Portfolio & Market Insights

BUILDING STRONGER PORTFOLIOS WITH ALTERNATIVE INVESTMENTS

August 2020

WELLSPRING FINANCIAL ADVISORS

LIVE **WELL**. SLEEP **WELL**.

Alternative Assets

Role in Portfolio Construction

1. Wellspring believes Alternative Assets will continue to play an increasingly vital role in portfolio construction and risk management. More families find that the diverse collection of alternative assets – from private equity and real assets to infrastructure and private credit – can play an integral part in reaching their long-term objectives.
2. The long-term expected return of Alternative Assets is a key input into a client's asset allocation decision. Wellspring believes future returns are embedded in an asset's current valuation, cost of debt, and recurring fees. We also think it's important to consider the range of potential outcomes and believe this leads to more informed and better asset allocation decisions.
3. Private Equity, Private Credit, Infrastructure, Real Estate and Hedge Funds each have unique risk and return profiles, which rise and fall at different points depending on a broad array of inputs and factors. Wellspring considers each asset class a fundamental building block of a well-diversified portfolio. Proper sizing and an ability to source top-quartile managers are also essential.
4. Allocations to private assets may range from 10% to 40% of a client's portfolio based on objectives, access to top-quartile alpha-seeking managers, risk tolerance, and annual cash flow needs. Allocations may be higher for investors with fewer restrictions. Determining the appropriate allocation in a portfolio should be informed by one's view on the asset's expected return, the need for liquidity, and an understanding of the investor's constraints and objectives.
5. Investors in private assets often make binary decisions based on opportunities as they arise. Instead of asking if an investment fits within the overall portfolio context, individuals often ignore current allocations and approach each investment as a standalone decision. Wellspring recommends setting and maintaining target allocations for each asset class and evaluating each constituent relative to the asset class expected return.
6. Understanding the key drivers of return for a portfolio helps mitigate factor concentration and minimize correlations hidden within broad asset class exposure. Wellspring recommends maintaining a well-diversified portfolio with broad exposure to various risk and return factors.

Private Markets & Alternatives

Return Expectations

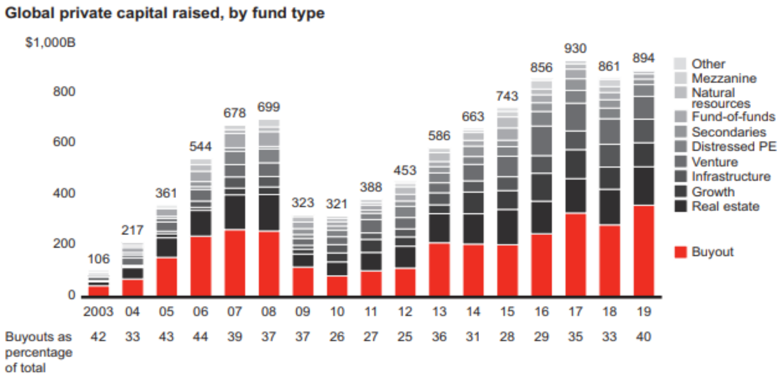
Asset	Return expectations (geometric, gross of fees)				Long-term expected volatility	Long-term correlation	
	5-year	10-year	15-year	20-year		Global equities	Global government bonds
U.S. private equity (buyout)	11.9%	12.1%	12.3%	12.4%	31.1%	80%	-20%
Global direct lending	8.7%	8.9%	9.0%	9.1%	14.3%	73%	-11%
Global infrastructure equity	8.2%	8.3%	8.3%	8.3%	18.8%	64%	5%
U.S. core real estate	6.1%	6.3%	6.4%	6.4%	12.2%	57%	16%
Real estate mezzanine debt	5.8%	6.2%	6.5%	6.6%	10.7%	69%	9%
Hedge funds (global)	5.4%	5.9%	6.3%	6.5%	8.1%	87%	-17%
U.S. Infrastructure debt	2.1%	3.2%	4.3%	4.9%	10.5%	28%	47%
Developed infrastructure debt	1.5%	2.5%	3.4%	3.9%	9.0%	31%	47%

This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.

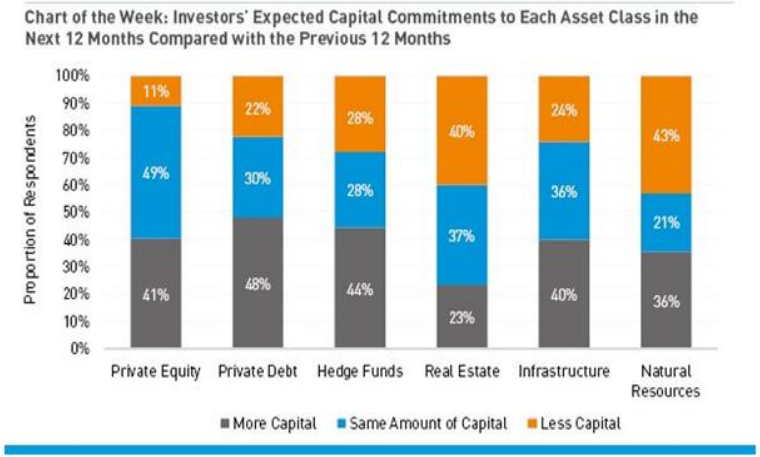
Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.

