The NMS Management
Investment Bulletin for the Endowment
& Foundation Community
January 2018

THE NMS EXCHANGE

IN THIS ISSUE

By Shawn Wischmeier
Chief Investment Officer
Margaret A. Cargill Philanthropies

By Mike Ruetz
Deputy Chief Investment Officer
Margaret A. Cargill Philanthropies

Risk Premia Portfolio: An Allocator's Approach

This is a summary of our experiences with implementing a Risk Premia allocation at Margaret A. Cargill Philanthropies (MACP) over the last four years. We summarize our research, strategic approach, and implementation. We also discuss benchmarking, governance considerations, and early results. Before diving into the nuts and bolts, let's attempt to frame what our program is and is not.

MACP's Risk Premia allocation is not a hot new, unique set of esoteric return streams that nobody has discovered or previously expressed in their portfolios. It is a differentiated way to harvest common return streams that have been well studied and expressed in portfolios in many ways for many years. MACP's Risk Premia allocation is not an internally managed hedge fund or long-biased smart beta product. It is a set of alternative, or non-traditional, betas generally constructed in a long-short manner to isolate returns drivers that have low to no correlation with traditional betas. Staff manages asset allocation and rebalancing internally; however, trading of individual securities is outsourced to a combination of banks and asset managers. MACP's Risk Premia portfolio is not a collection of high octane or actively managed strategies at high fees. It is a collection of low volatility, high Sharpe ratio strategies enhanced through moderate use of leverage, managed passively with a low expense ratio.

Research

Our research process began in early 2014 with a full literature review that included both academic and practitioner papers and presentations. From there we categorized risk premia investments into four broad categories that include macro, systematic, fundamental, and strategy. We chose to direct our research efforts towards fundamental risk premia investments (i.e. carry, momentum, etc.) given their identifiable economic rationale, the amount of available research that had been conducted previously, and the availability of data.

By focusing on fundamental risk premia, we were able to obtain numerous daily return series from several banks and asset managers. This allowed us to carry out detailed empirical analyses of the individual return series as well as group them by theme (i.e. carry, momentum, etc.) and asset type to begin building an intuition for how the various risk premiums behaved during different economic and market environments. With each return series we spent considerable time researching the persistence of returns, stability of risk characteristics and the inherent trading costs. The approach to our research required us to become highly familiar with the underlying methodologies.

We concluded the first phase of *[Continued on Page 8]*

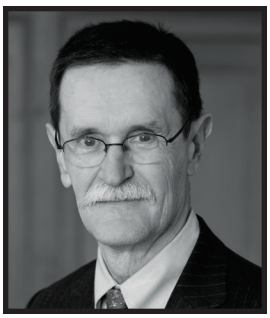
NMS MANAGEMENT

NMS Management, Inc.
Nancy M. Szigethy
Founder and
Chief Executive Officer

ABOUT NMS

NMS is a membership-based organization serving as the primary educational resource for the endowment and foundation community through its high caliber meetings. Believing that most successful business ventures are built on trust, and trust can only be developed through relationships, NMS strives to facilitate relationships through its membership platform.

As the chief source of unbiased educational forums, NMS promotes high standards of competence and ethics. As part of its mission, NMS provides its members with access to leading thinkers in the asset management industry through its content rich programming in a non-commercial setting of peers. NMS is the bridge to the latest investment ideas and information applicable to the endowment and foundation community.



By John E. Hull
Chief Investment Officer
The Andrew W. Mellon Foundation

Diversity, Equality and Inclusion — Doing Nothing is Unacceptable

As we close in on the end of the second decade of the 21st century, it feels to me like equality in the world of asset management remains frustratingly elusive. Consider these representative examples. Today, the addition of a female managing director with direct investment responsibilities at a top tier private equity firm or hedge fund is still considered a Jackie Robinson moment of "breaking a barrier." Today, you can count on one hand the number of firms where a woman or person of color is the primary decision maker in a $6.4 billion portfolio with over 85 active managers. Today, at a six hour private equity annual meeting, is it possible (it was) that the only woman to appear on stage is there to adjust the microphone of one of the speakers? Finally, today, was a hostile work environment at one of the largest private company positions tolerated for too long?

In April of this year, I completed my 15th year as the chief investment officer for The Andrew W. Mellon Foundation. Prior to joining the Foundation, I served in a similar role for 17 years at the New York State Common Retirement Fund. In reflecting on my 32 years of sitting in a CIO chair, the changes in the world of asset management have been enormous with new asset classes, new strategies and an ever expanding effort to be more global. The globalization trend has required investors to have a leap of faith and invest in regions where they know little about the language, the customs, or the people. For my generation, it is somewhat hard to believe that we now view Vietnam as a place for investment, not a place to which they fear being deployed. These changes and many others have created significant employment opportunities across the asset management landscape, but unfortunately the diversity of asset management professionals has changed much more slowly, both at asset management firms and institutions.

Unfortunately the diversity of asset management professionals has changed much more slowly, both at asset management firms and institutions.

In 2019, the Mellon Foundation will celebrate its 50th anniversary. The Foundation has maintained a deep commitment to the arts and humanities, including a long history of supporting diversity and inclusion across the program areas supported by the Foundation. An initiative that the Foundation is particularly proud of is the Mellon Mays Undergraduate Fellowship program (MMUF), which was established in 1989 to diversify the pipeline of students preparing for careers as college and university faculty. The MMUF program achieves its goals both by increasing the number of students from underrepresented minority (URM) backgrounds who pursue PhDs and by supporting the pursuit of PhDs by students who may not come from URM groups but have demonstrated a commitment to the goals of MMUF. Over the past 29 years, over 700 students have earned their PhD, and its graduates now serve as faculty members, college presidents, deans, and provosts.

We have long believed it is a natural extension for the Foundation to seek avenues to expand diversity and inclusiveness beyond the program areas that the Foundation supports, to include the field of asset management. This belief is not only for the sake of diversity itself, but because a more inclusive investment team will enrich the depth and quality of the investment process and lead to superior results. We have regularly asked our managers about their recruitment, retention, and promotion policies. These conversations highlight some of the major roadblocks to having a more inclusive workforce: "we recruit from the investment banks"; "we recruit only from a small and select set of colleges"; "we want the best athlete"; "we have a small team." In thinking about what we could do beyond a dialogue with our managers, we considered an emerging manager program, much like the one that was started in the early 1990s at New York State Common Retirement Fund. However, our asset base and heavy allocation to non-marketable strategies place limitations on the deployment of meaningful dollars to such a program. We also felt that the long-term goal should not be to have a small set of emerging managers, but to have a portfolio of managers that cared deeply about diversity, equality and inclusion. Earlier this year, we sent a questionnaire to a sub-set of the Foundation's managers (representing approximately 25% of total assets). We requested information regarding staffing to include data by gender and race for all employees, for investment professionals and for highly compensated employees. We also asked these three questions:

[Continued on Page 9]

Thin Air

By Scott Pittman
Senior Vice President/Chief Investment Officer
Mount Sinai Health Systems

Now is a good time to remind ourselves to invest in what we understand and not what others find interesting.

Last year, Mount Everest once again made the news with stories of success and tragedy. A Spanish climber set a new record for summiting without the help of fixed ropes and oxygen just as four climbers were being reported dead. It is interesting to note that most Everest climbers meet failure, death, while descending the mountain, having reached the summit. Exhaustion and time spent in extreme conditions can give way to carelessness and poor decision-making putting climbers in a perilous and unforgiving position, especially when unexpected events occur.

Like a climber that has reached a thin air environment, investors are being told that asset valuations are stretched and the market environment has become more dangerous. Despite these warnings, some investors feel pressure to take more risk to catch up with others ahead of them. Although we cannot change this environment, we can and should remain alert to its conditions, as we proceed with caution.

In Howard Marks' memo, *There They Go Again… Again*, he builds a very compelling case for why we are in a time of caution and why investors are not being compensated for the risks on the horizon. (You should read the memo if you haven't already). However, we have all heard the saying that "bull markets don't die of old age," and a case can be made today for constructive equity markets. Inflation is benign and rates remain low. The Federal Reserve is taking a slow and measured approach to ending monetary easing and raising rates. North Korea tensions have flared, but Europe, China, and Japan economic concerns have receded. Overall euphoria appears to be in check. Market valuations are full although only a handful of companies have driven the indices. As well, global growth and earnings growth appear positioned to continue on a steady path.

The tension exists in what to do in a constructive market when extreme caution is also warranted. The good news is that there are actions that can be taken to reconcile these two contradictory environments. These thoughts are organized into three categories: governance, asset allocation, and portfolio implementation.

Governance

Governance influences the balancing act of an investor's time horizon. As institutional investors, we like to say that we have long term capital with a perpetual time horizon. If this is true, shouldn't we be investing with a longer term view and plan accordingly? The reality is that one's time horizon is complicated, and both short and long term views influence decisions due to tactical and strategic factors and incentive structure. How many investment offices have no meaningful staff turnover across even one market cycle? How is governance impacted when investment committee members, CEOs, and CFOs change? How many investors get to report their 10 year, 15 year, and 20 year performance numbers rather than focus on their one-year, three-year, and five-year periods?

Effective governance gives strength to a disciplined investment process and keeps it from being pulled apart when tensions seem overbearing. Strong governance requires a constant and consistent effort. It is important to engage and strengthen partnerships with the committee and key decision makers, to be transparent and communicate the challenges ahead, to ensure portfolio risk matches expectations, and to evaluate whether structure allows for flexibility as events unfold.

Now is a good time to remind ourselves to invest in what we understand and not what others find interesting. It is important to have ownership of portfolio positions when the investment thesis is tested. Late cycle bull markets are not the best environments to reach for return and try to play catch up. We each manage a portfolio that reflects specific institutional needs, and even for institutions that can accept more risk, it is our job to take risk wisely and to avoid impairing our institution's mission. Perhaps now is also a good time to revisit spending rates and evaluate whether resources sufficiently support our future concerns.

Asset Allocation

The asset allocation process must incorporate relative trade-offs. In times of caution, we should re-evaluate expectations, test whether certain positions remain the best fit, and improve portfolio positioning. Now is an especially good time to challenge our biases and assess what can go wrong, and to re-visit portfolio structure and incentives. We should reinforce team communication across asset classes and encourage an opportunity cost mindset.

Diversification benefits are embedded within asset allocation. No institutional investor would seriously place all capital in one asset. On the other extreme, no investor should put the capital into thousands upon thousands of assets. Rather than diversifying, these thousands of assets serve to create very high cost betas at the portfolio level. Try this exercise — take every portfolio fund manager and count their underlying positions (for simplicity, maybe stop once 85% to 90% of their portfolio is explained). Next, add together all of these assets across your entire portfolio. Do you find that the outcome points to a well-diversified portfolio or a cluttered portfolio? How well do you think you will understand how that portfolio behaves in times of stress? Do the underlying assets appear to replicate betas at the portfolio level, e.g. do the combined U.S. stocks look like the S&P 500 or the total U.S. stock market? Diversification is critical for institutional investors, but we must balance it with conviction of ideas and opportunity.

