood's Harvey noted. "It's a balancing act."

With domestic, international and emerging markets equities all showing signs of attractiveness and hopefully positive returns in 2015, there is still a sense of uneasiness on the parts of investors as they believe they are entering a low return environment. The asset classes may outperform for a year or two, but investors are looking for downside protection and exploring other areas to deploy capital.

"It is challenging to reduce our allocation to equities right now since there is no attractive place to reallocate the capital right now," Jarry said. "We still believe active management can add value to a portfolio. With the prospects of a low return environment and increased volatility, we want to continue to maintain relationships with top-tier managers that can add alpha."

Talk Turns To Action For Divestment, ESG Initiatives

Discussions also shifted in 2014 to the divestment of fossil fuels from university campuses to their investment committees, leading to the removal of fossil-fuel related investments from numerous institutions such as Pitzer College, the Rockefeller Brothers Fund and the California State University—Chico Foundation and the anticipation that further divestment discussions will take place in 2015.



Overall, impact investing is at an all-time high. The assets engaged in sustainable, responsible and impact investing practices at the start of 2014 represent nearly 18% of the $36.8 trillion in total assets under management tracked by Cerulli Associates, according to the U.S. SIF Foundation's 2014 trends report.

From 1995, when the U.S. SIF Foundation first measured the size of the U.S. sustainable and responsible investing market, to 2014, the socially responsible universe has increased 929%, a compound annual growth rate of 13.1 percent, the organization said.

Donald Gould, a trustee and chair of the investment committee at Pitzer College, said that he has seen an increase of fossil fuel discussions first-hand and believes that notable institutions such as RBF and Stanford University have further legitimized the movement going forward.

"In terms of interest level, not a week goes by that I do not get an inquiry on how we thought about our decision," Gould said. "We've had an impact and I think it's the one we want to have and it set an example for [other institutions] to follow."

Gould says that the fossil fuel divestment movement has a greater impact in more ways than he could have ever imagined. In one case he cites a blog post (http://www.exxonmobilperspectives.com/2014/10/10/some-thoughts-on-divestment) from ExxonMobil in October that addresses the movement.

The company's feelings can be summarized in one sentence of the blog post when it characterizes fossil fuel divestment as "simply, a movement that is out of step with reality."

"I thought the fact that Exxon was compelled to do that means that divestment is on their radar and they're concerned about it," he said. "You don't devote a long blog post to something you believe is irrelevant."

Earlier this year, investment consultant Callan Associates sought to dig a bit deeper into the long-term interest of environmental, social and governance investing by surveying institutional investors to see where they stand on incorporating ESG standards into their investment decisions.

In Callan's *Moving the Dial: U.S. Investors Warm to ESG*, the firm found that overall, foundations, endowments, public funds and corporations were warming to the idea of ESG investing, with 26% of the investors incorporating ESG factors into their investment decisions, up from 22% from a study conducted last year. Among those institutions, more endowments and public funds have incorporated ESG into their investment decision-making than a year ago.

Anna West, v.p. and manager of Callan's Published Research Group, said that the increase could be attributed to the growing awareness of ESG, as well as an influx of new information from data providers and consultants on ESG and the types of strategies available to investors.

"Investors are realizing that it is not the case that ESG investments just include [negative screening] data…they can use ESG to enhance strategies," West said during an interview in November.

Natixis Global Asset Management surveyed institutional portfolio managers for their take on the ESG movement to mixed results. Forty-eight percent finding these strategies are public relations measures rather than a performance standard.

The divisions in opinion continued to show in the survey results, as about 45% of portfolio managers said they apply these screens to their investments and 55% say ESG measures help them mitigate idiosyncratic risks such as loss of assets from lawsuits, social discord and environmental disasters.

RBC Global Asset Management said that media coverage of socially responsible investing, including the divestment movement, has driven a great deal of interest in new strategies that could address sustainability concerns by investors.

