

ALVARIUM

Alvarium Current Investment Strategy and Insights

May 2020



Overview

As we prepare to re-open economies around the world from one of the most unprecedented global cessations of economic activity in response to Covid-19, we wanted to share with you our latest strategy views. Clearly events are still fluid and there is great uncertainty ahead. However, we are beginning to see some trends emerging.

Our base case is that the world will experience a modest and gradual recovery with low inflation as we head into the final quarters of 2020 and likely early 2021. This type of recovery favours quality in every asset class and that is where we are focused. We also see some tremendous longer term themes and opportunities, in digital/technology/on-line, healthcare, and sustainability as well as risks. We share with you below how our focus on manager selection in top quartile managers and access to direct investments help us to navigate through the turbulence and benefit from where we see powerful trends with strong returns, while positioning to be mindful of emerging risks.

The key points, as elaborated on below, are:

Fixed Income: We are cautious on broad fixed income as yields are unlikely to keep pace with inflation and offer little by way of return; however, inflation protected government bonds and senior, high quality corporate debt strategies, with low default risk are favoured.

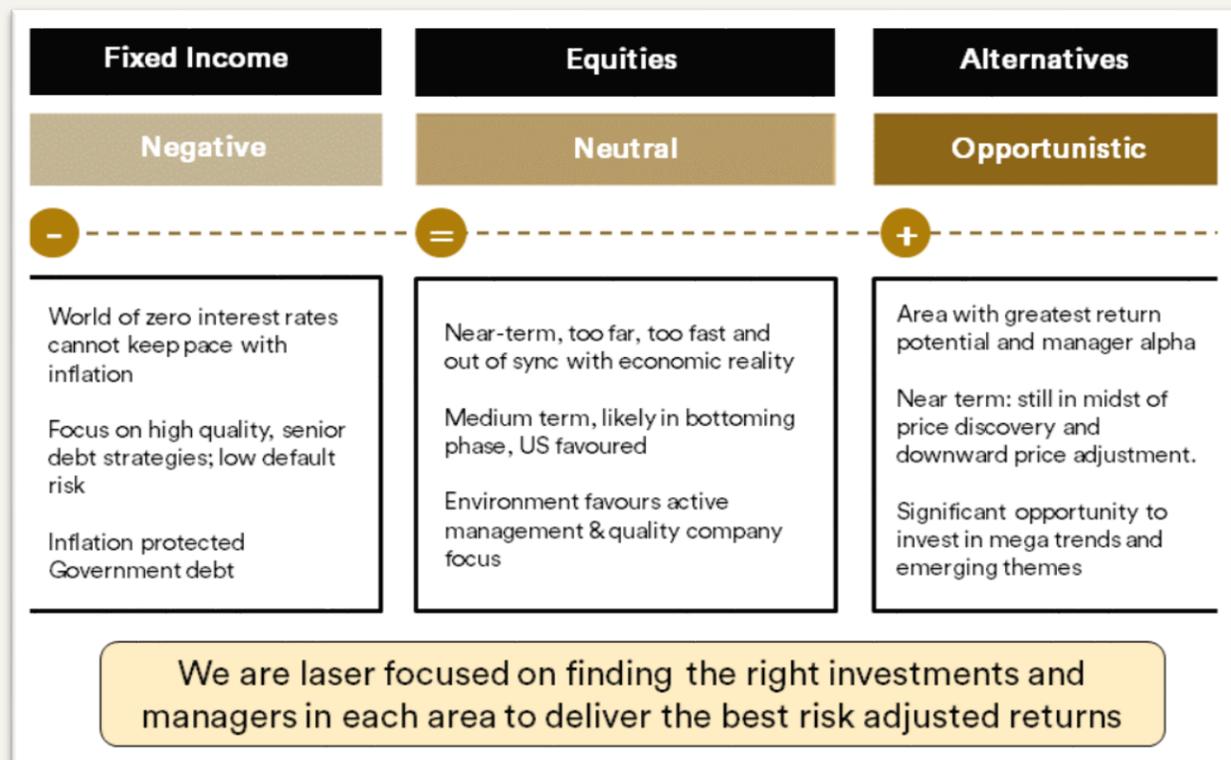
Public Equities: Recent price action seems out of sync with economic reality. We expect further volatility from here as the market looks ahead to 2021 and beyond and would not rule out a re-test of the old lows. But with a medium-term perspective, equities will benefit from the recovery and are likely to be in a bottoming phase. We favour active over passive strategies and managers who will give us exposure to quality companies, with strong franchises, free cash flow and solid balance sheets. The US market is likely to continue to outperform on a relative basis as it has the highest preponderance of resilient companies and sectors.

