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Winding down the quarter and ramping up the agita

Is it time to get less bullish on European risk assets?

China 2.0: a new economic dawn

Buyback bonanza

Tactical asset allocation review

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Winding down the quarter and ramping up the agita

Dear clients and colleagues,

Investors experienced a remarkable array of events last quarter, and many of them will continue to shape and impact the path ahead.

I turn first to geopolitics and the evolving coalition between the West and a group of Arab countries to join the battle against the Islamic State of Iraq and the Levant (ISIL) in Iraq and Syria. This represents renewed military engagement in a region where many hoped that was coming to an end – albeit a disappointing one. The ongoing conflict in Ukraine has flared with no sense of an enduring agreement between parties, and the threat of Russian irredentism casts a pall over the region. The 307-year union between England and Scotland appeared under the real threat of dissolution with the Independence vote last month.

The latest turmoil is the "Umbrella Revolution" currently unfolding in Hong Kong,[1] which has nothing to do with the weather and everything to do with self-determination.[2] The people of Hong Kong are agitating for universal suffrage. Under the agreement struck when Great Britain relinquished control of Hong Kong to China, the island would be governed under a "one country, two systems" framework. The people of Hong Kong get to vote for their representatives in government; however, those representatives are screened by Beijing. For those protesting in the street, this is not democracy.

The people of Hong Kong are agitating for universal suffrage

Of all these geopolitical concerns, the conflict on the island has the potential to surprise and disrupt markets most. Hong Kong has been a remarkably successful and stable place in which to do business. Trips to the island have never failed to impress me with a picture of robust capitalism: business is the business of the place. A stable environment nurtures investment. Business can only flourish if those risking their capital have a sense that their resources are safe from expropriation, and the opportunity for a return on their capital is realized. How all this turns out depends upon how the leaders in Beijing decide to respond. Brutal crackdowns on protesters will likely, and rightfully, poison the atmosphere for investment. If a more conciliatory approach is taken and a deal is struck, then markets will likely take a more constructive view of things, since such an agreement would represent the transit to a system of popularly elected officials – just what the protesters desire.

Second quarter US GDP was lifted from 4.2% to 4.6%

On the economic front, the growth story we have described in these pages was once again cast into sharp relief as the revision to second quarter US GDP was lifted from 4.2% to 4.6% on higher capital investment.[3] Rising capital spending is something we have been expecting for some time now, since it is an important fuel for economic growth that has not yet returned to pre-crisis levels. In the euro zone, the picture is mixed. The German economy continues to grow, but sentiment indexes such as the Ifo Surveys and purchasing manager indexes suggest the margin of growth that economy enjoys is shrinking. Overall, the slide in euro zone inflation is focusing the attentions of the European Central Bank on warming up the printing presses as they prepare a new round of quantitative easing (QE) with the purchase of asset-backed securities. Many are calling for the outright purchase of

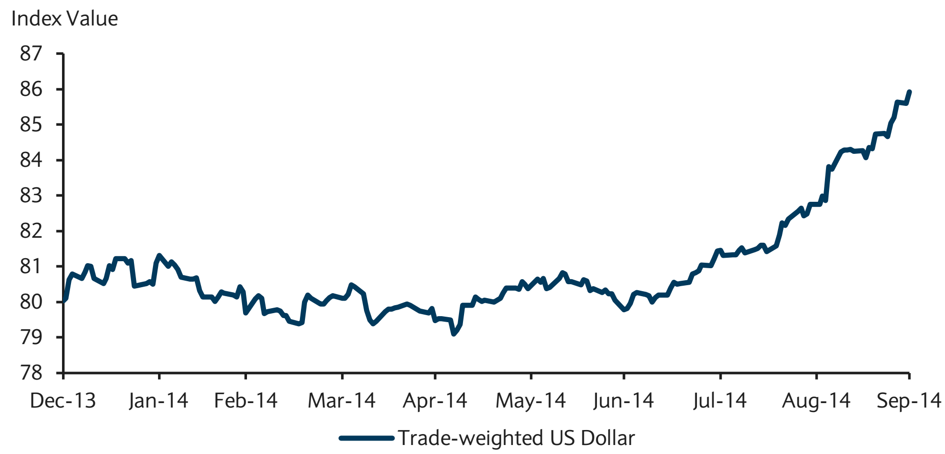
[1] This phrase seems to have first emerged in social media channels and for certain appeared in the traditional media in a 30 September 2014 article in *The Times*.
[2] Protesters are using umbrellas to deflect the pepper spray and tear gas police use to control the demonstration. *Foreign Policy* magazine has published remarkable photographs chronicling events.
[3] Source: Bloomberg, as of 26 September 2014.

government debt in the next iteration of the program. Whether an expanded program of quantitative easing would be supported in the *Bundestag* remains to be seen, but a new round of QE is unlikely to happen until the recently announced program has been executed.

Markets around the globe turned in differentiated performance during the quarter

Markets around the globe, like the economies in which they operate, have turned in differentiated performance during the quarter. US equities rose during the period while European equities fell, reflecting the relative growth propelling the markets.[4] US earnings season will commence in a few days, and expectations are for third quarter profits to rise by 7.6%.[5] There is significant potential for negative surprise as the dollar's meteoric rise commenced at the start of the quarter. (Figure 1) In the euro zone, earnings are also expected to rise and could very well be aided by a strong dollar.

Figure 1: The US dollar is an upward trajectory



Source: Bloomberg, as of 30 September 2014

More discriminating markets will emerge

Markets appear to be at an inflection point. Recently, volatility has been more of an academic concept than an investor's reality. As the "Great Money Print" unfolded, asset prices of every flavor rose and volatility fell. As one commentator put it, there has been a bull market in complacency. These days may be numbered. As the era of ZIRP[6] closes, industrial-scale quantitative easing ends in the US, and both the US and the UK prepare for interest rate normalization, more discriminating markets will emerge, likely bringing higher volatility. Make no mistake, markets and the economies in which they operate ultimately benefit when there is a real price for money. Markets that discriminate are the best and healthiest of markets. To be sure the best is yet to come; getting there will likely be the rough bit.

In this edition of *Compass*, we explore several investment topics around the globe. First, we consider the impact (if any) of disappointing Euro-area economic data to our bullish stance on the bloc's equities. Next, we examine the case of Chinese stocks in the context of the central bank's far-reaching economic modernization plan. Lastly, we address concerns about the quality of US corporate earnings given the recent increase in stock buybacks.

As always, we welcome your thoughts, observations, and comments.

Hans F. Olsen, CFA
Global Head of Investment Strategy

[4] Source: Bloomberg, as of 30 September 2014. US equities represented by Russell 1000 Index, European equities represented by Euro Stoxx 50 Index. Past performance does not guarantee future results. An investment cannot be made directly in a market index.
[5] Source: Bloomberg, as of 1 October 2014
[6] ZIRP – Zero Interest Rate Policy

Is it time to get less bullish on European risk assets?

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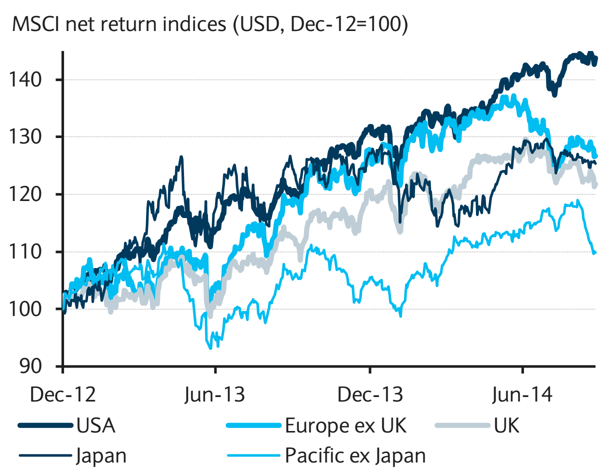
Europe has been one of our preferred equity regions for some time, and so far, this call has served us well. In the September 2014 *Compass*, we re-iterated our bullish stance on European risk assets, but since then both the geopolitical and economic backdrop have surprised to the downside. The participation of European banks in the European Central Bank's (ECB) much-heralded targeted longer-term refinancing operations (TLTROs) has also fallen short of consensus expectations, increasing uncertainty regarding future monetary actions. So we ask: should we be more cautious on European risk assets?

The story so far

The United States and Europe ex UK have been our preferred equity regions for several years now. Since 2013, the US and Europe ex UK have outperformed other developed regions in common currency terms. (Figure 1) Until the end of May 2014, the performance of our favored regions had been very similar, with the US and Europe ex UK up 38% and 35%, respectively.[7] Since then performance has diverged sharply with the US gaining 4% and Europe ex UK losing 6%.

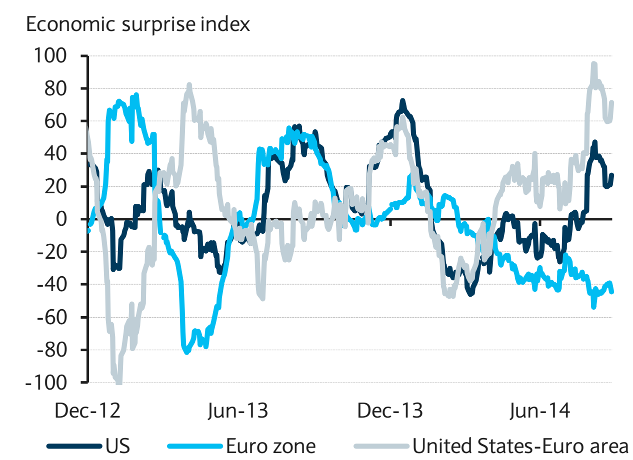
A 6% depreciation of the euro versus the US dollar since the end of May accounts for part of the Europe ex UK underperformance relative to the US in common currency terms.[7] Negative geopolitical and economic surprises in Europe help explain the additional underperformance.

Figure 1: Equity performance



Source: Datastream, Barclays; as of 24 September 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

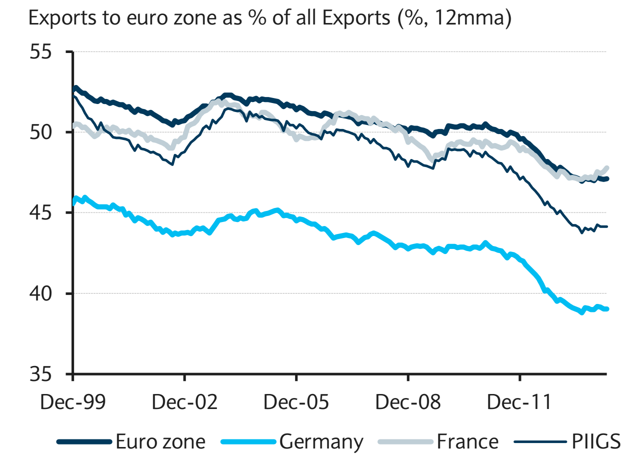
Figure 2: Economic surprises



Source: Citigroup, Barclays; as of 24 September 2014

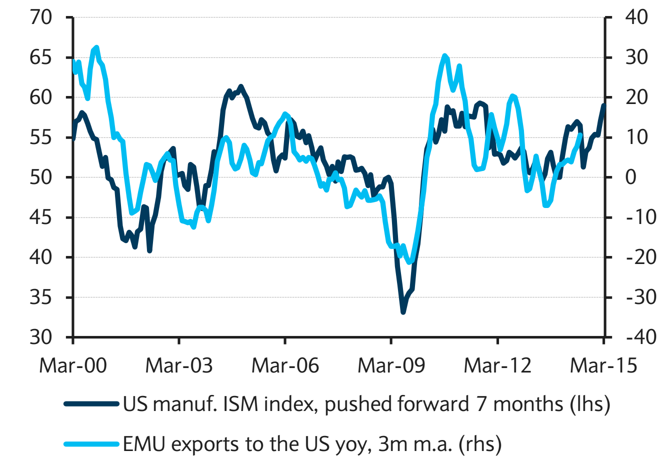
[7] As measured by the net MSCI indices in US dollars. Bloomberg, as of 24 September 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

Figure 3: Exports



Source: Datastream, Barclays; as of 30 April 2014; PIIGS include Portugal, Ireland, Italy, Greece and Spain

Figure 4: ISM manufacturing and EMU export to the US



Source: Datastream, Barclays; ISM as of August 2014, Export as of July 2014

On the geopolitical front, Russia's aggressive and continued disregard for the law of nations in the conflict in Ukraine culminated in a NATO show of force at a summit in Wales. Further, both the European Union and Russia increased sanctions to a level that will have an economic impact on both sides. It remains to be seen whether Moscow will accept that the government in Kiev still aims for an EU membership and conducts military exercises with NATO.

