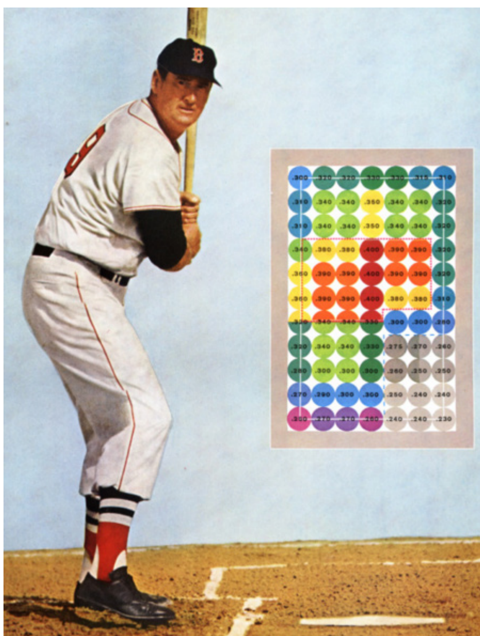
CAPITAL MARKETS QUARTERLY
THIRD QUARTER 2017

WE PLAY TO WIN THE GAME

Ted Williams, nicknamed the "Splendid Splinter," is regarded as one of the greatest players in baseball history. He reached base 48.2% of the time, which is far and away higher than any other player. This can be attributed to his proficiency at swinging only at pitches he could drive. In his book, *The Science of Hitting*, Williams outlined the following chart, which showed his batting average depending on the location of the pitch (see **Figure 1**). As illustrated below, his batting average dropped the farther the ball was away from the plate. Thinking of his chances for success in probabilities allowed him to wait on the best pitch and avoid swinging at those with a low success rate.

FIGURE 1



SOURCE: THE SCIENCE OF HITTING, TED WILLIAMS

As allocators of client capital, we also think in terms of probabilities. When we are determining changes in portfolios, every decision involves us answering the question, "are we truly getting compensated to assume more risk?" Our neutral stance is to stay close to our client's strategic allocation and remain committed to our starting lineup. However, when the odds are in our favor, we tactically adjust our stance and swing. If we do not believe the return rewards us for the additional risk, then we remain patient.

The strategic allocation is the asset mix that has been constructed to aid our clients in meeting their return targets based on their specific risk profile. This allocation is driven by asset class fundamentals (such as cash flow, future growth, and current price) and the types of return and volatility we expect each asset to achieve. Our goal is to build portfolios that are cycle-resistant and will achieve desired results in every market environment.

We believe focusing on the economic drivers, not asset classes, leads us to view the world through different exposures and ultimately to a truly diversified portfolio (see **Figure 2**). For example, crisis hedges (high-quality fixed income) are strategies that will protect our portfolio during equity market drawdowns. Growth assets (public and private equities) benefit from economic growth or areas that maximize the value of companies. Diversified alpha strategies (hedge funds) provide return streams that are tied neither to equities nor fixed income but offer high single digit returns. Furthermore, these strategies can protect from and capitalize on volatility in the markets. Inflation-sensitive strategies (TIPS, commodities, etc.) protect the long-term purchasing power of portfolios and react to the rate of change in inflation, not the current level.

TRANSFORMING PORTFOLIOS.
ADVANCING MISSIONS.

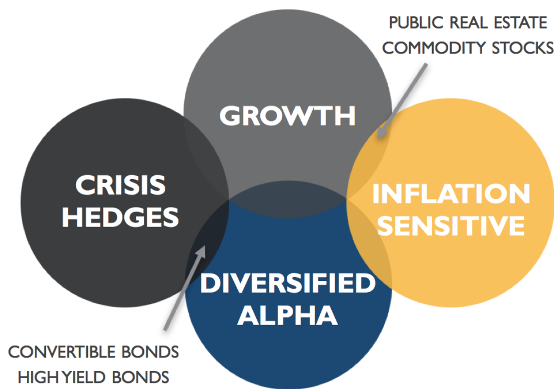
- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates is a leading institutional investment firm that provides objective, research-driven investment counsel to not-for-profit healthcare entities and mission-based organizations. Our hyper-awareness of financial market dynamics, seasoned industry knowledge and commitment to due diligence inform our forward-looking and customized investment management programs. Highland Associates was founded in 1987 and advises clients nationwide. For more information, visit www.highlandassoc.com.

