

MARKET MATTERS: 4TH QUARTER 2023

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"Investors should be fearful when others are greedy, and greedy only when others are fearful" – Warren Buffet

TAKEAWAYS

- 2023 showed a resilient American economy, along with the volatility of both bearish and bullish financial markets.
- A run up in stocks creates fear of missing out when investors should be fearful of buying in. Don't mistake volatility for value.
- The best offense is a good defense. Diversification maximizes long-term performance.

YEAR IN REVIEW

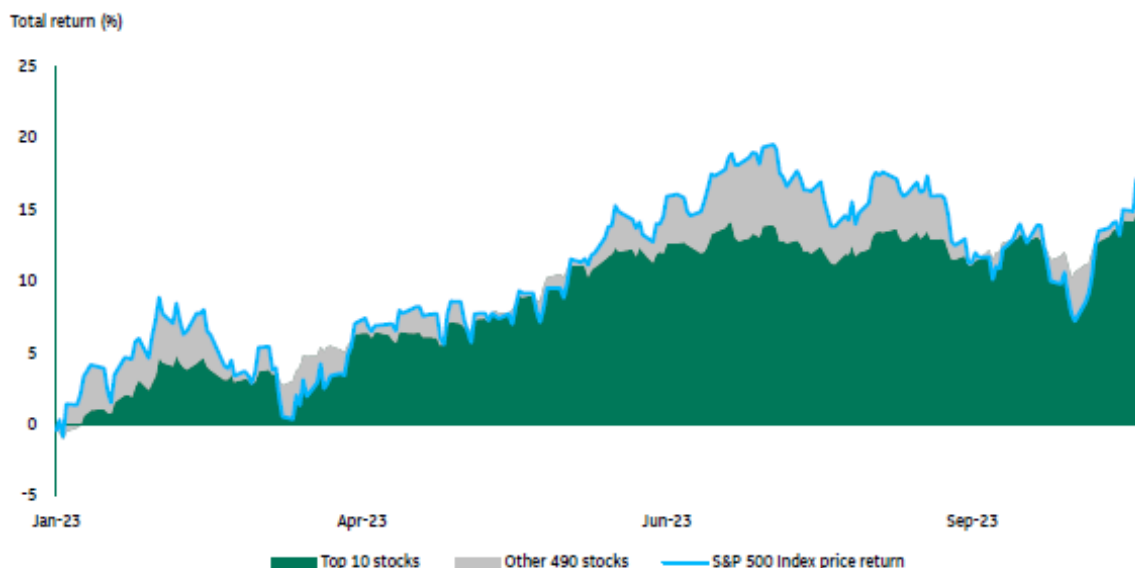
The S&P 500 started the year priced at 3,840, just off the trough of its drawdown in 2022. At the end of 2023 it ended almost 1,000 points higher, nearly recovering its all-time high at year-end 2021. In between, investors witnessed a period marked by high volatility in both prices and sentiment, as the Fed slowed and then indicated an end to its rate hiking cycle and market participants played the "will we or won't we" recession guessing game. Inflation now seems to have solidly decelerated, with consumer spending having slowed just enough, but not too much. Mild recessionary forces rolled through rate-sensitive sectors without causing an overall economic decline. Many market analysts are cautiously optimistic about the year ahead.

YEAR IN REVIEW: 2023 IN THE U.S. ECONOMY

Category	How it Started	How it's Going	Impact
Inflation (CPI)	6.5%	3.1%	Positive +
Fed Funds Target	4.25-4.5%	5.25-5.5%	Negative -
Unemployment rate	3.4%	3.7%	Neutral +-
Housing	Peak housing prices, home sales near all-time lows.	Minimal price declines, home sales post incremental decline.	Neutral +-
EPS growth	EPS growth negative, corporate earnings in "Earnings Recession."	EPS growth positive, EPS values forecasted to rise.	Positive +
S&P 500 Index	3840	4770 (+24%)	Positive +
Real Personal Income (USRPI)	15.4 trillion	15.9 trillion (+3%)	Positive +
Consumer Spending	13,983 trillion (Q4 2022)	15,461 trillion (Q4 2023)	Positive +
Retail Sales	4.9 trillion	Est. 5.1-5.2 trillion (+4-6%)	Positive +
Industrial Production (100+ = positive performance)	101.5 (Dec 22)	102.7 (Dec 23)	Positive +

FROM BEAR RUT TO BULL RUN

A bull run in stocks tends to spark an intense “fear of missing out” for investors that are diversified away from a concentration in large cap market exposure, especially those invested in alternatives with longer time horizons and variant return profiles. With a soft landing more likely and public markets generally expected to post good returns, it is tempting to forego diversification to take advantage of “easy” index returns.



