GRESHAM

2017 Annual Outlook

Mind the Gap

A surprise result in the U.S. election brings with it a new pro-growth agenda centered on the possibility for meaningful tax and regulatory reform and increased infrastructure spending. Relatedly, the U.S. economy, while still mired in the weakest economic recovery on record, remains the envy of the developed world. What the recovery has lacked in strength, it has now compensated for in duration, becoming one of the longest on record. As a result, U.S. labor markets are tightening and wage pressure appears to be increasing, leading to the possibility of rising inflation.

Facing the combination of higher growth and rising inflation, the U.S. Federal Reserve had little choice but to begin normalizing monetary policy by raising interest rates. Further, the prospect of additional rate increases in the coming year and beyond has grown substantially. While the U.S. faces the prospect of increasing interest rates, other advanced economies remain mired in slower economic growth and are maintaining their accommodative monetary policies that have led to historically low interest rates in these countries. It is this gap in interest rates that is driving U.S. dollar strength, which can have dramatic effects on other economies, leading to our title *Mind the Gap.*

Summary

The unexpected outcome of the U.S. election led to an equally surprising market reaction, as the U.S. equity market soared to new highs, buoyed by the possibilities of tax reform, the roll-back of regulation and much-needed infrastructure spending. Contemporaneously, the U.S. Federal Reserve raised short-term interest rates for the second time this cycle and laid the foundation for additional increases in the year to come should economic growth continue on its current pace.

As a result, the U.S. dollar has resumed one of the strongest rallies in history. As is always the case, it is relative differences that matter with currencies. The widening gap between U.S. interest rates and other developed nations' interest rates is propelling the U.S. dollar higher. We are particularly concerned about the potential impact of a sharply rising U.S. dollar on emerging markets, as previous episodes have led to crises in some countries. However, our research shows that most of these countries, particularly in emerging markets, appear surprisingly resilient given their wide adoption of flexible currency regimes, the accumulation of foreign currency reserves and the significantly lower percentage of external (i.e., dollar-denominated) debt financing. This may be creating additional opportunity for emerging market investing, but recognition and value realization may be delayed if investors are wary of past experiences in similar environments.

Equity markets have reached new highs, but the prospect for earnings growth and the additional possibility of tax reform may support these lofty valuations to some degree. We are most concerned about elevated valuations in certain segments of the U.S. equity market, such as small-cap stocks, which have rallied significantly since the election, and some sectors, such as utilities and consumer staples, which investors have inflated to extreme levels as they sought bond alternatives in a world starved for yield.

Increasing interest rates and resulting falling bond prices over the last few months have made bond investments only slightly more attractive. A key question for fixed income investors is what should be considered a "normal" level of interest rates in the current low-growth, low-productivity environment. Our view is that yields have not yet normalized, implying that we are not yet willing to reduce our longstanding underweight to bonds for our clients.

Hedge funds continue to present a challenge to investors: Will they produce performance, net of their high fees, that is adequate to justify their limited liquidity, lack of transparency, tax complexity and other disadvantages? To further complicate years of lackluster performance, we believe investors must now also be wary of increased "crowdedness" in the marketplace, which was a prime contributor to the poor performance of hedge funds in the first quarter of 2016. As a result, our implementation of hedge fund investments for clients has a renewed emphasis on avoiding crowded trades by exploring strategies in less efficient areas, often through different approaches and in more peripheral geographies.

More specifically, we recommend that investors:

- Keep fixed income allocations at reduced levels. We have maintained this stance for several years, which has benefitted our clients given the relatively low returns that high-quality bond investments have generated over this period.

- Remain cautious of U.S. equity allocations given the elevated valuations we see in the market. Ironically, while the market is up substantially since the election, it may not be overvalued if the benefits of corporate tax reform and pro-growth initiatives proposed by the current administration actually produce higher corporate earnings. Our greater concern in the U.S. equity market lies not in traditional large-cap stocks, but with small-cap stocks and certain sectors within the equity market that we describe within this Annual Outlook.

- Developed international markets represent a better value than the U.S. equity market, as expectations of improved earnings growth may begin to support these markets. Additionally, a stronger U.S. dollar further increases the competitiveness of overseas businesses with revenues derived in the U.S.

- Emerging markets represent an attractive proposition for long-term investors. While emerging market equities kept pace with U.S. markets in 2016, over the last six years investors have experienced significant underperformance, leading to capitulation, fatigue and record outflows. This is creating a good investment opportunity for long-term investors. However, with renewed U.S. dollar strength, we are now concerned that the bottoming process could be somewhat rocky and possibly prolonged.

- The use of managers operating in a hedge fund format remains a core aspect of client portfolios, and manager selection has never been more important in the face of a mature industry that struggles, on average, to generate excess returns for investors. The challenge is compounded by increasing crowding in many areas, requiring successful investors to look further afield for productive investments, as we address within this Annual Outlook.

- Private equity and real asset investments remain productive for investor portfolios. Caution is warranted, as we explain in more detail later in this Annual Outlook, as valuations in some areas have become elevated. While these are slower moving trends than in public markets, shaping allocations within a private investment portfolio, rather than the folly of trying to time these strategies, is important for maximizing the benefit of these investment programs.

Capital Markets in Review

The search for yield and growth, in a world short of both, was the predominant theme for the capital markets over the last several years. Then, the unexpected results of the U.S. election changed the mindset of investors quite dramatically, as the new President's promises of increased fiscal spending, economic growth through tax cuts and a roll-back of excessive regulations created new capital markets optimism. Independently, yet relatedly, the Federal Reserve declared that the chronically ailing U.S. economy appears healthy enough to stand on its own and provided a much anticipated increase in short-term interest rates, with the prospect of additional increases in 2017.

Capital markets reacted strongly to these actual and anticipated developments by embedding anticipated effects into security prices, as shown in Chart 1. World equity markets increased 7.5% during the year, with over half of this gain (3.8%), coming during the post-election period. U.S. equity markets, the epicenter of Trumpist economic optimism, increased an even healthier 12%, with five percentage points of these gains added after the election.

The post-election optimism was not uniform, as we describe in more detail below in a section dedicated

Chart 1. Performance and Valuation

		Performance			Valuation	
			Annualized		Forward P/E	
Market	Index	2016	3 Year	5 Year	Dec 2016	Dec 2015
World Equity	MSCI World	7.5%	3.8%	10.4%	16.3x	15.8x
U.S. Equity	S&P 500	12.0%	8.9	14.7%	17.3x	16.2x
International Equity	MSCI AC World ex U.S.	4.5%	-1.8%	5.0%	14.1x	13.8x
Emerging Market Equity	MSCI Emerging Markets	11.2%	-2.6%	1.3%	11.8x	11.0x
					Spreads vs. Treasuries	
10-Year Treasury	Citi Treasury Benchmark 10-Year	-0.1%	3.7%	1.4%	-	-
Municipal Bonds	Barclays Mgd Money Short/Int	-0.5%	2.1%	1.8%	73bps	67bps
U.S. High-Yield Bonds	Barclays High-Yield Corporate Bond	17.1%	4.7%	7.4%	409bps	694bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	10.2%	5.6%	5.4%	301bps	406bps
Hedge Funds	HFRI Fund Weighted	5.5%	2.4%	4.5%		
Conservative Hedge Funds	HFRI FOF Conservative	2.3%	1.9%	3.5%		
Commodities	Bloomberg Commodity Index	11.8%	-11.3%	-9.0%		
Gold	Spot Price of Gold	8.5%	1.5%	-5.9%		

Source: Bloomberg, MSCI, JP Morgan

to the possible effects of a Trump Administration, but several sectors are worthy of highlighting. For example, small cap stocks, which are anticipated to be significant beneficiaries of corporate tax reform and less affected by an increasing U.S. dollar, rose 13.8% in the post-election period alone. Similarly, U.S. financial stocks increased 16.8% during this same period, as the expectation for a roll-back of restrictive banking regulations and higher interest rates created positive tailwinds for these companies.

Beyond the Trump effects, 2016 was an important bounce-back year for the energy sector as well. In 2015, as the price of crude oil began declining from over $100/bbl to under $30/bbl, the S&P 500 energy sector index declined over 34%. As oil prices rebounded in 2016, the energy sector index similarly recovered nearly all of its prior losses, increasing 50% from its trough in late January. In the MLP sector, which primarily focuses on energy infrastructure assets such as pipelines, the losses in 2015 and into early 2016 exceeded 50%, but the remainder of 2016 saw a remarkable recovery of 65%.

Outside the U.S., international equity markets increased 4.5%, lagging U.S. markets as they have for the last several years. The gap was less in local market terms, as increases in the value of the U.S. dollar caused local returns to appear weaker from a U.S. investor perspective. This was particularly true for European markets, where the relative weakness of the Euro caused local currency returns to outpace dollar-based returns by nearly eight percentage points.

Emerging market equities nearly kept pace with U.S. equity markets, increasing 11.2% over the entire year, but the path was quite different. Emerging markets, coming off a poor 2015 as investor interest in the area reached new lows, rebounded sharply during the early portion of 2016. Through early September, emerging markets had increased 18.5%, offsetting the roughly 15% loss from 2015. However, post-election, while developed markets were surging, emerging markets declined over 4% as investors anticipated impacts of a strengthening U.S. dollar, driven by increasing interest rates and the potential for more protectionist trade policies. Further, the dispersion across various emerging markets was high as the impact of these effects will not be uniformly distributed. We discuss the potential challenges for some emerging markets in a subsequent section.

We normally don't spend much time focusing on foreign exchange rates, as we rarely invest directly in these markets. However, in this increasingly divergent and potentially protectionist world it is worth discussing this important aspect of global investing. The U.S. dollar plateaued during the first half of 2016 after one of its sharpest rallies in history when it increased 20% against a basket of U.S. trade partners. However, after the recent election, based on the expectation of higher interest rates and faster economic growth that few in the global economy will be able to match, the U.S. dollar increased another 9% in a few short months.