In the euro zone the economic surprises continued to be on the downside

Regarding economic news, US data surprised on the upside, while euro zone data missed expectations. (Figure 2) The divergence between news for the US and euro zone has spiked to a level not seen for over one and a half years.

How worrying is the economic news?

Does the latest economic news threaten our outlook on European equities? The basis for our bullish stance on European risk assets is that they will benefit from an increasingly strong global economy. The negative data out of Germany, therefore, is concerning. It is the largest economy of the euro zone, and its economy is export-driven with most of its trade partners located outside the bloc. (Figure 3) The German IFO business expectations index, a leading indicator for German exports, now points towards a contraction in German export growth.[8]

Germany's trade partners are predominantly outside the euro zone

The good news is that there are other indicators pointing in a different direction. Readings on German output recently rose, remaining firmly in expansionary territory, and offering hope that the principal economic engine on the continent will not slip into recession. Economic indicators outside the euro zone offer additional hope. The ISM manufacturing index in particular points towards an increased level of exports from the euro zone to the US. (Figure 4)

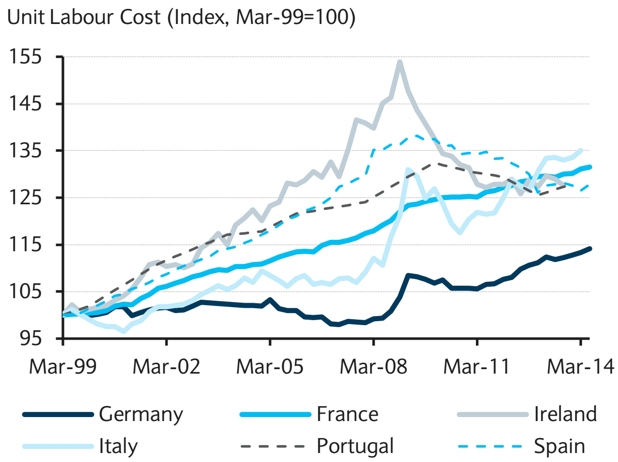
While Germany is well-positioned to benefit from global growth, structural issues in the core and peripheral countries are inhibiting their competitiveness. (Figure 5) For this reason, our expectations for the other large euro zone economies are more muted.

Spain has made great strides to improve competitiveness

France, as the second largest economy, remains in a bleak state, with the influence of entrepreneurs declining and the number of jobseekers increasing. (Figure 6) Hope that the French Government will soon enact meaningful reform should be muted. Popular support for the government is thin and getting thinner, while the political backdrop remains fragile. For

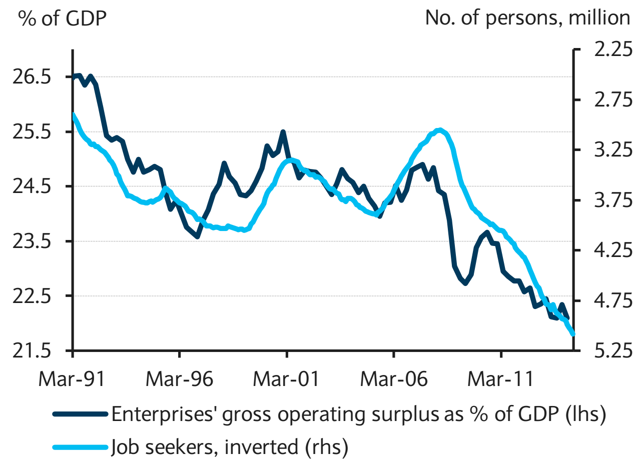
[8] IFO Institute, as of 24 September 2014

Figure 5: European unit labor costs



Source: Datastream, Barclays; data end dates range from Q3 2013 to Q2 2014

Figure 6: France – enterprise surplus and job seekers



Source: Datastream, Barclays; Surplus data as of Q2 '14, Jobseekers as of July '14

Italy, on the other hand, expectations are so low that Prime Minister Matteo Renzi's non-delivery on his promise to have 'one reform per month' has not yet affected his standing. Italy is the country that has the deepest pit to dig out of to become competitive. On the bright side, Spain has made great strides to improve competitiveness, leaving the ongoing autonomy movement in Catalonia as the highest risk for this country.

The depreciating euro: what is the impact on European risk assets?

Projected earnings growth for Europe is the highest among all developed market regions

The recent depreciation of the euro has served as a reminder that a weakening currency makes European equities less attractive for non-euro based investors. Despite this, the case for European equities outperforming on a local currency basis looks compelling: their valuations are attractive, especially when compared to their US counterparts, and their predicted earnings growth is the highest among all developed market regions[9]. The greater question for investors though is how will they compare with other equities on a common currency basis?

To answer this, we need to assess the medium-term outlook for the euro and the potential impact on equity markets. There is a widespread consensus that the euro will continue to depreciate, but by what amount is unclear. This reflects conflicting views on what drives exchange rates.

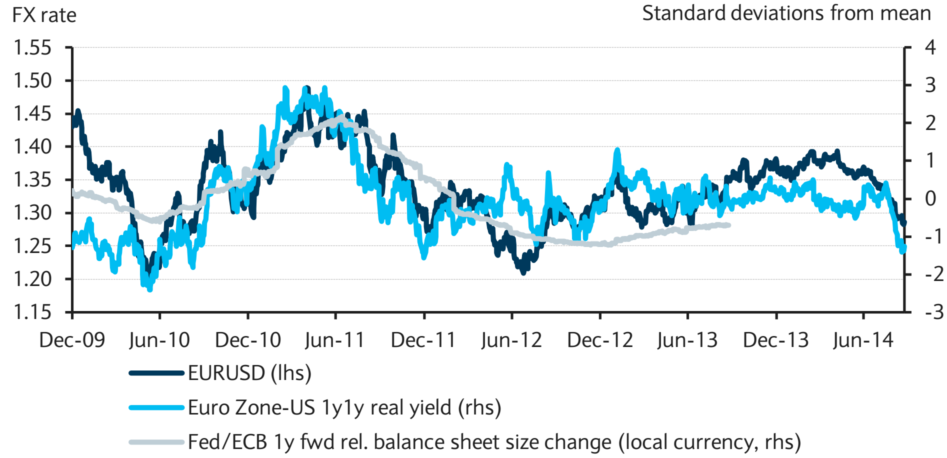
Both the one-year real interest rate differential between the euro zone and US, one year from now ("1y1y"), and the one-year forward relative change in the central bank balance sheet size offer reasonable explanations for the EUR/USD move over the last four years. (Figure 7) The longer-term outlook for the euro, however, differs markedly, depending on which driver is more heavily considered.

Those believing that central bank balance sheet sizes are a main driver of exchange rates arrive at the more severe predictions. In this context it is not surprising that our colleagues at the investment bank have placed a caveat on their forecast of the EUR/USD FX rate reaching 1.10 in one year time. They say it is contingent on ECB president Mario Draghi delivering on his plan to expand the central bank's balance sheet size back to the level seen at the start of 2012.

[9] Source: IBES, as of 18 September 2014

There is a widespread consensus that the euro will continue to depreciate

Figure 7: Exchange rates and possible drivers

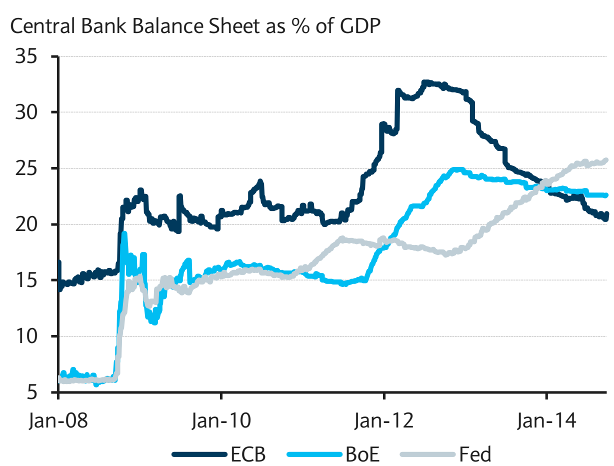


Source: Datastream, Barclays; as of 23 September 2014

The ECB balance sheet has not yet started to increase

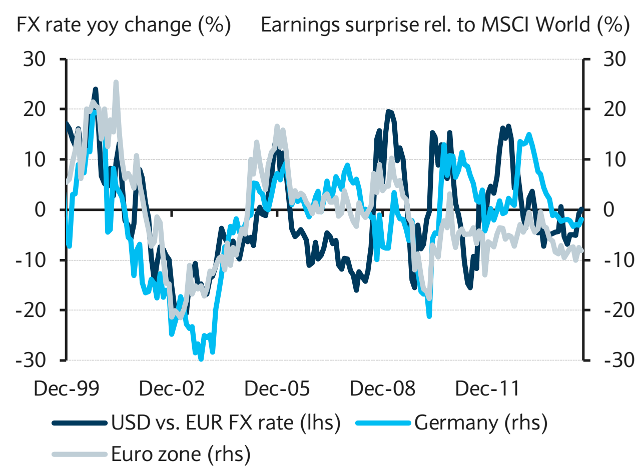
On the monetary front, the amount that was taken up in the first targeted longer-term refinancing operation (TLTRO) was just €82.6 billion. This figure fell short of consensus expectations and was partly offset by other factors – the ECB balance sheet has yet only increased by about €50 billion. [10] (Figure 8) This uninspiring first round of TLTRO raises doubts that the ECB can achieve the planned increase of its balance sheet with the measures made public so far. Some commentators are speculating that as a consequence, the ECB might engage in quantitative easing involving government bonds soon, arguing that it might not formally breach the treaties were the bonds purchased in the secondary market. It remains to be seen what level of resistance such plans would provoke from Germany. The independence of the central bank and its exclusive focus on inflation is of the utmost importance to Germany. Germans might be able to overlook the conflicts of interest that will result from the ECB taking on new banking supervision tasks as part of a single supervisory mechanism (SSM). They will, however, find it hard to believe that the central bank can preserve its political independence once it has government debt on its balance sheets.

Figure 8:Central bank balance sheets



Source: Datastream, Barclays; as of 26 September 2014

Figure 9: Exchange rate and earnings surprises



Source: Datastream, Barclays; as of 31 August 2014

[10] ECB, 18 September 2014

We could see the euro falling to 1.20, perhaps even 1.15 in the coming year

By many measures the euro is still expensive, and further depreciation is likely. Our view on the further extent of this decline is, however, muted. We could see the euro falling to 1.20, perhaps even 1.15 in the coming year. Regardless, the depreciation that has already occurred increases our confidence that euro zone equities can deliver on their projected earnings growth, as a lower euro benefits exports. A depreciation of the euro can be beneficial for German/euro zone local currency earnings surprises relative to global equities. (Figure 9) This should lead to an outperformance of euro zone equities relative to other developed market regions, which, in turn, will mitigate or even completely offset the effect of further currency depreciation.

It is likely that the ECB's actions might fall short of market expectations in the short-term, leading to a gradual pace of decline in the euro. There is a good chance that European equities will outperform other developed market equities on a common currency basis, leaving our bullish stance intact. We will continue to monitor carefully further developments in Europe, particularly in Germany, while acting on the assumption of decent Q3 GDP growth.

There can be no guarantees that the projections mentioned above will be achieved. International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

China 2.0: a new economic dawn

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China's growth story may be on the wane, but its equity markets still look a good bet as the central government's plan for economic modernization takes hold. Cheap valuations provide an attractive strategic entry point for investors who are able to withstand the near-term volatility prompted by the overhaul. Investing in sectors that are likely to profit from reform initiatives may be a valid interim strategy.

