

# Equity roundup



A summary of  
investment views  
across equity strategies

## Selected themes, trends, projections, and expectations

### Domestic

- We believe economic growth will provide good support for small-cap stocks. The revenue opportunity remains strong for small-caps, in part because they are highly leveraged to the U.S. economy.

### Core equity

- Among the potential negative factors we will be monitoring in 2016, we will pay close attention to continued moderation in consumer spending. We will also be closely watching sluggishness in the industrial side of the economy, which is stuck in a waiting game for new orders to improve.
- Given the current macroeconomic backdrop, small-cap core stocks could be especially sensitive to earnings misses.

### Growth equity

- Years of excessive debt creation and currency printing has encouraged a worldwide build-up of physical capacity. While some of it may have produced good returns or economic utility, it has possibly reached a point where incremental returns and economic benefits may not exist — thereby creating a drag on the global economy. The proliferation of such “malinvestment” around the world is hard to know, but we believe that it’s real, and is in the process of rationalization.
- Years after the global financial crisis, global deleveraging is still taking a toll. The evidence includes a breakdown in commodity prices, a slowdown in worldwide economic growth, and an appreciating dollar. These events have occurred simultaneously and in a short period of time, creating negative implications for economic growth and capital markets.
- In an economic environment in which growth may seem hard to come by, we believe there are areas of secular growth and well-positioned companies that could potentially add value to our portfolios. Wireless technology is one example. Accessing data through wireless devices is changing the way the world communicates.

### Large-cap value equity

- Possible risks facing stocks include excessive debt, uncertainty about monetary policy, slow economic growth, inflated asset prices, weak growth in corporate revenues (and earnings), and geopolitical instability. That said, the fall 2015 market rebound has taken us past what has traditionally been a difficult seasonal period for stocks. So, perhaps some of these risks will remain contained in the near term.
- We're beginning to see very early signs of a possible bottoming process in crude oil, and we're doing new fundamental research, based on adjusted crude oil price assumptions, for all of our energy holdings.
- Our emphasis is on defensive portfolio positioning. We have overweights in naturally defensive sectors like healthcare, consumer staples, and telecommunications. And we have underweights in some of the economically sensitive sectors, like consumer discretionary and financials.

### Small/mid-cap value equity

- The U.S. economy will likely continue its current rate of modest growth, at an annualized rate somewhere between 2% and 3%.
- Consumers spending on big-ticket items, which has shown recent signs of strength, could be offset by a decline in capital spending.
- We believe that when the Federal Reserve does raise interest rates, it will be at a slow, deliberate pace, returning to a normalized level. Therefore, we think investor nervousness at the prospect of a rate increase appears poorly placed.
- China is a major concern. Uncertainty prevails about the country's economic growth.
- In our view, small-caps are in good financial shape overall, as companies have put more of their capital to work on share buybacks and shareholder dividends.

### Global

- In China and India, reform measures will dictate the sectors to favor, while corporate earnings will help determine the time when value is most attractive.
- In our view, Asia generally remains a growth proposition, especially in light of a subdued global growth outlook and a slowdown across other emerging markets.
- In China, we expect more stability in 2016. We expect factors that slowed growth in 2015 — including slowing fixed-asset investment and a weak property market — to become more manageable in 2016.

### Asian equity

- Under the current macroeconomic backdrop, we will be selective in sectors that see sustainable structural growth. We believe “old economy” sectors such as banking, energy, metals-and-mining, materials, and property will continue to slow in a scenario of overall benign growth. But “new economy” sectors like insurance, healthcare, consumers, and alternative energy could be more resilient and generate above-GDP\* growth.
- In India, although stock valuations remain at a premium, we see little contraction in the growth premium given the country’s strong long-term prospects.
  - We are not counting on a rising tide to lift all boats in Asia; stock selection will be critical to navigating the risks in Asian markets.

\*Gross domestic product is the measure of all goods and services a country produces.