Ron Homer

"There has been a lot of publicity around impact investing and ESG…I think and we've seen a lot more activity in that we've been meeting with a lot wider range of clients interested in the space," said Ron Homer, co-founder of the Access Capital Community Investment Strategy at RBC and a managing director with the firm. "I would say that 2014 has been a year in interest of exploration than implementation, but I do think that over the last couple of months, because of the exploration and discovery stages, people are starting to hone in on strategies that could be implemented in 2015."

On the equity side, Homer said that there has been an increase in RFPs from institutional investors seeking managers to implement ESG screens.

"More consultants are asking about strategies because their clients are asking about what's available, while many more [consultants] have created departments and hired specialists, and that certainly has helped," he said.

In 2014, nonprofits such as the Meyer Memorial Trust and McKnight Foundation announced their intent to expand impact investing allocations into 2015 and beyond.

The Portland, Ore.-based Meyer Memorial Trust said it would invest up to $2 million to opportunities with the greatest potential for social, environmental and regional economic impact in Oregon and Southwest Washington, engaging investment advisor Threshold Group to assist with the effort, according to an April announcement.

The Minneapolis-based McKnight Foundation, which said it would allocate $200 million to impact investments, also hired Elizabeth McGeveran as its new impact investing program director during the summer as part of its dedicated efforts to the strategies.

Mellon Capital Management, which has been touting the benefits of ESG investing for its clients, was also a beneficiary of McKnight's efforts through its work with investment consultant Mercer to launch of a new Carbon Efficiency Strategy that was seeded with $100 million by the organization in October.

"[More institutions] have to recognize that you don't have to give up return in pursuing environmental and social goals," said Karen Wong, managing director and head of equity portfolio management at the firm, during a November interview.

Wong said that while institutions face a multitude of challenges in balancing their fiduciary and sustainability goals, they may be better-suited to an engagement approach over one of divestment.

"There is an argument that if enough people are getting out, it will force them to change. We want to be more inclusive and we have an engagement process in our strategy where we use proxy voting and signatory initiatives to engage companies," she said.

Gould disagreed with the approach of engagement over divestment when asked about these two sides of the argument being addressed by fiduciaries today.

"I think this idea that engagement is an alternative to divestment misses the point entirely. You're not going to engage Exxon to get out of the oil business, sell at a higher price than they need to or not maximize their profits from the sale of oil. You might be able to engage them about their drilling practices and labor practices, but that's a whole different set of issues," he said.

Breaking Down Smart Beta

Investors who are not bullish on active management for reasons such as fees, but are still looking to generate returns or reduce their equity risk, especially in low return environments, are beginning to turn to factor-based investing, also known as smart beta or strategic beta strategies.

In February 2014, Towers Watson reported that clients made over twice as many new investments in smart beta strategies during 2013, allocating around $11 billion across over 180 portfolios, compared to 2012 when approximately $5 billion was allocated across almost 130 portfolios, according to global data from the firm.

Eugene Podkaminer

In the past year, institutions such as the New Mexico State Investment Council allocated to the strategy, hiring smart beta manager FTSE Group to manage $300 million in its RAFI Low Volatility fund. In 2013, the University of Tennessee endowment said it would investigate the strategy, although it is unclear if it was further pursued in 2014.

When asked for his thoughts on smart beta, Lehigh CIO Peter Gilbert said that institutional investors may find solace in using the strategies as an equity surrogate.

"I've not spent a lot of time on it, but I think if you don't like active management, then it's certainly worth looking into," Gilbert said during an October interview. "If you don't have a lot of confidence in [active managers], which is true for a lot of larger pension funds, then looking at something private in a different approach may be useful."

Smart beta is a mechanical, pre-defined rules-based formulaic weighting approach to an investment strategy, typically through U.S. long-only stocks, which is designed to provide exposure to a particular characteristic or factor, such as value, quality, volatility or momentum, among groups of stocks that are similar, according to Eugene Podkaminer, senior v.p. of capital markets research at Callan Associates, and Richard Yasenchak, senior v.p. and client portfolio manager at INTECH, in separate interviews on the strategy.

Smart beta strategies inadvertently benefit from a rebalancing premium by selling stocks after they rise and buying stocks after the decline to a target weight, which on average, realizes a trading profit for the smart beta portfolio, according to Yasenchak.