A path of slower growth will avoid economic catastrophe

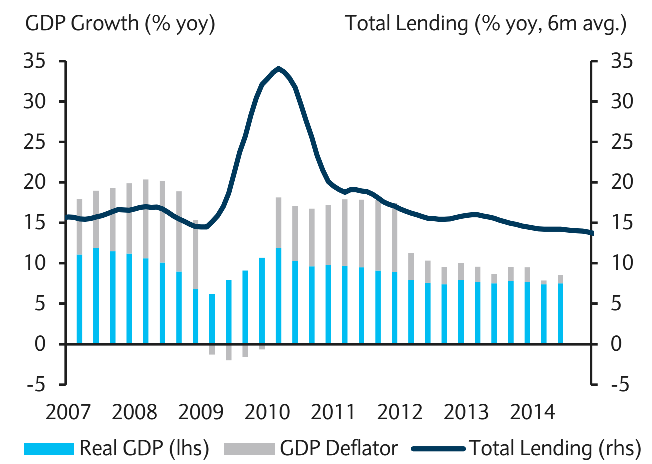
After three decades of remarkable growth, China is in the midst of an economic transition that is now entering its most defining stage. While much of the recent slowdown is structural – reflecting the economy's natural convergence towards high-income status – rising vulnerabilities in financial and real estate markets pose a genuine risk of destabilizing future growth. Policymakers must take complex steps to address these imbalances, intentionally accepting slower but safer growth in the near-term, while accelerating a new wave of reforms, as outlined in the Third-Plenum blueprint, to reinvigorate the Chinese economy.

Concerns over financial and property markets are weighing on current economic activity

The credit-fuelled investment growth that steered China in the aftermath of the 2008 global financial crisis was primarily responsible for generating the market inefficiencies and excessive build-up of leverage currently plaguing the economy. The focus of the new government has been to repress non-bank financing by imposing restrictions on shadow banking activities; the consequence of which has been a slowdown in lending growth and a sharp tightening of credit conditions, as new sources of funding have yet to be established.

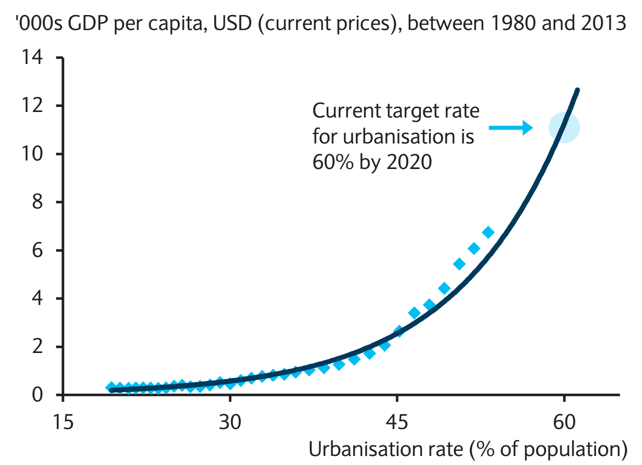
With banks cautious about new lending given the amount of nonperforming loans sitting on their balance sheets, economic growth in the second half of this year is likely to remain fragile. (Figure 1) Initial signs of this theme may already be playing out: value-added industrial output grew by a mere 6.9% in August from a year earlier, the lowest reading since 2009.[11] A further headwind to growth stems from China's property market, with the new

Figure 1: Slower lending is a drag on economic growth



Source: Barclays, Bloomberg as of 29 September 2014

Figure 2: Internal migration could lead to higher incomes



Source: Barclays, Bloomberg, IMF as of 31 December 2013

[11] Bloomberg, as of 31 August 2014

home price index falling for a fourth consecutive month in August,[11] as smaller cities continue to grapple with excess supply. The looming challenge is for the sector to endure a necessary correction, while avoiding a sharp slowdown that could spill over to the rest of the economy.

Reforms offer greater upside potential to long-run growth

In the absence of any external shock to the economy, concerns over a "hard-landing" seem overstated in light of China's policy buffers. While credit booms of this size have previously led to sharp corrections, a key distinction is the government's capacity – and most importantly, willingness – to prevent a loss of confidence or a sudden stop that could intensify the aforementioned vulnerabilities of the economy. With low public debt, moderate foreign debt exposure, large foreign exchange reserves, high domestic savings and controls to limit the exodus of capital, the likelihood of an abrupt adjustment in the Chinese economy is low.

China's next policy step will shape the future of the economy

Nevertheless, the outlook for Chinese growth is nearing a crossroad, and government officials are faced with an important policy decision: (1) to stimulate near-term activity with broad-based monetary easing, which risks compounding the economy's overreliance on credit and capital accumulation or (2) choosing to accept a slower growth path, ensuring that any forthcoming economic progress is achieved in a sustainable manner. Following a recent communiqué from Premier Li, the focus seems to be shifting towards the latter option.

The "mini-stimulus," introduced in April to ensure that economic growth of 7.5% would be met this year, seems to have run its course, given the latest batch of data. Yet in September, Premier Li played down the importance of this target, stating that the government will refrain from relying on monetary stimulus to spur one measure of the economy. Confidence in reviving economic activity was largely focused on the swift imposition of structural reforms that would facilitate the transition towards a more stable growth path.

Lower growth will not be detrimental if reforms are swiftly implemented

The cost of this approach – a protracted slowdown in the near-term to historic lows – may not be detrimental provided that the economy continues to create enough jobs and uncovers new sources of productivity growth through the reform-based agenda. The shift towards a more consumption-based economy and, for example, renewed emphasis on the labor-intensive service sector, would boost household incomes and expenditure. Furthermore, employment growth, one of the government's biggest concerns, remains robust: China's year-to-date job creation is close to the 10-million full-year target.[12] Thus, when reconciling a deceleration in growth with the potential for economic development, as further urbanization of the population would generate (Figure 2, prior page), investors have sufficient reason to remain positive about the long-run trajectory of the economy.

Managing the transition to the "new normal" of lower growth requires policymakers to balance immediate considerations with their vision for sustainable economic progress. Policies need to be supportive, but in a manner that expedites this goal. Implementation of reforms – and the subsequent adjustment process – may be costly in the short-term, but will undoubtedly help to secure a brighter, more prosperous future for China.

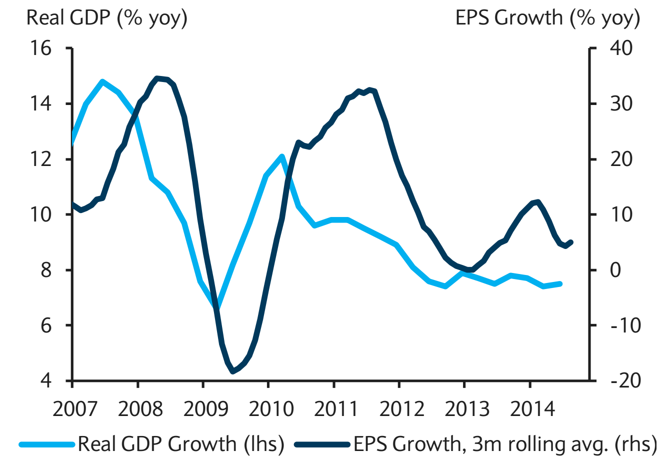
Reforming the strategy for Chinese equities

A slower growth rate is a secondary factor for Chinese stocks…

In an environment where the composition of economic growth is gradually changing, a viable equity strategy may be to target those sectors where reform-based policies are likely to have the greatest impact. A managed slowdown should not be a major concern, given the imperfect relationship between stock markets and the state of the economy. This is of particular significance for China, where the state-owned nature of the largest companies is

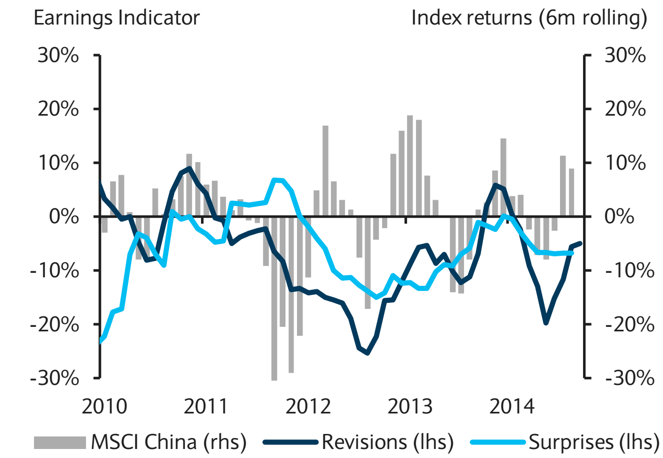
[12] Bloomberg, Ministry of Human Resources and Social Security of China, as of 31 August 2014

Figure 3: EPS and GDP growth has deviated since 2013



Source: Barclays, Datastream as of 31 August 2014.
EPS = Earnings Per Share

Figure 4: Earnings continue to surprise on the downside



Source: Barclays, Datastream as of 31 August 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

…successful reforms may prove to be a more potent long-term driver

somewhat responsible for the disparity between economic growth and corporate earnings. (Figure 3) These enterprises typically issued more shares as they grew, thus diluting the benefit of higher profits for existing shareholders. Eliminating these structural impediments is one potential way for Chinese equities to command higher valuations in the future.

While such changes may take some time to feed through – more so if implementation proves to be sluggish – continued pledges by officials to stand by their Third-Plenum agenda could see sentiment towards Chinese equities shift to a more upbeat outlook, even before the reforms come into force. This story, coupled with the government's targeted easing measures, partially explains the summer rebound in Chinese stocks: from late March through the beginning of September, the aggregate equity index had rallied by more than 20%.[13] But, while analyst expectations of future earnings have been moving in the right direction, reported results continue to surprise on the downside. (Figure 4) As previously argued in the wider context of emerging markets, without any discernible progress, a reform-related rally for domestic equity markets is likely to be short-lived. Investors are only so willing to reward markets and governments for the *promise* of future change.

A slowing China strengthens the case for officials to press ahead with structural changes. (Figure 5) Successful reforms are likely to be the most potent long-term driver for equity performance, with the potential upside for Chinese stocks characterized in our three reform-based themes.

The growth of Chinese consumerism may provide a boost to domestic industries

Reform Theme 1: The rise of the Chinese consumer

From an investor's perspective, the domestic consumption story remains attractive as urbanization and land reforms look set to boost household incomes over the medium-term. Changes to the country's *hukou* law would give migrants access to public services in smaller cities, therefore increasing the mobility of the labor force. The freedom for workers to move

[13] MSCI China Index, in local currency terms, was up 21.6% between 20 March 2014 and 09 September 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

Figure 5: China's "Super Six" structural reforms to watch

Reform Area	Announced Initiatives	Key Progress
Land rights	Farmers to transfer and leverage land as collateral – thus improving the wealth prospects for low-income consumers and increasing their mobility	Pilot areas on rural land reforms. Finance for shantytown renovation projects being sourced.
Urbanization and hukou reforms	The issuance of urban household registration cards, known as *urban hukou*, to millions of migrants in small and midsize cities	Government guidelines unveiled in March. 60% target rate for urbanization by 2020.
Fiscal and administrative reforms	Improve budget transparency through spending controls and stronger transfer system. Alignment of local government revenue and spending	Pilot municipal bond scheme announced in 10 areas
State-owned enterprises (SOE) reforms	Embed strong governance in local governments, banks and SOEs. Market will play a decisive role in allocating resources, with the playing field leveling out between SOEs and private sector businesses	Gradual but notable SOE reform and deregulation has occurred throughout 2014
Financial system reforms	Fully liberalize interest rate; strengthen regulatory and supervisory oversight; establish deposit insurance; use interest rates as primary tool for monetary policy	Lending rates have been liberalized, the next step is for deposit rates. Deposit insurance planned for 2014.
Capital account liberalization	Reduce interventions and move to a more flexible exchange rate; fully open capital account in carefully timed and sequenced reforms	RMB trading band widened to 2%. Cross-border investment between Shanghai and Hong Kong in 2014.

Source: Barclays, Bloomberg and International Monetary Fund (IMF)

to more productive areas of the economy would generate higher-value goods and services. With Chinese consumers boasting one of the world's highest savings rates,[14] their increased purchasing power is positive news for those companies that benefit from domestic demand.

Therefore, the investment case for China's consumer markets remains very much intact. Sectors such as consumer goods, technology and healthcare are likely to observe a period of strong earnings growth, justifying their relatively expensive valuations. While the aggregate retail outlook looks mixed, the combination of growing Internet access and rising incomes has produced a pocket of opportunity in the e-commerce industry. In August, online retail sales rose by 55% from a year earlier,[15] highlighting a significant change in the spending habits of Chinese consumers. This trend, which is likely to spill over to other related sectors, resonates well with the government's aim to foster consumption growth.

