

The background of the cover is a photograph of a person wearing a bright yellow raincoat and a hood, standing on a rocky beach. The person is looking out at the ocean under a cloudy sky. The foreground is filled with dark, wet rocks. The overall mood is contemplative and resilient.

# *IQ*

INVESTMENT  
QUARTERLY

WINTER 2023

## *Stepping Into the Open*

After a stormy year, investors should prepare for more near-term squalls but anticipate eventual recovery.

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PRIVATE WEALTH



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**JOHN F. GEER, JR., CFP®**  
Managing Editor

# Opening Doors

IN A NEW INVESTMENT ERA, OPPORTUNITIES CAN EMERGE FOR  
THOSE WHO LOOK.



The fatigue of many investors is palpable after a year that came with soaring inflation, higher interest rates and market distress, not to mention geopolitical tensions. The historic symmetric decline of both equity and fixed income markets meant that many traditional balanced portfolios simply did not work during 2022.

Entering these headwinds, we emphasized the tactical benefits of reduced market risk, and a focus on quality and less interest-rate exposure. This stance informed a general shift of our views: toward value-

oriented equities and shorter-duration fixed income, and a continued commitment to private markets where appropriate.

Looking ahead, we are both cautious about current conditions and optimistic as to the ability of investors to navigate new realities. Importantly, an era of excess liquidity, low rates and growth-stock-driven market returns appears to be over—likely replaced by an environment of more normal rates that rewards fundamentals. Over the past 15 years, many investors became over-exposed to equities and other risky assets. In our view, this makes it crucial to revisit asset allocations to ensure appropriate positioning.

As Joe Amato, President and CIO—Equities, explains in his outlook article on page 2, various steps can help mitigate risk while laying the groundwork for recovery. Our “Ten for 2023” investment themes (page 13) reinforce these ideas. Notably, last year’s weakness actually improved our outlook for long-term market returns, as explained by the Private Wealth Investment Group (page 16). And Jamie Iselin, Head of Municipal Fixed Income, observes that, even with some price improvement, many bonds are offering close to their best yields in years (page 9).

In our view, it’s key to look beyond traditional assets for opportunities. Private equity managers are increasingly accessing the secondary market for liquidity, which is offering intriguing valuations to investors. Philipp Patschkowski and Ben Perl from our Secondary Private Equity team have contributed an article explaining these dynamics (page 30). Of course, not everything that’s different is better, as reflected in Senior Research Analyst Scott Woodcock’s assessment of the FTX situation (page 8).

To us, however, investment is only part of the puzzle for clients, and should be integrated closely with comprehensive wealth and estate planning, complemented by efforts to enhance personal well-being. Along these lines, we present a 2023 planning checklist (page 27), and a New Year’s guide to setting family aspirations from Julia Chu, Head of Philanthropy and Family Governance Advisory (on page 23).


I hope you enjoy this issue of *Investment Quarterly* and that it helps you to start the year on track. We encourage you to reach out to your NB Private Wealth team to explore these topics in the context of your own unique goals and circumstances.

**STEPHANIE B. LUEDKE, CFA**

Head of NB Private Wealth

# *Market Focus*

STEPPING INTO THE OPEN



**JOSEPH V. AMATO** President and Chief Investment Officer—Equities

# *Stepping Into the Open*

AFTER A STORMY YEAR, INVESTORS SHOULD  
PREPARE FOR MORE NEAR-TERM SQUALLS BUT  
ANTICIPATE EVENTUAL RECOVERY.







In 2022, the best many investors could do was to simply take shelter. Major equity indices suffered their worst year since 2008. Bond prices fell sharply in the face of much higher inflation and an aggressive central bank tightening campaign, suffering their worst year of performance in recent memory.<sup>1</sup> Commodities shined, particularly in the first half of the year, with oil rising above \$120 before settling back down in the upper \$70s. But the financial turmoil was staggering—and unsettling for those used to generally calm and upward-trending equity markets.

Of the many issues to sort through last year, the key one for investors was runaway inflation, which, after decades-long dormancy, erupted globally as a result of COVID-related pent-up demand, supply chain and production issues, labor shortages and a surge in geopolitical tensions. The Federal Reserve and other central banks were at first nonchalant, but eventually became appropriately aggressive, leading to the Fed's curbing of quantitative easing and rapid interest rate increases. The combination of inflation, the central bank response and the potential impact on the economy created last year's perfect storm for markets.

Late in 2022 and so far in 2023, the market weather has been mixed—a good day here, a bad day there—but the feeling of uncertainty is palpable, as investors grapple with whether

we could find our way out of recent unsettled conditions or see things deteriorate once again. If the latter, many wonder about the length and severity of further downdrafts.

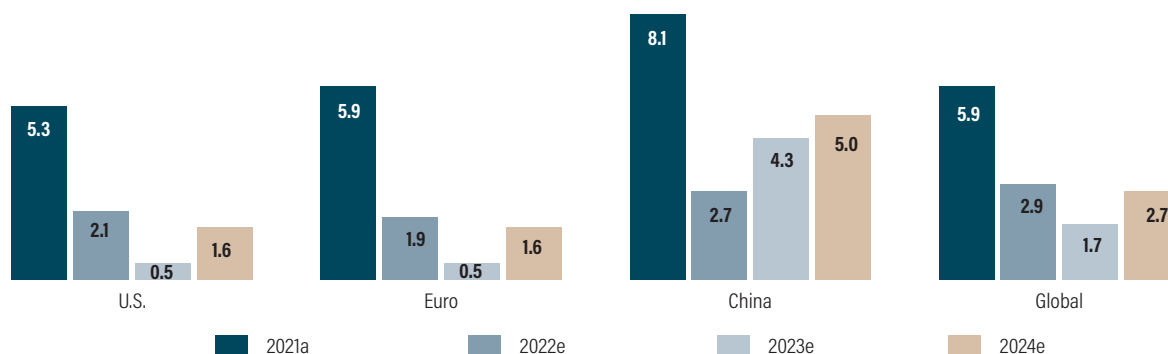
## ECONOMIC EFFECTS

Much depends on the macro picture. In the face of rate hikes, the U.S. economy has remained surprisingly resilient, growing a preliminary 2.9% in the fourth quarter—slightly less than in Q3 but better than the weak prints earlier in the year. The accumulation of COVID stimulus money has helped keep consumers spending, as have higher nominal wages, even as real wages (adjusted for inflation) have deteriorated. The labor market, a key focus for the Fed, remains remarkably strong, with just 3.5% unemployment in December, and a monthly average of over 300,000 jobs created over the past six months.

But cracks are appearing: The Conference Board Leading Economic Index is down 4.2% for the six months through December; layoffs at technology firms have accelerated; and the housing market continues to show weakness, both in volume and pricing. Manufacturing is also easing, with the much-watched Manufacturing Purchasing Managers' Index now in negative territory. Overall growth will likely slow to a crawl this year (see display).

## GROWTH TAKES A HIATUS

World Bank GDP Forecasts (%)



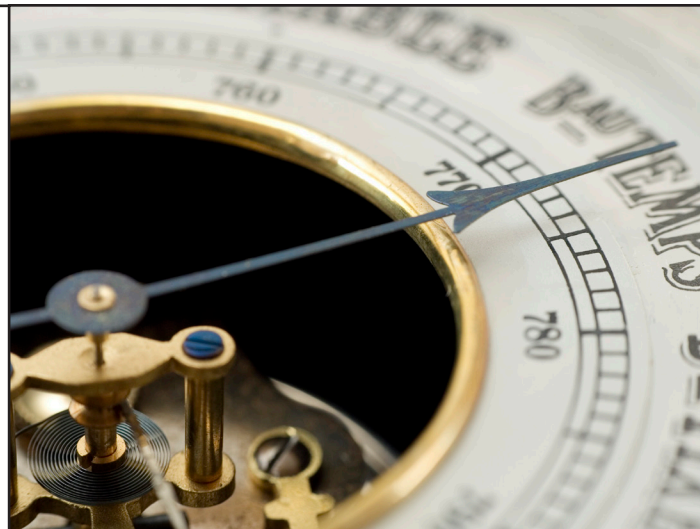
Source: World Bank, as of January 10, 2023. U.S. GDP for 2022 is a preliminary figure from the Commerce Department. Otherwise, 2022 – 24 figures are estimates.

<sup>1</sup> The Bloomberg U.S. Aggregate index returned -13% in 2022, the worst result in its more than 40-year history.



