



Verus^{↑↑↑}



SEPTEMBER 1, 2015

Scott Whalen & Omer Tareen

Finding Opportunity in a Low Return World

2015 Client Summit

True North

Some initial thoughts

In the post-crisis period we have seen a compression in risk premia...

- Valuations are rich
- Central bank activity and lower discount rates have pushed investors to reach for yield
- Investors may be pulling future returns into the present
- Global growth is lower than previous bull cycles
- Given today's compressed risk premia and low return environment, it is as critical as ever to think about where good opportunity exists
- We direct our attention across four areas: private equity, real assets, and thematic investing

Table of contents



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Valuations and the low return environment

Opportunities in private assets

Opportunities in real assets

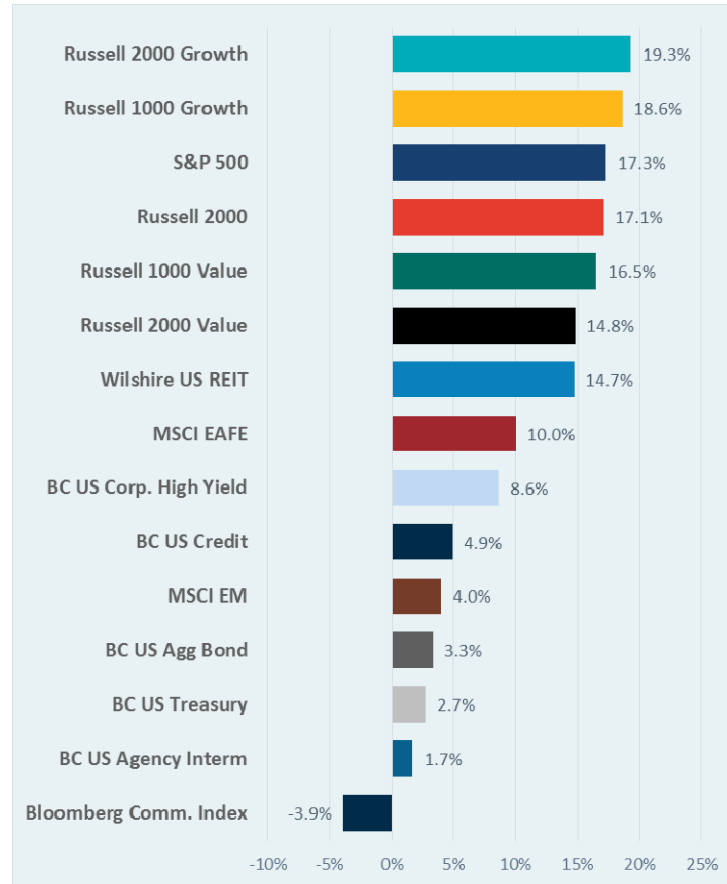
Active management in Emerging Market equities

Thematic investing in Japanese equities

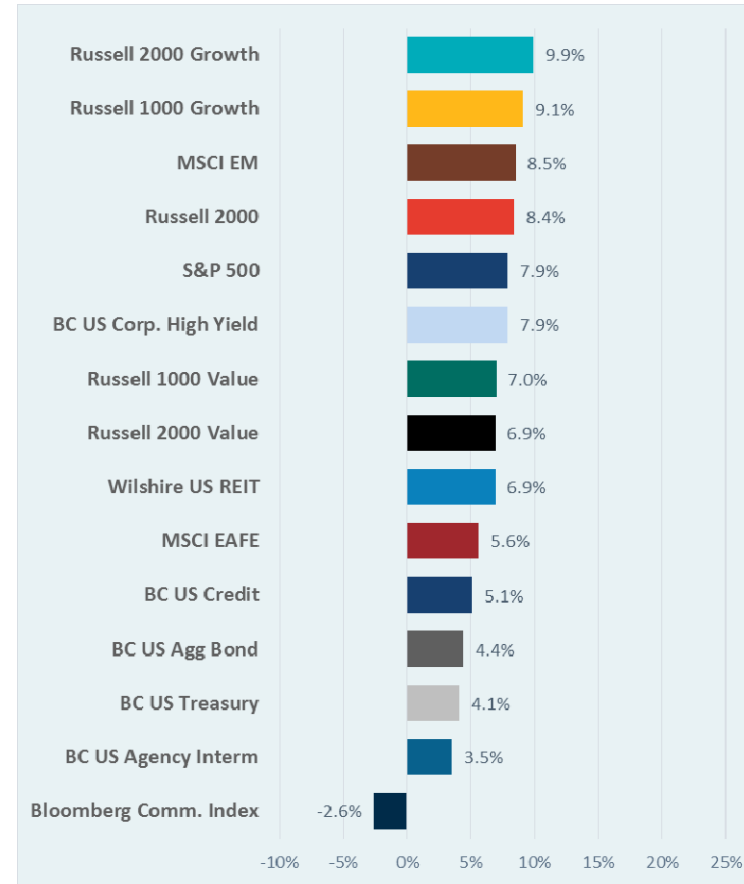
Valuations and the low return environment

Risky assets have performed well in recent history...