Reform Theme 2: Managing the creative destruction of SOEs

Creative destruction in a controlled form is likely to ensure overall economic stability

Significant reform and deregulation announcements about state-owned enterprises (SOEs) have appeared periodically throughout the year. These have often reflected the state's intention to level the playing field for the private sector, while ensuring improved efficiency for those strategically important firms that the government will retain control over. Many SOEs have made positive changes to their shareholding or management structure, progress that has largely been overlooked by the market. The reforms resemble those implemented in the late 1990s, when the initial transition towards a market economy led to a surge in productivity growth. Similar gains could reap long-term benefits for both state-owned and private sector businesses.

[14] Bloomberg, OECD, National Bureau of Statistics of China as of 31 December 2013
[15] Bloomberg, as of 31 August 2014

However, the process is unlikely to be a swift transformation: the government will have to carefully streamline SOEs in a manner that does not thwart the overall reform progress. Allowing these inefficient businesses to fail without enabling the private sector to pick up the slack would only magnify the economic slowdown. To some extent, the drive towards mixed ownership captures this idea. From an earnings perspective, officials are making progressive steps in corporate sector reform, with a particular focus on tackling corruption and refining corporate governance. If successful, this should lift the competitiveness and profitability of SOEs while allowing growth of the private sector, thereby improving the aggregate return on equity. (Figure 6)

Financial development and innovation could spur greater brokerage activity

Reform Theme 3: Brokers and insurers set to gain from financial reforms

The Third Plenum's initiative to broaden capital markets will likely see Chinese brokers – in particular those with a presence in both Hong Kong and China – benefit from increased trading volumes and new business opportunities. Brokerage firms with cross-border capabilities, of which there are only a few, may gain a competitive advantage and thus the ability to exploit pricing power. The state's focus on financial development and innovation within a relatively immature industry is in effect likely to spur investment banking activities on the mainland over the coming years.

In a similar vein, the insurance sector looks set to expand from the reform of pension and life insurance products. The government unveiled targets for the sector earlier this year, hoping to boost its overall contribution to the economy, in addition to tackling the reliance on risky shadow banking.

Is it time to enter the dragon?

Valuations look relatively attractive even when accounting for the heavy discount on banks

From a valuations perspective, Chinese equities are cheap, on both an absolute and relative basis. The broad index is trading at a price-to-book ratio of 1.5 – around 32% below the 10-year historical average – and at a 45% discount to US equities. Within the emerging markets universe, Chinese stocks are one of the most oversold (though not to the extent of Russia) and currently 20% cheaper than their Asian counterparts.[16] These valuations, while attractive on the surface, are somewhat skewed by the deeply-discounted banking sector (Figure 7).

Figure 6: China's return on equity remains subdued

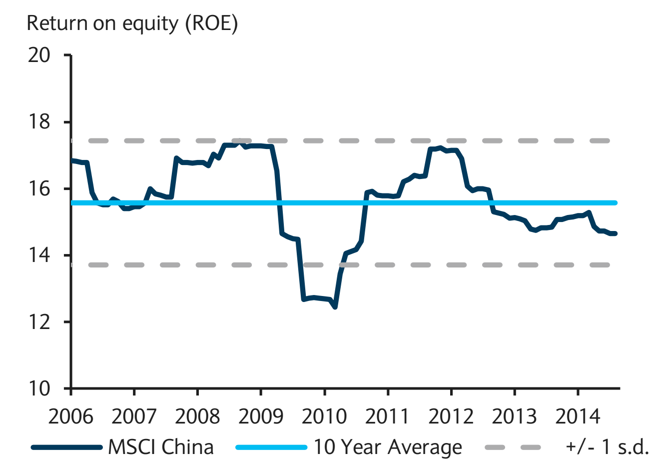
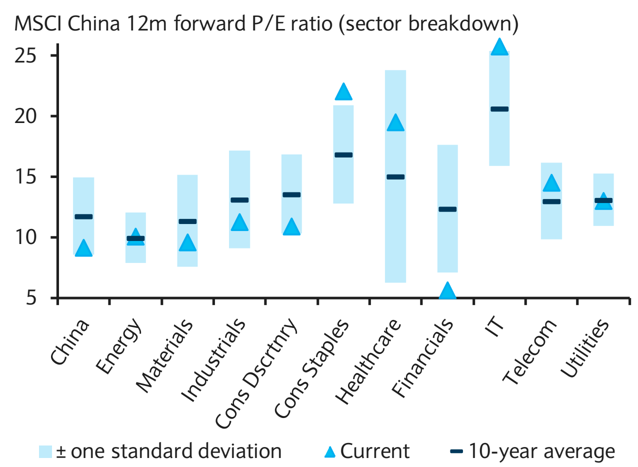


Figure 7: Banking sector weighing on absolute valuations



Source for Figures 6-7: Barclays, Datastream as of 31 August 2014. s.d. = standard deviation. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

[16] All valuation data sourced from IBES, as of 31 August 2014

However, moves to rebalance the economy may result in a structural re-rating of the overall equity market: a more sustainable growth outlook would alleviate the negative sentiment towards Chinese assets, therefore causing risk premiums to fall. There are initial signs that banks are tackling the issue of nonperforming loans through asset sales, capital raising and renewed dealings with "bad banks"; the forthcoming introduction of deposit insurance is also likely to provide some stability to the financial system, pushing sector valuations higher.

With expected volatility the tactical entry point is difficult to ascertain…

As officials facilitate the transition towards a lower growth rate, any short-term volatility in headline data is likely to feed through to the stock market. The recent weakness in activity has weighed on Chinese equities, with the index falling more than 9% since peaking in early September.[17] In contrast, there are key events in October that could provide some support. The opening of Shanghai's stock market to foreign investors is a step in the right direction for capital markets, while the Fourth Plenum is widely expected to shed more light on reform policy and economic targets, setting the tone for investors' expectations in 2015.

The slowdown in China is not indicative of a deteriorating economy, but a by-product of a much needed transition from an investment-led, commodity-intensive growth model to one that is more consumption-oriented. Enacting the reform blueprint – and enabling an economic overhaul – would not only improve the quality, but also the long-term sustainability, of growth. The shift in sentiment, added to the realization that quality supersedes quantity, may improve the outlook for earnings and steer prices higher.

…but the long-run strategic case for China remains in place

The re-rating process is likely to be gradual, but factoring in all the above elements, the strategic case for China remains in place. Successful reform implementation will be the catalyst for unlocking value in Chinese stocks, though it is difficult to gauge the exact timing of this. At this juncture, equity markets in China remain an attractive opportunity for those investors with a long-run investment horizon and willingness to overlook near-term volatility.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

[17] MSCI China Index between 09 September 2014 to 30 September 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

Buyback bonanza

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Increasingly companies are using stock buybacks to squeeze their earnings per share higher, an important valuation metric for investors. For the three months ended March 2014, they stood at 159.3 billion USD, the largest amount since September 2007.[18] Have equity market returns been inflated by this bit of financial legerdemain?

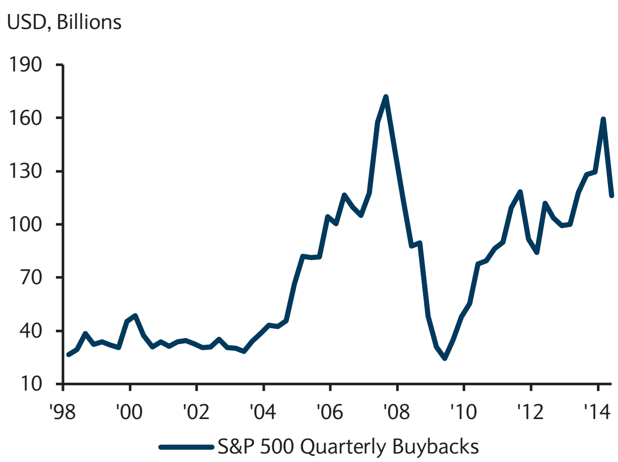
During the recovery period since 2009, we have seen news of "financial engineering," in which many successful American enterprises have used stock buybacks to manage their earnings per share. For the three months ended March 2014, buybacks stood at 159.3 billion USD, the largest amount since September 2007. (Figure 1) There has been debate in the public domain over the impact stock buybacks have had on equity market returns since the financial crisis. Here we examine the facts.

Buyback basics[19]

A buyback occurs when a business purchases its own shares – in the open market or via a tender offer – and then either holds them for future re-issue or cancels the repurchased shares altogether. Here are a few of the key reasons behind repurchases:

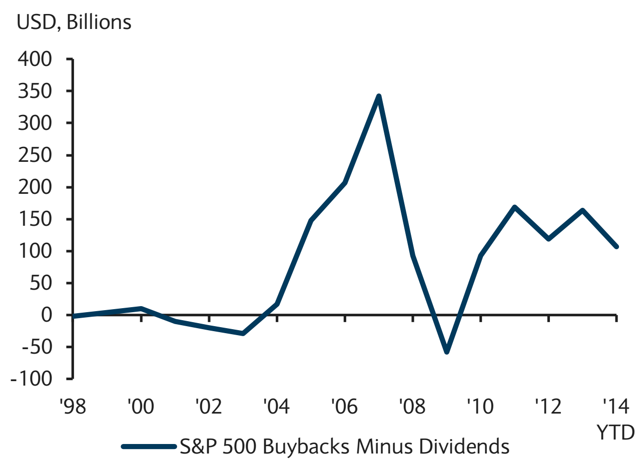
1. **Add debt to its capital structure:** By repurchasing shares, a company decreases its equity as a percentage of total capital, effectively increasing its leverage. Doing so may help a company optimize its capital structure: investors require less compensation for debt holdings than for equity holdings, since debts have a higher repayment priority. This is generally viewed as a buyback that enhances shareholder value.

Figure 1: Buybacks remain elevated



Source: Strategas Research Partners, as of 30 June 2014.
An investment cannot be made directly in a market index.

Figure 2: The value of buybacks has been greater than dividends



Source: Strategas Research Partners, as of 30 June 2014.
Past performance does not guarantee future results. An investment cannot be made directly in a market index.

[18] Source: Strategas Research Partners, as of 31 March 2014
[19] While many have written about the basics of buybacks, we found a particularly succinct review in *Student Accountant*, published by the Association of Chartered Certified Accountants in February 2009. We have drawn heavily on this work in our section here, though any errors are ours.

2. **Decrease agency costs:** Managers of the entity act as agents for investors, and there is always the risk that they will use capital unwisely. To be seen as efficient allocators of capital and committed to the interests of investors, company managements often return excess funds to investors through buybacks. This is generally viewed as a buyback that enhances shareholder value.

A share buyback reduces the total number of shares outstanding. Mathematically, this increases the earnings per share (EPS), as the total value of earnings is divided by a smaller number of shares

3. **Return excess funds:** Mature businesses often find themselves in a position where they lack profitable opportunities to grow. In such a circumstance, a company's management may determine that the most efficient use of capital is to return excess funds to investors. This is generally viewed as a buyback that enhances shareholder value.

4. **Signal the market:** If company management believes the company's stock price is not correctly reflecting fundamentals, it can lead investors to reassess the value by repurchasing shares. Putting the company's capital to work this way may carry more weight than a management discussion revising guidance upward. This is generally viewed as a buyback that enhances shareholder value.

5. **Increase earnings per share:** A share buyback reduces the total number of shares outstanding. Mathematically, this increases the earnings per share (EPS), as the total value of earnings is divided by a smaller number of shares. Since managers' long-term incentive plans are usually directly related to EPS, senior managers might engage in a share buyback simply to boost EPS, when capital might be better directed to profitable growth opportunities. This is not generally viewed as a buyback that enhances shareholder value.

6. **Management share option programs:** Management share option programs are based on the belief that the share price should increase. An undue focus here could cause managements to favor buybacks to the exclusion of dividends. Further, a buyback that accompanies the exercise of management options simply offsets the dilutive effect of share options. This is not generally viewed as a buyback that enhances shareholder value.

