

**Topics: the uniqueness of 2012's equity market rally; institutional investor intentions to reduce public equity exposure; a zoological assessment of the proposed Fair-Share Tax Act of 2012**

Here are some of Kipling's "*Just So Stories*"<sup>1</sup> adapted for global equity markets, investment trends and public finances as 2012 comes to a close. We will publish our 2013 Outlook on January 2<sup>nd</sup>.

### "How the low-growth equity rally box lost his spots"

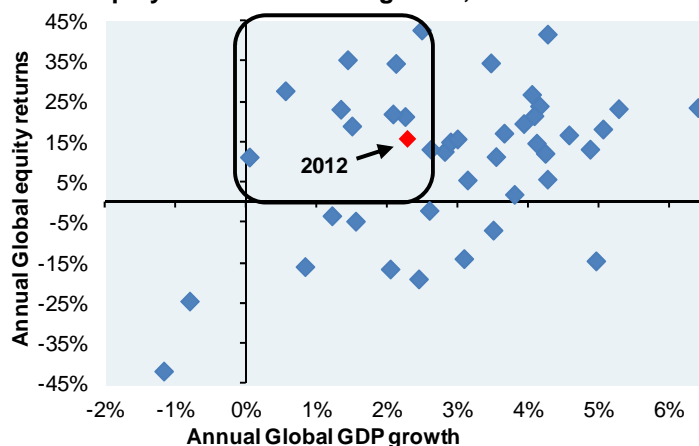
One of the universal assessments about 2012 is that credit and equity markets are heading for much better results than one might have expected (see table). We've got another month to go, but this year looks to be a reward to those who stuck to normal investment allocations despite the macro issues in play, and despite low global economic growth. One way to visualize 2012: the red dot in the chart, which shows global GDP growth and equity market returns each year since 1970. There's normally a connection between growth and equity returns, with the exception of the dots in the box, which are **low-growth equity rallies**.

#### 2012 year-to-date returns and valuation changes

Equity	Jan-12 P/E mult.	Nov-12 P/E mult.	2012 YTD Return
S&P 500	12.1x	13.6x	14.4%
MSCI Europe	9.8x	12.1x	15.1%
MSCI EM	9.4x	11.4x	11.2%
US REITs	21.8x	21.4x	15.0%
Credit	Spread	Spread	Return
US high yield	712 bps	592 bps	12.5%
EM\$ debt	400 bps	291 bps	17.1%
Bonds	Yield	Yield	Return
Barclays 7-10 yr UST	1.95%	1.64%	4.9%

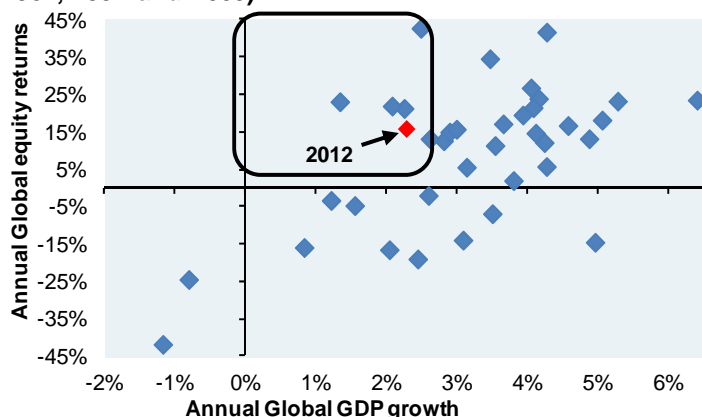
P/E multiples based on forward consensus earnings and funds from operations (REITs). EM=Emerging markets. Source: Bloomberg, J.P. Morgan Securities LLC.