FIVE YEARS ENDING JUNE 2015



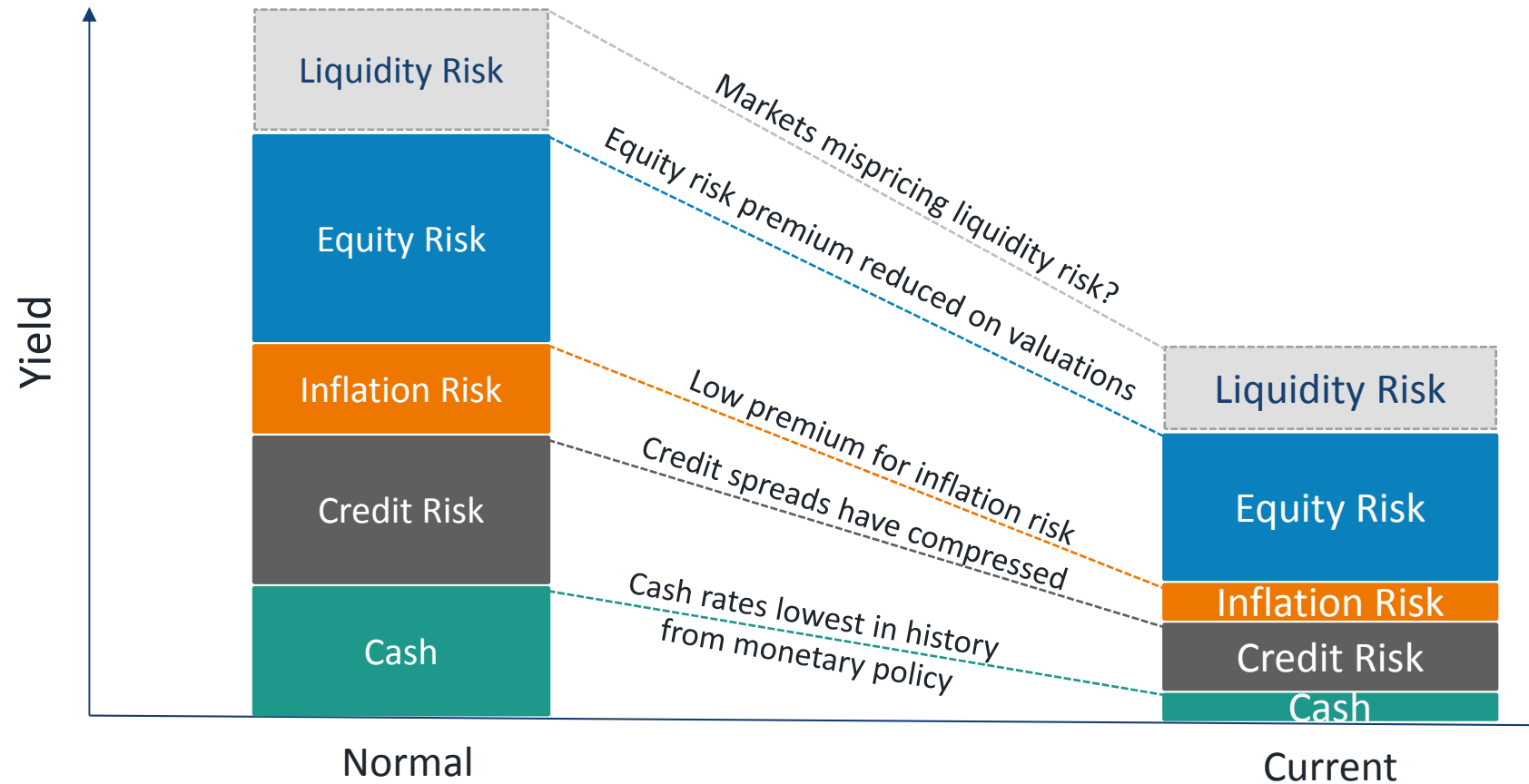
TEN YEARS ENDING JUNE 2015



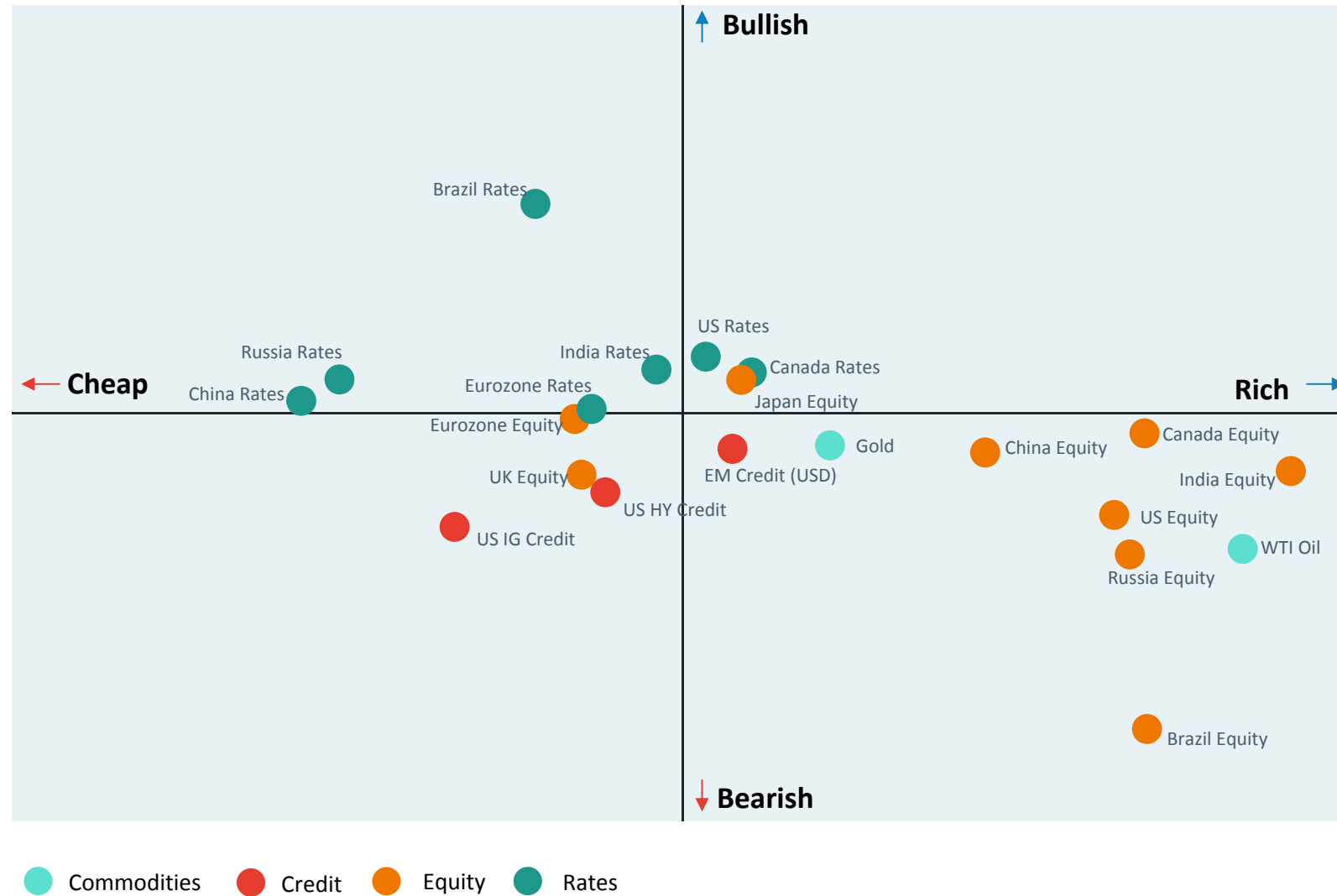
With the exception of Commodities, risky assets have performed well in recent history, with global equities seeing double digit returns over the last 5 years.

Source: Verus, Bloomberg. Total returns as of 6/30/2015.

...while monetary policy has compressed risk premia



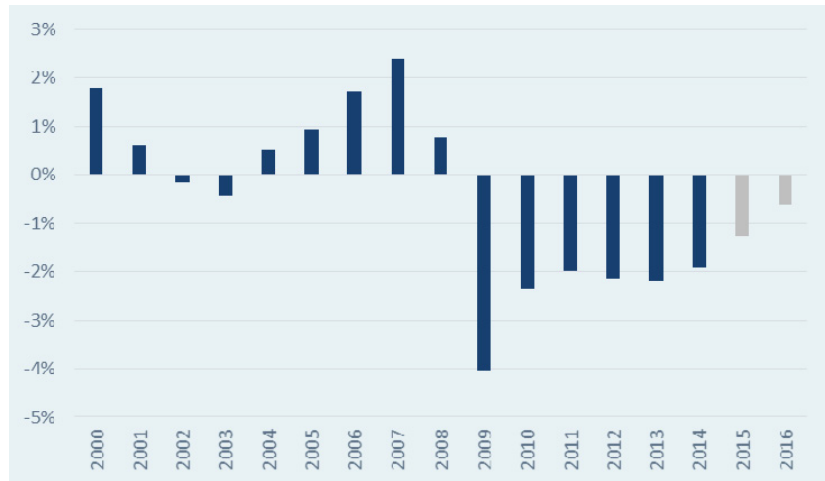
...leading to richer valuations



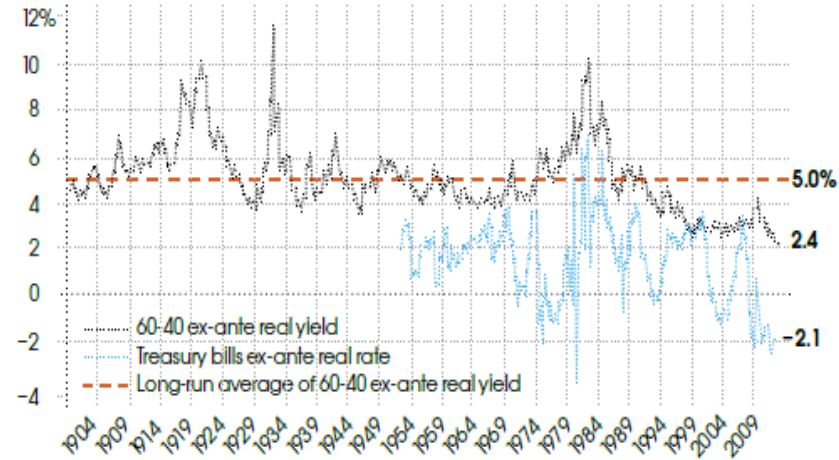
Source: Verus, Bloomberg. As of 6/30/2015.

Returns going forward are expected to be low

OUTPUT GAP – ADVANCED ECONOMIES

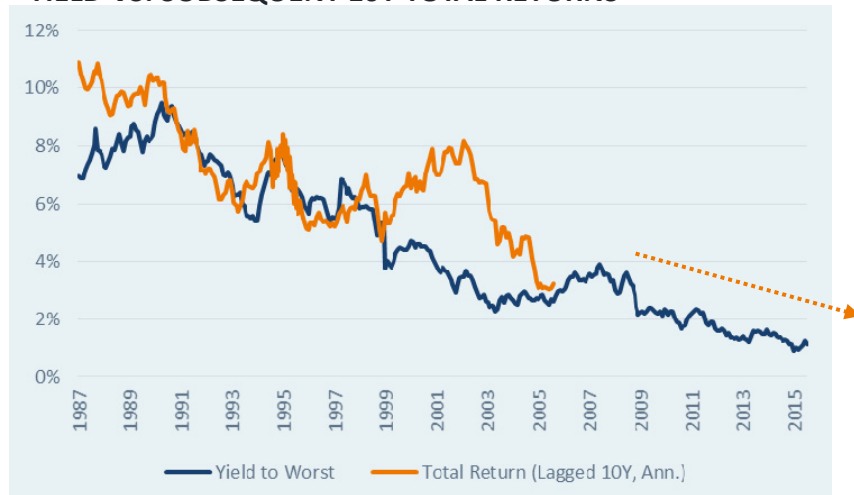


EX-ANTE RETURNS

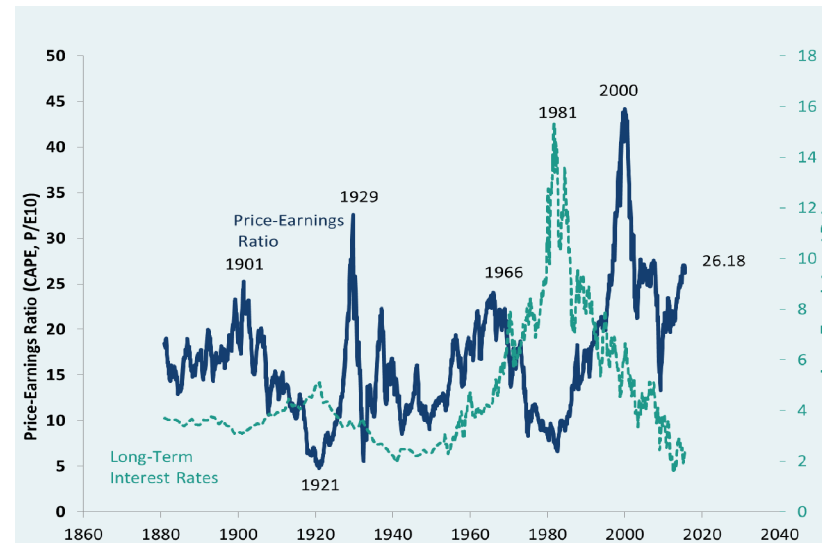


Source: AQR Capital Management.

BARCLAYS GLOBAL TREASURY INDEX - YIELD VS. SUBSEQUENT 10Y TOTAL RETURNS



CAPE RATIO VS INTEREST RATES



Source: IMF, Yale (Robert Shiller), Barclays, Bloomberg, AQR Verus

So what are investors' options?

1. Accept the current environment of lower returns
2. Increase risk taking
 - Lever up portfolio to achieve return target
 - Move down in quality to pick up yield (i.e. HY vs. IG), move into equities vs. fixed income
3. Add new sources of return through asset allocation and/or “stractical” tilts to capitalize on market dislocations

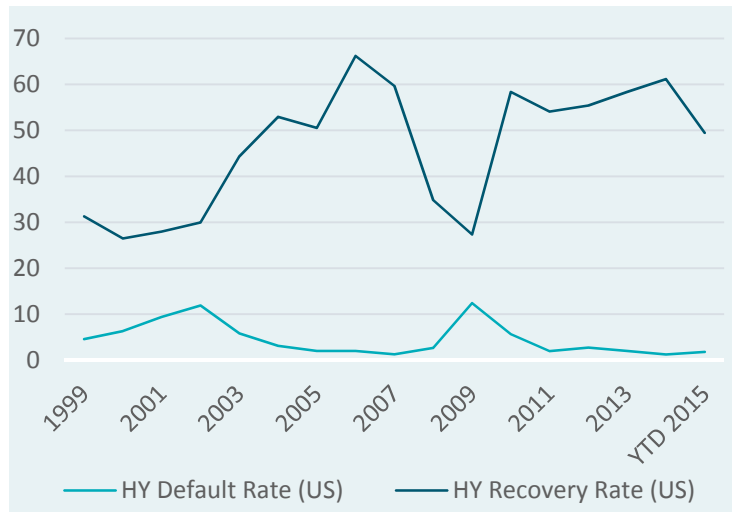
Are there any opportunities out there?