Repurchases compared to dividends

Buybacks are very similar to cash dividends, since they both represent a return of capital to investors. They have a similar effect on company's financials, since they both:[20]

- Reduce assets by the amount of the dividend or repurchase
- Reduce equity by the amount of the dividend or repurchase
- Provide investors with the same cash flow before tax

Investors may prefer their funds to be returned via buybacks if the capital gains tax is lower than the dividend income tax

However, there are two fundamental reasons why repurchases may be preferred. First, if the capital gains tax is lower than the dividend income tax, the after-tax cash flow from buybacks becomes higher than that from dividends. Second, buybacks offer more flexibility. Managers frequently are committed to maintaining dividend payments, since a failure to do so usually is followed by a very negative reaction by the investor community. However, eliminating a buyback program is unlikely to result in a similar investor reaction. This gives the company an option to cut the program if it needs to use funds elsewhere. In fact, buybacks tend to outnumber dividend payments most of the time in the US market. (Figure 2)

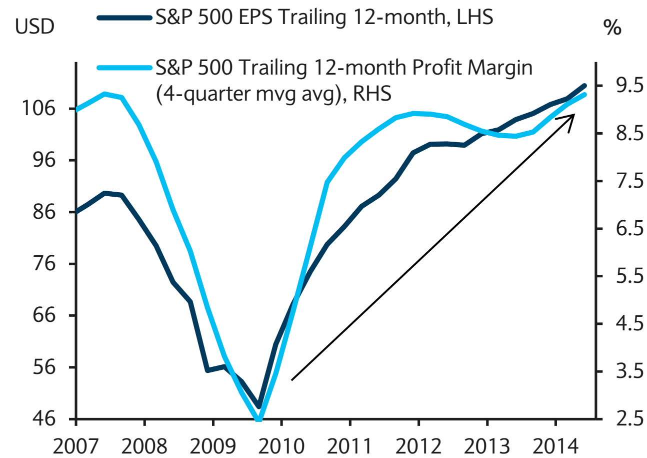
[20] CFA Institute, Dividends and Share Repurchases: Basics, December 2013

Figure 3: Earnings and sales have grown since the crisis

Notional Dollars			
	31-Dec-08	30-Jun-14	Percent Change
S&P 500 Operating Earnings (Trailing 12 months, USD billions)	431.6	996.7	130.9%
S&P 500 Sales (Trailing 12 months, USD billions)	9,082.0	10,170.9	12.0%
Per share			
S&P 500 Operating EPS (Trailing 12 months)	49.51	111.95	126.1%
S&P 500 Sales per Share (Trailing 12 months)	1,042.5	1,142.4	9.6%

Source: Strategas Research Partners, as of 30 June 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

Figure 4: Margin expansion drove earnings per share



Source: Bloomberg, as of 30 June 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index.

Increased margins are behind the rise in equity price

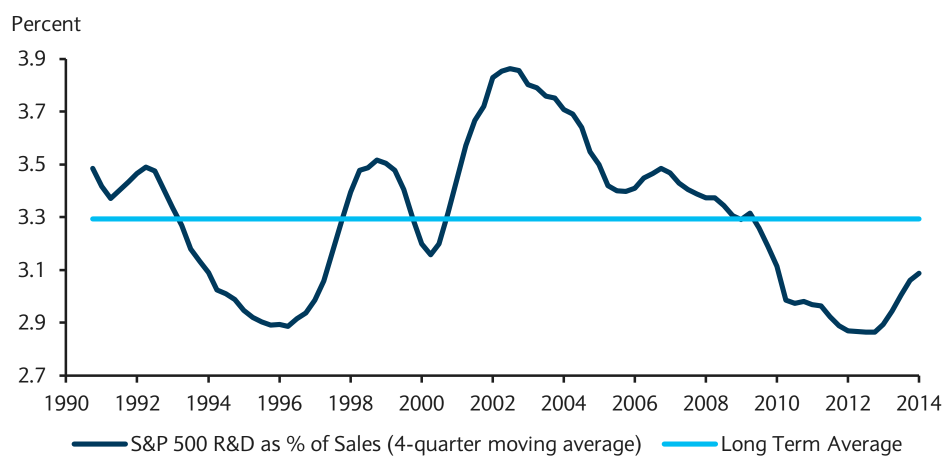
Repurchases: a reason for concern?

As of this writing, the cumulative total return from the S&P 500 Index since its March 2009 low is 228%.[21] There are many who claim that this return has been driven by an illusion of earnings per share growth driven by the "financial engineering" of share buybacks. To test this view, we evaluated the cumulative growth in the operating earnings of the S&P 500 from 2008 through June 2014 and compared that to the per share earnings growth over the same period. (Figure 3) Operating earnings grew 131% over the period, and EPS grew about 126%, roughly in line with actual earnings growth. No illusion of growth there.

A deeper look makes it clear that the rise in earnings per share has been due to margin expansion, not buybacks. (Figure 4) Margins expanded largely due to several factors. First, capital investment fell, and Research and Development expenses (R&D) were cut back. (Figure 5) While this can be an important category of expense for future growth,

Below-average levels of R&D spending supported margin expansion

Figure 5: Company managements managed R&D spending down post-crisis



Source: Bloomberg, as of 30 June 2014. An investment cannot be made directly in a market index.

[21] Source: Bloomberg, as of 30 September 2014

conservative cost management on the part of company managements was likely a prudent response to the extreme uncertainty of the post-crisis environment. The second factor that strengthened margins was the below-average amount and cost of labor used to generate the earnings post-crisis. In addition, profits were aided by revenue growth and write backs.

Market implications

Not all buybacks are created equal

The value of a buyback depends on whether it has been an efficient use of capital. In short, not all buybacks have the same purpose, and sometimes buybacks can be an effective and smart way of returning capital to shareholders.

Repurchases do not seem to be an explanatory variable for rising equity prices. Rather, equity price rises seem to have been driven by earnings growth, which has been aided by expansion in company margins.

Tactical asset allocation review

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Fixed Income

US Federal Reserve Chair Yellen assumed a dovish stance, which did not stop the Fed raising its median interest rate projections at the last Federal Open Markets Committee (FOMC) meeting; now it predicts a rate of 1.38% by the end of 2015 (previously 1.13%). While US treasury yields widened across the board, high-yield spreads moved out even more as part of this month's wider risk-off trend.

We remain underweight high-yield bonds relative to investment grade and government bonds. On a risk-adjusted basis, they remain expensive, and we believe most are prone to underperformance in the run-up to higher rates, as investors grow worried about the impact of that first hike.

President Draghi has high ambitions to expand the ECB balance sheet. Lower rates see yields narrow

Developed Markets

The US continues to lead the global economy and released another set of robust data points. The ISM manufacturing and non-manufacturing indices hit 3-year and 9-year highs, respectively. While unemployment fell to 6.1%, average hourly earnings growth rose 2.1% in August, suggesting less slack in the labor market.[22]

The S&P 500 Index notched another record high in September before pulling back late in the month. In Europe, an eventful month left equities flat, fixed income yields wider and the Euro weaker.[23] We see low demand for corporate loans given a low-growth environment, economic uncertainty and recent, weak data points. Overall we see the US economy moving steadily forward, carrying US equity markets with it. Though returns are more muted than in the recent past, we continue to see developed equities offering better risk-adjusted returns than most bonds, even in Europe where rates are expected to remain grounded for the foreseeable future.

Premier Li Keqiang tries to steer the tricky course towards a soft landing for China. Markets reacted poorly to soft data

Emerging Markets

In China, the Q2 rebound seems to have lost momentum in Q3. Key indicators such as retail sales, fixed asset investment and manufacturing PMI were just shy of consensus, but for the most part worse month-on-month. Industrial production notably disappointed, reverting to its lowest pace since the Financial Crisis, 6.9% year on year.[24] The mini-stimulus measures issued throughout March-July petered out quickly.

In partial response, Emerging Markets underperformed this month,[25] affected also by the rise in US treasury yields. Overall we are neutral Emerging Markets Equities and strongly underweight Emerging Markets bonds. We see the risk of outflows as the normalization process continues.

We see Emerging Market nations that rely heavily on exporting commodities underperforming going forward. Because commodities are for the most part oversupplied, prices will remain weak. Given the long lead times involved in commencing production, too many mines and rigs have come online too late. The Goliaths of the world, with lower overall operating costs, can continue to operate at low commodity prices, flooding the market with supply long enough to squeeze out the smaller players.

[22] Institute of Supply Management as of 1 September 2014
[23] S&P 500 as of 18 September 2014
[24] National Bureau of Statistics of China as of 13 September 2014
[25] MSCI Emerging Markets as of September 2014
Past performance does not guarantee future results. An investment cannot be made directly in a market index.

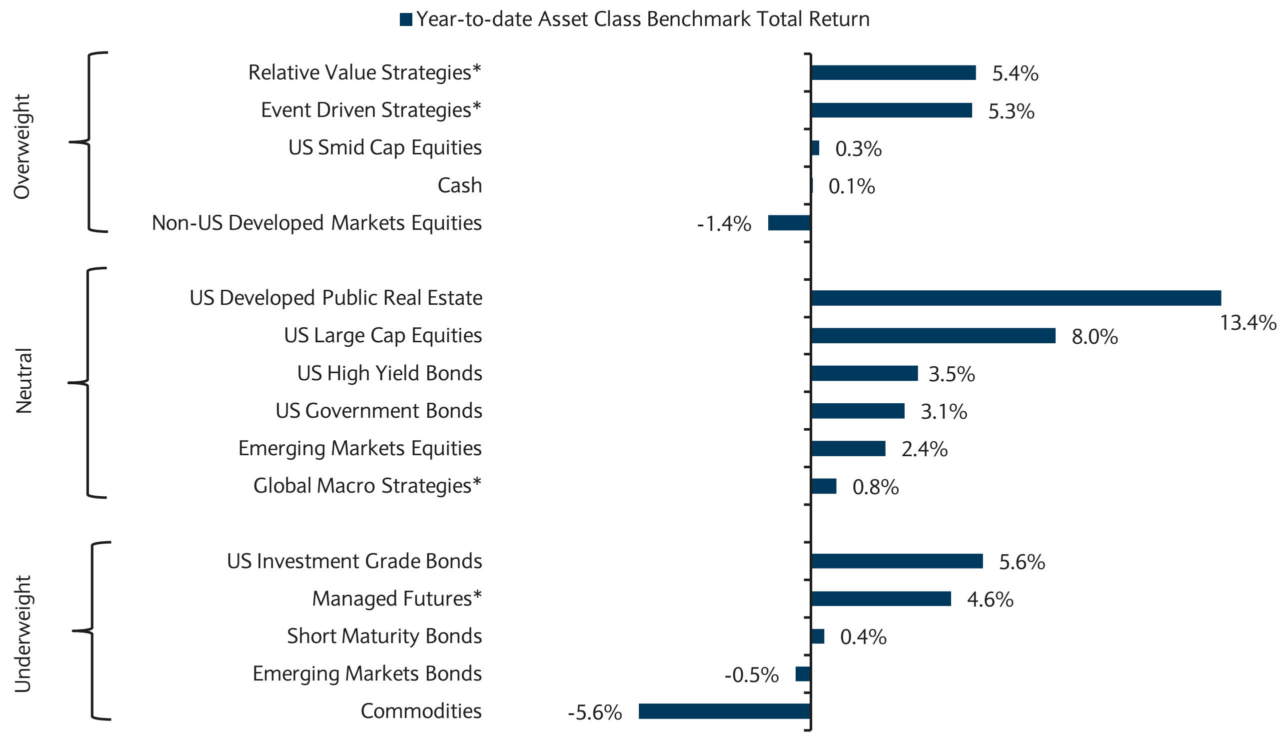
Figure 1: Strategic Asset Allocation (SAA) and Tactical Asset Allocation (TAA) by risk profile: asset class[26]

	Low		Medium Low		Moderate		Medium High		High	
Asset class	**SAA**	**TAA**	**SAA**	**TAA**	**SAA**	**TAA**	**SAA**	**TAA**	**SAA**	**TAA**
Cash and Short-maturity Bonds	46.0%	51.0%	17.0%	22.0%	7.0%	13.0%	3.0%	10.0%	2.0%	8.0%
Developed Government Bonds	8.0%	8.0%	7.0%	7.0%	4.0%	4.0%	2.0%	2.0%	1.0%	1.0%
Investment Grade Bonds	6.0%	4.0%	9.0%	7.0%	7.0%	5.0%	4.0%	2.0%	2.0%	0.0%
High Yield and Emerging Markets Bonds	6.0%	2.0%	10.0%	5.0%	11.0%	5.0%	10.0%	5.0%	8.0%	4.0%
Developed Markets Equities	16.0%	18.0%	28.0%	32.0%	38.0%	43.0%	45.0%	49.0%	50.0%	53.0%
Emerging Markets Equities	3.0%	3.0%	6.0%	6.0%	10.0%	10.0%	14.0%	14.0%	18.0%	18.0%
Commodities	2.0%	1.0%	4.0%	2.0%	5.0%	2.0%	6.0%	2.0%	5.0%	2.0%
Real Estate	2.0%	2.0%	3.0%	3.0%	4.0%	4.0%	6.0%	6.0%	7.0%	7.0%
Alternative Trading Strategies	11.0%	11.0%	16.0%	16.0%	14.0%	14.0%	10.0%	10.0%	7.0%	7.0%

Source: Barclays Wealth and Investment Management, as first published on July 22, 2014.
Gray: TAA is slightly underweight our SAA. Light blue: TAA is slightly overweight our SAA. No highlight: TAA is neutral weight the SAA.
See Figure 3 for benchmark indices used.

