Quarterly Investment Perspective

Higher Volatility, Steady Outlook

BESSEMER TRUST

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Executive Summary

- The third quarter saw increased market volatility, a new presidential candidate, a substantial Federal Reserve interest rate cut, and strong corporate earnings. These developments, among others, underscore the uniqueness of this economic cycle.
- We continue to expect lower inflation and interest rates and a steady slowdown in economic growth with a recession avoided. But we are attuned to economic, political, and geopolitical risks, and continue to filter out noise we believe is unlikely to have a lasting market impact — including the upcoming U.S. presidential election.
- Most important for our outlook is that companies continue to deliver earnings in a more supportive monetary policy environment. Also important are themes experiencing tailwinds insulated from the macroeconomic outlook. We highlight one here: cybersecurity.

The third quarter was not a quiet one: Volatility increased notably in early August, reaching its highest level since the pandemic, and Japanese equities faced their worst day since 1987 before rebounding. There is a new presidential candidate, the Fed started an easing cycle with a robust 50 basis point cut, and earnings for U.S. companies continued at a strong pace amid shifting dynamics. In all, a representative Balanced Growth portfolio increased roughly 6% in the quarter, bringing year-to-date gains to approximately 15%, outpacing its benchmark by one percentage point.

In this Quarterly Investment Perspective, we share our views on the additional ways this economic cycle is unique, while providing evidence supporting our view that the economy will continue to grow. The pandemic and resulting unprecedented fiscal and monetary interventions created numerous distortions that rendered traditional economic analysis less effective. As a result, predictions of an imminent recession haven't materialized as conflicting economic data releases often distracted the consensus from what mattered most. Amid the shifting market narrative that ranged from inflation and economic growth being far too hot in the first quarter to calls for an imminent recession in early August, our outlook has been consistent: Since the end of 2023, we predicted lower inflation, falling interest rates, and a steady slowdown in economic growth. This view has supported our continued overweight to equities, which has

Exhibit 1: Assessment of Economic Data Points

Key Takeaway: Key indicators have slowed but remain above recessionary levels.

Expansion	Slowing	Contraction
Retail Sales ISM Services Earnings Growth Corporate Bond Spreads	JOLTS Job Openings Jobless Claims Consumer Confidence Credit Availability	ISM Manufacturing Existing Home Sales

Consumer	Overall resilient, but pockets of weakness remain.
Employment	Historically low unemployment rate increasing, as labor supply increases and demand softens.
Manufacturing vs. Services	Manufacturing continues to contract; services are in a steady expansion.
Housing	Supply and demand imbalances have kept prices high, though elevated interest rates have slowed activity.

As of September 30, 2024. Source: Bessemer Trust

been additive to our performance over the period. Looking at the current dynamics, we continue to see a balanced outlook, with many important indicators pointing to growth, even if some signal a moderation of the rate of expansion (Exhibit 1).

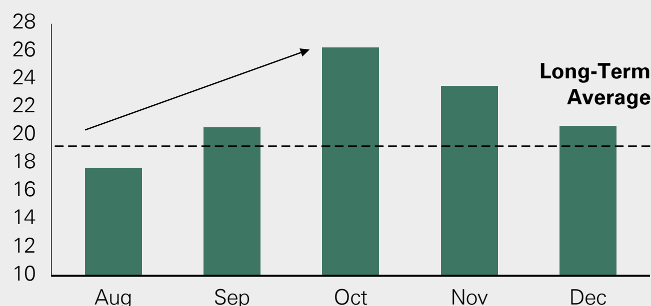
We are attuned to rising economic, political, and geopolitical risks, and continue to filter through noise that we believe will not have a significant or lasting impact on markets. The upcoming U.S. presidential election will surely dominate news headlines in the coming weeks, and we expect volatility to continue to creep higher in October as is typical in election years (Exhibit 2).

A divided government is the most likely outcome, in our view, limiting the major policy implications of the results. Indeed, in most years, including election years, November and December are seasonally strong months for the markets (Exhibit 3).

We see the most important implications for individual sectors, with financials and energy to benefit alongside Republican wins and "green" investments and multinationals supported in scenarios favoring Democrats. We have numerous communications lined up for the run-up and aftermath of the election, including our recent Investment Insights, "2024 U.S. Presidential Election and Markets Q&A," so please be in touch with your advisor for additional details as we move along the election cycle.

