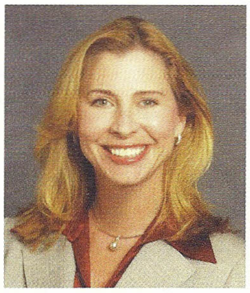
Quarterly Investment Perspective

Three Great Rotations



Rebecca Patterson, Chief Investment Officer

For the last three decades, U.S. government bond yields have trended lower, supporting prices and making investors around the world warm and fuzzy toward what they considered their "safe" assets.

The 2008–2009 financial crisis only magnified the perception that capital preservation necessitated a significant fixed income allocation.

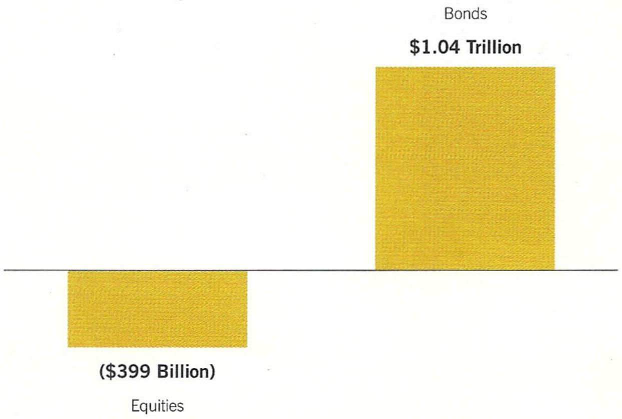
Between 2009 and 2012, U.S. bond mutual funds (excluding exchange-traded funds, or ETFs) saw $1.04 trillion in net inflows, versus some $400 billion in *outflows* from equity funds (the latter despite a nearly 58% gain in the S&P 500 Index, Exhibit 1).

Over the last two months, however, as the U.S. Federal Reserve hinted that an end to quantitative easing (QE) may be approaching, the U.S. 10-year Treasury yield popped up from around 1.6% to more than 2.6%, the largest percentage jump in yields since at least 1962. Investors' love for "safe" Treasuries, as prices fall, will likely cool; a significant rotation between asset classes may indeed emerge, prompted by Federal Reserve Chairman Bernanke. Not surprisingly, market watchers have gone on alert for what is now commonly referred to as "The Great Rotation" — an expected (some think inevitable) shift out of bonds and into equities.

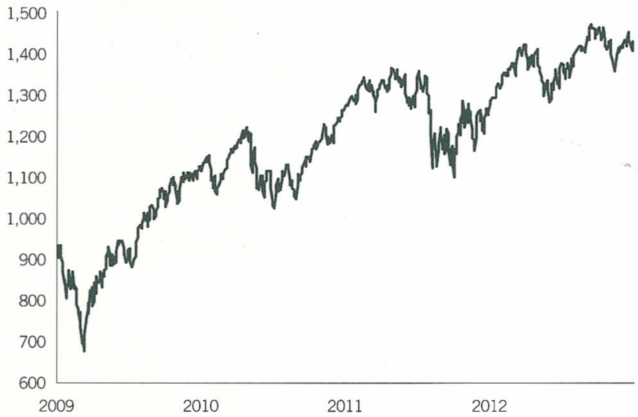
In this letter, we want to explore the Fed's policy "rotation" and what it may mean for global markets. However, we also want to consider two other "great rotations" that we believe may get less attention, but are just as important, as we construct our portfolios: the rotation between equity market leaders and the rotation between developed- and emerging-market investments.

