Asset Class Investment Strategies

Public Equities

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

Public equities consist of developed market equities, emerging market equities and hedged equities. We recommend an overall public equities exposure of 47% in our policy portfolio, which is in line with the strategic asset allocation. This is comprised of a 27% allocation to Developed Market equities (-5% vs SAA, a 5% allocation to Emerging Market equities (+1% vs SAA) and a 15% allocation to Hedged Equities (+4% vs SAA) with a particular focus on sector and regional specialist managers.

We are constructive on the outlook for global equities.

We expect market returns to be driven by strong global growth coming out of the COVID-19 pandemic, low interest rates with no expected near-term upward pressure and reasonable equity market valuations in the context of these two factors. On the back of the best alpha year in our history, we remain excited about alpha prospects in 2021 from our investment themes and active managers, as we anticipate continued high stock dispersion and more fundamentally-driven markets. Potential headwinds to the asset class include the risk of higher-than-expected inflation and rising taxes, while a significant growth-to-value rotation could be challenging for alpha.

We seek to construct a portfolio of diversified alpha sources that can deliver strong returns under different market scenarios. We maintain exposures to our longstanding core investment themes of life sciences, technology and China (25% of model portfolio), which are innovation-driven and growth-oriented. We complement these with a collection of value-oriented themes within consumer, small cap, community banking and sustainability (8% of model portfolio), as well as generalist, quantitative and co-invest strategies with balanced portfolios (25% of model portfolio). While our investment themes will naturally result in exposures deviating from global equity indices, we constrain such deviations to maintain a balanced portfolio across style factors, industry sectors and geographic regions.

Within our 32% long equities allocation, we favour long-duration strategies (10% allocation), co-invest (10%) and quantitative strategies (4%), de-emphasising traditional fundamental strategies which together with passive allocations comprise the remaining 8% allocation. We believe long duration strategies can generate superior risk-adjusted returns through a market cycle through their "private equity style" deep fundamental diligence, management engagement and structured investments. Our co-invest strategy provides access to deep fundamental stock picking from these high conviction managers in a readily accessible, liquid and low fee format. Finally, quantitative strategies provide a complementary alpha source within diversified, liquid and low-cost funds.

Within our 15% hedged equities allocation, we target a 12% allocation to specialists across sectors, geographic regions or market niches which have generated outsized contributions to our hedged equity returns, with the remaining 3% allocated to who we believe are exceptional generalist managers. Our continued overweight to hedged equities is driven by our expectation of low stock correlation and moderate equity market volatility leading to a fertile opportunity set for fundamental stock selection.

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Asset Class Definition

The public equities asset class consists of various investment strategies that invest in publicly listed and traded ownership stakes in companies of all sizes across all geographic markets and industry sectors. They may also bet against these companies by selling stocks short or structure their trades by buying or selling options and other derivative securities on the underlying stocks. We estimate the total public equity stock market at approximately $100 trillion of assets globally.

From an asset class perspective, we differentiate between hedged equities, where managers buy securities long and sell securities short and which generally run at lower risk levels than equity markets, and long equities, which run at risk levels similar to that of equity markets.

Role in the Portfolio

The main purpose of investing in public equity securities is to participate in the growth of the global economy. Long-term themes such as the commercialisation of new technologies, the rise of the internet economy and the rise of the middle-class consumer in emerging market economies are all captured by owners of public equities.

We seek to generate returns in excess of risk-adjusted equity market indices by investing in managers and strategies that can deliver alpha primarily through security selection. Active management in equities includes a wide variety of strategies with substantial differences in alpha expectations, from specialist hedged equities managers with the highest alpha expectations, to traditional fundamental long equities managers with more modest expectations. Given the abundance of low-cost passive solutions such as exchange-traded funds, the hurdle for active management is extremely high.

Golden Rules

We believe that the following golden rules enable us to "beat the odds" in a challenging asset class for active management and generate meaningful alpha in public equities, and we are formally introducing two new rules around investing "nimbleness" and diversification:

1. **We believe stock selection is the only reliable source of alpha generation.** We consciously avoid managers who attempt to generate their returns through top down exposure management and/or geographic, sector or factor rotation, as we have empirically found the former to destroy value through poor market timing and the latter only to be a modest amplifier of bottom-up security selection alpha. Our diligence process includes tools to isolate historical stock selection alpha and to analyse its sustainability and robustness.
2. **Focus on managers with deep fundamental and/or "big data" research capabilities.** We believe that developing high-conviction and differentiated views on individual companies' medium to long-term earnings trajectory is the most sustainable source of alpha. We carefully evaluate a manager's talent, expertise, network, process and capabilities that might enable them to generate such differentiated insights on a consistent and repeatable basis. Increasingly, we find that the ability to source, analyse and integrate "alternative data" into the research process is critical to success.
3. **Select managers who demonstrate nimble portfolio management and proactive risk management.** We believe that managers can add tremendous value by rotating portfolio holdings and adjusting position sizing in reaction to changes in the fundamental outlook and valuation of individual securities. This requires deep fundamental insights across the portfolio, a broad understanding of risk factors, intellectual flexibility to quickly pivot one's point of view, and the decisiveness to take investment action. However, size often becomes a hindrance to nimble portfolio management, and hence we are cautious of managers who experience too much asset growth.
4. **Insist on fee alignment tied to value add via fair fee structures and negotiated fee discounts which reward early and large investors.** We have seen all too often that excessive fees can significantly offset or even eliminate manager alpha. We have made significant progress in reducing these headwinds across the portfolio by systematically structuring and negotiating fees to ensure our clients receive their "fair share" of manager alpha.

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5. **Concentrate capital in strategy areas with significant alpha potential.** We have seen that certain strategies have considerably greater success in generating alpha, and we concentrate our capital in those strategies. We are comfortable avoiding strategies with a low probability of success and defaulting to passive investments where appropriate. Over 70% of our policy portfolio is concentrated in the following strategies:

   a. Specialist managers where differentiated expertise can drive excess return;

   b. Long duration strategies which focus on "private equity style" deep fundamental diligence, management engagement and structured investments;

   c. Co-invest strategies which access deep fundamental stock picking from high conviction managers; and

   d. Quantitative strategies which have proven long-term track records and deep pockets for maintaining their competitive advantage.

6. **Diversify our portfolios across investment themes, strategies and managers with different underlying sources of return and alpha.** We seek to create diversified portfolios that can generate alpha in a variety of market environments. While we are always looking to express our high-conviction themes, strategies or managers through sizing which can "move the needle", we are also conscious to make sure that such exposures are "right-sized" to reflect our conviction relative to the risk, and moreover balanced across style factor, industry sector and geography.

