PAVILION

ENDOWMENT & FOUNDATION PORTFOLIOS: *A 10-POINT GAME PLAN FOR 2018*

As 2018 begins, we anticipate a continuation of current economic and investment trends and see no basis for significant changes across portfolios. Despite expectations for continued positive, if more muted returns over the coming year, change will come. We recommend that clients use the current environment to prepare. This is not a recommendation for broad asset allocation shifts, but rather an implementation checklist designed to ensure that the portfolio is positioned for a timely transition when conditions warrant. We view this preparation as spring cleaning rather than portfolio remodeling, with our recommendations falling into three main categories:

- Liquidity
- Diversification
- Volatility

Background

Global growth likely will remain strong throughout 2018. This strength comes against a backdrop of stable and low inflation as well as ongoing monetary accommodation. These conditions have resulted in strong earnings growth that, when coupled with low and steady interest rates, have contributed to historically low volatility levels (both realized and implied) and facilitated the impressive performance of risk assets. These favorable conditions will allow central banks to continue the very gradual process of policy normalization. While this policy normalization will eventually create a more challenging environment for risk assets, we do not anticipate a significant deterioration until sometime in 2019. At that point, central banks will have shifted from a stance of slowing accommodation to an actual reversal of accommodation. By that time, any modest positive fiscal stimulus from U.S. tax cuts likely will have run its course.

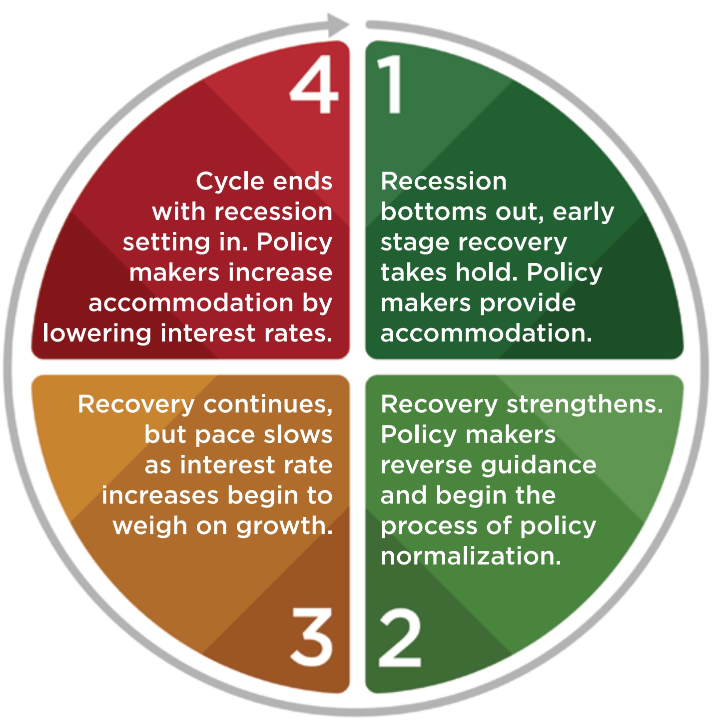
So where are we now? The graph below highlights four key stages of the business cycle. In our view, the cycle appears to be transitioning from the second stage to the third stage.

RISKS TO THE DOWNSIDE

Volatility increases, equities sell-off, credit spreads widen and high quality bonds rally as yield curve steepens due to policy changes.

RISKS BALANCED

Volatility increases, equity valuations become full as credit spreads tighten to below average levels. The yield curve flattens as policy rate increases continue.



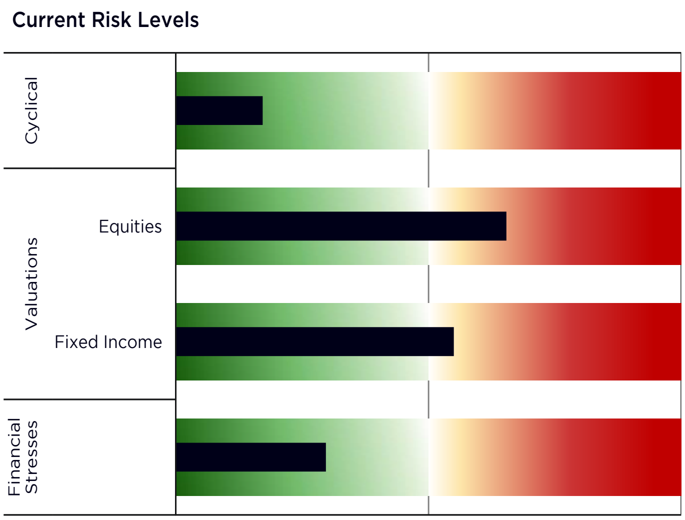
RISKS TO THE UPSIDE

Volatility begins to normalize, equities begin to recover, credit spreads stabilize while high quality bonds provide muted positive returns.

