



# BRIDGING THE GAP

Winter 2020

“The single greatest edge an investor can have is a long-term orientation.”

— SETH KLARMAN

## About Northern Trust Asset Management

Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments, so they can confidently realize their long-term objectives.

Entrusted with more than \$983 billion of assets,\* we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy.

That’s why we combine robust capital markets research, expert portfolio construction and comprehensive risk management to craft efficient solutions that deliver targeted outcomes.

[northerntrust.com](http://northerntrust.com)

\* Assets under management as of September 30, 2019. For complete composition of Northern Trust Asset Management entities included in the AUM total, please see disclosure at end of this document.

## THE PROBLEM

### IN A WORLD OF LOW EXPECTED RETURNS, FINDING ALPHA BECOMES MORE IMPORTANT THAN EVER.

Global markets have enjoyed a ten-year run and though we believe markets continue to have upside potential, there are potential mismatches around return expectations and actual attainable returns.

Read more



## THE SEARCH

### ALPHA, WHILE ELUSIVE, CAN BE FOUND IF ONE KNOWS WHERE TO LOOK.

Seeking alpha in public markets is challenging during good performing market environments. It’s possibly even more so during more challenging markets and a skilled partner is critical in identifying managers that can generate alpha.

Read more



## THE SOLUTION

### LEVERAGING LONGER TIME HORIZON AND SKILLED MANAGERS IS THE KEY TO MEETING GOALS.

Given the significant amount of capital looking for alpha in private markets, family offices will need to bridge the performance gap in this slower growth environment by leveraging their longer time horizon and partnering with experts in private market investments.

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**BRIDGING THE GAP**

At a recent meeting of families in London we polled the group assembled on what keeps them up at night.

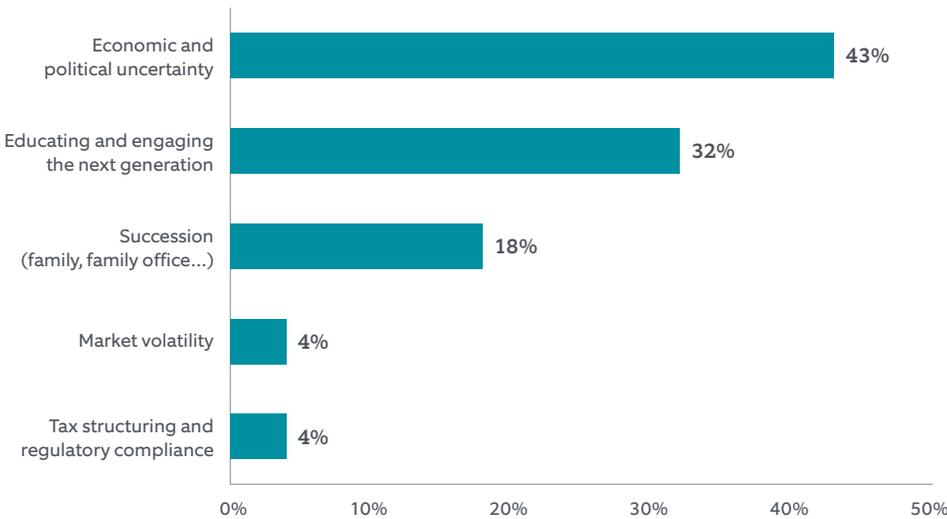
For the most part, their answers were unsurprising, given that this is a group that needs to be planning for multiple generations. Top of the table (see Exhibit 1) were concerns over economic and political uncertainty.

When we dug a bit deeper, we discovered that the group was actually concerned about potential mismatches between the return expectations that their family investment portfolios have generated and the realistic returns their investment portfolios are likely to generate in a low return world. Further discussion revealed that indeed there seems to be an emergent gap between historically anchored return expectations and the more sanguine capital market assumptions, like the ones we produce at Northern Trust.

**EXHIBIT 1: GLOBAL FAMILY OFFICE POLL**

Enlarge Chart >

As you plan for 2020 and beyond, what keeps you up at night? N=28



Source: GFO Private Investor Meeting Snap Poll Data.