Exhibit 1: Funds Flowed to Bonds As Stocks Climbed

Total Net Mutual Fund Flows, 2009–2012



S&P 500 Index



As of December 31, 2012. Reflects price return of the S&P 500 Index.
Source: FactSet, Investment Company Institute, Standard & Poor's

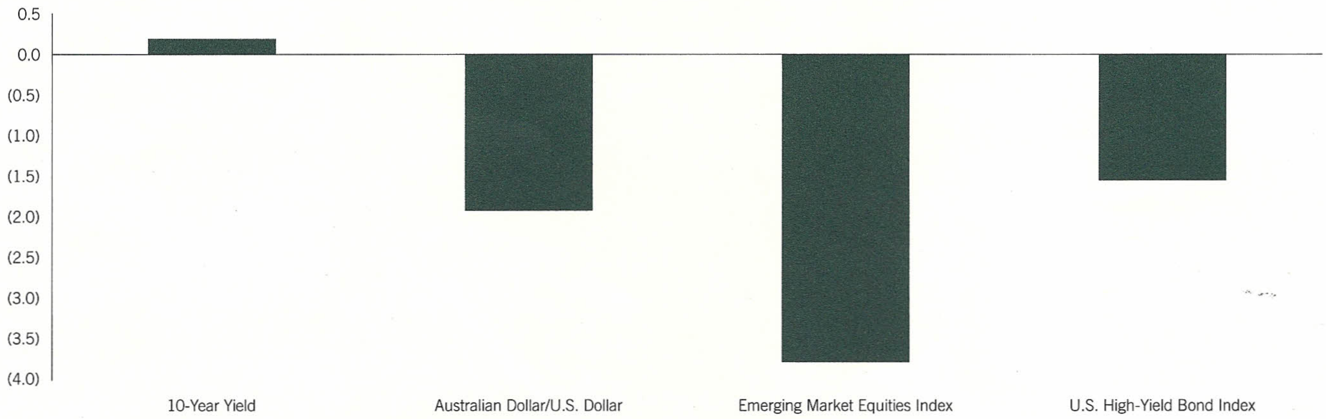
Start of the Great Bond Bear Market

The second quarter of 2013 was a painful reminder for investors that a change in Fed policy, no matter how clearly signaled, can be disruptive. Comments made by Chairman Bernanke along with the Federal Open Market Committee minutes released on May 22 pushed 10-year Treasury yields up by 20 basis points over just eight trading sessions. Another Treasury sell-off occurred in late June, after the Fed signaled that QE could end by mid-2014 — albeit with the key assumption that the economic recovery had to show sufficient momentum. As was the case in May, the late-June market reaction was broad-based and bearish.

In both cases, heightened bond market volatility, and fears that rising U.S. interest rates would make other higher-yielding investments relatively less attractive, led to abrupt selling of everything from emerging-market bonds and stocks to corporate "junk" bonds, high-dividend equities, and high-yield currencies (Exhibit 2). Indeed, the sudden market moves forced several emerging-market central banks to intervene in late May and June. They supported their quickly depreciating currencies to limit pass-through to local inflation. This marked a huge about-face from the previous years' fight against capital inflows and local currency strength.

As we look ahead, we believe the Fed will do everything it can to prevent its policy rotation from sustainably or dramatically weighing on investor sentiment and, in turn, the U.S. economic recovery. All the verbal guidance the Fed has provided in recent weeks seems, in part, aimed at making the eventual policy shift smoother by reducing its "surprise" element, and by emphasizing that an end to QE would depend on a significant improvement in the U.S. economy. Unfortunately, the Fed's QE programs were something unprecedented; the exit will also be a live experiment of sorts, possibly with a new Fed Chairman at the helm (Bernanke's term ends in January). It is simply not possible to remove all the surprises — to know with certainty what the exit from QE will bring for financial markets.

Exhibit 2: Higher Rates Led to Abrupt Selling Pressures
Percent Change from May 22–May 31, 2013



Reflects U.S. 10-year Treasury yield, MSCI Emerging Markets Index, and Bank of America Merrill Lynch U.S. High Yield-Master II Index. The 10-year Treasury yield represents a change of 0.2%, or 20 basis points. All other assets show percent return over the period.
Source: Bank of America Merrill Lynch, FactSet, Federal Reserve

With that in mind, we continue to think through the different paths the Fed might take in the months and years ahead, and what each path might mean for financial markets. In this section, we outline what we currently believe is the most likely scenario moving into 2014, and what those views mean for our model asset allocations.