Exhibit 2: Average Monthly VIX in Election Years (1990–2023)

Key Takeaway: Volatility tends to increase through October in election years and subside thereafter.



As of December 31, 2023. The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market.
Source: Bloomberg

Most important for our outlook is the fact that we see companies continuing to deliver earnings in a more favorable monetary policy environment. Over the next 16 months, the market is expecting eight 25 basis point rate cuts, along with earnings growth of 10% for 2024 and 15% for 2025.

It is rare to see more than 100 basis points of rate cuts alongside double-digit earnings growth. In fact, this has only happened once in over 50 years — in 1984 — a year that shares many similarities with the current economic environment, and it occurred during the middle of a bull market.

Also key are themes that are experiencing tailwinds that have very little to do with the macroeconomic outlook. We highlighted these themes from our portfolios in our last Quarterly Investment Perspective, and in this edition, we take a deeper look at cybersecurity.

Navigating Markets Amid Evolving Economic Signals

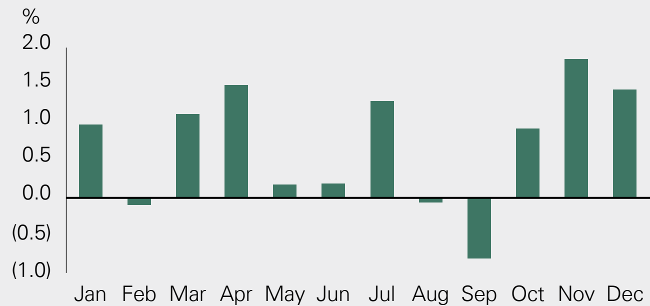
The Uniqueness of This Cycle: It's Actually Different This Time

In 1966, MIT Professor Paul Samuelson famously stated, "Macroeconomists have successfully predicted nine of the last five recessions." More than a joke, Mr. Samuelson highlights both the proclivity for risk aversion as well as the general challenge of accurate economic forecasting. The uniqueness of the current cycle has made forecasting even more difficult, perhaps leading to the rapid shifts in market narrative we discuss above. Below, we highlight several macroeconomic indicators that are behaving differently in this cycle.

The Sahm Rule: The Sahm Rule triggers a warning when the three-month average unemployment rate rises by at least 0.50% above its 12-month low, signaling a potential recession. In August 2024, this rule was narrowly triggered in part due to a rise in the labor force (largely caused by unusually high immigration). Estimates show that more than 35% of the increase in the unemployment rate since 2023 has been driven by an increase in the labor force. Although we are seeing clear signs of labor market softening in various indicators, the rise in unemployment is not necessarily a sign of acute

Exhibit 3: S&P 500 Average Monthly Returns (1950–2023)

Key Takeaway: November and December tend to be strong months for equities.



As of December 31, 2023. Source: Bloomberg

economic distress but rather of an expanding workforce. This nuance may reduce the reliability of the Sahm Rule as a recession predictor in the current context.

Housing: A drop in existing home sales of nearly two million units from the post-Great Financial Crisis (GFC), excluding COVID, high would be a bright red flag in a typical cycle. However, traditional supply and demand dynamics appear disrupted. Despite elevated mortgage rates leading to record-low affordability and diminished housing demand, home prices reached new highs in July. Unique to this cycle is the interest rate “lock-in effect” — when homeowners with relatively low fixed-rate mortgages are reluctant to relinquish them for new loans at higher rates. This dynamic has simultaneously constrained housing supply, preserved many households’ purchasing power, and increased household wealth levels given the rise in home prices. So, although certain measures of housing market activity would traditionally indicate an imminent economic contraction, the unique dynamics of this cycle have obscured that signal. For more detail, please see our recently published Investment Insights, “Housing Market Update in Five Pictures: Why This Cycle Is Different.”

