Third Quarter 2016

Quote of the Quarter:

"You're not imagining things, the economy really is rigged against you. Give Federal Reserve head Janet Yellen credit for one thing: She has united Democrats and Republicans—in their hatred of her and her organization."

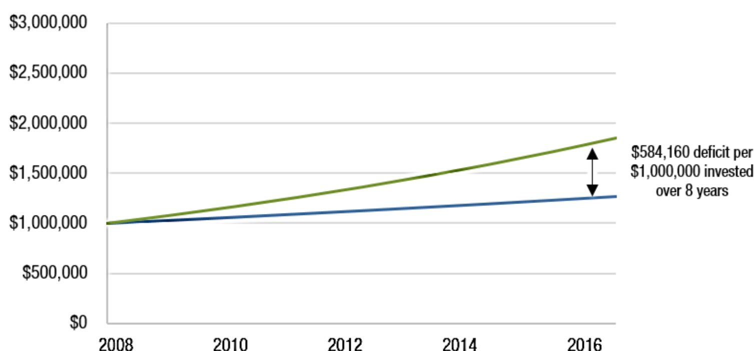
– John Crudele,
New York Post,
February 14, 2016

The Fed is Punishing Savers and Retirees

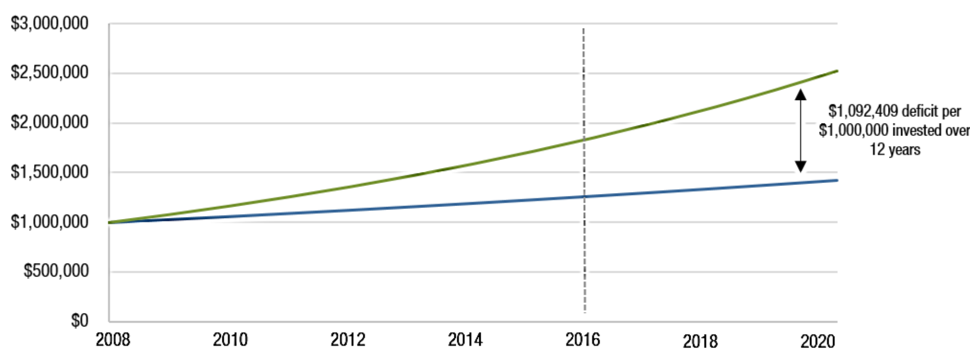
For eight years the Federal Reserve Bank has held interest rates abnormally low. The Fed's dual mandate of moderating unemployment and inflation seems to have morphed instead into keeping stock prices high. That has helped Wall Street tremendously but has punished the average person saving for retirement. We are all feeling it. Whether you are saving for your own retirement through an IRA, 401(k) or defined benefit pension plan or you are saving for your kids' college tuition, you know the last eight years have been rough, especially the last two years.

The median return for U.S. pension plans for the fiscal year ending June 30, 2016 was 1.1%. The median return for the prior year was a similarly meager 3.4%. In case you imagine the big, sophisticated pension plans are still performing well, consider that CalPERS ($300B+) earned just 0.6% last year; CalSTRS ($180B+) did only slightly better at 1.4%. Hedge funds and traditional energy investments have notably underperformed of late, adding to pension plans' woes. Over the last eight years, pension returns have generally been in the 0-5% range annually, significantly below the 7.5-8% return they need to be able to pay benefits in the future. This is starting to get serious—not just for pension plans but for mom and pop savers too—because the longer this low return environment persists, the more the problem compounds.

