Safeguarding assets

-- INTELLIGENT EXPOSURE TO A LATE-CYCLE BULL MARKET --

-- MANAGE YOUR LEVERAGE --

-- GLOBAL PORTFOLIOS ARE THE CORNERSTONE --

Safeguarding assets

Steven Wieting | Chief Investment Strategist and Chief Economist

Today's late-cycle conditions are a good time to seek to safeguard your assets. They also offer opportunities for doing so.

The US economic expansion is on course to break records. In July 2019, the recovery in the world's largest economy that began in mid-2009 is likely to become the longest since measurements began more than a century and a half ago. The bull market in US equities, meanwhile, already surpassed its previous all-time record in August 2018. In light of this – as well as high valuations across numerous asset classes - you may well be asking how long the recovery and bull market can possibly continue.

Citi Private Bank does not believe that the recovery and equity bull market are about to end. We agree with the old saying that 'bull markets do not die of old age.' Few of the economic or financial conditions that have figured around previous peaks are in evidence today. Inflation is largely contained, while US interest rates are rising only gradually by past standards.

Global growth is therefore well poised to endure through 2019 and perhaps beyond – see **Building stronger portfolios for turbulent times**. We thus remain positive on the near-term outlook for risk assets. That said, we recognize that we are in a late-cycle environment. Monetary conditions are no longer as easy as they were, particularly in the US. The US yield curve has flattened and may invert at some point in the next year or so, something that has historically signalled a recession further down the line. Emerging markets have suffered substantial volatility and poor relative performance over the past twelve months.

In this environment, we think it is important to explore ways of safeguarding assets. We do not want people to try to time the markets – that's a fool's game – see **This is not the time for market timing**. We recommend instead a number of constructive actions that you might take in order to help protect gains made over recent years while also continuing to seek opportunities. These include pursuing strategies that seek market upside while shielding against downside, managing leverage, and diversifying portfolio risks by globalizing allocations. We now explore some of these possibilities.

Intelligent exposure to a late-cycle bull market

Iain Armitage | Global Head of Capital Markets

In today's mature bull market, you need not choose between ongoing upside potential and protecting your assets.

Today's late-cycle conditions pose a clear dilemma when positioning portfolios. Should you stay fully exposed to risk assets and seek to capture the ongoing upside that we expect? Or, should you reduce exposure, so as to preserve gains made so far? Staying over-exposed for too long risks taking a hit when the next downturn arrives. Selling now, however, means missing out if the markets continue to rise. But what if you didn't have to make this seemingly binary choice? What if you could instead maintain exposure to potential upside, while also limiting downside risks?

As it happens, there are ways that you can do just that. By employing certain capital markets strategies, you can capture ongoing market gains while simultaneously helping to protect the value that your assets have accumulated. To see this intelligent market exposure in action, let's take the example of an investor who has a portfolio of developed market equities held for the long-term. In this scenario, the portfolio has delivered a total return of 95% since the financial-crisis lows of 2009. Now, though, the investor would like to protect some of this return while also keeping open the possibility of capturing more upside.

FIGURE 1. MAINTAINING EXPOSURE WHILE PROTECTING GAINS

	100% developed markets equities	50% equities 50% capital markets strategy*	Difference	POTENTIAL EFFECTS
Strategic return estimate	4.90%	4.81%	-0.09%	REDUCES RETURN
Standard deviation	16.23%	12.87%	-3.36%	REDUCES VOLATILITY
Sharpe ratio	0.16	0.19	+0.03	IMPROVES RISK-ADJUSTED RETURNS

*Capital markets strategy is a full capital at maturity strategy, as described in the article.
Source: Citi Private Bank as of 10 Oct 2018. Past performance is no guarantee of future results. Strategic Return Estimates are no guarantee of future returns. Developed Market Equities is an asset class within our AVS methodology and indexes are used to proxy for the performance. See Glossary for definitions.

Strategies that provide a payment at maturity can be customized according to your specific needs

The investor therefore decides to sell half of this portfolio of equities – **figure 1** - crystallizing the gains made so far. The proceeds of the sale are then invested in a full capital at maturity strategy that provides the same upside exposure to developed market equities for a four-year period. If equities continue to rise, this approach delivers one-for-one gains at the end of four years. If equities fall, however, the investor still receives the full original investment back at maturity.