## *Investment Barometer*

- Markets may be underestimating the stickiness of inflation, central bank backbone—and potential impacts on growth and corporate earnings.
- Bonds now provide a more compelling source of income, often offering generous yields for high-quality securities.
- Alternative investments including private equity and real assets continue to offer a valuable source of differentiated return.
- We believe investors should take a fresh look at asset allocations in light of current market realities and individual goals.



Importantly, the Fed's tightening campaign seems to be having an impact in inflation. Consumer price (CPI) gains have moved from a peak of 9.1% (annualized) in June to 6.5% in December, while core inflation (excluding the volatile energy and food sectors) has eased to 5.7%.

Breaking CPI into component parts, we've already seen a reduction of goods inflation, while shelter appears ready to ease as well. However, services prices—which tend to be sticky and are a large portion of the economy—could take longer. All told, we believe that inflation will gradually recede in 2023 but remain above norms, with core CPI finishing the year at around 3.5% versus the Fed's target of 2%.

At this point, we are in a bit of a waiting game. The Fed has done most of the hard work already, having lifted the fed funds rate by 425 basis points to its highest level in 15 years. However, policymakers need to see real evidence that inflation is waning. That suggests to us a few more 25-basis-point increases in upcoming meetings, depending on how the data plays out. After that, we are likely to see the central bank maintain peak rates for a while—likely into 2024.

So, a key wild card remains how long the Fed has to maintain high rates and if it has to raise them further than anticipated. A related question is how shallow or deep the economic decline will be. In our view, the risk is growing. Even without a technical recession, the unfavorable growth-inflation mix could be a threat to corporate profit margins and earnings—making most of us feel like we are in a downturn.

## **IMPLICATIONS**

What does this mean for markets and investors?

### **Stocks: Keep an Umbrella**

We believe these conditions create headwinds for equities, even if interrupted by periodic relief rallies as investors hope for easing from the Fed. Thus far, the downturn has largely been a function of price/earnings multiple contraction driven by higher interest rates. Reported earnings and earnings expectations have been fairly resilient, as many companies have been able to pass on price increases to customers. However, we wonder how long that resiliency will last.

The current bottom-up analyst expectation for 2023 S&P 500 earnings is around \$227, or 4% more than last year. Although less than what was achieved in 2022 (an estimated 5%), in our view, such potential growth seems too optimistic given current headwinds, and is also at odds with the top-down views of many Wall Street strategists, who see the economy's drift into recession cutting into earnings. As such, we believe there is likely to be disappointment, which could pressure valuations from here, although the timing and intensity of any downdraft remain to be seen.

The unusually uncertain macro environment suggests the range of potential outcomes is fairly broad. Best case, if we see a meaningful reduction in inflation and slower but still positive economic growth, earnings are likely to avoid a major shortfall even as the Fed is able to take its foot off

the gas, all of which could help stocks. A mild recession and commensurate pullback in earnings would be more negative, while full-blown recession and its knock-on effects would likely be far worse.

All this calls for a degree of caution in the near term. We are in favor of investors tilting away from market “beta,” toward value over growth, and toward current income (i.e., dividends) rather than long-term growth expectations. We also would emphasize U.S. over foreign stocks given the relative strength of our economy and the Fed’s leadership in the tightening process compared to other developed market central banks. We are getting closer to the point where adding risk could make sense—we’re just not there yet. It will be important to avoid the trap of becoming more negative as prices decline; that is often an optimal time to add risk.

#### Bonds: A Fresh Start

Fixed income’s synchronized retreat with equities last year was unusual, but also disconcerting for many investors given the traditional role of bonds as an “anchor to windward” for portfolios. However, a major silver lining is that yields are much higher now, providing income streams and, in some cases, total-return profiles comparable to equities (see display).

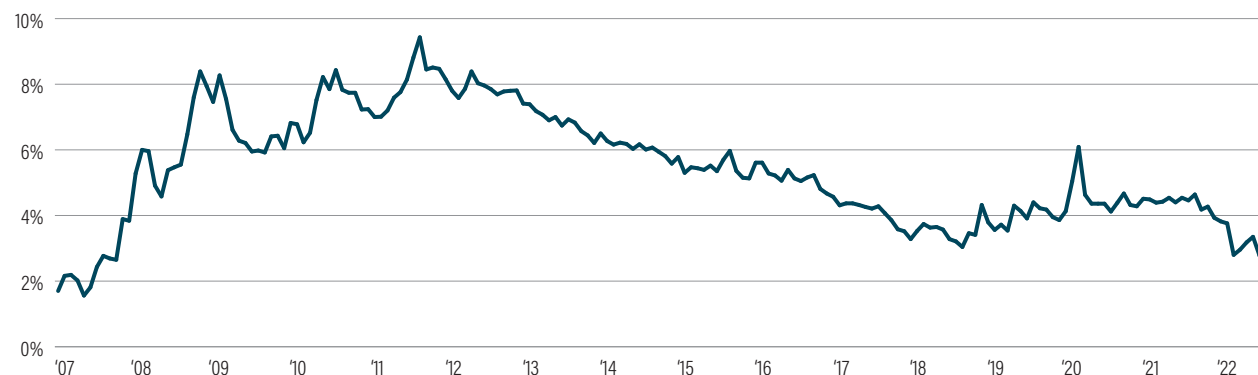
Overall, we favor an emphasis on quality, given the level of yields and the potential pressure from higher borrowing costs and slower economic growth on issuer fundamentals moving forward. Shorter-term yields are particularly appealing, although now may also be a good time to lock in exposure to longer bonds before policy rates begin to ease. Municipals have retained their comparable appeal for investors in higher tax brackets (see “New Horizon for Fixed Income” on page 9).

#### Weigh the Alternatives

Given our generally cautious outlook for stocks and coupon-driven bond prospects, we believe that exposure to alternative investments, where feasible, remains a valuable source of risk-adjusted return potential. We are intrigued by the impacts of current market weakness, which bodes well for valuations of new public-to-private transactions and “carve-outs” where companies adapt to a slowdown by selling noncore divisions. In addition, secondaries (seasoned fund investments sold on the secondary market) seem attractively priced as fund managers look for liquidity in a difficult environment (see “Private Equity: New Value in Secondaries” on page 30).

### BONDS’ APPEAL VERSUS STOCKS HAS IMPROVED

Stock Earnings Yield Minus 2-Year Treasury Yield



Source: FactSet. Data as of November 30, 2022. Earnings yield is earnings per share divided by stock price. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**



*We are seeing a return to an 'old normal' of higher interest rates and moderate growth, where business fundamentals may be more important than the benevolent hand of central banks.*

#### **ADAPTING TO EVOLVING CONDITIONS**

One of the hardest things about investing is breaking from habit, as successful approaches in one era become less successful in another. Economic dynamics, monetary conditions, business incentives, supply and demand, geopolitical influences and more may combine to alter the flow of capital. As we have explained elsewhere,<sup>2</sup> we are seeing a return to an “old normal” of higher interest rates and moderate growth, where business fundamentals may be more important than the benevolent hand of central banks.

In this evolving, sometimes turbulent era, we believe the time of “set it and forget it” stock/bond portfolios is waning, replaced by the need for nuanced judgment as to asset exposures and investment execution. Drawing from a wider array of opportunities will likely be important, as will understanding how portfolio elements can combine to achieve individual goals. Your NB Private Wealth team can help in considering these issues.

<sup>2</sup> See our “Ten for 2023” investment themes on page 13 and the broader Solving for 2023 outlook on our website at [www.nbprivatewealth.com/en/insights/solving-2023](http://www.nbprivatewealth.com/en/insights/solving-2023).

See disclosures at the end of this publication, which are an important part of this article.

## *Crypto-Concern in Context*

JUICY HEADLINES ASIDE, FALLOUT FROM THE FTX AFFAIR LOOKS TO REMAIN LARGELY CONTAINED TO CRYPTO MARKETS.

The collapse of the FTX Cryptocurrency Exchange late last year shook the political and financial worlds, as some \$10 billion of customer funds were reportedly removed from the exchange, much of which is apparently still unaccounted for. Bitcoin, which was already down 60% from its peak, fell even further in the wake of the bankruptcy.

We believe the failure of FTX has raised serious questions about the transparency, regulation and ethics of the \$1 trillion cryptocurrency market. Moreover, the story is likely to remain in focus, given the reported lack of guardrails at FTX and the arrest of CEO Sam Bankman-Fried, who faces charges of fraud, money laundering and election law violations.

