STRATEGIC OUTLOOK

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Strategic Frontier Management
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CAPITALIZING ON ENDURING BELIEFS

- After decades of economic policy experiments, there should be agreement how *Capitalizing on Enduring Beliefs* can provide sustainable potential growth and prosperity. Economic incentives and efficient fiscal management can secure a global competitive edge with constructive government policies. Stock and bond markets reflected an increased likelihood of new policy reforms after the U.S. election, which should bolster growth and normalize inflation.
- Aligned political balance of power across Executive and Legislative branches increases the likelihood of fiscal (tax and spending), trade, health care, and regulatory reform. Much can be done within the agencies, but permanent change requires legislative effort---negotiation takes time and patience. We seek greater potential growth and prosperity with liberty, free markets, equal opportunity, and rule of law. While the President hopes to set the agenda, Congress writes and passes legislation. There should be additional upside to equities and bond yields once meaningful legislation is enacted.
- Interest rates and central bank holdings must normalize as inflation firms and growth accelerates. Investors never observed increasing rates with such high convexity. Global interest rates are rising, led by U.S. rate hikes. International bond yields may not rise as fast, but they will rise too. Investors may be surprised if the Federal Reserve suspends its reinvestment program of maturing bonds by year end, as we expect. We should be vigilant about interest rate sensitivity, even within private market and equity portfolios. The consequences of monetary normalization are significant. Years of manipulating interest rates has created global imbalances and induced explicit moral hazard, which must correct. When valuation imbalances or interest coverage issues develop, bond vigilantes can emerge and sell indiscriminately.
- Global economic and capital market divergences are increasing now between countries, even within Emerging Markets. Some countries will be better positioned to benefit from increasing opportunities, while other countries will likely have to adapt to manage fiscal deficits with existing policy headwinds that limit their growth, even as higher interest rates increase interest burdens risking a sovereign crisis.
- Better than expected U.S. potential growth should boost inflation expectations. Lowered long-term rate policy targets and expectations will need to rise. Other countries must respond to a widening gap in competitiveness—devaluing currencies or imposing tariffs are unsustainable responses, in this regard. U.S. policy success improving competitiveness will likely be copied to avoid falling behind as it was in the 1990s, but also could lead to further policy abandonment of Social Democracy.
- *Capitalizing on Enduring Beliefs* is reflected in key factors of our Global TAA models for stocks, bonds and currency. They include: valuation, earnings, economic growth inflation, exchange rates, and interest rates. All of these fundamental indicators are intuitively affected by changes in policy. In equities, earnings growth provides the upside observed in equity indices. Some strategists suggest equity markets are overvalued, but strong returns are not sufficient to create a valuation bubble. Yet, rising inflation causes bonds to become increasingly overvalued. Rising inflation and hikes in interest rates should drive bond yields higher.
- Economic divergences and imbalances must affect long-term asset class return forecasts, as well as volatility and correlation. We observe higher equity volatility-of-volatility as expected, rather than simply higher volatility. Now that U.S. volatility fell well below equilibrium, near-term reversion to 10-12% should be expected. On the other hand, expecting higher global bond or currency volatility should be intuitive. Those betting on continuing low currency volatility and rising equity volatility are struggling. Global equity volatility fell further through Q1. Bond volatility should continue increasing as economic volatility rises and correlation declines.

In Search of Global Prosperity

We expect relative global prosperity will be influenced by U.S. policy reforms and distinct global divergences across economic conditions and markets. Improving business and consumer confidence can lift U.S. GDP as the market seems to be anticipating regulatory, tax and health care reforms to improve potential growth and promote greater global competitiveness. Europe and Japan are still languishing below their reduced potential---although valuations appear cheap, the lack of growth limits earnings growth.

Emerging Markets have stabilized, but are no longer a monolithic secular force and divergences are increasing between countries. A decade ago, developing countries benefited from urbanization, industrialization, globalization, emerging credit culture, and insatiable consumption. These were powerful drivers of strong growth, but as developing economies mature, differences become important.

A constructive and dynamic U.S. environment is emerging with increasing business and consumer confidence in the new Administration's economic policies. These policies seek to restore 2.8% potential growth, greater productivity, and improved global competitiveness. With most countries also improving, we expect that global growth can approach 3.5% this year, but G-7 growth will be closer to 2% in 2017 limited by the growth in Japan, France, and Italy.