We also witnessed other strong currency movements relative to the U.S. dollar around the world, as the Mexican peso declined 17%, with the majority of this decline occurring in the post-election period, and the British pound lost a similar 17% during the post-Brexit vote period. These currency movements are extreme when one considers that they change the value of an entire economy, including all of its related goods and services. While declines of this magnitude can be painful, one must remember that they reset the competitiveness of the global economy and generally set the stage for future growth.

Fixed income generally followed the inverse of the return pattern of equities. U.S. Treasuries declined a modest 0.1% during the year, after being up over 5% prior to the election before concerns about fiscal stimulus, economic growth and interest rate increases caused prices to decline rapidly over the last few months of the year. The U.S. Treasury ten-year note yield increased a surprisingly large amount, moving from 1.36% in July to 2.45% by the end of the year. Similarly, municipal bonds, which finished roughly flat on the year, lost nearly 3% during this same period, as yields rose in sympathy with the U.S. Treasury market. In contrast, riskier bonds tended to perform significantly better. The Merrill Lynch High-Yield Index increased 17% during 2016, rebounding dramatically from its dismal performance in 2015.

Hedge funds generally completed another disappointing year, increasing 5.5% on average. We expect hedge funds to lag equity markets when equities perform very well, such as in 2016. Over the last five years, the average hedge fund has returned only 4.5% per annum, less than half the return of world equity markets, which returned 10.4%, and far less than U.S. equity markets, which returned nearly 15% annually. Even on a risk-adjusted basis, the average hedge fund failed to deliver attractive results, producing flat to negative alpha (a measure of risk-adjusted return) over this period.

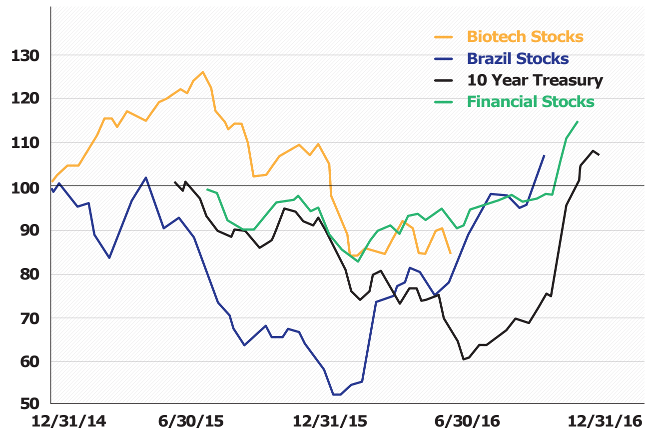
Recent under-performance of the average hedge fund illustrates the importance of identifying and gaining access to the right hedge funds to generate returns beneficial to an investment portfolio. Additionally, we discuss later in this Annual Outlook the growing problem of hedge fund "crowding," which has further hampered hedge fund performance, and made this challenge even more difficult for investors.

Private equity continues to deliver attractive performance. Cambridge Associates estimates that traditional private equity provided positive returns of 8% to 9% through the first three quarters of the year, and when valuations are complete for 2016 these returns likely will increase slightly in sympathy with the increasing public equity markets in the fourth quarter. Venture capital was roughly flat over this same period, as larger venture-backed companies failed to follow through on their lofty valuation increases of the prior years. This is consistent with our view that many later-stage venture-backed companies were over-priced, well ahead of their underlying fundamentals.

The last two years have seen bouts of extraordinary volatility with significant reversals in the pricing of many stocks, sectors and countries, as shown in Chart 2. The drivers of this volatility have varied from oil price movements to unanticipated populist voter outcomes, such as Brexit and Trump. While the sources of volatility will likely change in the future, we expect global uncertainties to remain high and the distribution of outcomes to remain similarly wide. This volatility will be exacerbated by stretched valuations, as assets

Chart 2. Political Events have Created Extreme Volatility in Some Asset Classes

Rebased to 100



Note: 10yr U.S. Treasury is based on % change in yield
Source: Bloomberg

are currently priced for near perfect outcomes in many areas of the capital markets, leading to the potential for greater downside price movements.

The Trump Effect

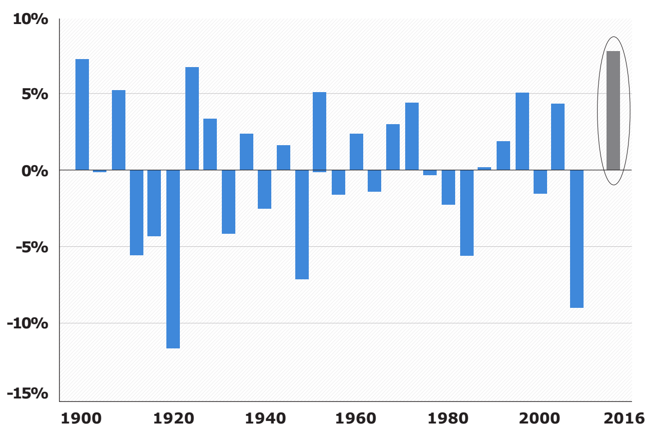
While the election of Donald Trump was certainly not anticipated, calling it a surprise probably would be too strong given the clear and accelerating anti-establishment sentiments around the globe. What is surprising is how the capital markets reacted initially to the election, and most particularly, the gains in U.S. equities, the selloff in U.S. Treasuries, and the strong move in the U.S. dollar relative to many currencies.

Let's begin our discussion of the so-called Trump effect by taking a step back to better understand the significance of election outcomes on capital markets. If history is any guide, investor emotion and market commentators tend to exaggerate the likely impact of election outcomes and the effect of potential policy changes. On the margin and over time, newly elected officials can influence the general economy and broader capital markets, but the impacts tend to be less powerful than many expect. As a result, we tend to focus more on economic data, corporate performance and asset valuation in guiding our thinking. However, elections can create short-term market volatility and potential investment opportunities, and the recent market reaction does bear further examination.

The post-election Trump rally has been the strongest on record, as shown in Chart 3. While this performance has soothed some who were worried about this most unconventional election, history suggests that the new regime will have limited impact on overall long-term market performance. An examination of historical U.S. Presidential election returns shows no clear connection or correlation between returns during the election-to-inauguration period and the subsequent year. Since 1896, the average election-to-inauguration stock market return for new Presidents has been -1.7% with the subsequent year producing an 8% return, whereas incumbents created a 1.4% return during election-to-inauguration followed by a 1.6% return in the subsequent year.

Chart 3. Trump Election Sparked a Rally in U.S. Equities

Performance of DJIA 5 Weeks After Presidential Elections



Source: Wall Street Journal

The incoming administration's early economic policy activity is expected to focus on immigration, healthcare, tax code reform and infrastructure spending. However, few specifics have been given in some of these areas, creating uncertainty for investors.

Healthcare reform is certainly a politically charged initiative, but the full repeal, replacement or defunding of parts or all of the Affordable Care Act may take longer than most anticipate given its complexity. The impact on related capital market sectors will be highly dependent on the actual eventual solution, so little reliance should be placed on early forecasts.

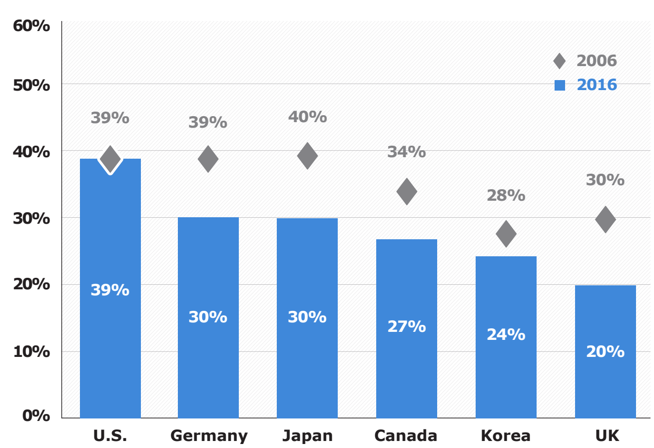
Tax reform is where there is likely to be impactful effort, as several policy approaches were already under consideration prior to the election. For personal income taxes, there is a strong desire to simplify the existing set of rules while lowering marginal tax rates to encourage spending. As revenue offsets, there will likely be limits placed on itemized deductions, possibly including charitable giving. Elimination of the estate tax has also been discussed, as has the potential for eliminating or limiting the income tax basis step-up currently applied to assets included in estates. These potential policy changes were the catalyst for many year-end tax planning strategies in 2016, but significant further action will require more clarity on tax change specifics.

Corporate tax reform is viewed as a higher tax-reform priority, as it will focus on increasing business competitiveness, rekindling job growth and fostering greater investment by corporations, which has been sorely lacking since the global financial crisis. While most other developed countries have reduced corporate tax rates over the last ten years, the U.S. has lagged in this regard, as shown in Chart 4.

