MEASURE TWICE, CUT ONCE: THE IMPORTANCE OF A THOUGHTFUL INVESTMENT PLAN

Strategic Asset Allocation in 2015

Global family offices typically have long investment time horizons – multi-generational to perpetual. As a global family office or affluent investor, your flexibility, size and sophistication allow you access to a full range of global investment opportunities. You likely also have a high target investment return and an awareness of the effects of volatility and the impact of drawdowns on compounding, particularly if your investment pool also is supporting regular distributions. Maintaining long-term real growth and meaningful ongoing distributions can be a significant challenge, particularly in an environment with low expected returns for many traditional investment categories.

Our strategic asset allocation recommendations are designed to help you meet these challenges. For 2015, our recommendations include:

- **Fixed Income.** Continue to reduce exposure to investment grade bonds while adding exposure to spread bonds.
- **Equity.** Maintain exposure to both developed and emerging market equities to help promote long-term compounding and to balance out the effects low interest rates can have on the portfolio.
- **Hedge Funds.** Expand allocations to protect against potential increases in interest rates and global volatility.

STRATEGIC ALLOCATION RECOMMENDATIONS ONLY A STARTING POINT

A strategic asset allocation provides a starting point from which you can tailor your portfolio for your unique circumstances. When working with global family offices or affluent investors, Northern Trust begins with five strategic portfolio objectives designed to cover the risk/reward continuum through a careful combination of investments (see Exhibit 1). Each serves as a starting point for customization, based on your goals and objectives.

- **Low Volatility.** Accepts a lower absolute level of expected return in exchange for a focus on greater stability and lower risk of drawdown in the return stream.
- **Conservative.** Begins to step out on the efficient frontier to achieve somewhat higher expected returns, with an increase in expected volatility.
- **Diversified.** Seeks to balance achieving returns with managing risk.
- **Growth.**[1] Tilts toward achieving higher expected returns by accepting greater expected volatility.
- **Maximum Growth.** Seeks to maximize compounding and, in the process, accepts a high probability for interim volatility.

1 We use the Growth objective as the starting point for investors with multi-generational time horizons that also seek to support meaningful ongoing distributions (typically 4% to 5% annually).

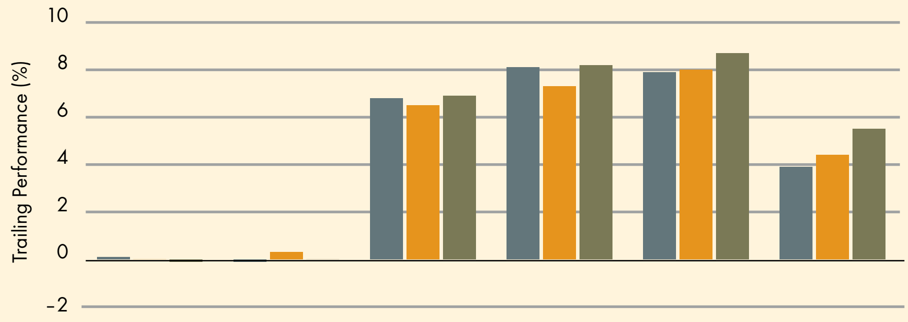
EXHIBIT 1: 2015 STRATEGIC ASSET ALLOCATIONS

	Low Volatility	Conservative	Diversified	Growth	Max Growth
Cash	5.0	3.0	1.0	1.0	1.0
Fixed Income					
Global Fixed Income	61.0	30.0	11.0	2.0	0.0
Global High Yield	3.0	4.0	2.0	2.0	0.0
Global Emerging Market Debt	0.0	6.0	11.0	7.0	0.0
Capital Growth					
Developed World Equity	0.0	9.0	17.0	29.0	50.0
Emerging Market Equity	0.0	2.0	3.0	5.0	9.0
Real Asset Group					
Global Inflation-Linked Bonds	2.1	3.9	5.1	4.2	0.0
Infrastructure – Public Global Listed	1.1	2.0	2.6	2.1	0.0
Commodities – Equities	1.1	2.0	2.6	2.1	0.0
Real Estate – Private Core	2.8	5.2	6.8	5.6	0.0
Alternatives					
Hedge Funds	20.0	20.0	20.0	20.0	20.0
Private Equity	4.0	13.0	18.0	20.0	20.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Expected Return	4.1	5.9	7.1	7.6	8.0
Risk (Standard Deviation)	4.6	6.6	8.6	10.2	12.6
Sharpe Ratio	0.7	0.8	0.7	0.7	0.6