Our base case:

- Gradually improving U.S. labor markets lead the Fed to announce it will begin "tapering" the pace of QE at some point later in 2013; an actual increase in the federal funds interest rate is unlikely to occur before 2015.
- With the federal funds rate "anchored" near zero and longer-term bond yields biased modestly higher, the U.S. yield curve will remain steep and/or steepen further.
- While the Fed shift may keep volatility somewhat elevated, U.S. equities should find support and resume their uptrend. The gradually improving economic backdrop will boost corporate earnings. Meanwhile, share buybacks and dividend increases are likely to continue, while lower bond returns and still-healthy corporate balance sheets may prompt some investors to rotate into equities.
- The growing divergence between U.S. monetary policy and still-easing central banks elsewhere (particularly among major developed countries) should help lift the U.S. dollar. That, along with still-muted inflation, will likely prolong commodity-market underperformance.

Portfolio implications:

- Maximum underweight to traditional government bonds; maintain lower-than-normal duration and look for opportunities to add floating-rate debt.
- Overweight equities managed with a continued focus on geographic, sector, and company implications of Fed rotation.
- Underweight commodity holdings; managers continue to hedge currency risk as appropriate (currently including the euro and yen).
- Overweight "defensive-growth" assets such as corporate credit (including bank loans that have floating interest rates) and, where appropriate, hedge funds. Such investments should prove less volatile than equities and help reduce portfolio risk in a choppy or outright down market.

Despite the Fed's best intentions and efforts to give clarity, we know the QE exit will still be something we have never seen before, and that a rising interest rate regime hasn't been experienced in 30 years. With that in mind, we will continue to consider different Fed and market scenarios and ensure we are able to quickly adjust the portfolio should this rotation bring any meaningful changes to our macroeconomic views.

Equity Leadership Rotations

While the Fed fixation may be understandable given the importance of U.S. monetary policy and its extraordinary nature of late, it is far from the only issue driving financial markets or global growth today. We always want to be thinking broadly — across countries and asset classes — to understand risks to, and opportunities for, our portfolios.

Using that wide global lens, another "great rotation" we constantly consider is that between different countries' equity markets. We believe that diversifying equity risk, in part across borders, helps our long-term performance. As shown in Exhibit 3, equity market leadership can rotate frequently and suddenly. In the seven years between 2006 and 2012, for instance, no country "led" for more than two years in a row (China in 2006 and 2007). The U.S., meanwhile, led in 2011, but trailed in 2006, 2007, 2009, and 2012.

Exhibit 3: Equity Performance Leadership Rotates

Rank	2006	2007	2008	2009	2010	2011	2012	2013 YTD
1	China	China	Japan	Australia	South Korea	U.S.	Germany	Japan
2	Germany	Germany	Switzerland	China	Canada	U.K.	France	U.S.
3	France	South Korea	U.S.	South Korea	U.S.	Switzerland	Switzerland	Switzerland
4	Australia	Australia	France	Canada	Australia	South Korea	China	France
5	U.K.	Canada	Germany	U.K.	Japan	Australia	Australia	Germany
6	Switzerland	France	Canada	France	Switzerland	Canada	South Korea	U.K.
7	Canada	U.K.	U.K.	Germany	U.K.	Japan	U.K.	Canada
8	U.S.	Switzerland	Australia	U.S.	Germany	France	U.S.	Australia
9	South Korea	U.S.	China	Switzerland	China	Germany	Canada	China
10	Japan	Japan	South Korea	Japan	France	China	Japan	South Korea

As of June 30, 2013. Reflects top 10 markets based on S&P Global Broad Market Index market capitalization. Total returns are in U.S. dollars.
Source: FactSet, Standard & Poor's