Private Equity: Private equity and venture capital may offer some of the most compelling return opportunities post the crisis. However, we are cautious on recent past vintages as price discovery is still underway; pricing in these investments tends to lag the public markets. However, top quartile funds with dry power and a proven ability to add operational value should deliver excellent returns. History has shown that the top performing vintage returns come after periods of economic crises and bear markets.

Hedge Funds: Hedge fund structures typically provide the best vehicle for taking advantage of price dislocations. Selective hedge funds can benefit from increased volatility and distress. We like managers that offer an alternative to fixed income; or have expertise in the distressed credit space. Select equity hedge managers are also likely to benefit from greater levels of dispersion within sectors and industries. We expect opportunistic openings for new capital to increase with select hedge fund “legends” in the coming months.

Real Estate: We see opportunities in real estate both debt (senior mezzanine, asset backed) and quality equity at discounted prices. Negative real interest rates make the present “liability-driven” investment policies of insurance and pension funds unsustainable. Real estate will continue to provide a stable, income advantage relative to bonds with the added benefit of long-term inflation protection. High quality properties, through funds or direct debt and equity opportunities that can access a better pricing environment in areas of good supply/demand are in focus.

Our views in summary



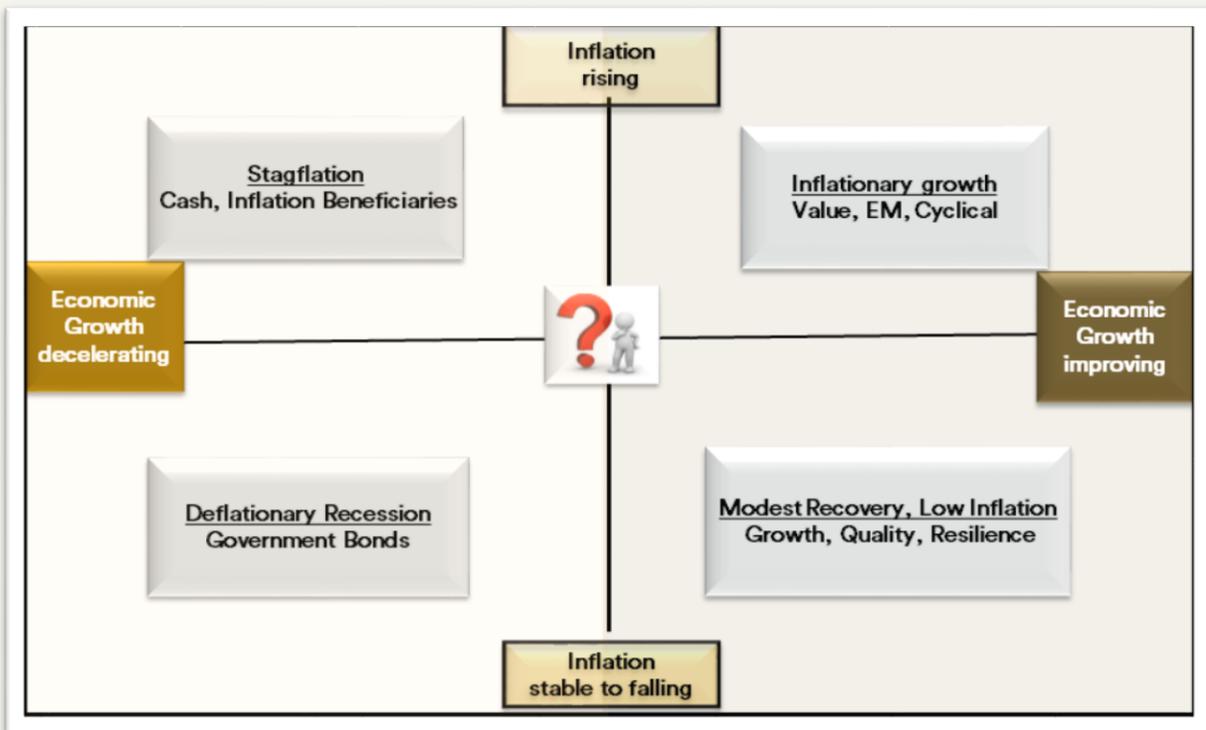
To explore these themes further, this piece is divided into the following sections:

- Our framework for the world as economies re-open;
- Implications for asset classes and sub asset classes;
- Some emerging trends and risks; and
- How we use diversification and manager selection to navigate through the turbulence and deliver strong risk adjusted returns.

Our framework for the world

The four-quadrant model below shows potential states for the global economy in terms of economic growth and inflation, and the asset classes that are likely to do well in each of the different regimes. To the left depicts asset classes that do well when economic growth is decelerating and inflation is either rising (above) or falling (below); to the right, shows the types of strategies that do well when economic growth is improving (recovery) and when inflation is either rising (top) or falling (bottom).

Markets of course are always about change and hence they will look to discount where we may be headed as opposed to the current state.



We are currently in the lower left-hand quadrant.

The shutdown of the global economy in response to Covid-19 and consequent cessation of economic activity has thrown the developed world squarely into a deflationary recession; the quadrant on the lower left. Economic news is dire, worse than the Global Financial Crisis (GFC) and consistent with some of the worst contractionary data at the time of the Great Depression. GDP levels across the world have fallen into deeply negative territory, with most strategists expecting double digit declines in GDP for the second quarter and global GDP to fall anywhere between 3-6% annualised in 2020. The Bank of England reports that this may be the greatest downturn in the UK in 300 years. Government bond yields have collapsed as a result.

However, unlike other severe contractions including the Great Depression, we see the falls in GDP as temporary, not as multi-year in duration.

Markets are currently discounting a shift to the right, coincident with economic growth recovering. We concur. We believe economies will recover (shift to the right) for a number of reasons:

- Policy makers have and will continue to provide unprecedented levels of fiscal and monetary stimulus to aid the recovery. Globally, stimulus packages are multi trillion in size and counting. The US, the world's largest economy will continue to do what it takes: with monetary stimulus of c.\$12 trillion, while fiscal packages have reached \$3 trillion, or nearly 10% of GDP; headline fiscal deficits for G4 and China combined are likely expand to c.14% of GDP in 2020 versus 10% during the GFC.
- The financial system and banks are in much better shape than in 2007 and so pose much less of a systemic risk to the financial system and thus are able to act as a conduit for monetary and fiscal stimulus; and
- Deep and long-lasting recessions are usually associated with significant contractions in the money supply, a collapse of the banking system or major policy errors. We currently do not see any of these as risks, at the moment.

However, we think the recovery will more likely be more of a gradual U, rather than V-shaped, and thus more reflective of a modest recovery with low inflation, the lower right-hand quadrant. Growth will resume as people are allowed to again re-enter a sort of new normal and there is considerable pent up demand in certain areas. On a comparison to economic cessation, some numbers can pick up quite considerably. However, we think the combination of potential virus re-infection and damage done the consumer, business and supply sides of the economy will weigh on the pace of the economic recovery, after an initial bout of activity.

It will take considerable time to heal and regain prior levels of output and growth. Some parts of the economy may never recover. A number of factors feed into this view:

Pandemic Threat

- No vaccine has yet been developed. This could take months or even years and once it has been developed, it will take time to roll out on a global scale.
- The New Normal of living with the virus and social distancing will result in many businesses, or whole industries, operating below capacity or at reduced demand;
- New waves of infection, as populations become complacent or new measures prove inadequate, could force policymakers to limit economic activity again;

Consumption

- Consumer fear remains high and confidence has been shattered;
- 30m+ people have so far registered as unemployed in both the US and Europe, with the result that more jobs have now been lost than created in the last 10 years. Those jobs will be slow to recover;
- Wealth destruction has been huge. Many smaller businesses may not survive, and people's savings have seen c. \$8 trillion decline in value.