### **Show Us the Money**

Nominally, FTX operated as an exchange on which customers could trade and hold cryptocurrencies. But when lenders started recalling their loans and customer sought to withdraw funds from the exchange in high volumes, an inadequate pool of liquid assets left the company unable to meet the redemptions.

Exchanges typically segregate unmarginated customer assets, so they should not experience this sort of liquidity crunch. But it appears that FTX used customer assets as collateral to finance the operations of Alameda Research, the firm's proprietary trading and investment business.

The incident raised fears about other large cryptocurrency exchanges, many of which operate offshore, like FTX, in jurisdictions that do not have stringent requirements around segregation and safeguarding of customer funds.

### **Low-Contagion Event**

However, we do not believe FTX will prove to be a systemic risk for markets. In fact, an arguably more serious incident occurred in May, when the TerraUSD algorithmic "stablecoin," which was

supposed to exhibit a 1:1 relationship with the U.S. dollar but was not fully backed by liquid assets, effectively "broke the buck."

The Terra/Luna ecosystem had a market capitalization close to \$50 billion at the time, and the event led to the unwinding of a significant amount of leverage in the crypto universe and the failure of some of the weakest players in the industry. The silver lining is that this appears to have helped limit the damage wrought by the later failure of FTX and the related fallout, including a recent bankruptcy filing by Genesis, the cryptocurrency lender.

The Terra/Luna collapse (and subsequent failure of Celsius and Three Arrows Capital) contributed significantly to last year's crypto sell-off. According to CoinMarketCap, the total market capitalization of all recorded cryptocurrencies has fallen from almost \$3 trillion in November 2021 to around \$800 billion today. For context, this compares to the \$110 trillion-plus market capitalization of global listed equities.

More importantly, institutions with large holdings in traditional markets—where stresses can therefore have wider ramifications—have tended to steer clear of significant exposure to cryptocurrencies, as have most hedge funds, foundations and banks. The same is not true of high-net-worth investors, of which almost half have reportedly adopted some exposure within the last two years, but this is not something that in our view poses any threat to the broader health of the market.


### **Continuing, but Contained**

In sum, the crypto universe remains relatively small in comparison to other risk assets like equities, with limited overlap for contagion into traditional markets. Beyond any financial implications, reports that various politicians received political contributions from Bankman-Fried may produce new storylines over time, but that's another topic entirely.

—**Scott Woodcock**, Senior Research Analyst  
Equity Research

See disclosures at the end of this publication, which are an important part of this article.





**JAMES L. ISELIN** Head of Municipal Fixed Income

# *New Horizon for Fixed Income*

## THE ERA OF MEAGER YIELDS APPEARS TO BE OVER.

After a prolonged era of loose monetary policy, the Federal Reserve has engaged in a sustained, aggressive campaign to raise interest rates and reduce inflation. In the wake of a global retrenchment of fixed income assets, many bonds now generate appealing income that may start to alter asset allocation views in the months and years to come.

### **PEAK INFLATION, DECELERATION**

Overall, our team and the market have become more comfortable with the concept that peak inflation has already arrived, with the drivers that would cause prices to decline now in place. However, the rate of deceleration is the subject of major debate. We anticipate that inflation could come down significantly this year, with a base case of around 3.5% by December 2023.

Even after a pleasing late-2022 rally, absolute yields in the market are much higher than at start of last year, and, in our view, investors can be fairly excited about potential return profiles from fixed income. The backup in rates provides something of a cushion against further upside surprises in inflation and interest rates. Although volatility has been high in the past year, we see it starting to come down.

Altogether, this more stable, higher income environment creates an appealing tableau when it comes to asset allocation decisions, which we believe may increasingly favor fixed income relative to more uncertain prospects in other asset classes.

### **MUNICIPAL OPPORTUNITY**

Taking a look specifically at municipal markets, yields on intermediate municipals are somewhere around 3% with a three-years-plus duration (or sensitivity to interest rate fluctuations). On a tax-equivalent basis (assuming the highest federal rate of 40.8%), that comes close to a percentage point higher than the roughly 3.5% yield of the 10-year Treasury.

As we mentioned in our *Solving for 2023* outlook, municipal credit quality tends to deteriorate more slowly than that of corporate bonds during tough economic times, largely because the weakness of businesses and other revenue sources must filter through to budgets before having a significant impact. This gives active managers plenty of time to adjust portfolios proactively. Stepping back, municipals remain among the most creditworthy fixed income asset classes in the world—which adds to their appeal as a place for investors to “hang out” as they wait for conditions to improve.

### MORE RATE EXPOSURE?

In terms of duration, we believe investors may wish to consider increasing their exposure to some degree. Yes, inflation and rates could surprise on the upside, but, all told, their direction is likely to be downward over the longer term, suggesting that this could be an opportune time to lock in higher yields before their retreat. In the context of our municipal discipline, we would look to the seven- to 12-year range of the yield curve, balanced out with some shorter assets to achieve a more modest three- to five-year average. For those who “aren’t there yet” in their optimism about interest rates, relatively high yields at the short end of the market appear to be an option.

### CREDIT: CASE BY CASE

Looking at credit risk, across fixed income it is likely to be more idiosyncratic going forward. Within municipals, essential service revenue bonds and tax-backed bonds are typically considered relatively resilient, but we believe individual bond and issuer fundamentals should generally be the focus.

Consider the State of California, for example. The Golden State put itself in a great position going into a tougher economic period, with a rainy-day fund that is now at its statutory limit. However, the nature of its tax system, which relies disproportionately on high earners, market activity and exercise of stock options, suggests potential headwinds—including a projected \$22.5 billion budget deficit for the coming fiscal year.

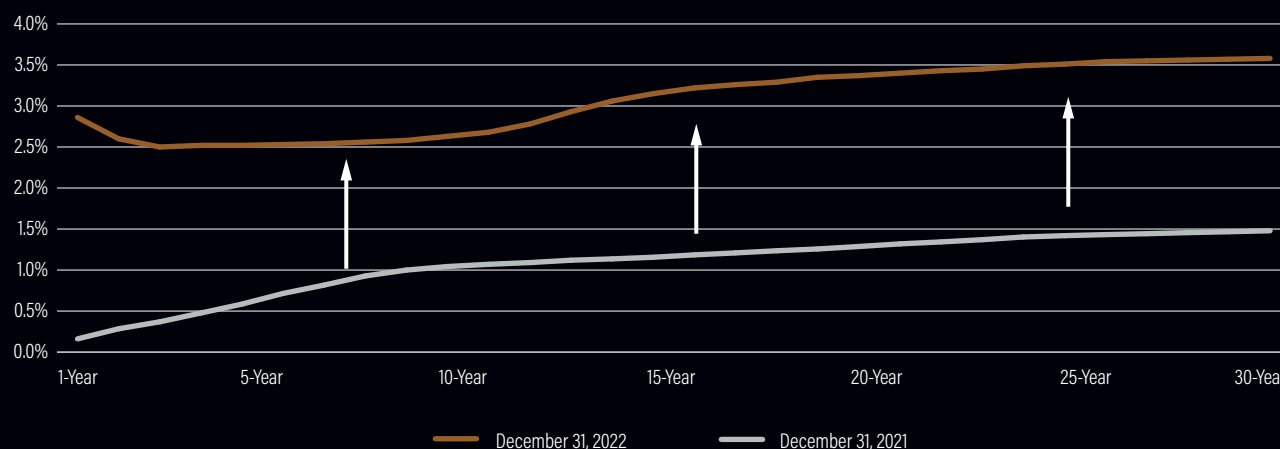
In our view, 2021 was all about the “tide lifting all boats” and taking more risk where you could find it. Going forward, the environment will likely be more about the market judging each credit on its own merits. All things being equal, while we are not overly concerned about risk at this point, we are more focused on buying quality. After all, you are getting paid for buying quality on an absolute basis, compared to 2021, when yields were so low on quality bonds that investors often migrated to higher risk to generate more income.

### TAILWINDS FOR 2023?

Although interest rates appear likely to remain volatile, we see rates as generally rangebound from here, leaving investors with healthy yields across fixed income, although credit naturally will become more challenging with market weakness. The tax-advantaged yield potential of municipal fixed income, coupled with its durable credit profile, could draw new demand this year. Should the mutual fund outflows from 2022 reverse course, the asset class could see a tailwind to reinforce investor confidence.