FIGURE 2

RISK DRIVERS AND COMMON SENSE VIEW OF RISK = DIVERSIFICATION



SOURCE: HIGHLAND ASSOCIATES

There are two ways to get on base: with either a hit or a walk. Our strategic allocation is akin to getting on base by walking. Yet there are periods when it makes sense to swing the bat and be rewarded for the additional risk. When the odds for success have greatly increased, then we will tactically shift the portfolio to capitalize on that perfect pitch.

> *The* ***strategic allocation*** *is based on the objectives (risk and return) and constraints (liquidity, time horizon, special circumstances) of the organization.*
>
> *The* ***tactical allocation*** *is a dynamic strategy that actively adjusts the positioning of the portfolio based on short-term market forecasts.*

There are many layers to how the tactical shift is implemented. First there is the move between broad asset classes, which is driven by the fundamentals and expected returns. We rank order each asset class and underweight the ones with lowest expected return and overweight those with the highest expected return. Next, we utilize sentiment and momentum to determine which sub-asset class to invest within the broad asset class. Lastly, capital is allocated to specific managers who use fundamentals to invest in select securities that will provide the highest expected return. This multifaceted approach gives us the best chance for successfully executing the tactical shift.

HOW DO WE KNOW WHEN TO ADJUST OUR LINEUP?

There are many different factors that can drive the market, such as central bank policy, earnings, investor sentiment, etc. There is also a lot of noise that can distract investors, especially long-term patient investors. Highland has a framework that identifies specific areas that collectively provide insight as to whether we are in a risk-on, risk-off, or neutral environment. Our Risk-On/Risk-Off Diffusion Index combines economic fundamentals, investor sentiment, and market technicals. For illustrative purposes, **Figure 3** highlights the following factors at a neutral position:

FIGURE 3

UNEMPLOYMENT

Unemployment is a good indicator of the underlying strength of consumers and businesses. When the unemployment rate is declining, then this is a harbinger of economic strength.

LEADING ECONOMIC INDICATORS

These ten leading indicators, which incorporate business outlook, economic activity, consumer expectations and market sentiment, signal strength or weakness of the economy on a forward-looking basis.

CREDIT SPREADS

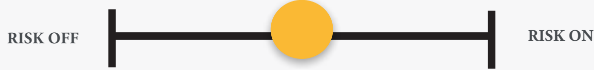
Credit spreads are a barometer of risk sentiment in the market. It measures the yield premium required by investors over risk-free treasuries. Typically spread tightening occurs in periods of economic growth, and spread widening in periods of economic weakness.

YIELD CURVE

Yield curve positioning is measured by the spread between longer and shorter dated treasuries. The spread indicates forward market and inflation expectations. It is important for understanding where we are in the market environment.

MONETARY POLICY

This measure considers how accommodative or restrictive current monetary policy is compared to history.



MOMENTUM

Equity market momentum indicates investor sentiment and risk appetite. For example, a taper in momentum would signal weary markets and a reduction in risk assets.

SOURCES: HIGHLAND ASSOCIATES

Within each of these factors, we compare how they are at present versus history, recent performance, and directionally where they are trending. Each of these indicators is then scored to provide context into the risk in the markets. When a majority of these indicators are showing strength, then we are being adequately compensated to take on additional risk. Conversely, when these indicators are weak, it says we should lower risk in portfolios. By combining the fundamental outlook that drives our strategic allocation with the Risk-On/Risk-Off Diffusion Index, this allows our portfolios to be more dynamic in positioning and perform in different market environments.

WHY NOW IS THE TIME TO SWING

We believe that we are currently in a market environment in which investors will be rewarded for taking on additional risk via global equity. From a fundamental perspective, global growth is at its highest point since 2011. Whereas global coordinated central bank action has been a big driver of market returns for the last 18 months, a shift toward global economic growth is now steering the markets. Although policy uncertainty continues to be a cloud over market sentiment, it has historically been a weak indicator for the direction of markets. The important ones—such as leading economic indicators, earnings growth, and market technicals—are all signifying this rally has room to run. The Highland Risk-On/Risk-Off Diffusion Index demonstrates all our indicators are showing strength (see **Figure 4**).