### Emerging markets equity

- Overall, we continue to be optimistic about the long-term outlook for emerging markets, though we believe in a selective, forward-looking approach that acknowledges the ongoing shifts in the global economic environment.
- As we begin the new year, the portfolios we oversee hold overweight positions in China, Brazil, and Russia, with underweight positions in Taiwan and South Africa. From a sector perspective, we are finding attractive opportunities in the information technology, telecommunications, consumer staples, and energy sectors, while we remain underweight in the financials, industrials, and materials sectors.
- Across emerging markets, the electoral calendar appears relatively light in 2016. Accordingly, we believe focus will shift further to economic reform efforts in multiple countries. China remains the most visible country undergoing significant programs, though major efforts are under way in India, Indonesia, and Korea.
- Within the Europe, Middle East, and Africa region, we anticipate focus will likely shift to the new government's actions in Poland, as well as possible policy shifts in Turkey following large gains by the ruling party.
- In Latin America, Mexico remains focused on executing structural reforms enacted during the past two years, while in Brazil, concerns revolve around the government's ability to improve fiscal sustainability and improve transparency following corruption scandals during the past year.

### Global and international value equity

- We believe that returns in non-U.S. developed markets will have more to do with long-term developments in economic growth, profitability, and valuation than the vicissitudes of local cycles. By these measures, we see some cause for optimism.
- In Japan, a steep valuation discount on book value suggests there is room for further gains, if the corresponding lag in returns on equity continues to close.
- As a group, U.S. companies are highly profitable and highly valued. With few indications of tightness in the economy (especially those that typically mark the top of the business cycle), and low prevailing interest rates, we believe further expansion of valuations could be justified.
- In our opinion, emerging economies are likely to remain the most significant source of volatility in the markets. There is little indication that the rate of deterioration in economic growth has started to slow — a necessary precondition to the renewal of confidence. Given the scale and duration of the investment cycle of the past decade, we are wary of further downside.

### Alternative / specialty and multi-asset

#### Global real estate equity

- One of the biggest questions confronting investors will be the direction of monetary policy around the world.
- Cost of capital will remain as a primary influence on real estate markets. If it remains in line, we believe it makes sense to expect real estate equities — as an asset class — to return somewhere between 7.0% and 8.5% in the new year. If the cost of capital goes up substantially, however, we could see flat-to-down markets.
- Interest rates are currently inching up, and if they continue doing so, we will take a more defensive posture (not just in the U.S., but also in Europe and Japan; both of these markets are experiencing a combination of higher debt and slower growth, making them more sensitive to changes in the cost of credit).
- We plan to continue taking a very conservative approach in certain markets, such as Hong Kong and Singapore, where we expect to see softening in housing prices.

### Global listed infrastructure

- ▶ We expect an economic environment of relatively slow growth and low interest rates — an environment in which infrastructure assets can perform well because they are less linked to the economy than other, more-cyclical sectors.
- ▶ Infrastructure sectors in which we expect to continue investing in promising projects include utilities, pipelines, and cellphone towers. This is particularly true if we continue operating in an environment of low growth and low interest rates.
- ▶ In a number of countries, state and local governments have identified infrastructure repairs that need tending. Some of these governments may lack the financial means to do so, and they could turn to the private sector to help finance such projects.
- ▶ We see a new era under way for renewable power generation, not least in the United States. A new phase of renewable adoption could very likely be driven by improving economics (that is, lower capital costs) and increasing investment from utilities as they look to meet environmental standards.

