Taft-Hartley Newsletter

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- **The 60/40 Asset Allocation Has Two Problems: The "60" and the "40":** In this paper our Multi-Asset Solutions experts explore the issues with a traditional 60/40 portfolio in meeting your return objectives, and provide important considerations for optimal Taft-Hartley portfolio construction.
- **ESG is paramount for sustainable near- and long-term returns:** Our infrastructure experts discuss the importance of environmental considerations, social factors and governance in private infrastructure investing.
- **When fundraising gets easier, investing is more challenging:** Our Private Equity experts explore how investors should be thinking about their PE portfolios in this late stage of a historically long recovery.

THE U.S. LABOR MARKET CONTINUES TO BE HEALTHY, BUT ECONOMIC GROWTH IS SLOWING, NOT STALLING.

The labor market continues to be strong at this late stage of the expansion, but as economic growth decelerates, the pace of labor market tightening is likely to slow as well. Although wage growth has accelerated recently, it has not caused higher inflation so far. With a reasonably healthy labor market and persistently low inflation, this should result in no further interest rate hikes from Federal Reserve this year.

J.P.Morgan
Asset Management

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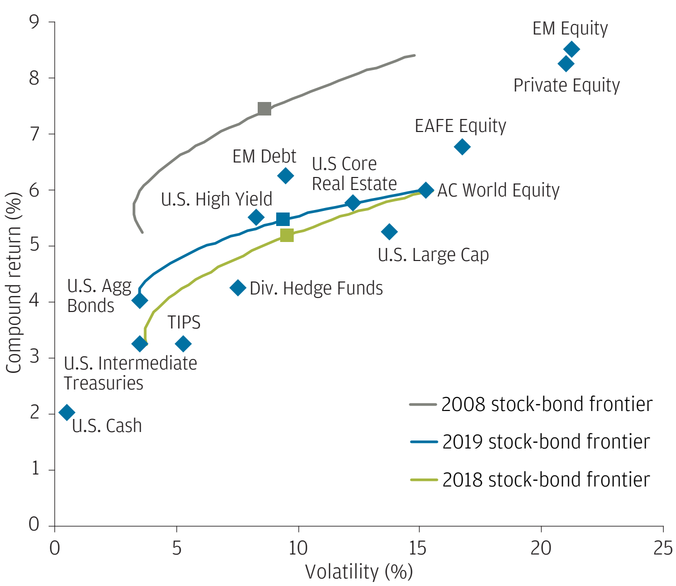
THE 60 / 40 ASSET ALLOCATION HAS TWO PROBLEMS: THE "60" AND THE "40"

Phil Camporeale, *Investment Specialist, Multi-Asset Solutions*

What a world we live in. Never in the history of financial markets have the four major developed market currencies – Dollar, Euro, Pound Sterling, and the Yen – delivered a "risk free" rate as close to zero. While this is an explicit problem for an aging developed market world craving income, it is an implicit problem for total return given the low "carry" component in fixed income assets such as core fixed income.

Moreover, in an effort to stimulate growth and inflation expectations, major Central Banks embarked on unprecedented balance sheet expansion known as "Quantitative Easing". While this produced asset price inflation in the U.S. with the S&P 500 up over 300% since March 9th, 2009 through the end of February 2019, it acted more as a steroid than a medicine as core inflation is still running below the Fed's 2% target with marginal wage inflation.

EXHIBIT 1: STOCK-BOND FRONTIERS: 2019 VS. 2018 AND 2008 ASSUMPTIONS (USD)



Source: J.P. Morgan Asset Management; estimates as of September 2017 and September 2018.

*EM = emerging markets; DM = developed markets.

A downshift in long-term return expectations

Where does this lead us now? Each year our team publishes "Long Term Capital Market Assumptions" which are 10-15 year annualized return assumptions for major global asset classes. Our 2019 long term capital market assumption for a static 60% U.S. Equity (S&P 500) and a 40% Fixed Income (Barclays Aggregate Index) asset allocation is now down to 5.5% annualized. This is a direct reflection of a quicker than expected run up in equity prices as well as anticipation of a continued low growth and rate environment. To put our 5.5% annualized number into context, this same static 60/40 allocation has delivered a whopping 12.2% return since March 2009 and is over 200bps lower on an annualized basis from our assumptions ten years ago..

Investment implications

This lower return environment may be a sobering new world for investors, but we believe there are important levers that investors can pull to confront the static 60/40 return challenge.