We should be extra mindful of opportunities where investors are less scrutinizing. Private equity is an area that seems to be experiencing investor euphoria as returns post 2008 have been very strong, investment duration has been shortened by a supportive exit environment, and valuations have appeared stable despite some sector volatility. How many investors do you know who have increased

[Continued on Page 10]

By Jennifer Heller
President & Chief Investment Officer
Brandywine Group Advisors

Learning to Listen: An Exploration into Deep Listening & Inquiry

Introduction

> **"Most people do not listen with the intent to understand; they listen with the intent to reply."**
> — Stephen R. Covey, *The 7 Habits of Highly Effective People*

Inquiring and listening are skills that are deeply fundamental to our jobs as investors (and managers). Too often, I find myself taking them for granted rather than treating them as skills, even art forms, which must be honed and practiced.

Here are some of the traps I fall into when engaging in conversation, or the acts of listening and inquiring:

- I ask a question to which I believe I know the answer, or I interpret an answer to coincide with my own viewpoint.
- I bring my pre-conceived notions and biases about the speaker or topic to the conversation.
- I converse while distracted by my to-do list.
- I converse while planning my next comment or question in my head.
- I interrupt, jumping to a conclusion about what is being said to me.

In short, I find myself asking shallow questions, or listening without really hearing. The sad truth is that I consider myself a relatively good listener, yet there is so much I have to learn about these two art forms which are so critical to my job (and my life). I decided this was a topic worth researching. With deep humility, I'd like to share some of my learnings with you, as I imagine I'm not alone in my struggle.

Deep inquiry goes beyond simply asking questions.

Defining Deep Listening and Inquiry

Conversation begins with inquiry. We must ask a question in order to receive an answer. Inquiry can be simply defined as "an act of asking for information", or more elegantly defined as "a seeking or request for truth, information, or knowledge."[1;2] It is this second definition on which I'd like to focus. When I engage with my team, with a potential or current manager, or with a reference, I am seeking not just information, but truth and knowledge. These latter two are harder to come by, and deep inquiry can be powerful tool for truth and knowledge-seekers.

Deep inquiry goes beyond simply asking questions. It is the practice of gathering as much information as possible, without bias, by opening people up rather than shutting them down. It requires asking questions that allow for "the complete picture and understanding needed to take the right next step, which leads to more optimal outcomes. Deep inquiry goes well beyond the basic 'nodding, and parroting back' technique in Listening 101 classes…It leaves 'what's known' or 'how it's always been done,' and opens up an exploration into best possibilities and potentials. Deep inquiry can also uncover the secrets and 'sacred cows' that lurk in the shadows, which can be threatening at first. As such, the practice requires presence, attention, and patience, rather than being frenzied, [distracted], and attached to pre-existing answers."[3] In short, this type of inquiry treats asking questions as a skillful exploration requiring one's full attention. It requires meaningful engagement with ourselves and our subjects in the search for meaningful, authentic answers.

Deep inquiry involves asking broad, open-ended questions. It involves bringing a "beginner's mind" to the discussion — a mind that is completely open and highly curious. John Barrell's book, *Developing More Curious Minds* (aimed largely at educators), describes what a good question looks like:[4]

- A good question is an invitation to think (not recall, summarize, or detail).
- A good question comes from genuine curiosity and confusion about the world.
- A good question makes you think about something in a way you never considered before.
- A good question invites both deep thinking and deep feelings.
- A good question leads to more good questions.
- A good question asks you to think critically, creatively, ethically, productively and reflectively about essential ideas in a discipline.

Asking insightful questions is meaningless without the ability to receive and process the answers. We must be open to hearing the answers to these questions, even if they are not the answers we want to hear. This is where deep listening comes in. Carl Rogers, a well-regarded American psychologist, introduced the concept of *active listening* in 1987. Active listening, in his words, entails getting "inside the speaker, that we grasp, from his point of view, just what it is he is communicating to us…we must (also) convey to the speaker that we are seeing things from his point of view."[5] Dr. Rogers encourages the listener to pay attention to non-verbal cues, listen for total meaning, paraphrase and seek clarification if the message unclear. These can be powerful tools to expand our understanding of what is being said.

[Continued on Page 10]

[1]https://www.google.com/search?q=inquiry+definition&ie=&oe=
[2]http://www.dictionary.com/browse/inquiry
[3]http://www.refresher.com/fostering-a-culture-of-deep-inquiry-and-listening/
[4]Barrell, John, *Developing More Curious Minds*, 2003. http://blogs.ubc.ca/stevemcg/files/2014/09/inquiry-questions.pdf
[5]Rogers, Carl and Richard Farson, "Active Listening", excerpt from *Communicating in Business Today*, R.G. Newman, M.A. Danzinger, M. Cohen (eds) D.C. Heath & Company, 1987.

The Questions for the Coming Year

By Louis-Vincent Gave
Founding Partner & Chief Executive Officer
Gavekal Dragonomics

Like obscenity and modern art, bitcoin price charts will mean different things to different people. Take for example this recent tweet from the Federal Reserve board's "uber-dove", Neel Kashkari.

If an uber dove at the Fed is worried about bitcoin, what about those who have real cause for concern?

This tweet startled me for various reasons, namely:

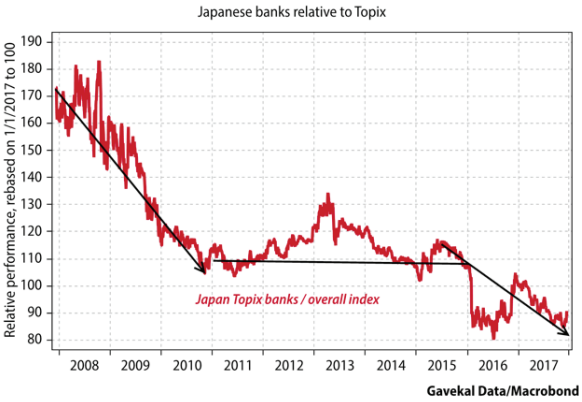
- Central bankers really do embrace their role as party-poopers whose mission is to take away the punch bowl before things really heat up (note, there will be no central bankers at my annual Christmas Eve party, so if you happen to be in Whistler, you should come along!).
- The above was tweeted by the most dovish Fed governor, so if Kashkari is scratching his head over bitcoin developments more hawkish governors are presumably pulling their hair out.
- And if dovish policymakers in the U.S. are publicly pondering the impact of crypto-currency speculation, central bankers in markets where such activity is rampant must be properly concerned.

Indeed, a recent Bloomberg article noted that 40% of bitcoins are owned by around 1,000 or so individuals who mostly reside in the greater San Francisco Bay area (the early adopters). Sitting in Asia, it feels as if at least another 40% must be Chinese investors (looking to skirt capital controls), and Korean and Japanese momentum traders. After all, the general rule of thumb in Asia is that when things go up, investors should buy more.

Asia's fondness for chasing rising asset prices means that it tends to have the best bubbles. To this day, nothing has topped the late 1980s Taiwanese bubble, although perhaps, left to its own devices, the bitcoin bubble may take on a truly Asian flavor and outstrip them all? Already in Japan, some 1mn individuals are thought to day-trade bitcoins, while 300,000 shops reportedly have the capacity to accept them for payment. In South Korea, which accounts for about 20% of daily volume in bitcoin and has three of the largest exchanges, bitcoin futures have now been banned (see The Bitcoin Bubble Changes Shape). For its part, Korea's justice ministry is considering legislation that would ban payments in bitcoin all together.

At the very least, it sounds like the Bank of Korea's recent 25bp interest rate hike was not enough to tame Korean animal spirits. So will the unfolding bitcoin bubble trigger a change of policy from the BoK and, much more importantly, from the Bank of Japan in 2018?

FIG. 1 Japanese Banks in the Wars



The aim of this paper is to look at this and other important questions whose answers may have a significant impact on the price of financial assets over the coming quarters.

1 – Will the BoJ change course in 2018?

In recent years, the BoJ has been the most aggressive central bank, causing government bond yields to stay anchored close to zero across the curve, while acting as a "buyer of last resort" for equities by scooping up roughly three quarters of Japanese ETF shares. Yet, while equities have loved this intervention, Japanese insurers and banks have had a tougher time. *(Figure 1)* Indeed, a chorus of voices is now calling for the BoJ to let the long end of the yield curve rise, if only to stop regional banks hitting the wall.

So could the BoJ tighten monetary policy in 2018? This may be more of an open question than the market assumes. Indeed, the "short yen" *[Continued on Page 12]*

FIG. 2 Pros/Cons of BoJ Policy Changes

Why the BoJ will keep QE	Why the BoJ could tighten
CPI at 0%	PPI at 3%
Real estate prices still low	BItcoin bubble is big in Japan
End of QE could trigger a yen squeeze	Banks need steeper yield curves
End of QE could trigger equity sell-off	Japanese trade surplus is back to positive
Kuroda firmly in charge	Pressures from U.S. for higher yen/weaker U.S.$

Investment Committee ABC

By Alexander Degwitz M.
Chairman
Investment Committee
GEM International Services

Migrating from a *patriarchal governing system* — common in early generation family businesses, where a single person is responsible for most decisions — to an *institutional* one where a group has to effectively reach agreements and execute decisions can be quite a feat. In the short term, it is "easier" and there is tremendous propensity to leave things in the hands of the willing leader when results are often adequate if not great and beneficiaries can keep a free pass to remain in their comfort zone, receiving distributions while having limited or no responsibility. Sounds ok, yet status quo in this condition means future generations remain disempowered, dependent and ill-prepared to handle their wealth; "Some 70% of family-owned businesses fail or are sold before the second generation gets a chance to take over. Just 10% remain active, privately held companies for the third generation to lead."[1] In the long term, the patriarch will not be around and survival of the family business (FB) will depend on developing functional and well-institutionalized groups that can transcend, where the right to participate is not entitled but earned and where there is a strong desire amongst beneficiaries to stay together. Stable governance groups can reduce the peaks and valleys of the spectrum of the individual human cycle, permitting more predictable and consistent conditions to prevail, which is the desired environment for businesses to succeed.

To achieve long term growth, a system of governance should evolve from a "Control Model" characterized as a governance system where "control rights are not fully separated from ownership, ownership tends to be concentrated and sees conflict of interest as endemic and seeks to institutionalize them or provide sanctions for them rather than eliminate them", to something more attuned to a "Market Model-board structures and practices that ensure that the board is a distinct entity, capable of objectivity and able to act separately from management".[2] This migration of governance model is often a consequence of the family's transition from a sibling partnership where governance is highly reliant on leadership of strong family individuals to a cousin consortium in which proliferation of partners demands stronger institutions to maintain a balance amongst partners whilst increasing the relative weight of professional managers vis-à-vis ownership.