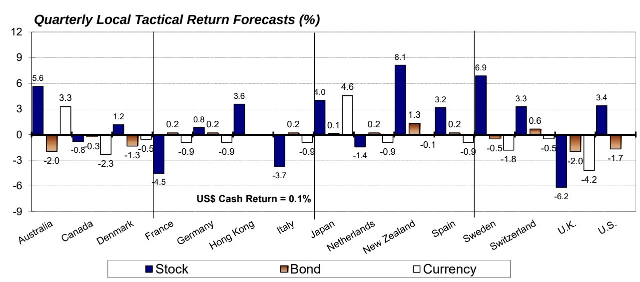
Economic Forecasts	**2012**	**2013**	**2014**	**2015**	**2016e**	**2017e**	**2018e**
GDP Growth (Y/Y Real)	2.3	2.7	2.5	1.9	**1.9**	**3.0**	**3.2**
S&P500 Earnings	6.0	5.7	8.1	-0.9	**1.1**	**9.5**	**11.5**
CPI Inflation (Y/Y)	1.8	1.8	0.7	0.7	**2.2**	**2.5**	**2.7**
Unemployment	7.8	6.7	5.6	5.0	**4.7**	**4.8**	**4.5**
Fiscal Deficit	-6.6	-3.2	-3.5	-3.0	**-3.8**	**-3.5**	**-3.0**
Fed Funds Target	0.25	0.25	0.25	0.50	**0.75**	**1.75**	**3.25**
10y Treasury Notes	1.85	3.00	2.17	2.27	**2.45**	**3.50**	**4.75**
S&P 500 Target	1426.	1848.	2059.	2044.	**2239.**	**2350.**	**2500.**

Source: Strategic Frontier Management

With transition in political power, a new economic regime has emerged with very different priorities. We expect U.S. potential real growth will increase from 2.2-2.5% to 2.8-3.0% given the President's agenda and Congressional support. We boosted our 2017 GDP to 3.0%, followed by 3.2% in 2018, based on constructive changes to fiscal and regulatory policy. The resulting policy pivot should promote better economic growth, investment, competitiveness, trade, and productivity, while reinforcing still high profit margins. Corporate and individual tax reform should reduce administrative and enforcement costs, while lowering rates. Adjustment to investor expectations drove a rerating of U.S. equity and bonds markets, but further adjustment will require more clarity on tax and regulatory reform.

Effects of a shifting balance-of-power usually lag for years, but the consequences of this election are likely to be more immediate given political alignment. New administrations typically prioritize work in series, but this Administration is likely to execute many initiatives simultaneously in parallel, unconcerned about expending political capital. Congressional leadership will lead drafting of constructive fiscal (tax and spending), health care, and regulatory reforms. Disappointing declines in potential growth since the Financial Crisis appear to us to be the result of cyclically transitory effects, consistent with *Capitalizing on Enduring Beliefs*. Hypothesized *new normal* or *secular stagnation* seem to be a symptom of misguided government policies and regulation, not lingering financial crisis or presumed inequality effects.

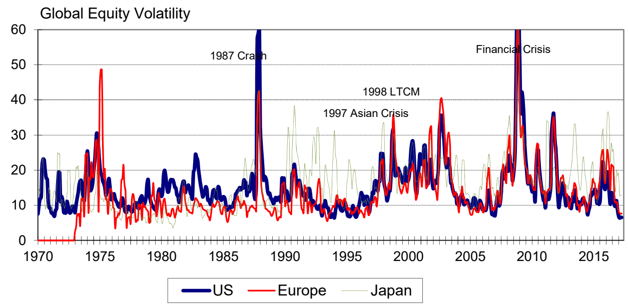
The S&P 500 returned 6.1% in the first quarter, extending gains over the last year (17.2%), and well in excess of bonds. We also have exceeded our year-end S&P 500 target of 2350, but await greater clarity on policy initiatives. U.S. 10-yr. Treasures returned 0.8% in Q1/2017, but tumbled -3.0% over the last year. Yield curve normalization has begun, although it has lagged our expectations. Treasury 10-year yields rose 1.2% from a low of 1.38% on July 8, 2016, returning -6.8% in the second half of 2016. The post-election surge in the S&P 500 Index (12.1% return) coincided with rising Treasury yields from 1.8% to 2.4% between Nov 1st – March 31st. International stocks (7.2%) outperformed the S&P 500 as the U.S. dollar weakened, but Emerging Market (MSCI EEM: 11.8%) returns were strong, led by our favorites: India, Korea, China, and Mexico. First quarter dispersion ranged from Russia (-4.6%) to Poland (17.7%), highlighting international diversification and that *countries still matter.*



Our forecasts suggest there is still upside for global equity markets, albeit limited after several years of strong price appreciation. The most attractive markets are the Netherlands, New Zealand, Switzerland, Hong Kong, and Japan. We also still favor a tilt toward small-cap and value equities. The outlook for bonds remains concerning, particularly in the U.S., U.K., Sweden, Japan, and Australia. The Eurozone appears to be a safe haven for bonds, but the Euro is likely to weaken.

Most strategists have anticipated higher equity volatility, particularly after the election. Instead, global equity volatility collapsed well below average. Our expectation was instead for greater equity volatility-of-volatility, with higher volatility in bonds and currency.

This is indeed what we observed as equity volatility has now fallen further to record lows. While we still don't subscribe to above average volatility, we now expect some reversion to its mean. Instead of reinforcing concerns about equity risk, strategists might help understand what drives volatility and correlation.



	Now	Dec. 2015	2009 Peak	Average
US	6.6%	14.5%	36.0%	15.2%
Japan	12.9%	16.9%	20.8%	16.1%
Europe	7.6%	16.3%	35.2%	13.9%

Revealing Thy Inner Bond Vigilante

Interest rates have remained too low for too long and now must normalize more quickly given the wide gap to traverse to 3.5%. Normalization requires adopting a systematic program (see 2004), instead of an arbitrary mantra of "data dependency". Aggressive monetary stimulus "keep interest rates low for an extended period" hasn't helped growth. Deferring normalization of monetary policy undermined central bank credibility.

