PARTNERS CAPITAL

Insights 2023

Asset Class Investment Strategies

Public Equities

Public Equities for Partners Capital refers to all investment strategies that primarily invest in listed equity securities. These include both what would traditionally be referred to as long equities (strategies that invest only long or manage portfolios that are heavily long biased and have equity risk similar to the market) as well as hedged equities (long/short strategies with lower equity risk than the market, down to equity market neutral strategies). Public Equities strategies can be further divided by a number of dimensions, including their geographic area of focus (developed markets, emerging markets, country-specific specialists), sectors (generalists, sector specialists), investment approach (discretionary fundamental, quantitative) and time horizon (short term, long duration).

We believe that Public Equities portfolios that are constructed to generate attractive long-term risk-adjusted outperformance should look to balance their exposures to these different types of strategies. Alpha, i.e. the performance of a strategy relative to its relevant benchmark, generated by different strategies has historically shown to be cyclical and hard to forecast. We believe we can add more value for our clients by identifying the best managers applying these different strategies and combining them in a portfolio with moderate tilts towards areas that we perceive to be most attractive rather than trying to time substantial skew risks to certain regions, sectors, or styles.

When it comes to building portfolios of different investment strategies, we favor a risk-based approach that also takes into account our level of familiarity with a strategy and differentiates between core and satellite strategies:

1. **Core Strategies** – Core strategies tend to have low to moderate volatility of active returns, which are to a large degree driven by idiosyncratic factors (rather than exposure to a certain style or industry), and typically have exposure to a broader set of return drivers. These features tend to make core strategies less dependent on a certain market regime to generate alpha, which can allow investors to make these strategies a larger position in their portfolios. On the other hand, the overall outperformance potential for core strategies is typically more limited due to the lower levels of risk these strategies take.
2. **Satellite Strategies** – Satellite strategies tend to be more narrowly focused on specific areas of the market. They are often run by specialist managers who have carved out a specific niche for themselves. Satellite strategies tend to come with higher volatility of outperformance but also the chance for higher total returns and alpha over time. The focus on a specific niche means that their success over shorter periods of time can in large parts be driven by whether their area of focus is in favor at the moment or not. This is especially true for directional satellite strategies which come with significant exposure to the beta returns of specific industries or regions which will at times overwhelm the effect of any stock selection alpha of a manager relative to the most relevant passive benchmark for their universe.

Major Trends

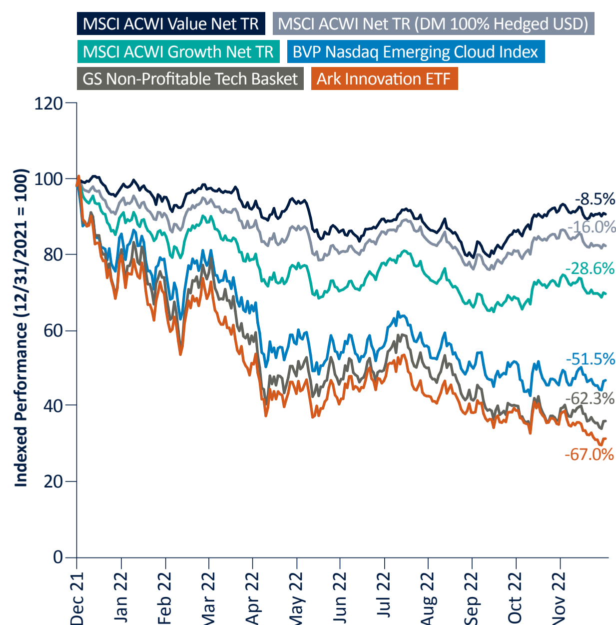
Market sell-off on the back of interest rate regime shift. 2022 was the worst calendar year for Global Equities since 2008. Russia's invasion of Ukraine added an inflationary shock to the aftereffects of significant consumer stimulus and the supply chain impacts from restarting the global economy after Covid. As inflation increased, central banks globally started to increase policy rates and government bond yields increased globally with the speed and extent of the hikes surprising most market participants to the upside. For 2022, the decline in equity markets can predominantly be explained by multiple contraction. For example, going into 2022 the consensus expectations for earnings per share for the S&P 500 for the year 2022 were $223. Going into 2023, earnings expectations for 2023 were $229 per share. Nevertheless, the Index has fallen by 19.4% in 2022 as the multiple on forward

earnings has fallen from ca. 21.4x to 16.6x. Looking forward, many believe we are close to the peak of interest rate hikes and the outlook for earnings will be more consequential for equity prices, particularly in a world of slowing economic growth.