Smart beta has a passive component where it does not attempt to make risk estimates or return forecasts on individual stocks or the overall portfolio and an active component where it does not hold the cap-weighted index, which is why the strategies fees' are cheaper than active management, but still come in higher than traditional cap-weighted index funds.

Implementing a low-volatility strategy is designed to reduce the risk of the equity portion of an investor's portfolio, which allows the investor to spend their active risk elsewhere, according to Podkaminer.

"Using the strategy in a context of managed volatility, as a dimmer switch on a light, you can take little risk reduction in the strategy when the markets are bullish and moving up or down or you can dynamically switch the level of risk to reduce it even more when the markets are stressed and trending down," Yasenchak said.

The negatives that accompany smart beta strategies are the primary risks of overcrowding and rebalancing as well as taking on exposure to particular risk factors.

"The difficulty with these approaches is that there is no bright neon sign advertising that a particular strategy will deliver a certain type of factor exposure, the asset manager leaves it up to the consumer to figure it out," Podkaminer said.

Equities are likely to perform well in 2015, with some volatility along the way, according to investors, but as a low-return environment looms in the future, they will begin to look to strategies such as smart beta or look into other assets classes to put capital to work to generate returns to meet their spending needs, although it remains to be seen how much capital will be leaving the asset class down the road.

Timothy Barron

"Unless there are significant cracks, it is hard to imagine substantial flows out of equity," Barron said. "There is a baseline argument that there is a protective layer under equity that is hard to quantify. Investors are generally subscribing to the idea that the possibility of 8% from stocks is more attractive than the certainty of 2.5% or so from bonds. The certainty of 2.5% or so bond returns does not give one a warm feeling especially if one's endowment needs at least 5%. In response to this perspective, we think there will be continuing effort to reach for risk not just in equity, but in alternatives to fixed-income such as real estate and hard assets, as well as some of the more esoteric fixed-strategies within the fixed-income sectors."

Fixed-Income: Where Do We Go From Here?

The curious case of fixed-income is still on the minds of institutions, as rising interest rate concerns continue to keep investors questioning how to compensate for the perpetuation of low returns in the asset class.

Seventy-four percent of fixed-income investors said they are concerned about how rising rates may impact their portfolio, according to a fixed-income survey released by Franklin Templeton Investments in November.

"It's our conviction that we are at the end of a 30-year decline in interest rates," said Michael Hasenstab, cio for Global Bonds in the Franklin Templeton Fixed Income Group, in a statement discussing the survey's findings. "We need to prepare for the next decade when interest rates will likely be rising, and we believe an attractive alternative is a portfolio that is actively managed, global and unconstrained."

Unconstrained bond mandates have been attractive to numerous institutions in 2014, as 12 mandates were completed during the calendar year across foundations, endowments, pension and operating funds, while several other searches are still in the review process and others were initiated in response to liquidations of unconstrained mandates managed by PIMCO, according to data compiled by *NPNews*.

When asked about the staying power of unconstrained fixed-income, a cio from the Southern region of the U.S. said that it is less about the viability of the strategy than the manager that is handling it.

"As I recall, PIMCO's unconstrained strategy, for example, was very conservative. What that means is they got really short [in duration], and that means they haven't done very well. I know a lot of people have moved into unconstrained mandates…but whether or not they're successful is dependent on the manager since one can be doing something completely different than their competitor. It's a loose definition by design, but that might also just be another way of saying they don't want to be in the Barclays Aggregate," according to the cio, who asked to remain anonymous.

Franklin Templeton's survey supports this view, as it found that 70% of investors are currently invested in active fixed-income strategies.

"Fixed income investors need to understand that if they choose passive investments such as index funds, they are essentially choosing to follow the herd," said Ed Perks, cio of Franklin Equity Group, in a statement discussing the findings. "That means buying what's popular and selling what may be only temporarily out of favor, rather than actually evaluating whether issues are overbought or present true bargains. There is nobody at the helm looking forward and evaluating, for example, whether a rise in rates is a brief spike or the beginning of a longer-term trend."