Estimates vary widely on the impact various tax reform proposals will have on corporate earnings. If the marginal rate is simply lowered, the impact varies because there already exists a wide variance in the effective tax rates among companies in the U.S. For example, many large multinational companies have

Chart 4. U.S. Corporate Taxes are Among the Highest in the World

Coporate Income Tax Rates



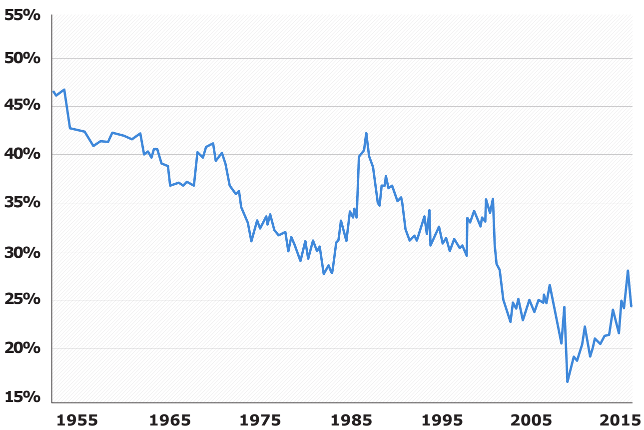
Source: JP Morgan

various ways to shelter or "off-shore" profits, thereby reducing their effective tax rates. When evaluated across the S&P 500, which more heavily weights these larger companies, the effective tax rate is surprisingly low, as shown in Chart 5. Reducing the slippage between the actual tax rate and the effective tax rate will be one of the primary goals of corporate tax reform.

Regardless of the changes and the company-specific impacts, corporate tax reform should increase U.S. corporate earnings in aggregate. As a result, U.S. equity markets may appear more attractive on a price/earnings basis, which is why many U.S. stocks have rallied since the election. With a reduction of the

Chart 5. Large Companies have Effectively Utilized International Operations

Effective Corporate Tax Rate of S&P 500



Source: BCA Research, Bureau of Economic Analysis

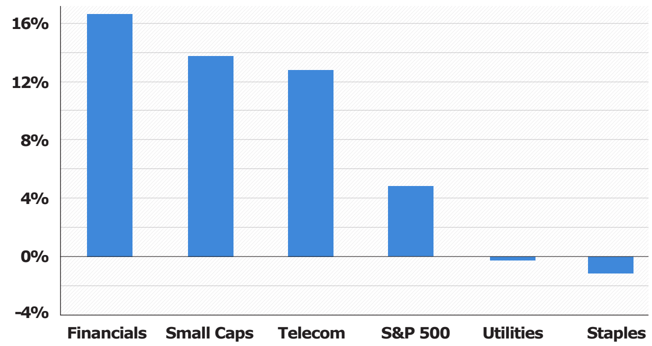
corporate tax rate to 20%, some analysts estimate the top quintile of "benefitting" companies may experience a 30% increase in after-tax earnings, with the bottom quintile increasing after-tax earnings by only 6%. More radical corporate tax reform plans being floated include a VAT-based tax that would tax imports and exclude exports and allow for the full expensing, rather than depreciating, of investment expenditures. This proposal would have a dramatically different effect on individual companies.

Since the existing tax rate dispersion among companies is quite wide and the structure of corporate tax reform will determine its impacts on specific companies, a company-by-company analysis will be necessary to truly understand the potential impact of tax reform on individual companies.

For this reason, it is very difficult to analyze or anticipate corporate tax reform effects. Nonetheless, the market has attempted to do just that, creating widely divergent results across the market, as shown in Chart 6.

Chart 6. Equity Performance Post Election Through 12/31/2016

Trump Policies Expected to Selectively Benefit Certain Sectors



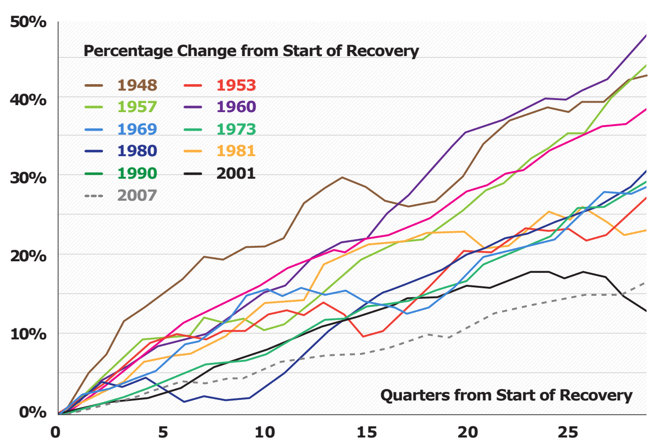
Source: Bloomberg

Economic Landscape and the Widening Gap

The global economic recovery since the financial crisis remains underwhelming. While the U.S. has been the strongest developed economy over this period, its economic recovery has been the slowest on record, growing at a meager 2.1% annual rate, as shown in Chart 7. Despite the lack of intensity of the current expansion – or perhaps because of it – it is now one of the longest in history, stretching over seven years. There have been only three longer economic expansions in the past seven decades.

Chart 7. Slowest Recovery on Record

Cumulative Increase in GDP



Note: Real GDP, chained 2009 dollars, seasonally adjusted
Source: Federal Reserve Bank of Minneapolis

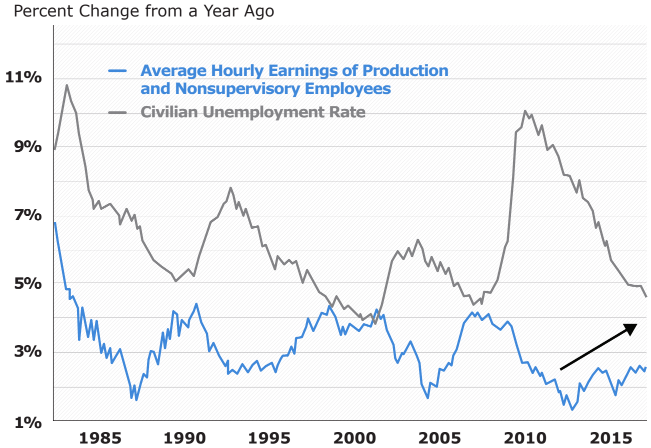
Looking forward, the IMF expects developed market GDP growth to marginally accelerate to a modest 1.9% in 2017 from 1.6% in 2016. The U.S. appears poised to lead most of the developed economies again in 2017, with forecasted growth of 2.2%. European growth is also expected to accelerate slightly, as the decline in the euro improves the collective competitiveness of the continent, if only marginally at this point. Emerging markets will continue to lead global economic growth, remaining around 4.5%, with China slowing to 6.5% . . . still the envy of the developed world.

While growth during this recovery has been weak, the sheer length of the economic recovery has begun to tighten labor markets, leading to the prospect of higher wages and increasing inflation. The unemployment rate is currently at 4.7%, near its lows for this cycle. Over the last few decades, the relationship between declining unemployment and increasing wages has been quite clear as shown in Chart 8. The cycle is no different if simply delayed, as the tightening labor market is beginning to create signs of wage inflation. At the moment, inflation levels are not overly concerning and, in fact, some additional inflation is likely a desired outcome to deflate large debt balances that still remain from the last few decades of profligate borrowing. But, it will have other consequences.

The most important and far reaching implication is that the Federal Reserve will likely continue to raise short-term interest rates to normalize U.S. monetary policy. As the U.S. economic recovery has become more self-

Chart 8. Tightening Labor Markets have Led to Higher Wages

Percent Change from a Year Ago



Source: Federal Reserve Bank of St. Louis

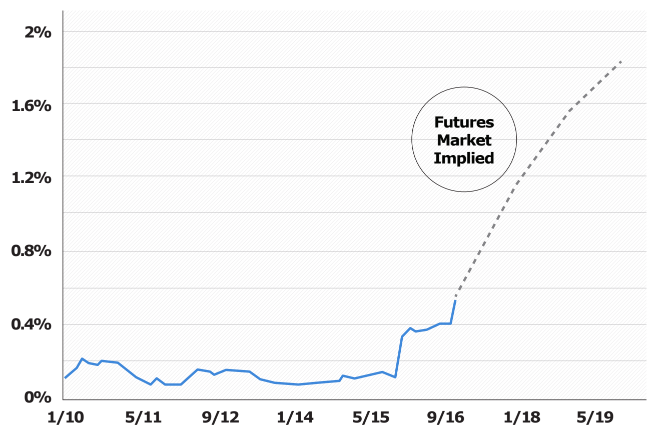
sustaining and the unemployment rate has continued to drop, the Fed has been sending stronger indications of the need to tighten monetary policy, including the most recent interest rate increase this past December. Correspondingly, expectations for future interest rate increases also continue to rise as shown in Chart 9.

Strong Dollar Implications

It is important to remember that U.S. interest rates are likely to continue to rise in sharp contrast to most other

Chart 9. Market is Pricing in Additional Federal Reserve Rate Hikes

Effective Federal Funds Rate



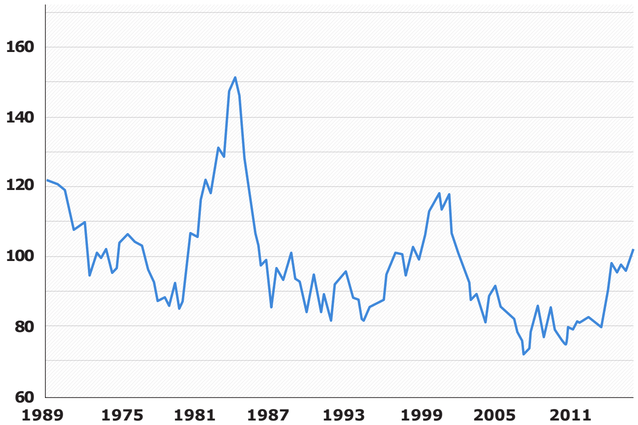
Source: Bloomberg

major central banks who remain in a highly accommodative position. Even with its numerous problems, the U.S. still looks to be in better shape than most other countries - and it is the relative position that drives currency exchange rates. As a result, we have witnessed renewed U.S. dollar strength due to the current and expected further widening of the interest rate differentials. It is this gap that is worthy of our consideration.

The U.S. dollar is in the midst of its third major up cycle since the era of floating rates began in the 1970s. Similar real interest rate differentials between the U.S. and other countries have been present in all three rallies. In this most recent rally, the U.S. dollar has risen to its highest level in nearly 14 years against a basket of major currencies as shown in Chart 10. Additionally, many expect this trend to accelerate if U.S. corporate tax reform includes some form of "border adjustment" that would tax imports and provide credits for exports.