Global equity returns vs. GDP growth, 1970-2012

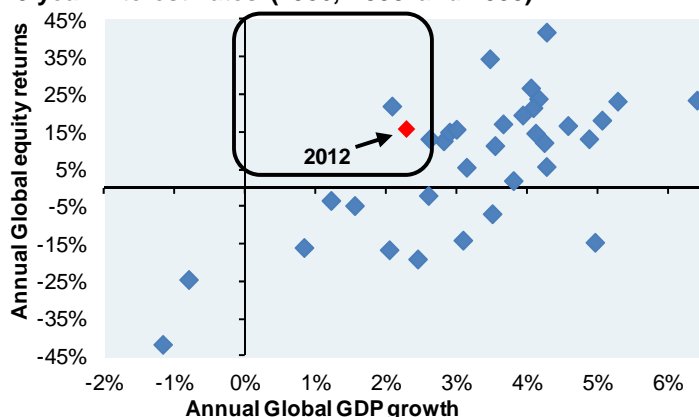


**How unique is 2012?** Let's remove the usual suspects: post-recession rallies, and rallies based on interest rate declines. In the next chart, we remove equity rallies that took place immediately after recessions ended and activity rebounded. Then, in the subsequent chart, we remove equity rallies coinciding with large rallies in the bond market. 1986 was the poster child for this: from September 1985 to December 1986, the 10-year Treasury fell from 10.5% to 7% and equities rose 42%. Neither case applies to what happened in 2012.

Step 1: Remove recession recovery years (1975, 1980, 1982, 1991 and 2009)



Step 2: Then remove years with large declines in 10-year interest rates (1986, 1993 and 1995)



**What we are left with is the conclusion that 2012 is kind of unique: a low-growth year with double-digit global equity returns not based on a recession rebound or a bond market rally.** The only other was 1998. Of course, a huge factor this year was the European rescue. What about 2013? Without the usual catalysts for a low-growth rally, a stronger recovery in global growth would probably be needed to generate similar equity returns. As things stand now, the pieces are in place for a modest improvement in growth in the US, China and EM Asia, but less so in Europe and Japan. At first glance, a 3% global

<sup>1</sup> From Rudyard Kipling's *Just So Stories*, published in 1902, with tales such as "How the Camel Got His Hump" (punishment for slacking), "How the Rhinoceros Got His Skin" (punishment for gluttony) and "The sing-song of Old Man Kangaroo" (punishment for vanity).

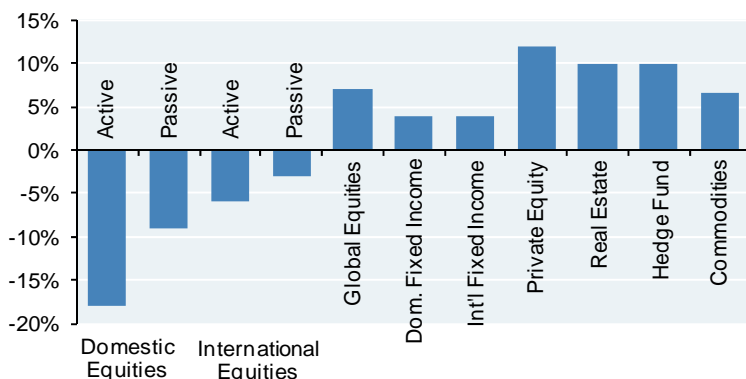
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growth rate would match up with high single-digit global equity markets returns in 2013. A fiscal “grand bargain” in the US could result in multiple expansion which would drive returns higher. Multiples of 13.6x on the S&P 500 have room to rise before becoming overpriced (at least from a historical perspective). How likely is this “grand bargain”? Recall the Republican Presidential debate in which some candidates pledged to eliminate or seriously constrict the Environmental Protection Agency. A proposal like this<sup>2</sup> reflects the fact that after the Budget Control Act, there really isn't that much non-defense discretionary spending left for politicians to fight over (by 2017, it will be at the lowest level in 50 years). On government spending, the grand bargain is mostly about cutting entitlements, which runs counter to voter sentiment. More to come in the 2013 Outlook.