Exhibit 1

Our policy portfolio for public equities focuses on specialist managers, long duration on strategies, co-invest and quantitative managers

Sub Asset Class	Hedged Equities		Long Equities			
Strategy	Specialist	Generalist	Long Duration	Co-Invest	Quantitative	Traditional Fundamental
Role and Allocation Rationale	— Core alpha generator in public equities — Diversify across 4-5 specialist areas	— Opportunistic investments in "best athletes" — Downside protection driven by short alpha	— High alpha potential in long equities through a market cycle — Maximise illiquidity budget and premium	— Access "long duration" alpha potential in liquid, low fee format	— Broad beta exposure with solid alpha potential, low fees and high liquidity	— Opportunistic allocations to exceptional managers — "Fill in" liquid long equity exposure in passives
Source of Alpha	— Sector or geographic expertise — Fundamental company analysis — Leverage	— Fundamental company analysis — Sector and geographic rotation — Leverage	— Deep, bottom up fundamental analysis — Management engagement — Structured investments	— Deep, bottom up fundamental analysis — Low fees and costs	— Differentiated data or analytics on securities — Portfolio construction and risk management	— Fundamental company analysis

Source: *Partners Capital*

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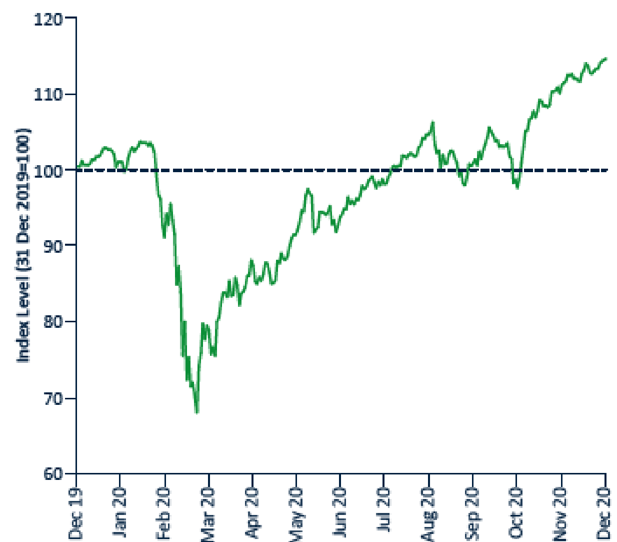
Market Overview

Equity Markets 2020 Performance

Despite one of history's quickest and deepest equity market drawdowns due to the global COVID-19 pandemic, global developed market equities ended the year up +14% on the back of widespread government stimulus and optimism about vaccine efficacy and distribution. Underlying the headline equity market return was significant dispersion across geographies and sectors driven largely by the impact of COVID-19. Global equity market returns were driven by gains within COVID-19 insulated sectors, such as technology, consumer discretionary and communication services sectors, while sectors more reliant on mobility, such as energy and real estate, underperformed during the year.

Exhibit 2

Global developed market equities as measured by the MSCI World Index ended 2020 up +14% in a year marked by the fastest bear market recorded in Q1 2020 followed by rapid and sustained market recovery



Source: Index data from Bloomberg. Indexed to 100 as of 31 December 2019.

In Q1 2020, COVID-19-induced lockdowns across the world resulted in a sharp downturn, with the S&P 500 declining more than -20% in 16 trading days, the fastest bear market in US history. Cyclically-oriented sectors were the most impacted, with oil contracts in late April closing at negative prices for the first time in history. The selloff was driven in part by both heightened volatility and active deleveraging, causing significant dispersion in market segments with growth outperforming value factors, mega and large cap equities outperforming small cap equities, and tech-related sectors enabling "work from home" outperforming physical retail and manufacturing.

Coordinated action by central governments, including unprecedented levels of market support and fiscal stimulus, stabilised investment markets in late March. These government interventions, and an increased understanding of the potential path of the global pandemic, drove a rebound in global equities in Q2 2020, led by businesses with low sensitivity to COVID-19 outcomes. The recovery broadened heading into Q3 2020, as investors started to look through to post-COVID-19 earnings forecasts and COVID-19 impacted sectors like consumer, industrials and financials gained strength. In Q4 2020, positive COVID-19 vaccine news propelled an even sharper shift from "work from home" to "recovery" equities, causing a dramatic rotation into cyclical sectors and small cap stocks.

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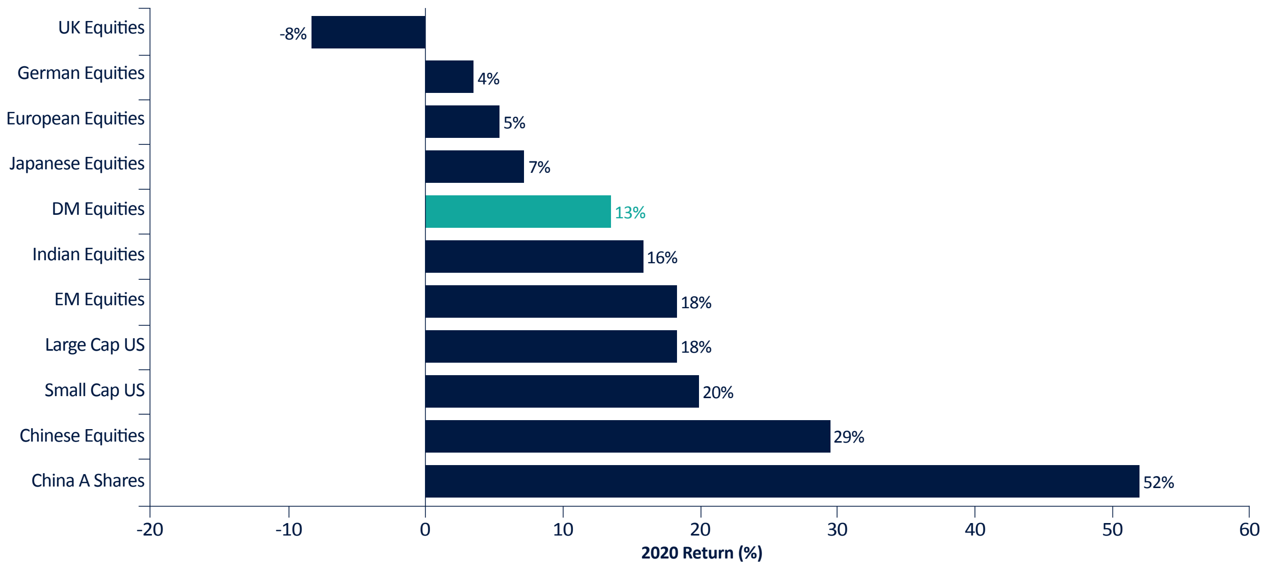
Exhibit 3

