Highland Associates, Inc.

Third Quarter 2014

CAPITAL MARKETS QUARTERLY

LEARNING FROM THE BEST IN THE BUSINESS

In the world, there are two opposing views: the world view and reality. The world view is the collective opinion of the world that is made up of news outlets and biased reporting. Reality, on the other hand, is how the world truly works. At Highland, we spend a great deal of time trying to decipher the enormous amount of information available in order to sift through the world view and make investment decisions based on reality. We do this by independent research and active intellectual discussions with trusted market participants.

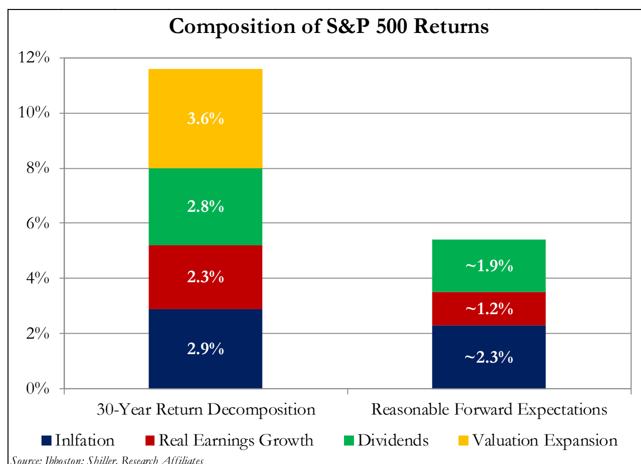
In September, Highland held its fifth client conference at the Ross Bridge Golf Resort & Spa in Birmingham, AL. This was a time for our clients to come together and to share some of their best practices with other investors. It was also an opportunity for our clients to hear from some of the best investment teams in the world. We discussed how these market participants see the world and what the investment implications are based on how they see the world. In this quarter's letter, we will present the topics discussed at the conference.

"Navigating the Global Markets through Tactical Allocation"

Jason Hsu, Co-Founder and Vice Chairman, Research Affiliates

Jason Hsu, co-founder of Research Affiliates, kicked-off the conference with his discussion on how investors should navigate the global markets through tactical asset allocation. Looking forward, investors will be confronted with a future that will be different from everything they've grown accustomed to over the past 20 or 30 years. Mr. Hsu believes investors need to adopt realistic return expectations. Too many investment plans still set return targets at long-term historical averages, assuming a 7-8% annual return for the classic 60/40 portfolio. In modeling expected returns, Research Affiliates has forecasted future long-term returns (5-10 years) of approximately 2.5% annually for bonds and 5.5% for stocks. Due to today's valuations and the slow economic environment, a typical blended portfolio can be expected to produce a 4-5% return, significantly below long-term averages. **Figure 1.1** shows the composition of the past 30 years of S&P 500 returns against what is expected in the future. Based on our projections, which are broadly similar, and the current opportunity set, Highland also feels it will be difficult for clients to achieve their policy return through investments in only stocks and bonds.

Figure 1.1



Most investors over rely on two "pillars," consisting of developed market stocks and bonds. Bonds have been successful in helping diversify portfolios for the last 30 years, but with yields at an all-time low, we find it difficult to picture them being as effective down the road. Mr. Hsu stressed that investors, if not already established, need to urgently build out a "Third Pillar" within their portfolios. This "Third Pillar" should not be highly correlated to stocks and bonds and can provide diversification in inflationary periods, as well as during times of low returns in stocks and bonds.

In order to build this "Third Pillar," investors should consider non-traditional asset classes, such as **hedging strategies, private investments, emerging market stocks and bonds, high-yield bonds, bank loans, and TIPS.** In the current market, Mr. Hsu makes the case for emerging market debt and equities. As the emerging market bond sector continues to grow, an increasing number of developing nations are tapping the credit markets. While the bulk of emerging market headlines focus on default, the majority of emerging market debt is investment grade. Overall, emerging economies and corporations have significantly lower debt-to-GDP or debt-to-equity ratios than those of developed nations, while also offering significantly higher yield. While EM equities have suffered from a lot of recent negativity, they seem attractive when compared to U.S. equity valuations and seem well positioned for long-term returns.