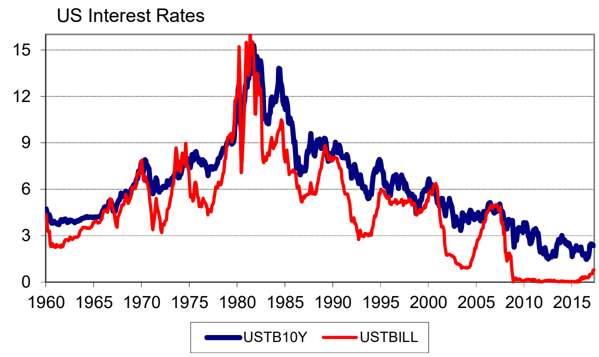
Interest Rates	2016	2017	2018	2019	Longer Run
FOMC Avg.	0.63%	1.40%	2.32%	2.89%	2.99%
SFM	0.63%	1.75%	3.25%	3.50%	3.50%
SFM Hikes	0.25%	1.00%	1.50%	0.25%	-

Source: FOMC Economic Projections for March 2017.

We forecast a Treasury yield of 3.5% by year-end, and 4.75% in 2018, coinciding to a 3.25% Fed Funds rate. FOMC rate hike expectations of just 2-3 increases in 2017 still lag our forecast for steady ¼% rate hikes every other meeting until reaching 3.5%, unless a recession emerges. Most investors probably aren't well positioned, and we suspect they have greater interest rate exposure than imagined in just bond holdings.

The wide gap to the Taylor Rule's indicated Fed Funds Rate is unsustainable, already exceeding 2.8% versus 0.75-1.0% today. We suggest needed normalization of the yield curve under current conditions does not require higher inflation to justify increasing policy rates. While historical averages suggest 4% short-term rates and 6.5% 10-year Treasury yields, equilibrium is most likely 3.5% short-term and 5.5% Treasury yields, assuming inflation averages just 2.5%.

Treasury 10-year bond yields will need to rise above 5% over the next two years or by mid-2019. Transparent guidelines for orderly normalization of interest rates and central bank holdings are critical to avoiding excess volatility. Extended bond losses can increase the term risk premium, which we've suggested could add 0.5% versus equilibrium, resulting in higher cost of capital for an *extended period*.



The New Interest Rate Paradigm (published March 2017) suggests several key conclusions, including potentially a more systematic course of normalizing rates (1%/year) and reducing QE holdings:

1. FOMC under new management within a year—more rule-based Hawks and fewer Doves with at least 3/7 Board of Governor appointments
2. Rapidly evolving public and private asset class risk measures, particularly volatility and correlation
3. Correcting imbalances and unwinding QE-bloated Federal Reserve holdings could begin by year-end.
4. Increasing sovereign bond risk of extended debt and rising interest burdens as bond yields increase
5. Higher potential growth and equilibrium inflation as tax and regulatory reform increase competitiveness
6. Adverse consequences of increased duration and bond leverage used by asset owners, hedge funds
7. Investors must appreciate the effect of high bond convexity[1], which increases interest rate sensitivity at current low yields.

Leverage and extended bond duration will amplify portfolio losses as bond yields rise. Investors may be surprised by larger bond losses for a 1% change in yield. Investors should also recognize that interest rate sensitivity extends beyond bond holdings to private market and equity portfolios. A toxic mix that concerns us is investors' extended duration and increased bond leverage over a period of explicit global central bank manipulation of interest rates as global debt soared.

[1] Bond convexity is a measure of changing bond return sensitivity to changes in interest rates, specifically the second derivative of bond price with respect to interest rate changes.

Outstanding global debt, investor leverage, and increased bond market illiquidity due to financial regulation sets the stage for a sovereign bond crisis, particularly in countries whose fiscal deficits can't afford materially higher bond yields (i.e., Japan, Italy, France, and others). On bond market illiquidity, few seem interested in the warnings of the largest bond managers, including Blackrock (Larry Fink), Janus, (Bill Gross), or DoubleLine (Jeff Gundlach). Central banks buying long duration premium bonds locked in losses to be shouldered by taxpayers. When extreme imbalances of valuation or interest coverage issues develop, *bond vigilantes* sell bonds indiscriminately.

During prior rate tightening cycles, equities exceeded historical rates of return after initial volatility. Rising rates require that growth is reasonably robust, thus rising earnings intuitively bolster equities. Bond holders are not so fortunate if policy rates are rising or inflation is firming. Slow increases in rates might minimize bond market losses, but excessive monetary stimulus, including unsustainably low policy rates, forward guidance and quantitative easing while holding rates low, has increased moral hazard. With such high convexity of 2.5% Treasury 10-year Note yields, bond losses compound faster with yield changes. Historical bond returns, volatility, and correlation are misleading and will have adverse consequences for investors that extended bond portfolio duration or added leverage in adopting risk parity, liability-driven investing (LDI), hedge funds, low volatility equity, high dividend yield, and similar yield-oriented strategies.

