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IQ

32nd Edition | Winter 2016

Investment Quarterly

After the Rate Rise

With U.S. interest rate increases finally out of the starting gate, investors are looking to what's next. In the first quarter, market volatility has cast light on a number of issues facing investors today. In this edition of *Investment Quarterly,* we examine one of them, market breadth, and what it may mean to equity markets in 2016. We also compare public and private markets, look at what can happen when investors try to time the market, and reveal the surprising negative consequences of not updating IRA beneficiary designations.

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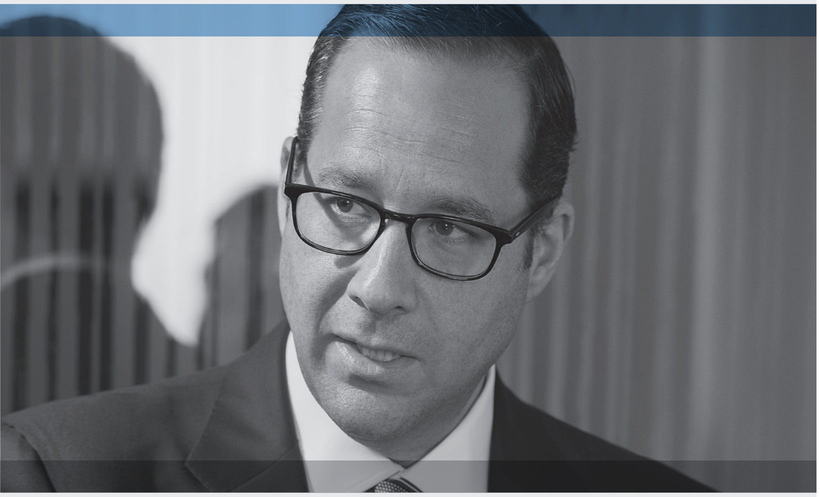

HIGHLIGHTS 1Q16

FROM THE ASSET ALLOCATION COMMITTEE

U.S. large cap equities: We moderated our 12-month return outlook to neutral given the U.S. equity market's recent run and tepid corporate earnings prospects in 2016.

Developed markets non-U.S. equities: Ongoing quantitative easing, along with resilient economic data in the eurozone and relatively attractive valuations, contribute to our favorable outlook for European equities.

Global fixed income: We adjusted our view of global fixed income upward to slightly underweight, fueled by expectations that buying opportunities may arise across global bond markets as rates rise and the dollar stabilizes.

High yield fixed income: Despite volatility, which will likely continue, we have a favorable view of high yield bonds given their intact fundamentals and relatively steady default rates.

Directional and lower volatility hedge funds: We continue to hold a favorable view of directional hedge funds and lower volatility hedge funds, which may be helped by the onset of monetary tightening in the U.S. We are also constructive on the distressed and equity long/short segments.

This quarter, we're watching

1. The U.S. election cycle
2. Commodity price dynamics (particularly oil and natural gas)
3. Ongoing divergences in global monetary policy
4. Currency movements
5. Earnings expectations for 2016

The First, Important Step Toward Rate Normalization

In December, after much anticipation, the Federal Reserve lifted interest rates for the first time since 2006, and has signaled its intent to follow a gradual path to policy normalization. Within this overall trend, suspense will likely build around each Fed meeting, as FOMC members and the markets debate the proper course of action. In light of the stimulus in recent years this is, to a certain extent, uncharted territory for U.S. monetary policy and will likely produce periods of volatility.

Meanwhile, the ground is shifting underfoot from a fundamental perspective as China's growth path remains uncertain, U.S. corporate earnings tread water and equity multiples appear fully valued. Among the investment segments we favor are European equities, higher-quality non-investment grade debt, and lower-volatility and directional hedge funds.

In our winter edition of *Investment Quarterly*, we examine the implications of narrow market leadership; survey the current public and private equity landscape; analyze how disruptor brands are shaking up the consumer packaged goods industry; and offer a wake-up call for those who haven't checked their IRA beneficiary designations lately. We hope you enjoy *IQ*. Please contact your advisor with questions about the markets or your portfolio.

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IN THIS ISSUE

ARISTOCRACY IN THE S&P 500

WHAT NARROW STOCK LEADERSHIP MEANS AND WHETHER WE MAY BE IN AN EQUITY MARKET BUBBLE.

Investment Strategy Group

Market followers may have noticed a theme in stories about equities lately, with headlines like "Only Six Stocks Responsible for Total Returns" and "Four Stocks Have Driven the NASDAQ." Some investors worry that narrow leadership is an early sign of a stock market bubble, as it has at certain times in the past. For others, a period of narrow leadership seeds a concern that not holding particular names may cause them to miss out on performance.

Below, we take a closer look at annual S&P 500 returns over the last 20 years and compare periods of narrow market leadership. While today's market leadership may be tighter than average, an evaluation of multiple factors may suggest we are not experiencing a market bubble, while lower return dispersion overall could help explain the challenges facing active managers today.

1. Narrow Leadership Is Potentially Less Meaningful When Market Returns Are Low

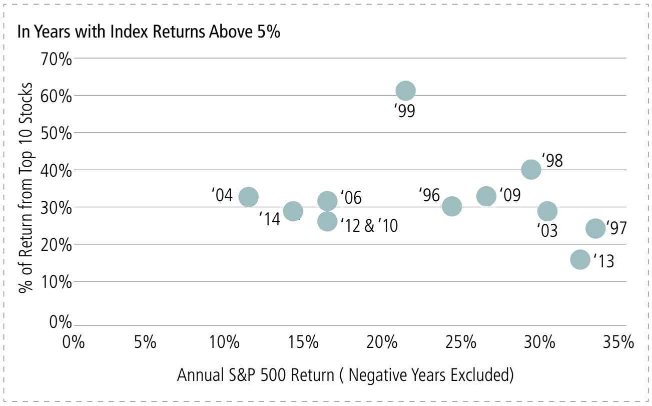
The narrow stock leadership story is an easy one to tell during periods when return levels are low. If the total return for the S&P 500 is 3%, for example, it can be easy to find a few stocks that together account for that total amount. During periods when market returns are higher, however, finding a few names that contribute such a high percentage of index returns becomes more challenging.

Let's examine contributions of the top 10 stocks to the S&P 500's annual returns over the last 20 years during positive return years. In years when the total market return has been low (0% – 5%), the percentage of returns coming from the 10 best-performing stocks is extreme. In 2011, for example, when the S&P 500 returned just over 1%, the top 10 stocks were responsible for over 300% of the total returns. For 2015 returns through the end of October, the S&P 500 was up 2.7%, and the top 10 names accounted for 112% of market returns.

Once the market is out of this very low return range, we see a more typical pattern in which the 10 best stocks have accounted for 15% – 35% of total market returns. In these markets, we can point to two periods of unusual narrow leadership: In 1998, the S&P 500 returned 29% and the top 10 stocks accounted for 40% of returns. And in 1999, the S&P 500 returned 21%, and the top 10 stocks contributed

61% of returns. Today, we know with the benefit of hindsight that, in 1998 and 1999, the Tech Bubble was forming, with a small number of technology stocks outperforming the overall market by a wide margin.