Notes: Return assumptions are total nominal returns. US dollar return expectations for all asset classes are shown in unhedged terms, with the exception of global ex-US Treasuries and hedge funds. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. Forecasted future performance is not a reliable indicator of future results. We use long-term volatility and correlation expectations. We break down each asset class into factor exposures and analyse those factors' historical volatilities and correlations over the past 20 years. Correlations with global equities and bonds are based on global measures excluding domestic equities and bonds. We combine the historical volatilities with the current factor makeup of each asset class to arrive at our assumptions. This approach takes into account how asset classes evolve over time. Example: Some fixed income indices are of shorter or longer duration than they were in the past. Our expectations reflect these changes, whereas a volatility calculation based only on historical monthly index returns would fail to capture the shifts. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Alternative Assets
Past & Future Allocations



Notes: Includes funds with final close and represents the year in which funds held their final close; buyout includes buyout and balanced funds; distressed PE includes distressed debt, special situation and turnaround funds; other includes private investment in public equity and hybrid funds; excludes SoftBank Vision Fund
Source: Preqin



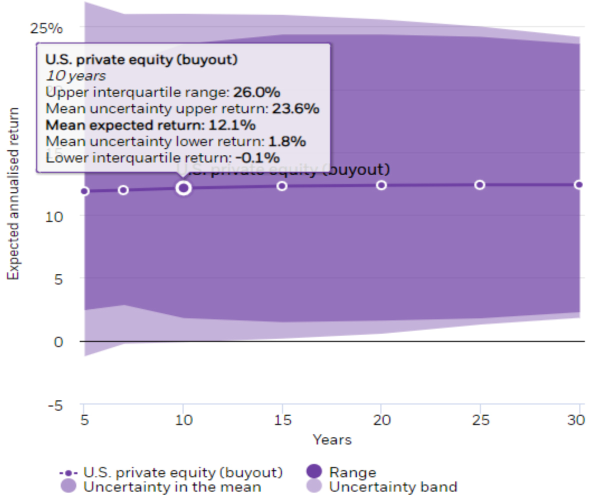
The COVID-19 recession appears to have increased investor interest in Alternative Assets. While investors surveyed by Preqin in June 2020 recognize the long-term economic damage caused by the pandemic, LPs also expect to allocate more capital to Alternative Investments due to the fallout from the pandemic. Investment levels may dip a little in the immediate future as risk budgets adjust. However, looking ahead, ***93% of LPs expect to either maintain or increase their allocation to Alternative Investments***, likely influenced by recent strong performance and generation lows in real interest rates. Private debt, private equity, infrastructure, and real estate have delivered solid, long-term results. More than two-thirds of investors say their fund returns had met or exceeded expectations in the past year. ***Compared to Preqin's prior investor survey completed in H1 2020, investors plan to increase their allocations to hedge funds, commodities, private debt, and infrastructure and maintain private equity exposure. Only the allocation to real estate is expected to decline (chart on the right).*** Demand for Alternative Assets in general and Private Equity specifically remains strong, with LPs eager to put capital to work. Last year was one of the most successful ever in terms of fund-raising. Limited Partners invested an estimated $894 billion into Alternative Assets, including private equity, real estate, infrastructure, and natural resources. Private equity alone raised $361 billion—the largest amount on record— and increased its share to 40% of total private capital, the highest level since 2006.

Private Equity
Impact of COVID-19

Private equity managers quickly assessed their portfolios' resilience and strength, given the unique challenges presented by COVID. The first thing Wellspring partners did was to ensure that the business in which they were invested had sufficient cash and runway to withstand the pandemic. General Partners scored each asset across qualitative and quantitative measures, including cash balances, availability of credit lines, and revolvers. The operational impact of business disruption on key performance indicators (KPI) was also quantified. Firms evaluated situations where debt covenants could potentially be an issue, analyzing the strength of the lender relationships and getting ahead of any conditions that could pose a challenge. There have been examples where additional equity capital has been needed to provide support to mostly consumer-facing or retail-oriented companies. In those situations, PE firms that had partnered with strong equity syndicates also offered support.

COVID-19 left few businesses and sectors untouched. However, the Private Equity funds in which Wellspring clients are invested were among the more resilient. We found that most companies had strong balance sheets and cash balances and an ability to manage through the recession. GPs informed us that the impact on portfolios has been more measured than expected, and we're now beginning to get early indications on 2Q marks. The overwhelming consensus was that we would see negative pressure on valuations. But instead, we are hearing that underlying investments are pointing to increases in valuation.

The chart on the right shows Blackrock's estimate for the mean expected return for private equity over the next ten years at +12.1%, with a range of +1.8% to +23.6%. The wide band of potential returns reflects the historically measured risk of private equity, shown here by the standard deviation of returns over the last 20 years. The dark purple band around the mean estimate reflects uncertainty and the range of possible outcomes for different time horizons.



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Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.

US Private Equity

The Importance of Due Diligence & Manager Selection

US PRIVATE EQUITY (LEGACY DEFINITION)