[26] The recommendations made for your actual portfolio will differ from any asset allocation or strategies outlined in this document. The model portfolios are not available to investors since they represent investment ideas, which are general in nature and do not include fees. Your asset allocation will be customized to your preferences and risk tolerance and you will be charged fees. You should ensure that your portfolio is updated or redefined when your investment objectives or personal circumstances change. Our **Strategic Asset Allocation (SAA)** models offer a baseline mix of assets that, if held on average over a five-year period, will in our view provide the most desirable combination of risk and return for an investor's degree of Risk Tolerance. They are updated annually. Our **Tactical Asset Allocation (TAA)** tilts our SAA views, incorporating small tactical shifts from one asset class to another, to account for the prevailing environment and our shorter-term outlook.

Figure 2: Year-to-date returns and TAA weightings for key asset and regional sub asset classes (by weighting)



*Returns as of August 31, 2014 for: Event Driven Strategies, Relative Value Strategies, and Managed Futures and Global Macro Strategies.

Source: Bloomberg as of September 30, 2014. We consider private equity to be part of the overall Developed Markets Equities allocation; however, as a reliable performance index is not available, it has been excluded from year-to-date returns/TAA weightings bar chart above. Diversification does not guarantee against losses. Past performance does not guarantee future results.

See Figure 3 for benchmark indices used. The benchmark indices are used for comparison purposes only. It is not possible to invest in these indices, and the indices are not subject to any fees or expenses. It should not be assumed that investment will be made in any specific securities that comprise these indices.

Figure 3: SAA, TAA and tilts with key regional sub asset classes (Moderate Risk Profile)

Asset Class (including key regional sub asset classes)	Recommended allocation SAA	Recommended allocation TAA	Tilt SAA vs. TAA
Cash & Short-maturity Bonds	7%	13%	+6%
Cash	0%	10%	+10%
Short-maturity Bonds	7%	3%	-4%
Developed Government Bonds	4%	4%	0%
US Government Bonds	4%	4%	0%
Investment Grade Bonds	7%	5%	-2%
US Investment Grade Bonds	7%	5%	-2%
High Yield & Emerging Markets Bonds	11%	5%	-6%
US High Yield Bonds	5%	5%	0%
Emerging Markets Bonds	6%	0%	-6%
Developed Markets Equities	38%	43%	+5%
US Large Cap Equities	12%	12%	0%
US Smid Cap Equities	5%	7%	+2%
Non-US Developed Markets Equities	16%	19%	+3%
Developed Private Equity	5%	5%	0%
Emerging Markets Equities	10%	10%	0%
Emerging Markets Equities	10%	10%	0%
Commodities	5%	2%	-3%
Real Estate	4%	4%	0%
US Developed Public Real Estate	4%	4%	0%
Alternative Trading Strategies	14%	14%	0%
Global Macro Strategies	3.5%	3.5%	0%
Relative Value Strategies	3.5%	4.2%	+.70%
Event Driven Strategies	3.5%	4.9%	+1.40%
Managed Futures	3.5%	1.4%	-2.1%

Gray = TAA is slightly underweight the SAA. Light blue = TAA is slightly overweight the SAA.
Source: Barclays Wealth and Investment Management, Americas Investment Committee, as first published on July 22, 2014.

Cash and Short-maturity Bonds: Cash by Barclays 3-6 month T-bills; Short-maturity Bonds by Barclays 1-3 Year US Treasury; **Developed Government Bonds**: US Government Bonds by Barclays US Treasury; **Investment Grade Bonds:** US Investment Grade Bonds by Barclays US Aggregate Corporate; **High-Yield and Emerging Markets Bonds:** US High Yield Bonds by Barclays US Corporate High Yield; Emerging Markets Bonds by JP Morgan GBI-EM Total Return Diversified; **Developed Markets Equities**: US Large Cap Equities by Russell 1000; US Smid Cap Equities by Russell 2500; Non-US Developed Markets Equities by MSCI EAFE Net Return; **Emerging Markets Equities** by MSCI EM; **Commodities** by Bloomberg Commodity Index; **Real Estate:** US Developed Public Real Estate by FTSE NAREIT US – ALL Equity REITs; **Alternative Trading Strategies:** Global Macro Strategies by Barclays Hedge Fund Global Macro Index; Relative Value Strategies by HFRI Relative Value Index; Event Driven Strategies by Dow Jones CS Event Driven Index; Managed Futures by Dow Jones CS Managed Futures Index. The benchmark indices are used for comparison purposes only. It is not possible to invest in these Indices; they are not subject to any fees or expenses. It should not be assumed that investment will be made in any specific securities that comprise the indices.

Barclays' key macroeconomic projections

Figure 1: Real GDP and consumer prices (% y-o-y)

	Real GDP			Consumer prices		
	2013E	2014F	2015F	2013E	2014F	2015F
Global	3.1	3.1	3.5	2.6	2.8	3.0
Advanced	1.3	1.7	2.1	1.3	1.5	1.6
Emerging	4.8	4.5	4.9	4.8	5.0	5.4
United States	2.2	2.1	2.7	1.5	1.8	1.9
Euro area	-0.4	0.7	1.1	1.4	0.5	0.8
Japan	1.5	1.1	1.4	0.4	2.7	2.3
United Kingdom	1.7	3.0	2.7	2.6	1.6	1.8
China	7.7	7.2	6.9	2.6	2.3	2.8
Brazil	2.5	0.1	1.0	6.2	6.3	6.3
India	4.5	5.3	6.4	6.3	4.9	5.2
Russia	1.3	0.0	-0.5	6.8	7.5	7.3

Source: Barclays Research, *Global Economics Weekly*, 26 September 2014
Note: Arrows appear next to numbers if current forecasts differ from previous week by 0.2pp or more. Weights used for real GDP are based on IMF PPP-based GDP (5yr centered moving averages). Weights used for consumer prices are based on IMF nominal GDP (5yr centered moving averages). There can be no guarantees that these projections will be achieved.

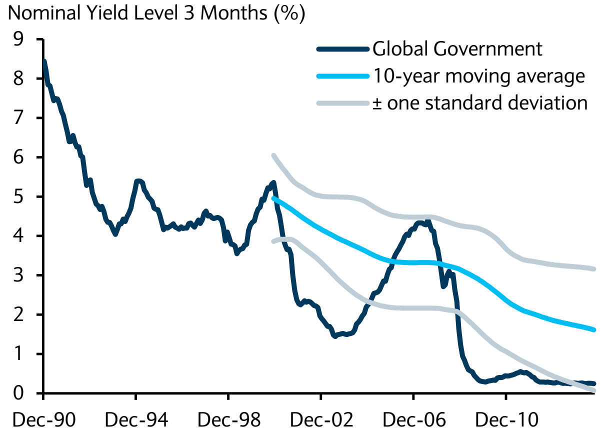
Figure 2: Central bank policy rates (%)

Official rate % per annum (unless stated)		Forecasts as at end of		
	Current	Q4 14	Q1 15	Q2 15
Fed funds rate	0-0.25	0-0.25	0-0.25	0.25-0.50
ECB main refinancing rate	0.05	0.05	0.05	0.05
Bank of Japan overnight rate	0.10	0-0.10	0-0.10	0-0.10
Bank of England bank rate	0.50	0.75	1.00	1.25
China: 1y bench. lending rate	6.00	5.75	5.50	5.50
Brazil: SELIC rate	11.00	11.00	11.00	11.00
India: Repo rate	8.00	8.00	7.75	7.50
Russia: One-week repo rate	8.00	8.50	8.50	8.50

Source: Barclays Research, *Global Economics Weekly*, 26 September 2014
Note: Rates as of COB 26 September 2014.There can be no guarantees that these projections will be achieved.

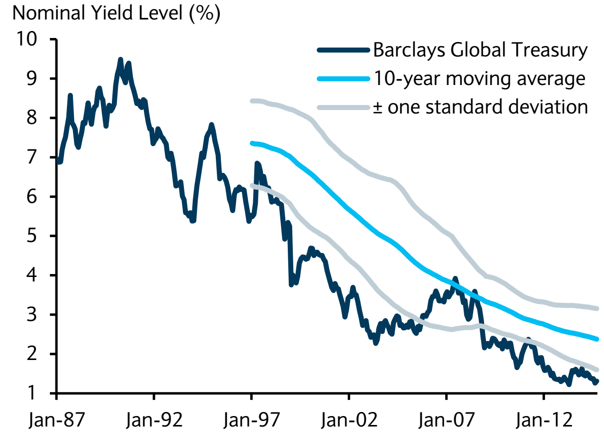
Interest rates, bond yields, and commodity and equity prices in context*

Figure 1: Short-term interest rates (global)



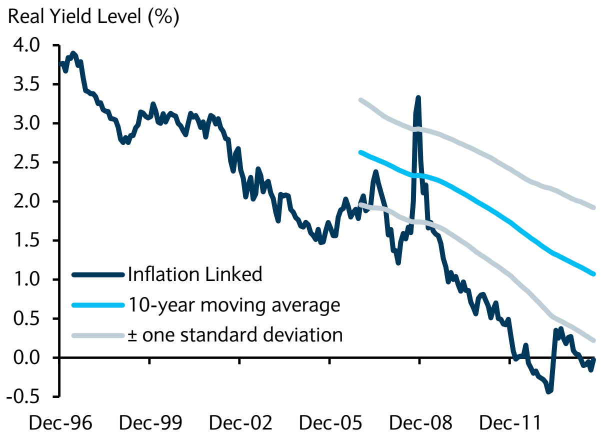
Source: FactSet, Barclays

Figure 2: Government bond yields (global)



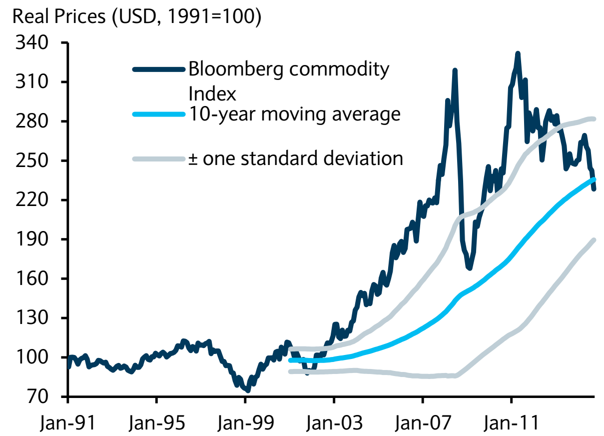
Source: FactSet, Barclays

Figure 3: Inflation-linked real bond yields (global)



Source: Bank of America Merrill Lynch, Datastream, FactSet, Barclays

Figure 4: Inflation-adjusted spot commodity prices



Source: Datastream, Barclays

Figure 5: Government bond yields: selected markets

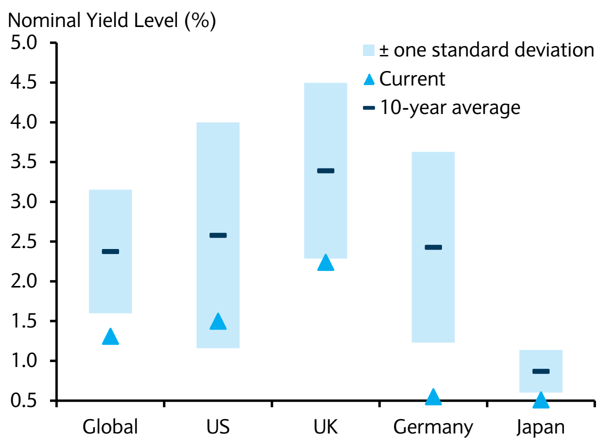
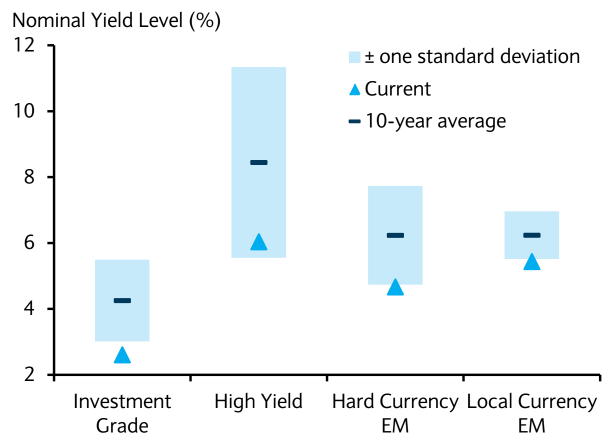


