"Only when the tide goes out do you discover who's been swimming naked."

-Warren Buffet

PREPARING FOR LATE CYCLE DYNAMICS

The later stages of a credit cycle typically present a challenging environment for investors, offering lower returns and greater risks than the early or mid-cycle periods. Although we expect the current economic strength (evident across much of the global economy) to continue into 2018, we believe that investors should start considering the ways in which they might prepare portfolios for the risks and opportunities that the late stage of this credit cycle might present.

Source: Mercer

Sterling Capital works with a variety of clients, many of them large. These companies will hire consultants to provide advice regarding asset allocation and selecting investment managers. One of Sterling's institutional client strategists recently visited with the world's largest consultant, Mercer Consulting, who has $11 trillion in assets under advisement. Mercer is by far the largest firm in the industry as highlighted on the next page.

Perhaps it is helpful to understand what is on the mind of one of the largest advisory firms in the world and where they are directing assets. Mercer highlighted a number of themes that are shaping their investment outlook. They note, "our investment themes are intended to highlight the forces that we believe will shape economic and market dynamics over the years ahead…and we would therefore not expect our themes to change dramatically from one year to the next…"

These larger themes include:

- The reduction of global central bank influence as it begins to pull back on providing liquidity to the world economy.

- The need for the finance industry to rebuild trust following the financial crisis and investors incorporating environmental, social, and corporate governance (ESG) issues into their investments.

- Increasing political fragmentation reflected in the Brexit vote in Europe and populist movements in the U.S. and abroad.

- Preparing clients for a more challenging environment as the global economic expansion matures.

We broke out this last point above as it can be considered the result of the first three points: a reduction in liquidity, reduced trust in government, and more fragmented institutions. How do investors "prepare portfolios for the risks and opportunities?" The name of our investment group encapsulates how we play offense in terms of investments; the Equity Opportunities Group is always on the lookout for "unique companies at unique prices." On the defensive side of the ball, one characteristic of our portfolios has also been that they tend to perform better than the benchmark in down markets. Downside protection has not been a concern for most investors as this current bull market becomes the longest in history this month at 114 months according to Strategas Research. But large investors such as Mercer have begun to increase their focus on downside protection in their selection of asset managers.

Institutional investors use a term called a "downside capture ratio" to measure the relative performance of portfolios versus their benchmark over various periods

INVESTMENT CONSULTANTS

RANK	PROVIDER	GLOBAL ASSETS UNDER ADVICE ($bn)
1	Mercer	$10,951
2	Aon Hewitt	$3,722
3	Cambridge Associates	$2,500
4	Russell Investments	$2,400
5	Callan LLC	$2,213
6	Willis Towers Watson	$2,200
7	RVK Inc.	$2,101
8	Nomura Securities Co. Ltd.	$1,894
9	Pension Consulting Alliance Inc.	$1,259
10	Meketa Investment Group Inc.	$1,022

Source: Pensions & Investments survey as of June 30, 2017.

of time. A downside capture ratio of 90 translates to investors losing only $0.90 should the benchmark decline $1.00. Why has downside capture been on the backburner in investor's minds? Well, last year it was impossible to calculate the monthly downside capture for funds benchmarked to the S&P 500 because every month was positive so there was no data for the calculation.

As firms such as Mercer and perhaps others begin to look at downside capture with a keener eye into 2019 and beyond, we'd highlight that across the five longest tenured Equity Opportunity Group strategies, downside capture ratios calculated from the date of inception range from 62 to 88, all well below 100.

As always thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterling-capital.com

*The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.*

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