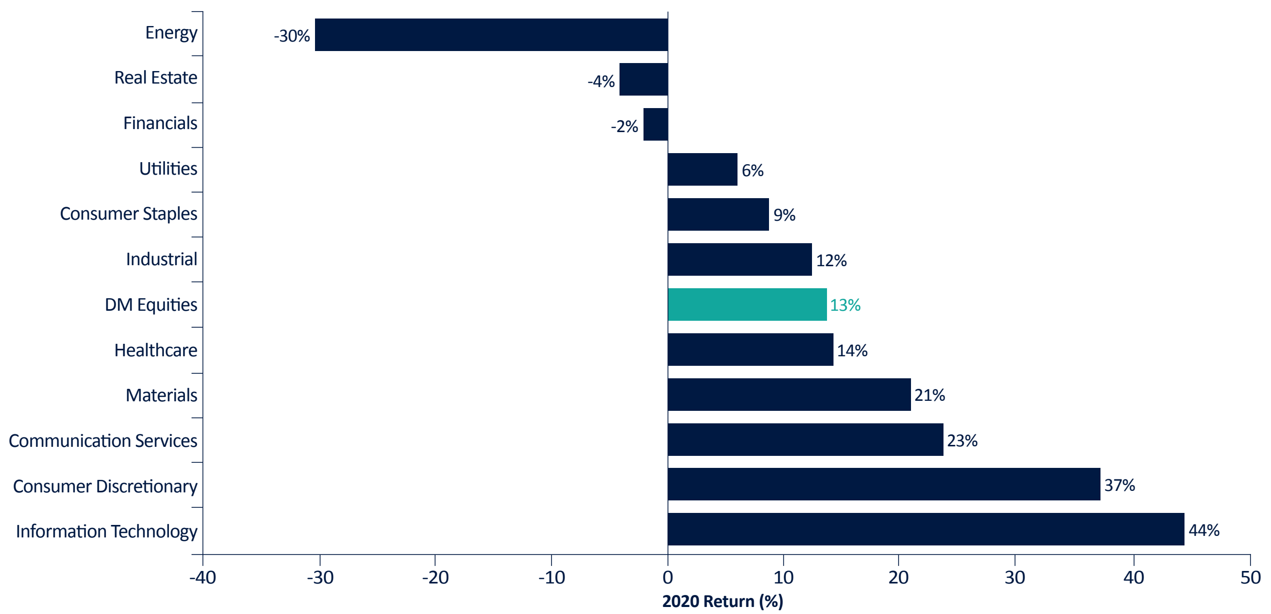
All major markets ended the year with positive returns except the UK as a result of Brexit. The US led developed markets, while emerging markets and China in particular had exceptionally strong returns for the year.



Source: *Index data from Bloomberg. Underlying indices in order presented above are: FTSE 100, DAX, MSCI Europe, Topix, MSCI World, MSCI India, MSCI EM, S&P 500, Russell 2000, MSCI China, CSI 300.*

Exhibit 4

Technology and consumer were the best performing sectors, as these businesses benefitted from COVID-19 dynamics or successfully pivoted their models to the new environment



Source: *Index data from Bloomberg. MSCI World Index and MSCI World GICS Sector indices*

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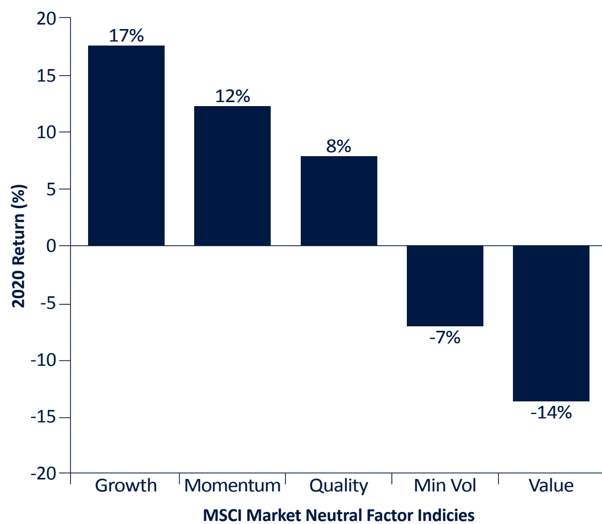
Exhibit 5

As shown with these market neutral factor indices, growth and momentum outperformed in 2020, while value lagged, continuing the performance trend from 2019 and the past 5 years. Market neutral factor returns are calculated as the excess return of the factor index over the beta adjusted MSCI World Index.



Source: *Index data from Bloomberg. MSCI World Growth, MSCI World Momentum, MSCI World Quality, MSCI World Minimum Volatility, MSCI World Value adjusted to be market neutral.*

Equity Market Valuations

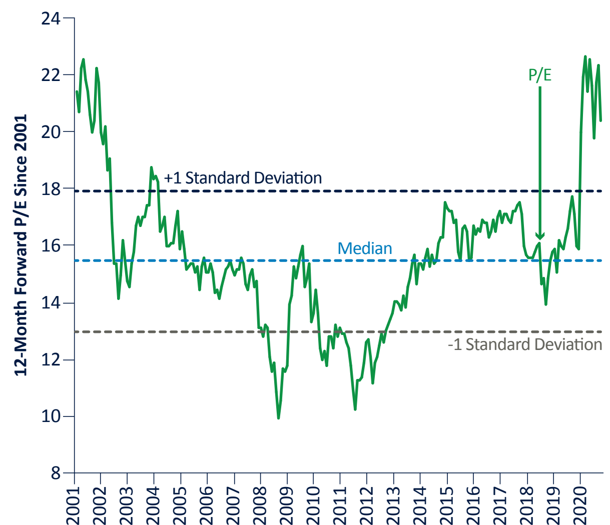
With global equity indices hitting all-time record highs despite the COVID-19 pandemic, we are frequently asked: what are our views on equity market valuations and forward-looking returns?