OPPORTUNITY	ASSET ALLOCATION IMPLICATIONS	TAA IMPLICATIONS
Divergent Central Bank Policies	Currency Hedging	Increased breadth for FX and Interest Rate TAA
Low Inflationary Expectations	Assess exposure to inflation-sensitive assets	Potential for inflation surprises
European Dislocations	Assess exposure to peripheral European debt	Relative Value opportunities in Core vs. Periphery
Japan Reforms	Evaluate potential structural underweights to Japan	Position for surprises or disappointments
Emerging Markets Divergence	Improved breadth for Active EM managers	Relative Value opportunities between EM countries
Low Volatility Environment	Calibration of risk models may not have "memory" of historical crises and may understate risk	Long volatility-oriented strategies may be pressured in the near term
Bank Deleveraging	Opportunities for non-traditional lenders (Hedge Funds, Private Equity)	Decreased market liquidity and depth

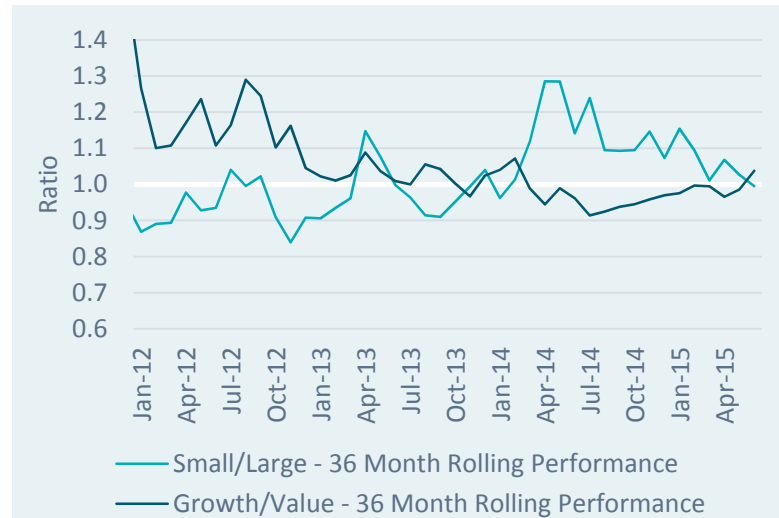
Standard tactical tilts?

- Credit: HY default and recovery trends are at top of cycle
- Domestic equity: style and cap size show no obvious opportunity
- International equity: EM valuations favorable relative to developed, but no “fat pitch”

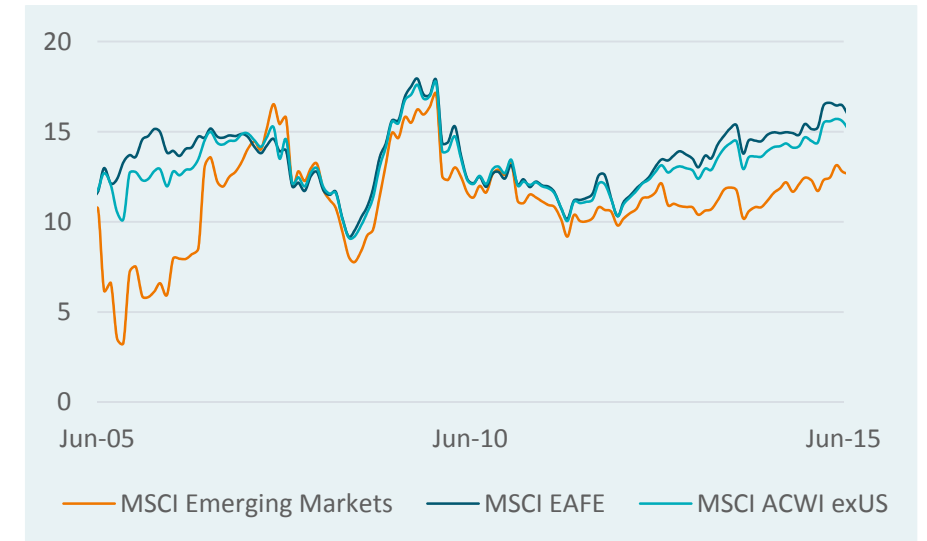
DEFAULT & RECOVERY TRENDS %



SMALL/LARGE & GROWTH/VALUE



12 MONTH FORWARD P/E



Opportunities in private assets

Current environment

- Private equity (PE) funds have generated solid returns over the past year driven by the accommodative exit environment.
- Valuations are high both in the U.S. and Europe. As long as credit remains cheap, valuations will likely remain elevated.
- Investment volume is well below that of the prior cycle.
- Exits reached an all-time high in 2014.
- PE commitments have increased in absolute terms but buyout dry powder has been relatively constant since 2007.

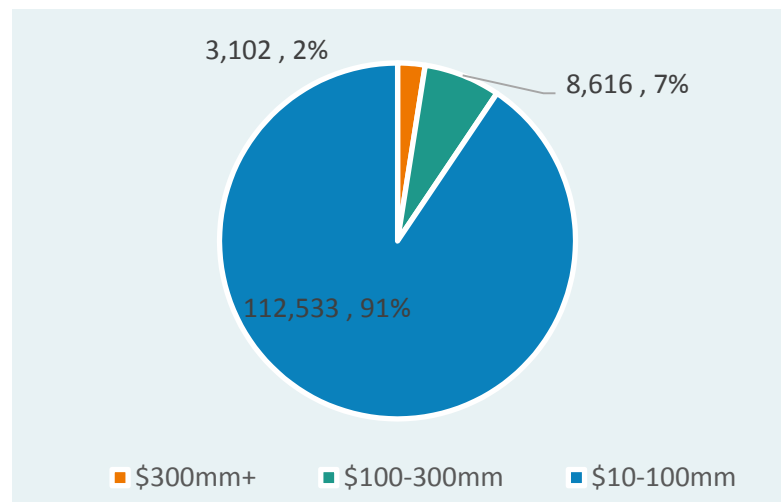
Summary findings

- Middle market buyout trading at lower multiples with less debt and a wider range of exit options
- Private capital continues to be compensated for originating loans both in the U.S. and Europe.
- High-yield bond issuance volume coupled with a market correction could create future distressed opportunity.
- Managers that have unique sourcing angles, operational expertise, investment patience during times of elevated valuations, and an opportunistic approach to selling appear capable of generating attractive returns.

Middle market buyout

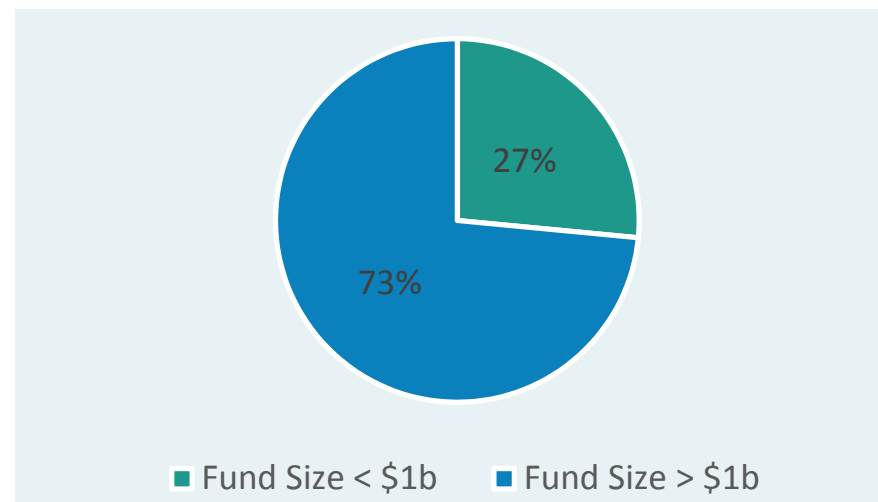
- **Market Size:** small, numerous and geographically diverse, they may have difficulty accessing public capital, and thus operate in a less efficient market.
- **Capital Flows:** 98% of total U.S. companies, 27% of aggregate PE fund raising.
- **Competition:** large funds are hampered by the amount of capital they need to put to work.

NUMBER OF PRIVATE COMPANIES IN THE U.S. (BY REVENUES)



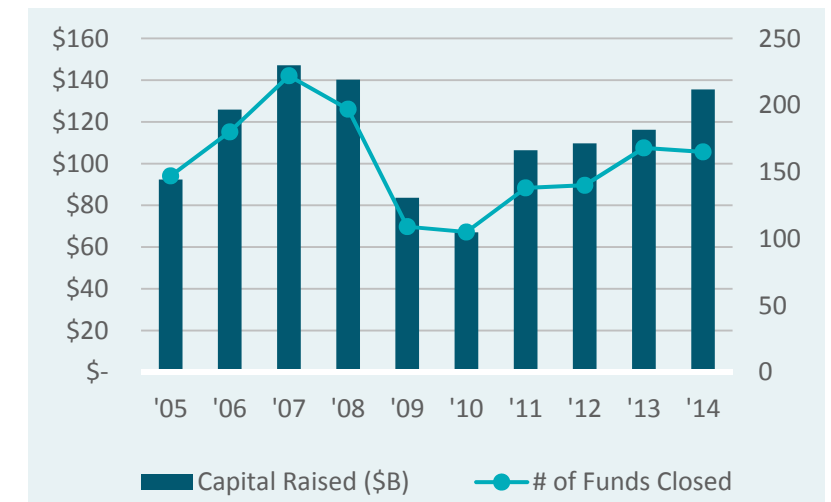
Source: Factset 2/28/2014

TOTAL PE FUNDRAISING 2005 – 2014 BY FUND SIZE (\$ RAISED)



Source: Pitchbook

U.S. MIDDLE MARKET FUNDRAISING (\$B)

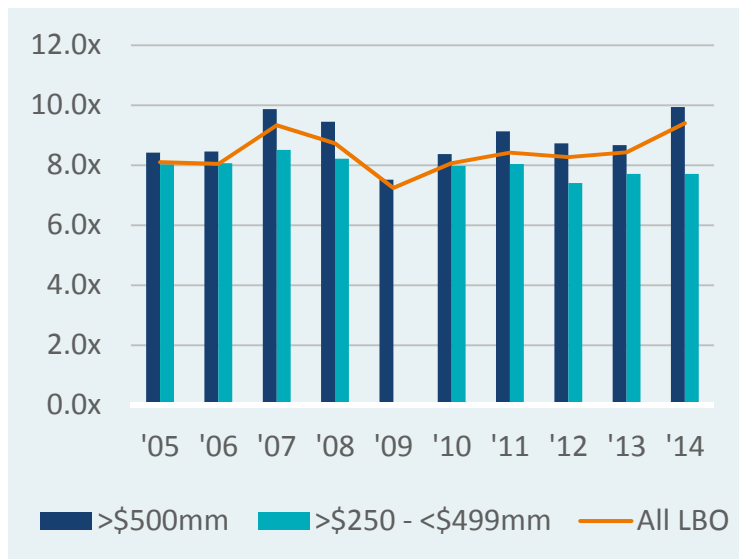


Source: Pitchbook

Valuations and exits

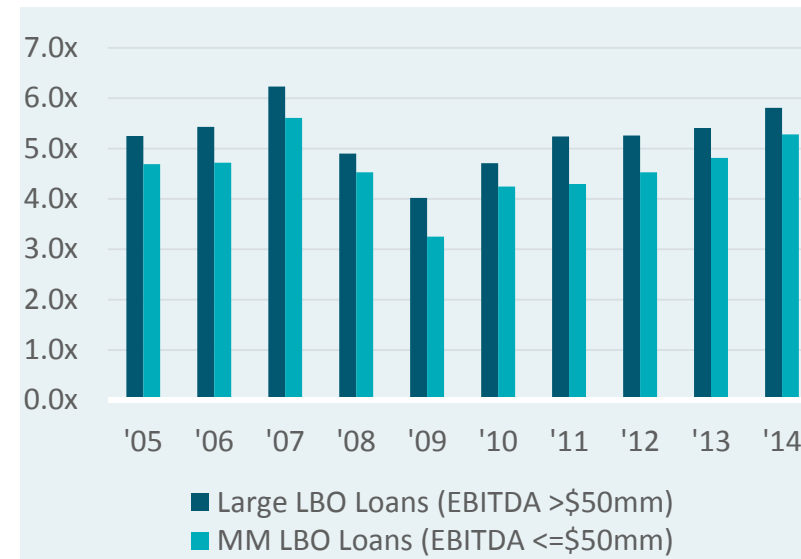
- **Valuations:** middle market multiples remain below both the 2007 peak and the large buyout space.
- **Exits:** middle market LBOs less reliant on the IPO window.
- **Timing:** Strategic acquirers often buy companies for non-financial reasons.