Significant sell-off in growth/unprofitable/ speculative assets: The index level moves discussed above hide the extreme rotations within the market in 2022. Exhibit 1 shows the significant performance differential between headline growth and value indices. The decline of more specific high-growth benchmarks such as the GS Non-Profitable Technology basket, the BVP Nasdaq Emerging Cloud Index or even the ARK Innovation ETF convey a better idea of the magnitude of underperformance of the highest growth areas of the market.

Exhibit 1

High Growth segments of the market underperformed substantially in 2022



Source: *Bloomberg*

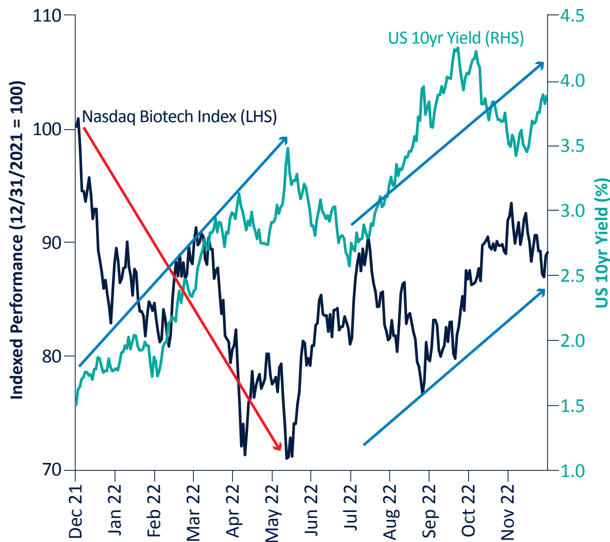
While many commentators attribute a large part of the underperformance of these areas of the market to the long duration of these companies' cash flows in a rising interest rate environment, it is hard to not also observe a distinct sentiment shift in markets away from speculative growth. While the low interest rate environment in 2020 had led to an appreciation in most speculative assets with limited fundamental differentiation, 2022 has seen the pendulum swing to the other side with a correlated sell-off independent of company fundamentals.

Narrow pockets of strength: There was only one sector in the global equity market that generated strong positive returns in 2022: Energy stocks were up +33.1% (Measured by the MSCI ACWI Energy Net Total Return USD Index). Energy prices had begun rising in 2021 as global demand for commodities rose with economic restrictions loosening. This was further exacerbated by limited inventories, an outcome of structural underinvestment in fossil fuels in prior years. The Russian invasion of Ukraine provided a further short-term spike to prices which moderated later in 2022. Against this oil price backdrop, energy companies were able to significantly increase their margins and earnings and positive effects were also experienced by companies exposed to increasing capex in both the traditional and renewable energy space. While some of our public equity managers were positioned to take advantage of this theme, many were underweight the space.

Stabilisation in biotechnology after a 15-month bear market: Against the backdrop of rising interest rates and a generally tighter liquidity environment, the life sciences sector had experienced significant underperformance. From its peak in February 2021 to its trough in May 2022, the Nasdaq Biotechnology Index had fallen by almost -40%. However, as shown in Exhibit 2, despite interest rates continuing to rise and other growth areas of the market, like emerging technology, continuing to underperform, this index recovered by almost 25% during the remainder of the year. This de-coupling was supported by the idiosyncratic characteristics of the biotechnology industry coming to the fore again during the second half of the year: Positive drug trials and takeover announcements supported not only individual companies but also led to a positive sentiment change for the industry overall.

Public Equities
continued

Exhibit 2
Biotech equities recovered in the second half of 2022 despite interest rates continuing to rise



Source: *Bloomberg*

China is the last major market moving on from Covid as a key driver of equity markets: While Covid was a dominant factor for global equity markets in 2020 and 2021, in most developed markets the less lethal Omicron variant and a higher level of population immunity significantly reduced its impact on equity markets in 2022. The major exception to this pattern was China where the country's "zero-Covid" policy resulted in repeated lockdowns of significant parts of the country, impacting both consumption and production activity. This was one contributing factor to China's underperformance in 2022 (MSCI China -23.5%). However, China's approach to Covid shifted significantly in early 2023 with policy makers pivoting to a fast re-opening strategy after signs of discontent against a continuation of the zero-Covid policy after the 2022 CCP Congress. While in the near term the policy change has led to a spike in infections and likely had a significant humanitarian impact, over the medium term the strategy should result in a normalisation of China's economic consumption and production environment.