While we acknowledge the elevated headline P/E multiple of global equity markets relative to history, we remain constructive on public equities for the following reasons: (1) high global GDP and corporate earnings growth in 2021, 2022 and beyond, with an acceleration of economic activity following the vaccine roll-out and continued fiscal support; (2) record low long-term interest rates with no signs of near-term upward pressure given accommodative monetary policy and only modest inflationary pressures (at present); and (3) reasonable valuations in many segments of the market (e.g., value and quality stocks, cyclical sectors) with frothiness limited to a small number of stocks and subsectors. Therefore, we see substantial value to active management in today's market environment.

As of 31 January 2021, global developed market equities (as measured by the MSCI World Index) were priced at a 20.2x forward P/E, with recent market valuations being the highest since the dot-com bubble in 1999-2000. This is 1.9 standard deviations above the median forward P/E of 15.4x over the past 20 years. The elevated valuation is particularly pronounced in US markets (21.8x current forward P/E vs. 15.9x long-term median) but exists in Europe (16.1x vs. 13.4x) and Japan (20.5x vs. 15.4x) as well.

Exhibit 6

Global developed market equities as measured by the MSCI World Index are trading at 20.2x forward P/E as of 31 January 2021, which is 1.9 standard deviation above the median value over the past 20 years



Source: *Bloomberg*

Current forward P/E metrics are based on estimated 2021 EPS for the relevant market. These numbers incorporate an expected strong earnings recovery at +30% EPS growth for developed markets, bringing earnings back to a trendline of +5% p.a. EPS growth for 2019-21. Corporate sales and earnings are expected to continue to grow significantly above long-term steady state levels in 2022 (consensus forecast of +15% EPS growth) as the global economy continues its recovery from the effects of the COVID pandemic. We believe that the strong growth outlook for corporate earnings over the next few years provides considerable support for current market valuations.

Another factor that must be considered is the record low interest rates on government debt globally. Low long-term interest rates tend to support equity valuations as they reduce the discount rate at which future earnings are valued. This impact can be particularly pronounced for growth equities where the vast majority of the value comes from longer-dated earnings. In order to evaluate this effect, we look at global equities earnings yield (E/P, the inverse of P/E multiples) relative to 10-year bond yields over time. The current spread (also known as the equity risk premium) stands at +4.3% for DM equities, slightly above (and hence

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Exhibit 7

Corporate EPS is forecasted to grow +30% in 2021 and +15% in 2022 for DM equities as economic activity recovers from the impact of the COVID pandemic

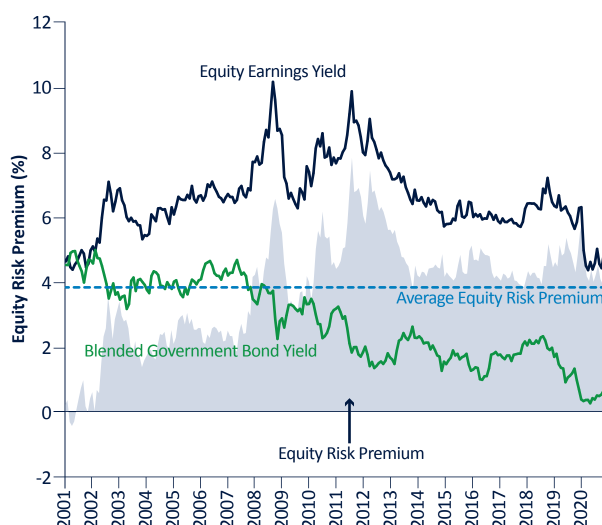
	Sales Growth				EPS Growth			
	2020	2021 (E)	2022 (E)	CAGR	2020	2021 (E)	2022 (E)	CAGR
MSCI World	-4.0%	10.4%	5.8%	3.9%	-14.9%	29.9%	14.8%	8.3%
MSCI EM	-2.9%	15.7%	7.5%	6.5%	-9.0%	40.2%	13.8%	13.2%
S&P 500	-3.5%	9.0%	7.2%	4.1%	-16.5%	22.0%	15.7%	5.6%
STOXX Europe 600	-12.8%	8.6%	5.5%	0.0%	-30.6%	33.5%	16.2%	2.5%
TOPIX	-9.0%	6.7%	3.5%	0.2%	-15.2%	46.8%	15.6%	12.9%

Source: *Goldman Sachs, I/B/E/S*

cheaper than) the average of +3.8% over the past 20 years. The same chart for the S&P 500 would reflect an equity risk premium of +3.5% vs. +3.2% average over the past 20 years.

Exhibit 8

While DM equities earnings yield stands at record expensive levels on an absolute basis, the spread relative to the blended (70% US, 20% Europe, 10% Japan10-year government bond yield is actually in line with historical mean over the past 20 years

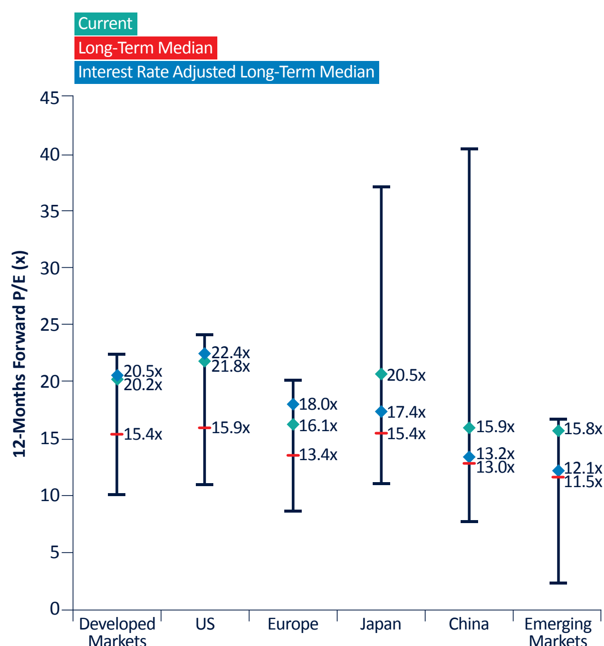


Source: *Bloomberg, Equity index returns are MSCI World.*

We can also express this by comparing the MSCI World's current 20.2x forward P/E to the 20.5x median interest-rate adjusted forward P/E over the past 20 years. For the S&P 500, the current 21.8x forward P/E is also in line with the 22.4x median interest-rate adjusted forward P/E over the past 20 years. Once adjusted for lower interest rates, equity markets generally appear to be more reasonably priced.

Exhibit 9

Current forward P/E for DM equities is in line with the interest-rate adjusted median ratio for the past 20 years. Historic P/E ratios are adjusted for current interest rates by adding the current regional interest rate to the historic equity risk premium to get an interest rate adjusted earnings yield, which is the inverse of the P/E ratio.