Investors may be surprised if the Federal Reserve suspends its reinvestment program of maturing bonds by year end, as we expect. Bond-bloated balance sheet holdings exceeding $4 trillion must begin declining toward $1.5 trillion. In October 2008, the Federal Reserve announced that it would begin to pay interest on banks' required and excess reserve balances—today that rate is 1%, and the interest burden to taxpayers will rise with higher interest rates. As central bank holdings decline, we expect the Federal Reserve also should at least reduce or eliminate interest on excess reserves (IOER).

Refunding $2.5 trillion in federal debt will not be easy, particularly with rising interest rates and bond investors losing money, as $1.4 trillion matures within the next five years. Added bond supply of QE holdings as we expect demand to diminish should increase risk premiums and crowding out of new issuance. The extent to which central banks continue to maintain low interest rates, quantitative easing and forward guidance increased explicit moral hazard. The U.S. Treasury has not extended maturity of outstanding debt, even as the Federal Reserve bought long Treasury and Agency bonds.

The next crisis may evolve more slowly than the 2008 Financial Crisis, but have greater impact on bond risk premiums. Sovereign bond yields could spike, similar to the 2012 Eurobond Crisis, which crowded out new issuance with fiscal financing concerns and rising interest burdens. Bond managers suggest that effects of rising rates should be more muted than feared, however bond yields started off at much higher levels in prior cycles. Higher convexity now threatens greater interest rate sensitivity of bonds. Liquidity concerns with excessive debt levels and record issuance needs coincide with rising policy rates. This suggests bonds are more susceptible as losses compound.

Economic Inflection Point

These are interesting times to exploit increasing dispersion and an unusual number of tactical investment opportunities. Coinciding with the inflection point in normalizing interest rates are other important economic and capital market divergences. Correlations between countries increased as currency volatility declined for years after the Financial Crisis---a consequence of coordinated monetary and economic policies. Regulation increased, but lingering effects are not uniform. Cyclical inflation was depressed by transitory effects of plunging oil prices and strong U.S. dollar, but inflationary forces have been increasing as rising secular potential growth evolves.

We are witnessing disruption in every industry that is individually unnerving and can marginalize entire industries in just a few years. Commercialization of disruptive and adaptive technologies of the manufacturing renaissance had a disinflationary impact on costs and resource utilization. Globalization, outsourcing, internet price transparency, hyper-competition, innovation, and creativity have all reinforced secular disinflation. Those with sustainable competitive advantage or offering unique value added will be more secure.

Advances in machine learning, data analysis, sensors, additive manufacturing, and a communication have enhanced efficiency and higher profit margins. We have highlighted notable accounting issues that understate growth, and thus productivity, due to alternative revenue sources and free internet applications or services. Consider the open source movement providing powerful essential programming tools for analysis. Michael Porter's idea of sustainable competitive advantage at a time of disruptive and adaptive transformation has never been more relevant. Turnover of investment themes has accelerated, as we discussed in *Ruthlessness of Unruly Forces* (Q4/2016).

High federal, state, and local debt of persistent fiscal deficits are going to increase interest burdens as rates rise. While we don't expect 1980s-like concerns about soaring interest costs, debt exceeding 80-100% of

GDP is unsustainable as interest rates rise. Low interest rates and quantitative easing has masked the significant increase in liabilities. Commitments to public employee health and pension benefits are reaching a tipping point given projected benefit obligations. Some states have managed to negotiate pension reforms, but others may require taxpayer bailouts.

Puerto Rico's recent $70 billion bankruptcy filing with its economy in recession forewarns concern compounding extended pension and entitlement liabilities. Restructuring debt will result in a significant loss for municipal bond holders that hoped to benefit from safe tax-exempt income. Puerto Rico enjoys state and federal tax exemptions, so many municipal bond funds hold their bonds to diversify holdings and increase liquidity. Thus, holdings are more widespread than holdings for a single state. Unrealistic rates of return, exceeding 6-7%, suggest public liabilities are understated. For example, CalPERS just reduced their return to 7%. Venezuela is suffering a similar fate.

We discussed the potential for improving U.K. competitiveness and other consequences of BREXIT in *British Independence Day* (June 2016) to improve relative to Eurozone peers. Britain decided to take back sovereign control and rejected EU central planning over basic civil rights, democratic freedom, liberty, and self-determination. The people declared independence by reasserting sovereign control over British laws, regulation, defense, and immigration. Britain may be the first of several countries to leave the EU, and risk of dissolving the EU has never been greater.

U.K. economic and currency uncertainty didn't persist long, but now that Article 50 has been triggered, new agreements must begin to fall into place. It is not necessary to start from scratch, but new agreements may be better than fixing what is broken. Realistically, not much will change for businesses and households for another year, although BREXIT is a monumental foreign relations and trade policy undertaking. Concerns about destabilizing growth or increasing risk of a global recession were mistaken and unfounded. In the weeks ahead, the European Parliament and Council of the European Union must assess how to reform itself and its policies. To survive, it will need to radically change to better serve the common market.