Northern Trust Capital Market Assumptions (CMAs) for portfolios of Moderate Risk (with a perpetual time horizon) suggest a diversified portfolio of assets will likely return around 5.4% annualized over the next five years – which is a materially lower estimate than investors were experiencing five to ten years ago. This return, after accounting for taxes, fees, and inflation, could bring real returns below 4%. This muted return environment leaves family offices with three choices:

- 1 Accept lower portfolio returns for the foreseeable future
- 2 Compete in public markets to seek alpha
- 3 Leverage their families' longer time horizons and focus more time on building out a greater allocation to private investments

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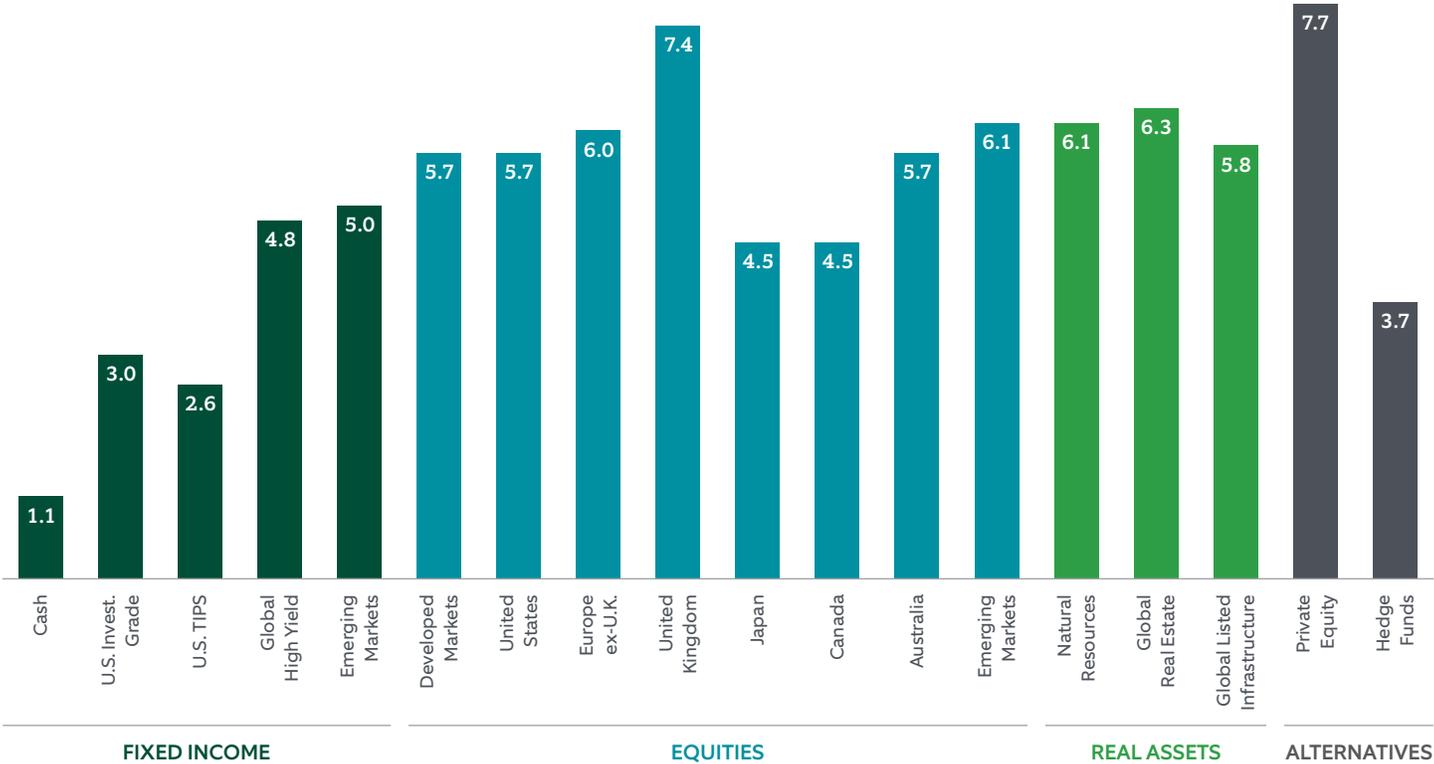
**EXHIBIT 2: CAPITAL MARKET ASSUMPTIONS — A REVIEW OF THE RESULTS**