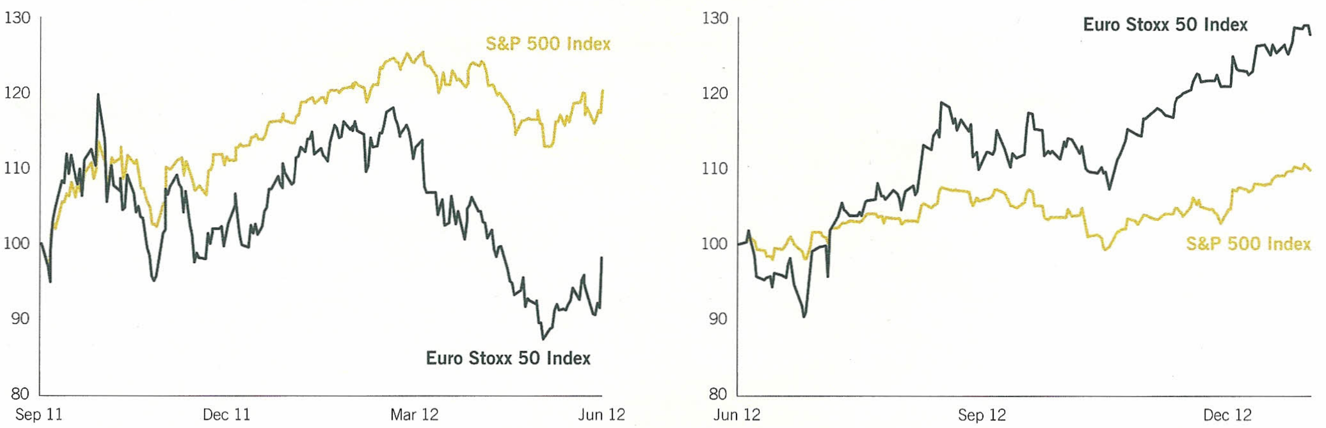
While we believe in global diversification, there will be times when we have a particularly strong country-specific equity view that we believe could help performance. What determines these views and market-leadership rotations? Why is it, for instance, that European equities outperformed their U.S. counterparts in the second half of 2012 but have been underperforming since? What allowed Japan to lead major global equity markets in recent months (especially with "hedged" yen exposure)?

A rotation in equity performance leadership can happen quickly and can be triggered by a variety of factors — there is no simple formula. Still, there can be some common threads; three in particular stand out when looking at the U.S., Europe, and Japan in recent years. First, equity leadership rotations tended to occur when differences in countries' market valuations were unusually pronounced. Second, rotations were aided by a changing investor bias toward a certain country's growth prospects. Third, there were often one or more events — catalysts of some sort — that got investors to act on this technical and fundamental backdrop.

Consider last year. As of May 2012, the S&P 500 Index had been outperforming the Euro Stoxx 50 Index for six of the prior nine months; the S&P had gained 15.8% while the Euro Stoxx had lost 10.4%. At the time, a forward-looking valuation measure, a 12-month forward price-to-earnings ratio, showed the widest discrepancy between U.S. and European stocks in 16 months. Then, during the summer, European business confidence surveys started to stabilize while U.S. surveys were still slowing. And finally, the market saw a catalyst in the form of European Central Bank President Mario Draghi. Specifically, in July 2012, he remarked that "the ECB is ready to do whatever it takes to preserve the euro." The hope for more aggressive, growth-supportive monetary policy, along with attractive valuations and relatively improving economic data, together lured capital back to European equities. The Euro Stoxx 50 Index then outperformed the S&P 500 Index for the next six months (Exhibit 4).

Many have marveled at the U.S. equity rally thus far in 2013, which is easily surpassing most analysts' expectations. But even more impressive has been