Chart 10. Dollar Resumed its Strong Up-Trend Post Election

U.S. Dollar Index Price



Source: Bloomberg

Some have argued that the U.S. dollar is more likely to decline. These arguments are grounded in the idea that the U.S. is currently running a current account deficit and is likely to expand its fiscal deficit due to plans for increased government spending. Further, many analysts believe the U.S. dollar is already overvalued based on recent price movements. Gavekal, a well-respected global research service, recently claimed that the U.S. dollar has reached its most expensive level in over 30 years on a purchasing power parity basis. While there are cogent arguments to be made for the dollar moving in either direction, it is an upward movement that creates the most risk to investors, as declines would simply be a return to business as usual.

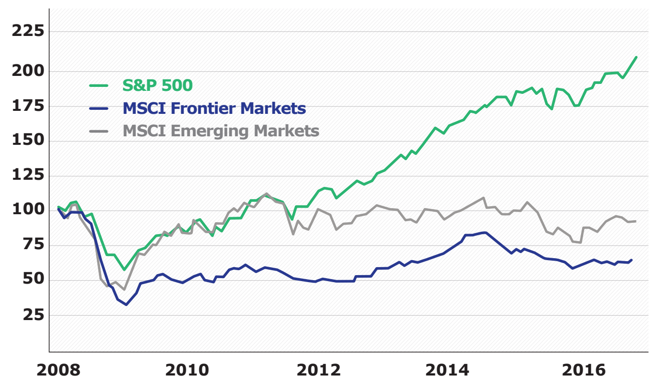
However, a strong dollar isn't all bad. It increases the purchasing power of U.S. consumers, by making foreign travel and imported products cheaper. As a result, a stronger U.S. dollar likely dampens U.S. inflation and possibly moderates the pace of U.S. economic growth and hence the pace of interest rate increases. However, it is the risks that accompany a stronger U.S. dollar that are more significant, particularly for emerging market countries.

Emerging Market Fragility?

For the last several years, we have felt that emerging market equities represented a better risk-reward opportunity for investors than developed market equities. Our thesis was rooted in the view that these markets generally presented better value than the increasingly expensive developed equity markets, particularly in the U.S., after nearly six years of relative underperformance, as shown in Chart 11. More specifically, we believed that these less efficient markets presented opportunities in specific companies with higher growth rates that will benefit over the longer-run by capturing the accelerating consumption of a growing middle class.

Chart 11. U.S. Equity Markets have Outperformed, Creating a Valuation Gap

Cumulative Performance Rebased to 100

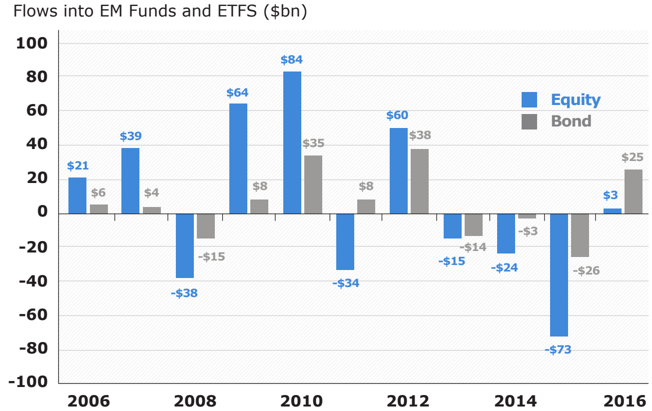


Source: Bloomberg

In late 2015, we felt that frustrated investors had finally capitulated, as we witnessed the largest investment outflows in history from emerging market equities, as shown in Chart 12. Frontier market flows also have been even weaker over the last several years. Although investment flows for these markets began to recover in 2016, the election of Donald Trump and the possible effects of some of his proposed policies have raised new questions about the direction of emerging markets.

Chart 12. Underperformance of Emerging Markets has Fatigued Investors

Flows into EM Funds and ETFS ($bn)

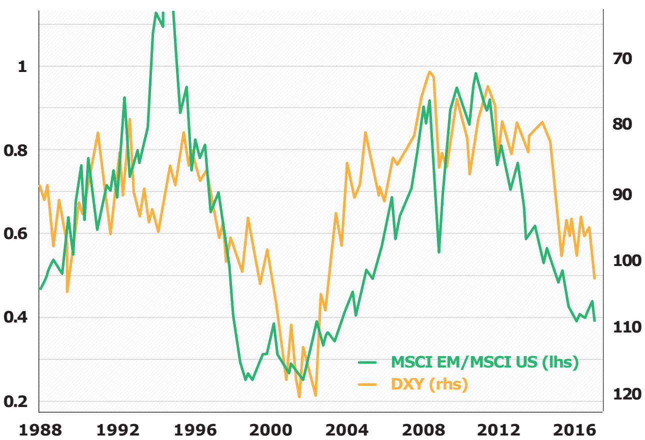


Source: Goldman Sachs

As discussed earlier, a combination of expected progrowth Trump policies and the specter of higher wages that may lead to inflation have led to increasing interest rates and a correspondingly higher U.S. dollar. Historically, a strengthening U.S. dollar has been a bad omen for emerging markets, as shown in Chart 13. Investors who experienced the Latin American crisis of the early 1980s, the Asian crisis of 1997, and the recent "taper tantrum" of 2014-2015 will remember these challenges. The fundamental linkage is that many emerging market governments and corporations were historically funded with U.S. dollar debt, which made them reliant on continued investments by developed market investors. During periods of stress, foreign investors withdrew their capital, causing a U.S dollar

Chart 13. Strong U.S. Dollar has Historically Led to Emerging Market Underperformance

DXY (U.S. Dollar Index) and EM Equity Relative Perfomance



Source: Gavekal Data/Macroband

shortage, amounting to an effective monetary tightening and, at the extreme, the potential for a liquidity crisis.

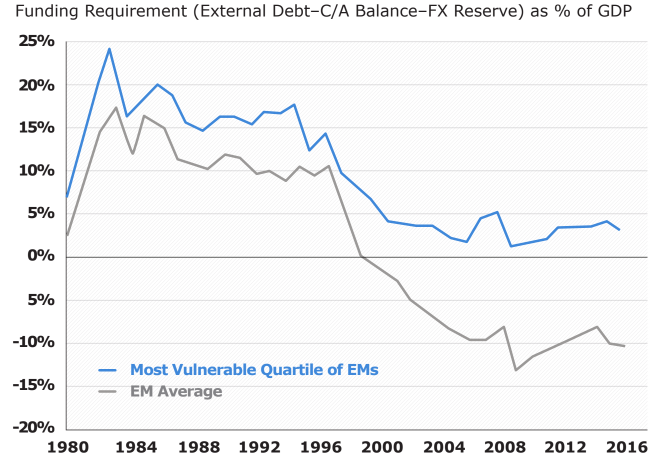
Reduced Fragility

Today, we believe emerging markets are significantly less fragile than in earlier periods. The most important factor is external funding, which can be understood by examining a country's short-term external (e.g., U.S. dollar-denominated) debt, current account balance and foreign currency reserves. To begin, floating-rate currency regimes have become the norm and proven to be effective shock absorbers for these economies by allowing adjustments to occur gradually, rather than be forestalled for political reasons. The relative strength of the U.S. economy over the last few years has led to the devaluation of many emerging market currencies. As a result, some analysts believe we are beginning this latest period of U.S. dollar strength with most emerging market currencies undervalued. Flexible exchange rate regimes have allowed most emerging market countries, companies and local banking systems to get ahead of the problem and gradually reduce their reliance on foreign debt, which has significantly reduced investment risk. Additionally, gradual currency declines have led to increasingly competitive economies and allowed these countries to improve their current account balances.

The combination of reduced foreign debt, healthy current account balances and foreign currency reserves has dramatically reduced the fragility of these economies, as shown in Chart 14. Today, the most vulnerable quartile of emerging countries are healthier than some of the riskiest countries during earlier crisis periods. As a result, we believe that a potential emerging market bubble has already been deflated over the last few years due to better fiscal management.

Chart 14. Most Emerging Market Countries have Improved Fiscal Health

Funding Requirement (External Debt–C/A Balance–FX Reserve) as % of GDP

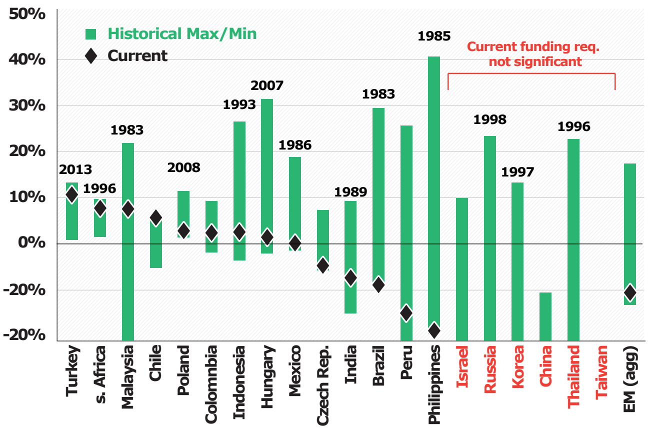


Source: Goldman Sachs

However, the risk with emerging markets is generalizing across these widely divergent economies. Chart 15 shows the external funding requirements for many emerging economies. On the right hand side of the chart, most of the largest emerging economies, including Brazil, Russia, India and China, would be considered less risky by these measures. The market has begun to recognize the differences among these economies and identify those that are most susceptible to U.S. dollar squeezes.