8 Year Gap from 3% return vs 8%



12 Year Gap from 3% return vs 8%

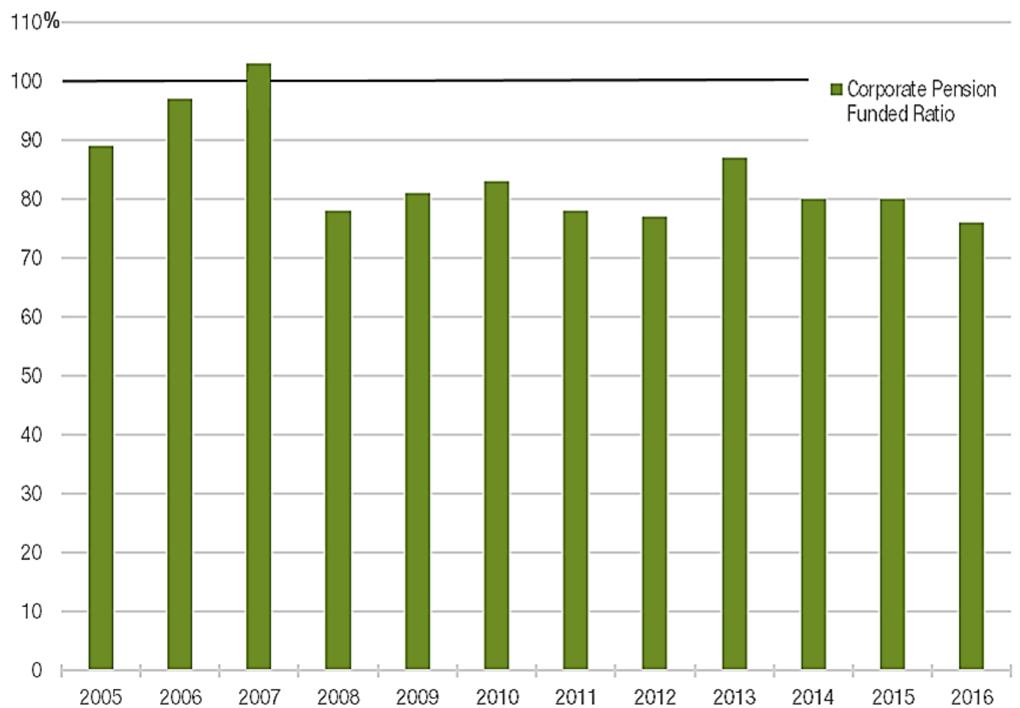


The long-term expected return for pension plans has been in the 7.5-8% range for the last few decades thanks to the great returns of the 1980s and 90s, but it has been a

roller coaster ride since then. With bond yields being so low for so long and stock values seeming fully priced today, earning 7.5% seems like a very tall order in the near future. The 10-year Treasury yield hasn't been above 4% since May 2008 and averaged just 2.6% over the last eight years (June 30, 2008 to June 30, 2016). The S&P 500 return has not helped much either, averaging just 6.4% over the same period. In the good old days if you allocated your pension assets 60% to stocks and 40% to bonds you could hit an 8% blended return, with an acceptable level of risk, if your stocks earned 10% and your bonds earned 5%. Today, stocks are expected to return 4.5% and the 10-year Treasury yields 1.6%. So that same 60/40 allocation today might earn a little over 3%. It is no wonder that many pension plans are only about 75% funded today.

Slipping Down

Corporate pension plans appear to be in the worst position to meet obligations in more than a decade



Source: Wells Fargo Securities.
2016 data is an estimate based on filings. The Wells Fargo analysis is based on 472 members of the Russell 1000 with liabilities over $100 million last year.

Expected rates of return for pension plans are now moving lower to the 6.5-7.5% range as reality sets in regarding this protracted period of low returns. The range should probably be lowered further still. Lower expected returns mean you must save more, lower your goals and/or adjust your investment strategy to achieve a higher return somehow. This is particularly vexing if you manage a pension plan, where it is difficult to raise the amount employees/employers contribute to the plan and it is even more difficult to negotiate a reduction in expected benefits (Detroit's bankruptcy comes to mind). Pension plans know they need to shift to using more alternative investments—private equity, infrastructure, real estate, etc. The state pension plans have been doing this for decades; Taft-Hartley plans have been utilizing alternatives at an increasing rate over the last 15 years but have room to add more. Individual savers, except for ultra high net worth investors, have had almost no access to alternatives due to Federal securities laws requiring minimum net worth and annual income tests (e.g., a $5 million net worth test for many funds).