In my understanding, it is generally healthy to shield businesses from the often-irrational and personality-infested issues that families face.

In my understanding, it is generally healthy to shield businesses from the often-irrational and personality-infested issues that families face. I can refer to a common case of what I consider a distortion in a management system whereby the same people who are responsible for ongoing concerns are responsible for managing liquidity. This mixture of roles and responsibilities without clearly defined parameters and procedures for capital disposition is likely to have negative consequences for both liquidity and business management: 1) Decision criteria for portfolio management may be unduly influenced by the money demand of the FB and 2) The effect of the proverb "necessity is the mother of invention" is jeopardized. Dependence on cash to operate results in an inverse correlation between cash availability and capacity to produce creative business solutions. To cure this condition a clear separation of governance for ongoing concerns from liquidity management is recommendable. In essence, the relationship between the two should be one whereby the Board Of Directors (BOD) of businesses solicits funds to the Family Office (FO) by demonstrating that it can produce better returns than those produced by investment portfolios and risk tolerance parameters allow further concentration of investment in the FB.

An FO can be organized as the executive arm of the family, to manage family affairs, investments, tax planning, property management, concierge services, etc. Its governance criteria can be similar to that of a normal Board of Directors (BOD), as it is responsible for oversight of what is often the fuel that sparks growth in the FB: liquidity. According to a friend and Wal-Mart USA ex-CEO Bill Simmons, the role of a BOD is simply to "provide direction". The asset management governance system of the FO can benefit from the same basic purpose and beliefs that guide a BOD. A simple example of some of our family guiding principles can illustrate how these can be equally relevant to both BOD and FO.

Guiding Principles that we aspire to live by:

"Our enterprises and their assets have the fundamental purpose of creating the conditions for their stakeholders to develop their full potential."

"The will of the group will always prevail over the will of any of its members."

"We are responsible custodians to the wealth of our descendants."

The most significant role of an FO is to organize an asset management capacity typically under a governance structure commonly called Investment Committee (IC). This body can be composed of members of the family and/or its businesses (internal members) and external ones that should be experienced money managers. Even though familiarity with financial markets should prevail, branch representation will often be the main driver in the selection process. Overlap between BOD and IC membership should be limited to avoid conflict of interest. The Family Council (FC) should appoint members for renewable terms to reduce trauma associated to rotation of family members. As is the case with the bylaws of a corporation that defines the rules of engagement of a BOD, it is important to create an operating agreement for any IC.

Often, the first job is to simplify and consolidate an unnecessarily large amount of legacy accounts into two or three fundamental portfolios based not on the origin of the funds but on the objectives each serves, for example:

[Continued on Page 16]

[1] George Stalk, Jr. and Henry Foley, Harvard Business Review FROM THE JANUARY-FEBRUARY 2012 ISSUE, "Succession Planning, Avoid the Traps That Can Destroy Family Businesses" P.1
[2] Joseph Astrachan, Andrew Keyt, Suzanne Lane and Kritsi McMillan. "Loyola Guidelines for Family Business Boards of Directors" P.3

Integrating Impact into Investment Management

By Jonathan Bailey
Head of ESG Investing
Neuberger Berman

By Jennifer Signori
Senior Vice President
of ESG Investing
Neuberger Berman

The notion that one can direct capital to generate positive social or environmental outcomes alongside financial returns is not an entirely new phenomenon. For decades, community development financial institutions in the U.S. have financed affordable housing and small businesses in underserved communities; global development finance institutions have funded private sector growth in developing countries; and foundations have incorporated program related investments in the form of loans, guarantees, or equity into their toolkits since the 1960s, and some have directed endowment dollars to mission related investments.

In recent years, however, a convergence of broader trends has brought a deeper consideration of the social and environmental impact of investments into the mainstream. There is a growing urgency to address the challenges facing the world and an acknowledgment that the same old approach is not enough. For example, an estimated $5 – 7 trillion is needed to achieve the UN Sustainable Development Goals to eliminate extreme poverty by 2030, and investors and corporations are mobilizing to help bridge the $2.5 trillion funding gap from governments and traditional development players alone.[1] Consumers increasingly care about how products are sourced and produced, how companies treat their employees, and the overall effect on the planet and their health; in fact, 87% of millennials believe the success of a business should be measured in terms of more than just its financial performance.[2] Meanwhile, more entrepreneurs are building for-profit companies that embody sustainable business practices and products. Today, there are over 2,260 certified B Corporations (for-profit companies that meet a rigorous standard of social and environmental performance) in 50 countries, ten years after the concept was first launched.[3]

This same values-alignment in how people spend their consumer dollars is being applied to how they seek to direct their investment dollars. A plethora of surveys and headlines reflect strong demand for investments that have a positive impact, especially from the millennial generation, which is expected to inherit $30 trillion by 2050 in North America.[4] According to recent surveys, 86% of millennials are interested in having an impact with their investments, and one-third of institutional investors plan to increase portfolio allocations to impact investing in the coming three years.[5;6] The traditional line of separating endowment activities from mission is increasingly blurring as demonstrated by foundations such as the Heron Foundation committing 100 percent of its endowment towards its mission and the latest announcement from the Ford Foundation to commit $1 billion from its endowment over ten years to mission-related investments. The institutional stewards of this capital and the asset management industry are responding to this growing client demand: from 2014 – 2016, sustainable, responsible, and impact investments in the U.S. grew 33% to $8.72 trillion.[7]

As an investment manager, we play a central role in managing our clients' capital to help them achieve their long-term goals. Pension funds, for example, manage assets in order to meet obligations to pensioners throughout their retirements. Foundations and endowments manage assets to ensure sufficient capital is available to support the organizations' mission-driven activities, such as providing a quality education or eradicating disease within a given timeframe. For families, the goals tend to be more varied, but are generally centered on growing and preserving wealth for future generations, while meeting a diverse set of other goals along the way. Some asset owners have taken a more explicit stance on targeting social or environmental goals alongside their financial objectives. However, regardless of this explicit intention, what all of these asset owners have in common is a focus on the long-term.

We believe that material environmental, social, and governance (ESG) characteristics are important drivers of long-term investment returns from both an opportunity and a risk mitigation perspective. This approach applies even for asset owners who may not have explicitly stated social or environmental goals, because over a truly long-term investment horizon, one cannot ignore the effects of environmental changes, governance issues, and socioeconomic determinants on the sustainability of businesses. We believe the consideration of material ESG factors is integral to the prudent management of capital over the long-term.

Material ESG factors vary across the investment landscape; for an energy company, considerations might include managing greenhouse gas emissions or water usage, while for a retail bank they might include managing its sales practices and customer data security. Our research analysts have worked with the Sustainability Accounting Standards Board (SASB), a California-based non-profit, to create a set of material factors across industries. A study has found that historically companies that address material ESG issues and ignore immaterial ones have outperformed those that address both material and immaterial issues by over 3% per annum and have outperformed companies that address neither by 7% per annum *(*Figure 1*, on page 18)*.[8] More and more evidence debunks the myth that one needs to forego investment return in order to achieve social or *[Continued on Page 18]*

[1]United Nations Development Programme, "Impact Investments to Close the SDG Funding Gap", (July 13, 2017).
[2]Harvard Business Review, "Sustainable Business Will Move Ahead With or Without Trump's Support", (November 16, 2016).
[3]Certified B Corporations, (August 2017).
[4]Accenture Consulting, "The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth",(2016).
[5]Morgan Stanley, "Sustainable Signals: New Data from the Individual Investor", (August 2017).
[6]Greenwich Associates, "Impact Investing: Institutions Awaken to New Possibilities", (February 16, 2017).
[7]The Forum for Sustainable and Responsible Investments 2016 Trends Report.
[8]Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., "Corporate Sustainability: First Evidence on Materiality", (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.

[Continued from Page 1]

our research by considering carry, momentum, and value across the asset types of equities, rates, commodities, and foreign currencies as investable risk premiums. Our research efforts then moved from analyzing individual risk premium returns to evaluating different approaches to constructing a portfolio of individual risk premiums. We evaluated several variance-covariance estimation techniques and portfolio construction methodologies through time series analyses and backtesting. As well, we worked with an individual from the academic community with a strong background in risk premia who reviewed our research methodologies and econometric models. The methodologies we identified in our research and apply today have led to consistency in portfolio construction and low transaction costs.

Approach

Since the inception of our Risk Premia allocation, we have deemed it to be a separate asset class and it is reflected as such in our Investment Policy Statement. To us, the Risk Premia allocation represents an uncorrelated asset class comprised of alternative betas that have inherent economic risk. We do not have expectations that the Risk Premia allocation will deliver positive absolute returns each year. Our belief is that the Risk Premia allocation will provide diversifying benefits to the total portfolio without sacrificing returns over full market cycles. Specifically, the expected low to no correlation of the Risk Premia allocation to the rest of the portfolio should reduce the overall portfolio volatility and diversify the sources of portfolio risk.

Our belief is that the Risk Premia allocation will provide diversifying benefits to the total portfolio without sacrificing returns over full market cycles.

Relative to the total portfolio, we dynamically manage the Risk Premia allocation to a similar ex-ante volatility target and we expect to achieve a somewhat higher net Sharpe ratio. This should allow us to earn a risk-adjusted return on the Risk Premia allocation that is the same or slightly higher than the rest of the total portfolio on an expected basis. To control for the volatility of the Risk Premia allocation, we explicitly allocate to those individual premiums we consider as being investable and size the notional exposure accordingly to achieve our volatility target.

The portfolio construction techniques and methodologies we utilize are intended to strike a balance between recognition of the current market environment and control for trading costs. Our portfolio construction process starts with estimating the variances and covariances of the individual risk premiums using an internal risk model. We then use the estimated variances and covariances to determine the weights for each individual risk premium by employing a risk parity portfolio construction methodology. Our risk models also provide an estimate of the necessary portfolio leverage needed to achieve our portfolio volatility target. Using this information, we direct the banks and asset managers that manage individual risk premiums on our behalf to trade and size each risk premium accordingly. Given our approach, we do not invest in multi-risk premia products or commingled vehicles. We typically rebalance quarterly, but we also estimate our ex-ante portfolio volatility on a regular basis and will adjust our notional exposures if our volatility estimates deviate beyond a threshold.

Implementation

To minimize trading costs and achieve allocation efficiencies we created a separate investment structure for our Risk Premia allocation. That led to us vetting and selecting an administrator and custodian as well as spending considerable time negotiating the terms of the various trading and control agreements. And although we felt operationally well prepared at the inception of our Risk Premia allocation, we learned a great deal in the first few months about NAV reconciliations, swap settlements, and managing daily collateral movements. Our operational capabilities are enhanced by having a strong and dedicated Trading and Investment Operations Team.