Source: Northern Trust Investment Policy Committee. Numbers are rounded to the nearest decimal place, and may not add up to 100.

The expected return and volatility of these allocations provide a good starting point when creating your specific strategic asset allocation, and can be viewed against your expected return objective and the amount of volatility you are willing to accept. You can make many decisions within the strategic allocation structure that may ultimately influence the risk/return outcome. One of these decisions is considering a tactical asset allocation that allows for meaningful tilts toward one or more of the asset classes within the strategic allocation. These tactical tilts may include being overweight specific asset classes (e.g., emerging debt, emerging equities, U.S. large-cap equities) or a more personalized recommendation based on the specific needs outlined in your statement of investment policy (e.g., greater concentration in defensive equity managers or concentrated mix of low volatility hedge fund managers as a potential enhancement to your fixed income total return allocation). Having this tactical flexibility within a strategic framework can provide a measurable benefit, as shown in Exhibit 2.

EXHIBIT 2: THE EFFECT OF STRATEGIC AND TACTICAL ALLOCATION ON PERFORMANCE



	3-Month	Year to Date	1-Year	3-Year	5-Year	Inception to Date
60/40	0.1	–0.1	6.8	8.1	7.9	3.9
Strategic Asset Allocation	0.0	0.3	6.5	7.3	8.0	4.4
Tactical Asset Allocation	–0.1	0.0	6.9	8.2	8.7	5.5

Source: Northern Trust Investment Policy Committee. Data as of 1/31/14.

The 60/40 portfolio is composed of 60% MSCI All Country World Index and 40% Barclays Capital Aggregate Bond Index.

STATEMENT OF INVESTMENT POLICY FORMS FOUNDATION FOR SOUND INVESTMENT PLAN

As an investor with a multi-generational or even perpetual time horizon, your investment decisions need to be based on long-term planning rather than current events. This is why we recommend that you start the planning process with a well thought out statement of investment policy.

The statement of investment policy not only clearly articulates your goals over specified time horizons, but also allows you to consider a variety of investments and tactical adjustments to help achieve your goals. Constructing a statement of investment policy can help you address some of the situations that are fairly unique to a family office, such as how to balance the needs of family members with different time frames, goals and expectations, and how to measure risk over various time horizons.

Your statement of investment policy needn't be overly complex, but should include:

- Mission statement or guiding principles
- Time horizon(s) for achieving objectives
- Clearly articulated goals (and how they will be monitored/measured)
- Return and risk objectives
- Constraints
- Asset allocation (strategic and tactical ranges)
- Expected return and volatility, along with stress test for strategic allocation
- Acceptable investment vehicles, including allowable nontraditional investments
- Research process
- Next generation educational process
- Frequency of review of investment policy statement

Laying the foundation for your investment program with a well thought out statement of investment policy can help you better understand the risk and return tradeoffs of your investment decisions. This will help you identify the appropriate strategic allocation, and give you the confidence to make tactical decisions that should improve risk-adjusted performance.

A CHANGING GLOBAL ECONOMY LEADS TO STRATEGIC ALLOCATION SHIFTS

A portfolio that has been forged through the lens of an investment plan, and thus is composed of investments that have been carefully researched and combined, will weather many of the world's unpredictable events. The goal of our recommended strategic allocations is to begin with a reasonably diversified portfolio that takes into consideration, and re-evaluates annually, current economic and political issues.

