HIGHLAND

CAPITAL MARKETS QUARTERLY

SECOND QUARTER 2016

INVESTING IN AN UNPREDICTABLE WORLD

HIGHLIGHTS

- **In a low-growth, low-yielding world, there is likely to be more political uncertainty, which will drive higher volatility in the capital markets.**
- **With bond yields hitting all-time lows and investors starved for yield, yield-seeking behavior is causing significant disparities between company fundamentals and stock price returns.**
- **With volatility here to stay, we prefer to maintain a quality and value bias within our clients' portfolios.**

In the 1800s, famed Danish philosopher Soren Kierkegaard exclaimed that "life can only be understood backwards, but has to be lived forwards." Many significant and surprising events in history are not understood until after the fact. This quote sums up why countless economic prognosticators and polls missed that the United Kingdom (U.K.) would vote to leave the European Union (EU). Before the referendum, it had been well regarded that the vote would be close, but that the remain-in-the-EU camp would win comfortably. However, the day after the vote, it was clear that there were many British citizens who were unhappy with the direction of the EU and the U.K.'s place in the bloc. In fact, 1.3 million more citizens voted to leave the EU than to stay—a substantial win for the leave faction.

The U.K. populace made their voices heard with the results of the historic referendum. Although this result was startling to many, it has now become clear that the populist movement in countries is rising, and this is perhaps a harbinger of more to come in the EU. Although at Highland we did not know exactly how this frustration would transpire, we have been expecting higher political uncertainty and more surprises due to the current backdrop. All of these influences will result in more political uncertainty, which will cause elevated volatility in capital markets.

In this "***Triple L***" environment of ***low*** growth and ***low*** yields for a ***long*** time, we try to anticipate the unexpected. Events that were once thought of as impossible are now a reality, including negative interest rates. There are now 23 countries (of which 19 are in the Eurozone) that employ negative interest rate strategies. For the Eurozone and Japan, the goal is to push rates lower to stimulate economic growth and spur inflation. For countries such as Denmark, Sweden, and Switzerland, the goal is to discourage foreign investors from buying their currency, thereby stemming its strength.

The real concern with negative interest rates is that they adversely impact banks' profits by reducing the spread that they make on issuing loans and financing their costs. BCA Research noted that a 0.4% decline in net interest income, the difference between what banks pay for deposits and what they earn from lending,

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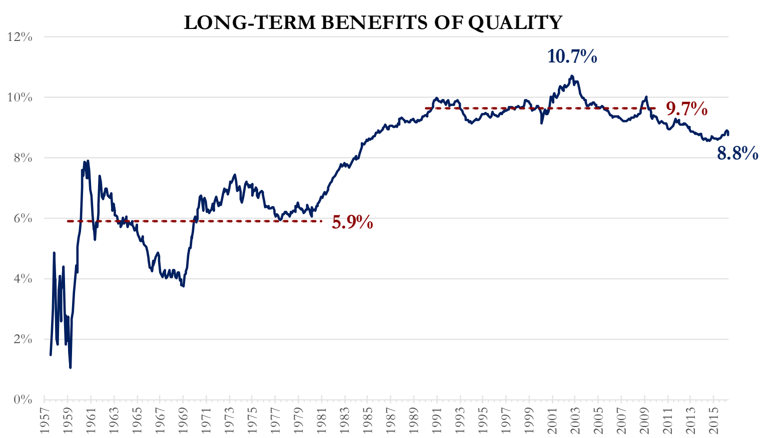
would completely wipe out all Euro-area bank profits. Since the publication of the BCA note, the 10-year German bund has fallen 38 basis points and is yielding -0.14% as of June 30th. The European banking system is also three times larger than the U.S. banking system and totals 245% of the European GDP, making it a key driver of its economy. In addition, according to an article on Bloomberg, European banks are less capitalized than their U.S. counterparts, with an average Tier-1 capital ratio that is over 200 basis points lower for its largest lenders. The market appears to agree with our assessment, as the FTSE All Cap Developed European Banks sector has declined 48% since the summer of 2015. An infamous bond manager recently described the negative interest rate strategies as the equivalent of 19th-century medicine, in which doctors regularly used methods that are now deemed unsafe to try to heal patients. For these reasons we worry that in this "***Triple L***" environment, governments and central banks will continue to experiment with measures that could cause long-term harm for short-term gains.