Source: *Index data from Bloomberg. Underlying indexes from left to right are MSCI World, S&P 500, MSCI Europe, Topix, CSI 300 and MSCI EM.*

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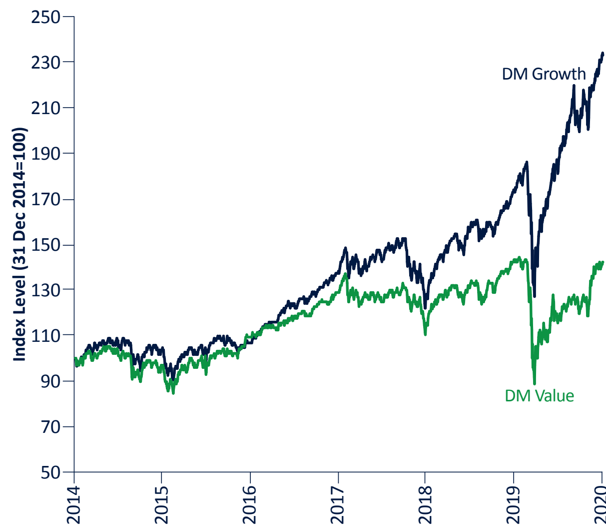
While overall equity market valuations appear reasonable, there are certain segments where valuations appear far more stretched. One of the biggest divergences has been the massive outperformance of growth vs. value over the past 4 years, with the DM growth index up +117% over that period while the value index only increased +30%. The valuation increases in certain pockets within this growth segment – e.g., high growth/no profit companies, recent IPOs, emerging technology businesses or software-as-a-service providers – have been even more dramatic. Beyond valuation, other "bubble" indicators (including retail buyers entering the market, broad bullish sentiment and purchases financed by high leverage) for global equities indicate a certain level of market frothiness. However, this is limited to a relatively small subset of equities, with one of our managers estimating that less than 6% of global companies are actually in "bubble" territory. This leaves wide swathes of the market at reasonable valuations, including, surprisingly, high-quality moderate growth compounders. We believe that our active managers should be capable of successfully navigating this market environment.

Exhibit 10

Growth and momentum outperformed in 2020, while value lagged, continuing the performance trend from 2019 and the past 5 years



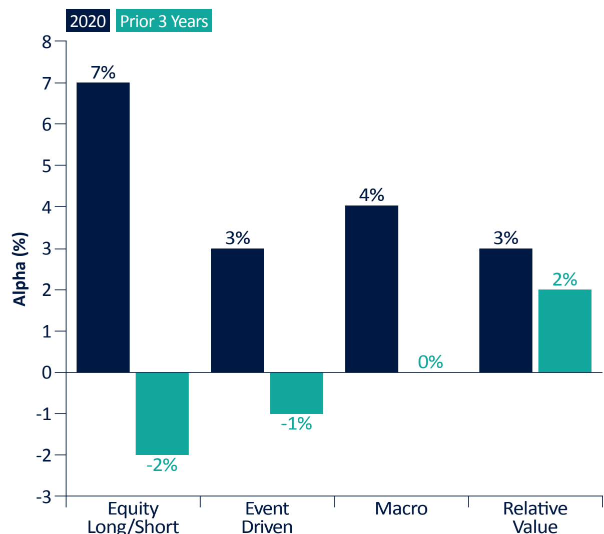
Source: *Bloomberg. MSCI World Value and MSCI World Growth.*

Hedged Equities 2020 Performance

The hedged equities industry had a bumper year in 2020 after many years of disappointing relative performance. As measured by the HFRI Equity Hedge Index, hedged equity returns at +16% made 2020 the highest total returning year since 2009 (+25%) and one of the best years for alpha returns in recent memory. For fundamental equity long/short managers, alpha returns, while volatile, were positive at nearly all points in time through 2020 on a cumulative basis. The industry overall saw alpha compression during the market sell-off in March, but quickly recovered in Q2. We do provide a word of caution, however, as we believe the Fed's actions during the initial market crisis alleviated pressure that could otherwise have led to further deleveraging across the industry, with potentially much worse outcomes for returns.

Exhibit 11

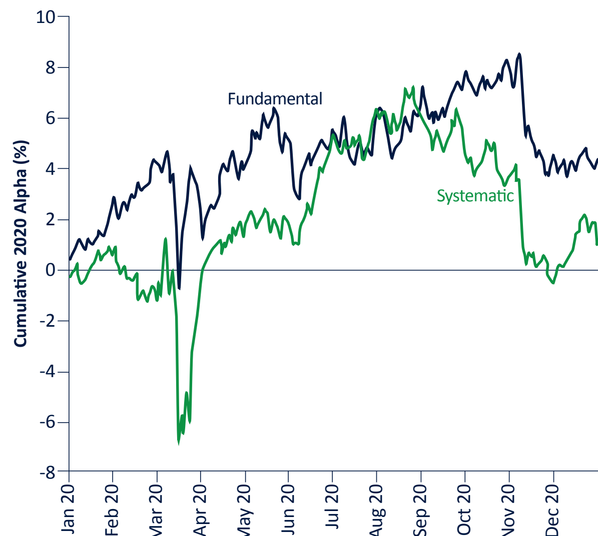
Equity long/short strategies delivered +7% alpha in 2020, ahead of other hedge fund strategies and a significant improvement over prior years' performance



Note: *Performance reflects HFRI strategy indices; estimates applied.*
Source: *HFRI, Partners Capital*

Exhibit 12

Fundamental equity long/short managers maintained positive alpha throughout the year, with alpha compressing to 0% during the drawdown but quickly recovering in Q2 2020



Source: *Based on Goldman Sachs research.*

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Public Equities 2021 Outlook

We remain constructive on global equity market returns in 2021 due to strong global growth coming out of the COVID-19 pandemic, low interest rates with limited near-term upward pressure and reasonable equity market valuations.

We continue to see a strong market environment for active management. Equity volatility and inter-stock dispersion, the raw materials for generating alpha, continue to run at elevated levels this year versus pre-pandemic markets. The number of public companies and major corporate transactions continues to grow, increasing the proportion of poorly understood businesses in public markets. In addition, we expect stocks to trade increasingly based on fundamentals in 2021 and 2022, as investors get visibility into the post-COVID-19 pandemic environment, management resumes providing guidance and companies demonstrate evidence of how their businesses strengthened or weakened through the pandemic.