Chart 15. Emerging Market Funding Requirements are Lower Today vs. Past Crises

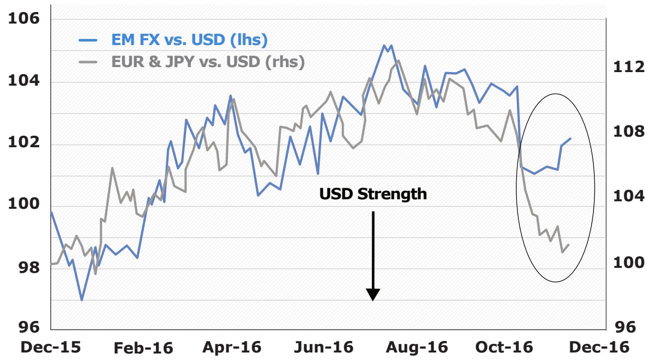
External Funding Requirement External Debt (2yrs maturity) – C/A Balance–Reserves



Source: Goldman Sachs

Chart 16. Emerging Market Currencies have Been Resilient to U.S. Dollar Strength

Relative Performance



Source: Goldman Sachs

Relatively safe countries have rebounded from recent emerging market declines, while at-risk countries, such as Turkey, Indonesia and Mexico, have been subject to continued selling pressure. The recognition of this new resiliency can also be seen by the relatively strong performance of emerging market currencies compared with developed market currencies after the initial post-election declines, as shown in Chart 16.

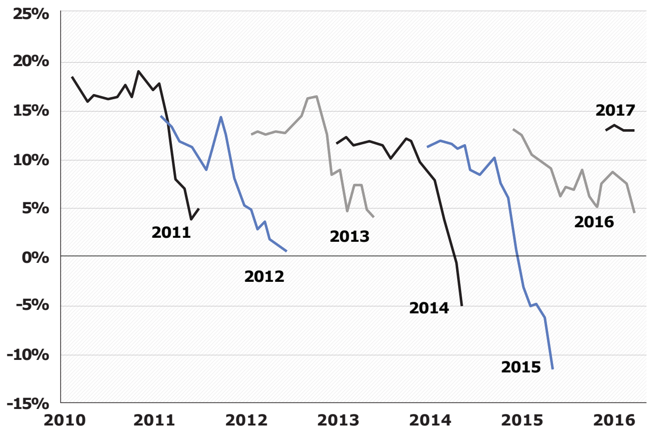
Improving Fundamentals

So far, we can make a good case that most emerging market economies are more resilient and significantly less susceptible to a crisis driven by a dollar squeeze in contrast to what we have witnessed over the last few decades. Additionally, many of these economies have improving underlying fundamentals that build a solid foundation for strong long-term performance.

In the broadest sense, emerging market corporate profits appear to be turning a corner after five years of stagnation. Earnings per share have declined 19% over the last three years, but have started to grow again, which most analysts expect to continue over the next few years. Chart 17 shows the downward annual earnings revisions over each of the last few years, highlighted by earnings growth turning negative in both 2014 and 2015.

Chart 17. Emerging Market Corporate Earning Appear to have Troughed

EM EPS Growth Revisions and Consensus Forecast Revisions in USD



Source: Goldman Sachs

As we have built our emerging markets strategy over the last few years, we have intentionally focused on managers who invest in non-benchmark companies, such as the ones described above. Our view was that most benchmark companies were the equivalent of "old economy" companies that tended to be state-owned, poorly managed and less exposed to the growing consumption patterns in these economies. Consequently, when we look through to the underlying companies in our emerging markets managers' portfolios, we see more consistent growth and higher expectations for future earnings growth than for companies that dominate the relevant indices.

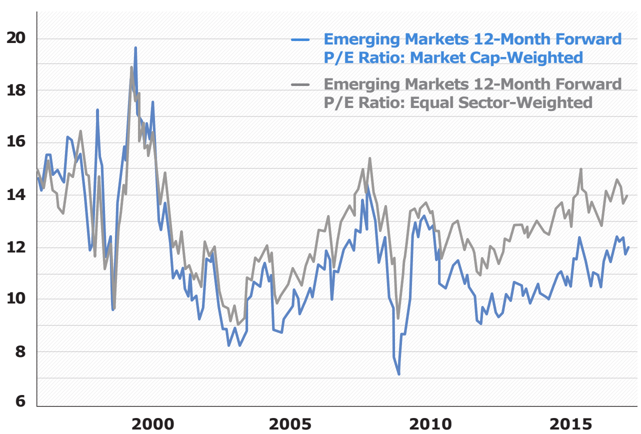
It is noteworthy, however, that the composition of the broad emerging market equity indices appears to be changing, as several more consumer-oriented companies have been added to the indices and have grown to represent a larger share of these benchmarks. For example, the weight of the technology sector in the MSCI Emerging Market Index has increased from 12% to nearly 25% over the past decade. We expect this trend to continue, but it has a long way to go before these companies and sectors represent the predominant share of index exposure.

Valuations and Market Flows

Making generalizing statements about valuations across these markets can be quite misleading. Simplistically, the P/E ratio of the MSCI Emerging Market Index, which is a capitalization-weighted index where the larger companies are weighted more, is roughly 12x as shown in Chart 18. While this seems attractive relative to developed market measures, the story is a bit more complex. If we look at an equal sector-weighted index, which underweights banks and energy companies that have been out-of-favor for several years, or simply look at the median stock, which accomplishes a similar adjustment in a different manner, emerging markets don't trade at nearly the same discount to developed markets as the simpler measures suggest. Emerging markets are not a single market, but rather a collection of widely divergent economies, with fragmented and inefficient equity markets that present talented stock-pickers a rich opportunity set.

Chart 18. Wide Divergence of Emerging Market Valuations Across Countries and Sectors

EM Forward P/E Ratio



Source: BCA Research

While talented managers may find good companies with high growth prospects trading at attractive valuations, it may take some time for these opportunities to be recognized by other investors and fully reflected in their valuations. Recent selling pressure by active managers and ETFs, who are facing redemptions after years of underperformance, has created good investment opportunities. For example, one of our managers who invests in smaller companies in China and Southeast Asia has assembled a portfolio that currently trades at 13x earnings, with earnings expected to grow over 20% annually. Additionally, these stocks have a current dividend yield of 2.7% and, in aggregate, the companies have no debt, allowing them to weather significant downturns and immunizing them to the potential stress of an increasing U.S. dollar. Regardless of how the broader market trades in the near-term, the fundamentals of such a portfolio will continue to accrue to the long-term benefit of its investors and eventually be recognized through increased valuations.

In the near term, however, global investors – who appeared to be turning more favorably toward emerging markets in 2016 – will likely return to a more cautious stance, as they digest the implications of a rising U.S. dollar and interest rates. Investor caution may be further fueled by more aggressive protectionist foreign trade policy as has been discussed by the new administration. We expect the bottoming process, which we saw beginning in early 2016, will now be extended and a bit rocky in the short-term, but the investment opportunities created by investor caution and improved fundamentals appear to be real and significant.

Market Valuations and Strategy Updates

Capital markets continued to be buoyed by an excess of capital flows due to artificially low interest rates, which has led to elevated valuations across most asset classes. However, in the post-election period, we have seen several significant shifts in both fixed income and equity markets that warrant further attention.

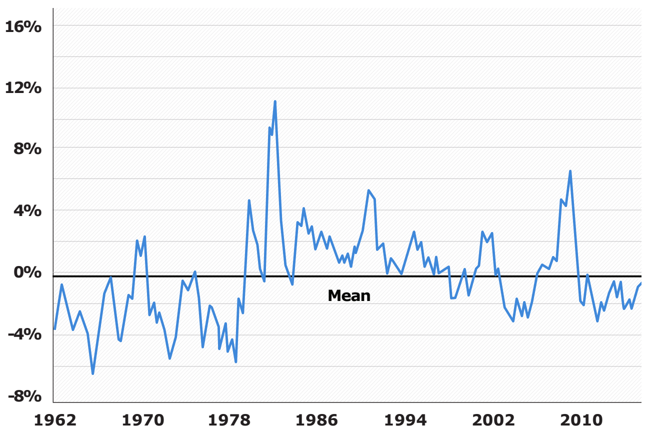
Fixed Income

With fixed income yields rising on expectations of Trump's pro-growth policies, plus tighter monetary conditions from the Federal Reserve, the key question for fixed income investors is, "What is normal?" For the last eight years since the financial crisis, we have experienced abnormal, and some would even say experimental, monetary policies that resulted in negative real interest rates in the U.S. and many other developed market economies. As these policies are unwound, at what level will interest rates normalize?

There are several ways to look at this question. First, long-term bond yields typically normalize around the structural growth rate of the economy, as shown in Chart 19. If one assumes real GDP growth of 1.5% to 2.0% and inflation of 1.5% to 2.0%, long-term interest rates should normalize somewhere between 3.0% and 4.0%.

Chart 19. Long-Term Interest Rates Normally Track Nominal GDP

10-Yr U.S. Treasury Minus Nominal GDP Growth



Source: Bloomberg, Federal Reserve Bank of St. Louis

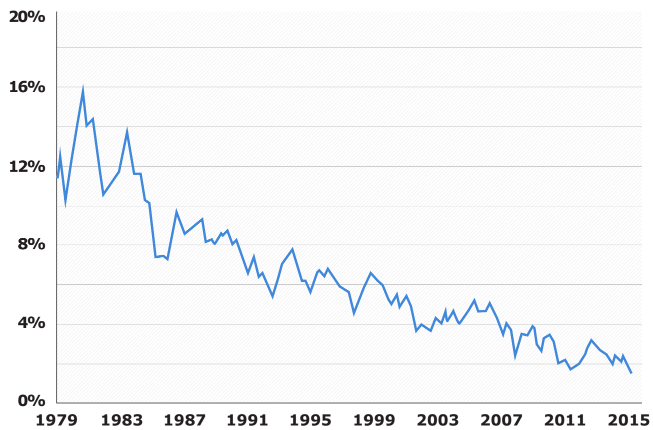
An alternative approach examines this question from the perspective of a bond investor. Long-term fixed income investors have typically required some return premium over inflation. Historically, this premium has been 2% or higher. In today's environment, this would translate to a normalized long-term bond yield of around 4%.