The day-to-day management and portfolio construction process relies heavily on technology. Our technology systems consist of an Oracle database owned by MACP and managed via cloud technology. We have a third-party service provider, which helps us write all code required to manage the data warehouse. This service provider has utilized SAS software to create the portfolio management tools that we use to gather data, calculate positions, assess risk, etc. The combination of this technology and a relatively small group of individuals internally is sufficient to run this strategy efficiently and effectively. It is not correct to assume that you might require an unusually large team to run such a program in-house.

Benchmarking

Benchmarking our Risk Premia allocation has not been a straightforward or easy task. Given the relative newness of dedicated risk premia investing, there are limited options when it comes to published multi-risk premia benchmarks. Moreover, the market characteristics of risk premia investments don't allow them to be easily benchmarked against public market benchmarks either. And because there is inherent economic risk within our Risk Premia allocation, we felt that a cash benchmark was not appropriate.

Although in the long-term we expect our Risk Premia allocation to have a zero correlation to the public markets, we initially chose to use a public market composite as our benchmark. The public market composite is comprised of our public market policy benchmarks and each is weighted according to its weighting in our strategic asset allocation. Since we sourced our Risk Premia allocation funding from the passive portions of our public market investments, the public market composite can be deemed an opportunity cost benchmark. However, we will consider benchmarking our Risk Premia allocation to one or more multi-risk premia benchmarks as they become available.

Governance

We are fortunate to have a strong governance structure, whereby we have sophisticated Board and Investment Committee members that provide both good oversight and allow the team to experiment with different approaches to implementing strategies such as these within well-defined risk limits. Our Investment Policy Statement clearly outlines the goals of the program and the boundaries under which the team may operate. To arrive at such a clearly defined structure, our staff made many presentations over the years of research to summarize key findings

and next steps. Educating and informing the Board and Investment Committee in parallel to our work allowed for both input along the way and for acceptance of our plan when the time came to implement. We also had a dedicated member of the Investment Committee work alongside our team on strategy and operational workflow development. The involvement of a knowledgeable Investment Committee member in the space helped provide validation and comfort surrounding our research and implementation methods.

Early Results

We are early in the process of implementation, only having live portfolio data since June 2016. It is too early to draw conclusive results from such a limited set of data, but we can infer some early takeaways from the data. First, managing the process internally has conclusively allowed us to realize significant cost efficiencies. We can access the returns series mentioned here at a relatively low cost, thus allowing MACP a structural advantage in terms of realized net returns. The Risk Premia portfolio has produced low to no correlation with traditional betas available in public markets and has thus far exhibited negative correlation with our full portfolios, excluding the Risk Premia allocation. Despite strong upward trending global equity markets and the low to no correlation with these markets, the realized returns have been sufficient to create a Sharpe ratio in-line with our expectations. The Risk Premia allocation has exhibited strong returns during periods of high market volatility, such as the U.S. Election and Brexit. We will continue to monitor the performance of the Risk Premia portfolio over multiple market cycles to test its ability to meet our long-term objectives.

Conclusion

The Risk Premia allocation has afforded us the ability to access a diversifying mix of alternative betas that have low to no correlation to the other investments in our portfolio while achieving a similar to slightly higher expected Sharpe ratio. The allocation will be sized over time as the program matures and meets longer-term objectives and/or new premiums are researched and added to the portfolio. We will continue to underwrite both existing premiums in the portfolio and research new premiums to add to the portfolio. Thus far, our experience has been positive and congruent with our forecasted expectations. We will continue to monitor over time to evaluate the effectiveness of the allocation against our goals. We welcome any discussions with asset allocators who are also working to integrate alternative betas into their portfolios over time.

Diversity, Equality and Inclusion — Doing Nothing is Unacceptable

[Continued from Page 2]

1. Please describe what you believe is the biggest challenge to having a more diverse staff at your firm and, more broadly, in the asset management field.
2. Please discuss any diversity and inclusion initiatives sponsored by your firm. These may include internal initiatives (e.g. outreach programs, targeted recruitment efforts, internships) or external programs.
3. Please describe how you believe the Foundation could support your efforts related to diversity and inclusion.

The survey results from the subset of managers were not surprising. They showed that women represented 14% of senior investment professionals and that African Americans and Hispanics were 0.4% and 3%, respectively, of senior investment professionals.

In discussing the survey results with the Foundation's Investment Committee, it was not clear what we should do next. The only point of agreement was that we need to commit ourselves to repeating the questionnaire and regularly engaging with the Foundation's managers about their efforts to have a more diverse and inclusive investment team.

There are clearly two open questions. First, are there other things for the Foundation to consider?

1. Should we expand our questions to extend beyond the staffs at the investment firms to the staffing at the companies in which they invest? Should we encourage venture capital firms to instill the value of inclusion and equality from day #1 with the start-up companies they support?
2. Should we be more open to engaging with a wider set of managers, including more diverse asset managers? Can we be constructive in helping to expand the opportunities for diverse asset managers?
3. Should we explore ways to develop a more robust pipeline through organizations such as Sponsors for Educational Opportunity ("SEO"), Girls Who Invest or Toigo? Is there a model similar to the Foundation's MMUF program to consider?
4. Should we encourage and support smaller asset management firms that support efforts aimed at inclusion and equality in the broader community?

If MIT, Stanford and Yale strive to have a diverse student body and faculty, is there not a role to play in the world of asset management?

Second, and possibly more important than our next step, is what can others do. Clearly some have been more successful than us and others will generate better ideas. However, there seems little room for sitting completely on the sidelines. If MIT, Stanford and Yale strive to have a diverse student body and faculty, is there not a role to play in the world of asset management? If the Gates, Mellon and Packard foundations strive to have a diverse staff and board, should they also strive to have a similar impact with asset managers? If the Getty, the Metropolitan Museum of Art and the Chicago Institute of Art take great pride in serving a diverse audience, is there not a role to play in the world of asset management? If Mount Sinai and New York Presbyterian take great pride in serving a diverse population, is there not a role to play in the world of asset management? If Cambridge Associates, Hall Capital and Summit Rock take great pride in having a diverse set of clients, is there not a role to play in the world of asset management? If we are willing to invest with ac-

Diversity, Equality and Inclusion — Doing Nothing is Unacceptable

tivist managers, why are we not willing to engage on a topic that is so important to the institutions we work for?

One of the great joys of being a CIO has been to watch my colleagues network with others in the world. If they can share information on managers, strategies and organizational structures, and frustrations, is it not possible to work together on the desire for greater diversity and inclusion? Would not an inquiry on diversity and inclusion efforts at a Bain Capital or Golden Gate Capital or Hellman & Friedman carry more weight if Mellon was joined by Duke or Harvard or Princeton?

As my time at the Mellon Foundation enters the bottom of the ninth inning, I am confident that the Foundation will continue its long-term commitment to equality and that with the support of others, the progress going forward will exceed my expectations.

Thin Air
[Continued from Page 3]

their private equity allocation and done so meaningfully? How many do you know who have reduced their private equity targets in the last year or two? I have talked to investors who are reducing other areas of their portfolio — hedge funds, fixed income, long only equity, real assets — but I've yet to find someone who is reducing their private equity exposure. According to Preqin, global private equity has doubled in size over the past decade with the rate of growth accelerating in recent years. Strong fundraising has seen private equity funds secure over $1 trillion in the period 2014 – 2016, an amount nearly equal to the size of the entire private equity industry at the end of 2006.

There will certainly be some great investments in private equity, and I do believe that the opportunity set in private investments will be interesting over the coming years. However, I also believe that many investors will be disappointed given today's over-valued assets, false sense of low risk, overly optimistic return expectations, and the flood of future capital flows. It seems more likely that overall return dispersion will be wider, the investment duration longer, and net returns lower.

Portfolio Implementation

Despite the upward run of passive investments, I believe active management will be an important component for driving future outperformance. The market has been unusually calm for an unusually long period of time. I would argue that this lack of volatility is a bubble, and passive strategies have worked very well in this directionally calm environment. As capital flows into them, share prices get distorted with no differentiation of quality. These passive measures become over-valued, and the probability of reversion increases. A portfolio positioned for long term outperformance probably looks much different than today's passive portfolio. The timing of any bubble is uncertain, and passive strategies may continue to do quite well in the short term. Still, I believe active management will be an important tool in the coming years. Now is not the time to sell active and buy passive. Navigating a storm in auto pilot may prove treacherous.

As we consider new opportunities, we are giving greater weight to those we believe provide a high certainty of return over those with just a high expected return. The higher certainty may originate from relative valuations, focused strategies, and teams with a sourcing or execution edge. Additionally, we should hold a little more liquidity, or at least raise the bar for giving it away, to be able to deploy into a period of dislocation or stress.

As asset valuations are reaching new highs, volatility does seem too low for the potential risks, but this does not necessarily mean danger is imminent. We are always concerned about what can go wrong but even more so today. We are taking risk, but continue to be cautious and prepare accordingly. Team culture is as critical as ever — how we collectively work to find the best ideas, exercise patience and investment discipline, demonstrate the ability to question one another, and take ownership of outcomes. Having sound investment partners, liquidity, and an opportunistic approach should prove invaluable in this time of caution.

Learning to Listen: An Exploration into Deep Listening & Inquiry
[Continued from Page 4]

Deep listening is a process and a practice which evolves beyond active listening, asking us to find a deeply receptive place in ourselves from which to hear the subtle levels of meaning and intention shared by another. To really listen, we must have a "calm, receptive state of mind, rather than a frantic, hurried, preoccupied one. From the former, clarity and precise understanding are possible; from the latter, habitual routine, assumptions, and miscommunications often result."[6] This practice asks us to look inward, gaining increased awareness of our beliefs assumptions and values, in order to set those aside to accurately hear others' beliefs, assumptions and values. We can then better examine our expectations, the systems within which we operate, and our and others' histories and contexts. Deep listening comes from a place of receptiveness and intuition.

Deep listening can be described as "generous, empathic, supportive, accurate, and trusting. **Trust here does not imply agreement, but the trust that whatever others say, regardless of how well or poorly it is said, comes from something true in their experience."**[7] This last component is subtle, but critical. It is a reminder that we all form opinions about ourselves and the world based on our own experience, our own lens. When we can suspend our own beliefs and listen to others

---

[6] http://www.refresher.com/fostering-a-culture-of-deep-inquiry-and-listening/
[7] https://www.mindful.org/deep-listening/

with an appreciation that everything they say comes from their own experience, their own truths, we can begin to really hear them.