By taking this approach, the investor has crystallized half of the portfolio's gains, retaining full upside exposure while limiting downside exposure. This leads to a potentially enhanced risk-adjusted return, albeit marginally lower absolute returns. Of course, if markets simply rise for four years, the investor would have been better off staying fully invested in equities, as this strategy does not earn dividends, unlike the cash position it has partly replaced. Over time, reinvested dividends are an important contributor to total returns.

Strategies that provide a payment at maturity can be customized according to your specific needs. As well as replacing broad-based holdings of equities, indices or exchange traded funds, they can perform the same function for mutual fund holdings that focus on particular themes, such as Asian growth, or robotics for example, allowing access to manager alpha. They can also address various other asset classes and sectors, including fixed income, foreign exchange, and emerging markets. The individual terms of this approach can also be adjusted to reflect your views. It is possible to select, for example, the desired tenor, the amount of protection and the specific market exposure, such as enhanced growth or income orientation.

While such strategies can help mitigate portfolio risk, they also come with risks of their own. For example, if the issuer of the strategy experiences financial distress, your investment could be at risk even if your view of the market has been correct and the strategy's value has increased. Also, there is only a limited secondary market, such that selling prior to maturity may mean you do not get back the full value of what you invested. It is therefore recommended that these strategies be held to maturity.

Today's late-cycle conditions present a compelling reason for integrating payment at maturity strategies as core holdings within your portfolio

We believe that such strategies – whether with full or partial protection – can serve as core holdings within your portfolio, replacing and complementing your holdings of equities, fixed income, foreign exchange and mutual funds. (See **Core and opportunistic investing** box in **Themes: Important actions and forces that will drive portfolio returns**.) We also think they can offer a way of building resilient exposure if you have been holding cash while awaiting an entry-point into the markets.

Today's late-cycle conditions present a compelling reason for integrating payment at maturity strategies as core holdings within your portfolio. Volatility – a key determinant of their cost – is at only around one-third of what it was in 2011, when the bull market was at a much earlier stage. As a result of this – and of the rising interest rate environment – the cost of establishing these strategies remains attractive. However, the lesson of history is clear: today's pricing will not last forever. If and when markets eventually do start falling, the cost of entering may no longer be economical. The time to prepare is before it is too late.

Benjamin Garrity also contributed to this article.

Manage your leverage

Kris Xippolitos | Global Head of Fixed Income Strategy

Late-cycle conditions call for smarter use of leverage rather than abandoning it altogether.

Investing for income has become increasingly challenging over recent years. Central banks' monetary policies helped to drive down the yields on many assets towards historic lows. In response to declining investment cash flows, many investors have tried to compensate by buying longer-duration and lower credit-quality assets. Some have also taken on leverage in an attempt to enhance returns.

Handle with care

Used prudently, leverage can be an effective tool when building a portfolio. By financing positions with borrowed money, investors can not only seek enhanced returns, but also diversify their portfolio by freeing up capital to pursue other opportunities simultaneously. Low interest rates improved cost effectiveness, while restrained volatility in many markets reduced the uncertainty of running leveraged positions.

Of course, leverage is also a double-edged sword. Just as it magnifies returns on investments in a rising market, it magnifies their losses in a falling market. However, we do not expect a widespread fall in risk asset markets any time soon.

We remain overweight global equities and high yield fixed income. And it is not our recommendation that investors avoid using any leverage at all. Our message is to be thoughtful and selective in how leverage is deployed. We certainly advise against using too much of it.