U.S. LBO PURCHASE PRICE MULTIPLES BY DEAL SIZE



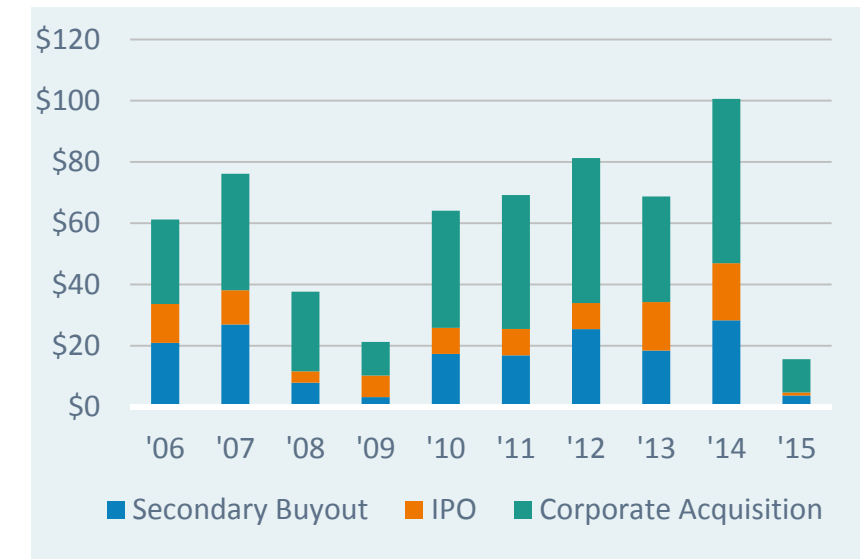
Source: S&P LCD's Leveraged Buyout Review – 4Q14

U.S. LBO DEBT/EBITDA BY DEAL SIZE



Source: S&P LCD's Leveraged Buyout Review – 4Q14

MIDDLE MARKET EXITS BY TYPE (\$B)

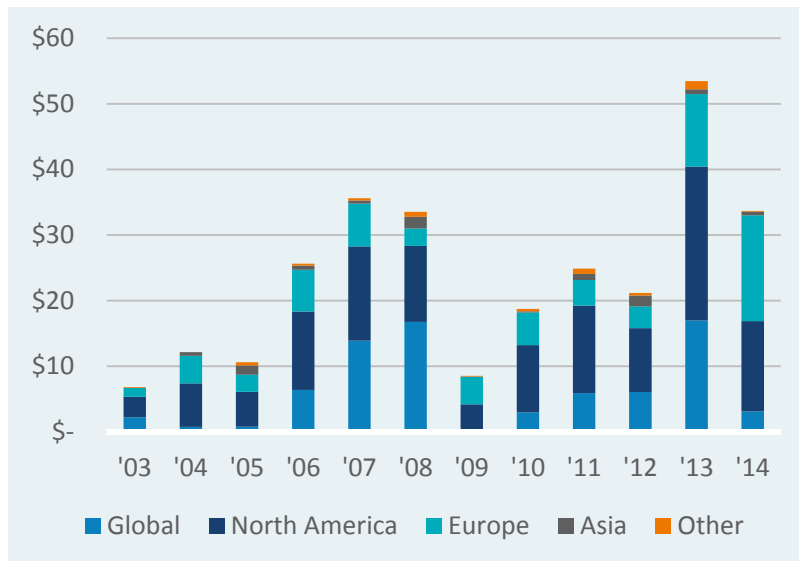


Source: Pitchbook. Data as of 3/23/2015

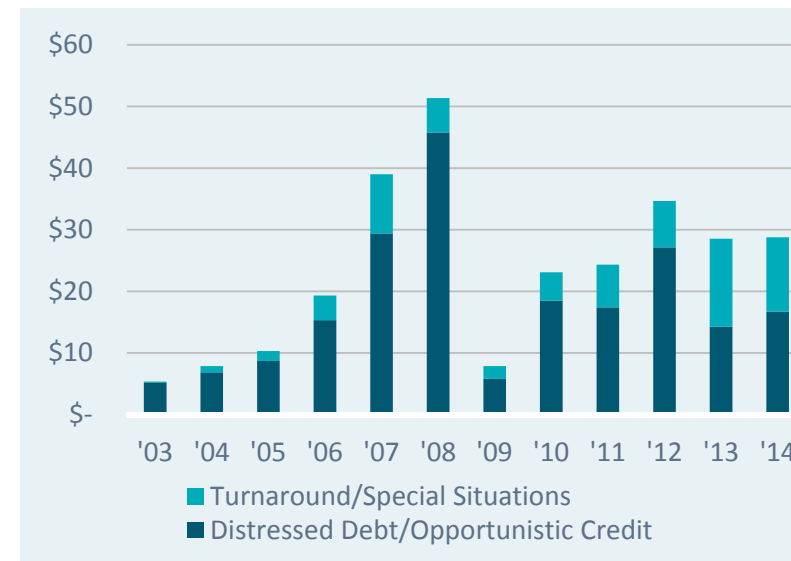
Private credit

- **Capital Flows:** 2014 was another strong year for global private credit fund raising.
- **Pricing:** dislocations at troubled companies and out-of-favor sectors.
- **Market Dynamics:** record high-yield bond issuance could create significant future distressed opportunities.

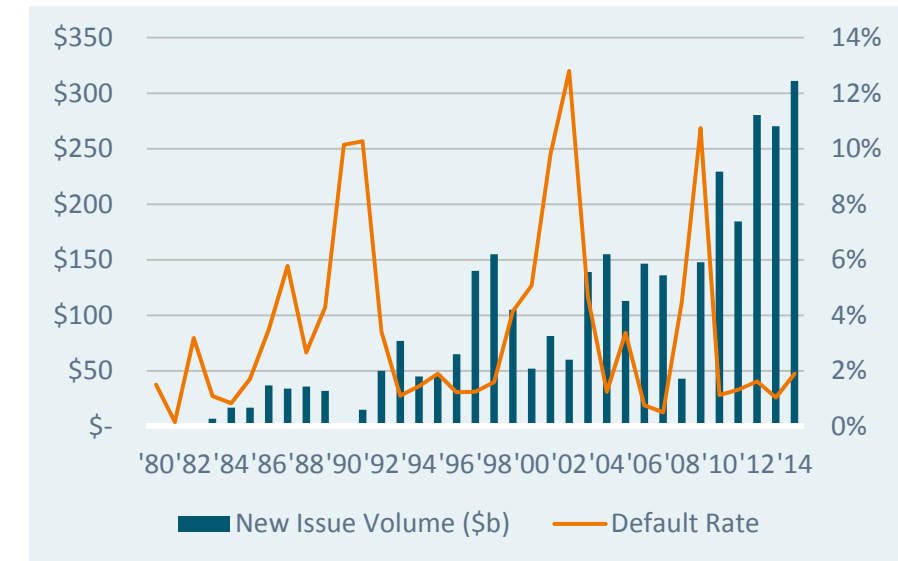
GLOBAL PRIVATE CREDIT FUND RAISING (\$B)



GLOBAL DISTRESSED FUND RAISING (\$B)



HIGH-YIELD BOND ISSUANCE AND ANNUAL DEFAULT RATES: 1980-2014



Source: Probitas Partners

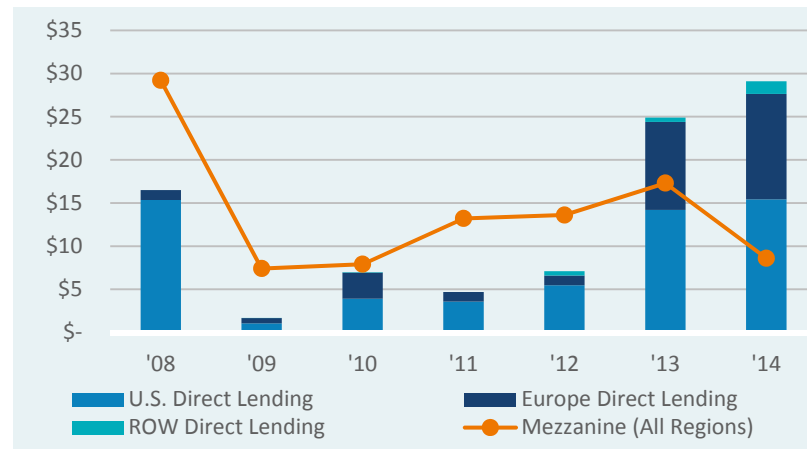
Source: Probitas Partners

Source: NYU Stern School, Moody's, Standard & Poor's

Direct lending

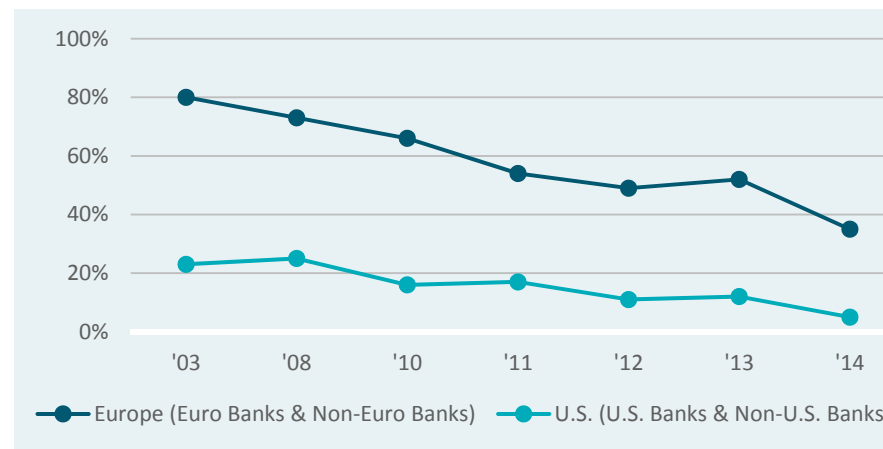
- Capital Flows:** Direct lending capitals flows into Europe have increased in recent years.
- Reduced Bank Lending:** Basel III and other regulatory restrictions have increased equity requirements.
- Middle Market:** The middle market structures are most attractive to lenders in a modest growth environment.