Investment

- Businesses will remain cautious as we emerge from lockdown, so we cannot expect a near term boost from corporate capital expenditure;
- Whole sectors are in complete disarray - energy, leisure, travel, hospitality - for some of these industries the damage may be permanent, while for others, recovery will take years.

Trade

- Supply chains will continue to be disrupted and we may also see a trend towards domestic manufacture of critical goods. Companies and governments will likely see the need to become more supply resilient in times of crisis, which could cause production delays as supply chains move back onshore.

There are some hopeful signs that may limit economic damage to only part of 2021.

- Encouraging news around treatment and vaccine development from a variety of firms, BerGenBio, Oxford and Gilead, for example;
- We have seen unprecedented collaboration between usually highly competitive pharmaceutical firms to develop anti-body therapies, as seen by GSK and Sanofi joining forces;
- Expansion of contact trace and testing measures could limit transmissions and minimise ongoing disruption to societies;
- Some countries such as China and New Zealand have seen no new cases of infection; these results could be repeated elsewhere as the virus wanes.

Over time, normalcy should reassert and economic activity could well climb back to levels prior to the crisis. However, most expect the trajectory of future GDP growth to be lower than would have been otherwise the case without the crisis, due to the effects of permanent damage in some sectors and lower productivity from social distancing.

Near term, we expect that inflation will remain subdued as a range of deflationary effects take hold:

- Sluggish economic demand, as outlined above, with the IMF forecasting that global output gap will remain deeply negative until at least 2022;
- Wage inflation will be constrained given current extreme levels of unemployment;
- Tech-led disruption, already a long-term deflationary pressure, will increase and accelerate, dampening firms' ability to raise prices; and
- Energy prices, namely oil, are in disarray as supply cuts have failed to keep pace with declines in demand. Other hard commodity prices have seen similar declines.

Thus, policymakers **will maintain exceptionally accommodative policies**, keeping policy rates low in order to aid the recovery and help finance government debt and deficits. **A modest growth**

and low inflation environment, with excessive liquidity support from Central Banks is beneficial to high quality financial assets, private investments and real estate.

However, in the near term, public markets may have rallied too far, too fast.

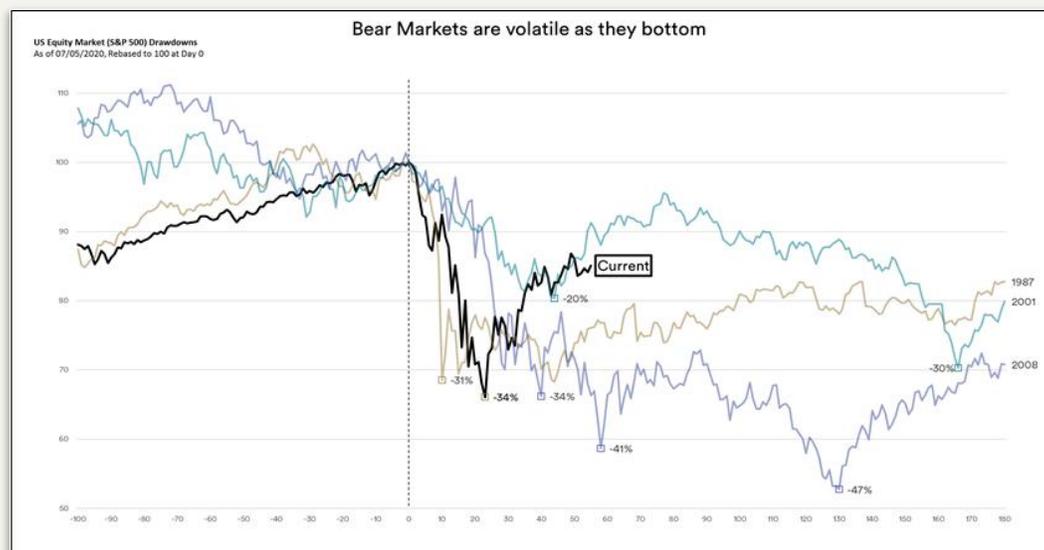
- Equities have recovered roughly 50% of the losses from the market's highs (Feb) and are close to 62% retracement.
- The strong rally in risk assets in April lifted many equity regions out of a bear market. S&P 500 posted a total return of 12.8% in April, the largest 1-month rally since October 1974, and MSCI World was up 10.6%, its best month since 2011.
- Equity markets are back near January 2018 levels, while NASDAQ is now back to January 2020 levels.