AS OF MARCH 31, 2020

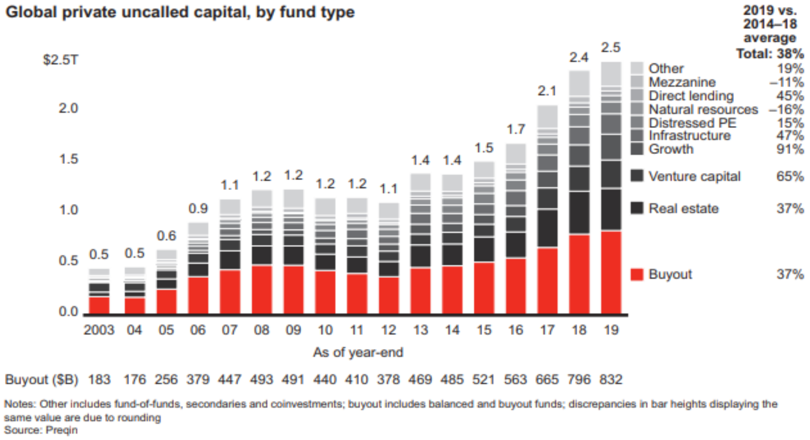
SINCE INCEPTION IRR & MULTIPLES BY FUND VINTAGE YEAR

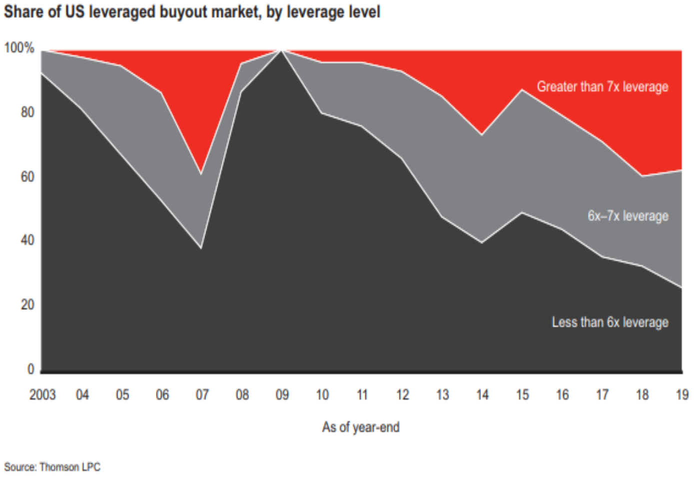
Net to Limited Partners

VINTAGE YEAR	POOLED RETURN (%)	ARITHMETIC MEAN (%)	MEDIAN (%)	EQUAL-WEIGHTED POOLED RETURN (%)	UPPER QUARTILE (%)	LOWER QUARTILE (%)	STANDARD DEVIATION (%)	DPI	RVPI	TVPI	NUMBER OF FUNDS
1995	20.41	16.01	11.24	18.35	30.72	1.06	23.21	1.95	0.00	1.95	34
1996	10.62	9.63	7.94	8.68	12.55	1.68	18.72	1.60	0.00	1.60	35
1997	6.85	7.06	7.30	6.87	13.32	0.12	15.52	1.41	0.00	1.41	49
1998	7.85	11.39	9.93	12.51	16.30	4.92	10.99	1.48	0.02	1.49	54
1999	15.20	12.32	12.13	12.94	18.06	5.12	14.12	1.91	0.01	1.91	51
2000	15.02	13.14	12.38	12.95	21.14	7.48	12.06	1.81	0.01	1.83	75
2001	22.31	22.22	18.24	21.88	33.52	11.53	18.02	2.20	0.02	2.22	31
2002	18.63	17.05	17.53	18.40	30.89	6.84	27.14	1.97	0.03	2.00	30
2003	15.77	14.64	12.72	13.87	16.98	3.11	13.61	1.90	0.01	1.91	33
2004	10.22	10.57	9.95	10.35	13.11	7.24	9.74	1.64	0.04	1.68	65
2005	8.49	7.95	8.16	9.75	14.06	3.52	11.57	1.57	0.06	1.62	91
2006	8.15	10.50	10.52	10.72	15.40	5.03	13.69	1.46	0.12	1.57	79
2007	11.35	10.46	11.21	10.96	16.01	5.21	11.99	1.39	0.26	1.65	94
2008	10.07	15.53	10.67	14.00	21.36	5.18	21.90	1.28	0.22	1.50	73
2009	19.03	19.30	16.21	20.45	23.29	10.00	15.77	1.50	0.67	2.17	34
2010	14.30	19.70	16.85	20.90	22.21	10.53	17.42	1.28	0.41	1.69	32
2011	13.54	12.70	13.31	14.77	18.11	8.07	13.42	0.99	0.63	1.62	66
2012	12.53	11.10	12.83	12.85	18.49	6.62	14.74	0.68	0.81	1.49	56
2013	9.38	11.65	11.59	12.84	16.49	6.31	10.81	0.49	0.86	1.35	70
2014	11.93	10.96	9.95	13.85	19.16	3.45	12.05	0.37	0.94	1.31	76
2015	10.61	11.95	8.64	12.38	19.59	3.28	25.24	0.20	1.02	1.23	82
2016	11.15	7.97	8.49	11.30	14.45	0.08	17.91	0.12	1.08	1.20	73
2017	-2.81	-4.69	-4.67	2.07	6.23	-14.79	24.80	0.03	0.94	0.97	58
2018	-7.84	-13.92	-10.83	-5.92	4.23	-25.86	26.79	0.02	0.93	0.95	59

Notes: Based on data compiled from 1,400 funds, including fully liquidated partnerships, formed between 1995 and 2018. Internal rates of returns are net of fees, expenses and carried interest. CA research shows that most funds take at least six years to settle into their final quartile ranking, and previous to this settling they typically rank in 2-3 other quartiles; therefore fund or benchmark performance metrics from more recent vintage years may be less meaningful. Benchmarks with "—" have an insufficient number of funds in the vintage