DIRECT LENDING & MEZZANINE FUND RAISING (\$B)



Source: Preqin Private Debt Online

PERCENTAGE OF U.S. & EUROPEAN LOAN MARKET SERVICED BY BANKS



Source: LCD Leveraged Loan Review, 4Q 2014. Please note, 2009 is not included due to no data points being available

ILLUSTRATIVE RETURNS AND DEBT STRUCTURE OF PRIMARY MIDDLE MARKET BUYOUTS

Debt Type	U.S.	Europe
1 st /2 nd Lien Senior Secured	Target: 5.5 - 6.75% LIBOR Floor, 2-3% fee	Target: 6 - 8% 3-4% fee
Unitranche	Target: 7.5 - 9.5% LIBOR Floor, 3% fee, call protection	Target: 9 - 11% 3-4% fee, call protection
Mezzanine	Target: 12 - 14% 2% fee, 2pts. avg. call protection	Target: 12 - 15% 3% fee, potential warrants

Source: Estimates by the Ares Direct Lending Group as of 12/31/2014. Based on hypothetical transactions and a review of current market conditions.

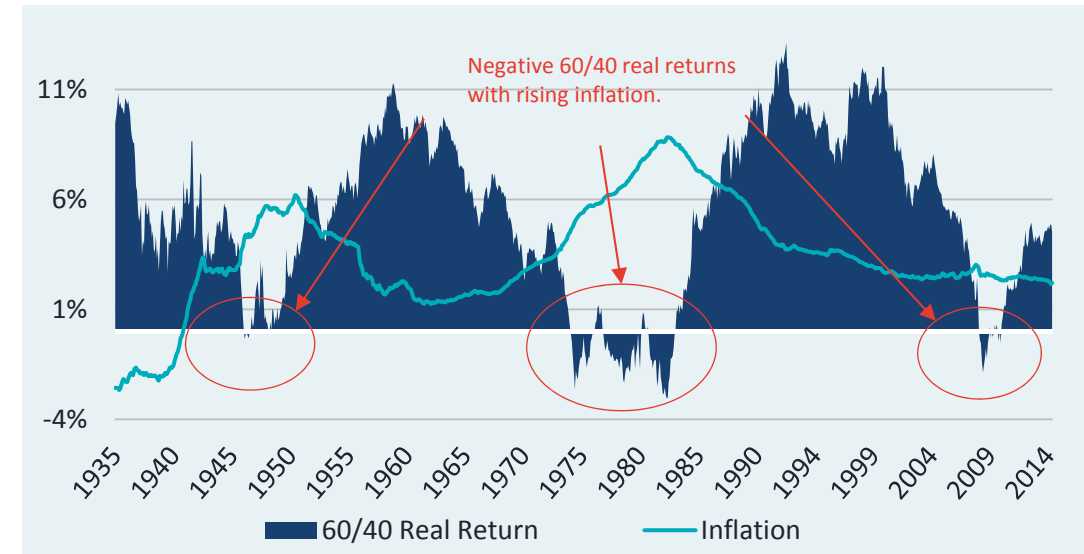
Opportunities in real assets

Why include real assets in a portfolio?

Why do we include real assets in institutional portfolios?

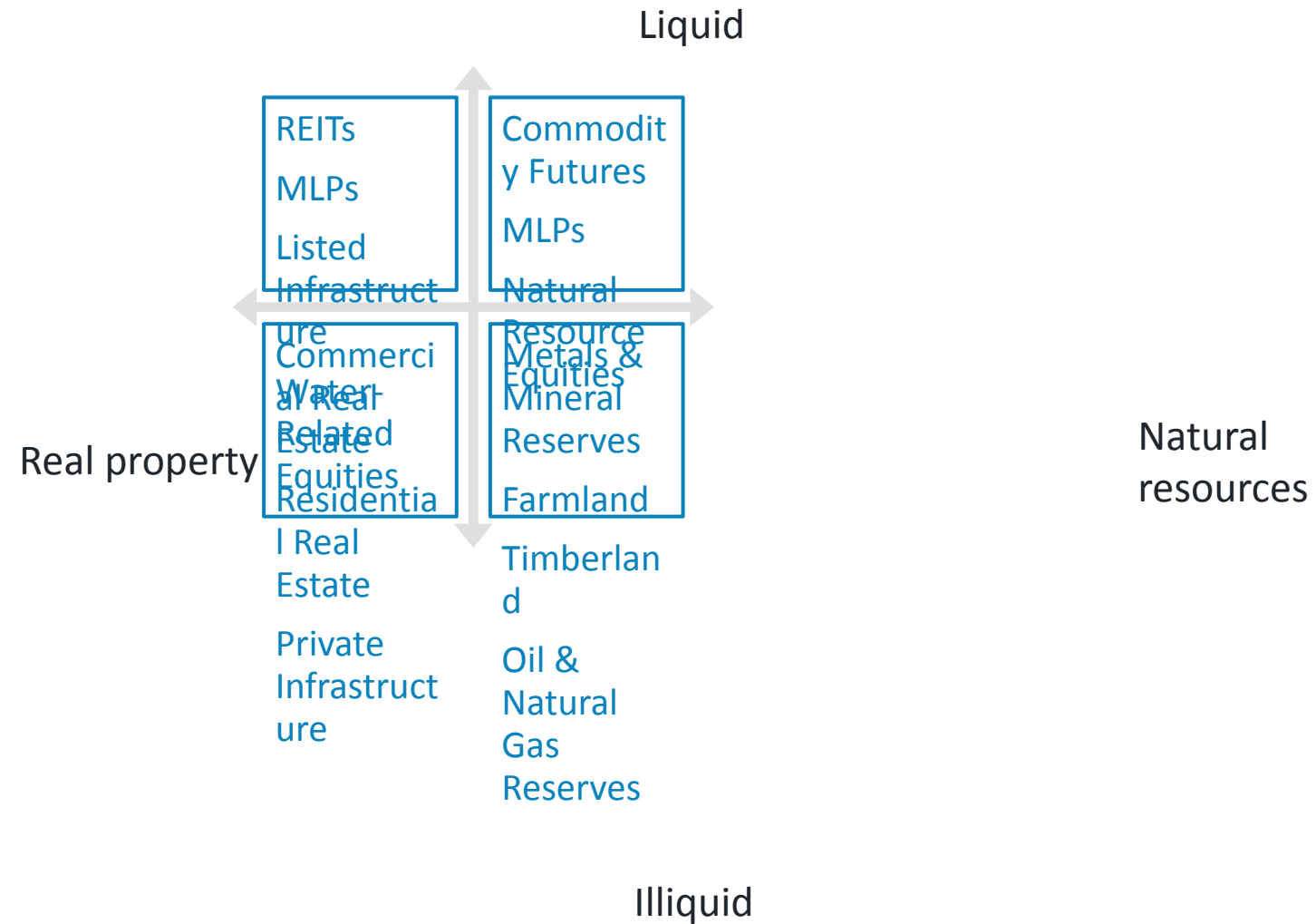
- Inflation protection
- Diversification
- Income generation
- Total return

INFLATION VS 60/40 REAL RETURNS (10 YR ROLLING)



Source: MPI, Bloomberg, as of 12/31/14

The real asset landscape



Current environment

- Inflation remains muted across the globe, and this trend will likely continue
- It is important to distinguish between strategic allocations and intermediate term valuation differentials
- Despite the sharp decline in energy prices and dampened global inflation expectations unanticipated inflation remains a risk

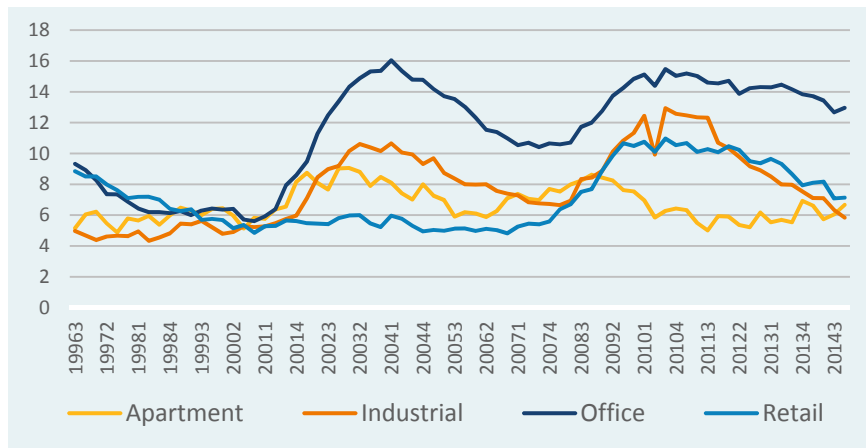
Summary findings

- Despite high levels of “dry powder” value added real estate remains relatively attractive given strong demand for purchasing stabilized assets
- Recent MLP price decline may have been overdone given 5+% yield and reliance on throughput, rather than price of oil

Real estate fundamentals

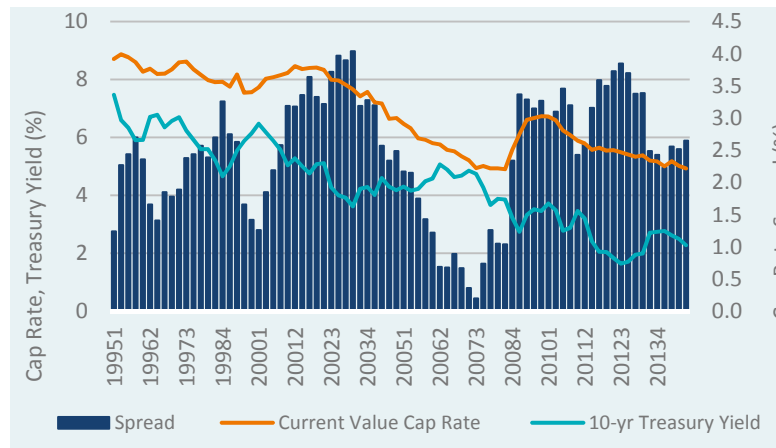
- Vacancy rates have been on a steady downward trend
- Industrial vacancy had the steepest declines
- Net operating income growth rates remain strong
- Multifamily growth rates have recently trended upward
- Cap rates have continued to decline