CONTRIBUTION OF THE TOP 10 STOCKS



Source: FactSet. Data reflects total returns for the S&P 500 for each calendar year, except 2015 year-to-date, which is through October 30, 2015. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

2. Today's Market Does Not Appear to Resemble a True Bubble

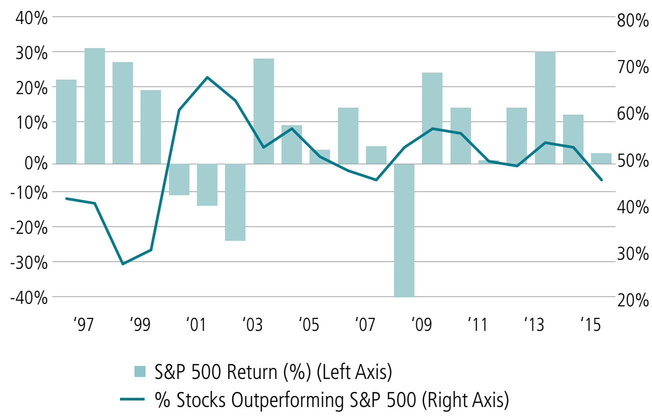
Another way of gauging market breadth is to look at how many stocks outperform the index during a calendar year. Doing so yields two pieces of information: First, how much is the index being driven by a small number of names versus broader performance trends? And second, how might this impact active managers' ability to outperform the benchmark in such an environment?

As you might expect, the average number of stocks outperforming the index hovers somewhere around 50%—about half of the stocks outperform, and about half underperform. Looking at the market this way reveals which periods deviate from the usual pattern and, again, the Tech Bubble stands out. From 1996-1999, only 27% – 40% of stocks outperformed the index, a much *lower* number than is typical—the S&P 500 during those years was driven up by a distinctly narrow group of high-performing names.

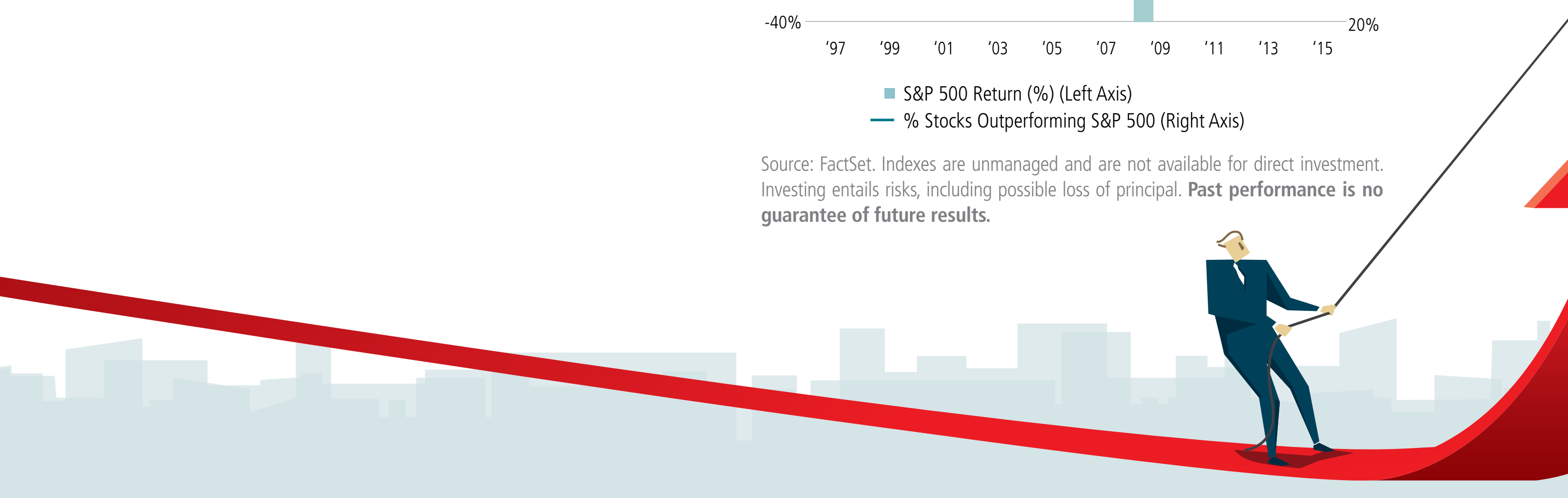
In 2000 – 2002, a considerably *higher* percentage of stocks outperformed the index, peaking at 67% in 2001. In contrast to 1996-1999, these were years of overall market losses; in this case, a small group of stocks was responsible for dragging the index down. Previously, during the formation of the Tech Bubble, a select group of high-returning companies had driven returns; when the bubble burst, a select group of plummeting names drove losses.

The Tech Bubble was an atypical market period. More often, the S&P 500 has been driven by broader performance trends, and the number of stocks outperforming the index has hovered around 50%. As for 2015 (year-to-date through October), the trend is a little below average, with only 45% of the 500-odd stocks in the index outperforming. But it is not the extreme case we observed in other market environments. In our view, given that this indicator has tended to be mean-reverting to around 50%, we believe that market breadth could pick up in the near future.

BUBBLE BURSTERS: DURING TECH BUBBLE, A FEW STOCKS LED THE WAY UP—AND DOWN



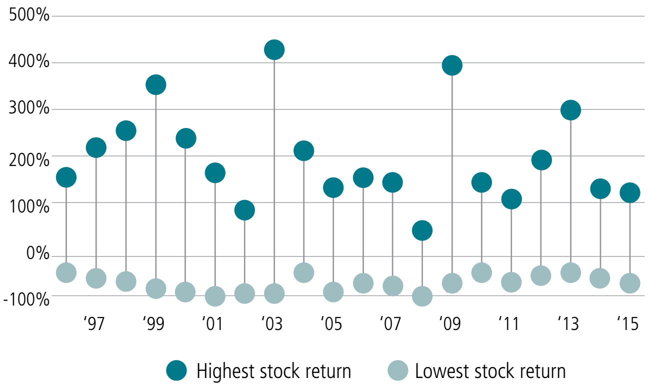
Source: FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**



3. Wider Return Dispersion May Favor Active Managers

A final way we can examine narrow leadership is to ask how widely dispersed stock returns are within the index each year. We can look, for example, at the magnitude of the range between the single best- and worst-performing stocks for each calendar year. In some years, there is a tight range between the top and bottom performers; in other years, the gap is wider.

