Tactical Asset Allocation

Our base case economic scenario is for a re-acceleration of global growth and a modest increase in inflation. We continue to underweight Government Bonds and Liquid Credit, favouring Private Debt which also includes attractive uncorrelated opportunities. We maintain an overweight allocation to Emerging Markets and Hedged Equities, with a commensurate underweight to long-only Developed Markets. Within EM we have an overweight to China, which we believe continues to offer interesting investment opportunities and scope for significant manager alpha, while the Hedged Equities overweight is the result of our strong preference for long/short sector specialist managers focused on innovation, life sciences, and technology. We also maintain a 2% allocation to Gold, which is not in the SAA, reflecting our concern of potentially higher inflation in the medium-term.

Tactical Asset Allocation Process

Our Tactical Asset Allocation (TAA) process seeks to optimise performance over the next 12-18 months. All deviations discussed here reference our central benchmark policy portfolio for a large non-taxable institutional investor denominated in USD, which we refer to as the Strategic Asset Allocation (SAA). The direction of these changes will be relevant to our taxable clients as well, but with different starting and ending allocations depending on each client's tax situation[1].

One of our founding principles is that attempting to time the entry and exit from markets will generally lead to sub-par returns over the long run. Instead, we believe the best method for securing stable long-term returns involves setting an appropriate risk budget using our Equivalent Net Equity Beta (ENEB) framework and allocating that risk across different types of market-risk including equities, credit, interest rates and inflation. In this way we ensure that portfolios are best positioned for where we are in a cycle, remain well-diversified and that clients reap the benefits of a regularly rebalanced multi-asset class portfolio.

A Strategic Asset Allocation (SAA) is typically set by optimising a portfolio given the expected long-term return and volatility of each asset class. We deviate from this SAA when our near-term return expectations deviate from the expected long-term returns. Our forward-looking assessment of likely near-term vs long-term returns draws heavily on our macro views (Chapter 2) to determine how certain critical events transpire in relation to what is already discounted into asset prices.

Our TAA process starts by closely scrutinising valuations across asset classes to infer what the market has discounted into prices. We then contrast that against what we believe could occur across our base, downside and upside scenarios (all probability-adjusted) to come up with our expected outcome. If near-term return expectations are materially different from long-term expectations, then there could be a TAA opportunity. Finally, we combine our expectations for broad asset class returns at a macro level with our expectations for specific micro-opportunities within asset classes and at the manager level to come up with additional TAA opportunities for skews within each asset class.

An open dialogue with our investment managers and most informed clients gives us a useful view of where specific opportunities are emerging, helping us to allocate capital to managers who specialise in the areas with the richest opportunity set, and where the likelihood of outperformance appears greater.

Changes to Strategic Asset Allocation

Partners Capital advises a wide range of clients, each with a bespoke portfolio given different objectives and constraints. To allow us to talk about asset allocation in more general terms in this publication, we describe a hypothetical Strategic Asset Allocation (SAA), which should reflect the 'typical' Partners Capital client portfolio.

The SAA is long-term in nature and we try to avoid changing it. However, a recent review showed that our average client today has a higher risk tolerance and a higher illiquidity budget compared to the average client portfolio when we last reviewed the SAA. Exhibit 1 overleaf summarises the changes. This will not have any direct impact on client portfolios and should not be interpreted as a recommendation to increase risk in your portfolio.

An additional change is the inclusion of Private Debt as an asset class. We first invested in Private Debt in the wake of the 2008 financial crisis when the sudden withdrawal of bank-lending created attractive opportunities for alternative lenders. At the time, we viewed this as a tactical short-term opportunity, but after more than a decade we continue to find attractive opportunities within Private Debt especially relative to Liquid Credit which has reached record low yields.

We have a structural preference for Private Debt relative to generic Liquid Credit given the superior total return potential and the bilaterally-negotiated documentation which provides superior downside protection. We therefore formalise this by adding Private Debt to the SAA in place of Liquid Credit, though the ability of a client to implement Private Debt in their SAA will depend mostly on their liquidity constraints. Those clients able to tolerate more illiquidity should always default to Private Debt rather than lower-yielding liquid alternatives. Allocations to Liquid Credit would therefore be appropriate for clients who cannot tolerate the illiquidity of Private Debt. However, we may also tactically allocate to Liquid Credit where we see dislocations and attractive sub-asset class opportunities, which would be funded from other liquid asset classes such as equities.

[1]Partners Capital are not a tax advisor. Tax treatment will depend on the individual circumstances of each client and is subject to change. Clients should consult their own tax advisors to understand the tax treatment of a product or investment.

Exhibit 1

Our SAA has been adjusted to better reflect our average client's portfolio and to formally incorporate Private Debt as a structural allocation

Asset Class	2020 SAA	2021 SAA	Difference
Cash	1.0%	1.0%	—
Government Bonds	6.0%	5.0%	-1.0%
Liquid Credit	7.0%	—	-7.0%
Private Debt	—	5.0%	5.0%
Absolute Return	13.0%	12.0%	-1.0%
Hedged Equities	10.0%	11.0%	1.0%
DM Equities	27.5%	32.0%	4.5%
EM Equities	3.5%	4.0%	0.5%
Private Equity	15.0%	18.0%	3.0%
Inflation-Linked Bonds	6.0%	5.0%	-1.0%
Gold	—	—	—
Commodities	—	—	—
Core Property	3.0%	—	-3.0%
Private Equity Real Estate	8.0%	7.0%	-1.0%
Total	**100%**	**100%**	—
Equivalent Net Equity Beta (ENEB)	**0.59**	**0.67**	**0.08**
Allocation to Illiquids	**23%**	**30%**	**+7%**

Notes: *The SAA is intended to be representative of our typical client portfolio. The change in the model portfolio SAA should not be interpreted as a recommendation to increase risk. Every client should continue to review their SAA as part of their annual Investment Policy Statement refresh, with consideration to their specific objectives and constraints.*

Source: *Partners Capital*

2021 Tactical Asset Allocations

Relative to the SAA, our 2021 TAA is well-positioned for a re-acceleration of global growth and a modest increase in inflation, which is our base case scenario, while still offering good protection against the more probable negative scenarios. The TAA is also designed to allocate capital in line with our core investment themes.