Private Equity
Dry Powder & Leverage





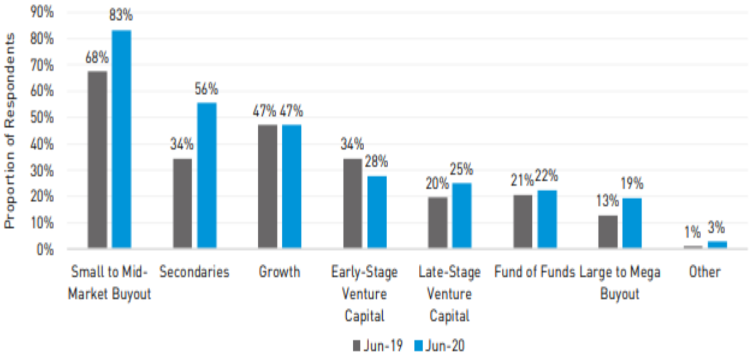
We expect the demand for private equity to remain strong as investors seek new sources of alpha in a prolonged low-interest-rate environment. Low-interest rates have led to a proliferation of private equity funds and record dry powder in the industry. Pitchbook estimates that private equity buyout and venture funds have over $1.2 trillion of dry powder available waiting to be deployed. This has led to heightened competition for companies, leading to higher valuations across many investments and even more leverage than before the GFC. Today, it's not uncommon for companies to be levered at 6-8x times "projected" cash flow (chart on the right). Credit markets have been exceedingly accommodating, given low-interest rates, leading some funds and managers to leverage underlying businesses even more. Excessive leverage is now giving way to restructuring in a number of these businesses. A significant percentage of private capital raised since 2015 has occurred at attractive terms, including covenant-lite. Oddly, cov-lite loans may lead to a more muted shake-out in the industry as business disruptions unfold. As noted in Bain's 2020 Alternative Assets report, despite a steady pace of investment since 2010, dry powder, or uncalled capital, has risen steadily. ***Dry powder hit a record high of $2.5 trillion in December 2019 across all fund types and $830 billion for buyouts alone (chart on the left). More than half of it sits in North America.***

Private Equity

Small End of the Middle Market

Return Expectations

Fig. 16: Investor Views on Fund Types Presenting the Best Opportunities in Private Equity, 2019 vs. 2020



Source: Preqin Investor Interviews, June 2019 - June 2020

Net IRR by Strategy: Most up-to-date (As of 12/31/19)

Past performance is not a guarantee of future results. There can be no assurance that a fund will achieve comparable results as any prior investments or prior investment funds of RCP. Source: Preqin - Performance Analyst. Top, Median, and Bottom Quartile North American PE Returns: Funds raised between 2000–2016; Net IRR by strategy – most up-to-date performance as of 12/31/19 (latest meaningful 12/31 data available). 1. RCP does not guarantee access to these types of funds. Note: All references to fund metrics and performance contained in this Presentation are qualified in their entireties by reference to all of the notes contained in the Appendix. The explanatory notes and methodology contained in those notes should be carefully reviewed in full.

Wellspring invests primarily in managers who focus on the small end of the middle market (SEMM). As a rule, we do not advocate allocating to managers or funds that use excessive leverage to generate returns. Companies' average leverage ratio is between 3-4x, not the 6-8x typical scene in the broader market, across the universe of private equity funds. Funds in which Wellspring invest focus primarily on smaller businesses, in which profit margins can be improved through operational changes rather than financial engineering. We also expect changes across the management suite, including CEOs, CFO, and COOs, as new insights and skills are often required to expand and grow the business. Many companies also experience a shift in their merchandising and marketing strategies and upgrades to their supply chain and shipping lanes. Wellspring believes the middle market's small end remains largely inefficient with top-tier managers outperforming peers in other segments of private assets (chart on the right). The chart on the left shows LPs' confidence in the SEMM increasing YOY, with most investors considering this asset class among the most attractive in the private market.

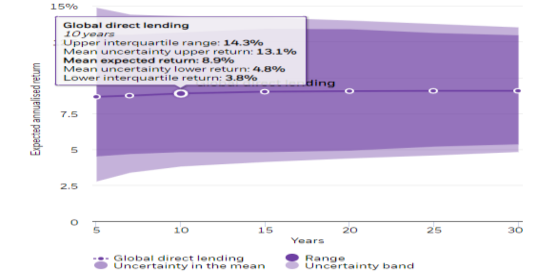
Private Credit

Opportunity Knocking

Private credit was one of the most negatively impacted asset classes of the market by COVID-19. By definition, a significant percentage of private credit and direct lending was to entities and institutions that were highly levered already. Although it may take time to burn through cash reserves and credit lines, we would not be surprised if defaults in private credit reach $500 billion to $1 trillion over the next 12-24 months. For perspective, this is about twice the amount of distress dry powder available to be invested. Wellspring believes the current supply-demand imbalance in private credit has created an attractive opportunity in which to invest.

Moody's expects default rates to rise to about 17% by mid-2021 with CCC-rated debt having a one in four chance of default. Moreover, Moody's projects distressed private credit to surge $500 billion to $1.0 trillion of loans with another $500 billion to $1 trillion in fallen angels and syndicated loans. According to Standard & Poor's, the number of companies whose credit ratings have been cut to junk from investment grade has increased to a record since the pandemic began. For reference, $500bn to $1 trillion in fallen angels is equivalent to about 8.75% to 17.5% of the overall IG index or 17.5% to 35% of BBB-rated bonds (chart on lower right). A meaningful percentage of BB and CCC rated structured credit has already breached existing covenants resulting in reduced flexibility and financing options for these entities.