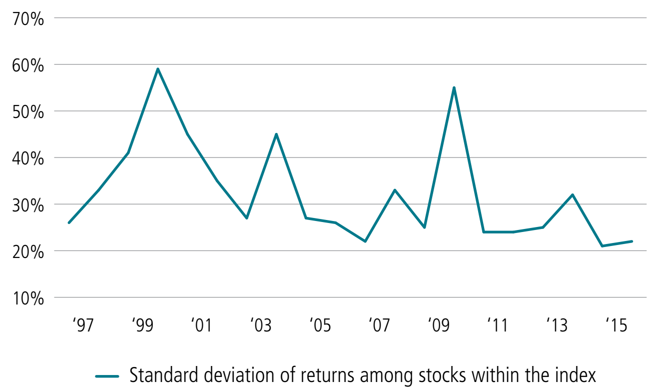
MITIGATED MAGNITUDE: CURRENT MARKET SHOWS RELATIVELY TIGHT RANGE BETWEEN TOP AND BOTTOM PERFORMERS



Source: FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Of course, this only tells us about the best and worst performers in a given year; perhaps these are outliers that misrepresent the index. For a more technical, but also a more nuanced picture, we can examine the dispersion of returns for all of the stocks within the index for each calendar year, calculated using standard deviation. This gives us the performance range for a bigger set of stocks. In years when the standard deviation is lower, there is a tighter band of returns among stocks in the index. Indeed, in recent years, the band of returns has been tight, with most stocks in the same, narrower performance range. This suggests that it may be more difficult for stock pickers to outperform the index in a calendar year if their selections don't significantly outperform.

AN ACTIVE DILEMMA: PERIODS OF LOWER RETURN DISPERSION CAN MAKE STOCK PICKING A CHALLENGE



Source: FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Today's Markets: Not Extreme, but Slightly Narrower than Average

Taken together, these measures paint a general picture of the current market environment. Whether we measure market breadth using the contribution from the top returning stocks, the range of stock returns or dispersion between stock returns in the index, it's clear that market breadth within the S&P 500 has been narrower this year than the historical average. Consequently, we believe the environment continues to be a challenging one for stock picking.

Fortunately, our analysis of the markets does not suggest that we are in an extreme environment like the Tech Bubble with large imbalances driving returns. As such, we believe the market structure appears healthy and that returns may be driven by fundamentals. Over the longer term, we believe that market breadth statistics are typically mean-reverting and could broaden in the near future.

What is Narrow Leadership?

When people talk about narrow leadership, they usually mean that a few stocks are contributing to returns in the broader market. Sometimes the outperformance of the few stocks is small, but sometimes it can be quite a gap. In extreme cases, when the outperformance is large and attributed to just a few names or a single sector, it can even indicate that a bubble is forming or that some other imbalance is driving the market.

ASSESSING RISKS AND OPPORTUNITIES IN PUBLIC AND PRIVATE MARKETS

Joseph Amato, President and Chief Investment Officer—Equity
Anthony Tutrone, Global Head of Alternatives

We want our managers to remain disciplined and focus on the rigorous fundamental analysis that has produced solid results over time.

The years since the financial crisis have seen increases in valuations for both public and private companies, but modest economic expansion and flattening corporate profit growth present possible headwinds for continued appreciation. Nonetheless, both markets offer opportunities with attractive yield and return potential. Joseph Amato, President and Chief Investment Officer—Equity, and Anthony Tutrone, Global Head of Alternatives, recently discussed potential opportunities and challenges associated with private and public equity markets.

Elevated Equity Valuations in both Public and Private Markets

JOSEPH AMATO: We are cautious as we look at the public equity markets, in large part due to interest rates and the Federal Reserve. Historically, at the beginning of rate-tightening cycles, equity markets have been choppy, which is understandable, as investors assess the impact of higher rates on economic activity. Also worrisome at this point in the business cycle is stagnant earnings growth. Earnings for 2015 will end up flattish—modestly down if you include the energy sector, modestly higher if you exclude energy. For 2016, forecasts call for 8% to 10% earnings growth which, in our view, seems aggressive given the slow-growing economy and revenue growth, which has been hard to come by.

Public equities are more fully valued in our opinion, especially given the challenging macro environment. A narrow group of stocks is driving equity indices, which makes beating the benchmark more challenging. Either you jump on the bandwagon and buy those momentum stocks at high valuations, or you stick with your discipline. We want our managers to remain disciplined and focus on the rigorous fundamental analysis that has produced solid results over time.

ANTHONY TUTRONE: Over the last several years, multiples in the public markets have increased more than those in private equity. The Russell 2000, for example, has gone from a valuation of 12.0 times earnings as of the end of 2008 to 21.0 times, as of the end of 2015. By comparison, private equity multiples have expanded from 8.8 times to 10.3 times during the same period, a much smaller move. Although we consider both markets to be at fairly high valuation levels, the discount for private equity has not only been maintained, it has grown, so it appears as though there's an opportunity to buy companies less expensively in the private markets.

Keep in mind that valuation is only part of the story in private equity. In addition to being disciplined on price execution, operational expertise and improvements in the business are important factors contributing to more attractive returns in buyout strategies. It's important to focus on manager selection, transaction selection and making sure that managers are properly aligning themselves with investors.

In venture capital, we believe early-stage situations are more attractive, with valuations that are far more modest than they are in the so-called "unicorn" companies with multibillion-dollar valuations. In our view, the opportunity in those unicorns has diminished, and many are having an increasingly difficult time going public at valuations higher than in the last round of capital raised.

Mergers and Acquisitions Contributing to Shareholder Value

AMATO: Companies will continue to pull financial levers to support earnings in a slow-growth environment, and mergers and acquisitions are one way to do so. Accordingly, we believe M&A will continue although credit markets are stressed, which may impact overall deal volume. Interest rates, though rising, are likely to remain low compared to historical standards. Margins for large companies are at peak levels, and the drivers of margin enhancement over the course of the past four to six years of the cycle—labor costs, energy costs, interest rates and tax rates—may act as a headwind over a similar forward-looking time horizon. These factors that have boosted profit margins do not appear to us to offer much upside in the future, which may enhance the appeal of M&A. The pace of mergers and buyouts will likely remain robust, and we believe that's positive for shareholders.

TUTRONE: Given what's going on in the commodity markets, which has spilled into the credit and equity markets, there have been significant redemptions in public equity funds and less money to participate in initial public offerings. We believe the highest-quality IPOs will still get done, but it's a challenged environment and private equity firms are likely to be more dependent on M&A for exits. With a slowdown in China and higher interest rates in the U.S., companies are looking to buy growth because, as Joe said, organic growth is difficult to achieve.

With regard to M&A, it's important to point out that there are two distinct stories when comparing the U.S. with Europe, where deal activity is well below 15-year averages due to slower growth and structural issues overhanging the market. Europe in 2015 accounted for about 21% of total private equity investment, compared to more than half of deal activity 10 years ago. We think buyout volume will increase in Europe as expansionary policies of the European Central Bank drive better earnings growth and liquidity in the market, which will give more confidence to acquirers of businesses to make both corporate buyouts and take-private transactions.

Investors Seek Yield in Low-Rate Environment

AMATO: Given long-term investor demographic trends, income will continue to be an important consideration and a key deliverable for clients. We believe it's important to build a stream of income from a diversified portfolio of securities. In particular, we think an unconstrained approach that can tap into various segments of the traditional fixed income market (corporate, high yield, TIPS and non-U.S. bonds) is well positioned in the current environment. Also, a multi-asset class portfolio, which incorporates fixed income, equity and pass-through vehicles like MLPs and REITs, provides the ability to be opportunistic in seeking income in what remains a dynamic market backdrop.

