HIGHLAND

CAPITAL MARKETS QUARTERLY
FOURTH QUARTER 2017

THE WISDOM OF THE CROWD?

> *"The person who follows the crowd will usually go no further than the crowd. The person who walks alone is likely to find himself in places no one has ever seen before."*—Albert Einstein

It is a well-known adage in investing that to consistently outperform, investors need to think differently. Contrarian points of view can help uncover opportunities for return. However, following a contrarian view just to be different is a fool's game. Going against the crowd is useful only if it is based on a sound decision-making framework. If not, we will succumb to what Warren Buffet describes when he says ". . . a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling."

Knowing where you are going is the important key in investing because there are times when the crowd that is fixated on short-term influences crosses paths with those rooted in a long-term focus. These crossroads can be brief but shouldn't influence the patient, long-term investor. The crowd is fickle and will pass when their attention is grabbed by the next bigger, better deal. Therefore, it is important to understand where the crowd is going and to re-evaluate your investment thesis to ensure you are sticking to a sound framework.

HOW THE CROWD FARED IN 2017

It is almost a rite of passage for Wall Street to provide market outlooks for the upcoming year. These forecasts originate from the largest investment banks, brokerages, and investment firms. Historically these outlooks tend to be very similar, and they are collectively known as the "consensus." Before we turn toward the outlook for 2018, let's take a look back and see how well the consensus fared last year.

As we entered 2017, there was excitement and trepidation in the U.S. due to a GOP sweep in November's election. With such control in Congress, it was expected that there would be extensive healthcare and tax reform that would benefit U.S. economic growth and small-cap stocks, in particular. Yet with elevated valuations in U.S. stocks, returns were expected to be muted. Wall Street's consensus for the S&P 500 was a 5.0% gain, the most bearish annual outlook in the last 12 years.

The table on the following page (**Figure 1**) illustrates some of the calls from the collective opinion of Wall Street as well as Highland and how they fared:

TRANSFORMING PORTFOLIOS.
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- *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 1

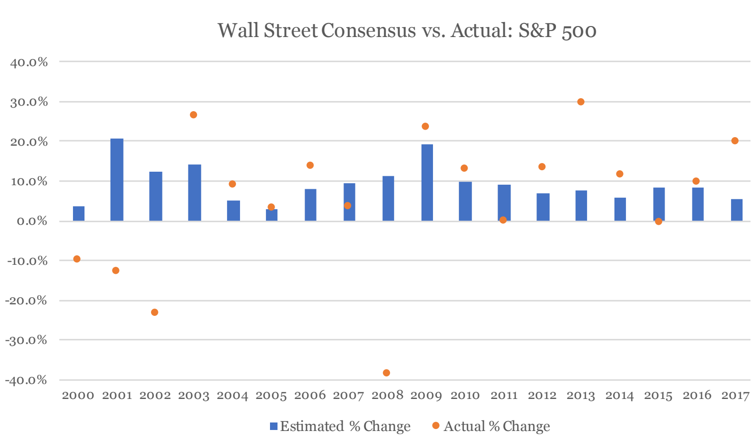
Asset Class	Consensus	Outcome	Highland's View	Outcome	Result
Global Trade	Weaken due to nationalist policies set forth in U.S. and Europe	X	Worried about whether Trump would enact protectionist policies and tariffs	X	President Trump's stance softened toward anti-trade and global trade reached highest levels in last six years
Economic Growth	Strengthen and broaden due to easy monetary policy and fiscal stimulus in other developed economies	✓	Same as Consensus view	✓	Improved global growth on the heels of stronger than expected growth in Europe and Japan
U.S. dollar	Strengthen	X	Weaken	✓	USD declined 10%, worst year in a decade
Interest Rates	Modest rise, steeper yield curve	X	Remain low, although noted that bond yields bottomed in summer 2016	✓	Yields were range bound / Yield curve flattened
U.S. Equities	Low single-digit returns	X	Same as Consensus. Favored global equity approach	X/✓ (Wrong on U.S. returns and right on global approach)	+22%, highest year since 2013; global equities had best year since 2009
Large Cap vs. Small Cap	Small Cap	X	No view, favored all-cap approach	N/A	Large Cap outperformed Small Caps by 7%
Volatility	Increase	X	Increase	X	9 of the 10 lowest readings by the VIX were posted in 2017

SOURCE: HIGHLAND ASSOCIATES; BASED ON HIGHLAND'S LONG-TERM ASSUMPTIONS

Many of the views from the most respected investment firms turned out wrong. These views were grounded in sound investment analysis, so how did they collectively miss the mark by such a wide margin?