### ATTRACTIVE YIELD ENVIRONMENT

AAA Municipal Bond Yields



Source: Bloomberg. As of December 31, 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**



# *Solving for 2023*

TEN FOR 2023





# *Solving for 2023*

## TEN FOR 2023

*Each year, our investment leaders identify 10 key themes they believe will be prominent in the markets over the next 12 months. The themes for 2023 are provided below.*

### MACRO: BACK TO THE 'OLD NORMAL'

#### **1 A YEAR OF PEAKS AND TROUGHS, WITH A RETURN TO THE 'OLD NORMAL'**

We think the next 12 months are likely to see this cycle's peaks in global inflation, central bank policy tightening, core government bond yields and market volatility, as well as troughs in GDP growth, corporate earnings growth and global equity market valuations. But we do not believe this will mark a reversion to the post-2008 "new normal." We see forces in both public and private sectors behind persistently higher inflation—and therefore a persistently higher neutral interest rate, a higher cost of capital and lower asset valuations.

#### **2 ADJUSTING TO HIGHER INTEREST RATES CONTINUES TO DISRUPT**

As rates rise and investors demand greater compensation for risk, the cost of capital goes up. This happens at some point in most cycles, but we believe the current adjustment is structural and both unusually large and rapid—raising the risk that it is disruptive. Many mortgage borrowers could be shocked when they refinance at 2023 rates. Many corporations structured their businesses for a low-rate environment and, as a result, are in for a similar sharp adjustment. And with government debt exploding during the pandemic, and bond traders who are wary of fiscal and monetary waste back on watch, some sovereigns may be forced into the kind of uncomfortable rethink experienced by the U.K. We think investors should be watchful for weak points that could cause broader disruption.

#### **3 MORE DEGLOBALIZATION**

Manufacturing supply chains, commodity markets, financial systems, regulatory regimes, fiscal and monetary policy frameworks—they all became more integrated between 1980 and 2008, and more fragmented since. We see many and varied reasons, including the political backlash against the unequal outcomes of globalization, the shocks of the Global Financial Crisis (GFC) and the pandemic, the waning internationalism of the U.S., and increasing tensions as geopolitical blocs realign. We anticipate more landmarks on this journey in 2023, as it is driven by strong political, security and risk-management imperatives.

#### **4 REDOUBLED EFFORTS TO CLARIFY 'ESG'**

Environmental, social and governance (ESG) investing became increasingly politicized in 2022 as the crisis in Ukraine triggered strong outperformance from fossil-fuel assets and stoked fears that ESG investors were starving domestic energy providers of capital. To counter this politicization, we believe more clarity is needed on the distinction between investing processes and pursuing investing outcomes. ESG integration is a process designed to ensure that financially material ESG factors are considered, alongside other factors, in traditional investment analysis. Exclusions, sustainable investing and impact investing are strategies that pursue a specific nonfinancial outcome, either in a portfolio or in the real world, alongside managing financial risk and return. We anticipate heightened focus on this clarification from the investment industry and its regulators in 2023.

## ASSET ALLOCATION: REVISITING THE STATUS QUO

### 5 RISKIER HOLDINGS MAY NEED REASSESSING

The bull market since the GFC has skewed asset allocations for many investors toward higher-risk assets within both credit and equities as a means to seek return against a backdrop of low fixed income yields in order to meet their financial goals. However, the sharp increase in interest rates may be changing this calculus. Not only do higher rates curb the potential appeal of growth-oriented securities, which handily outperformed post-GFC, but they also may enhance the potential appeal of higher-quality fixed income securities, including some tax advantages in the case of municipals. At the same time, alternatives and real assets may provide a way to introduce different return dynamics to portfolios in a post-pandemic world marked by higher inflation.

## FIXED INCOME: ADAPTING TO PERSISTENT INFLATION AND HIGHER RATES

### 6 GOVERNMENT BOND PERFORMANCE MAY DEPEND ON POLICY SUCCESS

We enter 2023 with high inflation and extreme levels of government debt. Against this backdrop, we see bond investors standing up more strongly for their interests against policymakers. Markets are punishing policy inconsistencies between the fiscal and monetary authorities. We believe government bond yields may be range-bound where policies are consistent, but potentially higher and more volatile where policies are inconsistent. Despite the pace of policy adjustment and attendant market rate moves, outside the U.K., central banks have so far not had to intervene to maintain market liquidity—but an emergent policy conflict remains a tail risk for bond markets in 2023.

### 7 THE ABILITY TO ABSORB HIGHER RATES IS LIKELY TO DOMINATE CREDIT

Over the course of a decade, corporations, much like individuals, have become accustomed to low interest rates, leading to debt structures built around falling or near-zero interest rates. Floating-rate borrowers will need to adjust right away, but because we see structurally higher rates ahead, we think fixed-rate borrowers will eventually need to adjust, too. We do not anticipate a major uptick in defaults: The economy has historically been able to generate healthy growth with rates at these levels; balance sheets are generally strong, and maturities are generally several years away, supporting a range of fixed income credit markets. Within municipal bonds, in particular, the impacts of economic weakness tend to be delayed, which could provide active managers ample time to adjust exposures. That said, in our view, the sooner investors work “higher rates for longer” into their credit analyses, the sooner they are likely to make what we regard as the necessary portfolio adjustments.

## EQUITIES: WINNERS AND LOSERS

### 8 EARNINGS ESTIMATES RECALIBRATE AND FAVOR THE FITTEST

Much of the equity bear market of the first half of 2022 appeared to be due to the application of higher discount rates to largely unchanged future earnings estimates. Consensus earnings growth estimates for 2023 did not fall in the same way as real GDP growth estimates, perhaps because high inflation has supported nominal GDP growth. As inflation turns downward but remains relatively high as the economy slows, we think earnings estimates are likely to be revised down. We also think dispersion will increase, favoring companies that are less exposed to labor and commodity costs, have more pricing power to maintain margins, and use less aggressive earnings accounting. We believe this will translate into greater dispersion of stock performance, potentially favoring active managers.

### 9 MANAGEMENT TEAMS REFOCUS ON SHAREHOLDER VALUE

When equity investors demand greater return potential and bond yields are elevated, one way to keep the cost of capital down is to refocus on delivering tangible, near-term shareholder value. When the economic going gets tough, effective management teams typically start improving capital structures and balance sheets, spinning out lower-return divisions, acquiring strategic targets, finding efficiencies and engaging creatively with shareholders. In these conditions, we tend to see the true potential of alignment between active shareholders and company management: 2023 could be a lively year in the boardroom.

## ALTERNATIVES: CHALLENGES AHEAD, BUT OPPORTUNITIES FOR THE NIMBLE

### 10 MORE DISPERSION AND TACTICAL POTENTIAL

Private markets won't be impervious to the ongoing slowdown. Exits are more difficult in volatile public markets, and while private company valuations tend not to fall as far as public valuations, we do think they are likely to decline. Such a challenging environment is likely to result in performance dispersion that often favors higher-quality companies. It's also important to remember that private equity funds generally invest over multiyear periods, enabling new and younger vintages with dry powder to seek opportunities as valuations decline. Tactically speaking, we think private equity secondaries have become a buyers' market, as we are seeing supply of transactions exceeding available capital; economic strains could also open up long-term value opportunities in inflation-sensitive real assets such as commodities and real estate.

See disclosures at the end of this publication, which are an important part of this article.



# *Asset Matters*

UNDERSTANDING CAPITAL  
MARKET ASSUMPTIONS





PRIVATE WEALTH INVESTMENT GROUP

# *Understanding Capital Market Assumptions*

LONG-TERM CAPITAL MARKET ASSUMPTIONS ARE A KEY CONSIDERATION IN THE CREATION OF STRATEGIC ASSET ALLOCATIONS FOR INVESTORS.