TUTRONE: Over the last several years, we've seen investors looking for yield and shorter durations, and they want it from sources with low correlation to the overall economy or markets. Right now, we see opportunities for private equity investors in private debt, like lending to smaller and private equity-backed businesses that are too small for the high yield market. Traditional sources of capital in some of these areas, like banks, have been pushed out of the markets for regulatory reasons. In private debt, illiquidity premiums can be quite high, which translates into higher yield potential for investors. Other unique opportunities are in buying distressed debt as default rates in the high-yield market increase, as well as royalties on drugs, medical devices and even music.

For investors with a greater appetite for risk, we see opportunities in smaller developed buyout markets like Italy and Spain, and in emerging markets, provided that the manager is experienced and has a deep understanding of their local markets.

We believe the highest-quality IPOs will still get done, but it's a challenged environment and private equity firms are likely to be more dependent on M&A for exits.

RISE OF THE DISRUPTOR BRANDS

Jacob Gamerman, CFA, Senior Analyst, Food and Beverage
Jane Gelfand, CFA, Senior Analyst, Household and Personal Care and Tobacco

AS CONSUMERS CRAVE MORE ***AUTHENTIC*** EXPERIENCES, MAINSTREAM BRANDS ARE LOSING GROUND.

The success of technology-based companies like Facebook, Netflix and Uber has helped drive consumer expectations to extraordinary heights; today, people want information and services on demand and customized to their specifications. Simultaneously, we are witnessing an increase in demand for expanded product choices as consumers seek to "curate" their lifestyles. In response, an explosion of nontraditional consumer packaged goods brands—which we refer to as "disruptor brands"—are grabbing market share from established category leaders and using their digital savvy to take advantage of next-gen marketing and distribution channels.

The Spice of Life

Supply and demand forces help explain today's explosion of choice in consumer products. From a supply perspective, dormant domestic manufacturing capacity and the globalization of production mean that access to a supply chain is no longer a barrier to entry. Further, as growth slows for many large, developed companies, the scarcity value of a successful consumer staples start-up has increased significantly. With more large companies on the lookout to acquire growth, the exit opportunity for entrepreneurs today is enticing.

On the demand side, the plethora of consumer review mechanisms means that the cost and error rate of trying a new product has declined, making a broader choice set more accessible. Consumers today can differentiate themselves not just by trading up to a higher price point, but by finding a unique product within the same price point.

The rise of craft brewers in the U.S. offers a real-world example of these supply and demand forces. The availability of brewing capacity, attractiveness of craft brands to larger brewers and consumers' desire to try differentiated taste profiles versus the mainstream light lager has fueled significant growth in U.S. brewers. Consumers like this choice and, consequently, the established mainstream beer brands have been losing share.

Outsiders Are In

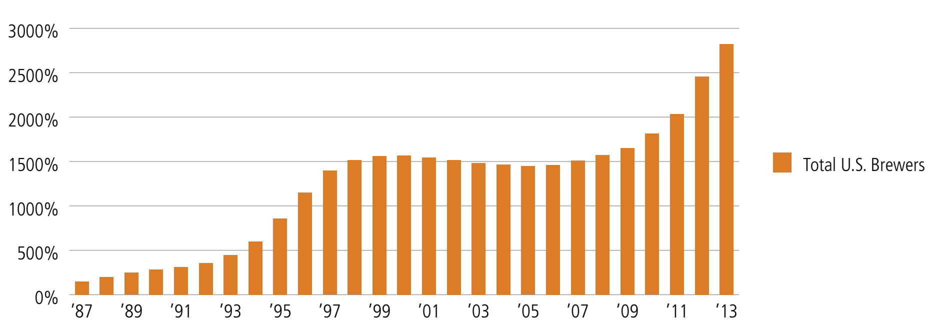
The rise of nontraditional disruptor brands can be explained in part by the demographic shift underway as the U.S. becomes increasingly multicultural, and millennials, who currently represent approximately 25% of the population, become a dominant force.

Today's consumers appear more adventurous and willing to try non-mainstream products if they are perceived to offer different, better or more "genuine" results. They are seeking attributes (for example, natural, organic and non-genetically modified) that are harder to find in large packaged goods companies. Many large companies that have built rich margin profiles offering scaled uniform products, meanwhile, are hesitant to change with the consumer. This has opened up traditional products and categories to attack and, to some extent, has promoted an innate distrust of "big companies" who strike the consumer as less genuine than the so-called disruptors.

We have seen this phenomenon in the pet food category. More than 60% of households in the United

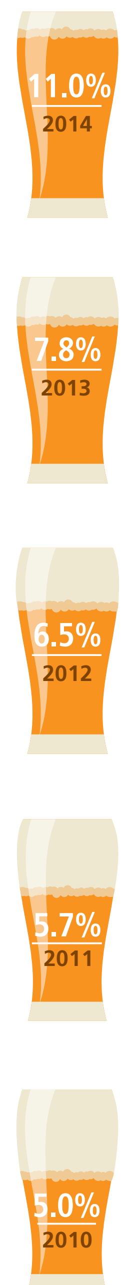
99 MORE BOTTLES OF BEER ON THE WALL

Craft brewers account for much of the rise in the total number of U.S. brewers.



Source: Brewers Association, Jefferies.

VOLUME SHARE FOR CRAFT BREWERS



Source: Brewers Association.

States have a pet and, increasingly, that pet is viewed as a member of the family. As consumers are seeking higher-quality ingredients in their own food, they are increasingly interested in finding those characteristics in their pet food. Seizing on these trends, several "outsider" companies focused exclusively on targeting these families have drawn comparisons between their "wholesome" ingredients and those of the traditional competition and, ultimately, captured a large portion of the category growth over the last several years. Larger competitors that had long dominated the pet food category, meanwhile, have struggled to reform their image to compete effectively, even resorting to buying small, more "authentic" brands to gain exposure to these changing consumer trends.

Shopping the Digital Aisles

Back in 2006, only 3% of U.S. retail sales were transacted online. In 2015, that number has more than doubled and manufacturers and retailers alike have become vocal on the importance of social media and having a comprehensive e-commerce strategy. Consumers now regularly interact with and make up their minds about brands first and foremost in the digital world. This easier access to consumers can provide an advantage to smaller brands, and is breaking down the traditional barriers to entry on which many large, consumer-oriented companies relied in previous decades.

Even long-established companies have had to adjust their thinking in this brave new world. There used to be a reference to the all-important "first moment of truth" as the manner in which the consumer first experiences a brand on a store shelf and the importance of getting that moment "right." Now there is a reference to the "the zero moment of truth," which describes the interaction between the consumer and the brand on computers, smartphones and tablets—long before he or she enters the store.