RISKS SLIGHTLY TO THE UPSIDE

Volatility remains low, equities continue positive performance, credit spreads tighten, rates begin to gradually rise with the yield curve flattening as markets begin to price in interest rate increases.

While entering the third stage of the cycle may seem ominous, it is important to recognize that business cycles do not recognize calendar time. Each cycle is different with stages potentially evolving over multi-year periods, and as a result, the cycle stage by itself provides an incomplete characterization of market risks. To address this challenge, Pavilion uses a risk management framework to evaluate risk on three dimensions: cyclical factors, valuations, and financial stresses.



At this time, cyclical risks and financial stresses appear low – a key reason why we believe that risk assets likely will perform well in 2018, despite stretched valuations. While this view, and the belief that we are moving into a late cycle stage are largely consensus views, there are no guarantees. The bottom line is that while we believe risk assets can continue to provide positive, if more muted performance over the next year, now is a good time for investors to take stock of their positioning and prepare for the risks that may lie ahead. It's time for spring cleaning.

To do list

Liquidity

Ensure that adequate liquidity exists in each portfolio sleeve such that rebalancing to capture diversification benefits and tactical positioning can be undertaken in a timely, cost effective fashion.

Diversification

Build in a portfolio stabilizer through fixed income: While interest rates are low and likely to rise, we anticipate increases will be gradual with rates normalizing well below recent historical averages. As a result, duration can provide investors with protection against a future policy misstep or other unforeseen circumstances. We favor high quality bonds that are unlikely to be adversely impacted by a risk-off or negative credit event.

If alternative strategies have been selected for diversification purposes rather than alpha sources, test their diversification potential in risk-off environments. Consider leverage, net exposures, beta exposure, down market capture, liquidity, position sizing, and the manager's risk management practices.

Volatility

Reduce credit spread duration exposure: Credit spreads are highly correlated with volatility and have tightened significantly in the current low volatility environment. As the cycle extends and approaches an inevitable turn, volatility will increase causing spreads to widen. With credit spreads at tight levels, very little upside beyond pure carry exists, providing investors with limited protection from future bumps in volatility, and a performance pattern that will be highly correlated with equities.

Evaluate equity portfolio structure: Passive management has performed well during the current bull-run due in part to the dominant performance of momentum. Some concentrated active equity managers have performed well also due in part to this momentum factor. Unfortunately, momentum works in a similar fashion when markets turn. Assess whether the index fund in use remains appropriate or whether a shift to a broader benchmark would lower risk. Many active managers have demonstrated an ability to outperform in down markets, as they avoid momentum (explicitly or implicitly). As a result, these active managers can add positive downside convexity, providing outperformance, in down markets. A shift in the allocation among managers may result in a lower volatility level as well.

Maintain barbell positioning of U.S. and emerging market equities: We recommend overweighting U.S. and emerging market equities and underweighting developed international equities. Emerging market equities should benefit from favorable valuations, stronger economic and earnings growth, and improved profitability. Emerging markets, however, tend to be more volatile than developed market equities. To maintain a beta near one, we recommend overweighting the lower beta, lower volatility U.S. equity market as a complement to the overweight to emerging market equities.

Maintain market exposures to U.S. large and small cap stocks. Valuations and fundamentals do not support an emphasis on either large or small cap stocks at this time. Moreover, small cap stocks are higher beta, so the allocation to this market segment should be evaluated in the context of the overall equity portfolio beta, which we recommend keeping near one.

Consider which alternatives strategies may provide downside protection. Similar to the point on diversification, evaluate the alternative strategies in place – particularly if they were selected as fixed income alternatives – to assure that they provide the desired level of protection when equity and equity-like market segments decline.

Focus Area	Implications	10-Point Action Plan
Liquidity: Prepare for an environment in which liquidity may be constrained when you want it most.	• Short-term cash needs • Liquidity in a market decline • Consider tax reform effects • Prepare for offense	1. Quantify reserves 2. Stress test private capital allocations 3. Assess possible impact on short term and long term 4. Identify dry powder and appropriate governance structure to implement
Diversification: The valuation of risk assets are stretched. Ensure that the portfolio has adequate sources of stability.	• Holistic view of equity sensitivity • Portfolio stability	5. Consider equity sensitivity that may be inherent in higher-risk fixed income or alternative managers 6. Overweight nimble managers such as global equity or opportunistic fixed income
Volatility: Prepare for greater volatility across all asset classes.	• Portfolio-level risk • Manager-level risk • Rebalancing	7. Portfolio-level risk analysis to assure Investment Committee awareness and to manage short-term expectations vs. long-term objectives 8. Trim or underweight higher-beta managers 9. Examine and reaffirm geographic tilts across the U.S., emerging markets, and Europe 10. Remain close to asset allocation targets