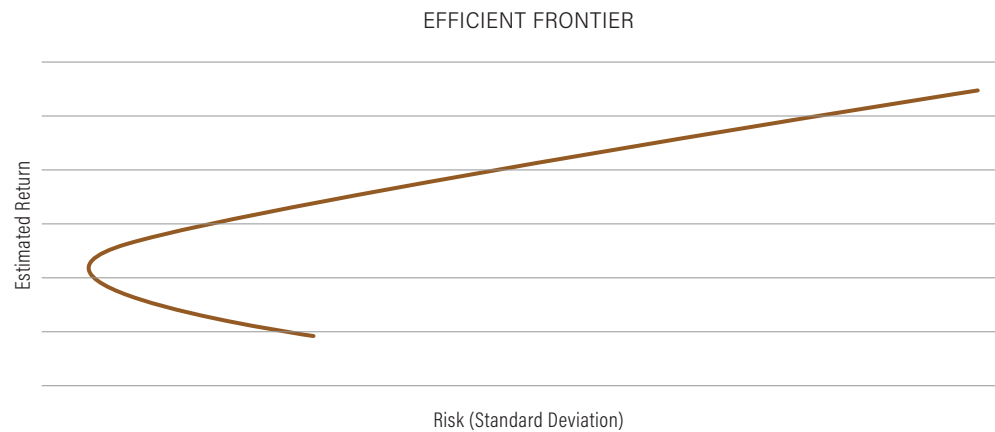
The development of a potentially effective long-term investment strategy incorporates multiple elements. At the macro level is the concept that diversification across asset classes can enhance return outlooks and mitigate risk. Generally, this is expressed in 'a strategic asset allocation'<sup>1</sup> catering to individual investment goals. At the micro level is implementation: seeking investment strategies within each asset class with the potential to meet or exceed expectations on a risk-adjusted basis. In between and related to these two elements is a key consideration for investment planning: capital market assumptions, which are essentially estimates for long-term asset class returns. These inform a strategic asset allocation and thus the weightings that individual investments may ultimately represent.

<sup>1</sup> See "Asset Allocation: Reaching for the Summit," *Investment Quarterly*, Fall 2022.



Akin to a manufacturing process, capital market assumptions are building blocks that go into the creation of the strategic asset allocation. Estimated returns, risk and asset class correlation can work together in what's called a mean variance optimization to create portfolios that seek to provide an optimal level of return for each unit of risk. These portfolios can be shown graphically in what's known as the "efficient frontier."

### THE SEARCH FOR AN 'OPTIMAL' PORTFOLIO



Source: Neuberger Berman. For discussion purposes only.

How one goes about creating such estimated returns is, naturally, crucial to the potential reliability of an asset allocation. Moreover, it's no exaggeration that having credible capital market assumptions is essential to the entire investment process: If you are using poor materials, the caliber of your equipment won't do you much good because you'll still end up with a faulty product.

At Neuberger Berman, we employ a multifaceted approach to estimating returns of various asset classes with the aim of being both systematic and objective. Our fundamentally based bottom-up methodology considers the drivers of returns for each asset class at the time of the forecast and over its long-term history. (See "Exploring Our Approach" on page 20.)

An important element is the baseline valuations from which the investor is starting. Following a period of significant outperformance, a given asset class may have a forward-looking return estimate that is lower than in the past. By the same token, estimated returns may go up after a period of weakness. Similarly, a phase of declining interest rates may reduce the total return potential for fixed income assets, but a sharp upward turn in rates could actually make bonds more valuable going forward—something that may help salve the recent pain experienced by many investors amid higher inflation and market declines.



## WHERE OUR CAPITAL MARKET ASSUMPTIONS STAND TODAY

The following graphics provide our 2023 capital markets assumptions, both in terms of return and volatility, for select asset categories over a 20-year period. Note that these figures reflect the extraordinary market action that took place in 2022. Amid severe market declines, long-term return profiles have improved—reflecting the additional opportunity that lower valuations can create on a strategic basis. Equity assumptions have generally increased by about a percentage point per year, while fixed income assumptions, in the wake of an interest rate reset, have increased by about 1.5% annually.

The breadth of assets is important, in our view. Just as global companies now seek flexibility and diversification of supply chains, investors can capitalize on multiple asset classes, sectors and strategies to mitigate risk exposure, and capitalize on the potential compounding advantages of a smoother return path for portfolios.

## 2023 NB CAPITAL MARKET ASSUMPTIONS

20-Year Return and Risk Estimates for Sample Assets

	Estimated Annual Return (%) <sup>1</sup>	Annual Standard Deviation (% Risk) <sup>2</sup>	Year-Over-Year Change in Annual Return (%)	Year-Over-Year Change in Standard Deviation (% Risk)
<b>FIXED INCOME</b>				
Cash (risk-free rate)	3.7%	0.3%	2.1%	0.0%
Investment Grade	5.7%	5.8%	1.7%	0.3%
Municipals	4.5%	4.5%	1.4%	0.2%
High Yield	6.5%	8.7%	0.8%	0.2%
Non-U.S. Developed Market Fixed Income	4.8%	5.4%	2.3%	2.7%
Emerging Market Debt	7.1%	9.1%	2.1%	0.2%
<b>EQUITY</b>				
U.S. Large Cap	7.8%	15.7%	0.8%	0.3%
U.S. Small Cap	8.6%	20.5%	1.2%	0.1%
Developed International Equities	8.1%	17.5%	0.6%	0.0%
Emerging Market Equities	8.8%	21.1%	0.9%	-0.4%
Other Equities <sup>3</sup>	8.0%	16.5%	0.8%	0.1%
<b>ALTERNATIVES</b>				
Commodities	6.2%	16.8%	-0.1%	0.3%
Hedged Strategies	6.1%	6.3%	1.7%	-0.1%
Private Markets	11.7%	17.5%	0.9%	-1.0%
<b>INFLATION</b>				
Inflation	2.7%			

Source: Neuberger Berman, Bloomberg Barclays, Cambridge Associates, FactSet. As of 4Q 2022.

<sup>1</sup> Arithmetic return = average (mean) return across years. Arithmetic returns ignore the impact of compounding in the context of analyzing investment returns.

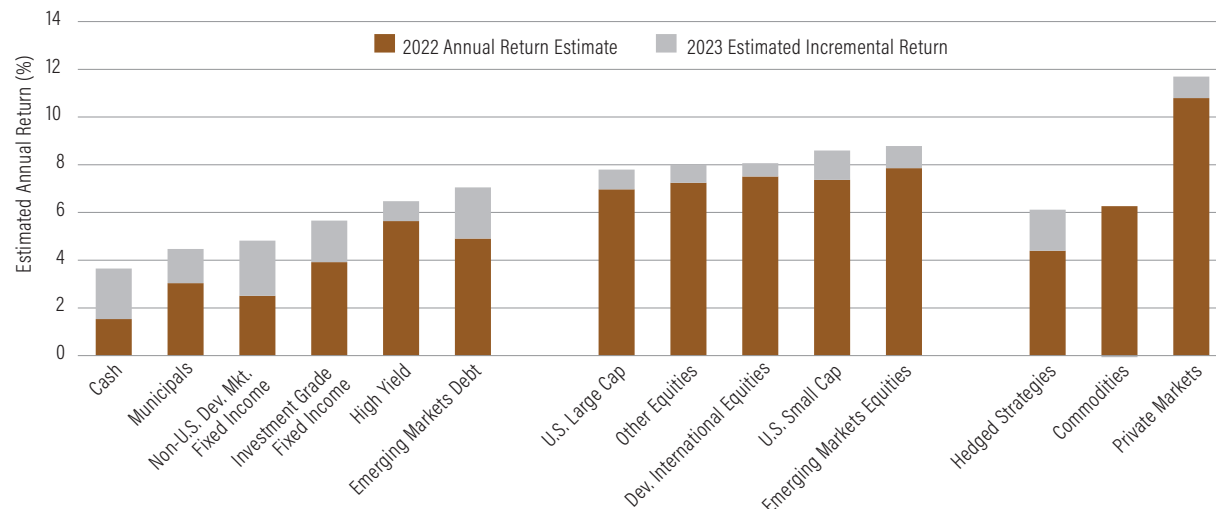
<sup>2</sup> Standard deviation is a statistical measure of the volatility based on the distribution of a set of data from its mean (average value). For example, a portfolio with an average return of 10% and a standard deviation of 15% would return a result between -5% and +25% the majority of the time (68% probability or 1 standard deviation); almost all of the time, the return would be between -20% and +40% (95% probability or 2 standard deviations). If there were 0 standard deviation, then the result would always be 10%. Generally, more aggressive portfolios have a higher standard deviation and more conservative portfolios have a lower standard deviation.

<sup>3</sup> Other Equities may include thematic, global, MLPs and opportunistic equity strategies.