Concerns about China have lingered for a few years, but China does not resemble Greece or Italy, nor is it on the verge of a real estate or banking crisis, as some suggest. China's growth expanded at 6.9% annualized rate. In Q1/2017 after a 6.5% trough in mid-2016, growth re-accelerated if national statistics are believed (trends reasonable, even if growth estimates suspect).

Our concern has been China's low and falling profit margins as their labor cost advantage diminishes and labor intensity declines. *The Rise of The Machines* has become China's Achilles Heel with cheaper energy and diminishing labor cost advantage. Displacing labor with robots accelerates on-shoring U.S. production—robots are indifferent where they live and how they get paid, thus transportation costs become more significant.

Response to considering taxing robots, as proposed in European Parliament, has been overwhelmingly negative and shelved, with notable exceptions of Robert Shiller and Bill Gates who think costs of automation can and should be redirected. The irony that a Microsoft founder might seek to tax technological innovation of robotics development is astonishing.

One of the more practical concerns is what defines a *robot* in an age of many products that reduce labor intensity. How about Expedia, Alexa (Amazon) or a robo-advisor, let alone draw the line between software, such as TurboTax, and Roomba? Robots at work on an assembly line or in a distribution center may concern those whose jobs are threatened, but America still leads the world in robotics. Taxing robots, however functionally ambiguous or virtual, would put companies at a disadvantage, limit productivity growth, and increase consumer prices. Taxing things discourages that activity and increase inflation---should we limit innovation to fund wage insurance, basic income, or retraining? It is unlikely with higher education available free via the Internet from… robots (Coursera).

Policy and Reform Initiatives

With a narrowly split Senate, we can see the why the filibuster has been weaponized---yet, it's time has come to sunset if we seek to improve government efficiency and effectiveness. Once upon a time, the Senate filibuster was a rare sighting, but it has been misused too frequently. Given the current balance of power, we believe there is increasing likelihood the Senate Cloture Rule will be modified before year end.

The **Infrastructure** program seems misunderstood, particularly with regard to financing. Fiscal stimulus is not needed and there is no room for adding to our fiscal deficit to fund unsustainable stimulus programs. We have learned many times over that we can't tax and spend ourselves into prosperity or productivity. We think the assumed $1 trillion infrastructure spending program is likely to be mostly privately financed. There are many roads, bridges, and essential services (i.e., water, sewer, communication networks, power, etc.) that need upgrading. Construction spending may increase jobs, but these are often transitory and typically funded by states or consumers paying usage fees (i.e., tolls, utility surcharges, etc.). There are many ways government can support and promote investment spending at far less cost to taxpayers.

Would this Congress propose a spending program rivaling the $831 billion American Recovery and

Reinvestment Act of 2009? Republicans opposed ARRA as misguided and wasteful. The accrued debt provided little economic benefit, nor bolstered potential growth. America was recovering from the recession by the time ARRA's ink was dry. We can finance many projects without increasing fiscal deficits, so Congress is unlikely to bust the budget for infrastructure.

While voters have assumed federal spending on infrastructure approaching $1 trillion, the program will probably not require much outlay of taxpayer funding. We expect spending is likely to follow an alternative path few seem to understand yet. Everything from credit financing to regulatory reform can help bolster infrastructure development, as discussed in: *Ruthlessness of Unruly Forces* (Q4/2016). Moreover, the federal government has amassed tremendous non-strategic land, property and other assets, which can be privatized or sold to pay for development or reduce debt without further burdening taxpayers. States have also accumulated assets they can leverage.

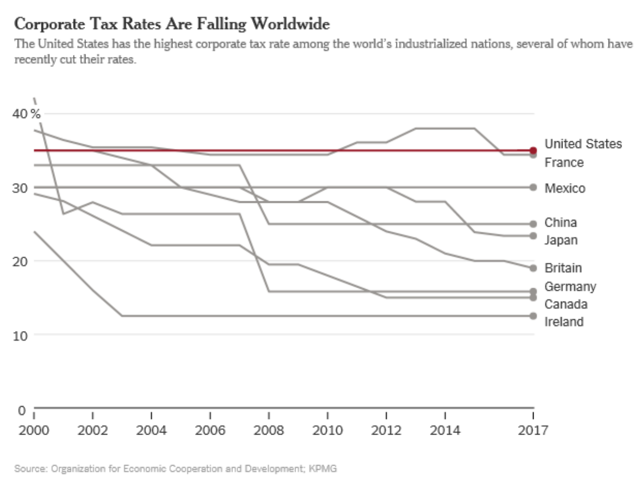
We believe public-private partnerships, regulatory relief for commercially compelling projects, as well as research and development incentives can provide more than $1 trillion in economic activity for less than $100 billion outlay of taxpayer money. Consider that simple agency regulatory approvals for stalled energy infrastructure projects (i.e., Keystone, other pipelines, refineries, transmission lines, and utility plants) exceed $400 billion, but not a dime of taxpayer money is needed. A steady pace of Executive Orders, plus many new agency initiatives, has already made a down-payment on infrastructure program development.