Wellspring believes Private Credit Funds that successfully navigated the 2009-2012 spike in defaults and provide financing to mid-market companies facing financing difficulties for timing or non-market-related reasons are well-positioned to benefit from recent dislocations. A high percentage of the debt expected to breach existing covenants was trading at Libor plus 2 or 3 percent at the beginning of 2020. Today, these spreads are much wider and represent an opportunity. Wellspring believes well managed Private Credit Funds are uniquely positioned to benefit from the current market.



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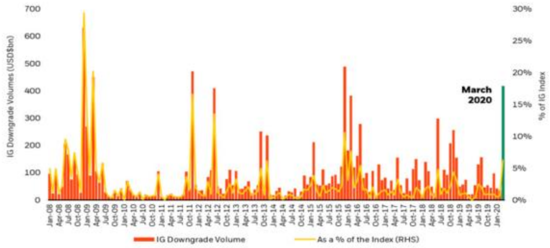
Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.

Investment grade downgrades have spiked since the coronavirus outbreak

Monthly IG downgrade volumes and percent of index outstanding



Source: Barclays Credit Research, as of 3/31/2020. After 2012, IG downgrade volumes include companies downgraded by S&P, Moody's and/or Fitch. Prior to 2012, volumes include only downgrades by S&P and/or Moody's. Index is the Bloomberg Barclays US Corporate Bond Index. Data only includes intra-index downgrades and not fallen angel bonds that have dropped out of the index. Indices are unmanaged and one cannot invest directly in an index.

Global Infrastructure

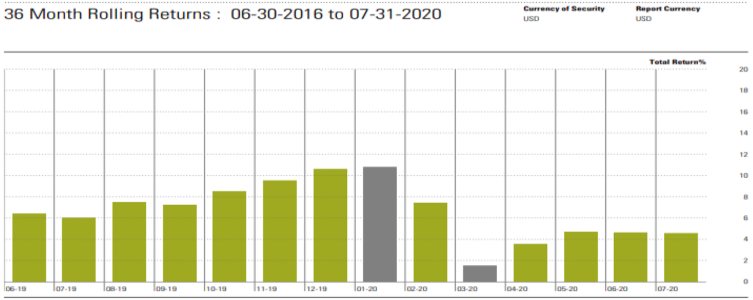
A Source of Stability in Volatile Markets

Infrastructure is typically purchased for safety and stability and because it's a proven diversifier of portfolio returns with predictable long-term cash flows (chart on the top). Core infrastructure serves as an anchor to portfolios through investments known for generating steady cash flow and income. ***Core infrastructure has historically included essential services providers such as electricity, gas, water, and wastewater. More recently, core infrastructure has been expanded to include work-from-home, Wi-Fi, and 5G investments.***

At the other end of the spectrum is 'value-add' and 'opportunistic' infrastructure. These projects generate returns not only through the distribution of quarterly income but also through capital appreciation. Opportunistic infrastructure includes higher-risk projects such as energy pipelines and transportation investments. Transports, including airports and major shipping ports, were notably impacted by COVID-19, given their high GDP sensitivity. The good news is that most lenders understand this relationship and have been willing to work with these entities to bridge existing financing gaps.

Because of the difficulty many infrastructure projects experienced post the GFC, many projects were far more conservatively financed during the 2010-2019 cycle. As a result, investors have not seen the number of distressed properties nor the dollar value of distress assets, typical in the months following a recession (1Q20 performance table on the left).

The value-add and opportunistic infrastructure segments, including airports, ships, and shipping vessels, are expected to continue to perform, albeit at reduced rates. While many of these properties have shown greater resilience than previously thought, with leases continuing to be paid, most remain a high risk and could take years to recover. Still, we believe a modest allocation to some of the more resilient properties makes good investment sense (table on the right detailing allocation to Energy & Industrial).



	Time Period	Period's Cumulative Total Return %	Period's Annualized Total Return %
Global Infras Instl (USD,	06-30-2016 to 07-31-2020	22.01	4.99
Highest Historical Return	01-31-2017 to 01-31-2020	35.94	10.78
Lowest Historical Return	03-31-2017 to 03-31-2020	4.56	1.50

Performance as of 07-31-2020

Best time periods

3 months	16.59% (Jan 2019 - Mar 2019)
1 year	31.66% (Jan 2019 - Dec 2019)
3 year	10.78% (Feb 2017 - Jan 2020)

Worst time periods

3 months	– 17.20% (Jan 2020 - Mar 2020)
1 year	– 8.89% (Jan 2018 - Dec 2018)
3 year	1.50% (Apr 2017 - Mar 2020)

	Portfolio
Sensitive	**38.10%**
Commun Svs	4.48%
Energy	19.07%
Industrials	14.55%
Technology	0.00%
Cyclical	**21.70%**
Basic Matls	0.00%
Consumer Cyc	0.00%
Financial Svs	0.00%
Real Estate	21.70%
Defensive	**40.20%**
Consumer Def	0.00%
Healthcare	0.00%
Utilities	40.20%
Other	**0.00%**