IMPORTANT: Estimates reflect both current and historical market conditions and are reviewed and revised at least annually. These returns and risk estimates are hypothetical in nature and used for discussion purposes only and are not intended to represent, and should not be construed to represent, predictions of future rates of return. Asset classes are represented by benchmarks. Actual returns and volatility may vary significantly. Assumptions are subject to change without notice.

## LONG-TERM RETURN PROFILES

NB Return Assumptions for Sample Asset Classes, 2022 vs. 2023 (%)



Source: Neuberger Berman, Bloomberg Barclays, Cambridge Associates, FactSet. As of 4Q 2022.

**IMPORTANT:** Estimates reflect both current and historical market conditions and are reviewed and revised at least annually. These return estimates are hypothetical in nature and used for discussion purposes only and are not intended to represent, and should not be construed to represent, predictions of future rates of return. Asset classes are represented by benchmarks. Actual returns may vary significantly. Assumptions are subject to change without notice.

## DEVELOPING INVESTMENT SOLUTIONS FOR CLIENTS

As part of our process, the Private Wealth Investment Group leverages broad expertise to help develop investment solutions for U.S.-based private wealth clients. Private Wealth Investment Group works closely with wealth advisors, portfolio managers and clients with the goal of designing and implementing customized and diversified investment plans. By tapping into the extensive investment capabilities across the firm, including the capital markets assumptions, asset allocation and environmental, social and governance disciplines, Private Wealth Investment Group incorporates our best thinking across both public and private markets to construct tax-efficient, multi-asset class portfolios.

Ideally, investment planning should not be a one-off process. Rather, it is important to revisit your overall investment framework on a regular basis in light of your goals. As reflected in our capital market assumptions and more tactical market views, the investment backdrop may change, and so may your priorities, lifestyle and/or family circumstances. Maintaining regular contact with your NB Private Wealth team can help facilitate the process of keeping your asset allocation on track. For more information on the development of a strategic asset allocation and our process, see our article, “Asset Allocation: Reaching for the Summit,” *Investment Quarterly*, Fall 2022.

See disclosures at the end of this publication, which are an important part of this article.

A full-page background image showing a serene landscape at sunset or sunrise. The sun is low on the left, casting a warm orange glow across the sky and reflecting on a body of water in the foreground. Silhouetted mountains and hills surround the water. A paraglider is visible in the sky on the right side.

## EXPLORING OUR APPROACH

To understand our approach to generating capital market assumptions, it may help to highlight some of the factors we employ within certain key asset classes.

In large-cap equities, for example, we consider three underlying drivers of return: (1) earnings growth, (2) yield generated by dividends and buybacks, and (3) change in valuation. Earnings growth is based on projections of Gross Domestic Product, inflation and corporate profit margins from economists' forecasts and market valuations. Dividend/buyback yields are culled from historical trends and rates implied in futures prices. Valuation changes are estimated based on current price-to-earnings ratios compared to historical trends.

Our return assumptions within fixed income consider fundamental drivers within each sub-asset class, including current market yields, defaults and coupon levels, and we look at the potential impact of changes in interest rates and differences in yield compared to U.S. Treasuries based on price changes and reinvested yield, among other factors.

While asset class returns have historically varied widely, their volatility and correlation have tended to be more stable. For this reason, our volatility estimates are generally based on historical levels experienced by each asset class.





# *Planning Focus*

SETTING NEW YEAR'S ASPIRATIONS FOR YOUR FAMILY





**JULIA CHU** Head of Philanthropy and Family Governance Advisory

# *Setting New Year's Aspirations for Your Family*

THE TURN OF THE CALENDAR PRESENTS AN OPPORTUNITY TO REFLECT AND PLAN FOR YOUR FAMILY'S WEALTH, IN MORE WAYS THAN ONE.

New Year's resolutions often focus on personal health and habits, but can extend to the holistic well-being of families as well—which can foster preserving and growing wealth across generations. Here is a framework for optimizing potential opportunities in the new year for your family.

## **Start With the Big Picture**

Wealth management traditionally concerns a family's financial capital, generally consisting of equities, fixed income, private equity, private credit, real estate, interests in operating businesses, residences and tangible assets such as art. However, a family's wealth can consist of other types of capital, which we believe also deserve cultivation and attention:



*We believe family members  
constitute the most  
important assets on the  
family 'balance sheet.'*

**Human capital.** We believe family members constitute the most important assets on the family “balance sheet.” Each has unique gifts and experience, and each can serve as a resource to others. The compromised physical and/or mental health of a family member can significantly affect the decision-making and focus of a family in navigating its future. Focusing on members’ physical, emotional and mental well-being remains critical to many families, particularly during a pandemic. Understanding the diversity and strengths of this reservoir of talent helps families maximize their potential. Just as importantly, proactively addressing harmful behavior, mental illness and substance abuse can also protect and nurture a family’s human capital.

**Intellectual capital.** Families often benefit from a solid baseline of financial and investment literacy. In addition, a family’s wealth of knowledge may extend beyond financial or business topics. Many families benefit from exposure to other subjects (e.g., philanthropy) and a global perspective. Regularly sharing personal and professional lessons can accelerate the whole family’s collective learning curve. This also extends to the practical wisdom acquired by family members in a wide range of areas across generations, for example in family history and lessons learned.

**Social capital.** A family’s formal and informal connections within and outside the local community may also constitute valuable intangible assets—sometimes the most important ones to legacy-minded founders. Prominent families often leverage significant visibility and influence as philanthropists, community leaders and role models. A family’s positive image and reputation can benefit all of its members.

#### **Cultivate Your Family Capital**

In addition to reviewing some of the ways to help grow your family’s financial assets, you may wish to consider the following actionable steps in the new year to cultivate the other “assets” of your family:

#### **HUMAN CAPITAL**

**Start with small steps.** Prioritizing your family’s wellness can help anchor resiliency and cohesion, and position members to protect and steward the family’s wealth for years to come. Healthy habits that families can enjoy together (versus those taken on individually) have a greater chance of incorporation into daily life, and begin with the examples created by parents. Deliberate adjustments, even if minor, in sleep, physical activity, stress management and dining have the potential to inspire other household members and can also foster lifelong habits.

**Regularly eat meals together.** Research has shown the connection between children having frequent dinners with their parents and a decreased risk of their smoking, drinking or using other substances; it has also been suggested that parental engagement fostered around the dinner table can be a potent tool to help parents raise healthy, substance-free children. Family dinners can be a valuable opportunity for teens to talk to their parents, where parents can listen and learn as well. Teens who have frequent family dinners are more likely to say that their parents know a lot about what's "really going on" in their lives; such parental knowledge is associated with decreased incidence of teen substance use. While family members often maintain busy schedules, committing to certain regular meals together, at a realistic cadence, may yield a distinct benefit.

**Plan family recreation.** Families that play together stay together. Whether incorporating a game or movie night into regular rituals, or gathering for an annual ski trip, these activities strengthen the neural family connections that create lifelong memories and ties. Better yet, incorporating children into vacation planning with a fixed budget can help them optimize their spending within a set framework—a critical financial skill.

**Consider mentorship across the extended family.** While parents often initially serve as the primary counselors to their children, their grandparents, aunts, uncles and older cousins can emerge as influential mentors as well. Wisdom can travel across family branches and generational lines, and may be accepted more readily than if provided directly by parents.

**Strengthen your family's contingency planning.** While investors commonly focus on market disruptions and other external factors, internal disruption through death, incapacity and/or divorce can have an outsized and disorienting impact on the family. The Wealth Planning Checklist on page 27 can help your family navigate the shock of such unplanned events.

## INTELLECTUAL CAPITAL

Families readily acknowledge the need for educating future generations on responsible wealth management. In our view, wealth education should be a long-term process of cultivating financial awareness, responsibility and self-sufficiency.

Financial literacy entails the financial knowledge and behavior to confidently pursue individual goals. Our articles on the following topics may help family members identify areas of further interest and learning. Please connect with your NB Private Wealth team for information.

- Finances and Budgeting for Teenagers
- Planning in Your 20s and 30s
- Prepare for and Identify Income Opportunities
- How Does Your Credit Score Impact You?
- Financial Lessons Every Adult Should Be Aware Of

Investment literacy includes the ability to understand the suitability (or non-suitability) of investments and the potential opportunities they provide. Our ongoing podcasts, white papers, blog posts and client events may broaden family members' awareness on a wide array of topics. We urge you to visit the **News and Insights** page of our website ([www.nbprivatewealth.com/en/insights](http://www.nbprivatewealth.com/en/insights)) regularly for perspectives.