Enlarge Chart >

*Political uncertainty and slowing growth will lead to below historical average global equity returns, still attractive compared to low-yielding fixed income asset classes.*

Global Growth Restructuring	Irreconcilable Differences	Stuckflation 4.0
Executive Power Play	Monetary Makeover	Staking Out Climate Risk

Five-year asset class total return forecasts (%).



Source: Northern Trust 2019 CMAs.

continued

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**DEFINING ALPHA**

Before families can begin the search for “alpha,” they first must be clear on defining their investment objectives and the risk they are willing to take to meet these objectives. As we know, alpha is idiosyncratic and, as such, can live anywhere. What we are less clear on is what investors mean when they say they are seeking to add “alpha” to their portfolios. Are they looking to outperform in a total return fashion? Are they looking to outperform in down markets? What kind of alpha are they seeking and where do they hope it will be found?

**Northern Trust takes a systematic approach and defines alpha as the additional return from manager skill (such as security selection and market timing) after accounting for the return attributed to the four main market factors (market, size, value, momentum). When researching active managers, we strip out these readily accessible factors which drive returns and focus entirely on the manager’s ability to generate alpha through uncompensated factors (true skill).**

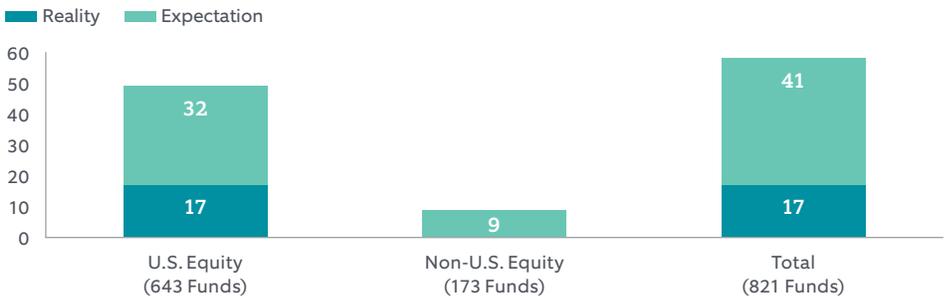
Defining alpha for each investor should, in turn, increase the probability for a more successful investment outcome and thus, help to bridge these emergent gaps in investor expectations in a low return world.

**PUBLIC MARKETS**

All too often we hear truisms about where alpha lives, specifically when it comes to the identification of less “efficient” asset classes. However, the data is very clear that all public markets are highly efficient and, therefore, locating managers who are able to demonstrate real skill (alpha) is challenging. As an example, when reviewing the Morningstar U.S. and Non-U.S. Large Cap Universe, there are 821 funds in that peer sample. Under normal market conditions, we would expect 41 funds to successfully provide alpha (821 x 5% based on a 95% confidence level). However when analyzing each fund against the market risk factors, we find that only 17 funds successfully provided alpha. Thus, a little over 2.5% of the peer sample possesses security selection skill, according to our measures.

**EXHIBIT 3: NUMBER OF FUNDS WITH STATISTICALLY SIGNIFICANT ALPHA**

Enlarge Chart >



Source: Northern Trust Asset Management, Morningstar. Past performance is no guarantee of future returns. Index returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in an index. Period analyzed is July 2005 to June 2019.

We can only conclude, then, that in order for family offices to increase their probability of finding alpha in the public markets, they need a skilled partner with a demonstrated successful track record in identifying managers that are capable of producing consistent alpha.