As we continue to expect more volatility in the capital markets, we prefer to orient portfolios toward quality and value biases. Investing in higher-quality companies and focusing on intrinsic value allows investors to concentrate on securities that have more consistent cash flows, increasing profitability, and lower leverage. During volatile markets, these types of investments put investors in the position to outperform over the long term (see Figure 1). By understanding history, we see that the quality/value[1] bias has added value, especially at the end of equity bull markets. This orientation allows us to position portfolios for the future, thereby putting investors in a place to meet their objectives over the long term.

FIGURE 1



SOURCES: AQR; HIGHLAND ASSOCIATES; LONG QUALITY STOCKS AND SHORT JUNK STOCKS (ANNUALIZED EXCESS RETURNS)

[1] Data sort companies by profitability, earnings growth, leverage, and payout of profits. Once data have been sorted, the Quality minus Junk (QMJ) factors are constructed as the intersection of six value-weighted portfolios formed on size and quality. At the end of each calendar month, AQR sorts the factors on size, then on quality. Portfolios are value-weighted, refreshed every calendar month, and rebalanced every calendar month to maintain value weights. The portfolios are an updated and extended version of the equity portfolios used in Asness, Frazzini, and Pedersen, 2014, "Quality Minus Junk," working paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312432.

FIXED INCOME

Global interest rates continue to reach historic lows, with the U.S. seeing one of the biggest declines. Since the beginning of this year, the U.S. 10-year Treasury yield has fallen from 2.27% to a historic low of 1.36%. A part of this decline can be attributed to the Federal Reserve backing off its expectations of four interest rate hikes in 2016 to zero or one this year. The divergence in monetary policy between the U.S. and other large developed countries contributed to a substantial rise in the U.S. dollar, which had a real impact on the U.S. economy and its businesses. This, coupled with increased uncertainty globally, led the Fed to begin to re-evaluate a near-term interest rate increase. According to the CME Group Fedwatch, March 2017 is the closest date where the market is pricing in a higher than 50% probability of a rate hike.

Another driver for these low, historic levels in the U.S. is lower or negative yields in other large developed countries. Currently, countries that account for 30% of global GDP are employing negative interest rates. There is now over $12 trillion in global sovereign debt that is yielding less than zero. Coincidentally, that is also the same amount of assets purchased by central banks globally since the financial crisis and the amount of cash and short-term investments sitting at banks and other financial institutions not being invested (see Figure 2). The U.S. 10-year has historically yielded 50 basis points higher than a 10-year German bund; however, the current spread is at a 20-year high of 160 basis points. Sovereign yields outside the U.S. are acting as an anchor to U.S. yields and will keep them lower for much longer. According to market-based futures, the 10-year U.S. Treasury is expected to yield only 2.4% in 2026.

FIGURE 2

SOURCES: BLOOMBERG; HIGHLAND ASSOCIATES

Even in today's low-rate environment, bond yields appear to be held down by technical factors. The perception that central banks turned more accommodative pushed down global sovereign and corporate bond yields. Looking toward the future, if economic growth were to accelerate, then yields could trend upward as investors focus less on the mechanism by which monetary policy is eased and focus more on the outcome of these measures – higher inflation.

With sovereign debt yields being driven lower by price-insensitive buyers such as central banks, Highland favors allocating to higher-yielding investment-grade corporates and asset-backed securities where the price is determined mainly on its fundamentals. The ratio of the Moody's A-rated corporate bond yield to the U.S. 20-year long-term Treasury yield currently stands at 1.98x, which has only been higher one other time since 1950. This results in a favorable risk versus reward for investing in high-quality corporate bonds as opposed to sovereign debt.