Highland likes to give flexibility at the manager level and allow our managers to actively allocate to areas of the market where they find attractive valuations. Because of this, our clients have received exposure to areas such as EM debt and equity without having direct investments in the asset classes. Highland is currently taking a deeper dive into the emerging markets to determine if it deserves a specific mandate, but we feel comfortable with the current exposure our clients are receiving. We agree with Mr. Hsu's idea for the need of a "Third Pillar", and Highland believes we have helped our clients build this through their alternatives portfolio. Whether it is through investments in real estate, hedge funds, or liquid alternatives, we feel confident that our clients are receiving the proper diversification to go along with their traditional stock and bond investments. Highland believes this diversification has positioned client portfolios to be able to successfully navigate a wide range of market outcomes.

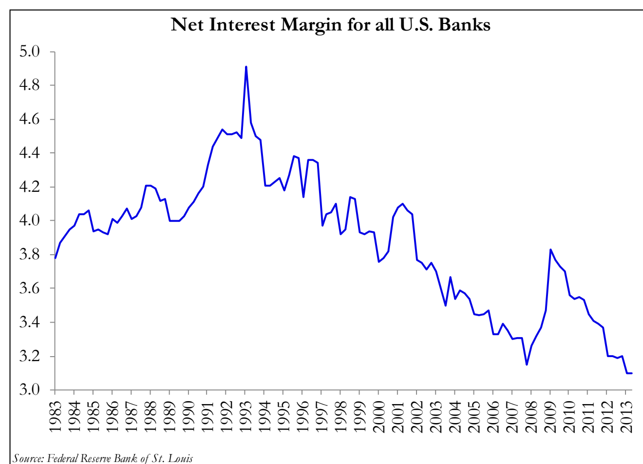
"A Conversation on the Economy, Markets, and Washington"

Peter Fisher, Senior Director at the BlackRock Investment Institute

Peter Fisher discussed his current views on the economy, the subsequent actions by the Federal Reserve and its impact on asset allocation decisions. While the Federal Reserve's actions were highly supportive of the U.S. avoiding a Great Depression scenario during the 2008-2009 financial crisis, Mr. Fisher was critical of the unintended consequences associated with quantitative easing (QE). One example Mr. Fisher cited is how the current low

interest rate environment has caused credit growth to remain anemic compared to past economic recoveries. Banks earn a profit (also called a net interest spread) based on the difference between the rate they borrow (short-term rates) and lend (longer-term rates). **Figure 2.1** illustrates this spread is at an all-time low, as long-term rates continue to be lower due to influence by Federal Reserve policies. Mr. Fisher argued that a gradual increase in longer-term interest rates could increase credit growth as banks are more incentivized to lend. Coincidently, when longer-term interest rates rose in 2013 during the "Taper Talk" credit growth actually accelerated immediately thereafter.