*continued*

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PRIVATE MARKETS

Given the difficulty of finding public equity managers who consistently produce alpha, many family offices instead focus a disproportionate amount of their time and resources searching for alpha in illiquid markets. This focus leverages two characteristics that family offices possess:

- A perpetual time horizon
- Operating expertise

The benefits of focusing a disproportionate amount of time on private market investments is supported by our research, as we do find a persistence to manager outperformance (alpha) in private markets. Although private markets are growing in competitiveness, we don't believe this space is as efficient as public markets. This lack of efficiency is mainly driven by fewer participants and higher barriers to access these investments. Similar to public markets, there are multiple flavors of private investments spanning from debt, to real estate, infrastructure, natural resources and equity.

EXHIBIT 4: HISTORICAL DRAWDOWNS OF PRIVATE INVESTMENT VERSUS THEIR PUBLIC MARKET EQUIVALENT

Enlarge Chart



Source: Northern Trust Asset Management, Morningstar. Past performance is no guarantee of future returns. Index returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in an index. Period analyzed is December 2002 to March 2019.

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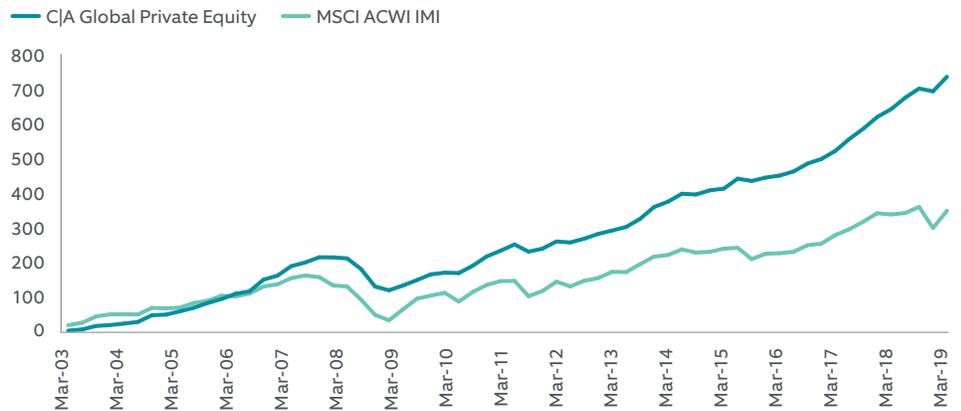
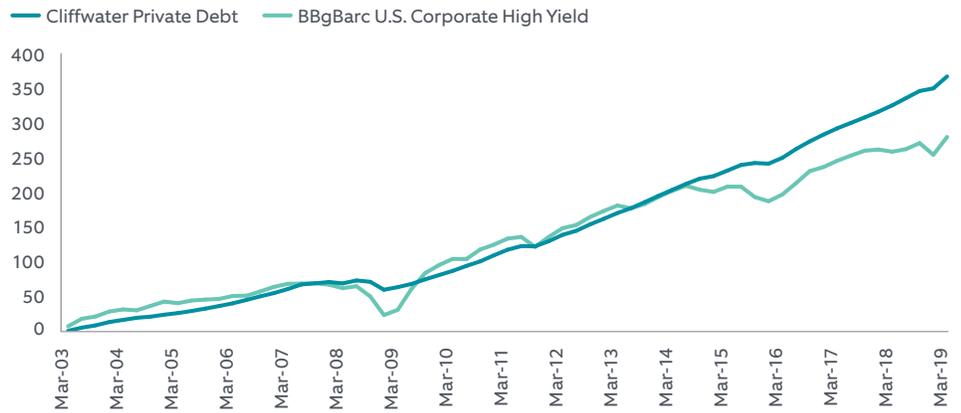
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In addition, those private investments are not marked-to-market as frequently as public markets, thus there are significant advantages of adding these investments to help manage total portfolio volatility and provide capital drawdown protection (Exhibit 4 above). Private investments have managed to outperform their public market counterparts on a cumulative basis with spreads more meaningful than alpha that is generated in public markets. These spreads are usually attributable to an illiquidity risk premium combined with manager skill, operating in a less efficient marketplace.

**EXHIBIT 5: CUMULATIVE WEALTH (\$) OF PRIVATE INVESTMENTS VERSUS THEIR PUBLIC MARKET EQUIVALENT**

Enlarge Chart >



Source: Northern Trust Asset Management, Morningstar. Past performance is no guarantee of future returns. Index returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in an index. Period analyzed is December 2002 to March 2019.