Source: Macrobond (November 2023).

Buyer beware: large cap growth stocks are looking very expensive, after a considerable run up at the end of last year. Forward P/E ratios for the S&P 500 are around 19x, compared to a low of 15.7 in October 2022 and a high of 21x in January 2022. The weight of the top 10 stocks in the S&P 500 is 32% based on market capitalization. These 10 have a current P/E ratio of 27.8x, bumping up the cost of buying the index while their weight significantly reduces the diversification of the 500 company basket. Mega cap tech with an almost 30x price-to-earnings ratio crowds out the impact of the remaining 490 constituents (see above). Instead of 500 companies, the index often acts like it holds less than a tenth as many. While the returns on these holdings can be impressive when they are in favor, these are the same stocks that led to the 25% decline in the index in 2022. The end of 2023 constitutes no more than price recovery.

VALUE VS VOLATILITY

For most investors, the pursuit of long-term value is what matters in a portfolio. In bull markets, fast-paced market changes in public equities can distract from this fact, but what matters is value, not volatility. The end of 2023 was a long-hoped for recovery from the pain felt in 2022, propelled by the end of monetary tightening and predicted easing in 2024. This year, investors may see positive results if interest rates come down, along with inflation reaching the Fed's goal, unemployment ticks up only modestly and growth is modest and on-trend. However, even in a more offensive context, the best offense is still a good defense. Diversified value protects a portfolio from unwelcome and unexpected drawdowns, safeguarding long-term performance.

Strategic asset allocation toes the line between prioritizing diversification or growth. Why not invest everything in the assets with the highest projected returns? To do so would be an inefficient use of risk. Diversification lowers risk and enhances risk-adjusted returns. For instance, adding bonds to a portfolio will typically lower overall return, but it will also lower overall risk and improve liquidity, making bonds attractive even though they perform less well in isolation. With alternatives, this story plays out in a more compelling manner. Alternatives tend to lower portfolio risk, without lowering expected return.

A HISTORICAL LOOK AT RISK AND RETURN (10 YEARS):

Allocation	Volatility	Annualized Return
60% Stock / 40% Bond	9.6%	8.5%
50% Stock / 20% Bond +30% Alts	9.5%	9.5%
40% Stock / 30% Bond +30% Alts	7.9%	9.0%

If you start with a 60/40 portfolio and take 10% off of stocks and 20% off of bonds to fund a private allocation (represented by a broad spectrum of alternatives in the above), this increases the model return by 1% annually while decreasing volatility. If, more conservatively, the allocation trims bonds by 10% and public equities by 20%, the annualize return still increases by 0.5%, while the volatility decreases by 1.7%. An impressive result.

FOUR PILLARS OF PRIVATE INVESTMENTS

To the right is a brief look at four core private asset classes and their benefits in terms of risk, return and income. Not only do they offer portfolio protection in the form of lower historical correlations to traditional asset classes, they also offer attractive returns. When allocating assets in a portfolio, any correlation less than 1 will add a diversification benefit, while negatively correlated assets that provide adequate returns offset risk while still providing upside (a win-win).

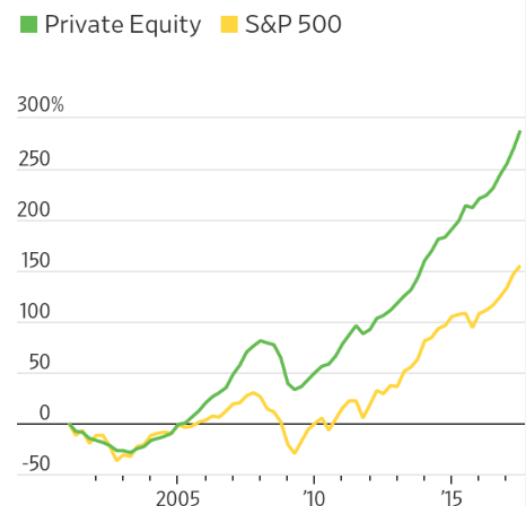
Asset Class	Correlation to 60/40 Portfolio	Annualized Return	Income Yield
Infrastructure	0.2	9-12%	Highly consistent income above or equal to HY bonds.
Real Estate	-0.3 – 0	8-12%	Income-oriented Funds offer a premium to HY bonds.
Private Equity	0.8	15+%	N/A
Direct Lending	0.7	8-10%	3+% premium over HY Bonds.