Consumers and the mediums through which brands reach them have evolved to such an extent that the traditional go-to-market models have lost some traction. Sourcing attractive investment opportunities requires us to sift through significant noise as we seek to understand which established companies are or are not adapting to the rapidly changing consumer landscape and which emerging brands are tapping into an evident consumer need not being met by the established players.

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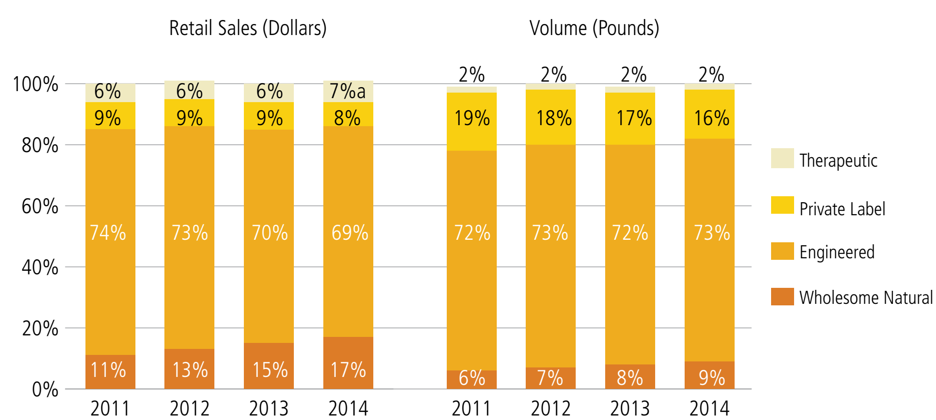
NUTRITIONAL NEEDS INCREASINGLY TOP OF MIND FOR "PET PARENTS"

Disruptor brands have capitalized on consumers' desire for more "wholesome" choices for pets.

Pet Food Retail Sales by Market Segment, United States, Tracked Channels



Source: SEC filings.

THE DIGITAL WORLD HAS TIGHTENED CONNECTIONS BETWEEN BRANDS AND SHOPPERS, TREND SETTERS AND OPINION LEADERS

❶ Brands can "live" online:

A brand can create a "digital habitat" to project its ethos, target its specific consumer cohorts via digital advertising and present interactive content for the consumer.

❷ Brands can sell their products online:

In a physical store, shelf space is limited and often earmarked for the most established, fastest-moving brands with the deepest pockets to entice the retailer to stock their product. In an e-commerce setting, shelf space is unlimited, democratizing the opportunities for smaller and upstart companies.

❸ Brands can listen online:

Digitally enabled innovation is a new concept driving R&D efforts at companies. Increasingly, brand owners can listen to the consumer rhetoric online—see reviews, spot unmet needs and unearth new trends, and then funnel these findings into new ideas.

SAVING IN THE AGE OF INSTAGRAM

Consider reminding your kids that good things come to those who save early.

Sharon Appelman, CFP®, Financial Planner

When children or grandchildren are starting a career, pressing interests—work, rent, food and the siren call of the smart phone—often take precedence over the remote, mundane prospect of funding retirement. Beginning a savings program early in a career, however, can pay considerable dividends down the road.

Hypothetical Retirement Savings Illustrations[1]

Let's examine the hypothetical case of Jane, a 25-year-old earning $85,000 per year. Her employer offers a 50% match for each dollar she contributes to her company's 401(k) plan, up to 6% of compensation. The following three scenarios reflect different saving schedules that Jane might pursue, and hypothetical outcomes given an assumed annual growth rate of 7.2% and annual salary increases that match an assumed inflation rate of 2.5%.

Hypothetical Retirement Savings

Illustration 1: Saving Early, Increasing Often → **$3,600,000**

Jane allocates 6% of her salary into the company 401(k) for the first five years, to benefit from the match offered by her employer. She increases her 401(k) allocation rate to 10% of her salary for the following five years, after which she increases the allocation to 15% until her retirement at age 65. Using a straight-line growth calculation (gross of fees), the hypothetical value of Jane's 401(k) savings at the beginning of her retirement would be $3,600,000.

Starting early and gradually increasing retirement plan contributions resulted in the highest hypothetical retirement savings.

Illustration 2: Slow and Steady → **$2,900,000**

Jane allocates 6% of her salary into the company 401(k) for the first five years, then increases her 401(k) allocation to 10% and continues at that rate until her retirement at age 65. Using a straight-line growth calculation (gross of fees), the hypothetical value of Jane's 401(k) savings at the beginning of her retirement would be $2,900,000.

Even though Jane contributes less each year, by starting early, the hypothetical retirement savings are higher than in Illustration 3.

Illustration 3: The Late Bloomer → **$2,480,000**

Jane postpones saving until age 35, then defers 15% of her salary into the 401(k) plan until her retirement at age 65. Using a straight-line growth calculation (gross of fees), the hypothetical value of Jane's 401(k) savings at the beginning of her retirement would be $2,480,000.

Postponing retirement plan contributions and foregoing the employer match for 10 years results in approximately $1.12 million less hypothetical retirement savings than Illustration 1.

The good news in all these cases is that contributing regularly to retirement accounts has the potential to generate a sizable nest egg over time. Parents and grandparents may not be at the forefront of selfies or social media, but they have plenty to teach the next generation about saving and the power of compounding. Encouraging loved ones to invest in their future selves while they are still young can help smooth their path long after the allure of Instagram feeds has faded.

[1] The Hypothetical Retirement Savings Illustrations are for illustrative purposes only and are based upon the following assumptions (a) wages rising at 2.5% annually; (b) hypothetical growth in retirement account shown as straight-line 7.2% annual growth, based on the blended growth rate assumption for our Investment Strategy Group's moderately aggressive asset allocation model (without alternatives). Results are gross of fees and do not reflect the fees and expenses associated with managing a portfolio. If such fees and expenses were reflected, results shown would be lower. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

A FEW POTENTIAL

PORTFOLIO DIVERSIFIERS

Long-short strategies: In long-short equity and credit strategies, managers make long and short bets on stocks or credit instruments in an attempt to capture both up- and downside and to manage overall exposure to the market based on fundamentals or other factors. These strategies seek to capitalize on attractive valuations in an array of instruments across industries and geographies. The extent to which long-short strategies correlate to their respective markets will depend on how a particular manager employs hedging techniques.

Absolute return strategies: Traditional strategies are often benchmark-focused. Absolute return strategies belong to a diverse alternative investment universe and seek to deliver attractive returns regardless of market direction.

Flexible bond strategies: Multi-sector bond funds often have flexibility to allocate to sectors that are farther out on the risk spectrum such as high yield, bank loans and emerging markets debt. While each of these fixed income sectors may increase the risk in a bond allocation, they offer attractive income generation potential and they may reduce portfolio duration and provide some downside mitigation from rising rates.

IS IT EVER A BAD TIME TO INVEST?

When the markets seem scary, it's tempting to wait for a "better" time to invest. History suggests this may be a mistake.