Although there is some debate as to whether the illiquidity premium is shrinking, given the growing popularity of private investments, one takeaway is clear. For those family offices looking to reconcile higher return expectations in a low return environment, it is worthwhile to invest the time and resources into an experienced team with a demonstrated track record to help identify these unique, alpha-generating managers, whether public or private. Bridging the gap and the ultimate return on your portfolio may depend on it.

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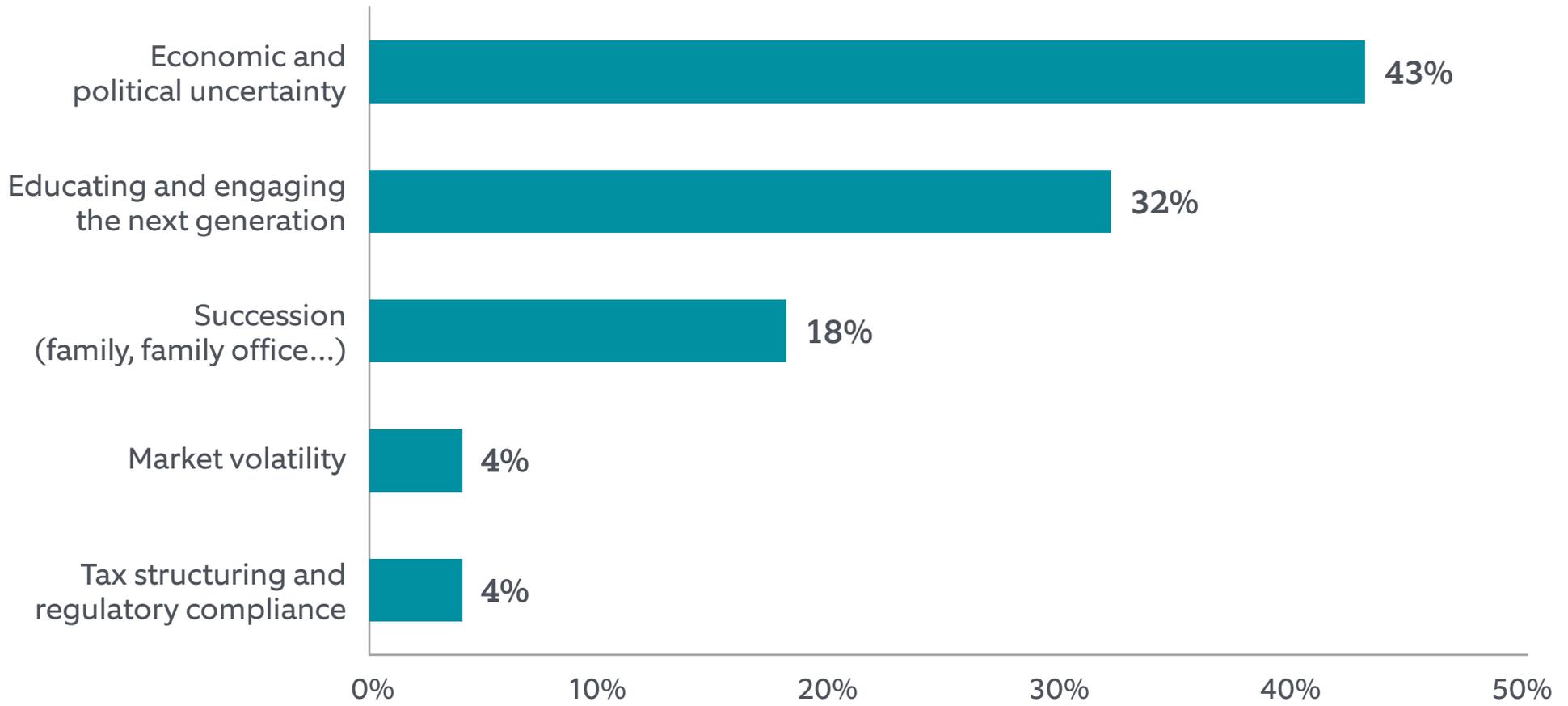
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# APPENDIX

## EXHIBIT 1: GLOBAL FAMILY OFFICE POLL

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*As you plan for 2020 and beyond, what keeps you up at night? N=28*



Source: GFO Private Investor Meeting Snap Poll Data.