Relatively lower correlations between assets/classes within a portfolio are generally positive for performance on a risk-adjusted basis. J.P. Morgan estimates a 0.8% correlation between global public equities and Private Equities, and a 0.7% correlation between direct lending and global equities, implying moderate diversification. When public markets fall, these only fall 70-80% of the time. Meanwhile, a 0% correlation between direct lending and global bonds would imply stability in the private sphere compared to volatility in the public fixed income sector. Infrastructure has a <0.2 correlation with a 60/40 portfolio, implying that out of 10 drawdowns, infrastructure returns only suffer twice. Portfolio diversification as a strategic move can provide volatility-reducing, anchor returns from investments that deliver stabilization with attractive upside.

These core private strategies offer clear benefits - lower volatility and risk-adjusted return premium over the long term. But with new lock-up investments, the J-curve can be painful to experience, even more so when the public markets have a rapid rise. Fund fees and expenses draw down valuations before offsetting income is generated or investments are marked up and profits are realized. The muted performance on paper can last for years. However, in the long term, patience in building an asset allocation geared towards lower risk and higher overall

Private vs. Public

Percentage change, assuming profits are reinvested



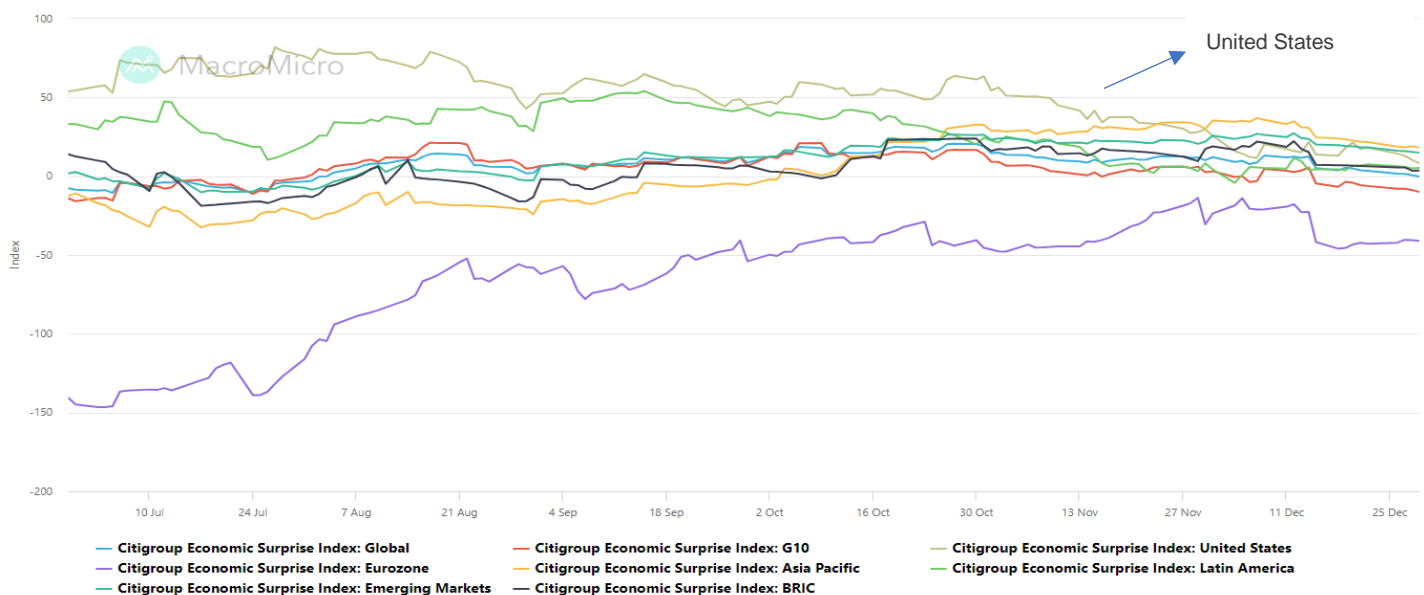
Source: Preqin

returns can pay off over the life-cycle of a portfolio. As they say, offense wins games, defense wins championships. The best long-term strategy is to reinvest distributions into new vintage funds to further diversify a portfolio over time and keep a portfolio in line with target as much as possible. Increasingly, more flexible fund structures are giving investors liquidity options and shorter time horizons, though these may come with strings attached that require careful consideration (gates, additional fees, etc.).