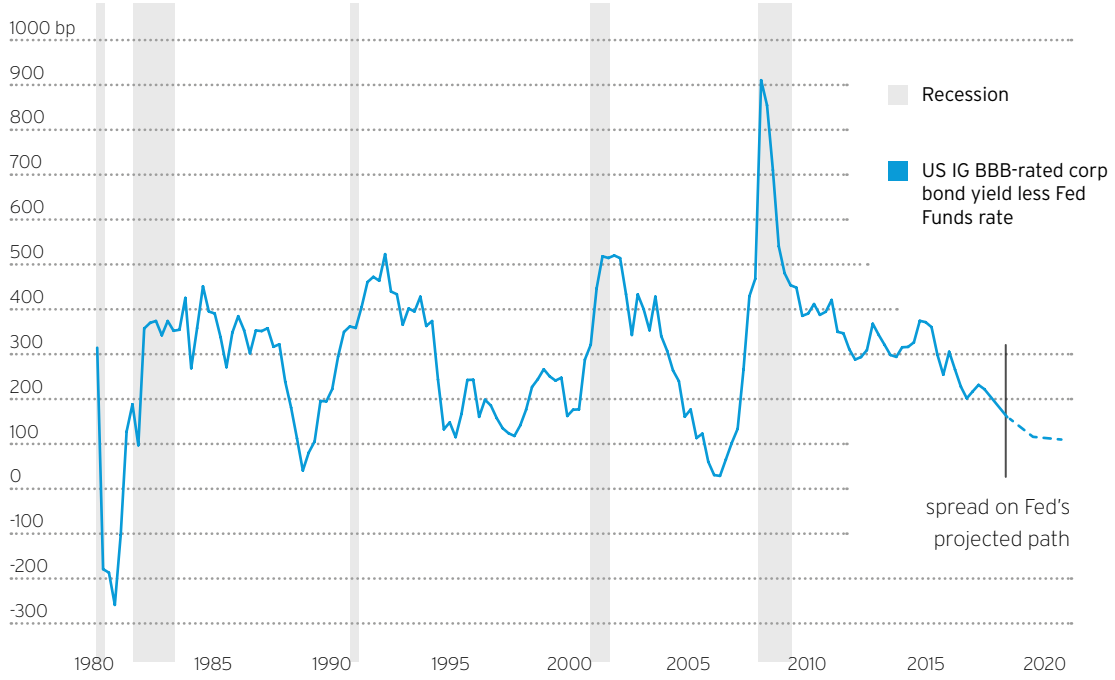
Leverage is costing more

The cost of leverage is on the rise. The Federal Reserve's monetary tightening cycle has helped to drive up 3-month US dollar LIBOR from 0.38% to 2.38% over the last three years. More importantly, the difference between shorter- and longer-term rates is narrower than it has been in more than a decade. The cost of borrowing – determined by short rates – has thus risen by more than the yields on the longer-term assets that leveraged investors might invest in. So, leveraged returns are falling.

We expect US rate rises to continue in 2019. The Fed is expected to hike at least three times during the year and may go further if financial conditions allow. It is thus possible that LIBOR could reach around 3.5% by the end of 2019. In this environment, the spread available from borrowing at short-term rates and investing in longer-term BBB rated corporate fixed income could dip towards their post-1982 lows – **figure 1**.

If investors wish to seek to maintain leveraged returns at current levels, they are therefore likely to have either to assume more duration and credit risk, or add even more leverage. Given the lateness of the cycle, caution is required.

FIGURE 1. DIMINISHING RETURNS FROM LEVERAGED POSITIONS



Source: Bloomberg, as of 10 Oct 2018. Short-term rates are represented in the chart by the Fed Funds rate, which helps determine LIBOR pricing. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

Be smarter with leverage

Despite the rate increases, borrowing costs remain well below long-term averages. So, we think that conservative use of leverage can still make sense. Another possibility for investors who feel comfortable doing so would be adding some lower credit quality assets to the portfolio as a substitute for leverage. For this purpose, investors might employ a specialist active manager who may be able to avoid those assets that are most at risk of encountering difficulties.

We also recommend that investors consider hedging their loan exposures. This can be done by utilizing capital markets strategies. For example, there are strategies available that can either lessen the impacts from rising borrowing costs, offset them, or even seek a profit from them. While some hedges come at additional expense, there may also be ways to minimize the cost.

For the most leveraged investors, we would urge undertaking a review of your overall leverage. This should take into account not only your overall leverage, but also the risks of the underlying investments involved. The objective is to identify an appropriate amount of risk-adjusted leverage such that your portfolio could experience a significant decrease in market value without your getting a margin call. Citi Private Bank's Global Investment Lab stands ready to help you explore the risks and opportunities arising from your leverage, and how best you might preserve your assets.