Positive alpha from shorts: While 2022 overall was a negative year for public equity alpha, the performance of shorts has been a bright spot. For the industry as whole, short positions have been a source of positive alpha as the average short position has declined more than the overall market. Some of the largest Prime Brokers, who have good insights into the equity long/short industry's overall short positioning, have characterised 2022 as the year with the strongest short alpha for more than a decade. Strong short alpha has also been a key contributor to the generally stronger alpha returns of equity market neutral funds, which tend to run with larger short portfolios. An environment of tighter financial conditions raises the bar for companies with lower profitability or greater financing needs who can no longer borrow as freely, and we expect this environment to continue to provide attractive catalysts for short positions.

The evolution of Hedged Equities at Partners Capital: Hedged Equities encompasses a wide range of strategies ranging from Absolute Return-style equity market neutral managers to managers that take a significant amount of equity market risk. Over the past years, we have expanded our Hedged Equities program at both ends of this spectrum. We've added a number of managers that see portfolio construction as a key value-additive skill and run portfolios well balanced between longs and shorts, making them less susceptible to market rotations. However, these strategies tend to take significant leverage risks. By and large, performance of this part of our portfolio has been strong, including in the challenging year of 2022. On the other hand, we have also added a number of directional managers that rarely short and run concentrated portfolios, often in our key innovation themes. While the long-term track records of these strategies remain attractive, the last two years have been challenging. We continue to believe that this barbell approach is attractive as it combines higher return generation potential driven by concentrated stock picking with the more consistent return profile of lower-net managers. However, we acknowledge that there are a small number of exceptional investment organisations that do not sit at the ends of this spectrum and can add further diversification

to portfolios. As such, while the exposure to this type of manager in our portfolios has fallen, we intend to maintain exposure to what we consider to be the strongest managers in this space. These managers differentiate themselves via the talent they attract, the research resources they can bring to bear and the process discipline honed over their careers.

Golden Rules

- Focus on stock selection as the main sustainable driver of outperformance in Public Equities. History suggests that market timing, sector timing or factor timing are not high risk-adjusted return strategies.
- Repeatable outperformance has to be rooted in a repeatable investment process.
- The more idiosyncratic the sources of returns, the more likely they are to be structural. Market/sector/style betas are more likely to be cyclical sources of return.
- Appropriate alignment between the manager and investors is key, with a special focus on tying fees to skill-based returns.
- Size managers based on active risk contribution, drawdown tolerance and breadth of alpha sources. Grow into investments with new managers over time.
- Diversify sources of active risk. No strategy works all of the time.
- Be disciplined in taking profits and rebalancing portfolios.

Sub-Strategy Attractiveness

Increased cost of capital improves opportunity for short alpha after interest rate regime shift: Positive view. 2022 was a negative year for public equity alpha generation. We note that the performance pattern of 2022 was one of significant underperformance during the first half of the year, the period that saw the market adjust to higher inflation and interest rate expectations, while also having to contend with the impact of the Russian invasion of Ukraine. As the year progressed manager alpha stabilised and delivered positive contributions in the second half. Public Equities managers have historically lagged during periods of regime change as most are slow to adapt to a new environment, especially when it comes to assessing the appropriate valuation multiples for their businesses. As markets settle into a new regime, managers' differentiated views of business quality and earnings trajectory should again become larger drivers of security returns. We continue to see an attractive set-up for alpha from short positions in this environment. Short alpha has broadly been strong after the "meme stock" episode in early 2021. While in the loose liquidity environment of past years, companies were only required to clear a historically low cost of capital hurdle and were given flexibility to refinance their debt on attractive terms. The recent tightening of financial conditions has set an end to this dynamic and challenges fundamentally weak businesses to show a path to profitability which in turn has driven a de-rating in their valuations. We expect this environment to continue in 2023, which should provide a positive set up for alpha from short positions.