We expect to structure all our future funds as 3c1 funds, rather than 3c7 funds, which will allow greater access for individual investors.

In light of that, we have been collaborating with wealth management platforms to provide even greater access to our funds for individual investors. Based on this collaboration, we have decided that all future funds will fit within section 3c1 of the Investment Company Act of 1940, rather than 3c7 as we previously have done. This will reduce the net worth and minimum commitment barriers to appropriate levels for individual investors, thus enabling broader participation in our funds. We view this as particularly important with respect to our cleantech/impact funds, where we have regularly been turning away sophisticated high net worth investors who fell just short of the 3c7 requirements.

Of course, we work closely with all our clients to provide them with innovative alternative investment strategies that are designed to outperform their traditional stock and bond allocations. Below are some recent examples:

Net IRR of Recent North Sky Funds (as of 6/30/2016)

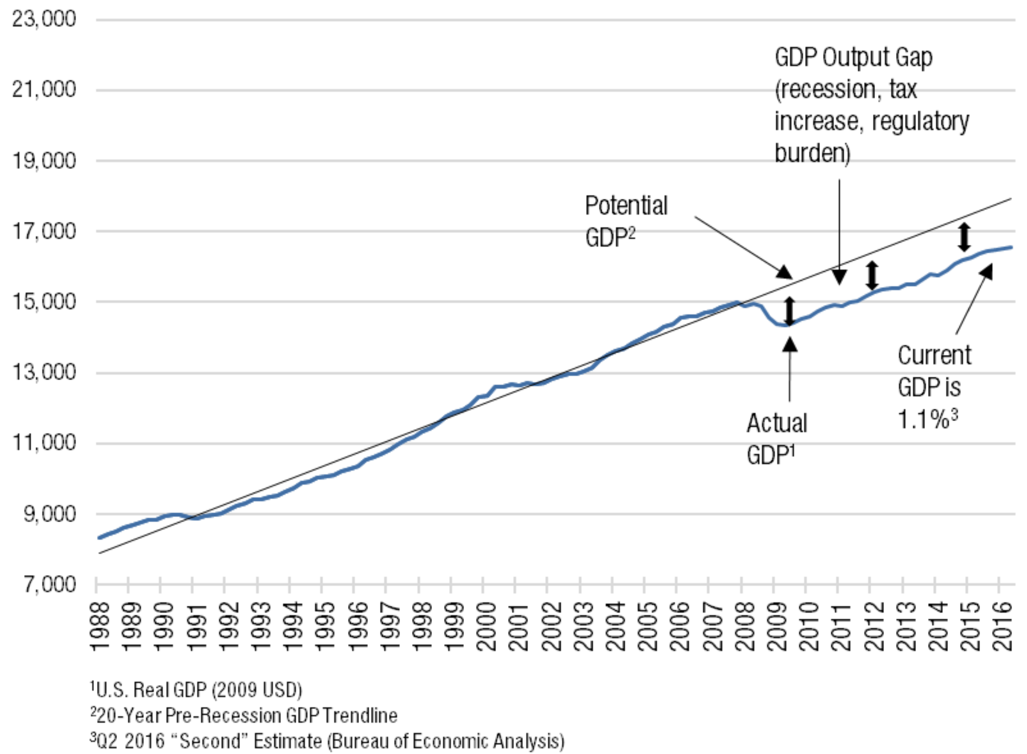
Fund	Strategy	NSC	S&P 500	Outperformance
PEP II	LBO & VC	7.7%	4.7%	3.0%
PEP III	LBO & VC	9.1%	6.6%	2.4%
PEP IV	LBO & VC	14.4%	11.1%	4.6%
AF I*	Clean Energy Infrastructure	9.8%	3.6%	6.2%
CGF III	Cleantech Secondaries	20.9%	15.6%	5.3%

Net IRRs for PEP funds were calculated using an allocation of 60% to LBO investments and 40% to VC investments.
* Benchmarked against the S&P Global Infrastructure Index.