Based on our diffusion index and long-term fundamentals, we recommend overweighting equities and diversified alpha strategies relative to fixed income. Our positioning has been to underweight fixed income compared to diversified alpha strategies since summer 2012. In light of prolonged lower returns expected for fixed income, we are recommending an even further underweight to the asset class. We believe the return potential in equities outweighs the additional volatility within client portfolios.

FIGURE 4

UNEMPLOYMENT

LEADING ECONOMIC INDICATORS

CREDIT SPREADS

YIELD CURVE

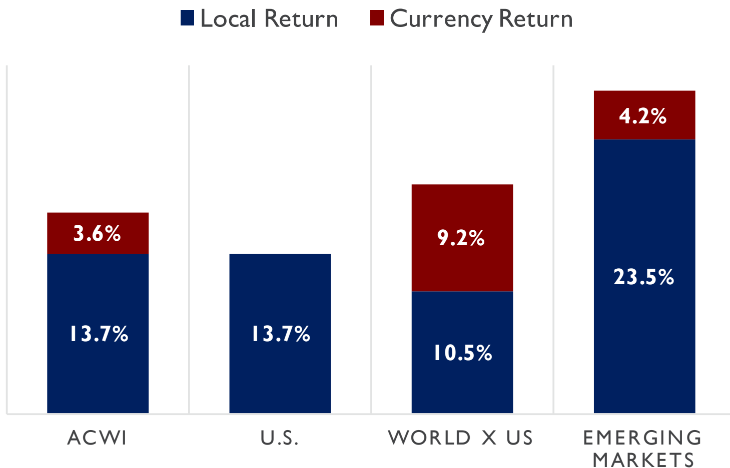
MONETARY POLICY

MOMENTUM

SOURCES: HIGHLAND ASSOCIATES

From a tactical perspective, we recommend overweighting international markets relative to domestic. Our capital markets assumptions for international and emerging market equities are higher than U.S. markets. Valuations in both developed international and emerging markets are still below the historical average. While these markets are outpacing U.S. equities this year, a significant amount of the return has been a result of currency moves (when the dollar falls, U.S. investors of non-U.S. equities benefit, see **Figure 5**). There is still plenty of room for higher earnings growth in international markets where earnings remain below 2007 levels.

FIGURE 5



SOURCE: HIGHLAND ASSOCIATES; FACTSET; YTD THROUGH 9/30/17

The wave of coordinated global central bank policy that supported the broad markets has subsided. As these policy makers begin to step away from accommodative policy, market volatility will be a factor for investors. Managers who have the skills and insights to find opportunity through differentiation can deliver value to investors. Finding cheap, broad market exposure worked well in the past, but the market is becoming more discerning. An example of this emerging trend was seen last quarter as companies that missed earnings had the biggest price declines since 2011. A rising tide no longer lifts all boats. Fundamentals, such as cash flow, future growth, and current price, are starting to matter.

HIGHLAND VIEWPOINT

In every market environment, there are pockets where it makes sense to follow the trend and take on additional risk to capitalize on the return opportunity. However, when we do take advantage of these periods, it is also important to dig through broad markets to find true value. This mind-set drives our **3-D** approach to ***Decode*** and ***Deconstruct*** to ***Deliver Value***. This can involve investing in small cap international strategies with an activist bent or emerging market strategies that focus on free cash-flow generative companies with business models not predicated on financial leverage. By employing this type of approach, we can invest in differentiated strategies that can deliver value above and beyond broad markets.

The future is never certain, and those who do not understand the past are doomed to repeat it. We believe we have a game plan that allows our clients to meet their objectives. By building portfolios that can perform in any type of market environment and tactically adjusting the portfolio when the odds are in our favor, we can help our clients achieve their long-term goals. We approach the plate as a patient batter. Our winning formula is to swing at the pitches where we have the best chance to hit the ball, get on base, and score. We believe that pitch is upon us now.

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AUTHORS:

SCOTT GRAHAM, CFA
CHIEF INVESTMENT OFFICER

ANDY WEBB, CFA, CPA
DIRECTOR

HIGHLAND ASSOCIATES

2545 HIGHLAND AVENUE SOUTH, SUITE 200

BIRMINGHAM, ALABAMA 35205

P. 1-800-405-7729 OR (205) 933-8664 F. (205) 933-7688