Figure 2.1

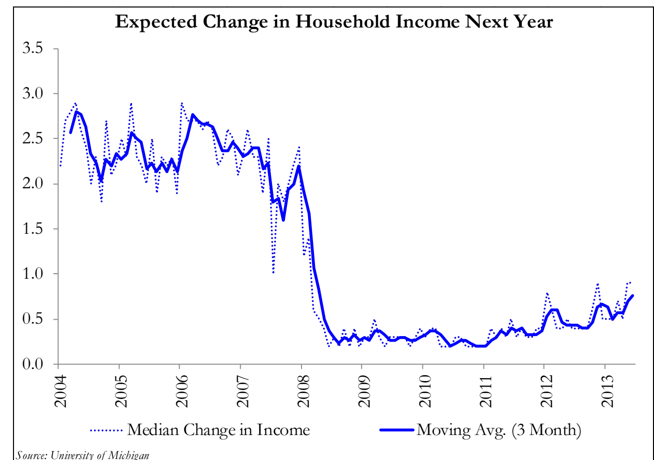


Source: Federal Reserve Bank of St. Louis

Another way that Federal Reserve actions have had unintended consequences, relates to volatility in financial markets. According to Mr. Fisher, financial markets have become shock absorbers for the overall economy as a result of Fed actions to stimulate the economy (zero-bound interest rates and QE). We have discussed this in past quarterly letters and continue to believe that investors will see higher than normal volatility in financial markets going forward.

Highland has held the view that the current slow growth environment will continue for a considerable time. Mr. Fisher shares this view for two primary reasons. The first is that we are essentially borrowing consumption from the future by artificially holding interest rates low to stimulate the economy. **Pulling economic growth forward has the effect of diminishing future growth and returns**. Another reason involves expectations for **income growth, which has been stubbornly low since the financial crisis** as wages have been held in check (see **Figure 2.2**). As consumer spending comprises 70% of economy, it will be extremely hard for growth to match historical levels without significant increases in wages.

Figure 2.2



Source: University of Michigan

Mr. Fisher advised the audience that "free money" has artificially increased asset prices making it hard to stay confident in one's asset allocation as there aren't many areas of the market in which risk isn't priced in. We have been preparing clients for a continued slow growth environment for some time now. Having a broadly diversified portfolio with diversified economic exposures (i.e. crisis hedges, growth, inflation, volatility control) positions our clients for an environment of slow growth and higher volatility.

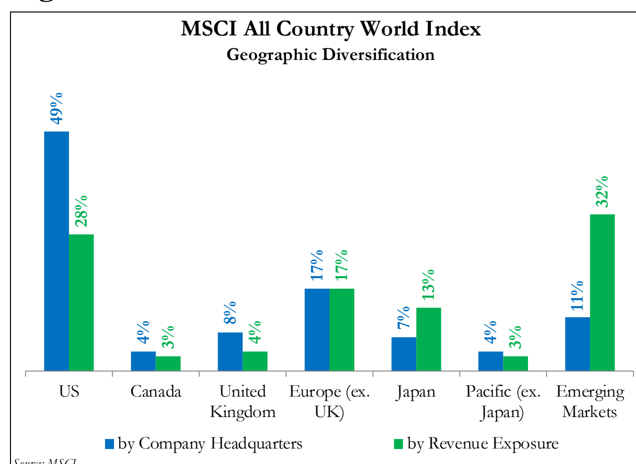
Global Investment Panel
Dave Holstein, CFA, Capital Group
Charles MacQuaker, Walter Scott
Heather Waddell, CFA, Templeton

As discussed in the previous sections, global managers are facing a multitude of challenges. Highland has taken great care to allocate to global managers whose commitment to thorough fundamental analysis and risk control has allowed them to identify and exploit the opportunities that accompany these challenges. As a result, seven of the eight global equity managers currently approved for use by Highland's Investment Committee have outperformed the MSCI All Country World Index on a trailing five year basis with an average annualized excess return of 0.9%[1] net of fees over the same time period. Highland's commitment to collaborative analysis has led us to choose these managers, each of whom shares our core philosophical foundation of exhaustive analysis, flexibility, and capital preservation.

We were privileged to have portfolio managers from several of these firms – including Capital Group, Walter Scott, and Templeton Investment Counsel – present their insights on the global investment landscape. Their key concerns included (1) the sustainability of earnings and corporate profits in a low growth/low return environment, (2) deflationary pressures and the threat of a "triple dip" recession in Europe, and (3) rising geopolitical tensions in the Middle East, Europe, and Asia. Equally important, the key opportunities they identified included (1) unsynchronized monetary policy at the world's leading central banks, (2) an abundance of secular growth drivers, and (3) select valuation opportunities.