We also recommend that investors consider hedging their loan exposures

Global portfolios are the cornerstone

Steven Wieting | Chief Investment Strategist and Chief Economist

While we believe in global diversification at all times, it is of critical value in today's environment.

'Go global now' was our single most important piece of advice in Outlook 2018. We demonstrated that investing over time in a broad variety of different asset classes from across the world has helped to lower the overall risk of many portfolios, while also potentially raising returns. Global portfolios have displayed endurance through market cycles, which has helped their owners preserve and grow wealth over time. We therefore stress the importance of global portfolios for helping to preserve assets at all times, but especially now.

When global markets are moving asynchronously, this is precisely the time when diversification and rebalancing are critical. Late-cycle conditions typically see increased market volatility. Portfolios that are highly concentrated in particular regions, risky asset classes or both are obviously more vulnerable to such turbulence. After cyclical peaks, global diversification has been pivotal in helping to preserve portfolio value. Such periods have also been when concentrated local or regional portfolios have proven to be most at risk.

Enduring through cycles

To highlight this, we explored asset class performance between 1952 and 2016. We then created historical globally diversified allocations, using indices to proxy for equities, fixed income, hedge funds, commodities, and cash within our Adaptive Valuation Strategies methodology. The resulting global allocation would not have experienced a negative return during any five-year timeframe during those six decades, a period that included the 1970s oil price shocks, the October 1987 stock market crash, the dot.com bust of the early 2000s, and the Global Financial Crisis of 2008.

As well as helping to preserve assets during episodes of market stress, a global multi-asset class allocation would have produced superior returns to a concentrated regional allocation. Over the entire period, a global multi-asset class allocation would have produced a 10.9% annualized return before fees. But an allocation only to equities and fixed income drawn entirely from the best performing individual region – the US – would have produced a 9.3% annualized return before fees.

The performance for each of the last seven decades of a globally diversified allocation – aligned at an asset class level to Citi Private Bank's AVS Risk Level 3 allocation in US dollars including hedge funds – is shown in the infographic. Over time, such an allocation would have produced higher risk-adjusted returns than any individual asset class. That's a big deal for a long-term investor.