The seemingly more stable global health, government policy and geopolitical environment in 2021 should also support more predictable and orderly market behavior. We certainly see risks to alpha in 2021, in particular from the extremely stretched relative valuations between certain sub-segments of the market like growth vs. value after years of significantly divergent returns. While we do not take a view on the timing of any potential mean reversion of these relationships, we do see the current environment as one in which portfolio diversification across style factors, industry sectors, geographic regions and individual securities is critical.

Investment Strategy for 2021

We remain focused on manager alpha as the core source of outperformance in public equities, and we have emphasised specialist funds and long duration strategies where managers, who are experts in their respective market segments and/or leverage specific management engagement or investment structuring capabilities, have the best chance of generating alpha.

Investment Themes

We actively take overweight (or underweight positions in investment themes where we believe there is a substantial opportunity for excess returns over the medium to long term. We have re-underwritten our three core investment themes of (1 life sciences innovation, (2 technology disruption and (3 Chinese domestic equities on the back of their substantial outperformance in 2020. However, we are mindful (a to “rightsize” these themes in our portfolios through taking profits and (b to complement them with more value-oriented exposure.

We are therefore maintaining or increasing allocations to the following value-oriented themes: (1) beneficiaries of changes in consumer behaviour catalysed by the pandemic, (2) activist investing in US small cap companies, (3) US community bank industry consolidation and (4) sustainability and decarbonisation. We believe that these themes should benefit from continued rotation from growth to value and can generate meaningful outperformance over the medium to long term.

We will briefly summarise our investment thesis for each theme and our updated outlook below. We will also provide an introduction to our four smaller themes and strategies.

Life Sciences (4%

We continue to see an attractive opportunity to profit from the explosion of innovation in therapeutics, diagnostics and devices by investing in promising public biotechnology companies through specialist managers, and have now had a meaningful allocation to this theme for the past five years. We believe that most of the value creation from this innovation is accruing to public markets investors, with a deepening opportunity set with 1,100 public biotechnology companies today vs. 560 ten years ago. Finally, we believe we have access to a set of talented managers with expertise in evaluating the scientific and commercial prospects of these companies.

There are four secular drivers that underpin our thesis for investing in the US biotechnology sector through specialist managers:

1. **Prolific innovation:** The biotechnology sector is experiencing a wave of technology-enabled innovation, including transformative therapies using gene therapy and targeted oncology techniques. These therapies have the potential to dramatically improve patient outcomes for many diseases.
2. **Supportive regulatory environment:** The FDA continues to be supportive of the industry, with shorter drug review timelines and fewer rejections, fostering therapeutic innovations.

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3. **Favorable pricing:** Prices paid for new innovative therapies and cures have continued to grow over the past decade and are expected to continue to do so where the medical value can be clearly proven.

4. **Persistent M&A environment:** Large pharmaceutical companies are acquiring smaller and more innovative biotechnology companies at substantial valuations to replenish their development pipelines and protect future revenues.

While we believe these secular drivers remain firmly in place, we are aware that the biotechnology industry has become increasingly competitive and well capitalised. This has led to increased valuations for companies with therapies in early stages of development and to increased uncertainty about the eventual winners and losers in the marketplace. We believe that our asset managers have both the scientific and commercial expertise to successfully navigate these dynamics and select the best assets. We have also expanded our life sciences exposure into Europe, which we see as a far less well covered, capitalised and priced market for biotechnology versus the US, and we have modest exposure to the emerging opportunity set in China.

Technology (5% with specialists / 16% total)

We are investing in public equities behind the theme of technological disruption and innovation through technology specialists, in addition to broader technology holdings through our generalist multi-sector managers. We continue to see acceleration in the adoption of new technology throughout the global economy, driven by (1) technological breakthroughs like cloud computing and artificial intelligence, (2) business imperative to digitise workflows and (3) consumer behavior shifts. The COVID-19 pandemic appears to have permanently accelerated business and consumer adoption of new technology by at least five years in the space of 12 months. Given technological innovation often leads to disruptors displacing incumbents, we generally look to gain exposure to this theme through hedged equities managers who have a proven ability to generate alpha returns on the long and short side of their portfolio.

We are cognisant that the incredible bull market in high-growth technology stocks has placed certain sub-sectors of the industry at very high valuations. However, we believe that the size and diversity of the industry, plus the rapid cycle of business formation and disruption, create sufficient opportunities for our asset managers to exploit without being forced into excessively valued consensus names.

China (5%)

We believe that an attractive opportunity exists to invest in domestic Chinese companies in sectors like technology, consumer, healthcare and industrials which are benefitting from the rapid innovation, huge pool of entrepreneurial talent and growing middle-class consumer demand in the country. The massive size, unique characteristics and competitive intensity of the Chinese market tends to favor private (non-state owned) Chinese enterprises, an increasing number of which are publicly listed. We also see upside to the potential for some of these companies to become true global businesses and market leaders. We invest with managers who have significant in-market expertise and extensive local networks to identify promising assets in this highly competitive market environment. Given the high level of market volatility, we also find that successful Chinese managers must have a combination of true long-term investment mindset and dynamic portfolio management capabilities.

We are mindful of two high-level risks to investing in China: (1) the evolving and sometimes unpredictable central government policy and regulation of private enterprises in various sectors and (2) the increasing tension between China and the US (and other Western countries) due to trade, economic policy and humanitarian concerns. We believe that both risks are manageable for the assets we tend to own through our managers. These assets are in industries where the Chinese government generally seems to support entrepreneurial innovation and industry growth, and they generally depend very little on accessing market opportunities outside of China. We do see the risk of substantial market volatility in China, so we focus on sizing our allocation appropriately and taking a medium-term view on our investments.

Consumer (3% with specialists / 10% total)

We have long had significant exposure to the consumer sector through our generalist multi-sector managers and other strategies. Comprising 20% of global equity market capitalisation (second in size only to the technology sector), the consumer sector encompasses a large set of companies with diverse business models operating in different areas of the value chain and serving a variety of end markets. We have seen this space in recent years become the epicenter of business disruption driven by the confluence of consumer behavior shifts, technology and business model innovation and legacy asset repurposing. Technology convergence has arguably been most prounounced in the consumer sector. All this makes the consumer sector an area with high potential alpha from managers who can piece together the complex dynamics and identify winners and losers in the space.