Life Sciences: Positive view on the opportunity set for life sciences managers going into 2023 and continue to invest in the space as one of the larger satellite positions in our discretionary pooled vehicles. We believe that the characteristics that make the sector structurally attractive for an allocation via specialist active funds remain in-tact: Ongoing innovation increases the ability of companies to develop drugs that address

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previously unmet medical needs, which creates significant opportunities for shareholder value generation. The sector is characterised by high dispersion in share price moves between winners and losers and requires significant domain expertise to invest. 2022 was a challenging year for the space as the rising interest rate environment impacted all long duration assets, including biotech. The sector was also not unaffected by the speculative mania of 2020 and early 2021, leading to notable excesses having to be priced out of the market. Over the course of 2021 and 2022, valuation levels have substantially re-set. This has helped catalyse a pickup in M&A activity as the problem of patent expiration cliffs for big pharma is not going away. The second half of 2022 has shown that in a more stable market, scientific breakthroughs were again rewarded with outperformance and the ability for companies to raise fresh capital, marking a return to a more normal market environment in the space. We continue to believe that the opportunity is best accessed via specialist managers with in-house domain expertise and a strong network in the industry. While over past years we had primarily allocated to very directional strategies, the continued unwind of excesses in the market should result in a more balanced opportunity set for both longs and shorts in 2023.

Emerging Technology: Positive view. While we continue to have conviction in the long-term return potential of investing in innovative technology, we have reduced the size of our emerging technology satellites. 2022 has been a year of significant multiple contraction in the space. However, some argue that this does not make the sector cheap but instead in many cases only represents a correction of the “irrational exuberance” of 2020. The de-rating of the sector has arguably been lacking differentiation with currently unprofitable companies selling off largely in unison, which should lead to opportunities for our emerging technology managers to identify companies that have been unduly punished. On the other hand, the near-term outlook for emerging technology companies overall is less positive. Despite being supported by strong structural tailwinds, companies in the space nevertheless tend to be exposed to the overall economic cycle. In an environment of slower economic growth, or even a recessionary environment, companies could experience a slowdown in top-line growth, which means that optically attractive valuation levels might turn out not to be a buying opportunity. The sector also does not provide the same idiosyncratic catalysts like successful drug trials in biotechnology. Moreover, while the life sciences industry is well-versed in managing the funding of early-stage, unprofitable companies through to clinical success, this discipline is less established in emerging technology and the impact of a tighter liquidity environment and higher cost of capital on companies’ ability to execute on their growth plans remains to be proven. For the reasons discussed above, the majority of our emerging technology managers run with below average levels of risk going into 2023. We expect managers to increase their risk level again once they see the near-term fundamental weakness reflected in company valuations or once there is more clarity on the path of economic growth and its impact on the sector.

Sustainability: Positive view. In general, we have seen strong returns from our managers focused on sustainability and energy transition in 2022 and we continue to have a positive view on the opportunity set. The structural changes that come from large scale electrification and decarbonisation will continue to impact revenue and profit pools for different industries and companies for the foreseeable future. These conditions should drive significant price dispersion between companies allowing active managers the opportunity to generate outperformance from stock selection. We prefer partnering with managers that can assess company fundamentals via domain expertise within industrials, energy, materials and/or utilities given the complex nature of energy transition. Additionally, we believe that there will be significant short opportunities from companies that fail to play a role within energy transition or that fail to live up to expectations within the space. The ability to benefit from active

selection for both long and short opportunities paired with the benefit of portfolio construction designed to minimise market, factor and industry exposure has led to the majority of our capital within sustainability and energy transition being allocated to long/short equity managers with low directional exposure. Our managers materially benefitted from short positions over the course of 2021 and 2022 where the market was previously too optimistic on new technologies that lacked proven products or companies that continued to prioritise growth over sustainable earnings power. Going forward, we continue to expect that there will be significant opportunity on both the long and short side of portfolios within the sustainability and energy transition theme.