Individual Tax Reform is expected to include simplification and flattening tax rates. Highest individual rates will likely decline from 39.6% to 35% with fewer brackets, but simplification eliminates most deductions and credits that have allowed some higher income individuals to enjoy lower effective tax rates. The tax code is so complex that it has become very costly to administer and enforce. Simplification would significantly reduce accounting fees and compliance costs, while encouraging many more to file their own tax returns. Many studies estimate the cost burden of federal income tax complexity to exceed $235 billion in lost productivity. Income deductions likely will be limited to mortgage interest, charitable contributions, and government taxes or fees (i.e., state/local income taxes, property taxes, and license fees), eliminating the need for the Alternative Minimum Tax. Most filers will only apply for the increased standard deduction.

Dividend and long-term capital gain rates may be reduced to 15% again, while the 3.8% Obamacare tax on investment income should also be eliminated. This is good news for bolstering investment and capital financing of new businesses. After-tax earnings distributed as dividends should not be taxed again, but lower rates are unlikely to be politically feasible. For investors, individual and corporate tax reform should incentivize investment, boost potential growth, and raise productivity, while reducing economic uncertainty.

Corporate Tax Reform is expected to have the greatest economic impact and reduce the 35% U.S. statutory rate toward the global average of 20%, while eliminating most tax breaks and accelerating expensing of capital investment. Small business owners who report pass-through corporate income on their individual taxes should also benefit from corporate tax reform. Dynamic budget scoring should reflect increased earnings growth, compounding over time.

Our 35% corporate tax rate exceeds all of our largest trading partners to the disadvantage of businesses---add assessed state and local tax rates, and it is clear why other countries, including Japan and Germany, benefited from cutting their tax rates over the last 16 years. The relative shift in tax advantage has been an increasing headwind to global competitiveness and is a primary reason for massive unrepatriated foreign earnings that companies paid tax on in host countries. Repatriating an estimated $4 trillion in assets overseas could provide an extraordinary boost to U.S investment and trigger a domestic investment boom up to four times greater than hoped for infrastructure programs.



There has been bipartisan support for corporate tax reform given the wide relative gap in global tax rates. This gap encourages corporate inversions (U.S.-based companies moving overseas to reduce income taxes) and unrepatriated foreign earnings. Lower tax rates should increase repatriation of foreign earnings, but might be accelerated by a permanent 10% tax that increases tax revenue and encourages repatriation. If tax and regulatory reforms are effective, global competitiveness improves, and there is no need for proposed border adjustment taxes.

In a similar way, we expect interstate relocations to accelerate with poor tax, regulatory, and labor policies being imposed in certain states like California, New York, New Jersey, and Michigan. State and local taxes represent a significant business cost and have an impact on operating margins. Thus, business location decisions are influenced by relative state tax burdens, cost of living, and labor cost decisions. Residents are fleeing in greater numbers to tax-friendly states. We expect businesses will follow suit, further eroding the tax base. It is easier to change state residency than disavow citizenship or execute a corporate inversion.

Principled Beliefs

Business processes, labor, health, energy, basic materials, employment, and education all are experiencing effects of a new industrial revolution that yielded greater profit margins, but also disrupted the status quo. Failing government policy performance over the last decade caused individuals to seek new direction from political leadership. Those that seek a return to America's founding principles, generally recognize benefits of *Capitalizing on Enduring Beliefs.*

There is a widening gap in our individual values and principles of *Capitalizing on Enduring Beliefs* in America. Unable to enact meaningful legislation since Dodd-Frank (financial reform), unelected bureaucrats in the DoL, SEC, Treasury, Federal Reserve, CFPB, NLRB, and other agencies used their regulatory powers to "legislate" within the Executive Branch. Consequences of this approach are that many agency rules and regulations created with the stroke of a pen are also unraveling with another stroke of a pen.

A significant example was the Department of Labor's August 2016 rule on *Savings Arrangements Established by Qualified State Political Subdivisions for Non-Governmental Employees,* which created a regulatory loophole to exempt states and municipalities from ERISA laws that govern retirement plans today. Before the rule was finalized, California and other states rushed legislation to take advantage of the new rule, despite concerns and likely unintended consequences highlighted by ICI, SIMFA, Financial Services Institute, and various other groups. It seems the DoL rule was just another mandate without a problem to solve. As with other new agency rules imposed last year, Congress has repealed this DoL rule, nullifying states' exemption.

There is no need for state-managed retirement plans for private sector workers. *Simple IRA*, *SEP IRA*, *Solo 401(k),* and profit sharing plans allow small businesses to simply provide retirement plans using existing commercially competitive investment products. These solutions are more appropriate than creating a new retirement savings plan option from scratch. Experience starting up 529 College Savings Plans highlights high administrative and management fees associated with good intentions. Thus, the rule was ill-advised for auto-enrolling workers in ERISA-exempt accounts requiring administering payroll deductions. There are sufficient investment options from a wide range of low cost providers. Most investment companies offer free or low-cost advice tools to their customers to help manage their portfolios. State-run programs would vary widely, and are unlikely to gather sufficient assets, provide advice, or enhance access.