1. **Be flexible.** Investors can stay reasonably within their risk profile, and be able to introduce dynamic asset allocation to an existing allocation to add or remove asset classes from their portfolio. Given the aforementioned return challenges going forward, investors should be willing to introduce tactical asset allocation to capture market dislocations within equities, fixed income, and alternative asset classes. We believe asset allocation flexibility can improve total and risk adjusted return and how we manage downside risk/total portfolio volatility through our asset allocation choices. A good example is how successful managers have navigated in and out of emerging markets over the past few years.

2. **Do homework on your managers.** If index performance is going to be challenging, manager due diligence is a crucial component to finding ways to outperform the index—or find alpha. We look for long tenured managers that have a proven track record over multiple business cycles and environments. Because a manager's style is favor for a short time period does not make them a good manager. Good managers should be able to generate alpha over various parts of the business cycle—early, mid or late.

3. **Prudent Use of Leverage.** Leverage is not a dirty word. Leverage can be used to manage risk or to generate return. Exchange traded futures or options on indices such as the S&P 500 or the Eurostoxx 50 are efficient ways to add and remove beta or risk from your portfolio depending on your tactical asset allocation views. In many asset classes, it is more economical to use futures to tactically trade risk versus bearing the transaction costs of buying and selling individual stocks/bonds. Another example is the way interest rate risk and equity exposure can be managed with the use of Treasury futures that can quickly add or remove duration.

4. **Private Markets.** Investors should be open to introducing private asset classes to their asset allocation as expected returns remain attractive to those for public markets. We believe there could be increasing alpha opportunities as disruption in the global digital economy is ripe for the private market industry. Although our cap weighted private equity forecast is roughly 300bps greater than public equity markets, manager selection is critical in this space.

To conclude, while the 60/40 static asset allocation has outperformed investor expectations coming out of the financial crisis driven by an unprecedented liquidity environment, there are reasons to believe that some of those returns have been borrowed from future returns. In this new challenging environment we would encourage investors to be open to flexible tactical asset allocation, have a process for determining consistent manager alpha potential, introduce leverage to make their cash work harder, and finally be able to allocate to private markets if possible.

ESG IS PARAMOUNT FOR SUSTAINABLE NEAR- AND LONG-TERM RETURNS

Matthew LeBlanc, *Chief Investment Officer, Infrastructure Investments Group*

Paul Ryan, *Portfolio Manager, Infrastructure Investments Group*

Private infrastructure investing has reached a tipping point. The integration of environmental, social and governance (ESG) standards is now mainstream, a forward-looking matter of strategic positioning rather than the backward-looking compliance consideration of the past. We view ESG as the No. 1 trend—critical to effective due diligence, underwriting and ongoing asset management, and a fundamental influence on investment outcomes.

Governance lays groundwork for sustainability

The first ESG component to be broadly adopted was governance, and it was the condition for the other two to take hold. Governance is threefold: majority control, which allows for implementing sustainable practices; an independent board of directors, which brings diversity of insight, relationships and experience; and business-wide policies—hiring, health and safety, and anticorruption, among others.

Next, environmental considerations, such as mitigating climate change risks and bolstering resilience, rose to the fore. Infrastructure investing has led other asset classes here, partly because meeting environmental regulations is a fundamental threshold for achieving expected returns. Examples from our portfolios include water companies meeting water conservation goals; renewable energy providers reporting on emissions avoided; and the adoption, testing and revision of disaster resilience plans.

Examples of infrastructure assets

Ffynnon Oer Wind Farm, South Wales, Wales

Cairns Airport, Queensland, Australia

Noatum Marine Terminal Málaga, Málaga, Spain

A high-performance diesel locomotive

The complexity and importance of social standards

Third and most challenging are social factors—an asset's impact on its community, customers, employees and other stakeholders. Social factors are complex and deeply influenced by local context, and many companies (especially monopolies) overlook them—even though a failure can cost a company its social license to operate.[1] What is meeting social standards? Giving utility customers access to real-time usage data, improving passengers' airport experience and communicating with those affected by weather-related events are examples. These take time and resources yet can both reduce risk and potentially be powerful catalysts for returns. Social factors we consider include positive reputation/customer satisfaction, community health and safety, local employment opportunities and employee voluntarism. And there can be a regulatory impact for infrastructure companies that fail to consider other social factors: community development; employee health and safety reviews; and reviews of customers, communities and supply chains.

In 2019, being proactive on ESG risks and opportunities will be paramount in the successful active management of private infrastructure assets.

[1] When a project and its operating procedures (waste management, human resources, etc.) have ongoing approval or broad acceptance by the local community and other affected stakeholders, such as employees and the wider public.