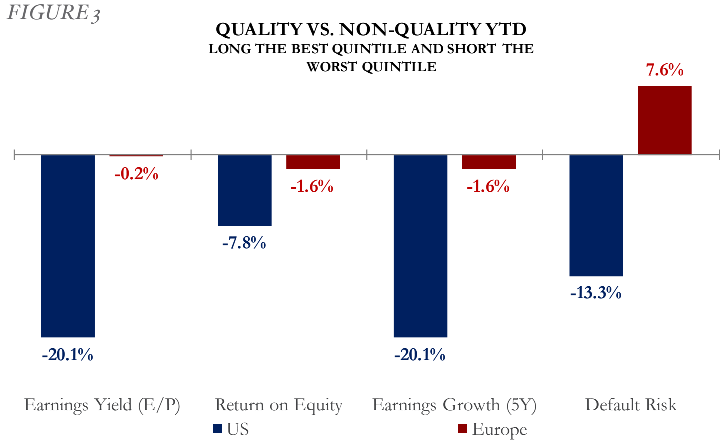
PUBLIC EQUITIES

Although equity markets declined fiercely and quickly after the Brexit vote, most markets have already recovered those losses. The market abhors uncertainty, and the U.K.'s vote to exit the EU with no actionable plan drove considerable volatility. However, once the market digested this news and the multiyear exit process, it was evident that Brexit would not have an immediate impact on the EU and U.K. The British pound fell to a 31-year low after the referendum. This weakness actually helped the country's multinational companies, which benefit from a weaker pound and comprise the majority of the English Stock Market, as measured by the FTSE 100. Investors took note of this, as the FTSE 100 is 8% higher on a local currency basis than its Brexit lows. Developed international equities are cheap on both a cyclically adjusted price-to-earnings basis, which should bode well for elevated future returns. Yet investors continue to place a discount on their depressed earnings due to the geopolitical uncertainty and future growth prospects, as well as the implications of negative interest rates. It is because of these reasons that in late 2015, we shifted our equity allocation to a neutral regional weighting to the MSCI All Country World Index. We expect international equities to generate high returns over the next ten years, but in the near-time, the risk associated with these markets does not warrant taking an overweight approach.

In the U.S. the markets have moved from worries about global uncertainty to focusing on the domestic economy. After beginning the year with a slowdown in economic activity where the economy grew 1%, the expectations are that the economy grew 2.3% in the second quarter. In addition, the Citi Economic Surprise Index, which measures the extent that economic indicators are beating or missing forecasts, turned positive for the first time since May 2015. Although earnings growth is still negative for the S&P 500, companies are guiding to stronger future earnings growth. However, with valuations stretched in the U.S., it is expected that returns will be primarily driven by earnings growth and dividends.

From the summer of 2015 to February 2016, global equity markets declined 20%. During this time, investors downgraded growth prospects as they questioned central banks' abilities to spur economic growth. With bond yields dropping globally, investors starved for yield bought defensive high-yielding sectors such as Utilities and Telecommunications, which are up 23% and 25% year-to-date, well above the U.S. market return of 4%. Utilities trailing price-to-earnings ratio is 22.1x or 40%, higher than its 20-year average of 15.5x. Based on where we are in this cycle, Highland prefers to have a quality and value bias within equities. These can be defined as low price-to-earnings, high return on equity, high earnings growth, and low debt to capital. Despite all of the market uncertainty, these quality factors are ones that have severely underperformed (see Figure 3).

FIGURE 3



SOURCES: NOMURA RESEARCH; HIGHLAND ASSOCIATES; DIFFERENCE IN TOP QUINTILE AND BOTTOM QUINTILE YEAR-TO-DATE RETURN FOR EACH CATEGORY

For example, on a year-to-date basis in the U.S., low price-to-earnings companies underperformed companies with high valuations and low to no earnings by 20%. The higher return on equity companies underperformed lower return on equity companies by 8%, and companies with higher, sustainable earnings growth lagged low-to-no-growth companies by 20%. Finally, companies with low probability of default lagged higher default risk companies by 13%. Despite the recent underperformance of quality-oriented companies, we remain convicted in our bias, especially during this current market environment. Highland's long-term view is for ***low*** growth, ***low*** yields for a ***long*** time. Based on this outlook, we believe a quality orientation is the best approach in navigating this backdrop.

HEDGED EQUITY

In an uncertain economic and political environment, investors will experience outsized bouts of volatility. A hedged equity allocation will enable investors to remain invested in the market but also provide some protection on the downside. During the first half of the year, the global equity market experienced two separate drawdowns of 11.5% and 7.5%. In addition, high-yield credit spreads have been volatile since 2014, rising 480 basis points from the summer of 2014 to February of this year. Since mid-February, they have fallen 300 basis points to their current level of 525 basis points. Distressed credit managers are able to profit on both the short and long side of these types of moves. When the market differentiates between companies and capital structures, these types of strategies typically perform well.