In either case, the recent increase of the 10-year Treasury yield to around 2.5% suggests that current yields are not yet offering a good entry point for bond investors and that the Federal Reserve likely has some room to continue raising interest rates, perhaps even beyond the additional 75 basis points (0.75%) expected by the market during 2017.

Interest rate normalization is an important element in determining forward-looking bond returns. Historically, investors have analyzed the yield curve to best gauge future bond returns, as this process offers an estimate of what investors will earn in the absence of interest rate changes and the corresponding price changes. The last 30-plus years have been the golden era for bond investments, as high current yields at the beginning of this period provided a great foundation for strong returns. Equally important, the consistent decline in yields since 1980, as shown in Chart 20, has resulted in significant price appreciation for bonds that is additive to the coupon income. Today, neither high current yields nor the potential for decreasing interest rates, absent a major economic shock, are present.

Chart 20. Bonds have Experienced a 30-Year Bull Market

10-Yr U.S. Treasury Yield

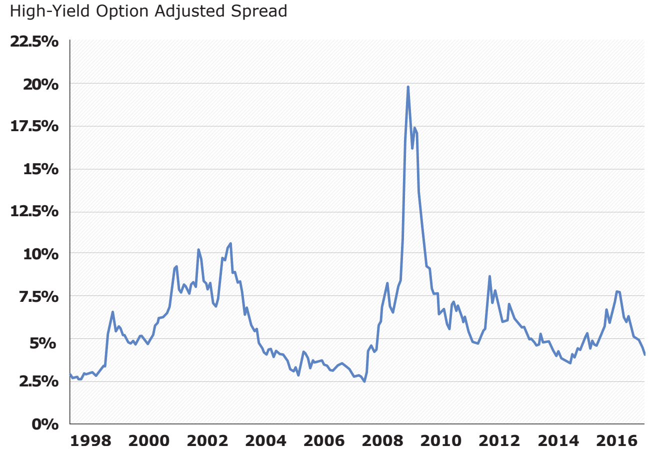


Source: Bloomberg

High-yield corporate bonds, which experienced a strong rebound in 2016 following a disappointing 2015, are equally unattractive. In addition to concerns about reduced return potential due to low interest rates, credit spreads are approaching their tightest levels since the global financial crisis, as shown in Chart 21. One mitigating factor for high-yield bonds is that earnings growth appears likely to reaccelerate, which would improve corporate fundamentals and forestall a widespread increase in default rates.

Chart 21. High-Yield Bond Spreads are Back Near Their Lows

High-Yield Option Adjusted Spread



Source: BofA Merrill Lynch

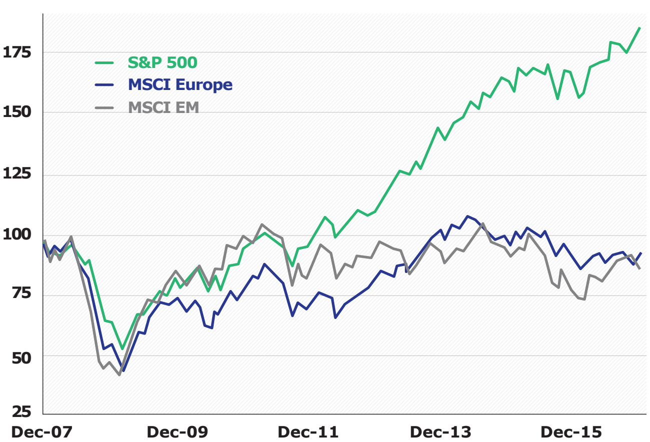
The municipal bond market sold off in similar fashion to the U.S. Treasury market in the fourth quarter on concerns about rising interest rates. Additionally, the threat of tax reform and heavy new issue supply exacerbated the declines and uncertainty in these markets. The yield of the broad municipal bond index ended the year at around 2.0%. While this is roughly 60 basis points higher than the pre-election yield, we still believe that muni yields need to rise further before reaching fair value based on the metrics described earlier.

Equity Markets

After the global financial crisis, the U.S. equity market has far outpaced peers around the world. Since the U.S. market troughed in March 2009, the S&P 500 has climbed nearly 300%, producing an annualized return of 18.7%! Over this same time period, European markets and emerging markets have increased a more modest 134% and 115%, respectively, producing annualized returns of 11.2% and 10.1%, as shown in Chart 22. The gains experienced by U.S. equity markets are impressive in almost any historical context, but they have also created a challenge for investors going forward, as earnings growth has failed to keep pace with this climb. As a result, the S&P 500 is trading at elevated earnings multiples, likely reducing future return potential for investors.

Chart 22. U.S. Equity Markets have Outperformed Since Financial Crises...

Cumulative Performance Rebased to 100

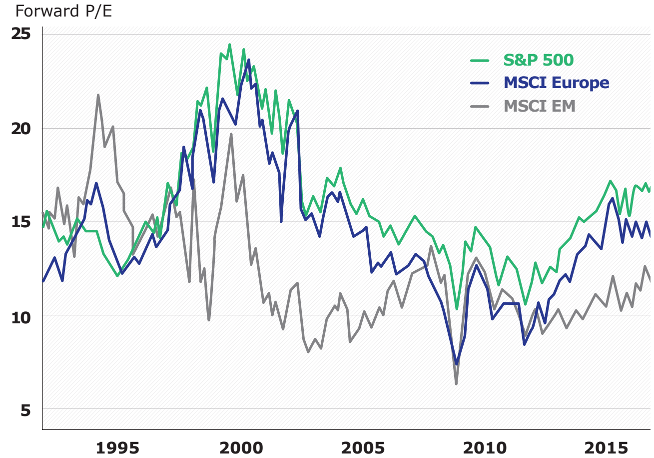


Source: Bloomberg

Currently, the S&P 500 Index, which is a capitalization-weighted index of larger U.S. companies, has a P/E ratio of 17.3x forward four-quarter earnings, as shown in Chart 23. This is well above the long-term average and represents the most expensive valuation in modern history, except for the technology bubble period of the late 1990s. We have been cautioning clients about these elevated values over the last two years, not because we felt an immediate correction was imminent, but because downside risk to investors was increasing and the earnings growth required to support such lofty valuations was not forthcoming. We contrast these elevated valuations with the more attractive pricing that can be found in Europe and many emerging markets.

Chart 23. ...Leaving Europe and Emerging Markets at More Attractive Valuations

Forward P/E



Source: Morgan Stanley, Datastream, IBES

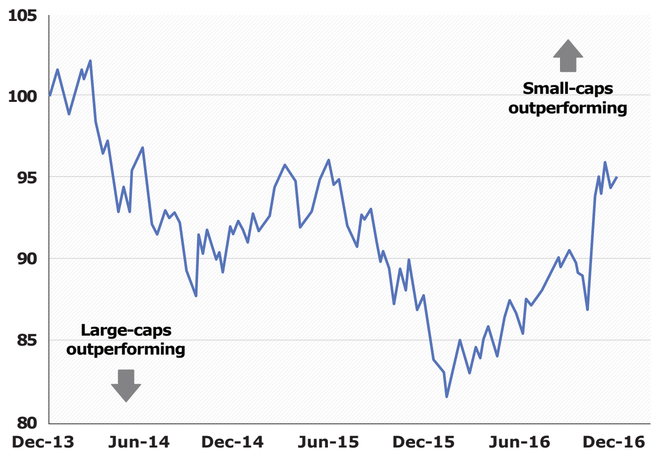
For most of 2015 and the first two quarters of 2016, S&P 500 earnings growth was actually negative, exacerbating our concerns about elevated valuations. Over the last two quarters, earnings have rebounded so that we now are likely to have two consecutive quarters of earnings growth for the first time since 2014. And, once full-year earnings have been reported, 2016 likely produced positive earnings growth. More importantly, analysts currently project 2017 earnings to grow by over 11%, driven by a strong rebound in the energy sector and good prospects in almost all other sectors.

What provides some additional confidence to U.S. earnings projections at this point is the likelihood of corporate tax reform under a Trump Presidency. While estimates vary by analyst and the specific company in question, some analysts have estimated that if corporate tax rates are cut to 20%, corporate earnings could increase by 15% to 20%. If so, while we begin from a lofty position, additional upside might be present beyond the gains already registered in the post-election period.

Even though S&P 500 valuations are elevated relative to the rest of the world, we are currently more concerned about certain sectors within the U.S. equity market. For example, the consumer staples sector of the S&P 500 trades at nearly 20x earnings. The utility sector, which has very limited potential for earnings growth, trades at roughly the same multiple as the broader indices. These are sectors that investors have inflated in their search for yield and stability in lieu of bonds, which have provided neither for the last few years. With these elevated valuations, our primary concern is that these sectors might be more prone to losses than their history would suggest or than most investors expect. This is particularly true in a world of increasing interest rates.