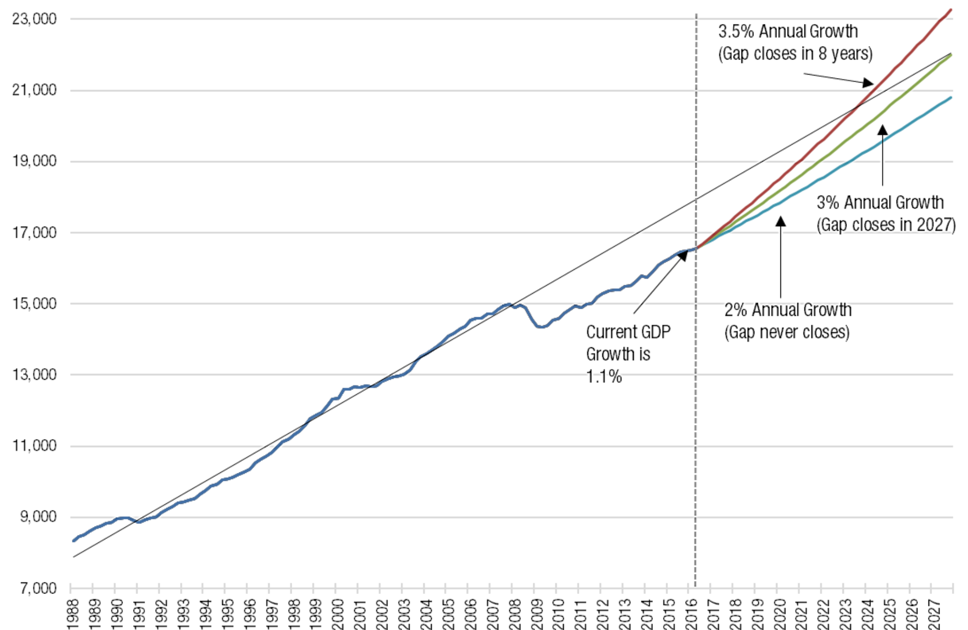
We Need Economic Growth

We can blame the Fed for keeping interest rates artificially low for too long and for the resultant harm to our retirement portfolios, but pointing fingers isn't going to solve the problem. What we need now is economic growth. Economics is the dismal science. Mix in politics and we have a mess. But the Fed has painted itself into a corner—wanting to raise rates, not wanting to cause a precipitous decline in the stock market but not able to achieve both objectives without fiscal help from Congress and the President. If the Fed raised rates in tandem with a cut in corporate taxes so the after-tax earnings of corporations would immediately increase, that could result in equity values holding steady or even increasing if the tax cut were viewed as permanent. There is a way out.

In our Q2 2015 Market Commentary we noted that our economy has been underperforming its potential for some time now. That underperformance has continued since our first comment about it, so we wanted to update the original chart and add a new one showing the growth required to get back to "normal."



The most recent GDP growth estimate was just 1.1%. We need 3.5% or more if we are going to get back to "normal" anytime soon.



We need fiscal and monetary changes from Washington, D.C. or else this low return environment will continue and our pension plans and social safety nets will go bust.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming events:

Oct. 18-20	**EmTech: MIT Technology Review,** Boston, MA events.technologyreview.com
Nov. 1-2	**Intentionally Designed Endowment Forum,** Chicago, IL www.intentionalendowments.org
Nov. 2-4	**Fox Fall Forum,** Chicago, IL www.familyoffice.com
Nov. 9-11	**SRI Conference,** Denver, CO www.sriconference.com
Nov. 13-16	**IFEBP Annual Conference**, Orlando, FL www.ifebp.org
Dec. 13-14	**CoRPaTH Summit & Crystal Globe Awards,** Las Vegas, NV corpath.org

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