VACANCY BY PROPERTY TYPE



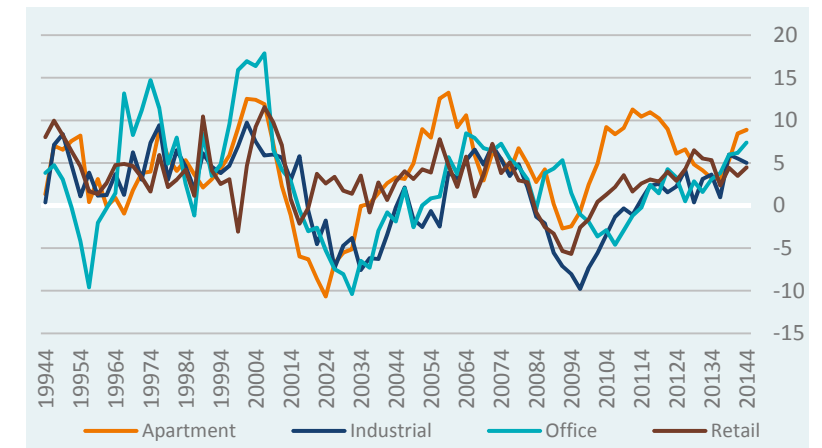
Source: NCREIF, as of 12/31/14

CAP RATE SPREADS



Source: NCREIF, as of 12/31/14

4-QTR ROLLING NOI GROWTH (%) BY PROPERTY TYPE

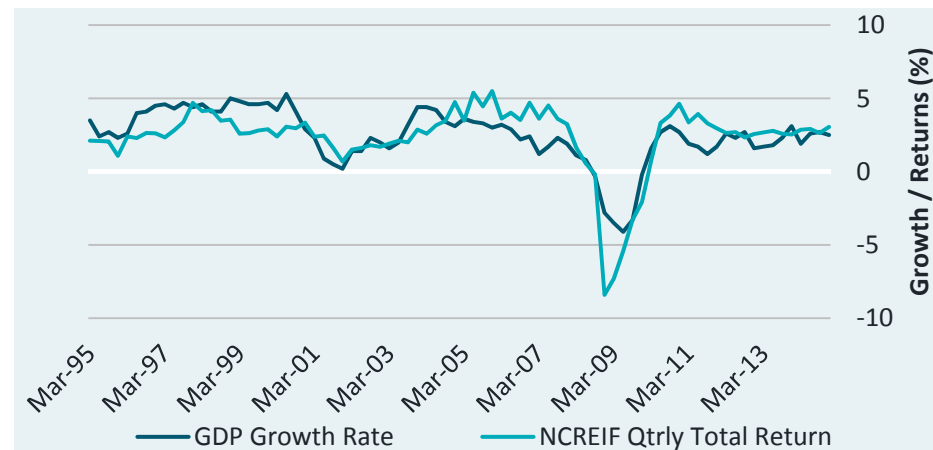


Source: NCREIF, as of 12/31/14

Real estate performance – recent history

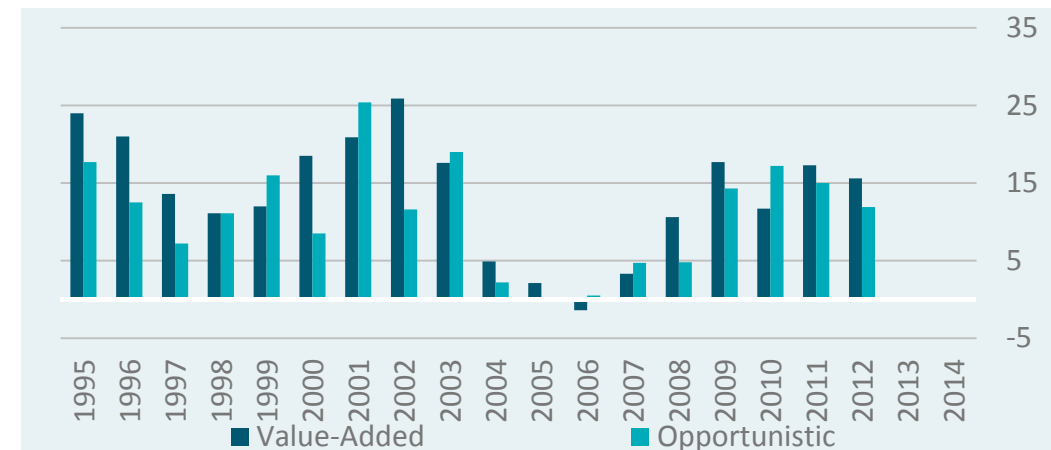
- Real estate is five years into its cyclical recovery
- Since the crisis, core and non-core returns have been high
- Traditionally, recessions have been a good time to invest in non-core assets

REAL ESTATE AND THE BUSINESS CYCLE



Source: NCREIF, as of 12/31/14

VINTAGE YEAR RETURN (%) – NON CORE REAL ESTATE

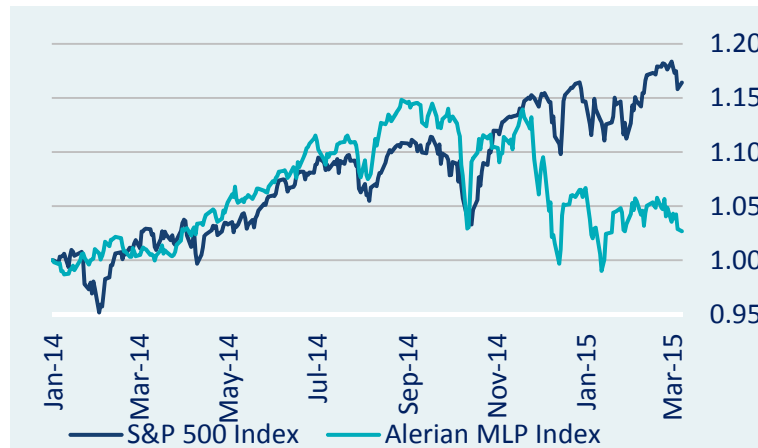


Source: NCREIF, as of 12/31/14

Master limited partnerships

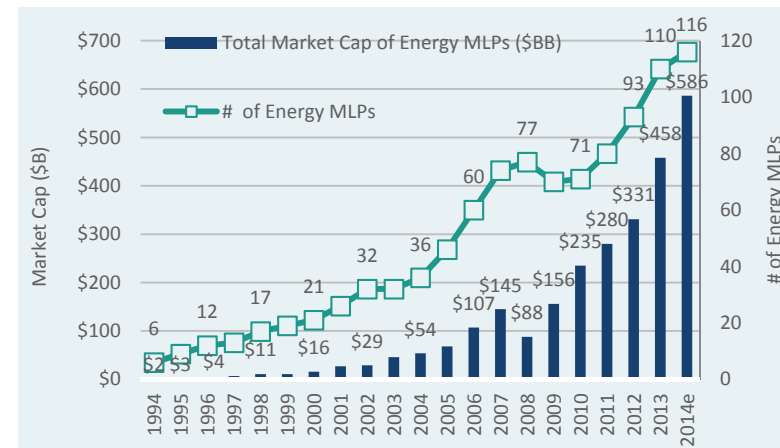
- MLPs have grown dramatically in recent years
- MLPs have significantly underperformed the S&P 500 since October
- The recent pullback may provide an attractive entry point
- Most of the cash revenues are distributed as dividends
- Other considerations

MLPS VS. S&P 500



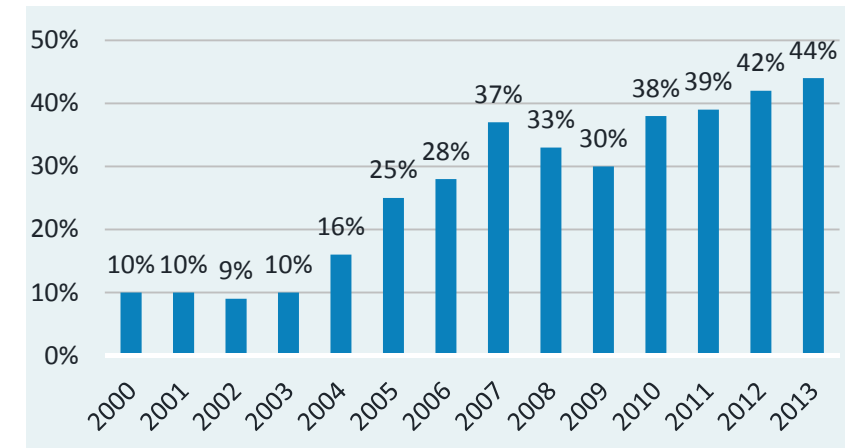
Source: Bloomberg, as of 03/9/15

ENERGY MLP UNIVERSE



Source: Credit Suisse, Wells Fargo

MLP INSTITUTIONAL OWNERSHIP

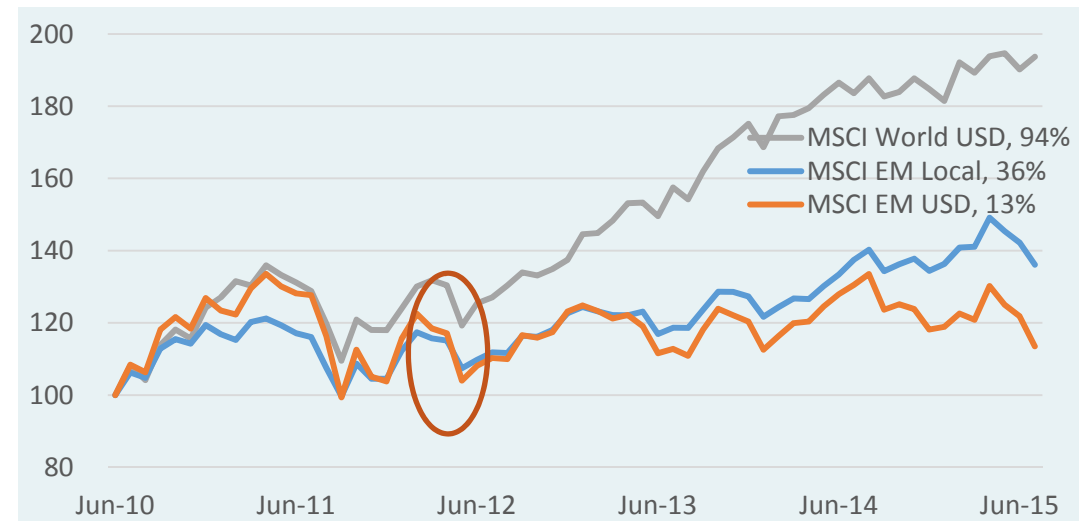


Source: Morgan Stanley, Westwood

Active management in Emerging Markets equities

Emerging markets – recent history

EM vs DM Performance over last 5 years



What has triggered the underperformance?

- Stretched positioning and relative valuations
- Capital outflows
- QE and then tapering
- China soft landing
- Commodities collapse
- Growth pickup in developed world (US in particular)

How do relative valuations look like?