Getting to Why

So much of our diligence work mirrors that of an investigative journalist. The qualitative part of our work involves interviewing the main subject, then interviewing as many people he or she touches as possible to try and piece together the truth about his or her motivations, philosophy, process, and performance. I recently listened to a podcast where Cal Fussman interviewed Larry King, who certainly meets the standards for mastery in the arts of listening and inquiry: Mr. King is now 83 years old and has conducted over 50,000 interviews, receiving countless awards. While Mr. King did not use terminology like "deep listening and inquiry", his commentary on how to effectively conduct an interview mirrors these concepts completely. He noted that you must "listen fully", letting your curiosity work for you. He said one of his most powerful tools is to put himself in the shoes of the person to whom he's speaking, being completely present with them. "What I want in every show I do is an intimate relationship with the guest — intimacy, trust. If the guest will trust you, you're home. **If they know you're sincerely interested in them you can go anywhere…if you can put yourself in their shoes you can ask anything."** [8] He notes that he never brings an agenda or judgment to his questions — he simply cares about getting to the "why", and doing it through empathy and trust-building.

There is an art to showing up to a manager meeting deeply prepared, with an understanding of your unanswered questions, and yet remaining open to discovery. Mr. King notes that the questioner can own the conversation, and be completely in control, simply by being curious about the "why". Instead of asking a direct question for which the manager or reference has a fully prepped answer, perhaps there is value to opening him or her up, going further back in time, understanding the rationale behind decisions to build team, process, or portfolio a certain way. Bill Petersen, former CIO of the Alfred P. Sloan Foundation, reminded me recently that a manager's pitch book tends to be "90% what, 10% how and 0% why." **The "what" is often much easier to get at, the "how" perhaps one level deeper, but the "why" is really what we are after to inform our own judgment.**

On reference calls, I find that simply asking "what's [name your manager] like?" and/or "tell me about him/her" can provide some excellent threads to pull on. My colleague, Greg, will often sit quietly for an additional 10 – 15 seconds after a reference seems to be done answering a question, and often the silence will provide a window for him or her to continue sharing detail that would otherwise have been missed.

There is a risk that team members will get angry, will feel unheard, or perhaps worst of all, won't speak their mind honestly for fear of hurting a colleague's feelings.

My team and I have also learned a surprising amount by paying closer attention to the subtle non-verbal cues and dynamics that exist between partners sitting across the table from us. We noticed a partner at one firm quietly rolling her eyes when another partner spoke — it was subtle, but evident — which led us to an important line of questioning about the power dynamics within that organization. We might have missed this cue had there not been two of us in the room, which allowed one of us to be completely present with the team and discussion while the other took notes.

This work is gratifying, but hard. It requires us to leave our ego outside of the door and to be fully engaged. Too often, I struggle with wanting the manager to know that I'm smart, that I've done my research and want to show off this knowledge. Or I'm distracted, thinking of my next two questions or my next meeting or the emails I haven't checked. These distractions can prevent me from listening or inquiring as deeply as I should.

Creating Buy-In

Creating a culture that fosters high levels of engagement and creativity, respect and collaboration demands a foundation of strong communication. A leader skilled in the arts of listening and inquiry opens the door to understanding every team member's values, vision, goals, and expectations. He or she can then work towards alignment at every level of the organization. A team that can ask deep questions and really hear each other's answers can evolve an integral, unified vision — meaningful dialogue can serve as a pathway for the clarity of thought, purpose, and action needed to get everyone on the team pulling towards the same goal(s). A culture buoyed by deep listening and inquiry can increase group commitment and buy-in while reducing compromise, ultimately leading to a more sustainable organization.[9] I'm of course painting a picture of the "platonic ideal", both in terms of leadership and outcomes, but only to make the point that the benefits from this work are real — perhaps even profound.

These skills can also improve our ability to work through team discussions, even team conflict. Let's take a discussion on a controversial potential investment as an example. We certainly have had our share of these discussions on our team, and they can be loaded with landmines. There is a risk that team members will get angry, will feel unheard, or perhaps worst of all, won't speak their mind honestly for fear of hurting a colleague's feelings. The obligation rests on me as a leader to move through this potential conflict and turn it into something productive, and I wrestle with this challenge with varying degrees of success. Mark Gerzon, a renowned expert in the field of global leadership and an experienced facilitator in high-conflict zones, notes that "under stress, the first thing that usually goes…is the capacity to ask a question."[10] If team members are oriented to really listen to each other, the discussion can evolve to a place of truth.

---

[8] Tim Ferriss Show: Cal Fussman Interviewing Larry King
[9] http://static1.1.sqspcdn.com/static/f/783993/15327402/1322512407130/Deep+Listening1.pdf?token=O6tvQY909phFHE2l83g8lQebI3o%3D
[10] Ibid.

Gerzon describes inquiry as "a light coming through the clouds….Once that light comes through…once learning begins, the [discussion or] conflict starts to change."[11] I find it can be scary to ask an open-ended question in the midst of a heated debate, as I have to be prepared for the answer, even if I don't like it. So what's the difference between ending an investment discussion with an open-ended question like "how are you all feeling right now about the decision we just made?" rather than asking a closed question like "OK, everybody agree?" The difference is that the first question can create commitment, while the second only creates agreement. **"Agreement is people saying yes, walking out the door, and doing whatever they plan to do anyway. Commitment is actually a follow through on the agreements made."**[12] Commitment gives buy-in, which is certainly what I want from my team before we make meaningful decisions.

Cultivating Our Skills

In their purest, most unencumbered form, asking questions and listening to the answers are forms of meditation. While a mindfulness practice (which I, for one, struggle with daily) can certainly play an important role in honing these art forms, there are simple steps anyone can take to sharpen these skills. Deep inquiry and listening can be modeled by any individual within an organization who is willing to be present, give their full attention to a discussion, and act with patience. Self-awareness is the basic grounds for listening and communicating effectively with others, as "a clouded mirror cannot reflect accurately."[13] These skills do not require anyone to change their values or beliefs — simply be present with those things and hold space for others to share their own.

One can work actively to ask questions that open, rather than shut down, discussion. Do our questions facilitate getting to an unbiased truth? Do they inspire new ways of thinking? Do they open the possibility for learning and growth or do they assume an answer or narrow choice? I am working to learn the difference between reacting and responding, which isn't easy. To me, there is value to simply recognizing that these are skills which require practice, and the effort to achieve something close to mastery in these arts seems well worth the effort.

Resources

http://www.refresher.com/fostering-a-culture-of-deep-inquiry-and-listening/

http://static1.1.sqspcdn.com/static/f/783993/15327402/1322512407130/Deep+Listening1.pdf?token=O6tvQY909phFHE2l83g8lQebI30%3D

http://www.alternativeresolutions.net/may-2013-newsletter/

https://www.mindful.org/deep-listening/

http://www.learningnetwork.ac.nz/shared/professionalReading/KATMUR20143.pdf

Gerzon, Mark, Leading Through Conflict: How Successful Leaders Transform Differences into Opportunities, Boston, MA: Harvard Business School Press, 2006.

Murdoch, Kath, "Sample Questions to Drive Inquiry", 2014, http://blogs.ubc.ca/stevemcg/files/2014/09/inquiry-questions.pdf

Walters, Jamie. "Fostering a Culture of Deep Inquiry and Listening", The Journal for Quality and Participation, Summer 2005.

[11]Ibid.
[12]Ibid.
[13]https://www.mindful.org/deep-listening

The Questions for the Coming Year
[Continued from Page 5]

trade is popular on the premise that the BoJ will be the last central bank to stop quantitative easing. But what if this isn't the case? There are, after all, pros and cons to keeping an uber-easy monetary policy as shown *(Figure 2, on page 5)*.

So all in all, we seem to be on a knife edge and any number of events in the coming months may force the BoJ's hand.

2 – Will inflation surprise on the upside?

From the very first Gavekal paper (see Theoretical Framework For The Analysis Of A Deflationary Boom) to the first book we wrote (see Our Brave New World) up to my more recent offering, (Too Different For Comfort) we, as a firm, have taken a broadly deflationary view of the world. A key factor for this over the past 15 years has been excess manufacturing added by China, together with millions of workers leaving the countryside year after year to try their luck in cities. In a sense, spending the past 15 years talking about deflation had less to do with being visionary than simply being observant.

But is the situation now changing? In a recent piece, I asked what would happen to companies whose sole purpose is to optimize excess capacity (i.e. half of the world's unicorns) if and when that excess capacity is used up (see A Brave New, New World). Again, simply by being observant rather than visionary, we know that:

- **Migrant workers are no longer pouring into Chinese cities.** With about 60% of China's citizens now living in urban areas, urbanization growth was always bound to slow. Combine that with China's aging population and the fact that a rising share of rural residents are over 40 (and so less likely to move), and it seems clear that the deflationary pressure arising from China's urban migration is set to abate *(Figure 3)*.
- **Reduced excess capacity in China is real:** from restrictions on coal mines, to the shuttering of shipyards and steel mills, Xi Jinping's supply-side reforms have bitten. At the very least, some 10mn

[9]https://www.mindful.org/deep-listening/

FIG. 3 China's Decelerating Urbanization

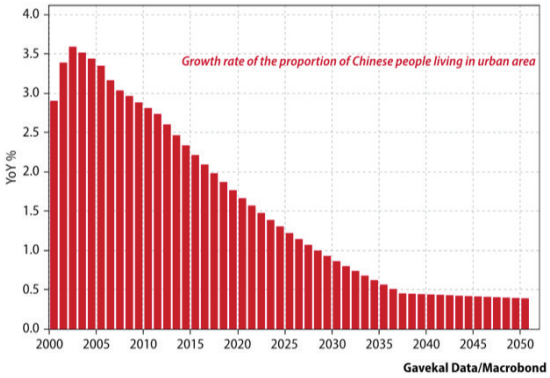
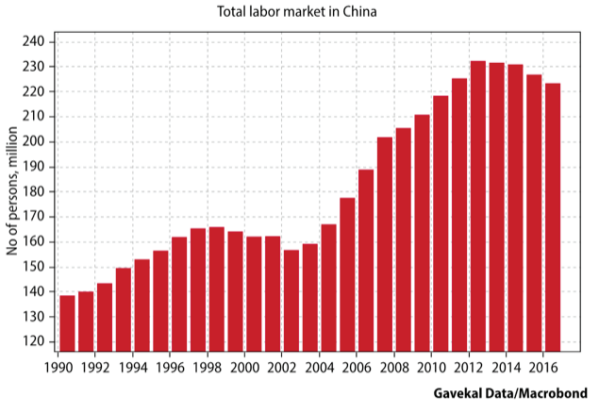


FIG. 4 China's Jobs Market Tops Out



industrial workers have lost their jobs since Xi's took office (note there are roughly 12.5m manufacturing workers in the U.S. today!) *(Figure 4)*.

To say that most "excess investment" China unleashed with its 2015 – 16 monetary and regulatory policy stimulus went into domestic real estate is only a mild exaggeration. Very little went into manufacturing capacity, which may explain why the price of goods exports from China has, after a five-year period, shown signs of breaking out on the upside. Another part of the puzzle is that Chinese producer prices are also rising, so it is perhaps not surprising that export prices have followed suit *(Figure 5)*. The point is if China's export prices do rise in a concerted manner, it will happen when inflation data in the likes of Japan, the U.S. and Germany are moving northward.