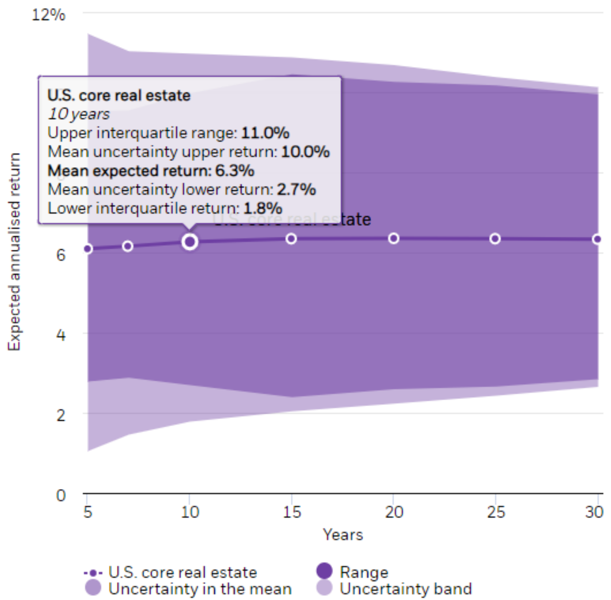
Private Real Estate

Reduced Expectations Amid More Rigorous Underwriting

Covid-19 may have structurally altered the path of Real Estate over the next several years, accelerating shifts in place before 2019. Emerging trends point to increased headwinds for Retail and Office and tailwinds for strategically located Industrial and Multifamily. Delinquency rates have risen in Lodging and Retail and are mostly contained in other areas. According to rent collection data from NAREIT, most properties continued to pay rents, with Retail, Hospitality, and Hospitals the exceptions. Hospitals were forced to forgo higher revenue procedures to address COVID-19 concerns. Freestanding retail and shopping centers rent collection remains weak, and the future unknown as many tenants remain under significant pressure.

Across the capital stack, banks remain cautious as the market shifted to a more lender-friendly environment. We expect stricter covenants, reduced leverage, and more stringent underwriting standards in the months ahead. Banks are adjusting valuations to incorporate reduced collections and lower rent growth. Several managers we spoke with are assuming flat or negative rent growth for the next 1-3 years, depending on the market and property type. Lenders are stress-testing cash flows for prolonged periods of higher vacancy and increased concessions and ensuring they are loaning against resilient assets. Since most underwriters do not participate in upside like equity holders, lenders are far more cautious in considering all the potential scenarios that could impact future cash flows.

The chart on the right shows Blackrock's estimate for the mean expected return for private real estate over the next ten years at +6.3%, with a range of +2.7% to +10.0%. Like fixed income, the 6.3% mean expected return reflects generational low-interest rates, removing a key return source for the asset class.



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Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.

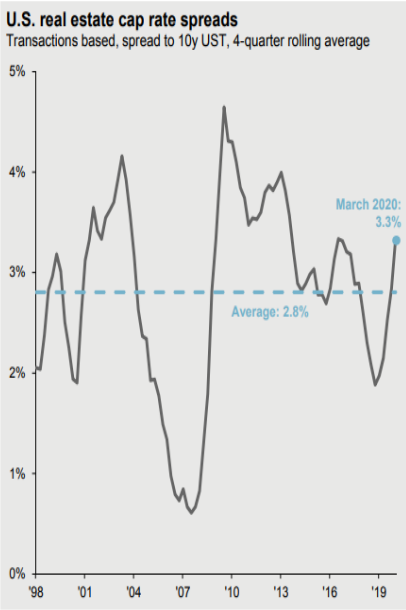
Private Real Estate

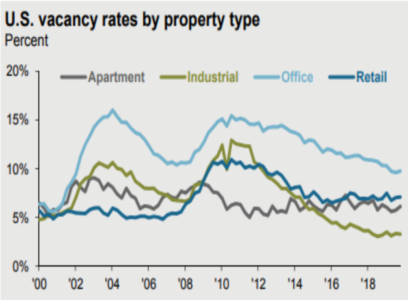
Increased Headwinds with Pockets of Opportunity

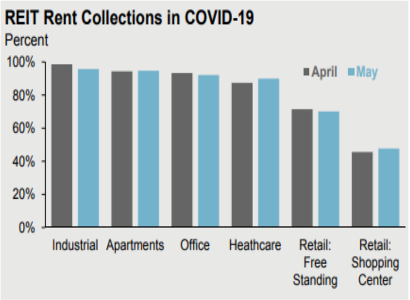
U.S. real estate cap rates have risen to the average seen over the past several years, but with mixed spreads depending on the sector (the chart of the left). Rent collection has trended lower across most property types (the chart on the bottom right), including Multifamily, Retail, Office, Industrial, and Hotels. But not all assets have been impacted equally, and an asset's quality and location have been critical drivers of performance (the chart on the top right).

Hotels and Retail properties have been the hardest hit by social distancing and government-mandated closures. Hotel occupancy is averaging 50-60% nationwide or 34 percentage points below normal levels. Rent collection for most of retail is still below 50%. Grocery-anchored retail and essential service properties are performing better than most. Mall properties remain under significant pressure. On the other end of the spectrum, Multifamily properties have held up well, with tenants spending more time at home and rent collection averaging in the mid-90s percent. Some analysts expect the migration out of cities and toward suburbs to continue with more people working from home and preferring remote locations vs. densely populated urban areas. We think it's too early to make this call.

Industrial rent collection held up well, averaging in the mid-90s. Last-mile warehouses strategically located near major cities have been a major beneficiary of COVID-19 with the growing reliance on e-commerce. Office fared better than retail and hotel but not as well as multifamily or industrial. Rent collections for office REITs are averaging above 90%. Before COVID-19, the trend was toward densification of office space, jamming as many people into as small an area as possible. Densification has given way to diffusion. More people find they can be just as productive working from home, especially given the general hesitation to working in close quarters with others. Within Private Real Estate, Multifamily remains our favorite asset class.