### Multi-asset

- Heading into 2016, we have begun taking a slightly more defensive posture, expanding our allocations to U.S. Treasurys and cash, mainly by reducing our exposure to large-cap value equities. (Large-cap stocks had reached valuations that were concerning to us, given the potential losses that rising rates might induce.)
- We have begun trimming real estate investment trust (REIT) allocations marginally and reduced our exposure to high yield bonds somewhat.
- Large-cap value equities comprise the largest component of the multi-asset portfolio, followed by high yield bonds, convertibles, and REITs. The portfolio is focused mostly on domestic securities, given our belief that the United States has been a better place to invest during the past five years. We also have investments in the United Kingdom, Europe, and Japan. There is very little exposure to emerging markets.
- While it's likely that the income generated by our approach — investing in a combination of dividend-paying equities, convertible bonds, REITs, high yield bonds, municipals, and U.S. Treasurys — will continue being somewhat lower than the absolute yield generated by certain high yield securities, we believe it will continue carrying less risk. Just as importantly, we believe it will also continue providing the opportunity for capital appreciation.

The views expressed represent the Manager's assessment of the market environment as of December 2015 and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice.

**Past performance does not guarantee future results.**

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## 2016 Investment Outlook: Equity roundup

Narrowly focused investments may exhibit higher volatility than investments in multiple industry sectors.

Investments in small and/or medium-sized companies typically exhibit greater risk and higher volatility than larger, more established companies.

Value investing focuses on buying stocks that are trading at bargain prices based on fundamental analysis, then holding them until they become fully valued. Typically, value investors select securities with lower-than-average price-to-book or price-to-earnings ratios and/or high dividend yields.

REIT investments are subject to many of the risks associated with direct real estate ownership, including changes in economic conditions, credit risk, and interest rate fluctuations. A REIT fund's tax status as a regulated investment company could be jeopardized if it holds real estate directly, as a result of defaults, or receives rental income from real estate holdings.

Listed infrastructure stocks represent publicly traded businesses that provide basic, often essential, services, facilities, and technology upon which the growth and development of a modern community depends. Companies often represent energy, transportation, and utility industries.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. The Fund may also be subject to prepayment risk, the risk that the principal of a fixed income security that is held by the Fund may be prepaid prior to maturity, potentially forcing the Fund to reinvest that money at a lower interest rate.

High yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment grade bonds.

The high yield secondary market is particularly susceptible to liquidity problems when institutional investors, such as mutual funds and certain other financial institutions, temporarily stop buying bonds for regulatory, financial, or other reasons. In addition, a less liquid secondary market makes it more difficult for the Fund to obtain precise valuations of the high yield securities in its portfolio.

Investing in derivatives may involve additional expenses and is subject to risk, including the risk that an underlying security or securities index moves in the opposite direction from what the portfolio manager anticipated. A derivative transaction depends upon the counterparties' ability to fulfill their contractual obligations.

A convertible security is generally a debt obligation, preferred stock or other security that may be converted within a specified period of time into a certain amount of common stock of the same or of a different issuer. Certain securities and markets can become illiquid quickly, resulting in liquidity risk. Both interest rate and market movements can influence its value.

Investing in forward foreign currency contracts, or using other investments to hedge against currency risks, is subject to special risks, including counterparty risk.

Taxable fixed income funds may experience portfolio turnover in excess of 100%, which could result in higher transaction costs and tax liability.

International investments entail risks not ordinarily associated with U.S. investments including fluctuation in currency values, differences in accounting principles, or economic or political instability in other nations.

Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility and lower trading volume.

Investments in securities issued by companies principally engaged in the infrastructure industry have greater exposure to the potential adverse economic, regulatory, political, and other changes affecting such entities.

Holding a relatively concentrated portfolio of a limited number of securities may increase risk because each investment has a greater effect on the Fund's overall performance than would be the case for a more diversified fund.

The payout of dividends is not guaranteed. While dividend payments can provide an important income cushion, they should not be construed as having the same level of risk as interest payments received from bonds. Generally speaking, dividend income can be more volatile than interest income.

The federal funds rate, or fed funds rate, is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

"Nondiversified" funds may allocate more of their net assets to investments in single securities than "diversified" funds. Resulting adverse effects may subject these funds to greater risks and volatility.

Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

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