Investment Strategy Group

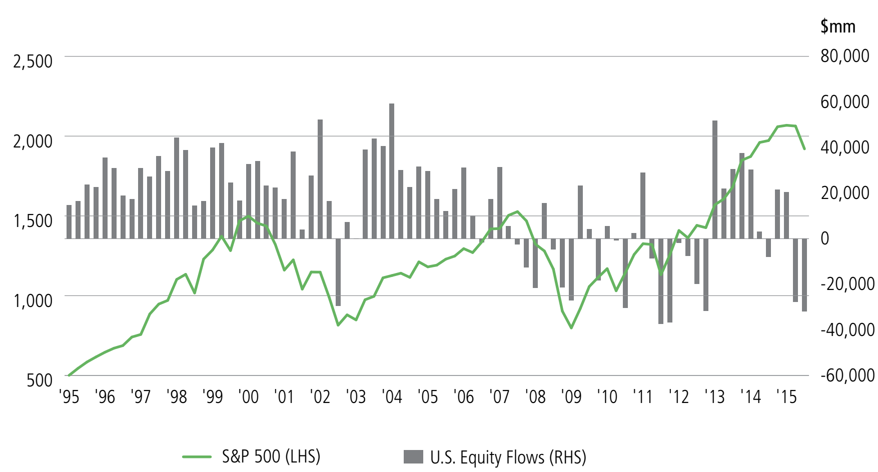
Many investors feel nervous about making a commitment to equities, particularly following robust periods of market performance. There are always economic clouds on the horizon, and no one wants to envision their investments taking an immediate loss. But trying to "time the market" by waiting for a more opportune time to invest may be a mistake as time horizon has often been a significant factor in long-term market results.

We would all time the market if we could do it successfully. Who wouldn't want to avoid major market declines, or fully participate in a bull market? The problem is that market timing requires one to make decisions that even professionals find difficult, if not impossible. This is not to say that considering the overall direction of the markets and making tactical tilts aren't without merit. Trying to time one's overall exposure to the equity market, however, brings with it a new set of risks and may ultimately derail an investor's long term goals and objectives.

The Pitfalls of Timing

Individual investors are notoriously bad at picking the right times to invest. Fund flows show that investors tend to move in and out of the market at precisely the wrong time—in essence, buying high and selling low. In 2008 and 2009, for example, during the depths of the bear market, investors pulled significant assets out of equity funds. Several years later, they moved back into equity funds just as many equity indexes were approaching or had surpassed old highs (see Figure 1).

FIGURE 1: MARKET TIMING TRAVAILS

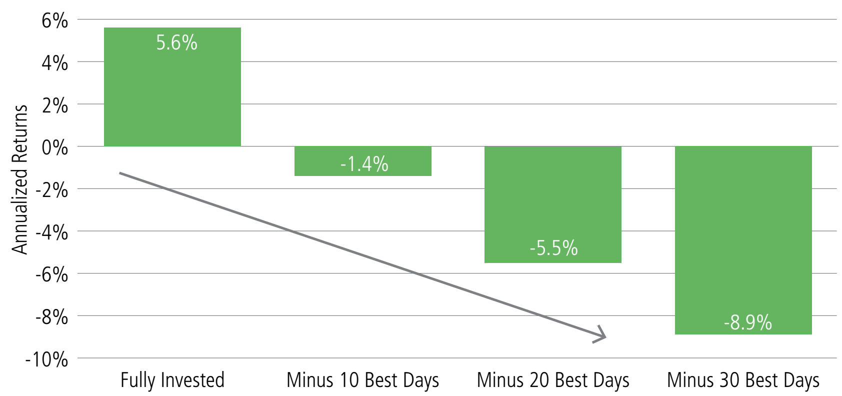


Source: Strategic Insight Simfund MF, FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

In fact, the patterns of overall equity market returns are one of the reasons that market timing is so difficult. Market increases have often come in spurts, and missing some of the market's best days could have a significant impact on returns, as those days have historically accounted for a surprising portion of the market's overall annual returns (see Figure 2).

FIGURE 2: IMPACT OF MISSING EQUITY MARKET'S BEST DAYS

S&P 500 10 Years Ending October 21, 2015



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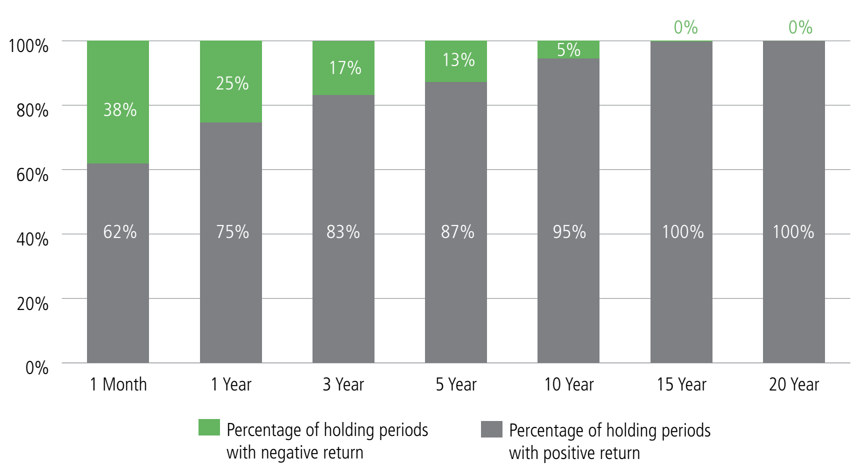
Over Time, Stocks Have Tended To Go Up

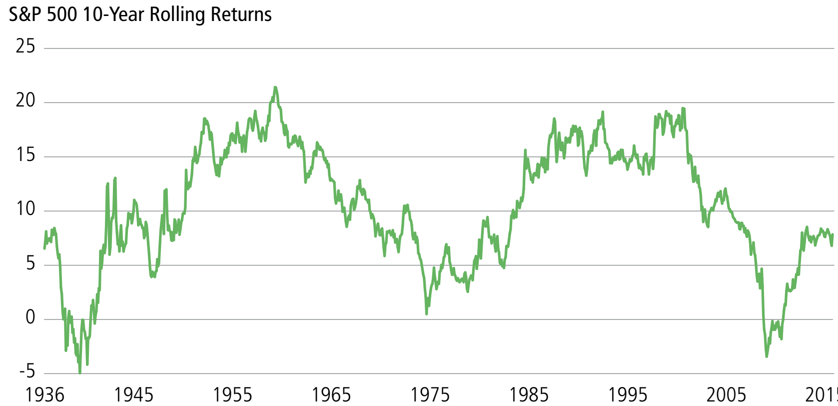
Over extended periods of time, the U.S. stock market has tended to rise in value. Consider Figure 3, which shows that the S&P 500 has risen in 75% of all one-year time periods since reliable market data began (in 1926). Over longer periods, the percentage of positive outcomes has also increased as well—for example, there has been no 15- or 20-year period in the S&P 500's history in which the index has registered a negative return. Figure 4 shows the S&P 500's performance over rolling 10-year periods (that is, the 10-year periods ending in 1935, 1936, 1937 and so on). In only two instances—ending in the depths of the Great Depression and in the midst of the global financial crisis—did the S&P 500 produce negative returns after a 10-year holding period. We believe this underscores the importance of maintaining a long-term perspective.