- The discount in EM valuations has reemerged and steepening towards pre 2004 levels
- EM markets tend to have higher dividend yields as well
- However, growth trajectory and impact from currency fluctuations remains uncertain

Source: Bloomberg

EM vs DM Valuation

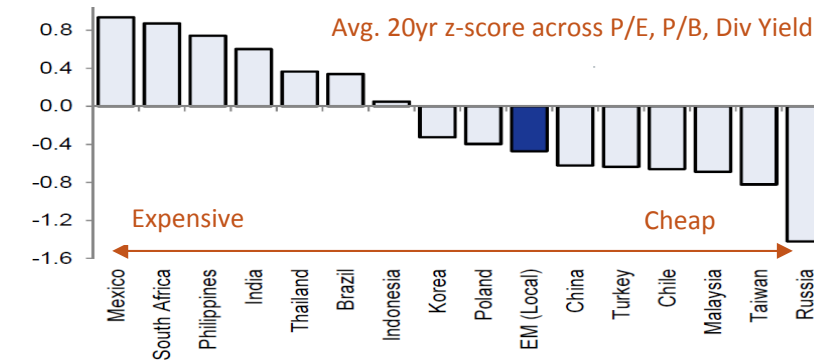


Emerging markets – Divergence

COUNTRY PERFORMANCE DISPERSION



VALUATION DISPERSION



REGIONAL SALES EXPOSURES OF MSCI EM STOCKS

Country	Domestic/ other EM	DM	Commodity Revenues	Other
Taiwan	55%	27%	13%	5%
Korea	53%	16%	28%	3%
Mexico	72%	10%	14%	4%
India	42%	10%	41%	7%
South Africa	60%	9%	27%	3%
Malaysia	75%	9%	13%	3%
Philippines	86%	7%	0%	7%
Brazil	56%	6%	37%	1%
Turkey	78%	5%	16%	1%
China	59%	2%	36%	2%
Chile	69%	2%	29%	0%
Thailand	22%	2%	75%	0%
Poland	59%	2%	39%	1%
Indonesia	88%	0%	12%	0%
Russia	16%	0%	83%	1%
EM	55%	8%	34%	3%

Divergence within EM Universe has led to dispersion in returns

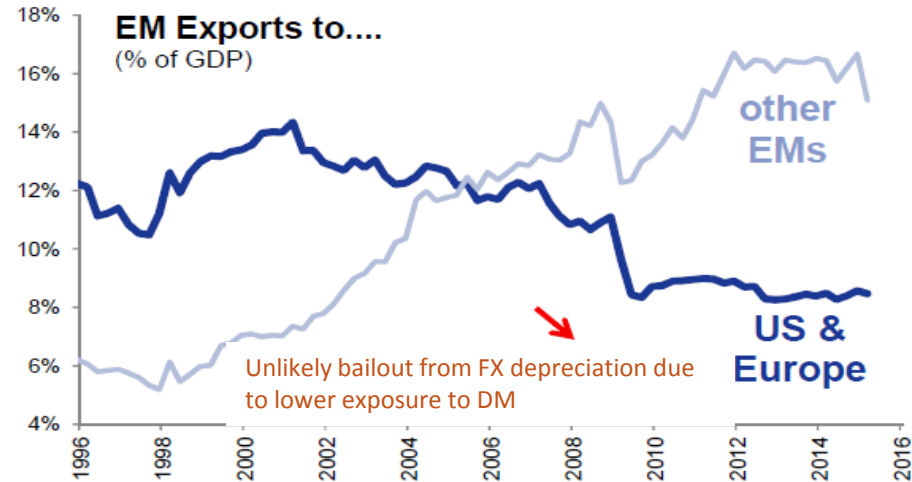
- EM countries have seen large dispersion both in local and USD returns
- Commodity driven country have witnessed large fluctuations in their currencies
- Wild swings have resulted in wide valuation dispersions
- EM exposure to DM has declined while EM exposure to other EMs has jumped

Source: Bloomberg

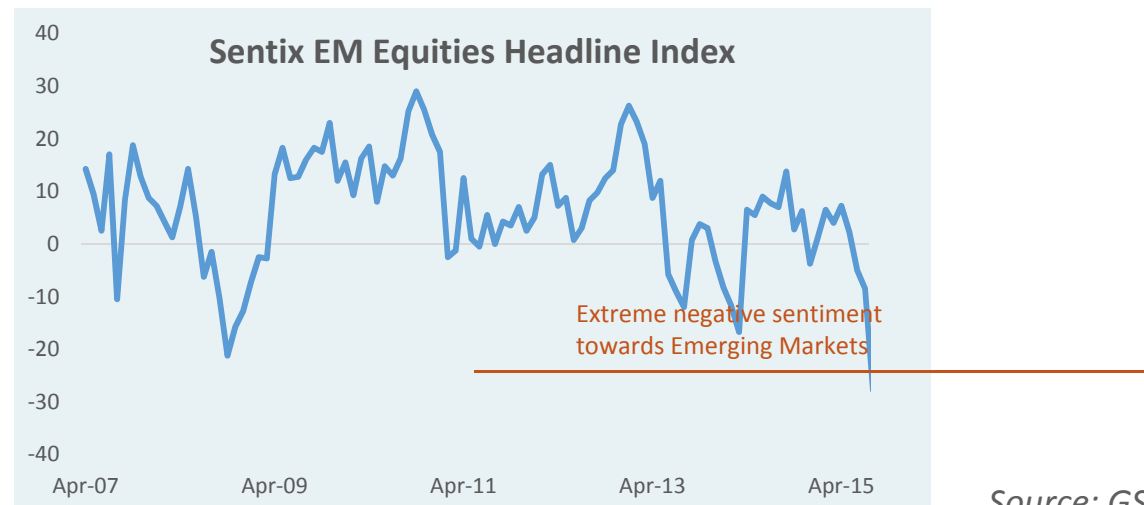
Source: GS

Emerging markets – What to Expect?

POSSIBILITY OF CURRENCY DEPRECIATION BAILOUT



INVESTOR SENTIMENT FOR EM EQUITIES AT AN ALL TIME LOW

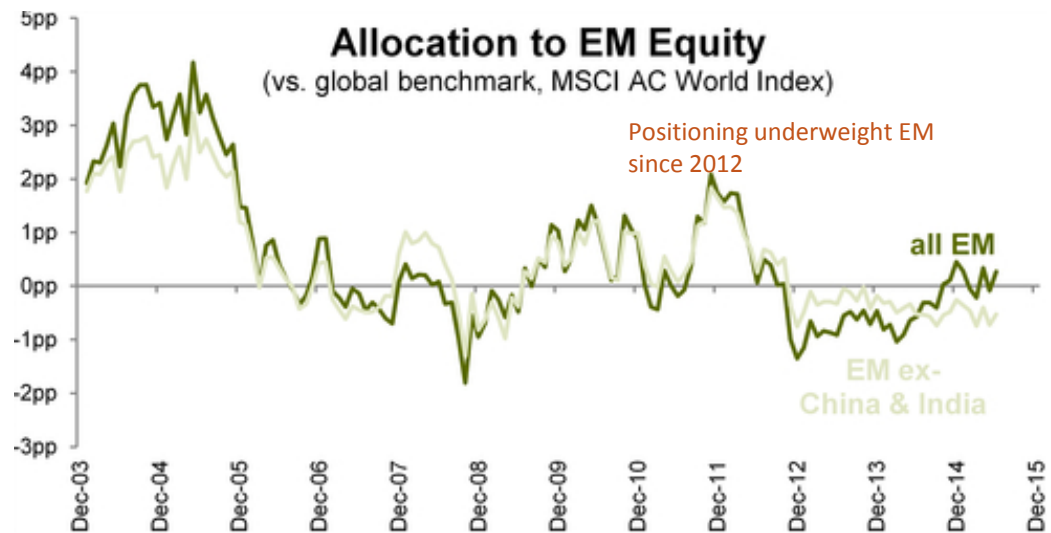


Source: GS

What to Expect?

- Historical fundamentals have changed
- Macro headwinds and country specific issues to continue
- Consensus remains bearish
- Dispersion to continue and can be exploited through emerging clusters within EM such as
 - Commodity exporters vs importers
 - DM exposed vs China Exposed
 - Consumer oriented vs Investment oriented
- ***It is time to start looking into allocating money to EM***
- ***All bodes well for active management***