Leading Economic Index: The Conference Board publishes an index of leading economic indicators that includes variables such as initial unemployment claims, building permits, credit conditions, and manufacturing activity among others. The Conference Board first announced that the index signaled a recession in July of 2022. In February 2024, the board abandoned its forecast. Since its 1960 inception, the year-over-year change in the Leading Economic Index has never been this weak without a recession, hitting a low of -8% in October of 2023. Regarding manufacturing specifically, the U.S. Manufacturing PMI dropped below 50 in November 2022, indicating a contraction in the manufacturing sector. It is still indicating contraction today, after only briefly moving above 50 in March of this year. This marks the longest period of contraction outside of a formal recession since data tracking began. This is notable because, despite a prolonged weakness in manufacturing, the broader U.S. economy continued to grow, driven by the expansion of the service sector from a resilient U.S. consumer. Continued demand for services, the Federal Reserve’s actions, and post-pandemic fiscal policies played a role in containing the slowdown, even as manufacturing struggled.

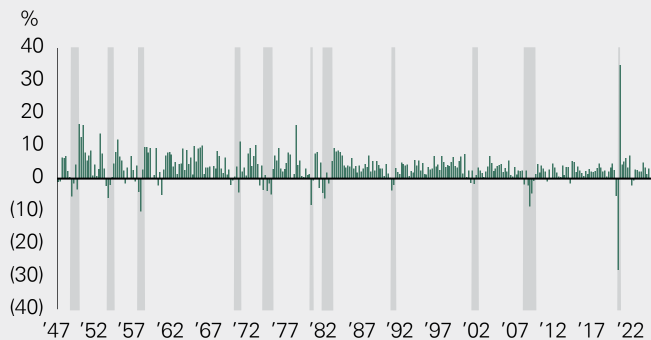
Recession Doesn’t Mean Crisis

Although our base case continues to be a controlled slowdown that avoids recession, we acknowledge that risks rise as growth continues to slow. We believe, if the economy were to tip into recession, the contraction would be mild compared to recent memory. Given the inherent difficulty in forecasting recessions, combined with the reality of the uniqueness of the current cycle, we think it is important to understand the history of economic contractions. Many investors today may equate economic recessions to economic and market crises. In recent history, that has been true, with the Great Financial Crisis (GFC) and COVID-19 pandemic creating a negative recency bias. However, taking a more complete view of market history paints a clearer picture of what to expect during a more traditional growth contraction. As long-term investors, such perspective is critical when managing the emotions associated with the unpredictability of any economic cycle.

For context, when excluding the GFC and the COVID-19 pandemic, recessions tend to last about nine to 10 months, with milder GDP contractions of 2.0%, a 25% market drop, and a quicker recovery time of 12 to 15 months. The GFC and the COVID-19 pandemic were more severe, perhaps skewing our perception. The GFC extended over 18 months, with a deep 4.3% GDP

Exhibit 4: U.S. Real GDP – Actual/Estimate

Key Takeaway: In recent years, recessions have occurred less frequently.



As of June 30, 2024. Source: FactSet

contraction, a 57% market drop, and a recovery period of four years. Although different given the nature of the catalyst, the COVID-19 recession was sharp but brief, marked by a swift 34% market drop, a 7.5% drop in GDP, and an unusually rapid five-month recovery. That said, one may argue that various segments of the economy experienced rolling recessions in various industries in recent years.

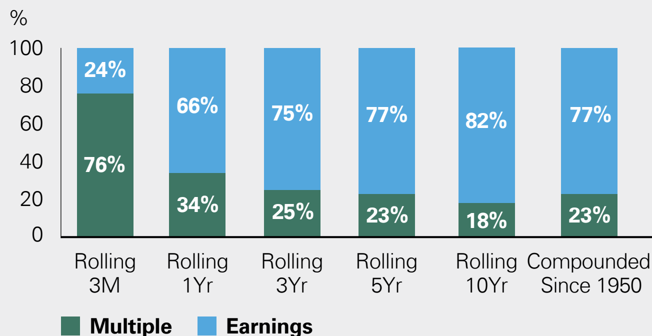
It is also worth highlighting that recessions have become less frequent. For example, from 1945 to the mid-1980s the U.S. economy entered a recession once every four years, on average (Exhibit 4). Over time, evolving economic policies (both fiscal and monetary), structural economic changes (more services oriented), and advancements in technology (higher productivity and better inventory management) have helped make recessions less common. Overall, from the mid-1980s to today, there have been only four recessions, marking a significant decrease in frequency compared to earlier periods. The time between recessions has stretched to an average of around eight to 10 years, a notable improvement in economic stability. Forecasters often attempt to predict the next recession, but the truth is that economic contractions are no longer particularly common.