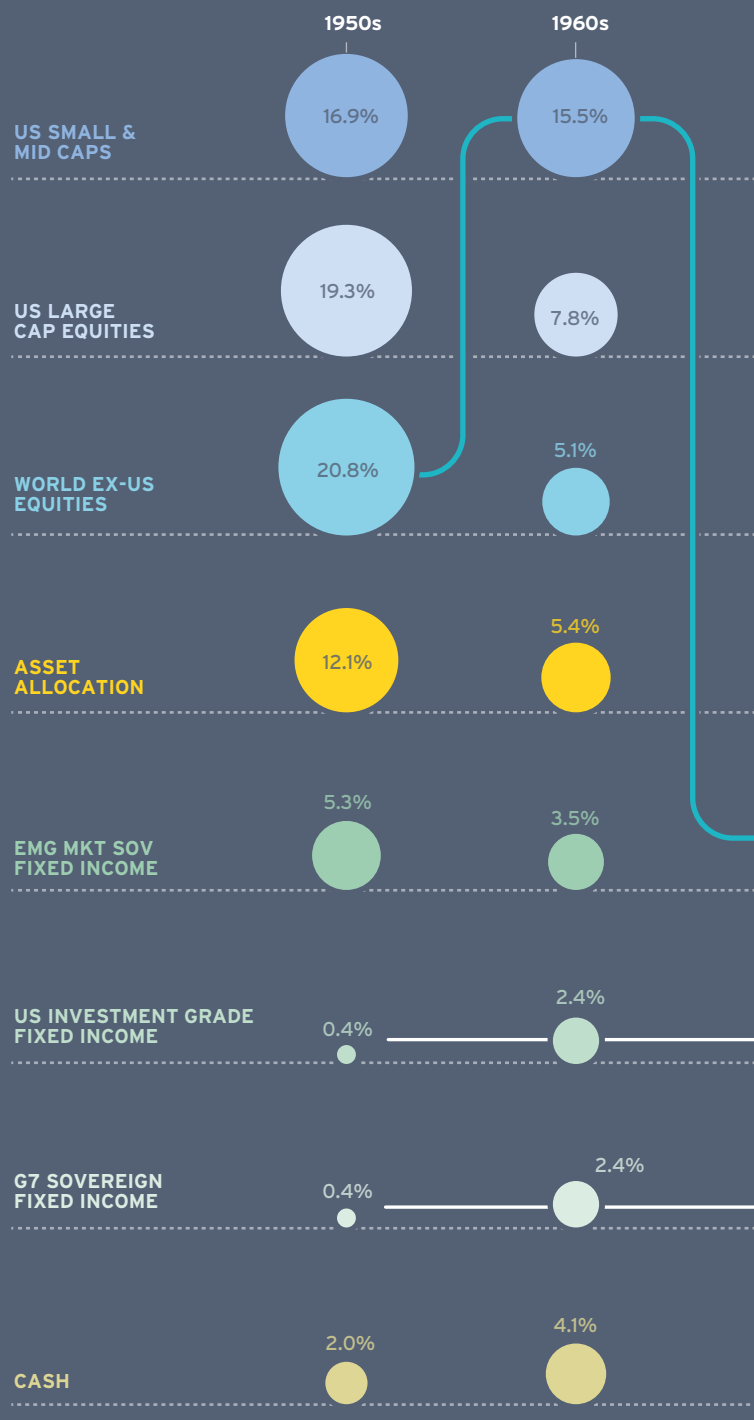
Despite the clear lessons of history, many client portfolios remain highly concentrated. In fact, we often come across portfolios that focus upon just two or three asset classes. A typical client's exposure is also concentrated 70% to 85% in a single currency. This is risky late in the cycle. After years of rising markets, it is all too easy for complacency to creep in. Allocations may have drifted from target weightings after long spells of strong performance by certain assets and weak performance by others.

Some investors believe their portfolios to be much more globally diversified than they really are simply because they are aligned to a certain benchmark. As of September 2018, two leading equity and fixed income benchmarks had respective weightings of 52% and 43% in one country alone: the US. This partly reflects the stronger relative performance of US asset prices over recent years. However, we believe that building a global portfolio demands much more than simply replicating broad benchmark weightings. The flipside of outsized weightings to individual countries is little or no exposure to others, even though these may offer attractive diversification potential.