### ***“How the Institutional Investor took both forks on the same road”***

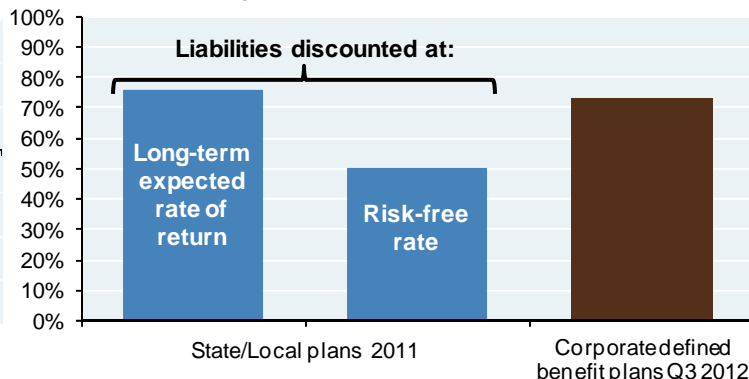
Despite better than expected performance of public equities this year, many institutional investors plan further reductions. The latest report from Empirical Research Partners<sup>3</sup> walks through some of these trends in detail. The main one: the continued intention of defined benefit pension plans to reduce equities and increase exposure to fixed income (even at today's low interest rates), **and** increase exposure to alternative investments (private equity, real estate and hedge funds). Defined benefit plans are not the only ones doing this: surveys of state and local pension plans indicate the same trends. And of course, endowments and foundations continue to move in this direction.

**US Defined Benefit Pension Sponsors: net share planning to significantly increase exposure over the next three years, %**



Source: Empirical Research Partners.

**Underfunding status of State/Local and Corporate plans**  
Pension plan funding ratio

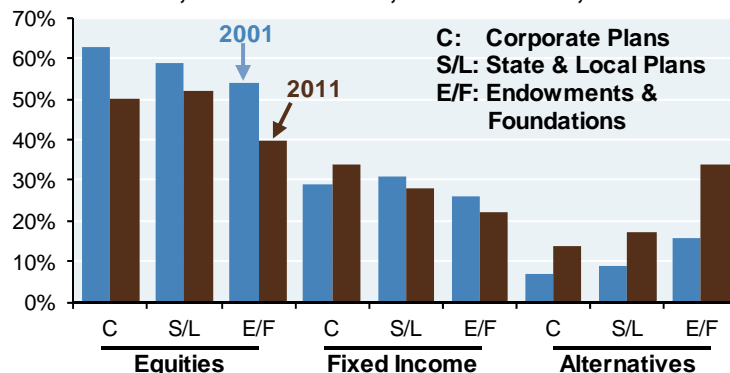


Source: Empirical Research Partners.

**Why the continued migration out of public equities?** Part of it can be explained by the collapse in interest rates, which as shown in the 2<sup>nd</sup> chart, has resulted in large underfunding problems at state/local plans and corporate plans. Even after regulatory relief (e.g., longer periods over which gaps have to be closed), the funding situation looks difficult. As a result, almost 50% of DB plans are making larger contributions, and buying bonds for purposes of liability-matching to reduce volatility. At the same time, they are also adding alternative investments (many of which use leverage) to seek higher returns. State/local plans have been even more aggressive in adding alternative investments. A Greenwich Associates survey indicates that pension plans assume that private equity will generate 2.0% to 2.5% over public equity, and that hedge funds and real estate will handily outperform fixed income.

**What to make of all of this?** It's unnerving that pension plans are in the position of having to adopt asset allocations that are heavily influenced by underwater funding ratios rather than just by fundamental value. Chalk this up as yet another unwelcome by-product of the Fed's zero interest rate policies (the impact on the life insurance industry is another one, as many of their liabilities pay guaranteed minimum interest rates). The

**US institutional investors: asset allocation to equities, fixed income, and alternatives, 2001 vs. 2011, Percent**



Source: Empirical Research Partners.

<sup>2</sup> According to the OECD's air pollution measure and the Columbia/Yale Environmental Performance Index, the US ranks around median. As a result, it seems premature to unplug the EPA just yet (if ever).

<sup>3</sup> “Endless Endowment Envy”, November 19, 2012. Of the research I digest each week, ERP is always at the top of the list as a must-read.

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illiquidity, manager selection risk and higher volatility of leveraged alternative investments has to be managed more carefully by closed/frozen defined benefit plans than by perpetual endowments or wealthy families. Other the other hand, their allocation changes may not be that radical (only a few percent), and return assumptions appear consistent with history for the better managers. The 3<sup>rd</sup> chart above shows that the average "public equity to alternatives" shift over the last decade has been 10% across institutional investor types.