A central theme of each of the three managers' comments was the distinction between the geographic and economic exposures of their respective portfolios. These managers have concluded that a focus on fundamentals (where companies are generating their revenue and profits) is far more effective than simply examining where a company is headquartered. By emphasizing business models that are positioned to benefit from secular trends around the world, these managers can effectively exploit growth and valuation opportunities while limiting risk. **Figure 3.1** shows just how significant the divide between geographic and economic exposure has become.

Figure 3.1

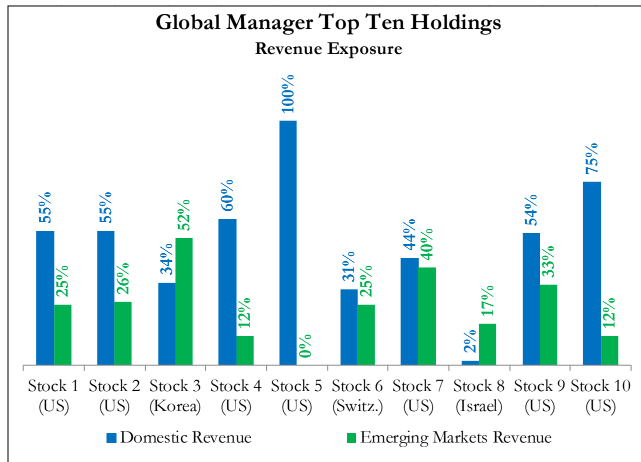


A look at one of Highland's approved global managers further illustrates the concept that a company's country of domicile is not necessarily indicative of where it conducts its business. In **Figure 3.2**, the manager's top 10 positions are shown, along with the percentage of revenues

[1] **The average outperformance is calculated using the monthly published returns for each manager's mutual fund. The MSCI All Country World Index is calculated by using the monthly published returns using net dividends.**

earned in the country of domicile and in emerging markets, where economic growth rates are generally much higher. Seven of the top ten holdings names are domiciled in the U.S., but only two of those firms generate more than 60% of revenues domestically.

Figure 3.2



These examples show that managers are finding opportunities around the world and positioning their portfolios to benefit from a multitude of secular growth drivers. These include (1) the emergence of middle class consumers in developing economies, (2) improving living standards in many parts of Europe and Asia, (3) longevity/opportunities in healthcare; and (4) connectivity/advances in technology around the world. Highland and our approved managers believe that it is these trends, and not simply a company's headquarters, that will drive future returns. As a result, we expect that the thorough, bottom up fundamental foundations of these global managers will continue to serve clients well on the challenging road ahead.

Private Market Panel
Allan Holt, Carlyle
Chris Pucillo, Solus

Highland continues to recommend volatility controlled strategies despite their underperformance relative to long only indices in recent years. Some large investors have recently made national headlines after the decision to remove some of these strategies from their portfolio. We feel that this would certainly be the correct decision if global markets appreciated into perpetuity. However, we are of the opinion that "this time" is arguably never different, as long as human psychology plays a material role in setting market prices.

Chris Pucillo discussed the distressed investing environment. Despite low default rates, Solus has managed to put approximately 40% of their portfolio into new opportunities this year. They feel that an increase in default rates is inevitable in the coming years, and the team continues to monitor areas which they believe will be fruitful such as utilities, shipping, and infrastructure.

In environments like the current one, our team at Highland spends a substantial amount of time looking at global markets and attempting to find areas that offer attractive returns and downside protection. When long term expected returns are lower, we believe that it is imperative to focus on the global supply and demand for capital, as the best opportunities often lie in areas where capital is scarce. Dry powder, which is the amount of committed and un-invested capital to private investment funds, is at an all-time high. Yet investor demand for certain strategies has not been matched in the better part of a decade. This flood of capital is bringing new entrants into many areas, and strategies such as value added real estate and mezzanine debt are

experiencing increased competition and lower return expectations without the generous use of leverage. Private equity strategies continue to find select opportunities, but many of the best managers continue to tread carefully.

