SOLVING
FOR 2020

NEUBERGER BERMAN

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CIO—MULTI-ASSET CLASS

## KEY POINTS

- Equity indices appear expensive, but there is value beneath the surface
- Non-U.S. markets offer value, especially emerging markets
- Investors can benefit from diversifying their sources of quality portfolio income
- Commodities and liquid alternatives could provide much-needed help in a volatile environment
- Private markets offer value and the ability to underwrite through-cycle themes

CONFERENCE SUMMARY

# PUTTING IT INTO PRACTICE

*"No other sector than technology ended up with higher returns than the S&P 500 itself in 2019."*

Erik noted how unusual recent years have been, with virtually all traditional and alternative assets posting negative returns in 2018 and then virtually all assets posting positive returns in 2019. In both instances, he argued, those returns were driven by shifts in monetary policy, and that the need for central banks to hand the responsibility for stimulus to governments would likely make 2020 a more volatile year with more dispersion of returns.

Overall, Erik identified five key investable themes for the year:

**Global equities—look beneath the surface**

At the index level, many equity markets, and especially the U.S. large-cap market, look fully valued, given the modest, 5 – 7% earnings growth anticipated for 2020. However, beyond the technology-dominated S&P 500 Index, Erik identified a number of potential value opportunities: in value stocks versus momentum stocks; in cyclical stocks and sectors versus defensive stocks; in smaller stocks versus larger stocks; and in non-U.S. markets, where there tends to be more value and cyclicality available.

**Emerging markets—equity and debt**

Arguably the most attractive of those non-U.S. opportunities is in emerging markets, Erik suggested. Growth acceleration in the developing world is beginning to outpace that in the developed world again and the aggregate current account balance of the 10 biggest emerging markets has moved into surplus. Against this improving fundamental backdrop, emerging market equities offer better earnings growth prospects and more attractive valuations then developed market equities, while emerging currencies remain undervalued and real yields in the bond markets have tightened but remain positive. This view rests in part on anticipation of a weaker U.S. dollar, and Erik noted that any persistent dollar strength would trigger a re-assessment.

**Pursue quality income**

Erik argued that the textbook approach to late- and end-cycle investing would be to move out of credit exposure early while hanging onto equity exposure to take advantage of a potential late-cycle rally. However, because of the long, shallow trajectory of the current expansion, Erik suggested that the coming downturn might also be shallow and extended, which would make sources of quality income attractive. While credit spreads in general indicate fair-to-full valuations, the income could remain useful in the whole-portfolio

context, he argued. However, traditional allocations such as investment grade credit and high dividend-paying equities do appear expensive and are highly exposed to interest rate risk; instead, investors might consider diversifying with less obvious sources of quality income, such as high-quality high yield, emerging market debt, REITS, collateralized debt obligations (CLOs), corporate hybrid securities, preferred stocks and inflation-linked securities.

**Prepare for volatility with true diversification**

Anticipating a more volatile year with more return dispersion between asset classes, Erik re-emphasized the importance of genuine portfolio diversification. He pointed to the historic tendency of commodities to offset geopolitical and late-cycle inflation shocks; the capacity for certain hedge fund strategies to mitigate and even exploit volatile environments—particularly, macro, momentum-trading and market-neutral strategies; and the potential for collateralized put option-writing strategies to help investors maintain equity exposure with lower volatility and improved drawdowns.

**Private equity comes into its own**

Erik noted that, while the valuation gap between private and public equity markets has narrowed, it persists, and in a low-return environment that 2 – 4 percentage points of extra expected return could be significant. Skillful private equity managers have more scope to generate further returns through operational improvements to the business in which they invest. Moreover, locking up capital for a multi-year investment program makes it easier to act opportunistically during the period when late-cycle turns to end-cycle, which is why many of the highest-returning private equity vintages were raised at the peak of the public-equity cycle; and it also helps investors to maintain the long-term discipline to underwrite themes that extend through the cycle.

Erik conducted his regular survey of delegates' return expectations for the year ahead. After a strong year for risky assets, a high 70% voted for equities as the best performing asset class in 2020; commodities got 16% of the vote; fixed income 10% and cash 4%.

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