Exhibit 4: European Equities Outperformed in the Second Half of 2012



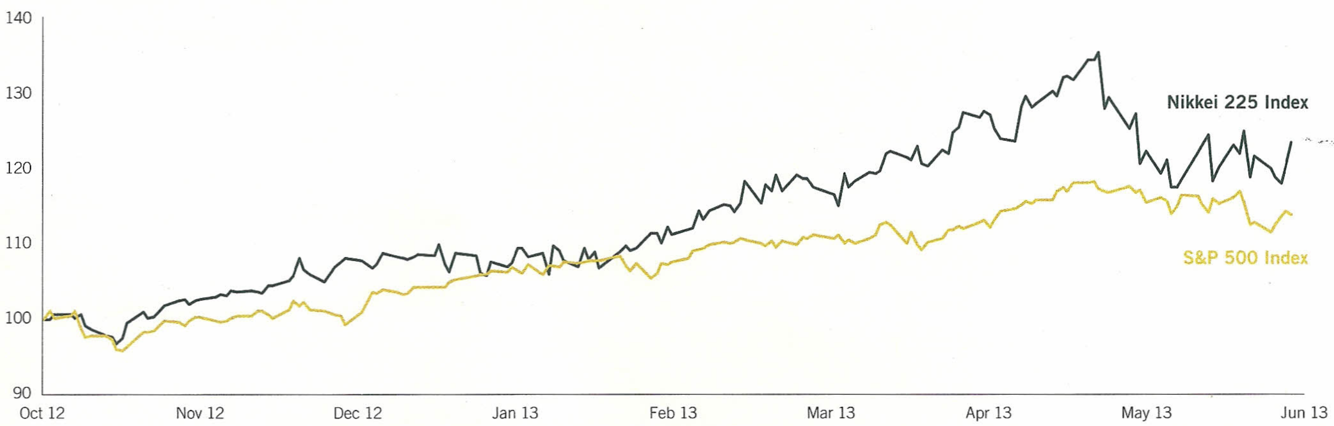
Returns are indexed at 100 and shown in U.S. dollars.
Source: FactSet, Standard & Poor's

Japan — despite a pullback in the second quarter, the Nikkei has led major equity markets since late last year. It gained 23.2% in U.S. dollar terms between end-October 2012 and end-June 2013, versus 13.8% for the S&P 500 over the same period (Exhibit 5).

What was the backdrop that led to Japan's outperformance? As was the case for Europe in the summer of 2012, Japan's equity rotation began with valuations. A forward-looking price-to-earnings ratio for Japan troughed around 10.4x last June, while the Nikkei 225 Index had only gained 18% since its 2009-crisis low (about 23% of the rebound seen by the S&P 500 over the same period). Around the same time, there were shifting expectations for policy and growth. In the U.S., investors were increasingly anxious about the so-called fiscal cliff and how significantly tighter fiscal policy might weigh on growth. In contrast, Japan was hearing more from eventual Prime Minister Shinzo Abe (elected in December 2012) about dramatically more reflationary policies as well as structural reform to support Japan's economy (see Bessemer's *Market Update: The ABCs of Abenomics*, June 10, 2013).

Our bottom line: The frequency of equity leadership rotations and the fact that these rotations can be triggered by a variety of factors reinforce our view

Exhibit 5: Japan Outperformance — "Abenomics" Working?



As of June 30, 2013. Returns are indexed at 100 and shown in U.S. dollars.
Source: FactSet, Standard & Poor's

that such tilts should only be considered within a broader framework of globally diversified equity holdings. However, at times, we believe valuation, policy, and fundamental factors may combine to warrant country-specific equity tilts in our model portfolios, and that such tilts can support performance. We are currently overweight U.S. equities and underweight a number of emerging equity markets.

The Emerging-Developed Divide

While equity market leadership can frequently rotate between countries, we would also note a slightly different, broader rotation — that between emerging and developed assets. So far, 2013 has not been kind to the emerging markets (EM) — stocks, bonds, or currencies. In the first half of the year, the MSCI Emerging Markets Index fell nearly 11%, while the J.P. Morgan Emerging Market Bond Index lost 8%.

To some, developed-market outperformance versus the emerging markets may seem counterintuitive. After all, developed markets have had slower rates of growth, lower yields, and, on average, larger budget and current account deficits than their emerging peers.

We believe these fundamental differences — which, on the surface, seem to favor emerging markets — are overwhelmed by two different factors: a downshift in emerging-market growth, and spillover from a stronger dollar and weaker commodities.