First, forecasting in the short-term is a loser's game. Renowned investor Warren Buffett once wrote in his annual letter that the only value of stock forecasters is to make fortune tellers look good. Looking at Wall Street estimates since 2000, it is apparent why Buffett made that statement. The experts on Wall Street miss the mark more than they get the estimate right (see **Figure 2**). Interestingly, the consensus always had an optimistic view on U.S. equities and never forecasted the S&P 500 Index to fall, even though the market fell or was flat in six of those years.

FIGURE 2



SOURCES: BESPOKE INVESTMENT GROUP; HIGHLAND ASSOCIATES

Secondly, consensus expectations typically assign a higher weight to recent facts when setting its outlook. This is an example of recency bias, which we highlighted in our latest ***Insight*** on FOMO. Taking a deeper look at the dollar consensus forecast in the table above, going into 2017 the dollar had been in a strong bull market since 2011. Naturally, this dollar strength was going to continue in the new year with tailwinds such as U.S. economic growth increasing and the Federal Reserve raising rates.

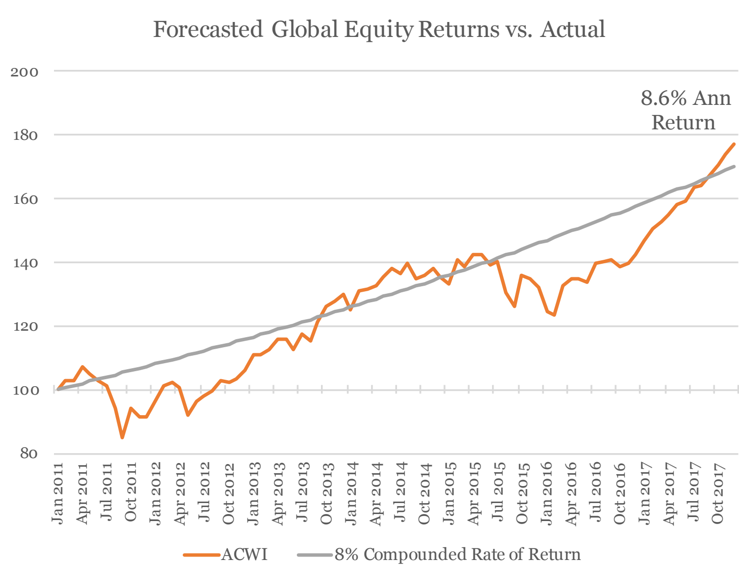
Wall Street would have been better off recalling former Merrill Lynch strategist Bob Farrell and his 10 market rules to remember. "When all the experts and forecasts agree, something else is going to happen." Even though the U.S. dollar has declined in every rate-hiking period over the last 30 years, the crowd was anchored toward U.S. dollar strength driven by higher rates and the threat of nationalism and anti-trade. Yet the dollar experienced its largest decline in the last decade as growth in Europe surpassed consensus expectations, leading many to bring forward the timeline for reduced monetary stimulus by the ECB.

With some of these prognostications, the collective opinion of Wall Street was directionally right, but the magnitude was sorely wrong. Investors would be best to remember Farrell's Rule #4, "Exponential rising and falling markets usually go further than you think." Consensus said the S&P 500 Index would generate low single-digit returns, yet it rallied 22% on strong earnings growth and the highest sales growth in the last six years.

As we wrote in a recent Insight, following the crowd does not always work. In many instances, this groupthink can lead you down the wrong path and far away from your objective. The solution to avoiding these pitfalls is to have an investment framework that is grounded in sound investment methodology and that removes emotion from decision making. Our capital markets approach combines market fundamentals, momentum, and the economic climate to guide portfolio positioning. We emphasize looking past the yearly gyrations in the market and focusing on long-term performance and whether we are achieving our clients' goals.

Our chances for accurately forecasting market returns in any year are low, but by concentrating on the fundamentals and having a long-term focus (10-year), we improve our odds. This is crucial because these forecasts are the foundation for constructing portfolios and assessing the opportunities in the marketplace. Take, for example, our return assumptions for global equities and how these estimates have compared to actual performance. At the end of 2010, our 10-year annualized return assumption for global equities was 8.0%. This fundamentally driven estimate was derived by using forward assumptions to calculate each of the individual drivers that make up global equity returns. At the end of seven years, our estimate has been very close to the 8.0% expected return (see **Figure 3**). This 8.0% return included a wide range of annual returns (as high as 24% to as low as -7%), yet this fundamental approach has achieved its goal to-date despite the volatility. Focusing on the long-term mitigates what we call "emotional corrosion," which means allowing noise to impact your investing decisions.