Why do we believe, even if a recession were to occur, that it would be relatively mild? First, household debt-to-income ratios are approximately 97% as of Q2 2024, which, while elevated, remains below the peaks seen before the 2008 financial crisis. The household debt service ratio (the percentage of disposable income that goes toward paying interest on debt) remains low, at around 9.8% as of mid-2024, compared to over 13% in 2007. This indicates that consumers are managing their debt levels prudently and can comfortably meet their debt payment obligations, providing a cushion against economic downturns.

Corporate balance sheets are also strong, with U.S. non-financial corporations holding over $1.9 trillion in cash as of Q2 2024, allowing them to manage downturns more effectively. The average debt-to-equity ratio for S&P 500 companies is around 1.3x, which is lower than the historical average. This indicates that companies are not overly reliant on debt, reducing their financial risk and vulnerability to unexpected increases in borrowing costs. Moreover, the banking sector's Tier 1 capital ratio averages around 15% in 2024, significantly higher than the 10% levels seen before the 2008 financial crisis, reducing the likelihood of a financial crisis exacerbating a recession. The corporate bond default rate remains low, at around 2.5% as of mid-2024, compared to historical averages of around 4%. This low default rate suggests that most companies are managing their debt obligations effectively, with fewer firms facing financial distress. Lastly, the Federal Reserve has shown a willingness to deploy monetary tools, as evidenced by its rapid interest rate cuts in 2020 and ongoing readiness to use quantitative easing to mitigate

Exhibit 5: S&P Price Return Contribution (1950–2024)

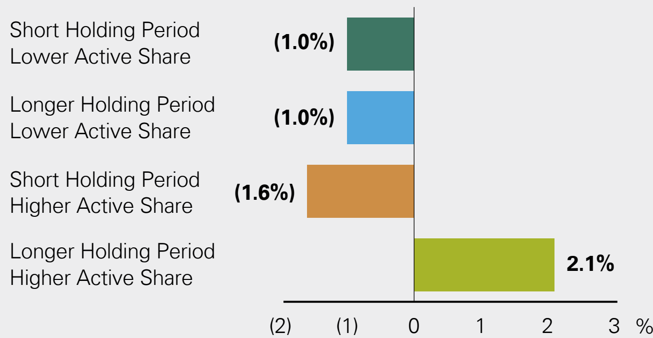
Key Takeaway: In the long term, earnings growth is the primary driver of returns.



As of September 23, 2024. Source: FactSet

Exhibit 6: Active U.S. Equity Funds Returns Relative to Benchmark

Key Takeaway: Net of fees, managers with concentrated portfolios (high active share) and longer holding periods (lower turnover) outperform.



Source: Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently (2016), Cremers and Pareek. Actively managed all-equity U.S. retail mutual funds from the CRSP Survivor-Bias-Free U.S. Mutual Fund Database with greater than $10 million in AUM from 1994–2013. Institutional institutional investor portfolios from Thomson Financial CDA/Spectrum database of SEC 13F filings (institutional investors with greater than $100 million of securities under management report their holdings) from 1986 to 2012. "Longer Holding Period" is defined as greater than two years while "Short Holding Period" is less than two years. "Higher Active Share" reflects 90+% while "Lower Active Share" is less than 90%.

the depth of any economic contraction. Together, these factors suggest that while a recession may occur, it is likely to be less severe than those seen in recent years.

We continue to believe that our active approach, combined with a longer investment horizon, gives our portfolios a structural advantage. Short-term stock returns are largely driven by changes in valuations (shaped by the business cycle), while longer-term returns are driven by fundamentals (Exhibit 5).

Academic work shows the value of being both active and long-term oriented. In a 2016 paper, the authors use active share and holding period to demonstrate the value of this concept empirically[1] (Exhibit 6). The results of their study demonstrated the difficulty of implementing a combination of patient and high active share strategies, primarily due to structural market realities (human bias to chase return, low switching costs, fund manager fee structures based on AUM) that incentivize short-term investing. We can use time to our advantage to defend against, and dilute away, certain cyclical headwinds from style, factor, or multiple fluctuation.