To be clear, there are environments in which public equities may outperform private equity:

- Periods like 1997-2000, when sectors such as technology substantially outperformed small/mid cap
- When inflation rises more quickly than corporate earnings, raising the cost of capital for Libor-based leveraged companies
- A timing problem, as in 2007, when private equity managers deploy capital at inopportune times in the cycle
- A more drawn-out bear market that is not immediately rescued by an explosion of money-printing by the Federal Reserve, such that leveraged owners lose more of the companies they hold before a recovery kicks in
- Increased competition for alternative investments. While alternatives-heavy endowments and foundations represent \$1 trillion in assets, corporate and state/local plans are over \$5 trillion and are moving into their asset allocation territory.

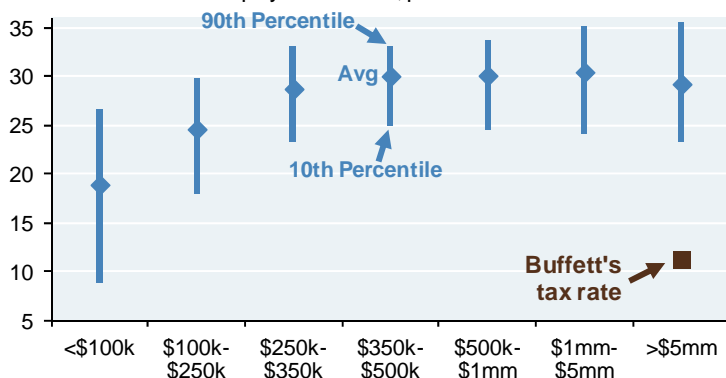
All things considered, portfolios which mix in alternative investments of different kinds (private equity, private credit, real assets) have generated higher returns than those without them. That's probably what lay at the heart of this ongoing migration.

### **"How the bird got confused and thought it was a hippopotamus"**

When Warren Buffett claimed that a lot of secretaries pay higher tax rates than the super-wealthy, I wanted to take a closer look, which we did last year. As shown in the first chart, Buffett's assertion is only the case in a minority of situations (like his own). The vast majority of taxpayers with adjusted gross income over \$1 million and over \$5 million have effective tax rates in the 22%-35% range, considerably higher than the range of tax rates paid by those with AGI below \$100k.

#### **Tax rates by Adjusted Gross Income Category**

Effective income and payroll tax rate, percent



Source: Congressional Research Service, Warren Buffett, WSJ.

#### **A zoologically proportional assessment of the deficit impact of the Fair-Share Act tax assuming current law**

Hippopotamus and Yellow-billed Oxpecker, Serengeti, Tanzania



Source: Joint Committee on Taxation, Tax Policy Center, US Treasury.

As a result, I was not expecting to see large revenue estimates from an analysis of the fiscal impact of the proposals in the Fair-Share Act of 2012<sup>4</sup>, since if the first chart is correct, there are not that many people that would be impacted by a minimum 30% effective tax rate. Now let's look at some numbers. The Congressional Joint Committee on Taxation and the Brookings Tax Policy Center analyzed the proposal, under the assumption that the Bush tax cuts sunset for the top two brackets. If that's the case, the incremental revenue raised by the Fair-Share Tax Act is around \$8 billion per year. This is real money and may be sound public policy, but in the context of a \$1 trillion budget deficit expected for FY2013, it's a rounding error. To convey this zoologically, in the second chart, we show two animals whose volume is proportionally the same (125 to 1): a hippopotamus, and its symbiotic companion, the yellow-billed oxpecker. I would like to think that elected officials and political commentators would avoid grandstanding and not mislead anyone on the fiscal impact of their proposals, but right now, there are some people who need help distinguishing between birds and hippos.

Michael Cembalest  
J.P. Morgan Asset Management

<sup>4</sup> Introduced by Sheldon Whitehouse (D, RI) and co-sponsored by 16 other Democratic Senators.

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