

A TIME TO BE ACTIVE

Following a strong run in markets, active management is key

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KEY POINTS

- Valuations of some asset classes sit at high levels following a strong market rally in early 2019
- Government bonds and the US equity market appear the most expensive, while other markets appear more attractively priced
- Active security selection and asset allocation are likely to be critical for investment returns over next decade given potential headwinds

AN EXTENDED MARKET CYCLE

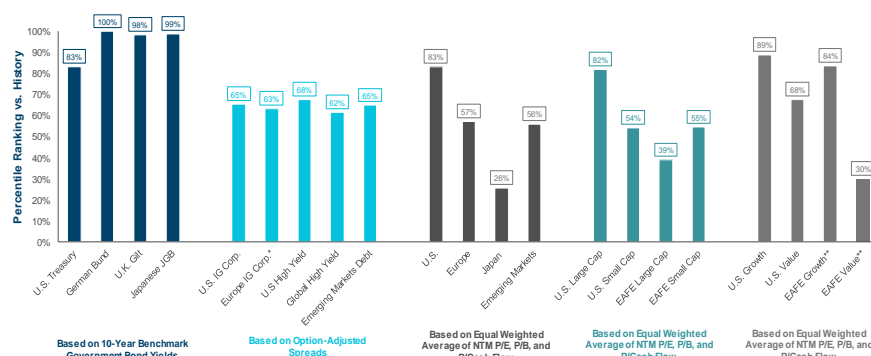
For much of the past decade, stock markets have followed a steady upward path supported by central bank stimulus, muted inflation and moderate economic growth. For the most part, investors have benefited from strong beta returns – or being exposed to the market as a whole – while individual security selection was often not critical to achieve investment objectives. We believe this is about to change.

Throughout the first six months of 2019, we observed a strong market rally across equities, fixed income and alternatives. Market performance was so strong that valuations of some asset classes now appear rather expensive when compared against historic data from the past 15 years.

At the most expensive end of the fixed income scale are sovereign bonds, with German bunds, UK gilts and Japanese government bonds standing at their highest valuations since November 2004. On the equity side, US equities are the most expensive at a global level, particularly large caps and large-cap growth.

VALUATION COMPARISONS

Percentile Rankings vs. Past 15 Years



Past performance is not a reliable indicator of future performance.

*Only includes 30 November 2004 to present due to data availability **Does not include P/Cash Flow due to data availability Indices used, from left to right above, beginning with U.S. IG Corp.: Bloomberg Barclays U.S. Investment Grade Corporate, Bloomberg Barclays Euro Aggregate Credit, Bloomberg Barclays U.S. Aggregate Credit – Corporate High Yield, Bloomberg Barclays Global High Yield, Bloomberg

Barclays Emerging Markets USD Aggregate, MSCI USA, MSCI Europe, MSCI Japan, MSCI Emerging Markets, S&P 500, S&P 600, MSCI EAFE Large Cap, MSCI EAFE Small Cap, S&P 500 Growth, S&P 500 Value, MSCI EAFE Growth, MSCI EAFE Value.

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Nevertheless, while markets currently appear expensive – particularly in government bonds and US equities – they are not as highly valued as we would normally expect after such a strong rally. In 2018, US corporate earnings ballooned following President Donald Trump’s tax reforms, so the earnings in P/E ratios have kept up with the price. In 2019, however, we saw a large drop-off in earnings estimates as the initial effect of those reforms fell away. With current earnings expectations sitting at low levels, this means there is some upside potential in equities. We believe, if companies deliver stronger than expected earnings, this could be supportive for equity markets.

On the earnings front, for 2019 as a whole we expect US corporate earnings to remain in positive territory, although this is dependent on what happens in the coming six months. Outside of the US, the story is mixed given that these markets rely more on global trade and tend to be more cyclical in nature. In Japan, valuations are at relatively low levels owing to concerns around global trade, while Europe and emerging markets saw valuations improve, but were faced with disappointing corporate earnings.

Pulling all of this together, we believe the heightened valuations that we see in the market today will result in relatively modest returns over the coming decade compared to history. High price today means low return tomorrow, all else being equal. With markets hovering near all-time highs, global growth slowing down, and central banks now looking to cut interest rates, we think we are heading into a market environment where a larger portion of investment returns will come from active security selection and asset allocation decisions, and a lower portion from the overall rise in the market - compared to the past. With clear valuation differences across and within markets, our view is that being selective within and across assets is essential: not everything is expensive and not everything is cheap.

OUR POSITIONING

There is little doubt that investors are facing a more challenging market and economic environment than they have seen for much of the past decade. Following an extended period of market growth, valuations are heightened in several asset classes, particularly government bonds and US equities. Looking ahead, we think beta market returns might be limited over the coming decade compared to the past. In this environment active investment decisions are likely to be more important in achieving investment goals, rather than relying on tracking the market. With a wide dispersion of returns within and across asset classes, active management is likely to play an important role in clients’ portfolios.

In the current climate, we believe equities still have room to grow, but downside risks are ample. As such, we are moderately underweight equities, preferring overweights in growth equities as opposed to value, and we also like emerging markets. In fixed income, we are underweight government bonds due to their low yields and instead see reasons to take some risk in this area. With that in mind, we see attractive opportunities in emerging market debt and high-yield markets as investors seeking yield may buy and support these asset classes. It is important, however, to maintain a balance in portfolios across risky and conservative assets to diversify risks.

Key Risks—The following risks are materially relevant to the information highlighted in this material:

Even if the asset allocation is exposed to different asset classes in order to diversify the risks, a part of these assets is exposed to specific key risks.

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

Currency risk—changes in currency exchange rates could reduce investment gains or increase investment losses.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

Foreign investing risk—investing in foreign countries other than the country of domicile can be riskier due to the adverse effects of currency exchange rates, differences in

market structure and liquidity, as well as specific country, regional, and economic developments.

Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Real estate investments risk—real estate and related investments can be hurt by any factor that makes an area or individual property less valuable.

Small and mid-cap risk—stocks of small and mid-size companies can be more volatile than stocks of larger companies.

Style risk—different investment styles typically go in and out of favor depending on market conditions and investor sentiment.

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