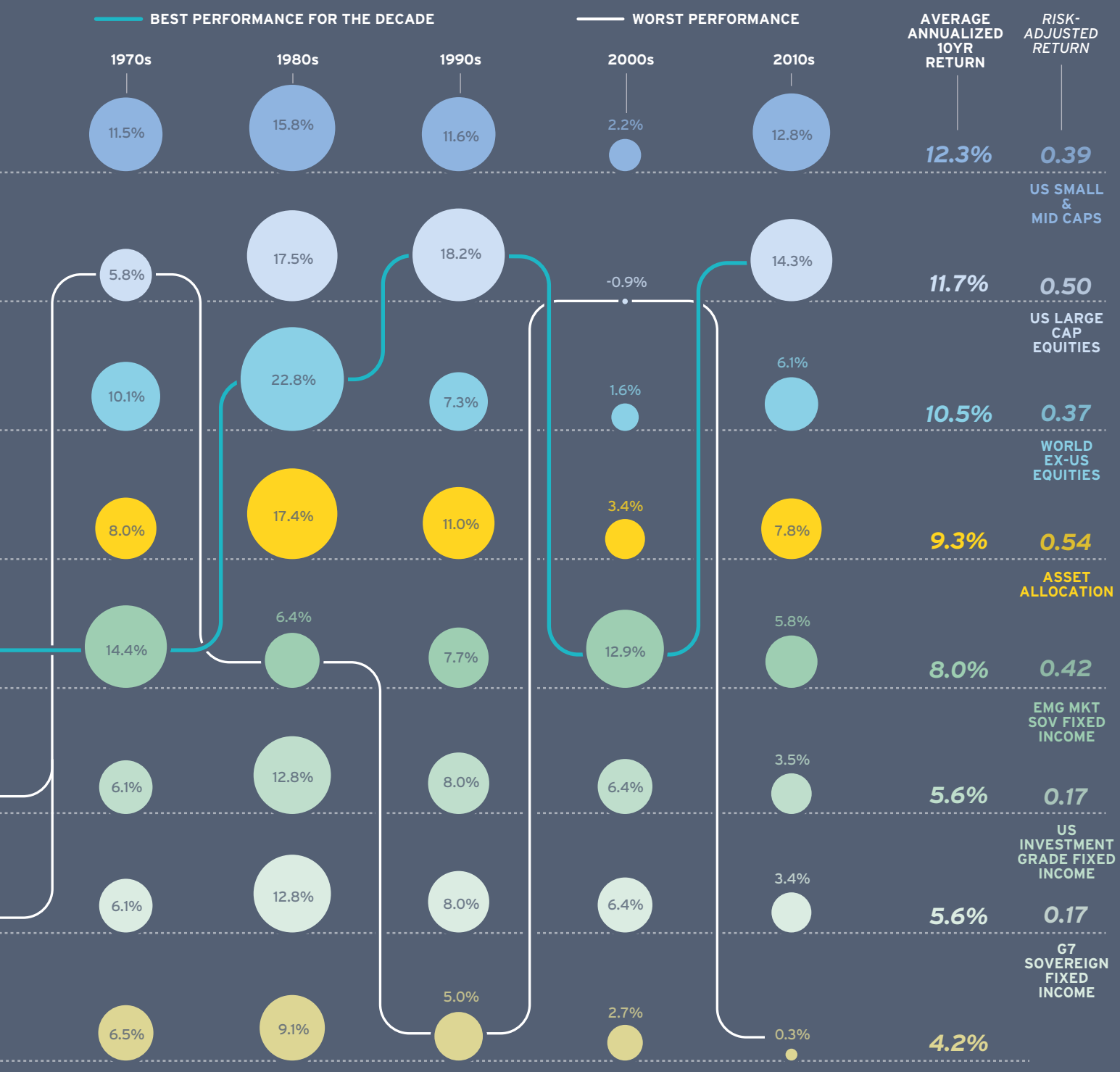
Never too late to go global

We encourage you to revisit your portfolio and to see how it aligns to the allocation that we recommend for you. To help you do this, our Global Investment Lab can produce an Outlook Watchlist report for you, which also shows your positioning compared to our investment themes. Your Investment Counselor can then discuss with you some customized opportunities for helping to safeguard your assets by going global.

ASSET CLASS PERFORMANCE BY DECADE



Source: Citi Private Bank's Office of the Chief Investment Strategist, Bloomberg, as of 27 Oct 2018. See glossary for asset class definitions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. Adaptive Valuation Strategies (AVS) is the Private Bank's proprietary strategic asset allocation methodology.



"Asset allocation" in this diagram represents an AVS Risk Level 3 allocation, which includes allocations to equities, fixed income, commodities, cash and hedge funds. Risk levels are an indication of clients' appetite for risk. Risk Level 3 – Seeks modest capital appreciation and, secondly capital preservation. The returns shown were calculated at an asset class level using indices and do not reflect fees, which would have reduced the performance shown. Risk-adjusted return is defined here as the Sharpe ratio. See glossary for definition of terms.

Glossary

ASSET CLASS DEFINITIONS

Cash is represented by US 3-month Government Bond TR, measuring the US dollar-denominated active 3-Month, fixed-rate, nominal debt issues by the US Treasury.

Commodities asset class contains the index composites — GSCI Precious Metals Index, GSCI Energy Index, GSCI Industrial Metals Index, and GSCI Agricultural Index — measuring investment performance in different markets, namely precious metals (e.g., gold, silver), energy commodity (e.g., oil, coal), industrial metals (e.g., copper, iron ore), and agricultural commodity (i.e., soy, coffee) respectively. Reuters/ Jeffries CRB Spot Price Index, the TR/CC CRB Excess Return Index, an arithmetic average of commodity futures prices with monthly rebalancing, is used for supplemental historical data.