There was good intention in attempting to increase savings rates, but a new mandate for retirement plans was redundant and unnecessary. Employers defaulting into these savings arrangements could not match deductions, nor would employees be able to roll accounts into IRAs, as allowed for qualified plans. Existing tax-advantaged savings options are vastly underutilized by those this program sought to help, including IRA, Roth IRA, and HSA plans. Widely available low cost investment options simply can't be matched by creating such a government program.

Soaring public pension liabilities in every country, state, and municipality are undermining the already bleak outlook for continuing defined benefit plans. More plans are being frozen and risk transfers imply that companies no longer view pensions as a viable benefit. Participation in defined contribution (DC plans: 401-k, 403-b, 457, SEP-IRA, etc.) and cash-balance plans now far exceed pensions as a share of U.S. retirement.

There is a retirement savings crisis in America. Greater reliance on IRA and defined contribution plans requires individuals to be more self-sufficient. As a matter of policy, we need to encourage workers to save more for retirement and future health care needs as access to pensions diminish. The widening gap in retirement security is troublesome, but the answer is not limiting or means-testing contributions. Individuals also need greater access to competitive investment advice, albeit with rational fiduciary standards. A smarter approach to financial regulation is needed to provide safe-harbor to advice providers that meet appropriate standards of practice and fiduciary responsibility.

The Quest of Asset Owners

We are fortunate when advisors are entrusted to manage *Other Peoples' Money* to add value in a prudent manner, specifically optimizing the expected risk-adjusted return subject to their guidelines. How can advisors add value? We suggest there is a smarter approach to investing rooted in *Capitalizing on Enduring Beliefs* applied with discipline. It is time to move on from high fees of mystery thrillers and complex science fiction literature. Investors are paying too much for market exposure (beta), including illiquid costly private market funds, still subject to the same market forces driving public listed securities. The most important factor in investment success is asset allocation, so shifting focus to global multi-asset allocation and risk factor exposures is not surprising.

Recent Milliman Corporate 100 plan survey results has highlighted unfunded liabilities unrealistic return expectations and continued de-risking, which drove down equity exposures, while boosting fixed income and alternative exposures. This change in asset allocation should lower plan returns, yet expected returns remain too high. Realized risk-adjusted returns have benefited from strong equity returns, yet liabilities exceed pension assets, while returns lag simple global balanced index allocations we believe would be more prudent, particularly as interest rates rise.

Asset owners have increased allocation complexity with higher exposures to alternative investments, but alternatives have failed to moderate downside risk and lagged performance of simpler balanced strategies. The diminishing illiquidity risk premium was intuitively appealing in theory, but high cost, scarce capacity, lock-ups, and portfolio rebalancing limitations for stretched valuations that have curbed performance. Thus, alternative allocations are being increasingly scrutinized, from costs to the ability of managers to add value managing illiquid securities. Dismal risk-adjusted returns and high costs seem to be encouraging recent alternative divestment among public pension plans.

With demand for greater return, active management can be a novel *alternative investment* with lower cost, greater liquidity, more transparency, superior risk attribution, and better likelihood of adding value than private market or hedge funds. Uncorrelated returns and value added that alternatives promise is accessible through active management. Evaluating private market and hedge fund managers is more difficult than public market managers. Security selection is a zero-sum game, so high fees and transaction costs increase hurdles to outperforming benchmarks. Why wouldn't this logic to apply to private market funds? Yet, many investors that embrace private market alternatives also index public market exposures. Low-cost active strategies (alpha) have never been more valuable given a low return (beta) regime expected.

Active management is an uncorrelated alternative investment providing greater liquidity, transparency, and diversification at lower cost. Active return is a scarce resource, but it is easier to find negatively correlated active strategy returns, than uncorrelated private market total returns. Investors have been rotating out of mutual funds into index funds and ETFs, but we are unable to track strong flows into SMA/UMA platform portfolios. Many ETF strategies reflect active factor tilts or are combined as tactical asset allocation strategies. Therefore, we believe the rotation into passive strategies is overstated.

The importance of managing risk factor exposures is obvious with access to better analytical capabilities. Over the last decade we observed various situations that underperformance was attributed to unintended risk factor exposures that are easier to hedge now. In 2004, the Federal Reserve unexpectedly began raising interest rates. Although an equity manager may have moderate tracking error with limited industry exposure, underperformance attributable to unintended interest rate exposure could be readily identified.

Proliferation of ETF index strategies has added many investable dimensions to our universe of global tactical asset allocation decisions. Combination of alternative factors into long-only "smart beta" strategies has been shown to be significantly inferior to a quantitative portfolio of individual securities with similar factor tilts in "Fundamentals of Efficient Factor Investing" by Clarke, de Silva, and Thorley (*Financial Analysts Journal*, 2016). Empirical results of this paper confirm intuition of *Capitalizing on Enduring Beliefs*. Management of multi-asset portfolios is becoming more sophisticated, including focus on multi-factor risk management. Appreciation for the importance of strategic asset allocation has increased---this is encouraging because total return depends more on allocation decisions than any other portfolio decision. Asset managers have increased resource investment in multi-asset solutions.