The changes to our strategic allocations for 2015 are subtle. We addressed most global economic changes with tactical shifts to either enhance returns or to provide downside protection. Some of the geopolitical issues we are currently monitoring include:

1. The impact of lower oil prices on global economic growth.
2. Potential for continued deflationary pressures in Europe and Japan, and the associated slower global growth.
3. The global impact of slowing emerging markets growth.

Geopolitical events will continue to provide challenging investment environments, and can affect risk-adjusted returns for specific asset classes as well as for the aggregate portfolio. This is why we revisit and adjust our strategic allocations each year, and make tactical adjustments throughout the year.

FIXED INCOME: SHIFTING EXPOSURE FROM INVESTMENT GRADE TO SPREAD BONDS

Fixed income serves a valuable purpose in many portfolios – especially those focused on capital preservation or income generation. However, in today's interest rate environment, allocations to investment grade bonds may continue to struggle to provide the combination of both income and appreciation that investors have enjoyed over the last 30 years.

In a rising interest rate environment, investment grade bonds provide little opportunity to realize acceptable absolute returns. Investment grade bonds, though, still serve a purpose in our most conservative strategic allocations (Low Volatility and Conservative), comprising 61% and 30% of our allocation, respectively. But as we move across the spectrum in expected return to our Diversified, Growth and Maximum Growth allocations, we continue to reduce our exposure to investment grade bonds to 0% in the Maximum Growth allocation. For portfolios that do include allocations to investment grade bonds, we believe it's worth considering active management, giving the manager a more flexible mandate in regard to duration, quality and tax status of the bonds.

Despite our belief that rates will begin rising in 2015, low rates may be with us longer than anticipated. For this reason, considering strategies to enhance yield, absolute return or provide a reasonable level of protection against rising rates, may be prudent.

Broadening your focus to also include spread bonds, such as global fixed income, emerging market debt and high yield, may better position your portfolio to achieve your goals. Although adding spread bonds will increase the volatility within your fixed income allocation because of their exposure to default risk, we believe the benefits of a properly sized allocation outweigh this risk. We also advocate selectively owning high yield corporate bonds where appropriate. Owning spread bonds with flexible duration mandates and higher yields should provide greater income as well as reasonable protection in a controlled, rising rate environment.

You also may want to consider adding a concentrated, custom hedge fund allocation to your fixed income allocation (see Scenario 2, on page 8). A custom hedge fund allocation would share similar volatility characteristics to a long fixed income allocation, but would have greater liquidity constraints. As compensation for the reduced liquidity, however, you could reasonably expect a better absolute return, with the added benefit of potentially providing a degree of protection against a more aggressive rising rate environment.

EQUITY: BEING ON TARGET WITH ASSET ALLOCATION IS KEY

In our 2015 strategic asset allocations, we continue to favor greater allocations to both U.S. large-cap and emerging market equities for investors seeking longer-term compounding of capital. While we have no allocations to equity in our Low Volatility allocation, we have included equity in increasing amounts for the remaining allocations.

As important as the amount allocated to equities is the consideration of how to invest that allocation. Although we believe in the potential benefits of indexing in the most efficient spaces (U.S. large cap and international developed equities), we feel many investors may benefit from choosing active satellite managers. This is especially true if your statement of investment policy dictates either a more defensive or aggressive stance for these targeted allocations. The key to success here is to be highly selective in choosing the managers.

Many good active equity managers, particularly master limited partnerships (MLPs) and dividend-focused managers, produce a substantial dividend that may provide needed income in our current low-rate environment. These managers also tend to be more defensively positioned within an equity allocation, providing a degree of protection if the markets decide to take a breather. Selecting the most opportunistic managers that offer either the potential for outsized gains or greater defensive posturing requires a strong research team with the ability to perform deeper due diligence. Ongoing monitoring also is critical when using active managers.