Global Developed Market Corporate Fixed Income is composed of Bloomberg Barclays indices capturing investment debt from seven different local currency markets. The composite includes investment grade rated corporate bonds from the developed-market issuers.

Global Developed Market Equity is composed of MSCI indices capturing large-, mid- and small-cap representation across 23 individual developed-market countries, as weighted by the market capitalization of these countries. The composite covers approximately 95% of the free float-adjusted market capitalization in each country.

Global Developed Investment Grade Fixed Income is composed of Barclays indices capturing investment-grade debt from twenty different local currency markets. The composite includes fixed-rate treasury, government-related, and investment grade rated corporate and securitized bonds from the developed-market issuers. Local market indices for US, UK and Japan are used for supplemental historical data.

Global Emerging Market Fixed Income is composed of Barclays indices measuring performance of fixed-rate local currency emerging markets government debt for 19 different markets across Latin America, EMEA and Asia regions. iBoxx ABF China Govt. Bond, the Markit iBoxx ABF Index comprising local currency debt from China, is used for supplemental historical data.

Global High Yield Fixed Income is composed of Barclays indices measuring the non-investment grade, fixed-rate corporate bonds denominated in US dollars, British pounds and Euros. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Ibbotson High Yield Index, a broad high yield index including bonds across the maturity spectrum, within the BB-B rated credit quality spectrum, included in the below-investment-grade universe, is used for supplemental historical data.

Hedge Funds is composed of investment managers employing different investment styles as characterized by different sub categories – HFRI Equity Long/Short: Positions both long and short in primarily equity and equity derivative securities; HFRI Credit: Positions in corporate fixed income securities; HFRI Event Driven: Positions in companies currently or prospectively involved in wide variety of corporate transactions; HFRI Relative Value: Positions based on a valuation discrepancy between multiple securities; HFRI Multi Strategy: Positions based on realization of a spread between related yield instruments; HFRI Macro: Positions based on movements in underlying economic variables and their impact on different markets; Barclays Trader CTA Index: The composite performance of established programs (Commodity Trading Advisors) with more than four years of performance history.

High Yield Bank Loans are debt financing obligations issued by a bank or other financial institution to a company or individual that holds legal claim to the borrower's assets in the event of a corporate bankruptcy. These loans are usually secured by a company's assets, and often pay a high coupon due to a company's poor (non-investment grade) credit worthiness.

Private Equity characteristics are driven by those for Developed Market Small-Cap Equities, adjusted for illiquidity, sector concentration, and greater leverage.

INDEX DEFINITIONS

The **Bloomberg Barclays Global Aggregate Bond Index** is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

The **Bloomberg-JP Morgan Asia Currency Index** is designed as a spot index of the most actively traded currency pairs in Asia's emerging markets valued against the US dollar.

The **CSI 300** is a capitalization-weighted stock market index designed to replicate the performance of top 300 stocks traded in the Shanghai and Shenzhen stock exchanges. It was considered as a blue chip index for mainland China stock exchanges

Citi US Broad Investment Grade Index (USBIG)—Corporate, is a subsector of the USBIG. The index includes fixed rate US dollar denominated investment grade corporate debt within the finance, industrial and utility sectors. This index includes US and non-US corporate securities (excludes US government-guaranteed and non-US sovereign and provincial securities).

Citi Emerging Markets Sovereign Bond Index includes local currency sovereign bond indices for 14 emerging markets countries. These indices comprise fixed-rate sovereign debt with at least one-year until maturity. They are market capitalization-weighted and rebalanced monthly for Brazil, Chile, Colombia, Hungary, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Thailand, Turkey, and South Africa.

The **Citi Euro Broad Investment Grade Index** is a multi-asset benchmark for investment-grade, Euro-denominated fixed income bonds. It includes government, government-sponsored, collateralized, and corporate debt.

Citi's US High-Yield Market Index is a US dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada. Recognized as a broad measure of the North American high-yield market amongst all Citi's fixed income indices, it includes cash-pay and deferred-interest securities. All the bonds are publically placed, have a fixed coupon, and are non-convertible.