## SOCIAL CAPITAL

A family represents more than just its financial assets and extends to its influence, impact and very reputation. Flexing social capital through philanthropy has the potential to enhance a family's connection to its communities and society at large.

### Discover Your Family's Interests

A family conversation often begins with a spirit of curiosity. In charting the new year, you may ask family members the following questions to help focus time and resources:

- If you could change one thing about the world, what would it be?
- How could you make an impact in this area?
- Where would you like to focus your efforts?

This dialogue may also provide an opportunity for you to share your own charitable giving history, to further demonstrate your values within your family.

### Volunteer as a Family

Volunteering opportunities are, of course, not limited to Thanksgiving or other year-end holidays; they exist year-round, and can provide a chance to bond as a family and further develop community ties.



Doing so on a recurring basis can also help to incorporate philanthropy directly into the family's culture of giving and service.

#### **Consider or Optimize Nonprofit Board Service**

As nonprofit boards benefit from the resources and social network of its members, family members may play a significant role by serving on boards in advancing the visibility of the organization.

For those who do not yet serve on boards, family members may consider how their talents could align with the causes they care most about, and become further acquainted with organizations they know well and respect, to ensure a mutual fit.

Those already serving on boards may review their roster of commitments to see if they still want further engagement, for instance in heading a committee.

Finally, to begin the path of community engagement, younger family members may wish to explore junior board service in the areas that most interest them.

#### **Integrate Wealth Planning Into Your Family Goals**

Cultivating your family's human, intellectual and social capital can involve spending financial capital—for education, travel, residences or philanthropy, to name a few examples. In addition, your own lifestyle may have spending peaks and valleys.

For instance, in philanthropy, you may decide to donate a certain amount now and more later, or donate now and retain a certain income stream, with the remainder ultimately passing to charity.

Our wealth planning team can model various scenarios to review and test your comfort level. We believe doing so at the start of the year, before anticipated large expenses, can enhance clarity and confidence in your family's future.

#### **Working With Us**

At NB Private Wealth, our team of planning professionals recognizes that there is no one-size-fits-all approach, and will work with you to design a wealth plan aligned with what matters most to you. We will take the time to evaluate how to build on your current resources to support your lifestyle, enhance your wealth and fulfill your purpose. By partnering with you and your various advisors, our team can provide insight into your total financial picture and create a plan that can evolve and change as your life does.

See disclosures at the end of this publication, which are an important part of this article.



# *2023 Wealth Planning Checklist*

The start of a new year can be an opportune time to consider your wealth plan and whether you are on track toward achieving your financial goals. A first step in this process is to inventory the components of your planning strategy. Here, we suggest 12 key questions you can ask yourself and explain the reasons why they are important.

**1. Do you have a Will or Revocable Trust to properly dispose of your estate that names fiduciaries (such as guardians, executors and trustees)? If so, when was the last time it was reviewed or updated?**

These documents represent your ultimate “financial plan” and are important for both tax and non-tax purposes.

**2. Do you have Living Wills, Health Care Proxies and Powers of Attorney?**

Sometimes overlooked, these documents allow you to name an “agent” to act on your behalf for either medical or business purposes if you’re incapacitated or otherwise unable to act.

**3. How do you hold title to assets?**

A common estate planning mistake occurs when married couples hold all of their assets as “joint tenants with rights of survivorship”; it may make sense for second homes and other vacation/rental properties to be owned by a limited liability company instead of in your name.

**4. Have you properly named designated beneficiaries for your retirement accounts and life insurance?**

Failing to do so can have unintended tax consequences in disallowing your ability to “stretch” retirement distributions over longer periods of time; in our view, life insurance should often be owned by an Irrevocable Life Insurance Trust (ILIT).

**5. Do you own term life insurance?**

Term policies can be a relatively inexpensive way to provide “income replacement” if an unexpected death occurs; in addition, permanent insurance can be employed as part of overall estate planning.

**6. Do you own property and casualty insurance?**

This type of insurance can be valuable for both liability and property protection purposes.

**7. Are you saving for education through a 529 plan?**

These state-sponsored plans allow you to save without tax consequences as long as distributions are used for “qualified educational expenses”; in some locations, contributions also provide a state income tax deduction.

**8. Are you contributing the maximum amount to retirement accounts?**

For 2023, you may contribute up to \$22,500 (\$30,000 if age 50 or older) to a company 401(k) plan and \$6,500 to an IRA (\$7,500 if age 50 or older).

**9. Do you have a large estate (generally, for 2023, \$12.9 million per individual or \$25.8 million per married couple)?**

If so, you may wish to take advantage of advanced estate planning strategies to minimize your future estate tax burden.

**10. Do you contribute to charity?**

A donor-advised fund can provide a simple and convenient way to satisfy your philanthropic objectives while minimizing your income tax burden.

**11. Do you have a financial plan?**

A number of factors should be evaluated to answer a common question: Do I have enough to retire? Your life expectancy, retirement age, cash-flow needs/large expenditures, investment assumptions, and much more should be considered.

**12. Who are your advisors?**

A complete list of your tax, legal, accounting, insurance and other financial advisors (complete with phone numbers and email addresses) should be available to other family members with instructions in the event of your death.

These are only some of the questions that may arise as you seek to assess your current situation and how well positioned you and your family are for the future. With the start to the new year, we encourage you to touch base with your advisors to explore appropriate planning steps. Your team at NB Private Wealth is always available to assist in these conversations.

See disclosures at the end of this publication, which are an important part of this article.

# *Sector Spotlight*

PRIVATE EQUITY: NEW VALUE IN SECONDARIES



**PHILIPP PATSCHKOWSKI**, Managing Director, Secondary Private Equity

**BEN PERL**, Global Co-Head of Secondary Private Equity

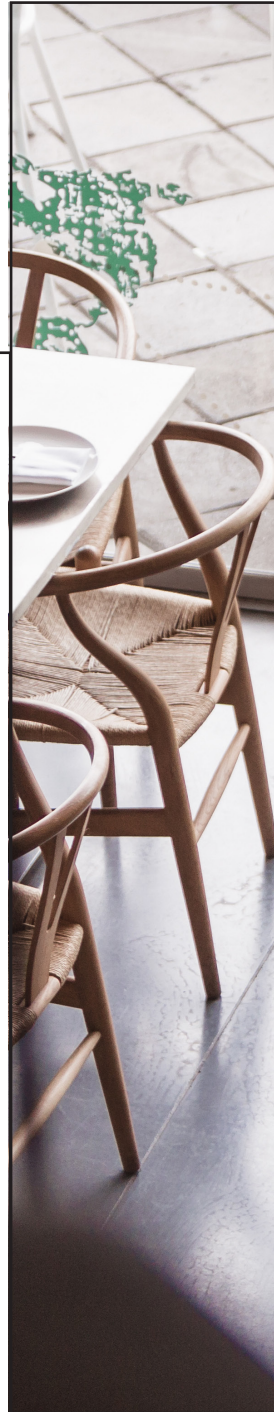
## *Private Equity: New Value in Secondaries*

THE SUPPLY OF SECONDARY TRANSACTIONS INITIATED BY PRIVATE EQUITY MANAGERS HAS BEEN OUTSTRIPPING THE CAPITAL AVAILABLE FOR SUCH TRANSACTIONS—WHICH WE BELIEVE IS GOOD NEWS FOR SECONDARY INVESTORS.

Many private equity investors entered 2022 with a major challenge: Their private investments performed better, and were drawn down faster, than anticipated. Later, economic headwinds roiled public markets and limited exit doors, leaving many investors overallocated to private equity.

Against this backdrop, the secondary market is one of the few options within private equity for liquidity—which is in greater demand than at any other time in recent years. However, available capital in the secondary markets generally hasn't kept pace with deal volume, thereby creating an attractive supply and demand imbalance that we believe will persist for a period of time.

To adapt, general partners (GPs) of private equity funds have increasingly led secondary transactions, in contrast to the sales typically initiated by limited partners (LPs). In the pages that follow, we briefly explore the rise of GP-led secondaries and why we believe they offer attractive opportunities for discerning investors.







## GP-LED DEALS TAKE CENTER STAGE

Today, GP-led secondaries are among the fastest-growing alternative asset classes. Transaction volumes have roughly quintupled over the past five years as traditional primary private equity fund managers seek to hold onto portfolio companies to continue creating value while offering greater liquidity to their LPs.