Having a meaningful allocation to well-researched equity managers should still be at the core of most portfolios for long-term compounding. All equity allocations are not the same and having a good understanding of the markets, valuations and impact of geopolitical events, as well as an experienced research team to help navigate these areas, can make the difference between a successful or unsuccessful outcome in the equity space.

HEDGE FUNDS HELP QUELL THE VOLATILITY IN AN UNPREDICTABLE WORLD

While hedge funds continue to receive bad press because of their higher cost structure and less tax sensitive nature, we firmly believe they may play an integral role in helping family offices or affluent investors achieve a better risk/return profile for their total portfolio. We agree that when markets increase with little volatility, hedge funds, by comparison, may underperform a traditional long-only manager. But for investors seeking consistent, risk-adjusted performance, including hedge funds in the portfolio can help achieve this.

Planning for multiple generations requires an investor to venture outside the narrow lens of traditional investments and incorporate more sophisticated strategies like hedge funds. Using hedge funds in your portfolio may make sense if your goal is to reduce volatility or provide the potential for greater return by investing in areas of the market not found in traditional, long-only investments.

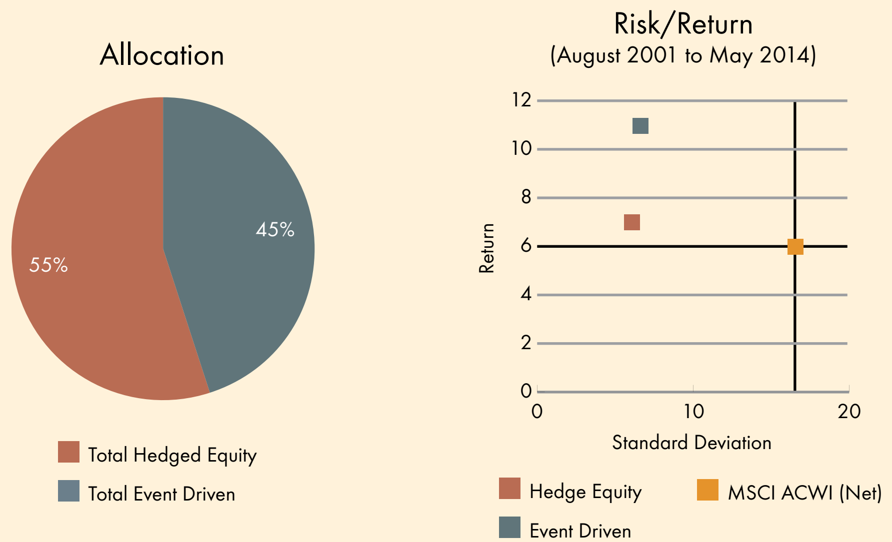
To illustrate the potential benefits offered by a custom allocation to hedge funds, let's examine two investment scenarios.

Scenario 1

This investor has a portfolio that currently includes a sizable allocation to fixed income. They have a pessimistic view of fixed income returns for the next few years, and would like to maintain a lower volatility profile, while increasing their potential to achieve a greater return.

After consulting with their advisor, the family office decides to invest a portion of the portfolio in a custom hedge portfolio (see Exhibit 3). The hedged equity allocation uses five managers covering different regions, including two global managers, one Asian manager and two U.S. managers. The event driven allocation uses three managers offering different sources of return, including an activist manager, a distressed/credit manager and a manager that invests across the capital structure.