During this time, the hedge fund industry has garnered negative news as many funds have struggled to perform. While the broad universe has lagged, we focus on managers that have the ability to outperform over the long term based on informational or structural advantages. The managers that have informational advantages usually end up investing in securities that fall into the quality/value universe. These managers struggled just as the traditional quality/value managers. On the other hand, managers with structural advantages (i.e., relative value, arbitrage, macro, etc.) performed very well. This is why we focus on a diversified approach that allows us to generate alpha over various types of markets.

REAL ASSETS

One of the strongest asset classes year-to-date has been inflation-sensitive assets. Inflation-protected securities benefited from declining real rates in the U.S. The real yield on 7-year Treasury Inflation-Protected Securities (TIPS) has fallen 75 basis points this year and turned negative for the first time since 2013. Commodities, which have been punished in recent years, are one of the top-performing asset classes this year. Oil has risen over $20 from its lows in February, and gold and silver displayed substantial strength this year up 25% and 34%, respectively, as of June 30th. Even in a low-growth environment, inflation-sensitive assets should benefit from rising inflation driven by higher wage growth and improving economic strength. Core inflation is currently running at 2.2%, while services inflation is firmly above 3%. In addition, producer price inflation has risen from -1.1% at the end of 2015 to 0.3% as of June. All of these factors point toward higher future inflation.

Our portfolio positioning continues to favor TIPS, which reduce volatility of other inflation-sensitive assets while still providing inflation protection. In addition, our higher-quality bias involves gaining the majority of our commodity exposure through investing in commodity companies with cash flows associated with their businesses. These are real businesses where the earnings are not entirely driven by the whims of volatile commodity prices. Lastly, we maintain an allocation to private real estate, which is backed by real assets and historically has provided steady income streams in low-rate, low-growth environments.

OPPORTUNISTIC

Private equity continues to experience a decline in activity from its highs in 2014 and 2015. This decline is partly attributable to the elevated volatility in both the credit and equity markets. However, this has primarily impacted the larger deal sizes in the traditional buyout space. On an industry basis, private equity managers have countered this by using less debt as a percentage for U.S. mergers and acquisitions. According to Pitchbook, the median debt percentages have fallen from a high of 62% in 2013 to 49% as of June 30th. The middle-market and growth areas that Highland traditionally favors are still seeing robust activity. In fact, deals between $25 and $100 million accounted for over 25% of all activity year-to-date, the highest proportion since 2012.

We expect private equity and private debt to generate low double-digit gains over the next several years. Our preference is to invest in strategies with cash flows, such as direct lending areas that historically were serviced by banks but have exited due to regulatory capital pressures. In addition, we look for investing in strategies where there is a scarcity of capital. With our expectations that private equity and debt will have similar returns, we favor moving up the capital spectrum and allocating more to private debt than private equity.

HIGHLAND

HIGHLAND'S VIEW:

From a political perspective, the world has changed since the United Kingdom voted to leave the European Union. The world and media woke up the next day and realized there is a battle being waged between globalization and nationalization. A couple of days after the Brexit vote, BCA Research succinctly summed it up best by stating, "Brexit means that politics and geopolitics will become an ever more relevant analytical lens for investors. The apex of globalization has come and gone."

Life is understood backwards, but it must be lived going forwards. We continue to see the markets trapped in this "***Triple L***" environment of ***low*** growth, ***low*** yields for a ***long*** time. This leads central banks to try unprecedented monetary experiments to spur growth. Our view is that without more structural and fiscal reforms, these will most likely fail to achieve their desired outcome. Although this will undoubtedly result in higher volatility, it will also lead to more opportunities for patient investors who can ride out the volatility and take advantage of buying opportunities. Nothing has really changed since this summer's vote; it's just that the world now recognizes what can happen in an environment with lower economic growth. With this type of backdrop, Highland believes it is prudent to maintain a quality bias with a higher margin of safety within our clients' portfolios.

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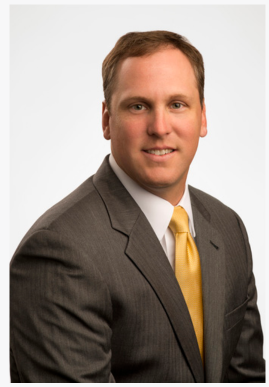

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