Opportunistic Positioning for Multigenerational Wealth

"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." -Winston Churchill

After the 2008-'09 financial crisis, we have been in a long and slow moving economic and market cycle, where immense amounts of money creation from global central banks have flown to the more liquid areas of the capital markets. This long and slow dynamic has been characterized as the "turtle cycle," with a recovery that inches forward, pushed by consistent flows of created capital. As the Fed ends quantitative easing in October, we think the European Central Bank will start quantitative easing very soon, prolonging this "turtle cycle" for at least another two or three more years.

This "turtle cycle" fueled by extraordinary money creation has inflated financial assets, especially the most liquid and mature markets. It is difficult to detect clear value in the three traditional assets classes going forward, in particular in the fixed income space. Our Investment Committee forecasts that a moderate risk traditional portfolio will have a return of 4-5% over the next 10 years. Cash yields are negative in real terms; bonds offer limited value with record tight spreads and high valuations; and equities are approaching the "beginning of the end" of the bull market. We share Professor Siegel's (from the Wharton School of Business) view that the market will peak at 18X versus the present 16X EPS. So where does this leave us? We are focused on finding "non-traditional" revenue producing assets which offer intrinsic value of 8-11% (i.e. real rates of 6-8%). We believe with time, liquidity will end up flowing into and appreciating the values of these non-traditional asset types, as investors recognize the opportunities. These non-traditional asset types constitute an opportunity for investors to position their portfolios for multigenerational wealth. Our Investment Committee forecasts that a moderate risk portfolio which includes non-traditional asset types will have a return of 6-7% over the next 10 years.

Dampened Outlook for Traditional Asset Classes

- Cash: It's hard to hold cash, when it yields -2% in real terms. However, we think investors should still hold at least 10% in cash for the flexibility needed to take advantage of opportunities that might come fast, as "black swans" erupts and capital markets sell-off quickly.

- Bonds: Our estimated performance of a diversified fixed income portfolio over the next 5 years is 1-2% per annum. While high grade bonds offer negative real rates, credit spreads are at their tightest level ever. As Fed chairwoman Janet Yellen alerted investors, valuations in the high-yield markets are extreme.

The Thinking Man's Approach

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The "turtle cycle" of the last few years has been characterized by a long and slow moving economic recovery and immense flows of capital into cash, bonds and equities. This cycle has made the future value of these traditional assets unclear. Our lowered expectations of return on a strictly traditional portfolio have forced us to explore non-traditional asset types for our clients who are looking for opportunities for multigenerational wealth. In this month's Thinking Man, we briefly discuss some of these non-traditional asset types we are looking at

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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- Equities: Stocks are slightly overvalued, but offer "relative" value versus the other two asset classes. Our 5 year forecasted return for equities is around 5-6% per annum versus the 18% per annum since the beginning of the bull market. We believe we're in the 7th inning of this bull market cycle. While the focus will be on corporate earnings, we think stocks will also become more expensive from the 16x to 18x at the peak of the cycle. Investors are coming to stocks searching for yield, which is a rare event.

All in all, the opportunity set in "traditional" asset classes is limited both on an absolute basis as well as on a relative basis versus the investment landscape of 5 years ago.

Finding Opportunity in Non-Traditional Asset Types

Our clients are looking to preserve their wealth for the coming generations. In the past, they have been able to do so by investing in a portfolio comprised of traditional assets. The "turtle cycle" has meaningfully lowered our expectations on return for traditional investments, and investors will no longer enjoy the same returns they once did on a strictly traditional portfolio. Investors looking for multigenerational wealth will have to look for higher returns, and as such, will need to diversify into non-traditional asset types. Chart 1 below illustrates yields on traditional versus non-traditional assets.