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## EXHIBIT 2: CAPITAL MARKET ASSUMPTIONS — A REVIEW OF THE RESULTS

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*Political uncertainty and slowing growth will lead to below historical average global equity returns, still attractive compared to low-yielding fixed income asset classes.*

Global Growth  
Restructuring

Executive  
Power Play

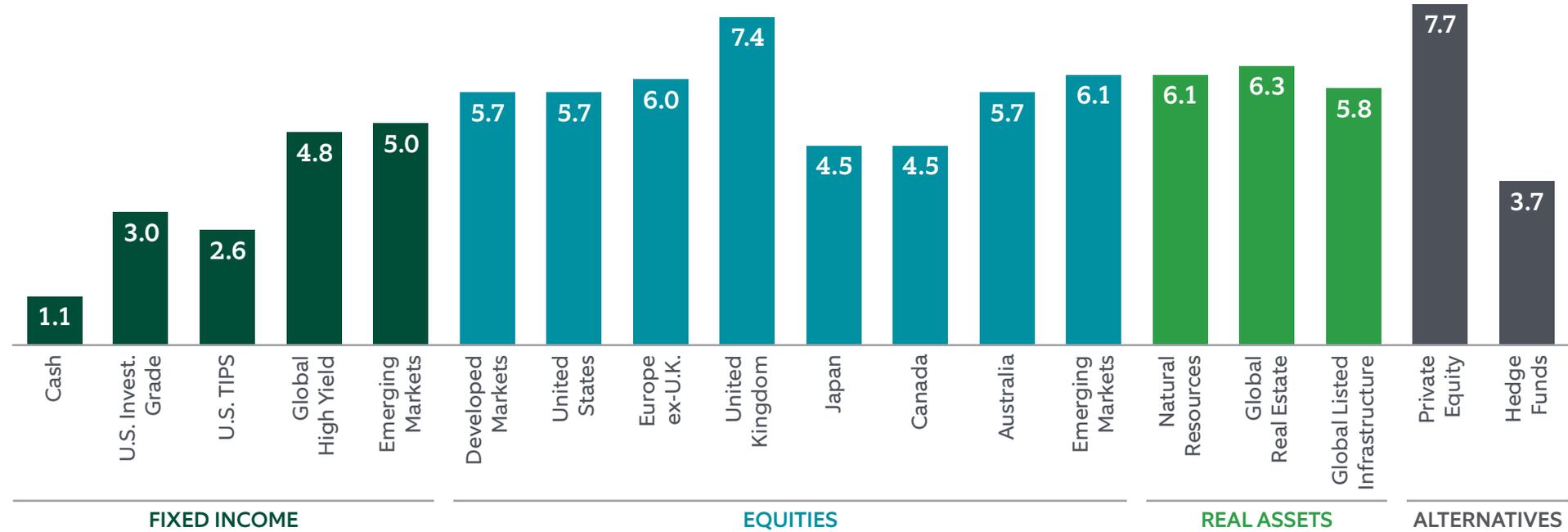
Irreconcilable  
Differences

Monetary  
Makeover

Stuckflation  
4.0

Staking Out  
Climate Risk

Five-year asset class total return forecasts (%).



Source: Northern Trust 2019 CMAs.