Source: NCREIF, NAREIT, J.P. Morgan Asset Management.
The cap rate, which is computed as the net operating income over sales price, is the rate of return on a real estate investment property.
Data is based on availability as of May 31, 2020.

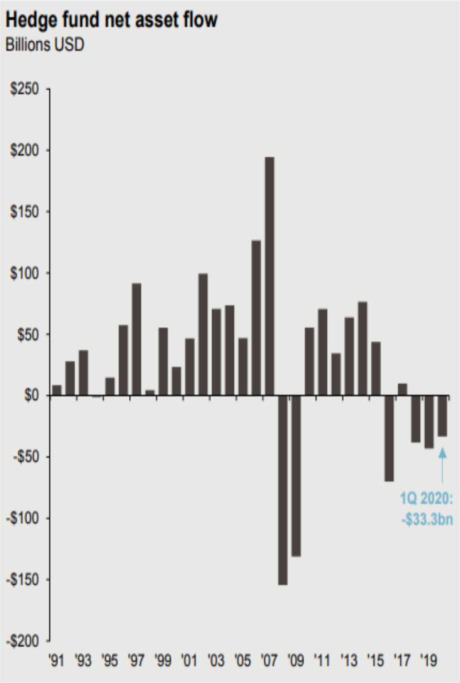
Hedge Funds

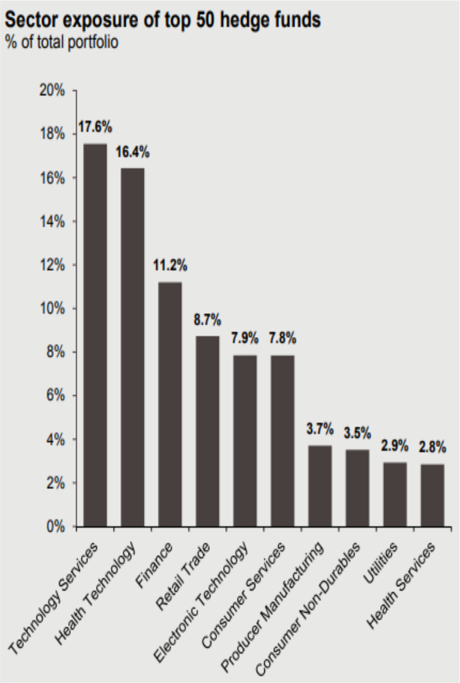
Macro & Long-short Offer Unique Return Profiles

Hedge funds are commonly used to diversify cash flow, reduce risk, and protect client funds during periods of elevated volatility. Depending on the mandate, hedge funds strive to deliver non-correlated returns that behave inversely to those in the broader market. Returns may be sourced through labor-intensive approaches such as workouts, public-equity activism, and event arbitrage, or through more traditional techniques such as long-short strategies, currency positioning, and credit protection strategies. Each mandate is highly specialized and typically managed by separate teams with a unique combination of sizing and risk management skills.

Wellspring recently evaluated a long-short fund with a mandate to invest in disruptive technologies. These technologies included Artificial Intelligence (AI), Machine Learning (ML), Augmented Reality (AR) and Virtual Reality (VR), Urban Mobility, Life Sciences, and 5G. Many of these technologies are considered emerging and well beyond the scope and crowding currently seen in the popular FAANG stocks.

Factor-based strategies have also gained prominence in recent years, with long-short funds tilting portfolios in favor of dominant sectors and key performance drivers. The chart on the right shows the sector exposure of the top 50 hedge funds. In reviewing several of the larger hedge funds, the distinguishing factor was the managers' ability to deliver consistent performance, while effectively hedging risk. Return dispersion was especially notably within hedge funds, with the differences between winners and losers widening in recent years. This has led to significant outflows in hedge strategiers over the past several years. (the chart on the left)

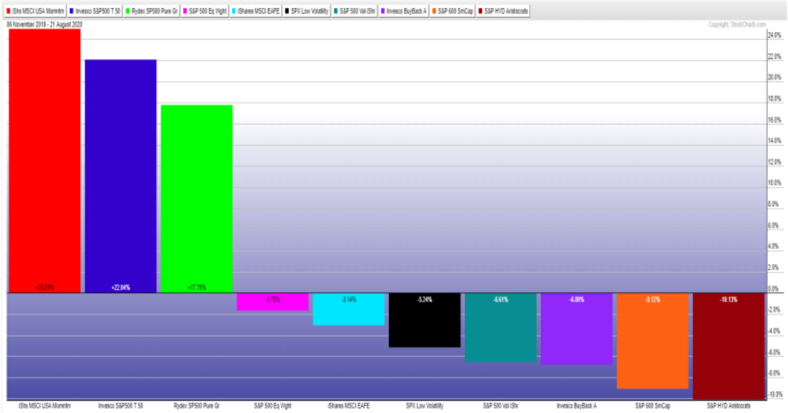


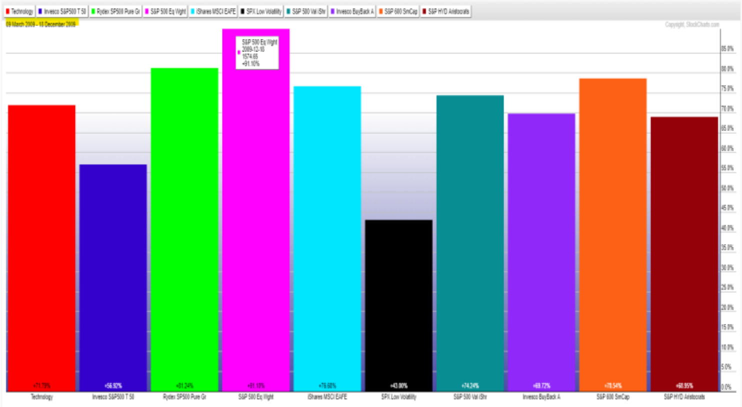


Source: HFRI, FactSet, J.P. Morgan Asset Management.
Data is based on availability as of May 31, 2020.