Indeed, for all the talk about how inflation is harder to find than morals in a movie production company, a sizable chunk of the recent inflation data is starting to point towards a creep higher in a number of prices. *(Figure 6)*

The structural outlook for inflation may be shifting.

3 – Why does inflation matter?

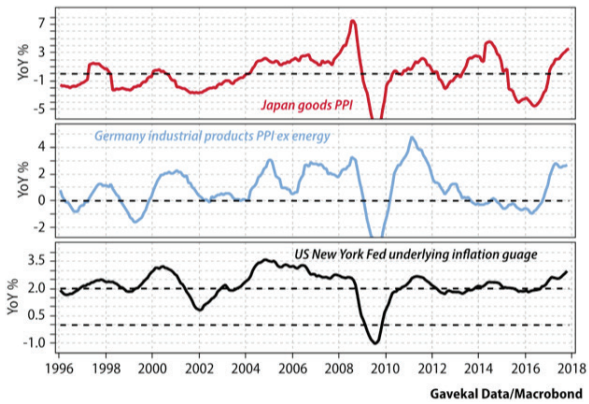
Forget the fact that higher inflation typically leads to lower P/E ratios (as firms are forced to keep more inventory, thereby exposing themselves to the economic cycle), while lower inflation tends to lead to higher P/Es. Forget also that equity market valuations around the world, but especially in the U.S., are decently high by any historical gauge, and thus arguably discounting a low inflation/low interest rate environment for years to come. The real reason I worry about inflation today is that inflation has the potential to seriously disrupt the happy policy status quo that has underpinned markets since the February 2016 Shanghai G20 meeting. And here, a historical parallel may be relevant.

Back in the early 1980s, foreign exchange volatility wreaked havoc on business spending plans and countries' ability to repay foreign currency debt. To remedy this situation, the world's key financial policymakers got together, first at the Plaza Hotel in New York in late 1985 and then in early 1987 in Paris to agree on a plan for coordinating monetary policies. The idea was to reduce currency volatility and so limit the scope for financial shocks. And so were born the "Plaza accords" and the "Louvre accords".

Unsurprisingly, global investors loved the idea that they would no longer get sucker-punched by large currency swings. Almost all risk assets ripped higher. Gold and silver miners were especially big winners as silver prices more than doubled between the summers of 1986 and 1987 (today, bitcoin has that easily beat!). Deep cyclicals rallied hard, as did emerging markets (Hong Kong equities more than doubled in the period, while Taiwan (where 10% of adults were day-trading) started to redefine what a bubble looked like. These go-go years came to an abrupt halt after a rise in bond yields through the summer of 1987. In response, the Bundesbank (which back then was a genuine inflation hawk) panicked and in October 1987 raised short rates. U.S. Treasury Secretary James Baker responded: "We will not sit back in this country and watch surplus countries jack up their interest rates and squeeze growth worldwide on the expectation that the United States somehow will follow by raising its interest rates."

FIG. 5 Chinese Producer Prices are Creeping Up

FIG. 6 Global Inflation is Also Creeping Up



This statement made on a Sunday morning television show made it clear that the Louvre Accord was dead and buried. The next day, the Dow Jones Industrials opened down -27%.

So why re-hash ancient history?

Because careful readers will have noticed that for the past 18 months, I have espoused the idea that, after a big rise in foreign exchange uncertainty — triggered mostly by China with its summer 2015 devaluation, but also by Japan and its talk of helicopter money, and by the violent devaluation of the euro that followed the eurozone crisis—the big financial powers acted to calm foreign exchange markets after the February 2016 meeting of the G20 in Shanghai.

Since then, markets have lived under the calming influence of the "Shanghai agreement" (such an agreement may or may not exist, but the fact that market participants think it does has minimized the required intervention!). And, as in the post-Louvre accord quarters, risk assets have broadly rallied hard. It's all felt wonderful, if not quite as care-free as the mid-1980s. And as long as we live under this Shanghai accord, perhaps we should not look a gift horse in the mouth and continue to pile on risk?

Any freak-out about inflationary pressure is likely to emanate from China.

This brings me to the nagging worry of "what if the Shanghai agreement comes to a brutal end as in 1987?" (back then, the Hong Kong stock exchange closed for a week as it could not handle a tsunami of sell orders).

For that to happen, one would need someone to play the role of Karl Otto Pohl who headed the Bundesbank through the 1980s. Now today, Mario Draghi is about as well suited to play that role as Ben Affleck is to play Batman. And frankly, in spite of the concerns expressed above about regional Japanese banks, Haruhiko Kuroda at the BoJ is also unlikely to upset the Shanghai understanding. So it is easy to conclude that, with everyone now happy to be on the back foot against inflation, there is no risk of a 1987 denouement of the established international order.

Except that this overlooks the single most important economy: China (let's face it: the last two upswings in global growth, namely 2009 and 2016, were triggered by China more than the U.S.). Indeed, the People's Bank of China may well be the new Bundesbank for the simple reason that most technocrats roaming the halls of power in Beijing were brought up in the Marxist church. And the first tenet of the Marxist faith is that historical events are shaped by economic forces, with inflation being the most powerful of these. From Marx's perspective, Louis XVI would have kept his head, and his throne, had it not been for rapid food price inflation in the years that preceded the French Revolution. And for a Chinese technocrat, the Tiananmen uprising of 1989 only happened because food price inflation was running at above 20%. **For this reason, the one central bank that can be counted on to be decently hawkish against rising inflation, or at least more hawkish then others, is the PBoC.**

And this is why a rise in inflation could end up dealing the markets a triple body blow. First, rising inflation would lead to lower valuations for most asset prices. Secondly, higher inflation would likely trigger a tighter monetary and fiscal policy in China. Thirdly, a tighter China threatens the cozy "Shanghai Agreement" which has prevailed since 2016. And how can one hedge against this threat? In 1987, bunds ended the year among the world's best performing asset classes. Of course, history never repeats itself; but if it ends up rhyming, owning short-dated renminbi- denominated bonds may be an obvious "portfolio cushion".

4 – What will the Fed do?

The fed looks to be on auto pilot…

Answering this question has always been an important driver of performance, yet this year the general level of "stress" regarding the Fed's upcoming decisions has been remarkably low. Almost every conversation I have had on the topic has been a version of the following:

a) The differences between incoming chair Jerome Powell and departing chair Janet Yellen are marginal.
b) In any event, Powell's policy choices in the near term are constrained by the "dot-plot" and the path that Yellen has traced out. For Powell to depart from the plan would require significant upside/downside surprise for the economy and markets.
c) So bottom line, unless there is a shock to the system, we will just have more of the same.
d) And more of the same seems fine, thank you very much!

…but imagine a different scenario

Needless to say, the above makes ample sense; and indeed, the path that Powell will follow is likely that offered by Yellen, and so discounted by the market. Yet, imagine a parallel universe, such that within a few months of being sworn in, Powell faces a U.S. economy where:

- Unemployment is close to record lows and government debt stands at record highs, yet the federal government embarks on an oddly timed fiscal stimulus through across-the-board tax cuts.
- Shortly afterwards, the government further compounds this stimulus with a large infrastructure spending bill.
- As inflationary pressures intensify around the world (partly due to this U.S. stimulus), the PBoC, BoJ and ECB adopt more hawkish positions than have been discounted by the market.
- The unexpected tightening by non-U.S. central banks leads other currencies higher, and the U.S. dollar lower.
- The combination of low interest rates, expansionary fiscal policy and a weaker dollar causes the U.S. economy to properly overheat, forcing the Fed to tighten more aggressively than expected.

The base case must remain that the Fed will follow broadly the path that it has set for itself. That said, the above scenario does not look far-fetched. Which means that looking into 2018, four scenarios seem most likely.

In the first scenario, events unfold fairly predictably and the Fed stays on its promised path. In this case, global currency volatility stays muted. In the second scenario, the U.S. embarks on a huge stimulus, prompting the Fed to tighten monetary policy aggressively. Meanwhile, other central banks continue to sit on their hands. This triggers

big capital inflows from the rest of the world into the U.S. and pushes the dollar higher. The third scenario sees the world experience some kind of shock (take your pick from a bad Italian election, a bank crisis in China, a Saudi-Iran war, a North Korea war or a political crisis in the U.S.) and the Fed responds with more QE. Finally, the fourth scenario sees the Fed deliver the promised monetary policy tightening, but inflation accelerates and the rest of the world tightens more aggressively than expected.

In the first two scenarios, the U.S. dollar will likely rise, either a little, or a lot. In the latter two scenarios, the dollar would likely be very weak. So if this analysis is broadly correct, shorting the dollar should be a good "tail risk" policy. If the global economy rolls over and/or a shock appears, the dollar will weaken. And if global nominal GDP growth accelerates further from here, the dollar will also likely weaken. Being long the dollar is a bet that the current investment environment is sustained.

5 – The other threat to the current environment: oil prices

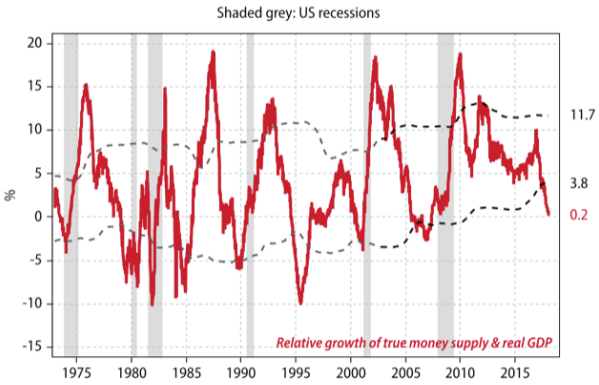
For ease of math, assume that the world consumes 100mn barrels of oil a day (the real number is around 97mn bpd). Then further assume that about 100 days of inventory is kept "in the system", whether in pipelines, boats or reservoirs. Now, funding these inventories takes money which is how a U.S. $20/barrel move in the oil price can have a big impact on the global liquidity situation. After all, if the price of oil is U.S. $60/bbl, then oil inventories will immobilize around U.S. $600bn in working capital. But if the price drops to U.S. $40/bbl, then the working capital needs of the broader energy industry drops by U.S.$200bn.

The point is that an environment of rising oil prices and tightening Fed policy is usually bad for financial assets. Simply put, the more money the Fed sucks out of the system, and the more that is tied up in the energy complex, the less is available to push up asset prices. On this score, it should be noted that excess money supply in the U.S. is decelerating *(Figure 7)*.

Should oil prices continue to rise, the resulting change in the liquidity situation could leave markets vulnerable. It follows that energy stocks may be a decent hedge for portfolios. To be sure, if oil prices head lower, then energy stocks will underperform, as the freed-up excess liquidity will flow into the likes of tech, emerging markets and bitcoin. But if oil prices do creep higher — or worse still, some kind of supply shock unfolds due to a Saudi-Iran confrontation or perhaps another collapse in Venezuela's output — then energy stocks will provide a buttressing effect against a very different investment environment.