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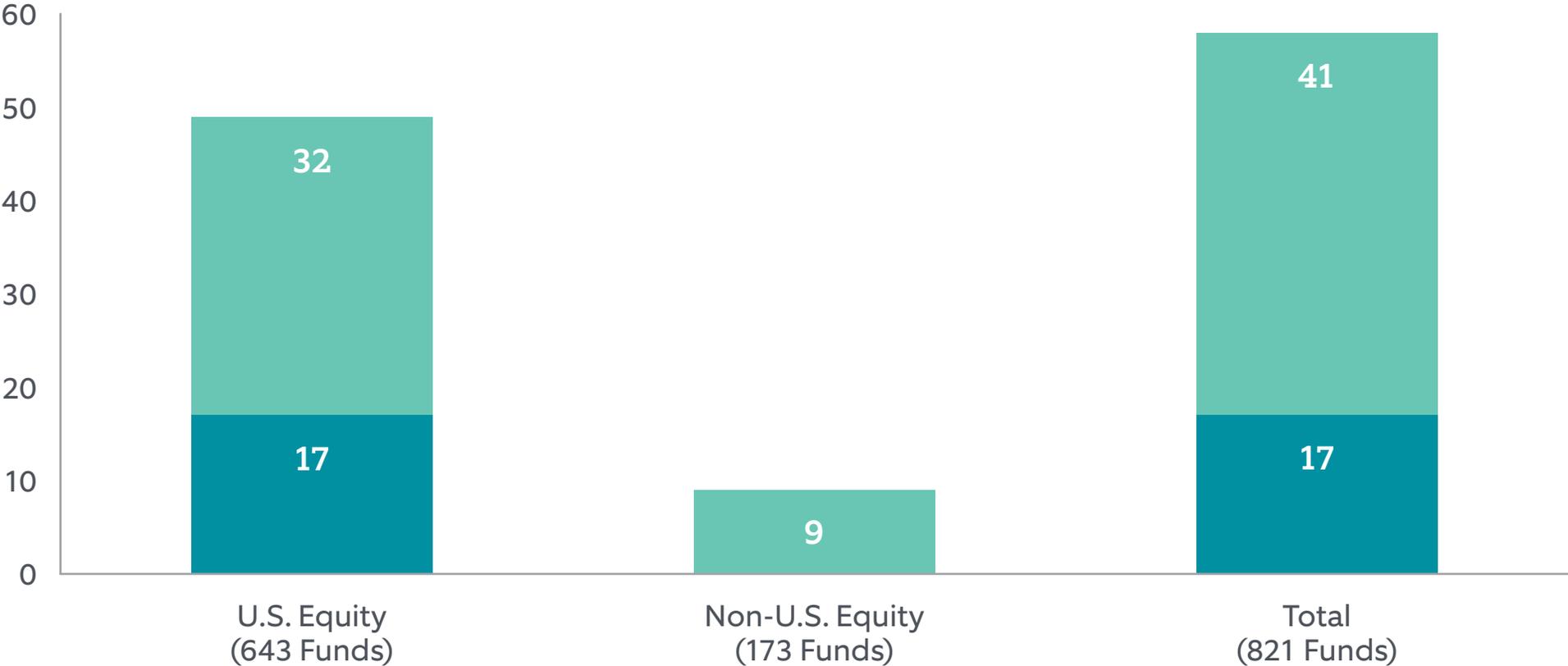
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Reality Expectation



Source: Northern Trust Asset Management, Morningstar. Past performance is no guarantee of future returns. Index returns do reflect any management fees, transaction costs or expenses. It is not possible to invest directly in an index. Period analyzed is July 2005 to June 2019.

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Cliffwater Private Debt  
BBgBarc U.S. Corporate High Yield



C|A Global Private Equity  
MSCI ACWI IMI



Source: Northern Trust Asset Management, Morningstar. Past performance is no guarantee of future returns. Index returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in an index. Period analyzed is December 2002 to March 2019.