Chart 1: Comparison of Prevailing Yields by Asset Class

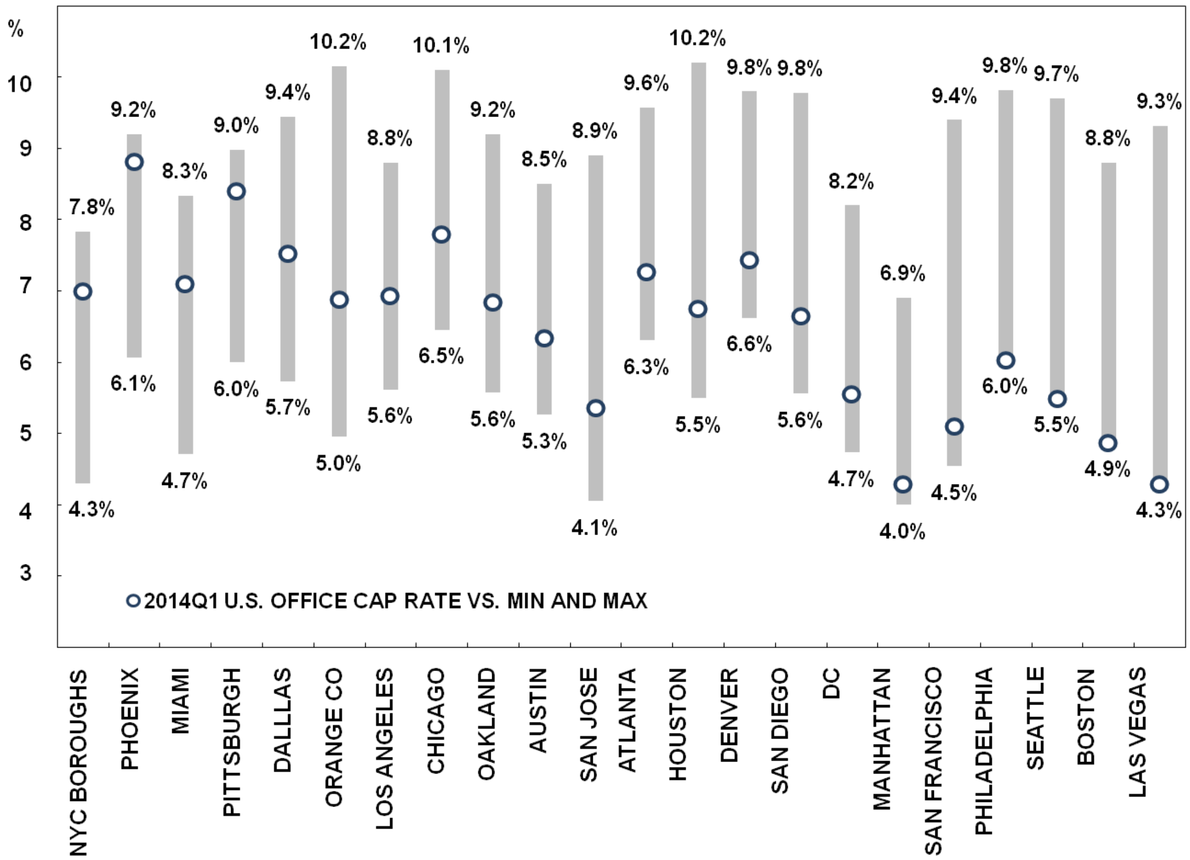
		Nominal	Inflation	Real	
Traditional	Cash	0.0%	2.0%	-2.0%	
	Fixed Income				
	High Grade	2.2%	2.0%	0.2%	BarCap US Aggregate YTW
	High Yield	5.4%	2.0%	3.4%	BarCap US Corporate High Yield YTW
	Equity				
	Public	5.1%	2.0%	3.1%	S&P500 Current Earnings Yield
Non-Traditional	**Alternatives**				
	Private Equity	11.5%	2.0%	9.5%	TTM Yield public traded global listed PE firms
	Private Debt	10.0%	2.0%	8.0%	Expected average of PD investments (BS)
	Real Estate (income)	11.0%	2.0%	9.0%	Average of RE income properties (BS)

We're looking at non-traditional asset types such as: revenue producing core commercial real estate; opportunistic hard money lending (against high quality assets); private debt; infrastructure and other niche asset types. Each of these briefly described below.

- Revenue Producing Core Commercial Real Estate
  While we started investing in CRE in 2009 right after the crisis, our focus has shifted from Trophy Assets/ Markets to Non- Trophy Assets or Trophy Assets in Secondary Markets.

  Trophy Assets in Secondary Markets: Taking into account how the historical CRE market caps have evolved (see chart 2) we identified that there are some more opportunities in looking for trophy assets in secondary markets. The chart below clearly shows that much of the initial shock after the 2008 financial crisis has been eliminated as many markets are close to cap rate minimums; however there are still pockets of opportunity in some cities.

Chart 2: Evolution of US Office Cap Rates



We identified an exceptional opportunity to acquire seller's leasehold interest in a trophy, Class AA office tower in Kansas City's highly coveted Country Club Plaza area. The property is comprised of a 10-story office building that offers 253,720 rentable square feet, including retail space on the first two floors, and a 940-space, six-level parking garage located directly beneath the office building. Located just five miles south of Kansas City's Central Business District, Country Club Plaza is the region's "crown jewel". This landmark commercial district is Kansas City's most exclusive collection of office, retail, restaurant, hotel and high-rise residential properties. The property is currently 98.6% leased to some of Kansas City's highest profile businesses and restaurants. The property presents a truly unique opportunity to establish a presence in the prestigious Country Club Plaza submarket, where investment opportunities are rare. The opportunity encompasses a high quality tenant with a 20 year lease at over 7% CAP rate and 11% cash-on-cash.