Alan Holt, Co-Head of U.S. buyout at Carlyle Partners, discussed private opportunities. Due to the current environment, Carlyle is finding less opportunity in traditional buyouts, and the strategy has favored complex carve-outs and growth equity investments due to favorable competitive dynamics. While the opportunity for distressed corporate and structured credit in the U.S. continues to wane, the opportunity set is alive and well in Europe. Distressed and activist structured credit strategies with a global or European focus offer attractive returns and a moderate degree of downside protection should the global economy weaken. Distressed or distressed for control, in some instances, can even have a counter-cyclical element, as performance for some strategies improves as global economies weaken. Highland believes that opportunistic allocations will continue to add value for long term investors, and we continue to selectively recommend new commitments for our clients, where appropriate.

"Maintaining a Disciplined Spending Policy and Its Long-Term Impact"

Lee Cohen, CFA, Wellington
Cara Lafond, CFA, Wellington

As endowments and foundations struggle to match their resources to an ever growing mission, it can be difficult for these organizations to balance funding short term needs with investing for the future. In looking at the organizations that are able to successfully maintain this balance of needs, there are three main rules of the road that they follow: (1) establishing a governance philosophy and process; (2) investing to meet the needs of your organization and (3) maintaining a disciplined spending policy.

What is good governance? We at Highland view governance as the process that establishes the roadmap that investment officers follow. Part of that process is establishing an effective committee culture. Wellington Management presented that a good investment committee should maintain the mission of the entity, seek diversity of opinions, value independence, and preserve "institutional memory" by utilizing rolling terms and staff involvement. The primary role of the investment committee should be tying the investment policy to the needs of the institution. The most effective committees are ones that filter out the short term noise of the market and focus on the long-term objectives of the organization.

Wellington notes that another key to success for endowments and foundations is clearly defining the objectives of the organization and how one plans to achieve them. It is critical to match the money to the specific mission of the institution. Committees must also understand that the best determination of success is whether or not an organization met the specific goals and objectives outlined in the investment policy statement instead of focusing on peer group comparisons. No two foundations look alike, so committees must understand their own uniqueness and tailor their program to meet their specific philosophy, time horizon and risk profile. Investing should not have "a one size fits all" approach.

The spending policy is the all-important link between an organization's assets and its mission. The spending rule must be both reliable and sustainable. Both Wellington and Highland believe it

should grow with the organization, avoid nominal declines, preserve the long term real purchasing power of the entity, and avoid overspending in down markets. It is important that committees avoid the temptation to make intra-year adjustments once the spending level has been established, failure to do so can jeopardize the long term goals of the institution.

Wellington lists three main types of spending policies from which a committee can choose. The first is an asset based method where spending is a percentage of an average asset base over an agreed upon trailing window. This type tends to have greater volatility of payouts and is best suited to those institutions with greater funding flexibility. A second type of model is the inflation adjusted spending policy where the previous year's spending is adjusted by inflation. This policy tends to have less volatility, but is also less in tune with the changes in the markets. The third type of spending policy is the hybrid model which is a weighted average of the other two policies. The hybrid model is a good balance of the consistency of the spending rate and the consistency of dollars spent over time. It is best suited for those institutions that rely heavily on their annual draw. Ultimately, it is the role of the investment committee to understand the goals and needs of their organization and to choose the most appropriate spending policy. Otherwise, the long term goals of the foundation or endowment may not be met.