US Small Cap: Positive view. There is a strong theoretical case for expecting small cap markets to be a more fertile hunting ground for alpha from stock selection. The smaller size of these companies makes them less relevant for many of the larger active equity investors in the market. Sell-side coverage also tends to be lower, arguably resulting in higher alpha potential for managers that have the ability to more accurately assess companies' business prospects. Partners Capital has for many years allocated capital to dedicated small cap strategies, mostly strategies that take a more valuation-sensitive approach to investing and are experienced in actively engaging with company management teams to help catalyse a realisation of the value they see embedded in their portfolio companies. Going into 2023, we see the structural alpha opportunity in US small cap companies supported by an attractive valuation tailwind. While US large cap equities, for example proxied by the S&P 500 index, trade at a P/E multiple close to the historical median going back to 2005, small cap stocks, proxied by the Russell 2000 (only looking at companies with positive earnings), trade in the bottom decile of their historical range over that period. As such small cap companies currently look attractive relative to both their own history and their large cap equivalents. On the other hand the typically higher cyclicality of small cap companies compared to large cap companies could argue for caution as earnings might have further to fall in the event of an economic slowdown. We therefore believe it is important to be selective in the space and are partnering with managers who either focus on identifying high quality companies or who have a track record of engaging with management teams and implementing change that can drive value creation for their investment.

China: Neutral view. Going into 2023, we are gradually reducing our overweight to Chinese equity markets. Our overweight was driven by Chinese equity markets offering exposure to an attractive market backdrop driven by economic and population growth, the opportunity for active managers to generate alpha in relatively inefficient markets and diversification benefits relative to developed equity markets. While the latter two arguments still hold, our view of the beta opportunity set has deteriorated. In the near term, re-opening from the zero-Covid policy could well support a market really, which argues for a gradual reduction of our overweight. However, over the longer term deteriorating demographics and a political leadership that arguably leads to increased geopolitical risk as well as less certainty of shareholder rights argue for a deteriorating long term strategic outlook.

2023 Strategic Priorities

- **Continue to balance out active risk in Public Equities portfolios:** The changing economic and interest rate environment argue for a broader diversification of active risk across the style spectrum and a reduction of the risk contributed from high growth innovation themes, especially in emerging technology. We are looking to reduce the risk contribution from these satellites and re-deploy risk into core managers that are less style dependent.

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continued

- **Identify managers that are balancing to our existing growth-oriented satellites:** As we look to continue to broaden the sources of alpha in our portfolios we are particularly focused on identifying talented investors that are able to generate outperformance in areas that are not well covered by our existing, more growth-oriented satellites.
- **Explore innovative approaches to achieve risk-managed beta-one exposure:** In an environment of elevated market and factor volatility, equity market neutral strategies that put a dedicated emphasis on targeting mainly idiosyncratic risks have in the past several years been able to generate attractive risk-adjusted returns. There is a lack of comparable offerings that deliver a similar active risk/return profile on top of broad equity market exposure. We look to explore partnering with successful hedged equity managers of this style to access their alpha streams in a beta-one format.
- **Explore opportunities in Emerging Markets outside of China:** As described above, we are in the process of reducing our overweight to Chinese equity markets. We have started to increase our research focus on potential opportunities in other emerging markets. This includes other opportunities in Asia (India, South East Asia) or other emerging market regions. Outside of Asia we have historically struggled to find emerging markets managers that are able to consistently generate returns in what are relatively niche geographies with the relative market returns for these markets often overwhelming local stock selection success, especially given that most of these regions require either long-only or long-biased investment approaches.
- **Partner with the highest calibre new launches:** Even in a difficult environment for new launches, we expect to be able to find a small number of high calibre investors that spin out from their previous shops. We put a special emphasis on identifying investors and teams with diverse backgrounds as part of our sourcing effort. Being in a position to identify and partner with what we perceive to be the best of them can allow us to secure attractive terms and future capacity for our clients.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Hedged Equities and Long Equities

	Hedged Equities	Long Equities
Risk-free Rate	3.5%	3.5%
Risk Premium	2.3%	4.5%
Illiquidity Premium	—	—
Manager Alpha	2.0%	1.0%
Total Return	**7.8%**	**9.0%**

Beta return of 8.0% for Long Equities reflects 5.2% nominal revenue growth (in line with IMF's forecast of nominal GDP growth), minus -0.5% from decline in profit margins, plus +0.7% from multiple expansion as equity risk premium contracts, plus +2.6% dividend yield. Beta return of 5.8% for Hedged Equities derived from 0.5x Cash + 0.5x Long Equities exposure, with manager alpha of 2.0% in line with our rolling 3-year pooled vehicle results over the past 10 years.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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