FIGURE 3: PERCENTAGE OF POSITIVE S&P 500 OUTCOMES HAS VARIED BY HOLDING PERIOD



Source: FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

FIGURE 4: BENEFITS OF LONG-TERM INVESTING



Source: FactSet. Data as of October 31, 2015. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

In the current low-yield environment, we favor diversification across a broader asset allocation framework that reaches beyond traditional equities and fixed income.

Managing Risk Through Diversification

Of course, the case for any given asset class only goes so far. Maintaining diversification is another way to help mitigate downside risk of an overall portfolio. Investors have often relied on a mix of stocks and investment grade bonds for this reason. In the current low-yield environment, however, we favor diversification across a broader asset allocation framework that reaches beyond traditional equities and fixed income to enhance diversification against broad market risk.

Investors today also have access to a broader array of investment options that can provide diversification benefits. For example, once the province of institutions and wealthy individuals, alternative investment strategies are now increasingly available in vehicles without investor qualification restrictions. So-called "liquid alternative" funds are retail mutual funds that pursue alternative investment strategies. Adding alternatives strategies to a portfolio of traditional equity and bond investments can help lower correlations to equity and fixed income markets. Given the significantly expanded range of alternative strategies available today to a broad audience, adding the potential diversification benefits of non-traditional approaches has become a simpler exercise.

Climbing The Wall Of Worry

Over time, the stock market has managed to navigate periods of economic crisis and geopolitical uncertainty and has overcome significant market pullbacks. Although the global economy continues to expand at a moderate pace, helped by the stimulative efforts of central banks, the proverbial wall of worry stands high today. The Federal Reserve's potential tightening cycle, China's slowing growth trajectory, weak commodity markets and elevated valuations are just a handful of concerns that have investors pondering a move to the sidelines.

The angst investors feel in the current environment is understandable and behavioral tendencies can be difficult to resist. Working with a financial advisor can provide investors with a long-term perspective and help them make decisions based on goals, objectives and risk tolerance rather than emotion.

SOLVING FOR 2016

CIO Roundtable: Sizing Up the Next Regime

Low growth, low rates, low inflation. This has been the pattern of global fundamentals over the past couple years, punctuated by episodes of elevated volatility. Are these dynamics changing? In our annual outlook, *Solving for 2016,* Neuberger Berman's senior investment leaders engaged in a broad-ranging conversation exploring economic prospects, monetary policy and opportunities on a global basis. An excerpt of this roundtable discussion follows.

Joseph V. Amato
President, Chief Investment Officer—Equities

Erik L. Knutzen, CFA, CAIA
Chief Investment Officer—Multi-Asset Class

Brad Tank
Chief Investment Officer—Fixed Income

Economic growth proved disappointing in 2015. What are you anticipating for 2016?

Erik L. Knutzen: The main tension throughout 2015 has been a tradeoff between improving growth expectations for the developed markets, and growth shocks associated with China and other emerging markets, as well as falling commodity prices. For 2016, the biggest question is where we are in the U.S., European and global economic cycles. And our belief is that there is still a ways to go, and that we will start seeing some pickup in growth in the U.S. and elsewhere in the developed world.

Joseph V. Amato: I think we will look back on 2015 and see market weakness as a mid-cycle correction. It was a year that prolonged the transition of central bank policies, where China's devaluation led folks to rethink the global growth outlook. In 2016, monetary policy will likely create a sloppy environment as investors adjust to the new rate regime, with growth and China still playing an important role.

Brad Tank: The remarkable thing within fixed income is that almost nothing happened in terms of rate changes in the developed markets, reflecting the wait for growth. In 2016, a couple of factors will be important. One is the rise of U.S. short-term interest rates, which will likely be underway throughout the year. Another is where we are in the credit cycle. If we are still at mid-cycle, as we believe, that should portend well for some of the riskier parts of credit markets, such as emerging markets debt and high yield.

How high can rates go, and how does the rate environment impact investors?

Tank: There has been a big disconnect between the Fed's expectations and the market. FOMC members anticipate raising the Fed Funds rate up to about 3.5% by the end of 2018, but the market is reflecting about a 2% Fed Funds rate at that time. Generally, when you're at the end of a cycle, you have a very flat, if not inverted, yield curve. So, with the 10-year Treasury bouncing around in 2015 in the 2%-2.5% range, the market view doesn't imply a huge lift in rates from here. For 2016, in the U.S. we envision increases of around 50-100 basis points, while in Europe and Japan we anticipate short rates remaining ultra-low, and supplemented by monetary easing.

Amato: An important theme for 2016 in the U.S. equity market is, in my view, quality. Over the past six years, rate suppression and easy access to capital regardless of the quality of the business has distorted equity returns quite meaningfully. As you start to move into a normalized rate environment, I think there will be more differentiation between companies. While we think rates are going to remain low, movement toward more normalized rates should start to differentiate between the good, the bad and the ugly.

Knutzen: When you think of your choices as an investor, and compare owning a Treasury or other government bonds at current low yields, versus for example the debt of a high-quality company with solid earnings and a moderate valuation, I would argue that investors are being compensated to move out on the risk spectrum toward investments with higher return potential.

To read more of this roundtable, as well as access the full contents of *Solving for 2016,* including videos and commentary from our senior investors on a broad range of asset classes, please visit nb.com/solving2016

Rates are dependent on growth, and growth could be affected by China. What are your expectations there?

Knutzen: In terms of risks, China is really first and foremost. Its importance was evident in the market reaction to marginal changes in Chinese growth at midyear, and then the devaluation of the yuan. Our view is that China is slowing but that it is not going into a hard landing, and that it will continue to be a contributor to global growth on the margin.

Amato: At the same time, this is an economy that is moving from an extraordinary level of investment-driven economic activity to one that needs to be driven by consumer activity—a tough transition. The government's policy intervention has reduced that risk, but I think it's still there.

Tank: A key takeaway for investors from 2015 is that you have to separate China's stock market, which is very speculative, from what's going on in the real economy. The shift you mention is going to take years and will result in lower, more stable growth. But I think China for the foreseeable future is going to be a source of periodic volatility or uncertainty for the markets, in part because policymakers there are still figuring things out.

Do you think U.S. election politics will impact the markets?

Knutzen: It's hard to assess the U.S. election so far in advance, but we think it's unlikely that any one party will have sufficient control of all the different levers of power to be able to make sweeping changes. So, it probably won't be a major driver of economic behavior and change for the U.S. or globally. Nevertheless, it is likely that we will see some micro bursts of volatility on certain policy issues, as we have seen recently in the health care sector after campaign rhetoric on drug prices, and that could create investment opportunities.

The emerging markets have been under stress—but would you say that results have been more diverse than advertised?