Events may dictate Fed policy, with clear implications for the US dollar.

FIG. 7 Excess Liquidity Growth is Slowing



Gavekal Data/Macrobond

Conclusion

To many investors' surprise, the past year was characterized by:

a) Massive outperformance of growth vs value
b) Massive outperformance of tech
c) Solid globally synchronized growth with low inflation
d) Low equity market volatility
e) Low bond market volatility
f) Low foreign exchange market volatility
g) Oil mostly range-traded, though breaking out on the upside towards the end of the year
h) Yield curves flattened/stayed flat

What are the odds that 2018 produces more of the same?

When I was a boy, I went to Jesuit school in France. And there, I was taught to answer every question with another question. Or better yet, with several questions (if only to ensure that one's conversation partner ends up too confused to press a point). So the quandary of whether 2018 will unleash "more of the same" to me comes down to five questions:

1) **Is the recent oil price breakout a sign of more strength to come?** My fear is that the recent upside stems from strong, global, synchronized growth and a lack of investment in the past few years. This lack of investment is important as the energy industry has become far more capital-intensive in recent years due to the rapid depletion of fracking wells compared to traditional wells and the associated faster wear and tear of equipment. Thus, I am inclined to own energy stocks as a hedge against a further rise in oil prices; a rise which will suck up excess liquidity and so cap gains in hitherto "hot" asset classes. I also like energy stocks as a hedge against a big geopolitical shock as I worry that Saudi and Iran are one big terrorist event away from going at each other's throats.
2) **Will inflation surprise on the upside in 2018?** There is little doubt that most of the world's structural trends (the digitalization of everything, robotics and population aging) are deeply deflationary. Yet, what strikes me as odd is that everyone in every investment committee meeting these days is a deflationist. Gone are the days when at least one or two people may argue that central bank printing would lead us down the path of Zimbabwe or Weimar Germany. The inflationists have either been fired, or beaten into silence and submission. Which probably means that the "deflation forever" thesis is, by now, most likely fully baked into most asset prices?

The Japanese could surprise us and dial back on monetary stimulus.

So much so that, even as inflation data around the world start to rebound, no-one seems to care! It should also be acknowledged that since the eurozone crisis of 2011 – 12 few modern economies have added much productive investment capacity. Sure, real estate has been on fire almost everywhere and it is hard to go to a major city and not see a number of large construction cranes scar the skyline. But beyond real estate, and beyond tech, where have the marginal investment dollars gone? Not into steel mills, petrochemical plants, oil refineries, cement factories, or new tankers; not even in China, Korea or Japan (which could usually be counted to invest regardless!). So if global growth continues on its current synchronized path, isn't the risk that this lack of investment in new capacity ends up causing demand to outstrip supply? If so, then a sell-off in global bond markets is likely, along with all long-dated assets (especially growth stocks with limited profits). Fortunately, hedging against such an event is fairly easy as financials around the world should, in this eventuality, see steeper yield curves rapidly translate into better profits.

3) **Will China tighten more aggressively in 2018?** The main reason I am worried about inflation is that this would likely trigger a far tighter stance from Chinese policymakers. And let's face it, the world is more fun when China steps on the accelerator than when it steps on the brakes. At the very least, it is easier to make money when China steps on the gas. Now this doesn't mean we can't cushion portfolios against a tighter China. And today, the most obvious hedge would be Chinese government bonds, denominated in renminbi, yielding 4%. In case of further Chinese tightening, such bonds may be as useful to portfolios as bunds were in 1987. As Charles often likes to highlight, he came into October 1987 with 30% of the portfolio he managed (against the World MSCI) invested in long-dated German bunds. In early October '87, he thought this might be too much. By late October '87, he had realized it wasn't enough.

4) **Will Japan tighten monetary policy?** The lack of inflation in Japan makes this seem a fringe possibility. Yet, there are three reasons why a policy change may occur. Firstly, at some point policymakers will need to be seen doing "something" in response to the bitcoin mania. The second is that Japan tends to play ball with American requests and very a mercantilist president wants wins on trade that won't be easy with an under-valued yen. The third is that regional banks are starting to really struggle, with the simplest fix being a yield curve steepening. Thus, while a change in monetary policy is not likely, it is a risk for the coming year and one that is currently "unpriced". With that in mind, investors who, like me, fear a BoJ policy reversal should (i) remove yen hedges/short positions, (ii) rotate equity portfolios from high flying exporters to long-suffering domestic financials and (iii) press bets on Japanese domestic real estate.

5) **Will the Fed continue to tighten monetary policy?** It has been said that Keynesians think governments should expand their balance sheets when an economy heads south, and shrink it once an expansion is under way. Meanwhile, Republicans think the government should expand its balance sheet when a Republican is president and shrink it when a Democrat is president. I used to take this adage in jest, but today, the joke is on us as the GOP seems intent on proving the premise with gusto.

The U.S. certainly looks to be on an expansionary path that may challenge the Fed.

Concretely, this means that the U.S. investment environment may be set to change. Specifically, between 2010 (when the GOP took over the house) and 2016, the U.S. experienced a tight fiscal and loose monetary policy. As Charles has shown over the years, this is the best combination for equity markets as tight fiscal policy and loose money almost invariably leads to far higher P/E ratios. Alas, the opposite is true for the reverse: loose fiscal policy and tight money typically trigger a de-rating of equity markets. And this is the policy mix we seem to be heading towards.

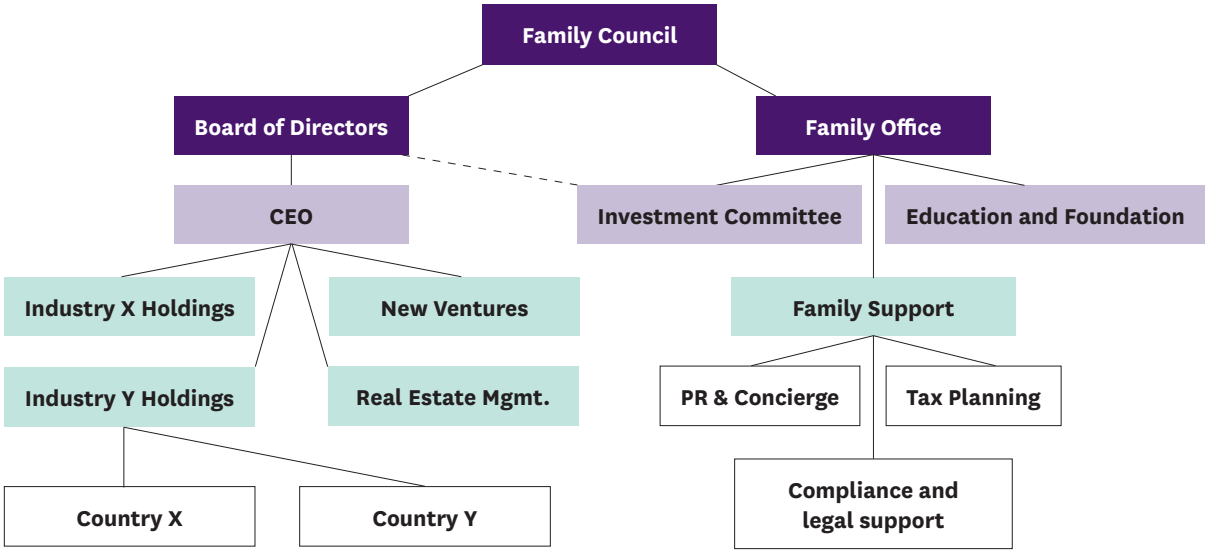
So pulling it together, investors who responded "no" to all five of the above questions with confidence should stick with the winners of recent years. In this eventuality, the investment environment in 2018 should not prove too different from the one that prevailed in 2017. However, investors who answered yes to the above questions may want to start building cushions in their portfolios against shocks. These cushions may be a greater exposure to energy stocks, financial stocks, renminbi bonds, the yen, rotating away from U.S. growth stocks and towards value stocks, or simply buying puts on U.S. equities.

Investment Committee ABC
[Continued from Page 6]

- **Capital Preservation Fund**, intended to be a "rainy day fund" with a relatively conservative profile and longer-term horizon, intended to guarantee payment of dividend to beneficiaries and cover cash deficits or investments as solicited by FC.
- **Operational fund**, intended to have a more liquid and less volatile profile, destined to provide support to businesses.
- **Foundational and/or Educational Fund**, intended to guarantee financing for philanthropic initiatives or education of members of the family and its enterprise leaders.

The IC has a long-term strategic goal and should be cautious not to take a chronically opportunistic approach to how it makes decisions. The IC should procure a disciplined approach to managing asset allocation based on portfolio goals and avoid regularly altering strategic course with the evolution of the markets. In our family we implemented an active asset management system whereby our in-house investment team bought and sold positions in single name bonds and equities from many geographies following strategies recommended by banks and experienced family members. I have seen intense work placed in keeping up with benchmarks, subjecting portfolios to significant volatility and unnecessary stress to the shareholders resulting from markets swings.

FIG. 1 Family Business Organizational Structure



In our case, following recommendation of the BOD, we engaged an outsourced asset manager to handle our liquid portfolios and eliminated our in-house team.

The main reasons were:

- **Size** Our wealth did not merit full time staff for asset management.
- **Experience** Proven professionals are likely to outperform in-house staff. Professional institutions should have a fully dedicated team with institutional knowledge, expertise, resources and market connectivity; hire the best money managers in each asset class.
- **Objectivity** Separate teams for analysis and IPS development from trading execution is recommendable; making portfolio decisions may be cumbersome when executors are employees.
- **Confidentiality risk** It is difficult to keep a tight lid on sensitive information when personnel are permanently exposed to colleagues in other areas of the family companies or in a country where such information can be used against owners' interests.