The **Citi World Broad Investment Grade Index** is a multi-asset, multicurrency benchmark which provides a measure of the global fixed income markets.

The **Euro Stoxx 600** represents large-, mid- and small-cap companies across 17 countries across Europe including: Austria, Belgium, Czech Republic, Denmark, Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **MSCI Emerging Markets Index** captures large- and mid- cap representation across twenty-four Emerging Markets (EM) countries. With 837 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI Emerging Markets (EM) Latin America Index** captures large and mid-cap representation across five Emerging Markets (EM) countries in Latin America. With 113 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI World Index** represents the performance of more than 1,600 large- and mid-cap stocks across 23 developed markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country

The **MSCI World ex-USA Index** represents the performance of large and mid-cap representation across 22 of 23 developed markets countries excluding the United States. With 1,005 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Standard & Poor's 500 Index** is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large-cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.

OTHER TERMINOLOGY

Adaptive Valuations Strategies is Citi Private Bank's own strategic asset allocation methodology. It determines the suitable long-term mix of assets for each client's investment portfolio. Correlation is a statistical measure of how two assets or asset classes move in relation to one another. Correlation is measured on a scale of 1 to -1. A correlation of 1 implies perfect positive correlation, meaning that two assets or asset classes move in the same direction all of the time. A correlation of -1 implies perfect negative correlation, such that two assets or asset classes move in the opposite direction to each other all the time. A correlation of 0 implies zero correlation, such that there is no relationship between the movements in the two over time.

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LIBOR – The London interbank offered rate is the rate of interest at which banks offer to lend funds to each other. It is used a reference rate for large amounts of financial contracts.

Price-to-book ratio (P/B) compares the capitalization of an individual stock or of an index of stocks to the value of that stock or that index's combined shareholder capital. It is calculated by dividing the current closing price of the stock by the most recently reported book value per share. A low P/B can indicate a lowly-valued company or index, while a high P/B can indicate high valuation.

Price-earnings ratio (P/E) measures a company's or an index of companies' current share price relative to its earnings per share. A low P/E can indicate a lowly-valued company or index, while a high P/E can indicate high valuation.

Return on equity (ROE) is the amount of net income earned as a percentage of shareholders equity. It captures a company's profitability – or aggregate profitability among numerous companies – by showing how much profit is achieved with shareholders' capital.

Sharpe ratio is a measure of risk-adjusted return, expressed as excess return per unit of deviation, typically referred to as risk.

Strategic asset allocation is the process of creating a long-term investment plan by assembling an appropriate mix of equities, fixed income, cash and other investments. It can potentially enhance portfolio returns and help manage risk. Strategic Return Estimates are Citi Private Bank's forecast of returns for specific asset classes over a 10-year time horizon. The forecast for each specific asset class is made using a proprietary methodology that is appropriate for that asset class. Equity asset classes are forecast using a proprietary methodology based on the calculation of valuation levels with the assumption these valuation levels revert to their longterm trends over time. Fixed Income asset classes are forecast using a proprietary methodology based on current yield levels. Other asset classes have other specific forecasting methodologies. Please note that hedge funds, private equity, real estate, structured products and managed futures are generally illiquid investments and are subject to restrictions on transferability and resale. Each SRE is gross of actual client fees and expenses. Components of the methodology used to create the SREs include the rate of return for various asset classes based on indices. Termination and replacement of investments may subject investors to new or different charges. Past performance is not indicative of future results. Future rates of return cannot be predicted with certainty. Investments that pay higher rates of return are often subject to higher risk and greater potential loss in an extreme scenario. The actual rate of return on investments can vary widely over time, especially for long-term investments. This includes the potential loss of principal on your investment. It is not possible to invest directly in an index.

Tactical asset allocation looks to adjust the strategic asset allocation of a client's investment portfolio to incorporate shorter-term market insights.

Volatility – is a statistical measure of the variation of returns for a given security, market index, or asset class. It is most often measured by way of standard deviation. The higher the volatility, the riskier the underlying asset is considered to be.

Yield-to-Maturity (YTM) is the total return received on a bond or index of bonds when held to maturity. The total return includes both the payment of coupons and the return of the principal at maturity.

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MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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