- Opportunistic Hard Money Lending
  Another non-traditional asset type we like is hard money lending against high quality assets or Bridge Loans. Bridge loans are often used for commercial real estate purchases to quickly close on a property, retrieve real estate from foreclosure, or take advantage of a short-term opportunity in order to secure long-term financing. As an example we recently participated in an opportunity to finance a $38mm cross-collateralized loan for eighteen months secured by a portfolio of 53 acres of premier waterfront residential and retail land in Hillsboro Beach and Boynton Beach, South Florida (market value of $80mm). Investors will receive 11.2% per annum, paid quarterly. This opportunity was acted on as it had an appealing collateral pledge (high quality properties) valued at a favorable valuation for the lender. Favorable terms at all levels for our investors is something that we continuously strive for when accessing these types of opportunities.

- Private Debt
  Private debt is often utilized by small and mid-sized companies looking for capital or financing. These firms are known as "middle-market" companies- broadly defined as those firms with EBIDTA of $15mm to $100mm and capital needs of $50mm to $500mm. Because of their size, these middle-market firms have limited access to liquid capital markets, which have high minimum issuance sizes. Also, these companies historically have had access to funding from banks but this changed after the 2008 financial crisis. Regulations such as Basel III were enacted, forcing banks to clean up their balance sheets and focus on core tier assets. As a result, many banks stopped lending to middle-market companies. In 2013, the majority of these loans were provided by non-banks, an opportunity for third party private debt suppliers (i.e. Shadow Banking). We see an opportunity for our clients in private debt, as the risk premium of over 5% above comparable high yield bonds compensates nicely for the illiquidity of this asset class. For more on the opportunity in private debt, see our Thinking Man #18.

  Infrastructure Assets
  Infrastructure assets are loosely defined as "the facilities and structures essential for the orderly operations of an economy." Examples of infrastructure assets include transportation networks, community facilities, and water and energy distribution systems. Investments in shale oil and gas, as discussed in our Thinking Man #21, are examples of infrastructure assets. Typically, infrastructure assets offer non-correlated returns as the underlying assets have a different sensitivity to economic cycles than typical financial assets have. They also benefit from growing demand for essential services provided, and monopoly-like characteristics of

high barriers to entry in their markets. Infrastructure investment shares some of the characteristics of fixed income (long-term steady income stream), real estate (physical assets) and private equity; Chart 3 below highlights the similarities and differences in investment profile. The long standing private equity oil and gas funds we are evaluating are targeting double digit returns.

Chart 3: Comparison of Infrastructure Assets Risk/Return Profile to Other Asset Types

How does infrastructure fit into a portfolio?
Infrastructure has a risk/return profile between equities and fixed income

	Similarities	Differences
Private equity	• Management control over investments • Converging investment techniques	• Different risk-return objective; lower exposure to economic cycle • Longer investment horizon; return less driven by exit strategy • Strong cash yield/lower capital growth
Real estate	• Cash yield is significant part of return • Absolute return objective focus • Importance of location	• Control over operating companies • Barriers to entry; less exposure to valuation cycles • Longer cash flow predictability, higher gearing • Normally larger individual asset size
Equities	• Equity ownership • Upside return potential	• Lower level of securitization/liquidity • Lower correlation with business cycle • Relatively predictable and high cash yield
Fixed income	• Long-term, predictable cash yield • Long duration asset • Low market risk	• Asset ownership • Growth/upside potential • Inflation hedge features • Indirect exposure to interest risk

Source: UBS Global Asset Management

There are also opportunities in niche asset types. These opportunities are spread across a wide variety of industries, but the investment criteria remains the same: income producing high quality assets and/or strong credits offering high spreads over comparable risk assets which offer higher liquidity. An example of this type of an investment is a specialty fund focused on the biotech sector, investing in debt securities that are collateralized with royalty streams from leading pharmaceutical products that have good sales visibility during the expected life of the debt securities, generally two to three years. The Fund will invest in high quality debt with coupons and yields over 10%, backed by the sales of well-established biopharmaceutical products that are marketed by leading pharmaceutical companies with solid credit ratings.

Conclusion

The combination of the "turtle cycle" with the extraordinary money creation have inflated financial assets, especially the most liquid and mature markets- making it difficult to find value going forward in cash, bonds and equities. Our returns for each of these asset classes have been downwardly revised; and the BSP Investment Committee forecasts that a moderate risk traditional portfolio will have a return of 4-5% over the next 10 years. The non-traditional asset types discussed above present an opportunity for investors to position their portfolios for multigenerational wealth; the

BSP Investment Committee forecasts that a moderate risk portfolio which includes these non-traditional asset types will have a return of 6-7% over the next 10 years.

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