Meanwhile, there is still enormous uncertainty for earnings and valuations (80% of US companies have dropped guidance). Analysts are having a hard time agreeing on what companies will earn and how much investors should pay for those earnings.

- By way of example, Amazon announced that its operating profit could be anywhere between \$1.5bn profit and a loss of the same amount.
- P/E multiples are already back to close to 17x consensus earnings (from a low of 13x), and even higher if 2021 earnings projections come down from here.
- The breadth of the rally has not been great: the US headline benchmark is around 17% below its February record, but the median stock trades down 28% from its peak, indicating significant underlying dispersion.

Hence, we believe that volatility will remain a feature of markets as equities continue to digest bouts of both positive and negative news. However, with a medium-term perspective, markets may well be in a bottoming phase, a process that often lasts months as markets consolidate crisis lows, see chart below.

Current Performance versus Prior Bear Markets



Source: Morningstar

Longer term, the trajectory of economic growth and inflation may well involve an anticlockwise journey around the quadrants. The recovery in 2021 or 2022 could be followed by a stagflationary future over the ensuing years as de-optimisation of global supply chains, supply destruction, much higher frictional costs in the economy due to social distancing measures and generally lower productivity take hold.

This all remains to be seen.

Implications for assets classes

Fixed Income (negative)

- Rates are likely to remain low as Central Banks support economic recovery and keep debt deflation at bay;
- Central Banks may look to anchor (long and short) rates at low levels to allow governments to maintain significant fiscal deficits.

In summary: a much more difficult environment to source safe and defensive returns.

Strategy

- Government debt provides a hedge against deflation (short end can be seen as cash substitute);
- Inflation protected Government bonds, particularly TIPS, can provide a hedge against a future rise in inflation;
- Quality corporate debt with a preference to own what the Fed is buying and where default risk is low.

Equities: (selectively positive, particularly US equities)

Equities will be a main beneficiary of any recovery, return to normalcy and positive impact from government stimulus. However, they will remain volatile near term and thus active management will be critical. In a modest recovery scenario, we favour stocks with exposure to **growth, quality, sustainable free cash flow, strong balance sheets and those that have the most resilient earnings**. Sectors such as consumer staples, technology, health care, communication services are favoured.

From a country perspective

- **US:** US has been the most aggressive in supporting economic growth and likely first to recover.
- **UK:** May lag US due to preponderance of more cyclical sectors in the index.
- **EU:** Given political tensions and delays in fiscal support, likely to lag recovery.
- **Asia/China:** First to normalise support economic growth; consumer growth theme remains.
- **Emerging markets:** Caution; health care systems vulnerable; as is the case more generally, focus on growth managers & quality (Managers that concentrate on the Asian consumer are favoured over Latin America).