FIGURE 3



SOURCES: HIGHLAND ASSOCIATES; FACTSET

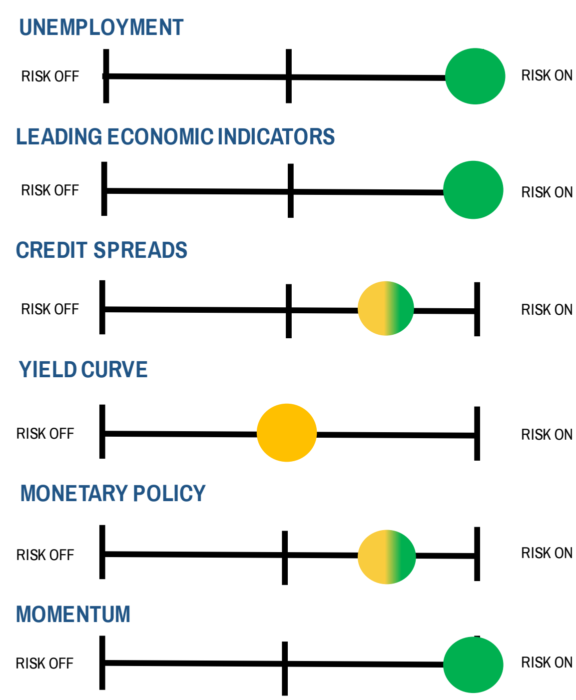
2018 CONSENSUS AND WHERE HIGHLAND DIFFERS

As we finish out a strong year in 2017 and turn to 2018, we see no reason to alter our outlook. The assessment of long- and short-term market opportunities is driven by our four-pronged Capital Markets process, which evaluates the following:

- Fundamentals
- Relative Value
- Market Momentum
- Economic Regime (influenced by Diffusion Index)

Our proprietary Highland Diffusion Index (see **Figure 4**; introduced in 3Q17 commentary) assists us in evaluating different economic and market factors and whether we should be increasing or decreasing risk. It points toward keeping a higher allocation to global equities for the time being.

FIGURE 4



SOURCE: HIGHLAND ASSOCIATES

From an asset allocation perspective, we favor a higher allocation to global equities and diversified alpha over fixed income. Fixed income yields are persistently low while the conditions remain ripe for a continued rise in corporate profits amid higher economic growth. The global economy is in sync for the first time in a dozen years. The technicals that support bond yields remaining low are still present. While credit spreads offered some additional premium last year, that surplus yield has substantially declined. Globally, investors are pricing very low default risks in corporate bonds. For example, European high-yield bonds are currently offering lower yields than the U.S. 10-year treasury bond yield.

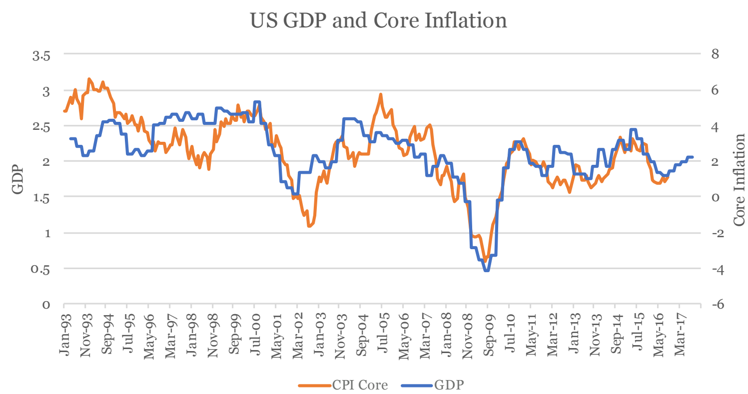
The year 2018 is likely to see the effect of diminishing momentum in the fixed income market for the first time in seven years. Every year since 2010 we've seen G3 (U.S., Europe, and Japan) central bank purchases of government bonds increase relative to net issuance. It is expected that this will start to reverse in the second half of the year as quantitative easing is substantially reduced, with the Fed and ECB leading the way. With low bond yields being a key driver of capital moving into higher risk assets across large parts of the world in recent years, the ramifications of higher yields due to reduced central bank demand amid rising inflation expectations could be significant. All of these factors could result in yield steepening in the longer end of the yield curve, although this might be tempered by increased buying from liability-driven investors.

The excitement from deregulation and newly enacted tax reform has been a driver of markets of late. According to Capital Economics, tax reform is expected to add 0.3% to GDP growth in 2018. We see this being broadly supportive of risk assets in general, which is on par with consensus views. These changes will make U.S. corporations more competitive with international businesses and should result in higher foreign investment. In addition to the lowering of the overall rate, one of the largest impacts will come from the ability to expense 100% of capital projects in the first year. This will benefit capital intensive businesses, which tend to have a higher weighting in cyclical and value sectors of the market.