Tank: Investors are gaining sophistication and appreciation for the fact that the developing markets are quite varied in terms of policies, valuations and opportunities, and I think those divergences are going to persist. Some places clearly are going to present terrific opportunities to invest, but there may be others where, for a generation you are going to want to shy away because the leadership and a clear path to a solid future are just not there.

Amato: Three things have driven emerging markets growth over the course of the last decade: the commodity super-cycle, a low cost of capital and structural reform. At this point, the commodity cycle is essentially over, rates are set to head upward and reform has turned out to be very hard. You can't paint all emerging markets with one brush, so you will see divergent trends, but broadly defined I think it's going to be a more challenging environment.

Knutzen: There are some bright spots. Some of the Asian markets still have reasonable growth and solid country-level balance sheets, but bond spreads have blown out as if they are Latin American commodity-producing countries. For an investor who looks past the current noise, there are some interesting opportunities generally, so it's important to keep looking at these markets.

TRUST COMPANY CORNER

PREVENT BENEFICIARY DESIGNATION MISHAPS

MAKING SIMPLE ELECTIONS NOW CAN HELP YOUR IRA ASSETS LAND WHERE YOU INTEND LATER.

Diane E. Lederman, President and CEO, Neuberger Berman Trust Company N.A.

Imagine a scenario in which your ex-spouse receives your $2 million IRA after you die, despite your having designated your children as beneficiaries under your will. This scenario is not only possible, it has happened. But it's also preventable, provided you establish and maintain current beneficiary designations on your retirement accounts.

Wills and revocable trusts are the cornerstone of estate planning, and you may spend considerable time and money crafting and maintaining these documents over a lifetime. For all the effort that goes into traditional estate planning documents, however, many people do not give enough thought to filling out beneficiary designation forms for retirement accounts like IRAs. Their completion is important because the distribution of these assets generally is not covered by a will or revocable trust. Given the estimated $24.9 trillion in retirement assets in the U.S., planning for these assets has developed into a vital component of the estate planning process.[1]

Why Beneficiary Designations Matter

When you purchase a life insurance policy, you designate beneficiaries in the policy documents. The same is true of retirement accounts, like IRAs and defined benefit or contribution plans. Designating beneficiaries on IRA documents means that your will or revocable trust does not control who inherits the property—these designations supersede the instructions in your will or revocable trust. So changes you make to your will to remove a spouse because of a divorce, for example, must also be made to your beneficiary designations. Although the laws of some states, such as New York, remove a divorced spouse as the beneficiary of a will, there often is no similar law covering IRAs, leading to the scenario in which ex-spouses may inherit IRA assets.

Not designating a beneficiary at all (or not updating the beneficiary designation forms after the death of a beneficiary) can cause further headaches. In that case, the administrator's plan documents may dictate who will inherit your IRA. Commonly, they send the IRA into your estate, where the beneficiary you want to receive the assets may not. Not having a designated beneficiary can also impact how quickly assets must be withdrawn from the account after your death.

Optimizing Beneficiary Designations

In addition to directing who will receive your IRA after your death, beneficiary designations determine the pace at which assets will need to be withdrawn. Due to their tax-advantaged status, it is generally preferable to keep assets in IRAs for as long as possible to allow the assets to grow on an income tax deferred basis.

Spouse designated beneficiary: Several options are available to a surviving spouse that is the designated beneficiary of an IRA. The most common option is to roll the inherited IRA into the spouse's own IRA. At this point, the assets are treated as if the surviving spouse is the original owner, and required minimum distributions (RMDs) begin at age 70 ½.

Non-spouse designated beneficiary: In general, non-spouse designated beneficiaries must begin taking RMDs soon after the death of the original IRA owner, but the amount of the RMD is calculated based on the beneficiary's age. Younger beneficiaries, therefore, can stretch out the IRA's tax benefits over a longer period than older beneficiaries, and potentially benefit from an extended period of tax-deferred growth. Naming a young beneficiary can make an inherited IRA an attractive wealth creation tool if your estate will not be subject to estate or generation-skipping taxes, or if that tax burden can be paid with assets outside the IRA (see below, Consider Estate and Generation-Skipping Taxes).

No designated beneficiary: When there is no beneficiary designation on file, the plan documents signed when the account is opened name the beneficiary. Frequently they provide that the IRA passes to the

[1]Source: Investment Company Institute, as of March 31, 2015.

estate. If that happens, there is no option to stretch out the IRA distributions over the beneficiary's life expectancy. Instead, depending on when the original account owner dies, RMDs will be based on the original owner's life expectancy or the assets will need to be withdrawn in their entirety within five years of the owner's death. Either way, a potentially powerful wealth creation strategy is forfeited.

Using a Trust as a Designated Beneficiary

Many people incorporate trusts in their estate plans because they have minor children or beneficiaries that may not be able to manage an inheritance on their own. If you designate these individuals as IRA beneficiaries, they will have the ability to deplete the account as soon as they inherit it. A better option may be to name a trust as the designated beneficiary. If you create a trust under your estate planning documents, the same trust could be named as a designated beneficiary for your IRA.

Provided certain conditions are met, when a trust is a designated beneficiary, RMDs are calculated based on the age of the oldest trust beneficiary. Distributions from the trust are made according to the trust terms. The trustee, rather than the beneficiaries, has access to and control over the IRA and can decide to take minimum distributions over time or withdraw all of the assets and hold them in the trust.

Consider Estate and Generation-Skipping Taxes

IRAs and other retirement plans are subject to estate and generation-skipping taxes. If your estate's total value exceeds the current federal gift and estate tax exemption (which, in 2016, is substantial at $5.45 million for an individual and $10.9 million for a married couple), the IRA will be subject to federal estate taxes, as well as any applicable state estate taxes. If your designated beneficiary is a grandchild or a more remote descendant, the IRA may also be subject to generation-skipping taxes. Importantly, if IRA assets are withdrawn to pay those taxes, the withdrawal may also be subject to income taxes. While there is an income tax deduction available for the estate tax paid on IRA assets, all in, income and estate taxes may result in the depletion of much of the IRA's value.

This potential tax burden drives many wealthier IRA owners with charitable intent to consider designating a charity as a beneficiary. This approach tends to be a tax-efficient use of retirement assets, as it bypasses income, estate and generation-skipping taxes. In this case, it is common to name a charity as a contingent beneficiary, with the spouse (who is not subject to estate tax if a U.S. citizen) as the primary beneficiary. Then the surviving spouse has the option to disclaim the IRA if the funds are not needed, thereby passing it to the charity, or to roll it over into his or her own IRA where the charity can be named as beneficiary.

Seek Advice to Avoid Missteps

As retirement plans account for an ever-larger share of wealth, it is increasingly important to incorporate them into the estate planning process. The rules regarding beneficiary designations are complex and mistakes can be costly. Consider working with your financial advisor or estate planning attorney to help ensure your beneficiary designations are up to date and work well within the context of your overall estate plan.

This material is informational and educational in nature, is not individualized and is not intended to serve as the primary or sole basis for any investment or tax-planning decision. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. Please see the disclosures at the end of the publication, which are an important part of this article.

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