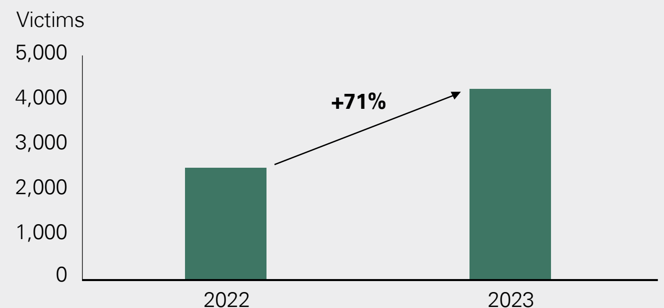
Cybersecurity

Our investment approach emphasizes identifying large secular trends that can further insulate returns from the gyrations of the economic cycle and capitalize on long-term opportunities. Investment opportunities with large, stable, demand drivers can provide both ballast and long-term growth to our portfolios. The rising importance of cybersecurity is a key example of one such theme.

We can perhaps track the initial increase in cyber threats to a single innovation — the iPhone in 2007. Our habits as technology consumers changed dramatically in subsequent years: 90% of us now have a smartphone, 75% of us use at least one social media app on a regular basis, and 70% of all consumer data now resides in the cloud versus on a personal device. Said simply, the "attack surface" has significantly expanded. Over time, this has created a massive hacking economy, with organized crime groups now similar to traditional crime organizations. They hire, recruit, and have year-end goals. Investment in cybersecurity has become essential for protecting sensitive data, maintaining business continuity, and safeguarding against evolving cyber threats. In recent years, several

Exhibit 7: Number of Ransomware Victims (Corporations)

Key Takeaway: Growth in new technologies is expanding the reach of cyberattacks.

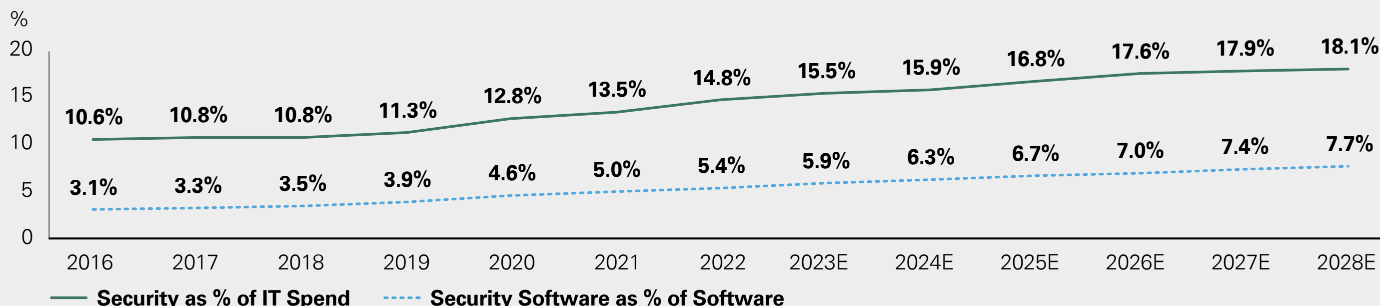


As of December 31, 2023. Source: Morgan Stanley, Recorded Future

[1] Cremers, K. J. Martijn and Pareek, Ankur, Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently (December 1, 2015). Journal of Financial Economics (JFE).

Exhibit 8: Security Spending as a Percentage of Total IT and Software Spend

Key Takeaway: Cybersecurity increasingly takes a greater share of total technology spending.



As of February 14, 2023. Source: Gartner, Goldman Sachs

high-profile breaches and an overall rise in corporations that have fallen victim to cyberattacks underscored the critical requirement for robust digital defenses (Exhibit 7).

The frequency and scale of cybercrimes have grown rapidly, with total damages estimated to cost the global economy more than $9.5 trillion in 2024 alone. The damages include stolen money, stolen intellectual property, loss of data, and loss of productivity. Prominent examples include ransomware attacks that disrupted a critical service provider in the automobile industry, CDK Global, and in turn caused widespread disruption across the sector in North America. The healthcare exchanges in the U.S. were in turmoil for weeks when Change Healthcare fell victim to a ransomware attack. Last month, it was reported that a background-check company, National Public Data, had exposed more than 2.9 billion records of U.S., British, and Canadian citizens.

Public Market Investment Opportunities in Cybersecurity

As a result of the ever-increasing threat, security spending continues to grow steadily as a percentage of total information technology and software spending (Exhibit 8). Consequently, revenues for publicly traded cybersecurity-related companies have also increased significantly (Exhibit 9).