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We have recently added to our exposure in this space through consumer and technology + consumer specialist managers, who invest behind these drivers of our overall alpha-oriented thesis for the space:

1. **Profound shifts in consumer behavior:** The way consumers acquire and consume goods and services has changed in fundamental ways over the past 10-20 years, facilitated by internet and mobile technology. A new generation of consumers with starkly different tastes, behaviors and values has considerable and increasing purchasing power. Digital and streaming media, the shared economy, peer-to-peer social networking and commerce and online gaming are just some of the examples of industries that have been created or transformed as a result.
2. **New technology-driven models for sales and distribution:** The way companies engage, transact and build relationships with their customers has undergone massive change. What started as the surge of basic e-commerce business models in the late 1990s/early 2000s has blossomed into businesses deploying an intricate web of digital and physical assets, personalising experiences through computer algorithms plus human connection and providing consumers flexibility to "meet them where they are." The emergence of direct-to-consumer and omni channel models in retail is an example of how these changes are reshaping an entire industry.
3. **Repurposing legacy assets and investments in digital ones:** Established consumer companies are determining how to leverage their legacy assets (and which ones to jettison) and making massive investments into digital assets (with varying levels of success) in order to adapt to and compete in the current marketplace. Many traditional business models are struggling to retain relevance. Competitive dynamics in many industries are evolving rapidly.
4. **Pronounced market share shifts and consolidation:** All the dynamics above are leading to dramatic market share shifts within many areas of the consumer sector, with new entrants displacing traditional players. Established companies successfully transforming their business models are winning against those struggling to do so. Best-in-class companies are consolidating share at the expense of smaller "Mom-and-Pop" businesses. Partnerships, mergers and acquisitions are accelerating market share gains and business extensions.
5. **Acceleration of structural changes due to the COVID-19 pandemic:** The COVID-19 pandemic has led to a rapid acceleration of longstanding consumer trends and a dramatic pull forward of customer adoption of new models in the consumer industry. Many of these changes are expected to become permanent as the extended nature of the pandemic creates new consumer habits, "discovery" of new models leads to long-term use and businesses make significant investments to support these new ways of doing business. Certain businesses have structurally improved their competitiveness and intrinsic value due to actions taken during the pandemic, while others have suffered.

We see tremendous opportunity for those investors who can identify early disruptive trends in consumer industries, piece together their complex impacts on the entire ecosystem and underwrite the under-appreciated winners and losers to generate significant returns. We focus on managers taking a true long/short approach to investing in this space given the presence of winners and losers from these dynamics – our thesis is based on the ability of active long/short managers to generate alpha rather than a directional bet on the consumer sector. We have invested behind what we believe to be exceptional investment teams within consumer specialist managers, in addition to strong consumer investors within generalist multi-sector funds.

Small Cap Activism (2%)

We see an attractive opportunity in activist and structured investing in small cap US companies. This investment theme is focused on companies with established businesses that need outside capital and/or engagement to unlock their full potential value. The investment approach is to provide capital in either structured equity-linked investments or as common equity, and then to work closely with management to execute an often transformational business plan over several years.

Our investment thesis is based on: (1) large under-followed universe of 2,000+ companies with significant variation in underlying business quality, (2) attractive entry valuations due to high stock price volatility plus potential for structured investments (one of our managers has 50% of its capital in structured investments with downside protection and full upside participation), (3) demonstrated strategic and operational value add capabilities of our investment managers in this space and (4) variety of exit options including sale of stock back into the public market, strategic transaction and acquisition by financial sponsor (one of our managers has had 25% of its exits through private transactions).

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We believe that our managers within this investment theme should be able to generate high idiosyncratic returns over the long term that will substantially exceed the market performance of small cap equity and broader global equity markets. In addition, their investment portfolios tend to be comprised with low to moderate growth companies in traditional industries trading at reasonable valuations, a set of more value-oriented stocks that we believe complement our core growth-oriented themes.

Community Banking (1.5%)

We see compelling investment returns over the next two to three years for the US community bank industry, enhanced by the potential for excess returns through active management in the space. US community banks are small, local banks whose primary function is generally business and commercial lending to small and medium enterprises in communities thoughout the United States. These banks may also engage in depositary banking, business banking and investment management, among other activities. The relationships between bankers and community businesses remain central to these banks. Our investment thesis for community banking is as follows:

1. **Attractive valuations relative to expected credit defaults:** Community and regional banks are trading at a meaningful discount to their long-term price-to-book and price-to-equity averages. We believe that the credit write-offs for the industry, and certainly for the individual banks in our portfolios, will be well below what is priced into their stocks. Under what we believe to be the most likely scenario for bank credit write-offs, the implied return for the industry would be +20% to +30% p.a. over the next 1-2 years.[9]
2. **M&A tailwinds in the community and regional bank space:** Consolidation of US community banks is a continuing trend with long-term structural tailwinds despite a "pause" in 2020. Despite the challenging year, our US community banks manager experienced no deal breaks in portfolio company M&A activity. Industry trends based on post-GFC consolidation history indicate a 4.5% average annual consolidation from 2020-2030. For reference, this would leave c. 3,000 banks in 2030 compared to c. 10,000 in 1999.
3. **Impact of deregulation and lower regulatory burdens:** We see continued benefits to the industry from a broad push towards lowering regulatory burden and easing M&A activity. In addition, new codification of the Bank Holding Companies Act now permits investment funds to control up to 24.9% of a bank's shares, up from 10.0% prior, allowing investment managers to build larger share ownership and take more board seats in these companies.
4. **Significant dispersion in a large investment universe:** The US community bank industry comprises approximately 5,000 individual publicly traded banks with average market cap of less than $1B and median market cap in the hundreds of millions. These stocks have exhibited meaningful dispersion due to variations in business mix, regional exposure, credit underwriting quality and management execution, among other factors. Few investors or organisations have the focus, experience and relationships to invest successfully in this space.

In addition to this standalone investment thesis, we believe that these stocks would benefit from a general market rotation into value-oriented equities or from increasing interest rates, which balances out other exposures in our portfolios.

Sustainability (1.5%)

We are planning to substantially increase our investment behind the broad theme of sustainability and decarbonisation, especially as it relates to the energy transition economy. This theme encompasses the diverse set of companies across various industries leading and benefiting from the shift towards more sustainable approaches to energy and resource production and usage, reducing human impact on the environment and addressing global climate change. While we have modest exposure to this theme today through some of our generalist managers, we plan to make a dedicated allocation in 2021 and substantially increase our investment here.