PUBLIC MARKETS VULNERABILITIES

The top 10 stocks in the S&P 500, 32% of the index's market capitalization at year-end 2023, include Apple, Microsoft, Amazon, NVIDIA, and Alphabet/Google. Apple and Microsoft alone make up over 13% of the index by weight. On paper, the S&P 500 represents 80% of the investable, publicly listed, U.S. equity universe. In its behavior, the returns of the index represent the returns of relatively few stocks, all of which trade at a huge valuation premium to the overall market. These top stocks are, unsurprisingly, highly correlated and highly volatile. They tend to move in the same direction, at the same time, negating the apparent diversification of broad index exposure. Though they are expensive, the heavy hitters in 2023 are not expected to earn their keep. Of the 169 global companies that are currently forecasted to have earnings growth of 25% or more, only 3 of the top 7 S&P 500 stocks made the cut, and they ranked 52nd, 159th, and 162nd (none close to top quartile). The top holdings bode for poor relative performance as rich valuations revert to the mean.

Exogenous shocks also impact publicly traded equities the most. While individual conflicts will come and go, higher levels of geopolitical risk are expected to be a durable feature of the investment landscape. Climate change, including heightened natural disaster risk, also poses an outside threat. AI and other technology will change the economy and investment reward profiles, but while new technologies are promising, the promise is one of change, not of profit (yet). Some companies working heavily on AI have seen valuations soar on unrealistic profit forecasts that are likely to never materialize. Investors should be cautious in positioning portfolios with the mindset that unexpected vulnerabilities will arise. Below is the Citi



Economic Surprise index for the last 6 months. A high number on the left axis indicates a higher probability of a positive surprise, expected to boost sentiment. A negative number indicates a negative surprise being more probable, creating impetus for a sell off. The United States (top line for most of the period) has consistently come down from over 50 to close to 0. Tomorrow's headline could cause a sentiment rally or selloff. Don't let your guard down – the best offense is a good defense.

2024: MANAGER COMMENTARY ON THE YEAR AHEAD

JP Morgan, “Guide to the Markets”

2% growth, 0 recessions, 2% inflation, 4% unemployment.

Economic growth is likely to slow, bringing valuations under pressure. Alternative investments can support the outcomes investors seek in portfolios, like diversification, inflation hedging and [higher risk-adjusted returns]. Step out of cash and into risk assets while maintaining diversification.

Macquarie, 2024 Outlook “A World in Transition”

Global Debt and Credit Markets: Patience may be rewarded in 2024

With inflation falling, gross domestic product (GDP) growth slowing, central banks pausing...we see investment grade bonds as good value and we are constructive on duration. In the US, municipal bonds and agency mortgage-backed securities (MBS) also offer a good risk-adjusted return proposition, in our view. Credit spreads are generally not at levels consistent with recessionary conditions, so we are more cautious on credit, particularly higher-risk credit.

Global Listed Equities: Searching for value amid market volatility

Listed equities may face headwinds from the more volatile economic backdrop and the fact that bonds have become a worthwhile alternative again. While US large-cap stock valuations look stretched, opportunities may remain in small-caps and listed real assets. Outside of the US, China and Europe look increasingly attractive on valuation grounds.

Real assets: Cyclical challenges but positive longer-term drivers

Infrastructure continues to be relatively well placed in 2024 due to its defensiveness, ability to protect against surges in inflation, relatively high yield, and robust policy support globally. It also has a large exposure to the secular growth trends of digitalization and decarbonization (and inflation protection).