Figure 6: Global credit and emerging market yields



*Monthly data with final data point as of COB 30 September 2014. Past performance does not guarantee future results. An investment cannot be made directly in a market index. Source for Figures 5-6: FactSet, Barclays

Figure 7: Developed stock market, forward PE ratio

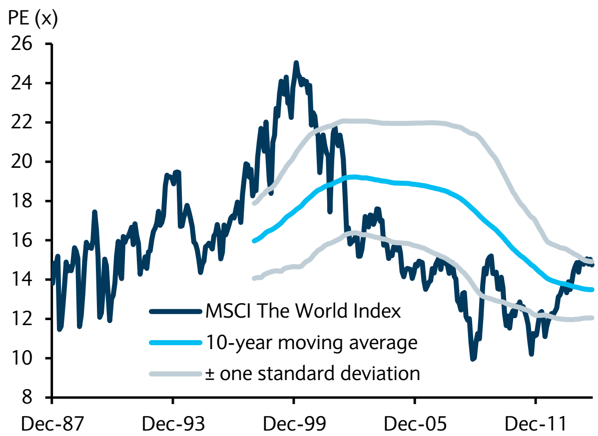


Figure 8: Emerging stock market, forward PE ratio

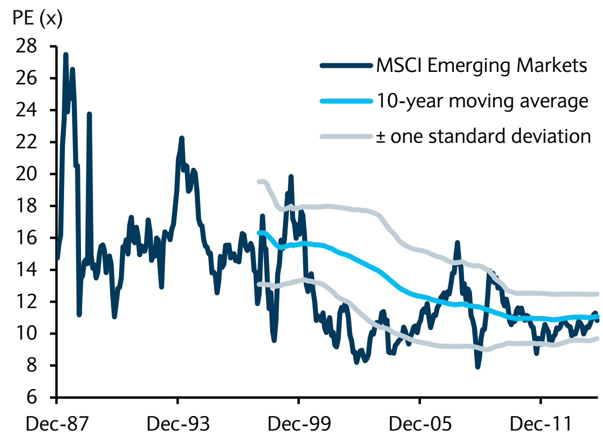


Figure 9: Developed world dividend and credit yields

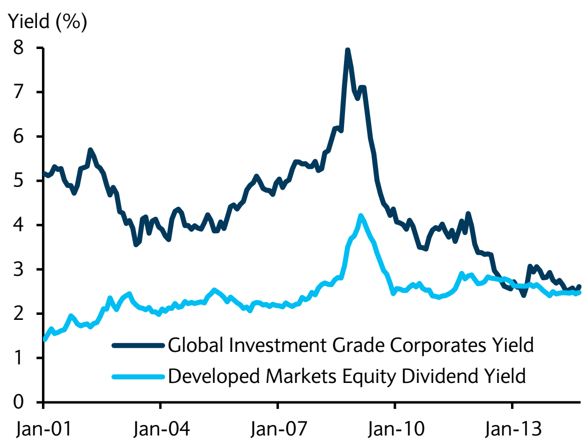


Figure 10: Regional quoted-sector profitability

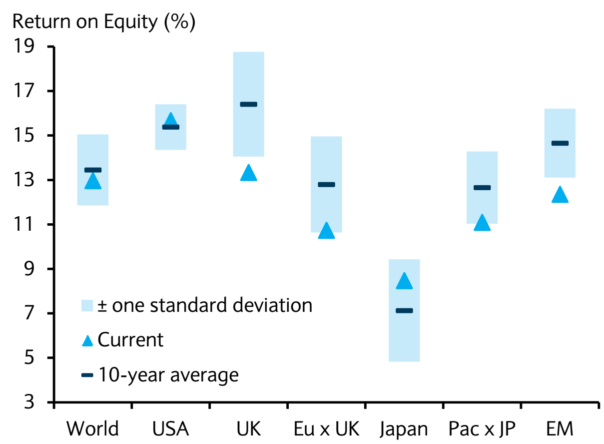


Figure 11: Global stock markets: forward PE ratios

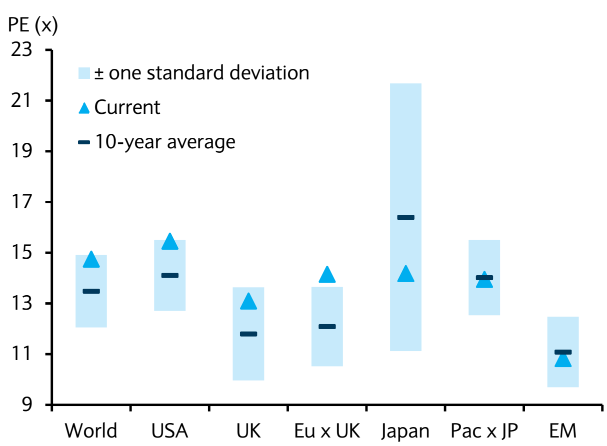
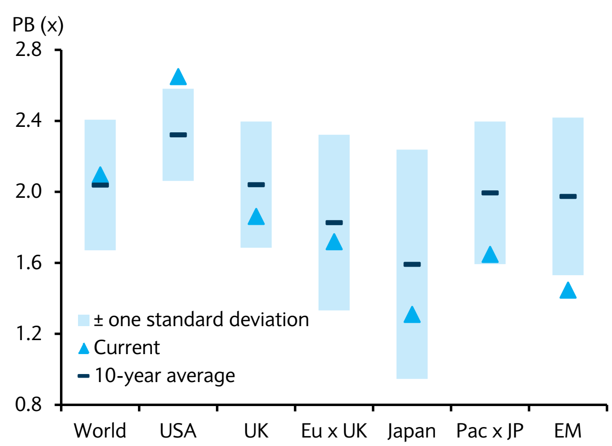


Figure 12: Global stock markets: price/book value ratios



All sources on this page: MSCI, IBES, FactSet, Datastream, Barclays

Past performance does not guarantee future results. An investment cannot be made directly in a market index.

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All end points of data for figures in this document are the same day as source dates unless otherwise indicated.
Chartered Financial Analyst Institute owns the **CFA** designation, which it awards to individuals who successfully complete rigorous certification requirements.

Asset class risks

Alternative Trading Strategy – There are specific concerns related to alternative investment strategies with respect to private wealth clients. These include: investor taxability; suitability of funds that require long lock-up periods for investors with liquidity needs or multiple investment horizons; communicating complex strategies to a non-professional client; greater likelihood of decision risk (changing strategies at the point of maximum loss) and clients whose wealth stems from concentrated positions in closely held companies may not be suited to other illiquid investments.

Bonds – Bonds are subject to market, interest rate and credit risk; and are subject to availability and market conditions. Generally, the higher the interest rate the greater the risk. Bond values will decline as interest rates rise. Government bonds are subject to federal taxes. **Municipal bond interest** may be subject to the alternative minimum tax; other state and local taxes may apply. **High yield bonds**, also known as "junk bonds" are subject to additional risks such as the increased risk of default. Debt securities may be subject to call features or other redemption features, such as sinking funds, and may be redeemed in whole or in part before maturity. These occurrences may affect yield. Like all bonds, corporate bonds tend to rise in value when interest rates fall, and they fall in value when interest rates rise. The longer the maturity of the bond, the greater the degree of price volatility. If you hold a bond until maturity, you may be less concerned about these price fluctuations (which are known as interest rate risk or market risk), because you will receive the par or face value of your bond at maturity. **Distressed Debt** – Although distressed debt opportunities are cyclical, in that they multiply during economic slowdowns, the time taken to profit from them depends on how long a firm takes to restructure, which varies from one case to another. The process can be lengthy - for instance, if the negotiations between a firm's management team and its creditors start to drag. Event risk relates to unexpected company-specific or situation-specific events that affect valuation. Market liquidity risk arises because distressed securities are less liquid, and demand runs in cycles. J-factor risk relates to the judge presiding over bankruptcy proceedings. The track record in adjudication and restructuring can play a significant role in both the overall outcome and determining the optimum securities in which to invest.

Cash Equivalents – Portfolios that invest in very short-term securities provide taxable or tax-advantaged current income, pose little risk to principal and offer the ability to convert the investment into cash quickly. These investments may result in a lower yield than would be available from investments with a lower quality or longer term.

Commodities – Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. An investment in commodities may not be suitable for all investors. Commodities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. Commodities are volatile investments and should only form a small part of a diversified portfolio. Diversification does not ensure against loss. Consult your investment representative to help you determine whether a commodity investment is right for you. Market distortion and disruptions have an impact on commodity performance and may impact the performance and values of products linked to commodities or related commodity indices. The levels, values or prices of commodities can fluctuate widely due to supply and demand disruptions in major producing or consuming regions.

Equities – Large Growth and Value Stocks – Portfolios that emphasize large and established US companies may involve price fluctuations as stock market conditions change.

Stocks of small- and mid-capitalization companies tend to involve more risk than stocks of larger companies. Investments in small- and mid-sized corporations are more vulnerable to financial risks and other risks than larger corporations and may involve a higher degree of price volatility than investments in the general equity markets.

International/Global Investing/Emerging Markets – International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Real Estate Investment Trusts (REITs) – The properties held by REITs could fall in value for a variety of reasons, such as declines in rental income, poor property management, environmental liabilities, uninsured damage, increased competition, or changes in real estate tax laws. There is a risk that REIT stock prices overall will decline over short or even long periods because of rising interest rates. Other risks include: **Sensitive to Demand for Other High-Yield Assets**. Generally, rising interest rates could make Treasury securities more attractive, drawing funds away from REITs and lowering their share prices. **Property Taxes**. REITs must pay property taxes, which can make up as much as 25% of total operating expenses. State and municipal authorities could increase property taxes to make up for budget shortfalls, reducing cash flows to shareholders. **Tax Rates**. One of the downsides to the high yield of REITs is that taxes are due on dividends, and the tax rates are typically higher than the 15% most dividends are currently taxed at. This is because a large chunk of a REIT's dividends (typically about three quarters, though it varies widely by REIT) is considered ordinary income, which is usually taxed at a higher rate.

Index definitions

Barclays EM Local Currency Governments is a broad-based index that measures the total return of 20 different local currency government debt markets spanning Latin America, Europe, the Middle East, Africa and Asia.

Barclays Global Aggregate – Corporates – The corporates portion of the Barclays Global Aggregate index grouping.

Barclays Global Governments 1-3 years – The 1-3 Yr component of the Barclays Global Treasury Index. The Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 38 countries denominated in 23 currencies. The three major components of this index are the U.S. Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican, and South-African government bonds. The index was created in 1992, with history backfilled to January 1, 1987.

Barclays Global Governments 7-10 years – the 7-10 Yr component of the Barclays Global Treasury Index. The Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 38 countries denominated in 23 currencies. The three major components of this index are the US Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican, and South-African government bonds. The index was created in 1992, with history backfilled to January 1, 1987.

The **Barclays Global Emerging Markets Index** represents the union of the USD-denominated U.S. Emerging Markets Index and the predominately EUR-denominated Pan Euro Emerging Markets Index, covering emerging markets in the following regions: Americas, Europe, Middle East, Africa, and Asia. As with other fixed income benchmarks provided by Barclays, the index is rules-based, which allows for an unbiased view of the marketplace and easy replicability.

Barclays Global High Yield represents the US High Yield Index, Pan-European High Yield Index, High Yield CMBS Index, and non-investment grade portion of the Barclays Global Emerging Markets Index.

Barclays Global Treasury Index tracks fixed-rate local currency government debt of investment grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 37 countries denominated in 23 currencies. The three major components of this index are the U.S. Treasury Index, the Pan-European Treasury Index, and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican, and South-African government bonds.

Barclay Hedge Global Macro – Represents a measure of the average return of the macro geared/strategized hedge funds within the Barclay database whose positions concertedly reflect the direction of the overall market as attributed to major economic trends and events. The portfolios of these funds are comprised of an offering of stocks, bonds, currencies and commodities in the form of cash or derivative instruments. A majority of these index linked funds invest globally in both developed and emerging markets.