The IC has to understand family needs clearly and be accountable for implementing decisions, define overall strategy and risk tolerance for portfolio managers. This can be done by way of an Investment Policy Statement (IPS), which should be proposed by the IC and approved by the FC. This tool provides explicit parameters to define types of assets and the allocation to each. It should also contemplate the entire asset base of the family, as one should limit additional exposure to risks one is already exposed to. As per discussions with a friend, Gregory Curtis — Founder and Chairman of Greycourt & Co. — an IPS is a living document, which in plain language should guide investment policy both over the long and short-term. It should include:

1) **Investment Objectives** the purpose for the funds, general risk tolerance, and important factors for the family such as geographies, leverage, volatility, loss of corpus etc.
2) **Performance Objectives** can be described in terms of absolute return (i.e., 5%) and/or relative return as compared to a composite benchmark that has a similar volatility or asset class composition to the allocation in the portfolio.
3) **Distribution/Spending Policy** what and when are the family's draws required.
4) **Definition of Investment Advisors** as well as selection/retention criteria.
5) **Performance Measurement and Review** defines reporting content and periods as well as benchmarks associated with each asset class or manager.
6) **Asset Allocation Targets** defines how return goals will be reached.
7) **Investment Manager Evaluation Criteria** investment style, risk profile and organizational stability are as important as performance in choosing money managers.
8) **Modification policy** defines the procedure to revise and change the IPS as well as mandating pe-

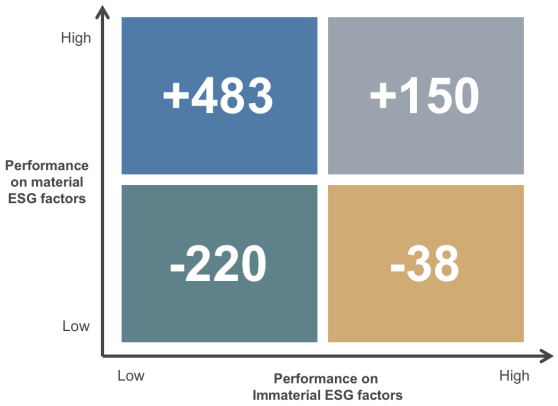
riodic review. The Operating Manual and the IPS Statements should have balanced rigidity to provide fundamental structure and dynamic parameters to allow enough discretion to respond opportunely to the market changes.

The result should be an empowered IC with an effective decision-making body and a system capable of evolving well with financial markets.

The example in *Figure 1 (on page 17)* contains a possible structure to reflect the interdependence amongst the three primary governing entities. The FO is a very broad concept implemented differently by each family, yet most have asset management as their core purpose, which is why a solid Investment Committee institution is central to the FB organization. There is no single solution for all, but often one's experience can help others find their own way. I have seen highly successful FBs that have dysfunctional FOs and vice versa. Do not let this discourage you, take the opportunity to use the structure of the stronger one to rethink and rebuild the weaker one. To transcend over time and serve as good stewards to the wealth of our descendants, having well defined roles and well regulated FB and FO are aspirations all families should strive for.

Integrating Impact into Investment Management
[Continued from Page 7]

FIG. 1 Basis Points of Relative Performance of Top and Bottom Quartile Companies by Focus on Material or Immaterial ESG Factors



Source: Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724.. Performance is from April 1993 to March 2013.

It is important that we thoughtfully consider how we incorporate ESG factors in a manner consistent with the specific asset class and style of each investment strategy.

environmental impact. While certain investors may have the discretion to choose more patient capital strategies, fiduciary investors can seek opportunities that meet or exceed risk-adjusted market returns while considering the social or environmental impact of their investments, and could even make the case that factoring in ESG makes them better long-term investors. For instance, U.S. active ESG funds outperformed the SP 500 by 31 basis points and U.S. active non-ESG funds by 49 basis points over a 10-year period ending June 30, 2017[9] *(Figure 2, on page 19)*, and for a 3-year period ending June 30, 2016, the MSCI Emerging Markets ESG Index outperformed its parent index by a cumulative 12% on a total return U.S. dollar basis with more than 50% of the outperformance attributable to ESG factors.[10] In fact, the Department of Labor provided updated guidance to ERISA plans in 2015 that "environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tiebreakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."[11]

As a multi-asset class investment manager, we are a reflection of our clients, who own diversified portfolios, have a mix of holding periods and investment styles, and have varying risk, return, and liquidity needs. Our investments range across public equities and fixed income to alternatives such as private equity and credit, in both developed and emerging markets. It is important that we thoughtfully consider how we incorporate ESG factors in a manner consistent with the specific asset class and style of each investment strategy. For instance, our Socially Responsive Investing team has been integrating relevant ESG criteria into its investment process since 1989, as part of its fundamental due diligence process of identifying high quality businesses in the U.S. equities context. The team analyzes sustainability issues that can pose a material risk or serve as growth opportunities for companies and also actively engages with management on key issues. Across our investment platform, our dedicated ESG Investing team works closely with portfolio managers and research analysts across asset classes, such as fixed income and private equity, to deepen the ESG integration into standard investment processes.

Incorporating ESG or impact into asset allocation adds another dimension to portfolio construction. Just as there is a spectrum of asset classes with a range of characteristics such as return, risk, and liquidity, there is a spectrum of how impact can be targeted and manifested across different investments, including:

- **Avoiding** certain negative outcomes by screening out companies that significantly contribute to these negative outcomes via their products or practices,
- **Assessing** the ESG characteristics of a company's products or practices and appropriately valuing any ESG risks or opportunities, seeking neutral or positive outcomes,
- **Amplifying** positive outcomes by selecting only companies that have an overall benefit to people or the environment based on ESG characteristics of their products or practices, or
- **Aiming** to intentionally generate significant additional positive outcomes by targeting companies that contribute to solutions to pressing social or environmental challenges via their products or practices.
- In addition to looking at impact at the company or enterprise level, the **role of the investor** is also an important driver of determining the overall impact of an investment. For example, by making valua-

[9]Morningstar.
[10]Cambridge Associates, "The Value of ESG Data: Early Evidence for Emerging Markets Equities", (October 2016).
[11]Department of Labor, Interpretive Bulletin 2015-01, (October 26, 2015).

tion or capital allocation decisions based on the integrated assessment of ESG factors, the investor is signaling to the market that impact matters. The investor may engage with management to encourage change and improve positive outcomes, or may direct capital to grow a new or undercapitalized company or market. Or the investor may support system-wide improvements in transparency, reporting, and regulation. All of these actions can act as an impact multiplier.

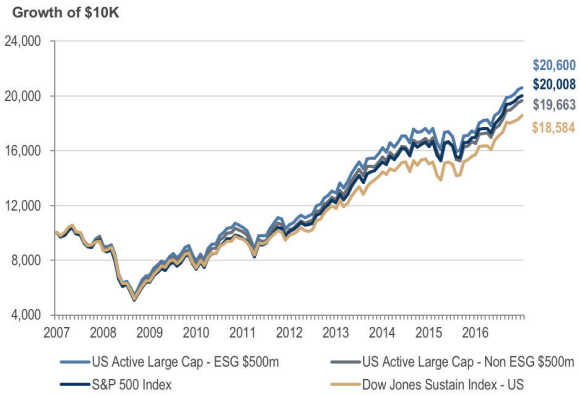
Just as investors have portfolios with investments across different asset classes, investors can have portfolios with investments across the impact spectrum.

Historically, there has been considerable confusion in the industry around different labels and terminology — responsible versus sustainable versus impact, for example — but ultimately we believe it is important to emphasize outcomes, or the effects on people and the environment, rather than the means or the labels. We are focused on understanding the key underlying environmental, social, and governance fundamentals of an investment as an integral part of our analysis in order to form a perspective on the impact of an investment.

- What are the environmental, social, and governance factors that are material to this business in this particular industry?
- Are these material factors risks or opportunities for the long-term sustainability of the business?
- What are both the positive and negative effects of the company's operations on various stakeholders, such as suppliers, employees, customers, and the environment?
- What is our role as an investor to improve our integration and engagement in order to amplify impact, when appropriate?

These are important questions that investors are seeking to better understand and are grappling with how to best measure and manage the impact of their investments. This poses an exciting opportunity to partner with our clients to innovate and help develop solutions, such as leveraging big data, quantitative analysis, and our fundamental research teams across asset classes to develop multi- faceted insights. We believe this is one of the most exciting areas of innovation in our industry. Just as clients are evolving their approach to the integration of impact into their portfolios, we are evolving to deliver on our steadfast commitment to help our clients achieve their long-term goals.

FIG. 2 U.S. Active Large Cap ESG and Non-ESP versus Indexes (as of June 30, 2017)



June 30, 2017	U.S. Active Large Cap - ESP Funds[1]	U.S. Active Large Cap - Non ESP Funds[2]	S&P 500 Index	DJ Sustain Index — U.S.
10-year Return	7.49	7.00	7.18	6.39
15-Year Return	8.41	8.50	8.34	7.35
20-Year Return	7.62	7.81	7.15	-

Source: Morningstar.
1. US Active Large Cap - ESG is an equally weighted net-of-fee portfolio that includes all funds that meet the following criteria: Morningstar category of Large Blend, Large Growth or Large Value and deemed socially conscious by Morningstar. The number of funds that had aggregate Fund assets of at least $500 million as of June 30, 2017 included in US Active Large Cap - ESG with a 10-year track record was 16 out of 34; 15-year track record was 11 out of 22; 20-year track record was 7 out of 12.
2. US Active Large Cap – Non ESG is an equally weighted net-of-fee portfolio that includes all funds that meet the following criteria: Morningstar category of Large Blend, Large Growth or Large Value and deemed not socially conscious by Morningstar. The number of funds that had aggregate Fund assets of at least $500 million as of June 30, 2017 included in US Active Large Cap - Non ESG with a 10-year track record was 398 out of 725; 15-year track record was 330 out of 572; 20-year track record was 240 out of 368.
The hypothetical analysis assumes an initial investment of $10,000 made on June 1, 2007 in the oldest share class of each respective Fund equally. This analysis assumes the reinvestment of all income dividends and other distributions, if any. The analysis does not reflect the effect of taxes that would be paid on Fund distributions. The analysis is based on hypothetical past performance and does not indicate future results. Given the potential fluctuation of each of the Funds' Net Asset Values (NAV), the hypothetical market value may be less than the hypothetical initial investment at any point during the time period considered. See Additional Disclosures at the end of this piece, which are an important part of this presentation.
S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.
The Dow Jones Sustainability U.S. Composite Index is designed for investors seeking an index tracking U.S. securities that applies a sustainability best-in-class selection process. The index tracks the performance of the top 20% of the largest 600 U.S. companies in the Dow Jones Sustainability North America Index, selected by the RobecoSAM's Total Sustainability Score.

Mark Your Calendar for Upcoming NMS Management Forums

NMS FORUMS AND ROUNDTABLES FOR THE ENDOWMENT AND FOUNDATION COMMUNITY

Membership Forums

The Winter Investment Management Forum for Endowments & Foundations
February 10 – 13, 2018

Networking Event for Service Provider Members
June 14, 2018

The Fall Investment Management Forum for Endowments &Foundations
September 23 – 26, 2018

Holiday Forum for Members
November 29, 2018

Roundtable Programs
(BY INVITATION ONLY)

Alternative Investing and Hedge Fund Roundtable
April 15 – 17, 2018

CIO Spring Roundtable
June 3 – 5, 2018

The CIO Roundtable
November 4 – 6, 2018

NMS MANAGEMENT, INC.
Headquarters:
68 S. Service Road, Suite 100
Melville, NY 11747

NYC Office:
590 Madison Avenue, 21st Fl.
New York, NY 10022

www.nmsmanagement.com