WHEN FUNDRAISING GETS EASIER, INVESTING IS MORE CHALLENGING

Larry Unrein, CFA, *Portfolio Manager and Global Head of the Private Equity Group*

The private equity (PE) market has seen solid fundraising for almost a decade from investors interested in maintaining, if not expanding, PE allocations (**EXHIBIT 2**). Increasingly, investors anticipating only modest long-term returns from traditional public markets have turned to PE to help generate the returns they need. Institutions, on average, require returns of 7.5% to 8.0%,[2] while, according to our 2019 Long-Term Capital Market Assumptions, a traditional 60/40 global equity-debt portfolio can be expected to return something closer to 5.5% over the next 10 to 15 years.[3] Fundraising has also been fueled by investors anxious to rebalance out of asset class holdings that have appreciated beyond their strategic targets and into PE portfolios where multiple years of healthy distributions (in excess of contributions) have served to reduce allocations below strategic levels.[4]

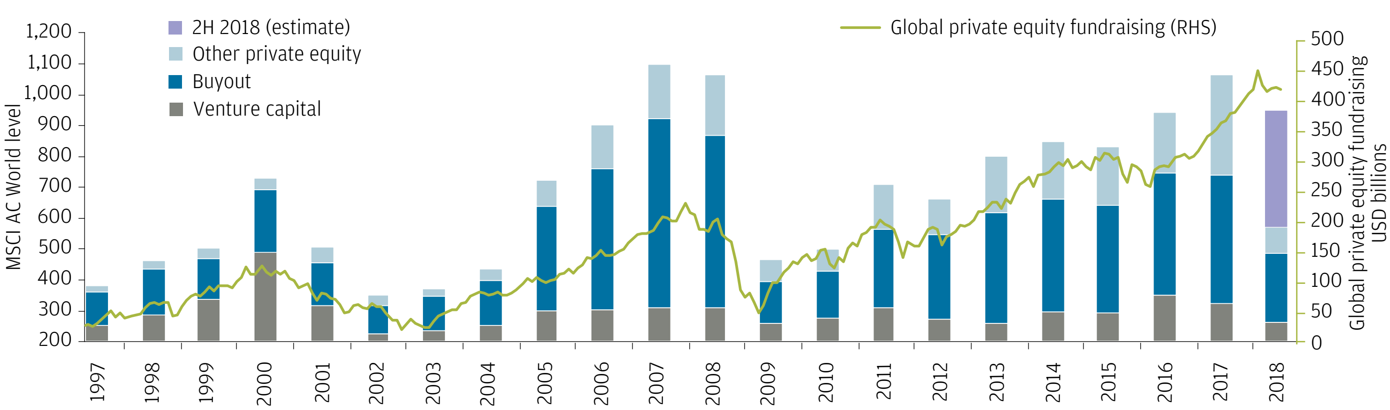
[2] Average pension return assumptions from Public Plans Data-the Center for Retirement Research at Boston College and the Center for State and Local Government Excellence, as of September, 2018; endowments and foundations (E&F) return target estimated by J.P. Morgan Asset Management; 8% = spending rule (5%) + inflation (2% based on J.P. Morgan's 2019 Long-Term Capital Market Assumptions) + management fees (1%).

[3] 2019 Long-Term Capital Market Assumptions, J.P. Morgan Asset Management; data as of September 30, 2018.

[4] On a global basis, distributions to PE limited partners exceeded contributions in each year from 2011 through 1H 2017. Cambridge Associates Private Investment Database, 1H 2017. See http://docs.preqin.com/reports/Bain-and-Company-Global-Private-Equity-Report-2018.pdf Figure 1.16.

Global PE fundraising has been strong for almost a decade. How can all these funds be put to work effectively?

EXHIBIT 2: INVESTOR SENTIMENT



Source: FactSet, Thomson ONE; historical data and 2H 2018 total fundraising estimate as of June 30, 2018.

Yet when funds are more easily raised, it becomes more difficult to invest them productively. Demand outpacing supply generally means higher valuations, greater use of leverage and/or lower potential future internal rates of return. How, then, should investors be thinking about their PE portfolios in this late stage of a historically long recovery?

Maintain a sense of reality and discipline

In our view, investors have three choices: Lower return expectations, sacrifice underwriting standards or be disciplined in seeking out solid opportunities in this late cycle with the potential to deliver on private equity risk and return objectives over the long term. We believe that, even in the current market environment of rising valuations and intense competition, there are ample opportunities in PE markets to help investors achieve required, risk-appropriate returns. But it will take skilled, discerning investors with well-established sourcing networks, a disciplined due diligence process and the ability to implement effectively to achieve those goals. It may also require a willingness to underweight or overweight specific sectors depending on where high conviction opportunities can be found in this market.