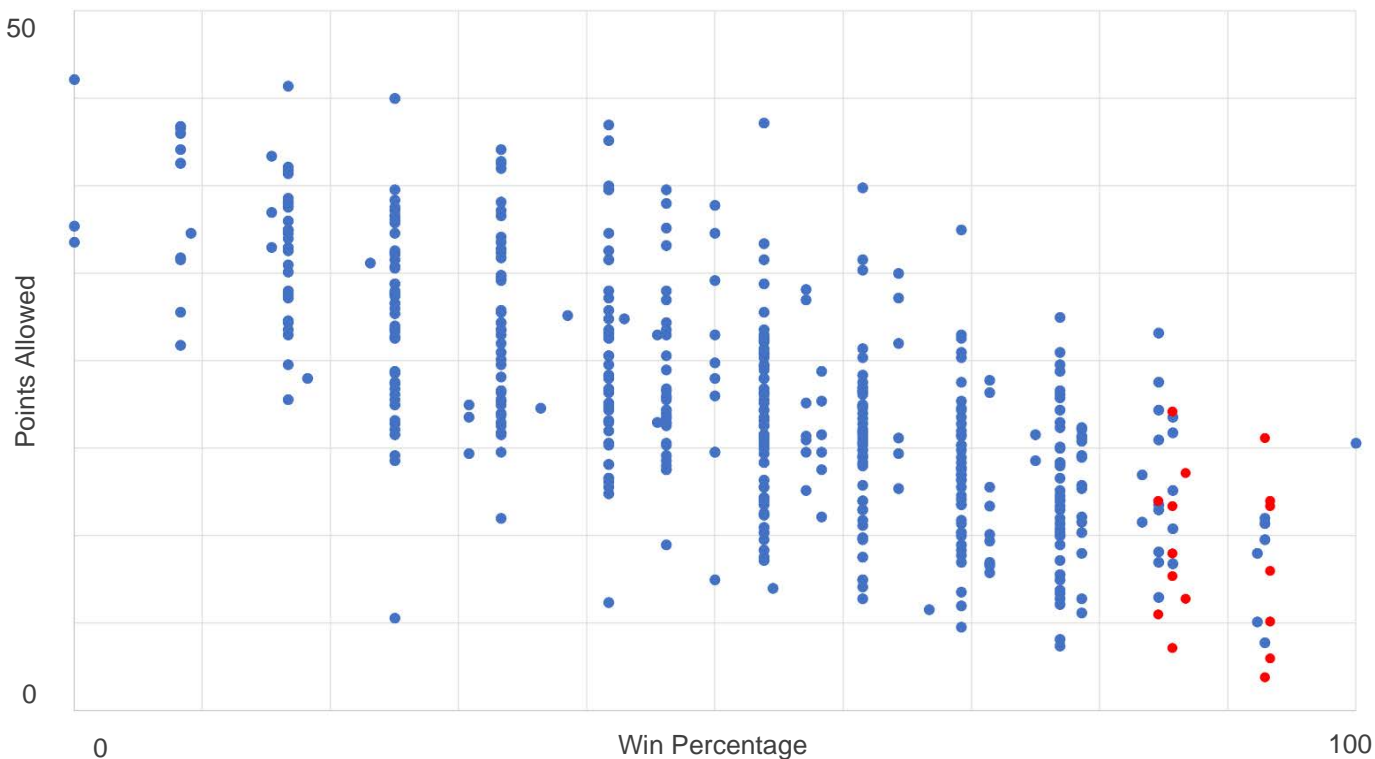
Following two challenging years, real estate’s pricing reset is expected to create opportunities particularly in the rental housing and logistics sectors, supported by stronger demand drivers and a pullback in new supply. Offices face ongoing headwinds from working-from-home practices, but repurposing and repositioning opportunities could emerge in 2024 as pricing adjusts below replacement costs.

THE BEST OFFENSE IS A GOOD DEFENSE: MAXIMUM DIVERSIFICATION

Monetary policy may be resigning, but we don’t know what will fill the power vacuum for shaping investor sentiment. Shake off the fear of missing out in favor of staying the course and staying defensive. The outlook for the year ahead is optimistic for investors, but diversifying away from concentrated risk that can be overbought or oversold as fast as a new headline can be published will reward investors in the long-term. “Win by not losing” is a simple, and still effective, rule for investing.

Asset Class		Relative Value Conviction		
		Low	Medium	High
Private Real Estate	U.S. Core Real Estate			
	Europe Core Real Estate			
	APAC Core Real Estate			
Private Real Assets	Global Core Infrastructure			
	Global Core Transport			
	Global Timberland			
Listed Alts	U.S. REITs			
	Global Listed Real Assets			
Private Alt Credit	U.S. RE Mezzanine Debt			
	U.S. CMLs			
PE	Private Credit Secondaries			
	Private Equity Secondaries			

Appendix: NCAA College Football Playoff Games: “Defense Really Does Win Championships”



Each dot represents a game over the 2014 – 2018 seasons.

Each red dot is a team that made the playoffs. No CFP winner gave up more than 22 points on average – all were at least 20% below the mean # of points allowed.

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