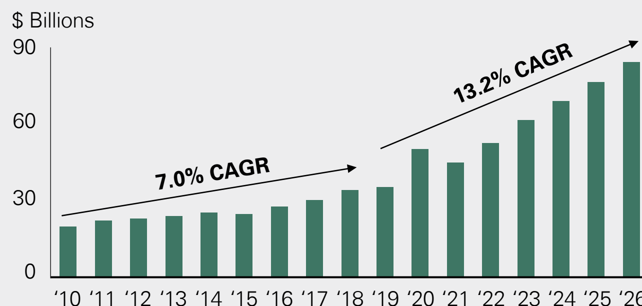
Given these persistent tailwinds, Bessemer portfolio managers have identified several investment opportunities. For example, Fortinet (FTNT) is a leading security vendor, particularly for network firewalls, focusing on small to medium size businesses (historically an underserved market segment). The company is founder-led: Ken and Michael Xie hold 17% of the stock, aligning them with shareholders, and the company has compounded revenue at a rate of 24% since 2018.

Private Equity Investment Opportunities in Cybersecurity

Private equity managers are addressing the growing need for investment in cybersecurity, from venture capital firms seeding the startups that will develop

Exhibit 9: Public Cybersecurity Revenue

Key Takeaway: As cyber threats grow, companies expect cybersecurity revenue to increase.



As of August 31, 2024. Public cybersecurity revenue excludes Microsoft.
Source: FactSet

tomorrow's cutting-edge technologies, to growth buyout managers who acquire and scale the industry's emerging leaders (Exhibit 10).

One example of this trend is Claroty, a venture-backed company specializing in securing industrial control systems, operational technology, and Internet of Things environments. The company's focus is highly aligned with a recent report released by the U.S. Government Accountability Office highlighting the security vulnerabilities of these systems following the detection of malware inside U.S. energy, water, and other critical systems. Claroty is also benefiting from the market shift away from disparate point solutions toward bundled platform offerings that can address network defense, threat detection, and other cybersecurity needs within one deployment.

Generative AI Cannot Scale Without Embedded Cybersecurity

The rise of generative artificial intelligence has revealed the need for new approaches to cybersecurity. Many large language models rely on open-source data, which introduces vulnerabilities to malware and otherwise maliciously or inadvertently compromised code and data. Consequently, to engage generative AI securely, enterprises require automated and adaptable security that can identify and neutralize threats at scale in real time. Venture capital managers are investing in the tools and applications that will be deployed against the growing risks related to large-scale generative AI rollouts in global enterprises.

As one example, Protect AI has raised significant venture financing to build a suite of services that large companies and governments can use to prepare their infrastructure to onboard generative AI capabilities. These services include detecting and mitigating data leakage, "prompt injection" attacks, and integrity breaches. This security-first approach provides end-to-end visibility, governance, and remediation tools that have developed to replace legacy security tactics in response to the rapid transformational shift to generative AI. As a new category of AI-native cybersecurity is created, a robust landscape of specialized companies is emerging, presenting significant financial opportunity for private markets investors.

Exhibit 10: Private Investments in the Cybersecurity Space

Key Takeaway: Private companies are at the forefront of cybersecurity innovation, developing cutting-edge technologies to combat increasingly sophisticated cyber threats.

Private Equity Firm	Cybersecurity Investment	End Market
Accel	Corelight	Network Detection
Bessemer Venture Partners	Claroty	Operational Technology
Boldstart	Protect AI	Generative AI
Founders Fund	Resilience Cyber Insurance	Ransomware Mitigation
Genstar	ACA Group	Cybersecurity Consulting
Lightspeed	Rubrik	Data Security
SignalFire	Horizon3.ai	Autonomous Security
TA	DigiCert	Trust Certification
TLV	Bonfy.AI	Generative AI
Unusual	Arctic Wolf	Security Operations

As of September 30, 2024. Source: Bessemer Trust

Parting Thoughts

Thank you for reading our latest Quarterly Investment Perspective. As always, we will continue to monitor economic and market trends and provide our latest thinking in written communications, videos, and interactive forums. We welcome your engagement. Please contact your client advisor with any questions you may have.

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