Strategy

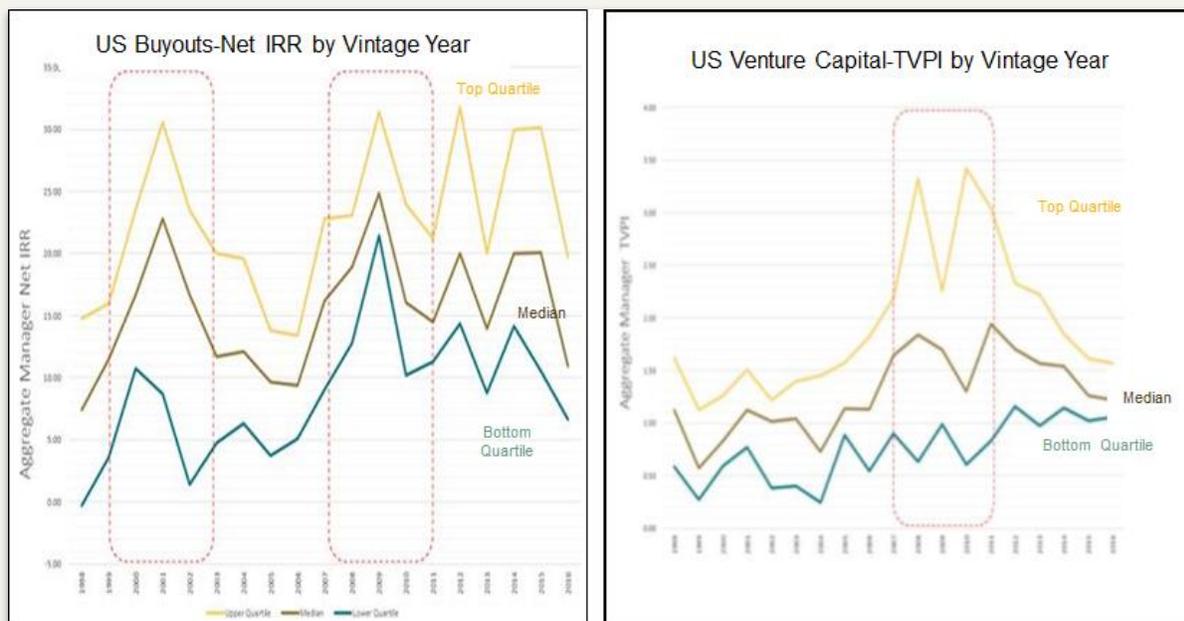
- Favour active managers as they are better placed to identify the best opportunities
- US large cap growth likely to continue to do well given support from governments and longer-term structural themes (highlighted later)
- Global funds that select companies with strong free cash flow & balance sheet-survivors
- Digital infrastructure, Technology, Health Care and Communications Services sectors favoured

Alternatives: opportunistic

It is important to note that many of the illiquid alternative asset classes are still undergoing price discovery and may not fully reflect downward price adjustments until the latter half of this year. However, new fund launches with coveted managers in private equity, venture capital and real estate are under review, as are well-priced, high quality direct strategic opportunities.

Private Equity & Venture Capital: Historically, the best vintages tend to be launched prior to, or in the midst of, a market downturn. Operational value add and dry powder are key to returns; we are looking at new funds from coveted managers. The same themes targeting technology, digital, health care and environment are likely to dominate in venture capital.

The best vintages tend to be launched prior to, or in the midst of, a market downturn



Source: Prequin

Real Estate “The new Fixed Income”: A similar shift in favour of real assets is near-certain in this decade, as negative real interest rates make the present “liability-driven” investment policies of

insurance and pension funds unsustainable. Real estate will continue to provide a stable, income advantage relative to bonds with the added benefit in many cases of long-term inflation protection. We are currently seeing opportunities in high quality properties accessed either through senior, asset backed debt or direct equity opportunities that can access better the pricing environment and in areas of likely demand recovery. However, selection will be critical as some areas of real estate may experience a new normal with the potential for reduced demand.

Hedged Equity: These strategies are likely to benefit from greater levels of dispersion within sectors and industries than seen at any time in the decade past. We expect opportunistic openings for new capital to increase with select hedge fund “legends” in the coming months.

Absolute Return Hedge Funds: Strategies that offer an alternative to fixed income could play an important role in providing some uncorrelated return while diversifying a portfolio away from excess duration and fixed income credit risk. Again, many coveted managers are re-opening for capital.