Barclays Municipal Bond Index – The Index currently contains approximately 46,200 bonds. To be included in the index, bonds must be rated investment-grade ("Baa3/BBB-" or higher) by at least two of the following ratings agencies: Moody's, Standard & Poor's and Fitch, if all three rate the bond. If only two of the three agencies rate the bond, the lower rating is used to determine index eligibility. If only one of the three agencies rates a bond, the rating must be investment-grade. To be included in the index, bonds must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

Barclays Short Treasury Index – this index is composed of all treasuries that have a remaining maturity between one and twelve months.

Barclays Treasury Bill Index includes US Treasury bills with a remaining maturity from 1 month up to (but not including) 12 months. It excludes zero coupon strips.

Barclays U.S. 1-3 Yr. Treasury – Barclays Capital 1-3 Year U.S. Government/Credit Index is composed of all bonds of investment grade with a maturity between one and three years.

Barclays US 3-6 Mo. Treasury – Comprised of all treasuries with 3-6 month maturities purchased at the beginning of each month and held for a full month. At the end of the month, issues with less than three months to maturity are sold and rolled into newly selected issues.

Barclays US Agg Bond Index – The index is market capitalization weighted that includes Treasury securities, Government agency bonds, Mortgage-backed bonds and Corporate bonds. It excludes Municipal bonds and Treasury Inflation-Protected securities because of tax treatment.

Barclays US. Aggregate Corporate – An unmanaged index considered representative of the U.S. investment-grade, fixed-rate bond market.

Barclays US Corporate High Yield measures the US corporate market of non-investment grade, fixed-rate corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Barclays US Data Surprise Index – This index shows the degree to which economic analysts under- or over-estimate the trends in the business cycle. The surprise element is defined as the percentage (or percentage point) difference between analyst forecasts and the published value of economic data releases.

Barclays U.S. Treasury – The index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Barclays US Aggregate Treasury 7-10 year Index – A subset of the U.S. Treasury Index, which includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. The U.S. Treasury Index was launched on January 1, 1973

The **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the **Economic Surprise Index** suggests that economic releases have on balance beating consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indices also employ a time decay function to replicate the limited memory of markets.

Dow Jones CS Event Driven – Represents an aggregate of Event Driven funds. Event driven funds typically invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event. Such events can include: mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes as well as other types of corporate events. Event driven funds can invest in equities, fixed income instruments (investment grade, high yield, bank debt, convertible debt and distressed), options and various other derivatives. Many event driven fund managers use a combination of strategies and adjust exposures based on the opportunity sets in each subsector.

Dow Jones CS Managed Futures Index – Focuses on investing in listed bond, equity, commodity futures and currency markets, globally. Managers tend to employ systematic trading programs that largely rely upon historical price data and market trends. A significant amount of leverage is employed since the strategy involves the use of futures contracts. CTAs do not have a particular bias towards being net long or net short any particular market.

The **EURO STOXX 50 Index**, Europe's leading Blue-chip index for the euro zone, provides a Blue-chip representation of supersector leaders in the Euro zone. The index covers 50 stocks from 12 Euro zone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The EURO STOXX 50 Index is licensed to financial institutions to serve as underlying for a wide range of investment products such as Exchange Traded Funds (ETF), Futures and Options, and structured products worldwide.

FTSE All Country Local Currency Index – The **FTSE All World Index** covers 48 different countries and approximately 2700 stocks. The indices aim to capture up to 90%-95% of the investable market capitalization of a country, incorporating both large and medium cap stocks.

FTSE EPRA/NAREIT Global Developed Index is designed to track the performance of listed real estate companies and Real Estate Investment Trusts (REITs) worldwide. It incorporates REITs and Real Estate Holding & Development companies. Index constituents are free float-adjusted and screened for liquidity, size and revenue screened.

FTSE NAREIT - All Equity REITs – An index that consists of all Real Estate Investment Trusts that currently trade on the New York Stock Exchange, the NASDAQ National Market System and the American Stock Exchange. Equity REITs include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

HFRI Relative Value TR is comprised of investment managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. Relative Value is further subdivided into eight sub-strategies: Asset Backed, Convertible Arbitrage, Corporate, Sovereign, Volatility, Yield Alternatives-Energy Infrastructure, Yield Alternatives-Real Estate, and Multi-Strategy.

HFRX Global Hedge Fund Index is comprised of all eligible hedge fund strategies including, but not limited to: convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

The **Ifo Business Climate Index** is a closely followed leading indicator for economic activity in Germany prepared by the Ifo Institute for Economic Research in Munich. It is a composite index which is derived from an index for the current business situation and a separate expectations index. The Ifo Business Climate Index is based on ca. 7,000 monthly survey responses from firms in manufacturing, construction, wholesaling and retailing. The firms are asked to give their assessments of the current business situation and their expectations for the next six months. They can characterize their situation as "good", "satisfactory" or "poor" and their business expectations for the next six months as "more favorable", "unchanged" or "more unfavorable". The balance value of the current business situation is the difference between the percentages of the responses "good" and "poor", the balance value of the expectations is the difference between the percentages of the responses "more favorable" and "more unfavorable". The business climate is a transformed mean of the balances of the business situation and the expectations. For the purpose of calculating the index values, the transformed balances are all normalized to the average of the year 2005.

Ifo Business Climate Survey – A key monthly survey that measures the business climate in Germany. It is widely followed as an early indicator of the state of the German economy. The Ifo Business Climate Survey is based on approximately 7,000 monthly survey responses from firms in manufacturing, construction, wholesale and retail.

ISM Manufacturing Index – An index that assesses the state of US manufacturing sector by surveying executives on expectations for future production, new orders, inventories, employment and deliveries. Values over 50 generally indicate an expansion, while values below 50 indicate contraction.

JP Morgan GBI-EM Total Return Diversified – The JPMorgan Government Bond Index-Emerging Markets (GBI-EM) indices are comprehensive emerging market debt benchmarks that track local currency bonds issued by Emerging Market governments. The Diversified version was launched in January 2006.

The **Markit PMI™ (Purchasing Managers' Index™)** series are monthly economic surveys of carefully selected companies compiled by Markit. They provide advance insight into the private sector economy by tracking variables such as output, new orders, employment and prices across key sectors. Economic analysts, business decisionmakers, forecasters and policy makers leverage the PMI surveys to better understand business conditions in any given economy. Central banks in many countries use the data to help make interest rate decisions, and analysts in the financial markets use PMI data to forecast official economic data. A PMI of more than 50 represents expansion of the sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.

MSCI All Country World Index represents a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2009 the MSCI ACWI consisted of 45 country indices comprising 23 developed and 22 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI Asia ex Japan Index – A free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of Asia, excluding Japan. As of January 2009 the index consisted of the following 10 developed and emerging market country indices: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

The **MSCI China Index** provides coverage of the large and mid cap segments in China and is constructed according to the MSCI Global Investable Market Indexes Methodology. The MSCI China Index is part of the MSCI Emerging Markets index.

MSCI EAFE – The MSCI EAFE Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed equity. As of January 2012 the MSCI EAFE Index consisted of the following 22 developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI EM Index represents a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of February 2013, the MSCI Emerging Markets Index includes 23 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI EM LatAm Index – captures large and mid cap representation across 5 Emerging Markets (EM) countries* in Latin America. With 140 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI EM Asia – captures large and mid cap representation across 8 Emerging Markets countries*. With 535 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI EM FX Index – tracks performance twenty-five emerging-market currencies relative to the US Dollar.

MSCI EMU Index measures the performance of stocks based in the European Economic and Monetary Union. It consists of stocks in the following 11 developed-market countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain. The index contains almost 300 stocks and represents about 85% of the market capitalization in these countries.

The **MSCI Europe ex UK Index** captures large and mid cap representation across 14 Developed Markets (DM) countries in Europe*. With 330 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European Developed Markets excluding the UK.

The **MSCI USA Index** is designed to measure the performance of the large and mid cap segments of the US market. With 617 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

MSCI World Index represents a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of February 2013, it includes 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

MSCI World ex EMU Index captures large and mid cap representation across 13 of 23 Developed Markets countries* (excluding those in the EMU): Australia, Canada, Denmark, Hong Kong, Israel, Japan, New Zealand, Norway, Singapore, Sweden, Switzerland, the UK and the US. With 1,373 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

NAREIT Global RE Hedged – The FTSE EPRA/NAREIT Developed Real Estate Index Series is broken down into eight index families and 141 indices in Asia Pacific, Europe and North America. It is the FTSE EPRA/NAREIT Developed Total Return Index in USD.

NCREIF TBI Index – A quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All properties in the NPI have been acquired, at least in part, on behalf of tax-exempt institutional investors - the great majority being pension funds. As such, all properties are held in a fiduciary environment.

Russell 1000 – measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. As of December 31, 2011, the weighted average market capitalization was approximately $86.1 billion; the median market capitalization was approximately $5.1 billion.

Russell 2000 Index – A Frank Russell index which consists of the 2,000 smallest securities in the Russell 3000 Index, representing approximately 8% of the Russell 3000 market capitalization. This index is widely regarded in the industry as the premier measure of small capitalization stocks. Dividends are reinvested. Indices are unmanaged, do not reflect the deduction of fees and expenses and cannot accommodate direct investments.

Russell 2500 Index – Measures the performance of the 2,500 smallest companies in the Russell 3000 Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.

Russell 3000 – A market capitalization weighted equity index maintained by the Russell Investment Group that seeks to be a benchmark of the entire U.S. stock market. This index encompasses the 3,000 largest U.S.-traded stocks, in which the underlying companies are all incorporated in the U.S.

The **Standard & Poor's (S&P) 500 Index** represents a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market companies; the NYSE Euronext and the NASDAQ OMX. A selection committee selects the companies in the S&P 500 so they are representative of the industries in the United States economy.

An investment cannot be made directly in a market index.

Other definitions

Asset-backed securities (ABS) – Securities whose income payments and hence value is derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets which are unable to be sold individually.

Bundestag – The lower house of the federal legislature of Germany.

Duration – A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices.

Outright Monetary Transaction Facility – The European Central Bank's outright monetary transactions (OMT) or bond-buying programme was announced by Mario Draghi, president of the European Central Bank, in September 2012. Under the outright monetary transactions programme the ECB would offer to purchase eurozone countries' short-term bonds in the secondary market, to bring down the market interest rates faced by countries subject to speculation that they might leave the euro.

A **Plenum** is a meeting of China's Communist Party's Central Committee held on an annual basis. The **Third Plenum** of the 18th Congress took place in November 2013 and delivered major steps to overhaul the economy, as typically associated with the event, in a 60-point reform agenda.

Price-to-Book Value (P/B) – A valuation metric that compares a stock's market value to its book value. Book value refers to a company's total assets minus its total liabilities. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. Another way is to divide the current share price by the book value per share.

Price-to-earnings (P/E) multiple – The ratio of a stock's price to the company's earnings per share (EPS). It is calculated by dividing the stock's price by its EPS. It is a measure of how much an investor is paying for earnings.

Quantitative Easing (QE) – A monetary policy pursued by a central bank, in this case the Federal Reserve, that increases the bank's balance sheet through the regular purchase of government and other securities. It increases the money supply by providing financial institutions with capital in an effort to promote increased liquidity. QE is used when central bank interest rates are near zero and cannot be lowered by much. For more information, see *http://www.federalreserve.gov* website.

Single Supervisory Mechanism (SSM) – The European Central Bank (ECB) is preparing to take on new banking supervision tasks as part of a Single Supervisory Mechanism (SSM). The Single Supervisory Mechanism will create a new system of banking supervision comprising the ECB and the national competent authorities of participating EU countries. Among these EU countries are those whose currency is the euro and those whose currency is not the euro but who have decided to enter into close cooperation with the Single Supervisory Mechanism.

Targeted longer-term refinancing operations (TLTROs) – On 5 June 2014 the European Central Bank announced Targeted Long-Term Repo Operations (TLTROs]. Their main purpose is to stimulate bank lending to non-financial corporations. The operations would offer conditional cheap funding to banks in large size and for maturities of up to four years. Private loan conditions should ease in response, particularly in the euro area periphery, but the impact on area-wide credit is uncertain. Also, TLTROs might effectively be used for government bond carry trades.