Our sustainability thesis is driven by three interconnected "mega trends": (1) decarbonisation across industries, as corporations shed carbon-intensive assets, (2) electrification, where increasingly cost-effective energy sources and storage are driving adoption, and (3) the circular economy, where waste and pollution are designed out of the system. These trends are supported by new technologies and shifting cost curves, changes in consumer purchasing habits and public sentiment, and citizens voting for government support and regulation favoring a sustainable future. National and supranational government bodies are also incenting sustainable corporate behavior with "stick and carrot policies," rewarding the sub-industries and corporations willing to lead with capital in the forms of grants and subsidies. Corporations, facing both pressures from consumers and government bodies, as well as from investors with increasing calls for divestiture or activism to shed carbon-intensive assets, are shifting their technology and R&D spending to align with these demands.

[9] Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance. Please see important Disclaimers at the end of this material.

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Given the emergence of both winners and losers from this structural change, we focus on equity long/short strategies within this space. We target specialist managers, typically within the infrastructure and utilities space, who have a multi-industry approach, as the impacts will be felt across standard industry sectors. We also prefer strategies that isolate this idiosyncratic thematic element and attempt to mitigate undesired betas common in the space, such as to oil, industrials and materials.

Long Equities Investment Strategy (32%)

Within long equities, we concentrate capital in long duration, quantitative and co-investment strategies, which comprise 24% of the 32% allocation to long equities in the model portfolio. We recommend a 10% allocation to long duration, 10% to co-invest, and 4% to quantitative strategies focused on top external manager platforms. The remaining 8% allocation in long equities is reserved for exceptional traditional fundamental strategies or for passive allocations to manage portfolio liquidity or exposures.

Long Duration (10%)

Long duration strategies take advantage of patient capital to target opportunities for outsized returns in public equities through a variety of approaches. This is the strategy area within long equities with the highest expected alpha. Long duration strategies seek to generate their alpha through a combination of five elements: (1) "private equity style" deep, fundamental diligence on a concentrated set of companies as the foundational element; (2) close engagement with company management teams over many years, sometimes taking the form of activism; (3) aligned fee structures with performance fees paid only on alpha; (4) true domain expertise in a specific industry, geographic, thematic or other market niche; and (5) ability to structure investments or participate in "off market transactions."

We make small, targeted opportunistic investments within our long duration portfolio, such as into Indian financials through a local manager initiated in late 2020 or into North American railroads through a directly held basket in 2018 to 2020. We also express many of our broader investment themes in larger size. Finally, we expect managers in this area to systematically incorporate ESG considerations into their evaluation of and engagement with companies, and we are working with our managers and other industry participants to support implementation of best practices in this "ESG integration" approach.

Co-Invest (10%)

Our public equity co-investment program now includes four individual strategies, three focused on developed markets (including our new ESG variant) and a fourth focused on Asia. All have the aim to offer access to the top stock ideas of our highest conviction managers.

Given the concentrated nature of these strategies, we seek to diversify the portfolios across geographies, industry sectors and style factors to manage risk. We do this by selecting a diverse set of underlying managers including a mix of growth, value and quality managers – and by having portfolio exposure guidelines by geography, industry sector and market cap.

Quantitative (4%)

Quantitative strategies have been a more recent addition to our long equities model portfolio, with a focus on long/short equity funds which are managed to a beta of 1 to equity markets. We believe the addition of such quantitative funds into portfolios is accretive on account of their attractive underlying alpha engine, enhanced capital efficiency and superior portfolio construction approach, which reduces alpha volatility and enhances the quality of the alpha. These funds are also generally diversified, liquid and low cost relative to fundamental strategies.

While quantitative strategies have some elements of a "black box" for investment diligence, we believe there are specific traits that are essential for success. These include platform scale providing a significant budget for R&D, ability to attract and retain research talent in size, differentiated access to proprietary algorithms, high volumes of data and accumulated experience, and a proven historical track record. While we saw muted performance from these strategies in 2020, a year marked by exogenous shocks to the market that dampened the performance of forecasting models based on historical relationships, we continue to view this strategy as attractive going forward.

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Traditional Fundamental (8%)

We will allocate to traditional fundamental strategies only on a highly selective basis. While we remain skeptical of this strategy area as a whole, we are open to allocate to truly exceptional managers and saw significant value add from our managers in this space during the turbulent market in 2020. We avoid most traditional fundamental funds because they have been generally less liquid, more expensive and more prone underperforming in sharp market reversals. Most fundamental strategies also tend to have a style bias (quality/growth) which can explain most of the alpha, making for an even harder case to allocate to these funds. Since our default allocation is passive equities, we have the luxury to allocate only when we identify these exceptional situations. We target fundamental managers with the following traits that we believe may make them exceptional: outstanding senior investment talent, a clear structural research advantage, nimbleness and dynamic investment actions, a desirable portfolio management approach and a highly attractive fee structure.

Hedged Equities Investment Strategy (15% Allocation)

We believe the environment for fundamental stock selection will be favourable in 2021. The expected return to a market that trades more based on individual company fundamentals vs. COVID-19 or macro factors, and the high dispersion in stock price performance between individual companies even within industries and sectors, should support alpha generation from talented stock pickers. While hedged equities managers will make adjustments to their risk management approaches on the back of the retail trading driven “short squeeze” and portfolio deleveraging in January, we do not expect these adjustments to structurally impair the alpha opportunity for the industry. We do think, however, it emphasises the importance of investing in managers who focus on out-of-consensus names, especially on the short side, and who employ sophisticated and disciplined risk management, as we have long done.

Sector Specialists (12%)

Within our 15% allocation to hedged equities, we recommend a 12% allocation to specialist managers within select industry sectors, geographies and other market niches. We have identified and invested in specialist managers in the following market niches across hedged and long equities, as detailed in the investment themes section:

- Life sciences
- Emerging technology
- China
- Consumer evolution
- Small cap activism
- Community banking
- Sustainable energy

To support our focus on specialist managers, we have had to evolve our approach to portfolio construction. In general, we have increased the diversification in our hedged equities portfolio by including a greater number of managers to offset the higher volatility of individual manager outcomes for specialists. In our view, the optimal portfolio should be diversified across market niches, as well as across investment styles and individual managers. We believe we can offer this portfolio most effectively to our clients through our hedged equities pooled vehicles.

Generalists (3%)

We reserve our remaining hedged equities allocation for exceptional generalist managers, in particular those who have a successful and consistent approach to short selling. We believe these managers can allocate investment capital and research resources to the areas with the most interesting investment opportunities at any point in time. We generally prefer smaller and earlier lifecycle managers, who have the ability to trade small and mid-cap stocks and who can differentiate themselves through short selling. We also tend to focus on managers who invest in sectors (like cyclicals and industrials) and pursue strategies (like long/short small cap) that provide diversifying exposure to our core investment themes and overall portfolio.

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