EXHIBIT 3: CUSTOM HEDGE FUND ALLOCATION FOR SCENARIO 1



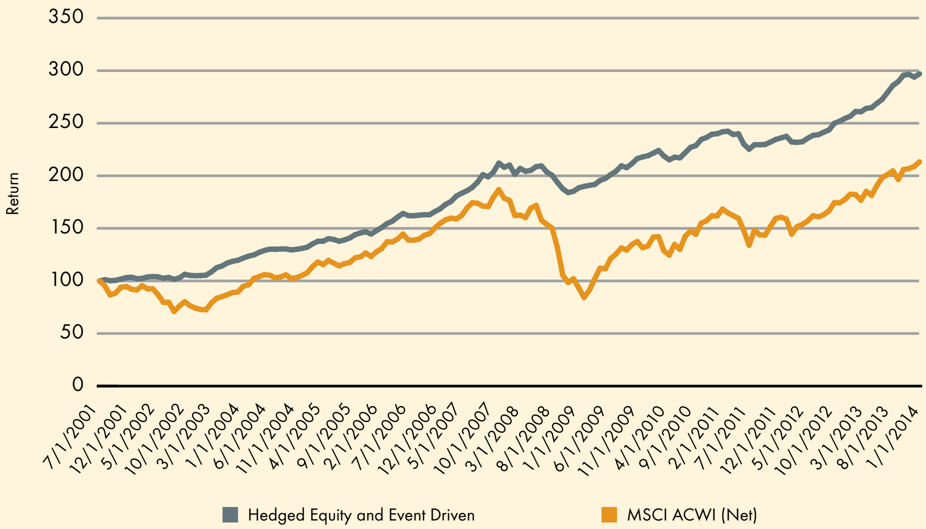
Source: Northern Trust Hedge Fund Team

As you can see in Exhibit 4 (on the next page), the hedged allocation achieved its target purpose of increasing alpha while keeping volatility closer to the volatility found in a typical diversified fixed income portfolio:

- The custom hedge fund program exceeded its long-only benchmark by around 46% (8.9% vs. 6.1%) and accomplished this with 69% less volatility than the comparable long-only index.
- The custom hedge fund portfolio shows low beta relative to the comparable long-only index, indicating a rich source of less-correlated returns relative to the long-only index.
- The hedge fund allocation also had a substantially higher Sharpe ratio (1.4 vs. 0.3), indicating that the higher performance was achieved with lower volatility.

EXHIBIT 4: PERFORMANCE OF HYPOTHETICAL HEDGE FUND ALLOCATION FOR SCENARIO 1

July 2001 to January 2014



	Return (%)	Standard Deviation (%)	Downside Risk (%)	Beta vs. Market	Alpha vs. Market (%)	Sharpe Ratio
Hedged Equity and Event Driven	8.9	5.2	4.0	0.2	7.4	1.4
MSCI ACWI (Net)	6.1	16.6	12.8	1.0	0.0	0.3

Source: Pertrac

Scenario 2

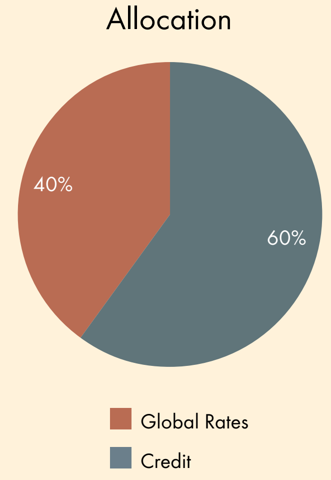
This investor has a soured view as to the total return potential of fixed income and is now concerned about potential capital loss in its fixed income portfolio as rates eventually creep up. They would like a solution that will diversify the duration risk in their current fixed income program, but would also like to achieve a low correlation to the current equity portfolio.

This investor's advisor encouraged them to think of a custom hedge fund solution as a strategy, as opposed to an asset class. By doing this, they keep the dollars allocated to fixed income managers using hedging strategies, which provide a more dynamic and broader range of available investments.

The resulting portfolio includes three managers, and is allocated as follows:

- The global rates allocation has one manager seeking to capitalize on changes in rates, regardless of direction.
- The credit allocation includes two managers: one focused on corporate and asset-backed securities and the other on securitized credit, seeking to capitalize on its expertise on how certain structures behave and adding value within these asymmetric differences.