The last extended wave of emerging-market outperformance, roughly between 2002 and 2008, was driven, in part, by strong growth across a number of key EM countries. China benefited significantly from joining the World Trade Organization in 2001. Growing international trade supported not just China but also other countries that supplied China with a variety of goods and commodities. Russia, meanwhile, gained from reforms undertaken after its 1998 crisis. Between 2002 and 2008, emerging-market GDP grew by 6.9% annually, well above historical averages.

Today, many emerging economies have effectively "emerged" — easy productivity gains have been captured, wages have risen, and the pace of growth, partly as a result, has slowed. China's leaders, for instance, seem content with GDP growth around 7.5%, a contrast to double-digit growth rates only a few years earlier. The investor community does not seem to be so content, however, especially as recent growth has disappointed consensus forecasts.

Adding to recent EM angst are increasing expectations for a Fed policy rotation and, with it, a sustainably stronger U.S. dollar. Emerging markets had been attractive over the last decade in part because falling U.S. yields pressured the dollar (Exhibit 6). Commodity-exporting emerging-market countries like Brazil, Chile, and Russia had benefited as well from solid global commodity demand *and* a weaker dollar, together lifting many commodity prices.

The backdrop of strong domestic growth and appreciating currencies, as well as rising commodity prices, led investors to increase emerging-market exposure between 2002 and 2008. While positions were cut back sharply during the 2008 crisis, they were quickly rebuilt afterward because of both relatively improved economic fundamentals and a search for higher yield. Between 2009 and 2012, emerging-market bond funds saw a dramatic $264 billion in inflows. Today, those EM assets — especially emerging-market debt — are losing value as investors reduce what had become, in some cases, outsized exposures. This rotation away from emerging markets may last a while longer, especially if the dollar remains supported and commodity prices lag.

Exhibit 6: Rising Dollar Suggests Emerging-Market Underperformance

As of June 30, 2013. EM/DM reflects MSCI Emerging Markets Index divided by MSCI World Index, with both indices in U.S. dollars and indexed at 1. The Trade-Weighted U.S. Dollar Index is a weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.
Source: FactSet, Federal Reserve

As of end-June, our model allocations were underweight emerging-market equities and had reduced exposure to emerging-market debt. That said, we certainly would not write off all emerging markets. Quite the contrary, broad-brush rotations can often create value in underappreciated assets for the thoughtful bottom-up portfolio manager. Consider Embraer, a Brazilian aircraft company. Despite the emerging-developed rotation and a Brazilian equity index that was down some 28% in the first half of the year, the company's stock price (in dollars) climbed more than 30% in six months. Other examples of emerging-market companies that have decoupled from the regional bear market this year include Naspers in South Africa (media and e-commerce) and ITC in India (conglomerate focused on consumer goods, hotels, paper, and agri-businesses).

Current Themes

Where do all these great rotations leave us as we face the second half of 2013 and look toward 2014? At least three investment themes stand out:

- The shift in Fed policy seems likely to generate volatility for a while, as investors get used to a new fixed-income regime. However, a gradual shift by the Fed, alongside modestly improving growth and still-robust corporate balance sheets, should help lift equities, albeit with some bumps along the way.
- We remain overweight U.S. stocks but are always on the lookout for country rotations — parts of Europe are looking more interesting as peripheral European Monetary Union business confidence improves and equity valuations become more attractive.
- Finally, we believe developed markets are likely to be more in favor than emerging markets for the foreseeable future. That said, a desire to globally diversify and our managers' mandate to identify specific attractive investments through bottom-up research suggest that we will continue to have some emerging-market exposure — equity, debt, and currency — in our model portfolios.

One thing that will never "rotate" at Bessemer: our commitment to participate in up markets but protect our clients' irreplaceable capital in down markets.

Atlanta • Boston • Chicago • Dallas • Denver • Greenwich • Los Angeles • Miami • Naples
New York • Palm Beach • San Francisco • Washington, D.C. • Wilmington • Woodbridge
Cayman Islands • New Zealand • United Kingdom

Visit us at www.bessemer.com.