Tax reform is a big step forward, but it is not the cure-all remedy that some have espoused. Our concern with the tax reform is that it is being enacted when unemployment slack is low, U.S. debt levels are elevated, and economic growth has run close to 3% for three straight quarters. Under normal conditions, we would expect the government to try and reduce fiscal deficits at this point in the economic expansion, thereby having room to inject stimulus if the economy were to weaken.

There are many side effects from this stimulus package that alarm us. For one, we worry about this new reform being inflationary, causing the Fed to become more aggressive in its rate hiking. Historically, there is an 18-month lag between economic growth and core inflation (see **Figure 5**). With the U.S. economy growing faster than most have anticipated and the unemployment rate approaching 4%, we expected inflation to rise in the back half of 2018 even before this stimulus was passed. If this does result in much higher inflation, then this would give the Fed cover to raise rates more quickly than the market is expecting and slow growth.

FIGURE 5



SOURCES: HIGHLAND ASSOCIATES; FACTSET

As inflation rises, we question how this could impact the movement in the U.S. dollar. If interest rates are rising due to sustainable economic growth, then this should benefit the U.S. dollar and be good for the economy. However, if rates are rising because inflation is mounting, then this is historically bad for the U.S. dollar.

Highland's view is that the dollar will move sideways in the near term, which differs from consensus views of a strengthening dollar. Lately, Treasury Secretary Steven Mnuchin's comments regarding wanting a weaker dollar to benefit U.S. companies has put pressure on the greenback. There is too much uncertainty with a new Federal Reserve Chairman and how the fiscal stimulus will impact growth to get a clear path on the dollar in the near term. We still believe the long-term trend is for the dollar to decline. Economic growth in non-U.S. countries is strengthening and approaching pre-crisis levels, while U.S. deficits are rising, supporting this notion.

Collectively, Wall Street strategists are forecasting U.S. equities to rise 6% in 2018, driven by higher earnings growth and a compression in valuations. Interestingly, the S&P 500 is close to meeting this target, up 5.7% year-to-date through the end of January. We believe investors should expect muted returns for U.S. equities over the next 10 years, but we could see U.S. equities have a near-term melt-up and rise substantially in the short term. However, with valuations elevated, the Fed raising rates, and investor sentiment close to highs, we think it is prudent to have a higher weighting to inexpensive markets with room for higher earnings growth. Therefore, we continue to favor an overweight to international markets relative to domestic.

Nevertheless, investor sentiment has increased substantially over the last year and risk is being priced accordingly. As of January 31st, the S&P has now gone 451 days without a 3% pullback, making this the longest run in history. The VIX remains low as investor complacency is becoming a risk. Although we expect the bull market to continue as earnings revisions are approaching 15-year highs, we believe owning securities that are non-correlated to traditional assets that can drive returns is prudent in this environment. With the market pricing in little equity or credit risk, our positioning is to continue overweight to diversified alpha strategies, which can take advantage of any spike in volatility or credit premiums.

2018 AND BEYOND

Global equities have experienced a parabolic rise since their last correction in the first quarter of 2016. This has been on the back of stronger economic growth and rising corporate profits. In times like these we ask, Are we at a turning point and is this type of growth sustainable? We believe global markets still have some room to go. We find evidence that this synchronized growth is broadening and should support risk assets in the near term, consistent with our Diffusion Index. Further, we are just now seeing investors' behavior beginning to approach more of a euphoric state as fund flows into equities are starting to rise. This part of the cycle can last one to two years and historically results in some of the best years for investors.

However, there are risks out there that bear considering. We are in unprecedented times with the Fed trying to unwind its asset purchases while raising interest rates, albeit gradually, in an environment with tight credit spreads. This is all occurring under the watch of a new Federal Reserve Chairman who could choose not to follow Bernanke and Yellen's playbook, which has been beneficial for investors. In addition, we have not experienced any bouts of higher inflation in many years. Yet oil prices have risen more than 50% since June 2017, and the price changes in copper and gold are pointing toward a shift in investor expectations regarding inflation.

IN THE CROWD, BUT NOT FOLLOWING IT

We believe we are approaching a turning point in how investors allocate capital going forward. It will be important to dig through broad markets to find value as certain areas of the market will benefit more than others. Our mind-set is not to take the consensus at face value, but to conduct our own analysis looking at the fundamentals and what is going to drive the market moving forward. This attitude drives our ***3-D*** approach to ***Decode*** and ***Deconstruct*** to ***Deliver*** Value. The best investment decisions are guided by thoughtfully considered frameworks for decision-making and avoiding being pulled with the crowd. That way, we can stay on course and let others pass on by because we are setting our sights on places they can't find.

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