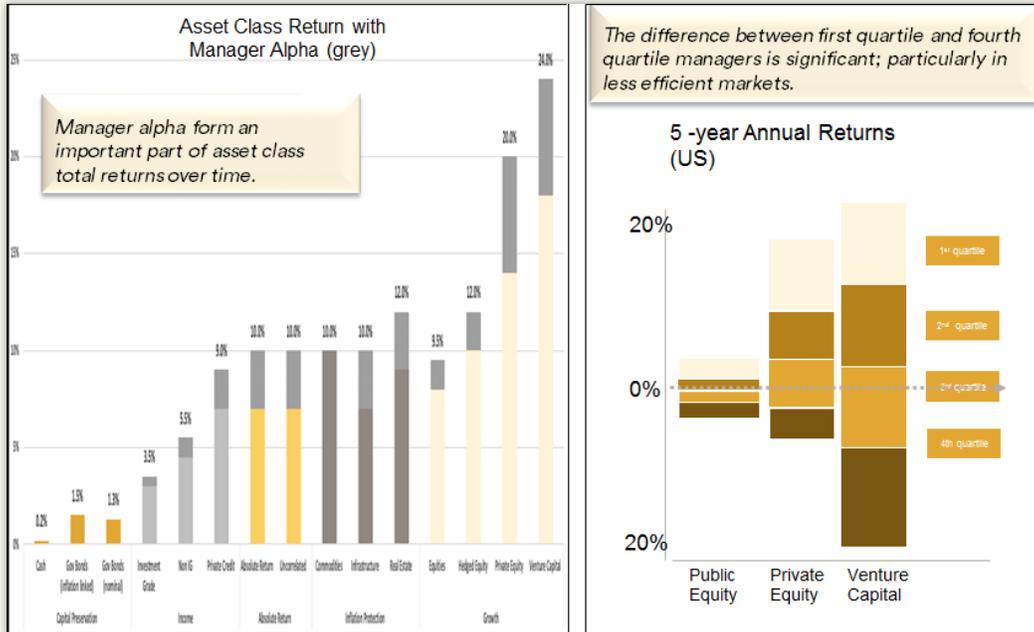
Credit Hedge Funds: We are reviewing opportunistic investments in dislocated structured credit markets, including Non-Agency RMBS and CMBS strategies. Depending on the depth of the recession, rescue financing strategies might also become highly attractive.

Gold ETF's with physical gold backing, or direct holdings of physical gold, are attractive in a context of currency debasement, possible direct financing of government deficits, low interest rates and increasing political risks (per the risks section below).

Across all asset classes it is important to remain aware that many companies and whole sectors may not make it back to pre-2020 levels (e.g. parts of hospitality, airlines). This will be a complex recovery with many uncertainties.

This is why we fundamentally believe that active management at its best will add significant alpha in all asset classes through this period. It is especially vital in private markets to partner with highly sought after, experienced managers, with a proven ability to add significant value operationally, and with expertise honed in prior distressed cycles.

Our manager selection process is focused on finding these manager gems.

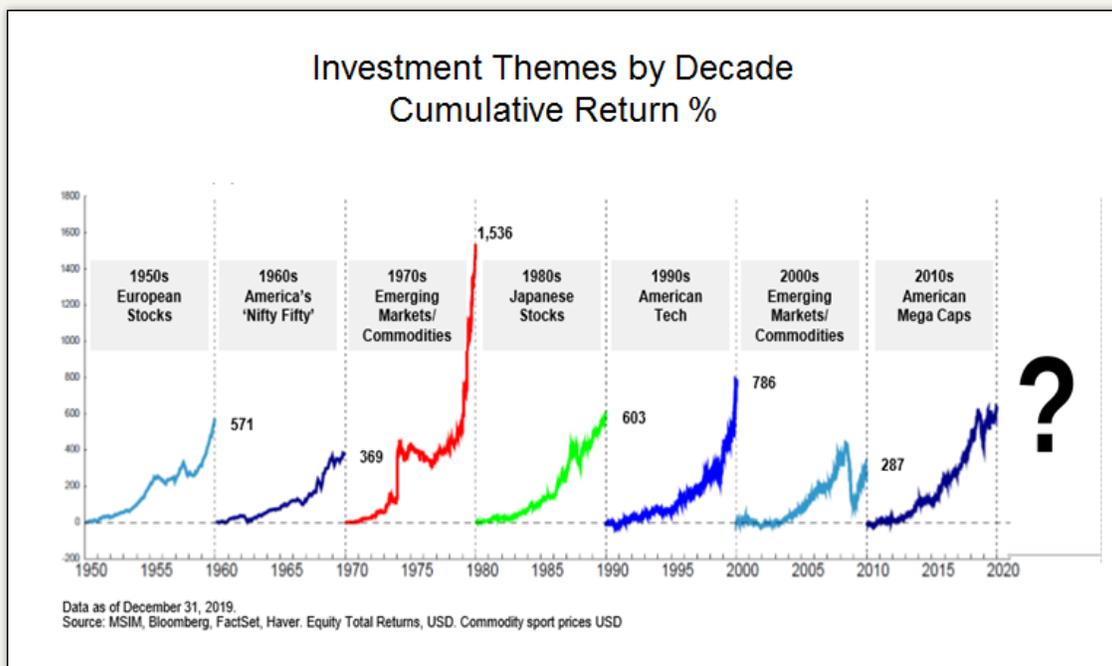


Source: Cambridge, Prequin, Blackrock and Morningstar (manager alpha is illustrative only and based on top quartile estimated averages)

Some emerging mega-themes

Post every crisis, and indeed every decade, there emerges some powerful mega-trends that deliver outsized returns for a sustainable period of time.