EXHIBIT 5: HEDGE FUND ALLOCATION FOR SCENARIO 2



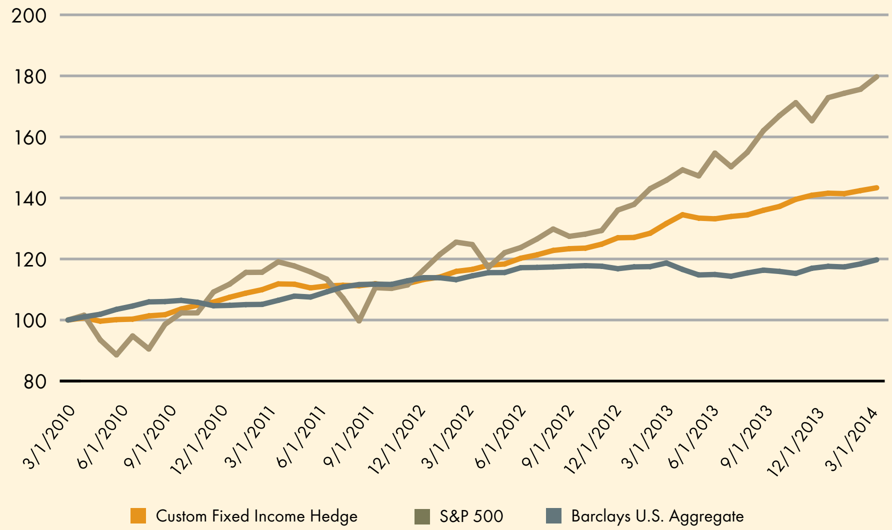
Source: Northern Trust Hedge Fund Team

As you can see in Exhibit 6, the hedged allocation achieved its targeted purpose of adding to the total return of the fixed income portfolio while maintaining a similar volatility to the current fixed income allocation:

- The custom hedge fund program's net return has handily outperformed its benchmark, thus adding real value to this fixed income allocation.
- The custom hedge fund was able to provide this return while having a very similar volatility profile as the comparable benchmark.
- The custom hedge allocation also has a substantially higher Sharpe ratio than the long-only Barclays U.S. Aggregate benchmark (3.4 vs. 1.6), thanks to its similar risk profile but substantially higher return.

EXHIBIT 6: PERFORMANCE OF HYPOTHETICAL HEDGE FUND ALLOCATION FOR SCENARIO 2

March 2010 to March 2014



	Return (%)	Standard Deviation (%)	Down-side Risk (%)	Beta vs. S&P 500	Alpha vs. S&P 500 (%)	Beta vs. BC Agg	Alpha vs. BC Agg (%)	Sharpe Ratio
Fixed Income Hedge	9.0	2.7	1.9	0.1	8.1	–0.1	9.3	3.4
S&P 500	15.1	13.6	10.0	–	–	–	–	1.1
BC U.S. Agg	4.4	2.8	2.1	–	–	–	–	1.6

Source: Pertrac

REFOCUS ON THE BIG PICTURE FOR BETTER INVESTMENT RESULTS

Many investors have, understandably, become complacent in the recent buoyant equity and fixed income environments. The world's uncertainties have not gone away. Equity markets have increased materially over the last five years and geopolitical issues continue to test your ability to stay focused on your ultimate goals. Our strategic allocation recommendations for 2015 focus on broadening the range of investments beyond investment grade fixed income and standard equity allocations. Considering strategies such as custom hedge portfolios or investments in spread bonds can help better position you to achieve your long-term goals.

It's important to regularly take a step back and clarify what you really expect your portfolio to accomplish over the longer term. Now is a good time to determine, along with a professional advisor, how much risk you are willing to accept in achieving these returns. A statement of investment policy is a great way to stay focused, and it makes tactical adjustments easier to initiate as the environment changes – measure twice, cut once.

LEARN MORE

Although our recommended asset allocations for global family offices and affluent investors are designed to address the needs of most organizations, assessing allocations based on your specific objectives and within the context of your statement of investment policy remains important.

If you would like to learn more about Northern Trust's investment process and how it relates to your goals as a global family office, please contact your relationship manager or visit us at **northerntrust.com**.

Northern Trust

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