Chart 24. Small Cap Stocks have Surged Post Election

Relative Performance Russell 2000 vs. S&P 500



Source: Bloomberg

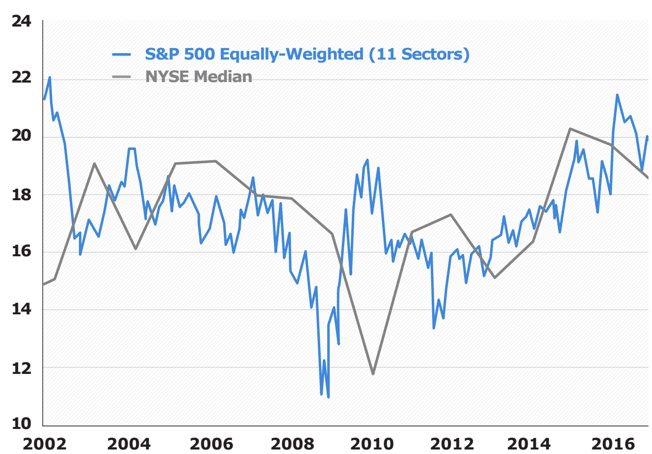
Even more concerning to us is the level of valuations for U.S. mid-cap and small-cap stocks. Chart 24 shows the relative performance of small-cap stocks to large-cap stocks. More recently, small-cap stocks rallied nearly 15% during the post-election period through year-end 2016. The widely accepted rationale is that protectionist policies and corporate tax reform will disproportionately benefit smaller, domestically focused companies, which tend to have higher effective tax rates due to limited international operations that allow for sheltering of profits. While this may be true, it appears that valuations more than fully reflect these considerations. For example, the Russell 2000, an index of small-cap companies, already trades at 26 times 2017 expected earnings, which is near its all-time high.

Of similar concern are equal-weight portfolios, which evenly weight the companies in a benchmark, rather than overweighting the larger companies, as is the case with a capitalization-weighted benchmark, such as the S&P 500 Index. All things being equal, when we implement a passively managed portfolio, we typically have a preference for investing in an equal-weight solution, as capitalization-weighted portfolios tend to rebalance their weighting towards stocks that have already appreciated in value. This approach leads to a portfolio that inevitably buys more of a security after its price has already gone up, which is not a formula for long-term investment success. An equal-weight approach gives relatively more exposure to mid-cap companies, in that they carry the same weight as the larger companies in the portfolio.

There is a limit to this investment preference, which we appear to be approaching them, as "all things," and particularly valuations, are no longer equal. The valuation for the median stock on the NYSE is not just expensive, but by some measures is near an all-time high, as shown in Chart 25. Both equal-weighted portfolios and small-cap portfolios have now become far more expensive than the capitalization-weighted S&P 500 Index, trading at 19.2x and 21x, respectively.

Chart 25. Small Companies Pushing Equal Weight Portfolio Valuations Higher

Forward P/E



Source: BCA Reserch, Kenneth French Database, Dartmouth Tuck School of Business

Unlike the tech bubble in the early 2000s, when capitalization-weighted indices were loaded with larger, high-flying technology stocks, today it is the smaller companies in the U.S. that have become relatively more expensive. These factors, combined with concerns about some of the over-valued sectors we mentioned earlier, should give investors pause when allocating to U.S. equities. While tax reform and positive investor sentiment may continue to buoy stock prices in the immediate future, the downside risk to investors in some parts of the U.S. equity market has grown to worrisome levels unless actual earnings growth surprises investors on the upside.

Hedge Funds

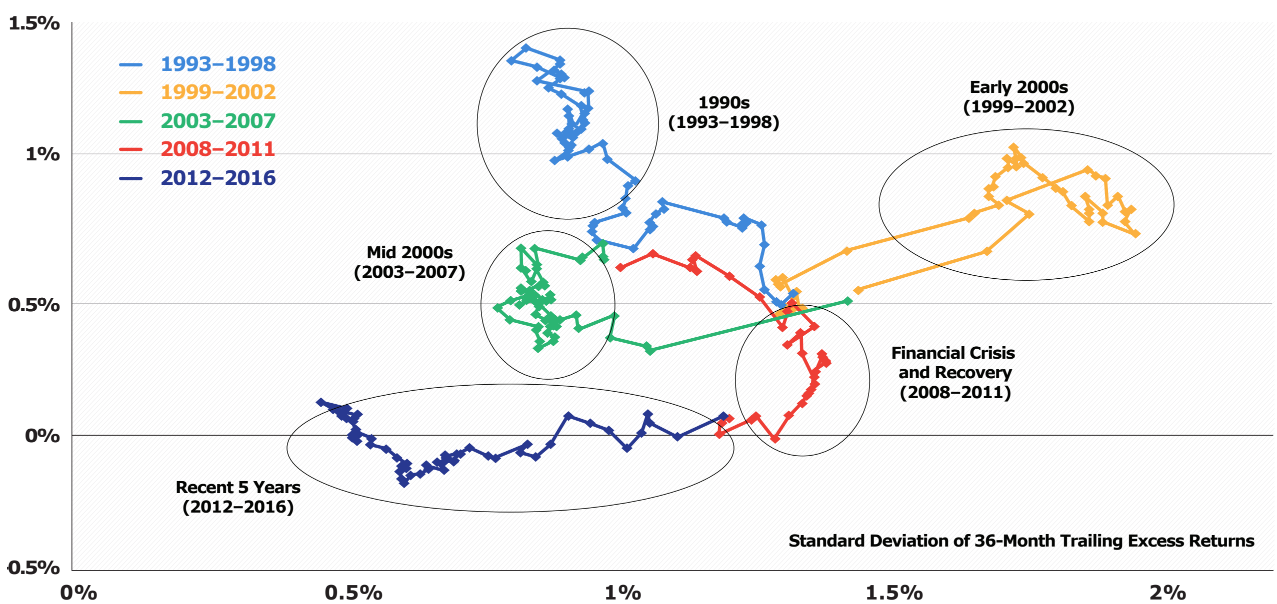
Over the last two decades, average hedge fund performance has continued to decline. This is a perfectly rational outcome, caused by a combination of an increasing number of hedge funds during a period of increasing market efficiency. Chart 26 shows the progression of performance from a golden era of hedge funds in the 1990s to the post-global financial crisis period. It is clearly evident, despite a circuitous path of performance and volatility, that the average hedge fund's ability to generate "alpha," a measure of risk adjusted excess performance, has continued to decline over the last few decades. Further, over the last five years, most hedge funds have delivered zero value-added performance to their investors after paying their large management and incentive fees.

It is also noteworthy that the dispersion of alpha generated across hedge funds, as illustrated by the horizontal axis in the earlier chart, has never been lower. Several factors likely contributed to this continued degradation of performance. As hedge funds flourished through the 1990s and 2000s, institutional investors began allocating large sums of money to the space, ultimately reducing opportunities to make sizable returns in many strategies. Further to the financial crisis, macro events dominated capital markets and overwhelmed the nuances of company-specific investment fundamentals, which has historically been an important driver of hedge fund performance.

Some observers have simplistically characterized this recent period as a "risk-on, risk-off" market. However, our experience suggests that there is an additional factor driving more homogenous returns which we refer to as hedge fund crowding. There is no consensus definition of this type of crowding, but most involve trying to measure the degree to which hedge funds are "crowded into" the same companies or types of investments.

Chart 26. Average Hedge Fund Performance Continues to Decline

Hedge Fund 36 Month Trailing Excess Returns

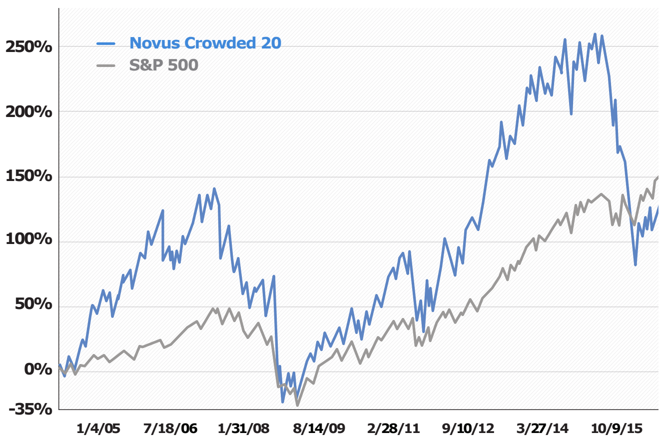


Source: Barclays

Some definitions look at the hedge fund ownership percentage of a specific stock while others look at hedge fund holdings, which managers are required to publicly disclose each quarter. Novus, one of the premier risk factor analytics companies, measures crowdedness by examining a combination of the percentage of the company shares owned by hedge funds and the liquidity of the underlying stock.

Chart 27. Crowded Hedge Fund Positions can have Significant Volatility

Performance of Crowded Stocks



Note: Novus Concentration – 20 most crowded stocks in hedge funds
Source: Novus

Why do we care about hedge fund crowding? Primarily, it's because the unwinding of these crowded positions; when everyone is forced to sell; can create a severe performance problem. As a hedge fund begin sellings, creating downward pressure on the stock price, others attempt to limit their losses by lowering their exposure to the same asset, which creates even more selling pressure. This behavior snowballs into a vicious cycle, producing severe losses for investors.

We recently experienced this type of an unwinding in late 2015 and into the first quarter of 2016. Over this period, while the S&P 500 declined less than 10%, the Novus "Crowded 20," which is an index composed of the twenty most crowded stocks, declined roughly 45%, as shown in Chart 27. The unwinding of crowded trades was a significant contributor to the poor performance of the hedge fund industry in the first quarter of 2016. While crowding can be a positive performance driver, as investors pile into these stocks, the downside can be quite extreme and has historically outweighed any positives investors might capture. Most importantly, hedge fund managers and investors need to recognize that crowding is a new and powerful risk factor that must be analyzed when making investments in this area.

For investors who have struggled to identify the best managers and have generated average results over recent years, this new risk may lead some to abandon the area entirely. Some of this has already begun, as hedge funds just experienced net outflows for the first year since the financial crisis. We believe an industry shake-out is long-overdue, hopefully leading to less crowded trades and lower fees more commensurate with the reduced potential for value-added performance.