Areas of opportunity

Small to midsize private companies

Within corporate finance, which accounts for the bulk of PE assets, we see attractive opportunities in firms with revenues of USD 10 million to USD 100 million. While large and mega deals steal the headlines, smaller, below-the-radar opportunities are more numerous and typically less leveraged, with less inflated valuations.[5] Private equity partners experienced in working closely with the management of these smaller firms can help realize business improvement and growth opportunities, enhancing the potential for greater investor returns.

Europe, China and, selectively, India

The world economy is providing an expanding global opportunity set for PE investing. At the same time, we believe a broadly inclusive, top-down, globally diversified strategy may be less appropriate for private equity than for public equity investing. In our view, investors are best served by a more selective, market-by-market, deal-by-deal, bottom-up approach to PE investing, allowing identification of the best opportunities wherever they reside. Our focus outside the U.S. continues to be on the key private equity markets—Europe, China and, selectively, India—and the high growth areas within them.

Technological innovation and disruption

Finally, an unrelenting wave of technological innovation and adoption is giving rise to an array of new business ventures hardly imaginable a decade ago. These innovations are improving efficiencies, disrupting businesses and transforming traditional modes of communication—a fundamental shift we expect to continue. We see particular opportunities in rapidly changing e-commerce and in cybersecurity—a non-discretionary technology expenditure for many.

Such game-changing innovations are far more likely to be conceived and nurtured as start-ups than as homegrown businesses within mature public firms. And many of these ventures are choosing to remain private longer[6]—due in part to a greater availability of private equity financing and the costs and regulatory constraints involved in going public. Exposure to these technological innovation-driven growth opportunities is getting harder and harder to achieve through public equity markets.[7] However, venture capital investing is risky and there are many failures; that makes expertise in specific technology sectors and access to early-stage companies with leading entrepreneurs critical to successful investing.

In short, private equity investors can't ignore the macro environment—the length of the current recovery and the stores of dry powder seeking investment opportunities, now approaching $1 trillion.[8] In our view, particularly within the small to midsize corporate finance market, valuations may not yet be as concerning as they were near their 2006–07 peak. But timing private equity markets is extremely difficult. Now, as always, skillful, disciplined investing at a measured pace over time remains the key to meeting return objectives.

5 For example, purchase price multiples for deals below USD 200 million averaged 7.5x vs. 9.9x for the overall buyout market, for the 10 years ended June 30, 2018. Akerman Q3 2018 Perspectives RW Insurance; PitchBook, data as of June 30, 2018.

6 During the period 1996-2000, the average company completing an initial public offering (IPO) was 6 years old at the time of the offering. In the early 2000s, the average age rose to 8 years. Following the financial crisis, it increased to 10 years. https://corpgov.law.harvard.edu/2018/10/09/cashing-it-in-private-company-exchanges-and-employee-stock-sales-prior-to-ipo/.

7 For example, from 1997 to 2017 the number of U.S. listed companies declined from roughly 7,900 to 4,300 (Standard & Poors, September 9, 2018). In contrast, the number of venture capital (VC) deals involving start-up firms valued at over USD 1 billion (i.e., "unicorns") rose from fewer than 10 in 2007 to 75 in 2017. Unicorn Report 2018, PitchBook; data as of August 1, 2018.

8 PitchBook, data as of September 2018.

J.P. Morgan Asset Management | 270 Park Avenue, New York, NY 10017

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J.P. Morgan Asset Management is proud to have worked with the Taft-Hartley community for **over 60 years**. We help empower better decisions by dynamically responding to your needs, managing over **$15bn** in assets for more than **200 Taft-Hartley plans**. Together, we can solve anything.

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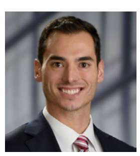
FOR TAFT-HARTLEY SOLUTIONS, PLEASE CONTACT:

Keith Cahill
212-648-0845
keith.m.cahill@jpmorgan.com

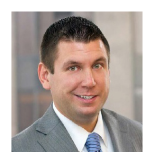
Will Floersheimer
212-648-1622
will.floersheimer@jpmchase.com



Matthew Johnson
212-648-1538
matthew.j.johnson@jpmorgan.com

Stephan Murphy
212-648-2109
stephan.t.murphy@jpmorgan.com

Alex Schneider
312-954-5855
alex.schneider@jpmorgan.com



Thomas Villanova
312-732-3558
thomas.j.villanova@jpmorgan.com