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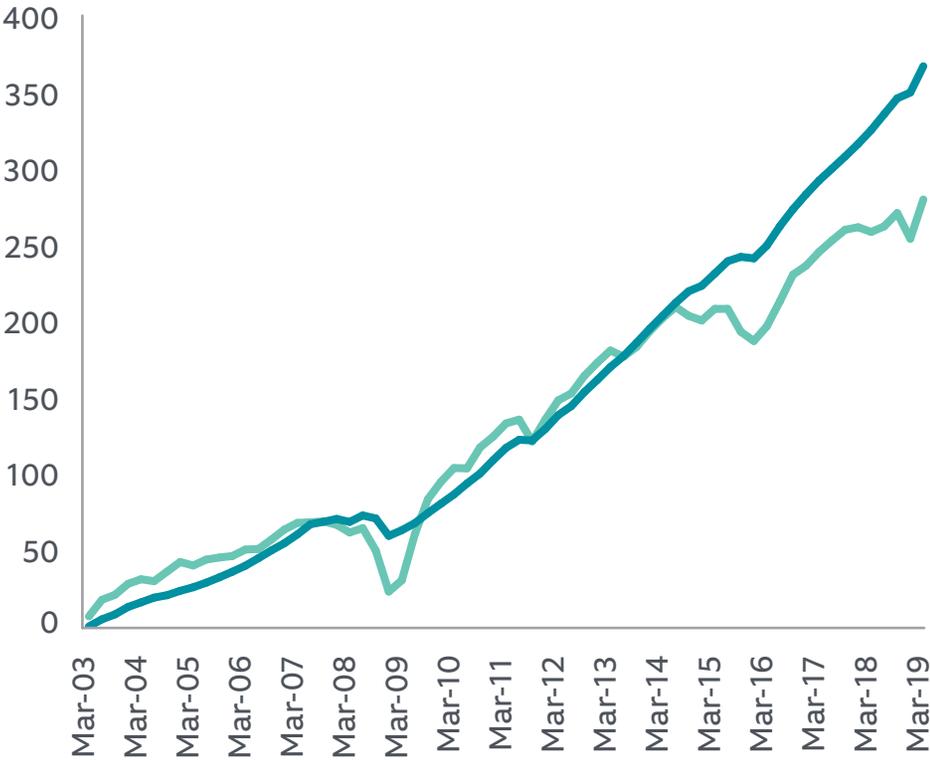
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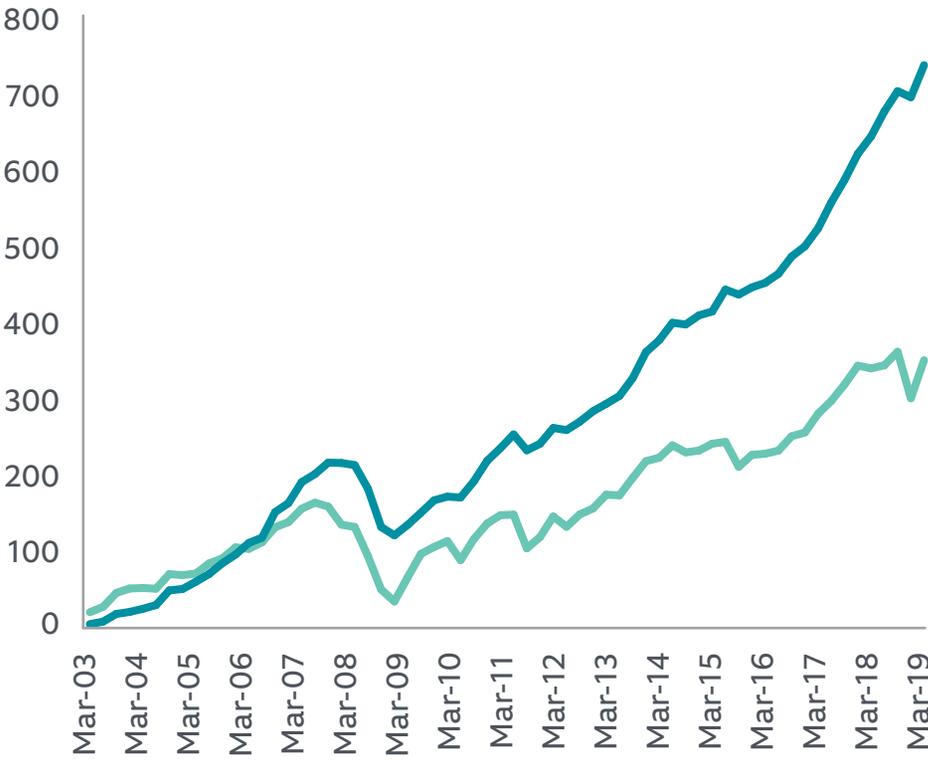
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