This chart looks at the cumulative returns from these mega trends over the last 7 decades.



Some contender themes we think about post Covid-19 are:

- **Digital/Technology/On-line:** the pandemic lockdown accelerated move from the physical to the virtual world. Tech usage almost everywhere has gone through the roof. Microsoft's CEO calls this the 'remote everything' with massive implications for entire areas of daily life including work, education, entertainment and medicine. We expect a more permanent shift to working from home and team based digital collaboration. New digital technologies, and new on-line business models will emerge, as will new ways of collaborating and interacting (sports, music, events).
- **Healthcare:** More focus will be placed on innovating to provide treatments and vaccines against viruses such as COVID-19. We would expect to see a greater share of government spending going to healthcare, likely coupled with a change in the political mood. Telemedicine, digital diagnostics and use of AI in data analysis as well as technologies aimed at containing infections in public spaces are set to rise. This is a sector with tremendous investment and innovation opportunities for years to come.
- **Sustainability:** The crisis also may be the making of ESG and impact investing. Cleaner air and lower emissions have been a positive of the containment and may result in a significant shift in public sentiment and awareness of the benefits of lower emissions. To get to carbon-neutral by 2050, we expect an acceleration of ongoing investment in new technologies in all things renewable, green and electric.

Some risks to be aware of

As we emerge from this crisis, there is no lack of risks that could derail an economic recovery. We believe our quality bias, with strong diversification across a range of asset classes in leading managers will serve us in good stead as we navigate through potential risks ahead.

- **China/US rivalry escalates:** As Trump holds China accountable for the virus, we could see a return to a trade war and accompanying tariff renewal; longer term implications for supply chains and a consequent rise in costs/inflation; heightened strategic competition as calls for unravelling of globalisation continue.
- **EU construct:** Italian public opinion may be shifting against the EU If Germany continues to prevent pan-European "solidarity" from financing post-Covid recovery, the risk is of a nationalist government in Italy threatening to leave the Euro and the EU.
- **Wealth and income gaps continue to widen:** The pandemic has hurt the "little guy" – more as the lower middle-income class has suffered the largest job losses, with over 60% of laid-off workers not having the option to "work from home." Demand for better social safety nets/health care will mount, with louder calls for this to be funded through higher taxation. We expect to see a rising trend in political populism.
- **Greater government intervention:** Recent fiscal stimulus may be categorized as "progressive," including paid sick leave and wage subsidies. Could we see greater government intervention in the markets and more calls for a new economic model in the western world, where the government plays an increasing role? The evolution of fiscal policy over the next decade could bring significant risks.

- **Removal of stimulus and unintended consequences of the policy actions:** It will be difficult to unwind such an enormous intervention once the crisis subsides. Significant risk of “Moral Hazard” as investors continue to expect governments to back-stop risk going forward. A lack of ‘system cleansing’ of bad players and inability to price risk can weigh on future economic growth.

Over time, inflation may build if:

- Government deficit financing crowds out the private sector, leading to rising corporate credit spreads;
- Productive capacity is destroyed (supply/demand);
- Supply chains move to higher cost domestic sources, including rising labour costs as the migrant workforce is reduced through restricted travel;
- Oil prices rise again as demand increases and continued cuts in production occur; and
- Central Banks leave money supply too loose for too long.

Summary

We see a world ahead offering significant opportunity for long term patient capital, but also some significant risks. Diversification across asset classes, sectors, style and vintages is the best way to take advantage of these emerging opportunities and trends. Diversification is the key to preserving wealth over the long term.

At Alvarium, we are strong believers in this multi-asset class approach—not only for the assets we are responsible for, but for ensuring we consider and understand our clients’ overall position, to provide the best and most suitable advice. Moreover, we believe that our global network and research capability help us to identify the best investments and managers to participate in powerful trends and return opportunities, while aiming to cushion overall portfolio risk.

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