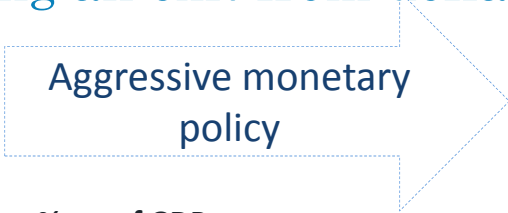
GLOBAL EQUITY MANAGERS ALLOCATIONS



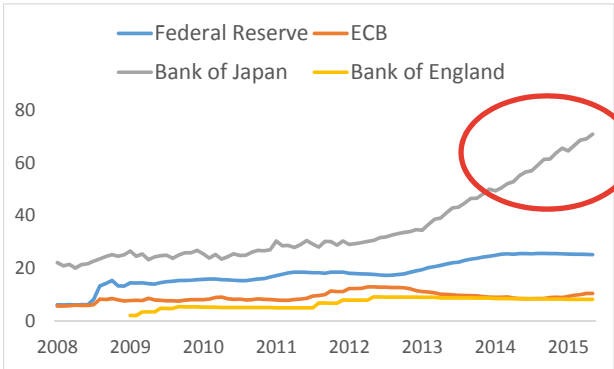
Thematic investing in Japanese equities

Abenomics recap

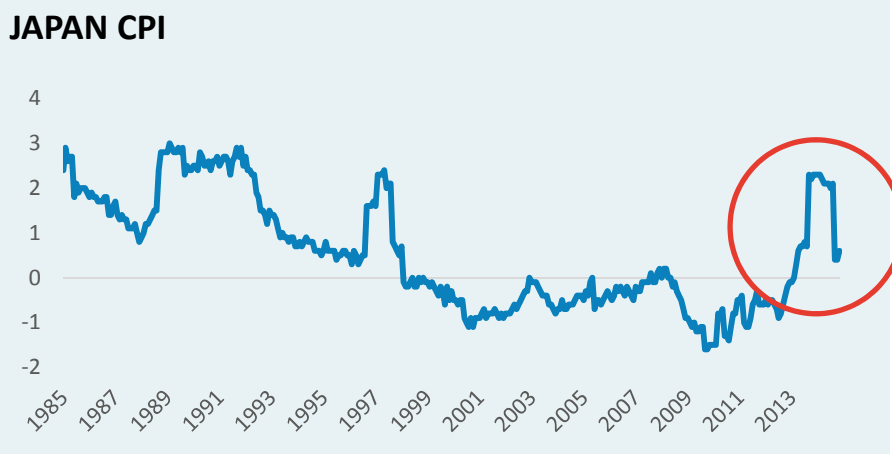
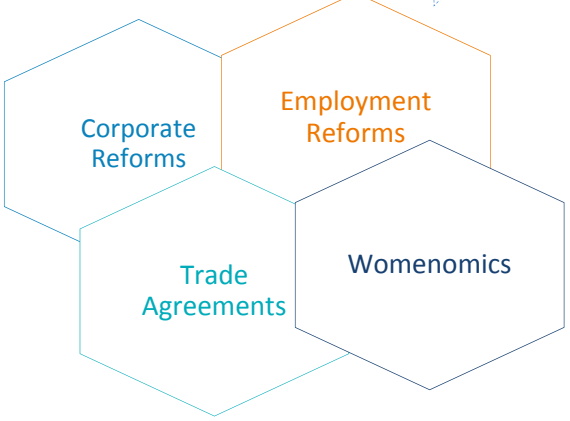
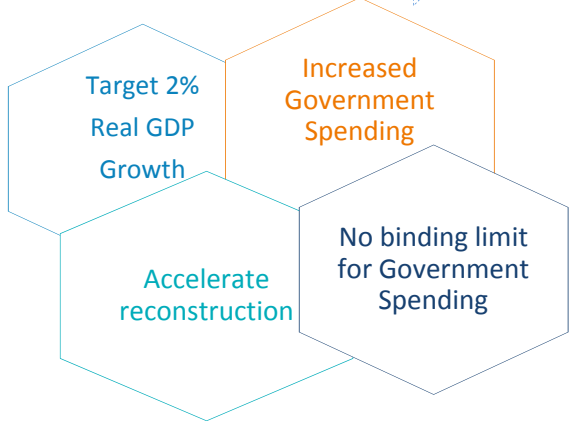
3 arrows targeting an exit from deflation



QE as %age of GDP



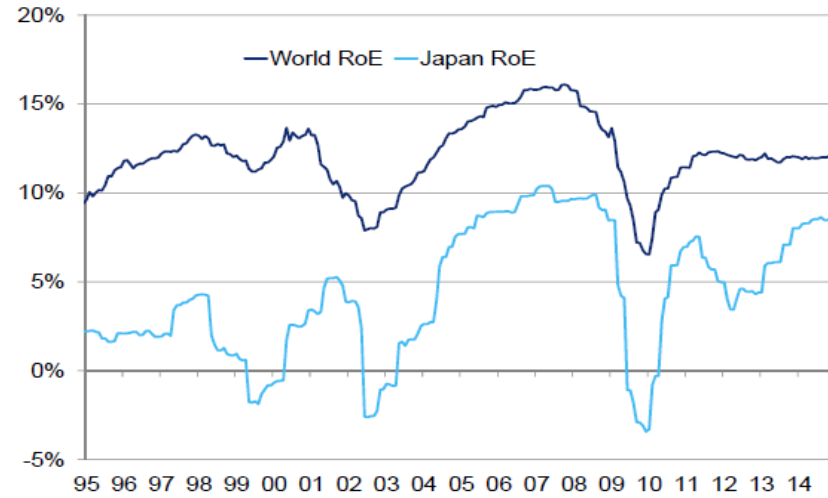
Source: Bloomberg



Source: Bloomberg

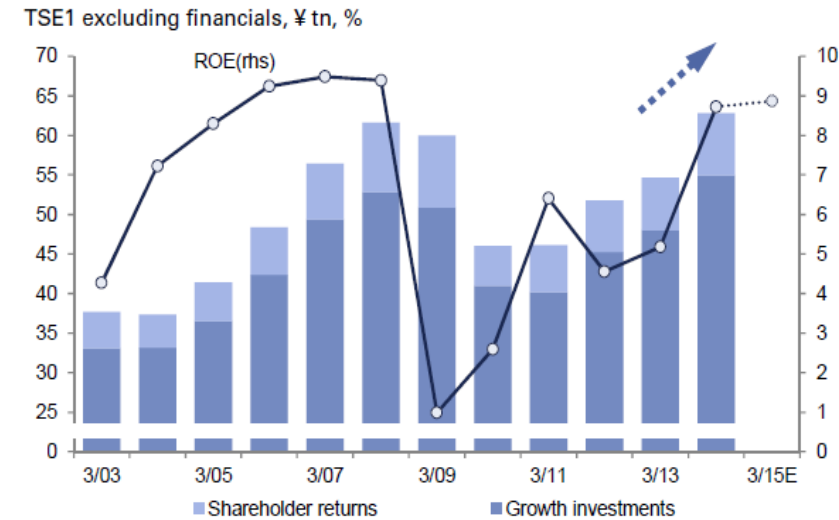
Structural Changes in Japan

Corporate reforms targeting cultural change in corporations



Source: Citi

Historically, shareholders have not been the top priority for managements



Source: GS

Cash hoarding preferred over dividends and reinvestments

Comply or explain



Cross-shareholdings disclosures and dialogue with shareholders

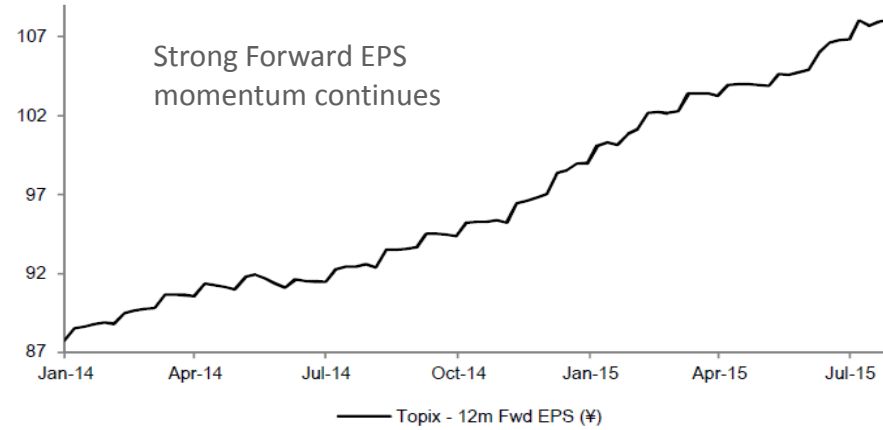


Improve governance through independent directors

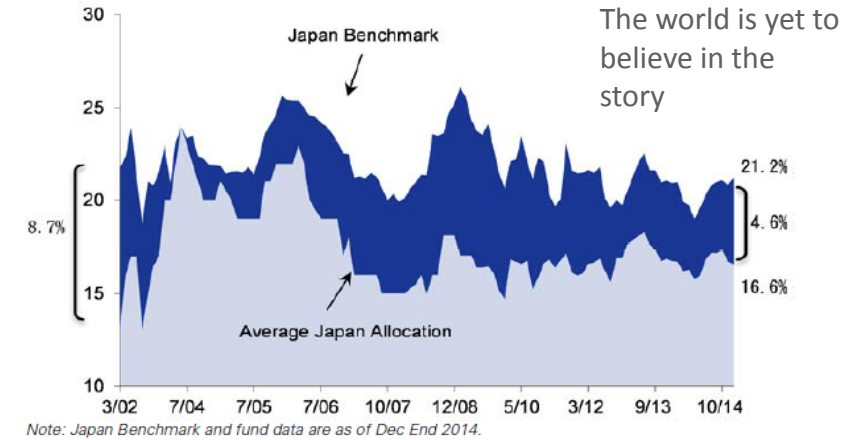
Equity implications

If proved effective, corporate reforms can continue to have significant implications

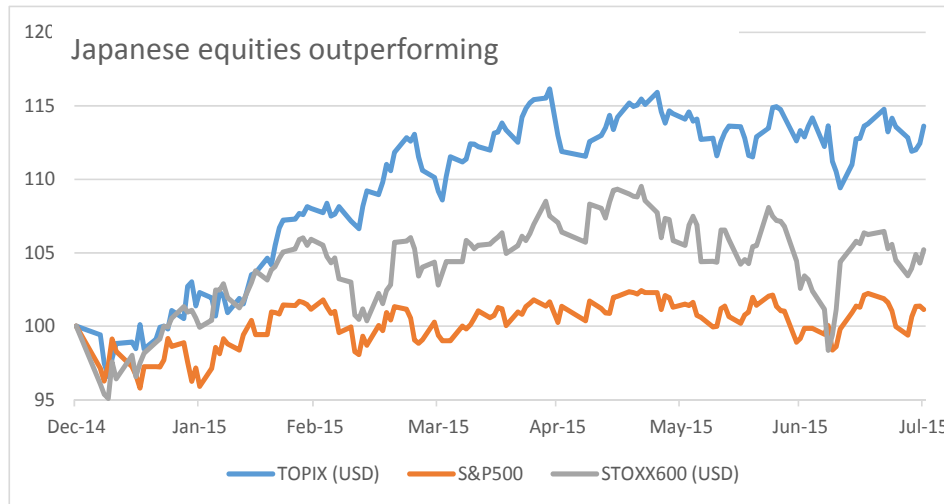
TOPIX 12M FWD EPS



GLOBAL ACTIVE MANAGER ALLOCATIONS TO JAPAN

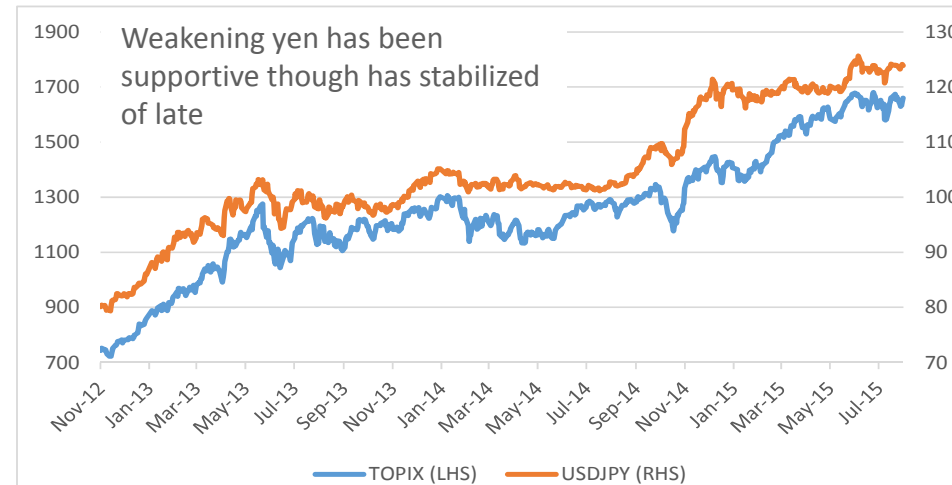


TOPIX VS US AND EUROPE IN USD



Source: Citi

TOPIX VS JPY



Source: GS