So-called “continuation funds” account for a vast majority (about 80%) of GP-led transactions. In this structure, a GP decides to sell one or more portfolio companies from a typical, 10-year primary fund to a new investment vehicle—the continuation fund—managed by the same GP and set up in negotiation with secondary investors. We believe that GPs are increasingly turning to the secondary market to structure continuation funds because of several important benefits relative to traditional exit options (i.e., a sale to another private equity firm, an initial public offering or a sale to a strategic buyer):

- LPs in the primary fund can either cash out their current stakes or roll them into the new fund to extract additional value from select, high-conviction assets, allowing the individual LP to manage its specific duration and cash flow objectives.

- GPs get extra time and capital to create more value in some of their most successful portfolio companies. Historically, the best performers were often sold to competing private equity firms, often generating strong results for the acquirer. Today, rather than choosing to sell their best holdings, GPs are increasingly partnering with investors in the secondary market to create liquidity.

## SECONDARIES: KEY BENEFITS

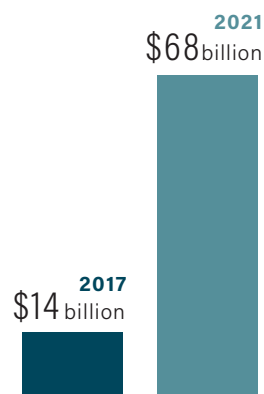
In addition to providing the advantages noted above to legacy investors and a fund's GP, we believe that GP-led secondary transactions can be appealing to secondary investors for a variety of reasons. Broadly speaking, they can provide a competitive potential return profile combined with lower risk potential than traditional primary funds, driven by these characteristics:

- **Reduced execution risk.** Unlike primary funds that commit capital with limited visibility as to how it will ultimately be put to work, secondary partnerships can analyze a portfolio's existing holdings and make more informed investment decisions. The GPs that secondary investors partner with often have a deep, hands-on knowledge of the company, industry and management teams, given they already own the asset.

## *GP-Led Secondary Transaction Volumes*

**48%**

COMPOUND  
ANNUAL  
GROWTH RATE



Source: Jefferies Global Secondary Market Review. Data as of October 2022.



- **Shorter investment hold periods and quicker potential for the return of capital.** Secondary investors often access mature investments already held by GPs for some time and therefore may be closer to exit.
- **Greater diversification.** A secondary private equity fund might contain 50 to 100+ underlying holdings, compared with 10 to 20 in a primary fund.
- **Alignment of interests.** In more traditional funds, the seller is typically focused on maximizing price. In GP-led transactions, the seller is also a purchaser alongside limited partners, encouraging fair and transparent price discovery.
- **Limited leverage.** Portfolio companies within GP-led funds often have reduced leverage from previous levels, benefiting the new buyers.

These risk-mitigating attributes may be particularly compelling in today's challenging investing environment. We believe we are also entering a compelling tactical opportunity in the space as the conditions for a buyer-friendly secondary market are taking shape.

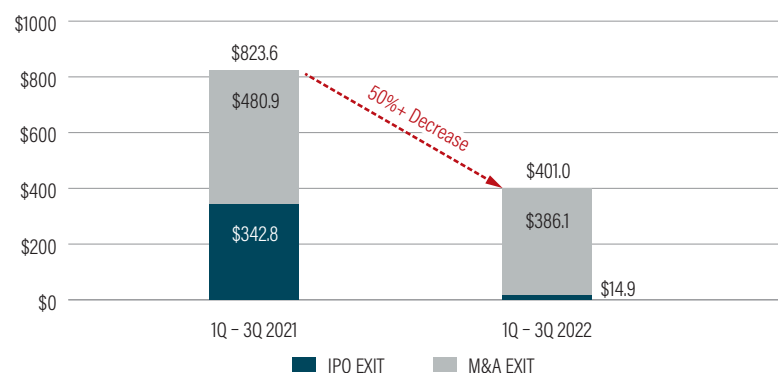
#### A BUYER-FRIENDLY MARKET

With that in mind, despite the rapid growth of GP-led transactions, we believe this market has plenty of additional runway as more GPs and LPs desire alternative liquidity solutions. We also believe current market conditions will likely accelerate the above-mentioned long-term growth trend and create even more attractive opportunities for experienced secondary investors as there remains a limited supply of capital to meet the increased demand for liquidity.

- **Fewer exit routes resulting in demand for liquidity.** The combination of private equity's strong performance in 2021 and the recent public market downturn has left many primary-fund LPs overallocated to private markets.

#### EXIT PROCEEDS FOR GLOBAL PRIVATE EQUITY-BACKED ASSETS

(\$ Billions)



Source: PitchBook, as of Q3 2022. Exits reflect U.S. and Europe only.

## Key Terms

**General partner (GP):** The portfolio manager of a private equity fund.

**Limited partner (LP):** An investor in a private equity fund.

**Primary fund:** A private equity fund that makes investments across multiple companies; the fund's timeframe may be up to 10 years, with investors making commitments upfront and capital calls taking place gradually to put those commitments to work as investments are made.

**Secondary market transactions ("secondaries"):** Buying and selling of preexisting investor commitments to primary private equity funds, typically initiated by LPs, as well as investing in GP-led secondary transactions.

**Secondary fund:** A private equity fund dedicated to secondary market transactions, focused on the purchase of more mature or seasoned limited partnership stakes, historically from other limited partners, but now more frequently as part of GP-led transactions.

**GP-led secondary:** A secondary market transaction initiated by the general partner. The most common form of a GP-led secondary is a **continuation fund**, which allows the GP to transfer one or more of its portfolio companies to a new fund formed by the same GP and a new set of LPs.

Meanwhile, the economic headwinds—including persistent inflation, spiking interest rates and geopolitical turmoil—has limited off-ramps for many PE investors, resulting in an estimated 50% drop in private equity exits through Q3 2022 (see display on page 33). Continuation funds are helping GPs balance conflicting investor demand for liquidity and their desire for more value creation from portfolio investments.

- **Dearth of dry powder.** Slow fundraising by secondaries funds continues to lag the surging supply of assets.
- **Talent deficit.** Growth of the GP-led secondary market has outpaced the investment talent pool, in our view. New entrants to the GP-led market often need to hire staff that can take years to train.

As deal supply continues to outpace available capital, we believe experienced secondary investors will have a good chance to be highly selective in building attractive portfolios of high-quality assets managed by blue-chip GPs at reasonable valuations.

#### **MAKING THE MOST OF THE OPPORTUNITY**

In our view, market dynamics and the acceleration of GP-led secondaries deals are creating a meaningful opportunity for investors that can allow for the allocation of capital to private equity in a risk-managed framework. Secondaries generally have what we consider compelling attributes for investors interested in exposure to more mature private equity investments, resulting in earlier distributions and more clarity as to underlying company risk and opportunity. Still, the area can be complex, requiring meaningful expertise and experience from secondary managers to help capitalize on this important trend in private equity, as well as current scarcity of capital and market volatility.

# *Highlights 1Q23*

FROM THE ASSET ALLOCATION COMMITTEE

Markets could face volatility over the next 12 months amid slower economic growth, high (though declining) inflation and tight monetary policy.

## **EQUITIES**

Given decelerating growth, actual and estimated corporate earnings are likely to ease in the coming months. We continue to favor more defensive equities with less exposure to market dynamics; value over growth with a tilt toward quality, income-oriented names; and U.S. over foreign markets.

## **FIXED INCOME**

Fixed income securities now offer far more generous yields than the norm over the past 15 years. We favor investment grade bonds given their improved risk-reward profile, and have a neutral view of high yield (although with a favorable view of higher quality issues within the category). Emerging markets are a neutral, with attractive relative yields and the potential to benefit from a softening U.S. dollar and China reopening. Municipal bonds offer favorable after-tax yields for those in higher tax brackets.

## **REAL AND ALTERNATIVE ASSETS**

We see a growing role for alternative investments that have tended to provide uncorrelated returns, mitigate volatility of traditional asset classes or take advantage of that volatility. Commodities continue to have appeal given supply limitations, although recession risks are building. We also favor private real estate and, in private equity, we see investment potential in reduced valuations, including among secondaries.

All views are over the next 12 months unless otherwise stated. See disclosures at the end of this publication, which include additional information regarding the Asset Allocation Committee and the views expressed.



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**NEUBERGER BERMAN**  
1290 Avenue of the Americas  
New York, NY 10104-0001