We remain confident that traditional, large, "me-too" hedge funds will continue to disappoint investors. In response, we continue to diversify our investment strategies away from highly crowded areas toward markets and strategies that are less efficient and to managers with smaller asset bases. In some cases, this requires a deeper network and understanding of more niche geographies such as China, India and Latin America. In other cases, this requires identifying specialists in sectors where disruption and mispricing is temporarily or consistently present.

Private Equity

Private investments remain a powerful driver of long-term investment returns. However, it is important to keep in mind that discussing these multi-year investments even once a year can be too frequent and imply that the landscape is changing faster than in reality.

Valuations in 2016 remain elevated for buyout investments generally, and in particular for larger deals. On average, U.S. purchase-price multiples remain above 10x EBITDA, consistent with the elevated pricing we have seen since 2014. Smaller companies present more risk, but they are available at lower valuations, generally between 5x to 7x EBITDA. The easy availability of debt financing over the last few years has contributed to these elevated valuations. In fact, many transactions can easily receive debt financing representing 6x EBITDA, reducing the equity contribution by the private equity sponsor. While leverage can increase the return potential from these deals, it also increases the downside risk to investors.

Fund raising remains near all-time high levels and is becoming concentrated in the hands of a smaller number of larger managers, as the number of funds raising capital has fallen over the last few years. Additionally, the overhang of uninvested capital from prior vintages, estimated at over $700 billion and concentrated in larger private equity funds, remains near record levels. As a result, we expect the competition for company acquisitions, particularly for larger deals, to remain fierce.

Given that this environment hasn't changed much over the last few years, we have maintained our primary strategy of investing with smaller managers who have differentiated insights and approaches. We also continue to prefer investments that can be improved and sold to larger, conventional buyout funds with an overhang of capital to invest. As a result, manager selection remains critical in attaining attractive returns.

Venture Capital

The sometimes opaque world of venture capital investing is prone to hyperbole surrounding the next great invention or opportunity, which can to lead to investors chasing similar types of deals and companies. Unfortunately, a short-term focus and chasing recent past returns is particularly dangerous in venture capital, as current investment successes were formed many years prior and likely have a significant advantage over newly funded ventures.

We continue to believe in the transformative power of disruptive business models that can handsomely reward long-term investors, as has been the case in the past. Technology will continue to evolve; artificial intelligence and big data are currently in vogue, but these are simply continuations of long-standing technological evolutionary trends. Beyond technology, we continue to monitor trends in healthcare, as changes to the currently lengthy and expensive drug approval process may provide new opportunities. In China, we have witnessed the application of mobile internet in the consumer sector on a scale that potentially dwarfs that of the U.S. Also, other trends that have worked in the U.S., such as enterprise software, have the potential for widespread application in China.

One note of caution for investors is that later-stage deals remain expensive by historical standards. While some of these companies remain good investments despite higher prices, many will prove to be quite expensive if they fail or are merely less successful than once hoped.

Real Assets

Real estate valuations remain relatively high in most developed markets. In the U.S., valuations have stabilized or even improved due to concerns about the potential for rising interest rates and what appears to be pockets of excess development leading to an increased supply of properties. Higher valuations should sound a note of caution for investors. However, investors can still find specific locales where rent growth has lagged and there is strong potential for improvement. Overseas, slow economic growth in many developed economies and concerns about the rise of the U.S. dollar raise the hurdle for non-U.S. real estate investments.

After a rollercoaster ride over the last few years, oil, natural gas and other commodity prices seem to have stabilized for the moment. However, as we saw over the recent cycle, asset quality matters, particularly in a down-cycle when some assets can become uneconomic, causing investors significant losses. Investors should avoid the complacency of assuming that prices will remain stable in unpredictable energy markets. Building a resilient portfolio in this volatile area requires a focus on high quality assets and avoiding excess leverage, which may require investors to forego some upside potential, but will protect capital better during difficult periods as we witnessed over the last few years.

For oil and gas, we continue to focus on investing in onshore North American assets. Onshore assets can provide attractive risk-adjusted returns without requiring appreciation of oil and gas prices. These assets may become very attractive to larger energy companies should they need to increase reserves for future growth. Unlike the rampant speculation that occurred earlier in the decade, it's critical for these assets to show that they can remain economically productive even during commodity price declines.

For metals and mining, the ultra-low valuation environment for mining companies may be approaching the last few innings. It's difficult to time when valuations will improve, but the dearth of capital being invested in this area gives us an opportunity to acquire high-quality assets at attractive prices. Should prices recover, the additional upside to these assets could turn good returns into great returns.

Investment Themes

From many perspectives, 2016 was a challenging investment year masked by what turned out to be decent performance from U.S. equities. This underlying turmoil and dispersion, unlike the prior few years, is likely to continue as we are entering uncharted territory. In the U.S., we are starting the process of unwinding eight years of experimental monetary policy. To make matters more complicated, many advanced economies remain reliant on these aggressive monetary policies in an attempt to stimulate economic growth. This growing gap between the U.S. and other developed nations creates the potential for highly unexpected outcomes. Hence the title of this Annual Outlook, *Mind the Gap*.

One requirement for investment success is the humbling realization that no one knows with certainty what lies ahead. However, we can at least understand where we are to better guide our decisions. One of our core investment tenets is that price is one of the more important drivers of idiosyncratic investment risk. As a result, understanding current valuations is central to making sound decisions.

In this context we offer the following recommendations for investors:

- Cash offers poor long-term returns, essentially guaranteeing a loss of real purchasing power due to the erosive effects of inflation. However, in the current environment of high uncertainty and high valuations, investors should consider having a year or two of spending cash available so that if asset prices decline, they can avoid forced selling at depressed prices.

- Long-term interest rates have increased over the last six months and the U.S. Federal Reserve is expected to continue raising short-term interest rates. However, we believe interest rate "normalization" has not yet been achieved. As a result, while bonds are modestly more attractive now than six months ago, we continue to recommend that investors underweight fixed income allocations within their portfolios.

- While our focus tends toward a global orientation in equity markets, recent U.S. market activity warrants special mention. U.S. equity markets remain overvalued by historical standards, with the S&P 500 trading at over 17x forward earnings. While higher valuations should sound a note of caution for investors, underlying earnings finally appear poised for some growth amid expected corporate tax and regulatory reforms, at least in the near-term. The immediate question for investors who still adhere to a U.S.-centric framework is, how much of this boost has already been priced into the equity market during the post-election rally. We retain our cautious stance on U.S. markets relative to the rest of the world equity markets, but recognize the potential for additional upside in the near-term.

- Our more pressing concern about U.S. equity markets as we discussed earlier in this Annual Outlook, is that certain sectors have become even more expensive than the broader markets. Small and mid-cap stocks have reached near historic levels. Additionally, many of the so-called bond-alternative sectors, such as utilities, dividend paying stocks and a number of consumer staples also have become overvalued. These sectors, which in theory might provide some investor protection if equity markets correct, have lost some of their defensive characteristics due to their high valuations. Once again, this does not mean that losses are in store for investors, but the margin of safety, even for longer-term investors, has been eroded.

- We recommend investors adopt a global framework for equity allocations in portfolios to provide a more flexible mandate that allows skilled global stock-pickers to find great companies without being limited by geographic or benchmark-hugging constraints.

In this context, international equities present investors with more compelling valuations after several years of underperformance, and as many of these managers have begun to rotate into them and away from overvalued areas of the market.

- Our interest in emerging markets remains high based on the potential to invest in more rapidly growing companies at better valuations in these highly inefficient markets. After years of underperformance and related investment outflows, we believe a bottoming process began in 2016 that would allow these attractive investments to be recognized through higher prices. Unfortunately, with the prospect of a rising U.S. dollar and active discussions of protectionism, investors are likely to remain cautious in the near-term, making this bottoming process rocky and somewhat prolonged.

- Hedge funds generally, after several years of disappointing performance, have become even more challenged as crowding within stocks in their portfolios has created an additional risk for investors. However, in the current investment environment of high valuations and high uncertainty, using managers who operate in a hedge fund format with lower market exposures and opportunistic approaches can provide outsized returns and potentially protect capital. Manager selection is of utmost importance, particularly in the context of avoiding managers prone to investing in crowded trades, which can magnify losses to investors. We believe it is necessary to find and gain access to managers with smaller asset bases that can exploit smaller stocks, in less efficient sectors and geographies. We believe traditional hedge fund allocation approaches will continue to disappoint investors.

- Private investments remain a foundational allocation for long-term investors. Manager selection remains particularly important in these markets, due to extremely high manager performance dispersion. Competition among larger private equity managers remains intense, resulting in high deal values and leverage that make these allocations less attractive. Similarly, later-stage venture investment valuations remain high, removing some margin of error for these investments. Smaller traditional private equity managers and earlier-stage venture managers in both the U.S. and China still appear to have good prospects.

Concluding Thoughts

Rarely is there such a thing as a bad asset, but merely a bad price paid for an asset. One of the outcomes of a decade of artificially low interest rates is that capital has flowed into markets elevating prices across a broad range of assets. Elevated prices, on their own, do not mean that losses are ahead for investors, but they do mean that upside potential is limited and the margin for error is reduced. Prudent investors will tilt their portfolios away from those assets most overvalued by exuberant market participants.

In the face of certainty, investors should seek concentration. Unfortunately, we rarely get this kind of certainty and today's market is no exception. Similarly, investors should also recognize that when uncertainty is high, diversification is even more important.

About Gresham

Gresham Partners is an independent investment and wealth management firm that serves its clients as a multifamily office and an outsourced chief investment officer. Gresham has been serving select family offices, foundations and endowments since the firm was established in 1997. Today, we manage or advise on over $5 billion for about 85 clients located nationally. A copy of Gresham's Client Composite performance record is available upon request. Past performance is no guarantee of future results.

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