Risk factor investing has increased transparency of econometric risks and factor anomalies *Capitalizing on Enduring Beliefs.* Operationalizing new risk factors has been limited by lack standardization, like GIC equity sectors or bond sectors (corporate, mortgage, asset-backed, government, etc.). While familiar with large-small size or value-growth, addition of new factors include: momentum, credit, carry, currency, valuation, interest rates, commodity, growth, and inflation. Improved portfolio and risk management tools reveal previously unmeasurable exposures that can now be managed, rebalanced, and even hedged.

Active management should be a zero sum game. While management fees and transaction costs are visible, the cash drag on equity funds continues to be significant (S&P 500 returned 13.3% x 5% cash = -0.67%/year drag over 5 years). In a 20% decline, 5% cash drag might add 1%). Excess cash held in equity funds can average 4-5%, so this persistent risk undermines fund performance. This is one reason why active equity funds may perform better in declining markets.

Yet, consider lost potential value added for those that dismiss the active management of large-cap stocks, which are a more significant share of portfolios.

Compare these value-added contributions:

<u>0.4%</u> = 1% x 40% Large-cap vs. <u>0.3%</u> = 2% x 15% Small-cap

Conventional wisdom suggests focusing on specialized strategies, such as small-cap equity, international or high yield bonds. Yet, the long-run monthly hit ratio or manager hit ratio is similar across equities. Large-cap management fees and trading costs are less, while liquidity is greater. Thus, the cost hurdle of large-cap equity is lower than small-cap or international products, but greater portfolio share increases potential value added. If prudent private market exposures are limited to 20-25%, how much excess return must these strategies contribute to make a material difference?

Concluding Thoughts

We expect global equities to outperform global bonds as interest rates rise and U.S. policy reforms bolster our long-term economic growth outlook. Our global tactical asset allocation models favor overweighting global equities versus bonds. Resilient high U.S. profit margins should support equities and drive earnings growth, while interest rates normalize with a stronger U.S. dollar. We are concerned that low volatility and high dividend yield equity tilts could be vulnerable. Financial and Industrial companies, including Defense and Transportation, should benefit most in this regime. A disciplined view rooted in fundamentals can provide the means for *Capitalizing on Enduring Beliefs.*

Global interest rates are expected to rise, led by rate hikes in the United States. Investors need to be vigilant about the impact of rate sensitive holdings, even within private markets. We believe the Federal Reserve has settled into a steady ¼% interest rate hikes every other FOMC meeting or +1% per year to at least 3.5%, although not yet formalized. Monetary normalization will include winding down bond holdings of about $2.5 trillion within the next five years. This will continue until 10-year Treasury bond yields rise above 5%, unless a recession emerges.

A three decade long bond bull market led investors to adopt unrealistic bond risk and correlation estimates. Increasing economic divergences will lead to market divergences, not only between countries, but also across sectors and risk factors. Persistent bond losses should increase the inflation risk premium. An inflection point in interest rates with record debt outstanding suggests that anomalous risk premiums must adapt to investor preferences—dividend yield and low volatility factors are most at risk given imbalances.

Change in risk factor behaviors likely coincides with evolving asset class volatility and correlation. Thus risk estimates are more uncertain. Bond and currency volatility have increased with global divergences, but equity volatility declined dramatically. Higher bond and currency volatility will be exacerbated by economic dispersion and reduced bond market liquidity. Investors need to extend their time horizon and simplify their asset allocation to improve performance. We believe international diversification should provide greater benefit, suggesting *countries still matter*.

Secular influences of innovation, technological change, hyper-competitiveness, and other forces were ushered in by a new Industrial Revolution, benefitting from a communications revolution and manufacturing renaissance. The more systematic or quantitative the chore, the greater is the likelihood of transformative change. Nearly every aspect of financial services, from asset management to banking, was disrupted. This reduced cost and improved quality, but consumer prices for financial services are only now beginning to decline, such as robo-advisors or ETF solutions.

Too often simplicity is sacrificed for provocative or complex solutions that may seem to have greater appeal. We subscribe and been well-served favoring Einstein's simplicity principle: "...as simple as possible, but no simpler". Simple regression remains a powerful tool for inference, analysis, and forecasting. Analytical tools used today leveraging big data sets usually begin with basic linear regression. Practical solutions often involve nonlinear relationships. Machine learning is not as complex as assumed and such methods have been around for decades. They are finally becoming more accessible with large dataset application demands. However, we should not lose sight of the elegance in a common objective function used by most algorithms: Minimizing estimate error is the basic objective function of attribution and forecasting.

Active management is uncorrelated by construction, thus may be superior liquid *Alternative Investments* providing greater transparency and portfolio diversification at lower cost. Global Tactical Asset Allocation strategies benefit from increasing dispersion and can be configured as overlays that need not displace underlying strategies. Strategic Frontier Management's tactical asset allocation process has been *Capitalizing on Enduring Beliefs* managing client portfolios worldwide for 25 years.