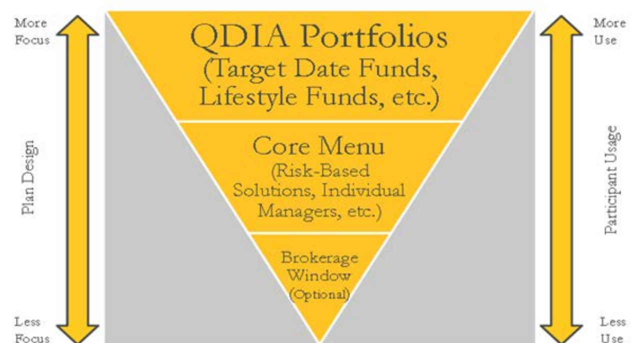
"Institutionalization: An Evolution in the Investment Line-Up for DC Plans"

Laurie Tillinghast, Head of DC Product & Strategy, UBS Realty Investors

Defined contribution plans have evolved from being a supplemental retirement plan to becoming the largest retirement solution for most of the workforce. During this evolution, plan designs and investment options have remained largely unchanged, which has created several problems for plan sponsors and participants. The largest problem is that participants are not equipped to meet their retirement goals given the current investment outlook of slow growth and lower returns from both fixed income and equities. Other problems associated with the current framework include participants being less educated, under-diversified, and invested in retail focused investments.

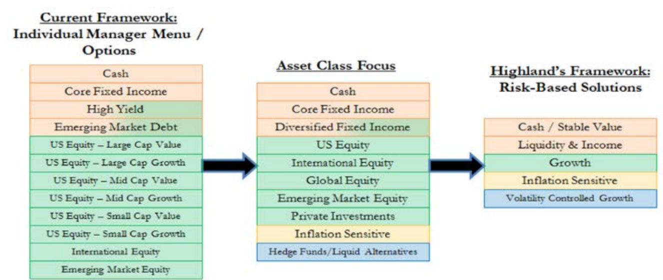
Highland believes that these issues can and should be addressed to help plan sponsors meet their fiduciary responsibilities while helping equip their participants with the necessary investment tools. First, plan sponsors need to review the plan design and work to get participants invested in the Qualified Default Investment Alternative (QDIA). **Figure 4.1** below shows that the QDIA should be the largest focus for plan sponsors and the most used investment option among participants. This can be demonstrated by looking at a participant study conducted by JP Morgan. Their study found that 69% of current participants say they should fall within the QDIA category, but 80% of retirement assets are currently invested within the core menu.

Figure 4.1



Next, the core menu options need to be re-evaluated. Historically, plans have offered many retail-oriented investment options that have led participants to create portfolios dominated by equity risk. Plan sponsors can address this problem by simplifying the core menu and moving to risk based options that provide participants with a diversified menu of institutional investment pools. This change is depicted in **Figure 4.2** and offers many benefits that are not available in the original core menu. These benefits include the simplification of choices, less disruption for manager changes, the availability to expand asset classes, increased diversification, and the ability to gain access to institutional investment options. One example is the ability to include private real estate within the inflation sensitive pool. Private real estate is an institutional investment option that is used widely among defined benefit plans but is rarely available in defined contribution plans. This investment option would help provide participants with an inflation sensitive product that cannot be a stand-alone option within a plan, but can be included within a pool of assets. Highland Associates believes that these two steps are necessary given participants increased reliance on defined contribution plans for retirement savings and the current investment environment.

Figure 4.2



Conclusion

Once again, it was great seeing everyone at this year's conference, which was a fantastic time to learn in detail about the changing world around us. If you were unable to join us this year, we hope you will be able to make it next time. If you would like to receive any materials from our conference, please feel free to contact us and we will provide them to you.

HIGHLAND'S CURRENT POSITIONING

⇩ DEFLATION/CRISIS HEDGES

⬄ GROWTH

⇧ VOL. CONTROLLED GROWTH

⬄ INFLATION SENSITIVE

About Our Firm: Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for not-for-profit institutions. We serve a national client base of institutional investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of June 30, 2014, we serve as investment consultant on approximately $19.5 billion in assets. With every engagement, our goal is the same: to protect our clients' assets while prudently growing their portfolios over time. Please visit our website at www.highlandassoc.com to learn more about our firm.

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