Factor Modeling

The Rise of Algorithms (2020 vs 2009)





Part of the capital allocator's job is to analyze and explain past performance. The challenge is not only to correctly attribute and interpret performance but also to position portfolios to take advantage of possible mispricing. And while most investors insist their managers be skilled at sizing bets, most positive and negative returns can usually be explained by simple exposure to systematic factors, like growth, size, and value. One tool used by hedge funds to manage client risk is factor exposure. While different methodologies may be used to determine which factor or factors are most influential in driving performance, the key is to understand each factor's impact and whether its impact will persist or fade over time.

The chart on the left shows the most recent 200-day performance of 10 factors often considered while constructing portfolios. They include Momentum (+25%), Top 50 Capitalization (+22%), Growth (+17.7%), S&P500 Equal Weighted (-1.75%), EFA (-3.1%), Low Vol (-5.2%), Value (-6.6%), Stock Buyback (-6.9%), Small Cap (-9.1%) and S&P Dividend Aristocrats (-10.1%). The chart on the right shows those same factors for the first 200 days following the 2009 GFC. Then, as typical in most periods following recessions, returns were far more evenly distributed and included a much broader group of stocks. While still early in the COVID recovery, the wide disparity in factor performance suggests either a large percentage of stocks remain stalled due to less than robust earnings outlooks or factor models are more prevalent today than previously understood.

Factor Modeling
Will Factors Mean Revert?

Environmental, Social & Governance (ESG)

ESG is a broad umbrella that incorporates Environmental, Social, and Governance (ESG) considerations in constructing portfolios. Investors often evaluate ESG through a lens of nonfinancial data on environmental impact (e.g., carbon emissions), social impact (e.g., employee satisfaction), and governance characteristics (e.g., board arrangement). Each of these issues can have a significant effect on how a company generates profit.

Environmental refers to how businesses perform as stewards of the environment through its operations and distribution channels. Climate change, pollution levels, and care for natural resources such as fresh water and forests are significant issues in today's economy.

Social refers to stakeholders, including employees, customers, suppliers, and communities. Investors are increasingly interested in how a company treats employees since capable employees, with good health care and safe working conditions, usually perform more successfully.

Governance is the foundational structure of a company and includes long-term capital allocation strategy, productivity and independence of the board, tax issues, and business ethics. Each is considered an essential ingredient for a company to be successful.

Table 1. Main ESG Issues

Environmental	Social	Governance
• Climate change and carbon emissions • Natural resource use and energy and water management • Pollution and waste • Ecodesign and innovation	• Workforce health and safety, diversity, and training • Customer and product responsibility • Community relations and charitable activities	• Shareholder rights • Composition of boards of directors (independence and diversity) • Management compensation policy • Fraud and bribery

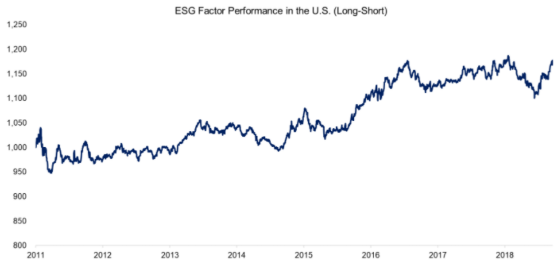
Environmental, Social & Governance
Performance Measurement

There are two considerations that fund managers generally weigh when incorporating ESG factors into portfolio construction. First, can the factor be used to influence portfolio returns? And second, will the ESG factor be used to deliver a specific sustainability-related outcome rather than be additive to returns? Funds that consider ESG factors during portfolio construction are known as ESG integrated. These funds weigh the impact of ESG factors on cash flow, credit rating, and a company's overall financial return profile. Funds that use ESG to pursue environmental or social outcomes before financial returns are known as ESG dedicated. It's essential to understand the difference between the two styles as the returns are often dramatically different.

ESG factors are increasingly being considered in the initial stages of evaluating a company. This includes the development of a transmission mechanism that measures the factor's impact on profitability. Once the transmission mechanism is understood, it may be included as part of a more comprehensive company investigation. Measuring ESG's influence on the returns of a portfolio is a complicated process. Similar to if a manager were asked to quantify the returns related to currency fluctuations, too many variables influence returns, making it nearly impossible to assign attribution, especially for qualitative measures like ESG.

Third-party rating agencies are beginning to create composite scores for ESG factors that attempt to quantify those most important stakeholders. There are two problems with a composite ESG score. First, they fail to distinguish which ESG factors lead to improved performance versus those that are values-driven. Second, ESG scores are often based on information provided by the companies themselves. Companies are free to determine what and how data is communicated. Larger and more resourceful companies tend to have more favorable ESG disclosure (chart on the bottom right).

Increasingly clients are asking if they can both do well and do good. And the answer is yes! (chart on the top right). ESG allows fund managers to look at companies in a more holistic way. For fund managers, anything that impacts performance matters. So, while some of these issues may not have a financial impact today, they may affect returns at some point in the future.



Source: FactorResearch

Risks & Disclosures

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