And similar to reports from the past two years, institutions are continuing to look to active fixed-income, including credit-related strategies, as an alternate to passive core fixed-income exposure.

"I think there is value in active [non-traditional fixed-income] management," the cio from the South said.

"We've added hedged or relative value credit. I think credit strategies are where people have gone to and I don't see that slowing down. I think it's really people wanting to get out of the Barclay's Aggregate."

Despite all of the concerns over interest rate fluctuations, arguably the most cause for changes in fixed-income portfolios came as the result of organizational changes at fixed-income shop PIMCO.

The departure of Bill Gross from PIMCO to join Janus Capital Group led to mixed feelings among investors, citing the reorganization of the firm's as one that made the firm stronger in the long run if the large outflow of assets did not hurt the firm in the short run.

"Our general attitude about investment management firms and my attitude is that as long as the team we hired remains intact, I'm happy," former Wyoming State Treasurer's Office CIO Michael Walden-Newman said after Gross's departure in September. "I've been through it all-if someone gets a divorce and moves, I've stayed with the team. If the team gets married and changes its name, I've stayed with the team. If whomever we hired in the first place is still there, I'm comfortable."

"In this case, my question to them is, as an investor with $2.6 billion in a bond fund with PIMCO, why should I not take my money out if the founder of the firm has abandoned ship? I'm confident with the team intact, but when the founder leaves there's some disruption. My responsibility is to the people of Wyoming and the people have $2.6 billion of their money with the firm," he added.

Emerging market debt continued to mark itself as an area of diversification for institutions, even as the Natixis survey showed that only 5% of investors anticipated it would be the top-performing asset class of 2015. By comparison, 12% of investors anticipate global equity will outperform in the new year.

However, institutions have still found a place for emerging market debt as an area of uncorrelated bond returns, with investors and their consultants aiming to carve out allocations.

Central Michigan University, for instance, this year had carved out a maiden 3% allocation to emerging market debt for its endowment pool following a recommendation from new consultant NEPC.

When discussing the undisclosed managers to fill the allocation earlier this year, NEPC pointed to a firm's top-down approach to their portfolio construction strategy and that they were less quantitatively oriented than the other managers considered. Having a research team devote a great deal of time to obtaining an in-depth understanding of local emerging market conditions regarding monetary policy, politics and business cycles through extensive travel and discussions within the countries in question was also viewed as a strong attribute to the recommendation.

Earlier in 2014, the Nunavut Trust disclosed an investment with emerging market debt manager Ashmore Investment Management, which was hired to fill out new allocations to the Ottawa, Ontario-based fund's new investment policy based on its positive long-term outlook for the strategy, CEO Fern Elliot said at the time.

James Barrineau, co-head of emerging markets debt relative at Schroder Investment Management, said in a Dec. 16 report that for the first time in years, real value is opening up in emerging market debt.

Barrineau said that the clearest signal of cheapening assets in emerging markets has been the decrease of the Mexican peso in value against the dollar.

"…we passed the lows in nominal value achieved in 2011—at the height of the European crisis—and began to approach the absolute lows achieved post the 2008 financial crisis. Though it is simplistic to look at only nominal values, real exchange rates—arguably stretched in value for most of this century across EM—are correcting at an extremely brisk rate," he said.

Van Eck Global provided its take on emerging market debt in *Why Emerging Market Bonds?*, where it discussed the benefits of the strategy. The firm said that improved economic/fiscal policies and creditworthiness have contributed to the development of emerging economies and that the market appears small in size relative to its contribution to global GDP, leaving room for possible growth.

As of the June report released by Van Eck, institutions own 82% of emerging market bonds, with emerging market corporate bonds having had higher yields and their issuers tend to have less leverage than equally-rated developed market borrowers.

Despite the overall positive outlooks for both the equity and fixed-income markets, a rise in volatility that ended the calendar year appears to be a telling sign that there may be a fair amount of tricky market conditions ahead for investors.

"As a result of the returns that we've seen over the last five to 10 years, we are prepared for a lower return environment across all asset classes over the next five to ten years," Jarry said. "With that being said, I would not be surprised if domestic equities continue to outperform over the next year."