Exhibit 2 on the next page lays out our recommended tactical asset allocation recommendation which we discuss here. We recommend a 5% underweight to government bonds, taking them down to zero. This reflects our view that over the medium-term higher inflation is a more credible threat to investment portfolios than deflation. The actions of central banks and policymakers over the last 12-months indicate a willingness to do whatever it takes to reflate the economy, and there is a risk that the recent fiscal and monetary profligacy goes too far. Long-dated developed market government bonds with very low yields offer little protection from such a risk. However, if yields were to rise – for example to c. 2.5% on the US 10-year Treasury - we would consider adding back to nominal government bonds.

This 5% government bond underweight is used to fund an overweight to Gold (+2%) and Private Debt (+3%). Gold provides an alternative safety asset that should serve as a store of real value should inflation move higher, while Private Debt has benefited from an expansion of the opportunity set resulting from the pandemic. The dispersion in fundamental outcomes created by the COVID-19 crisis has generated attractive opportunities in rescue lending and distressed private assets. We expect the continued economic impact of the crisis to create refinancing and restructuring opportunities over the next 12-18 months which will allow managers with available capital to benefit from improved pricing and better structural and legal protections.

Within public equities, we recommended a 27% allocation to developed market equities (-5% vs SAA), a 5% allocation to emerging markets (+1% vs SAA) and a 15% allocation to hedged equities (+4% vs SAA). This relative positioning within the public equity portfolio is largely a consequence of our positive outlook on technology, life sciences and China, all of which we access primarily through our strong line-up of sector specialist Hedged Equities managers with deep domain knowledge in their area of focus. The overweight allocation to Hedged Equities also reflects our belief that an environment characterised by increased volatility and uncertainty favours talented long/short active managers capable of exploiting the resulting market dislocations.

We continue to advocate maximum use of the illiquidity budget in client portfolios. This will vary depending on the underlying liquidity needs of the client. As a rule of thumb, our modelling suggests most long-term pools of capital can tolerate holding a third of the portfolio in illiquid assets. The TAA emphasises this point, with a total allocation of 33% in illiquid assets compared to 30% in the SAA. The 3% increase relative to benchmark is allocated to Private Debt, as explained above. Private Equity is an 18% allocation in both the SAA and TAA, representing the largest component of an overall illiquidity budget. This reflects our conviction that private equity will continue to play its role in boosting overall portfolio returns by contributing the highest returns of any asset class. We also recommend a benchmark weight to property, with a focus on opportunistic and value-add private equity real estate ('PERE') investments which we believe will continue to offer better risk-adjusted returns with a greater opportunity for generating alpha compared to core property, particularly as structural changes resulting from COVID-19 pandemic continue to cause structural shifts in property markets.

Exhibit 2 summarises our recommended 2021 TAA for a non-taxable investorand contrasts it with the 2021 SAA. We have modified versions of the 2021 TAA for our US, UK and other taxpaying clients with changes that move in a similar general direction. A more detailed summary of our views of each asset class is then presented below[1].

Exhibit 2

Tactical Asset Allocation (TAA) compared to the long-term Strategic Asset Allocation (SAA) benchmark

Asset Class	SAA	New TAA	Difference	Rationale
Cash	1.0%	1.0%	—	Maintain minimum liquidity buffer subject to operational constraints given very low/negative yields.
Government Bonds	5.0%	—	-5.0%	Government Bonds are unattractive given low yields and asymmetric risk to the downside from any unexpected rise in inflation.
Liquid Credit	—	—	—	Generic Liquid Credit strategies offer little upside with very tight spreads providing scant compensation for either rising defaults or rising inflation. However, there are attractive sub-sector opportunities for investors who cannot allocate to Private Debt in structured credit and short duration lending strategies.
Private Debt	5.0%	8.0%	3.0%	Private Debt continues to take advantage of opportunistic lending strategies, sector specialists and less-correlated alternatives such as litigation-related strategies, offering a significant premium to Liquid Credit. Skew away from vanilla middle-market corporate lending strategies which remain competitive.
Absolute Return	12.0%	12.0%	—	Absolute Return appears more attractive compared to recent years due to (i) increased capital efficiency driving better total return potential from our focus on multi-manager platforms (ii) tactical opportunities in merger arbitrage and SPACs (iii) AR strategies may fare better in reflationary environment with rising rates e.g. macro, Fixed Income Relative Value.
Hedged Equities	11.0%	15.0%	4.0%	Maintain overweight reflecting the confidence in our manager lineup and their continued ability to generate outsized alpha, particularly in the current environment of high dispersion and low inter-stock correlation. Our "long innovation" theme is best expressed through specialist tech and biotech managers in Hedged Equities.
DM Equities	32.0%	27.0%	-5.0%	Underweight to long-only equities reflecting a preference for more nimble, specialist hedged equity managers and an overweight to EM equities. Within DM equities, we focus on long duration, co-investment and quantitative strategies.
EM Equities	4.0%	5.0%	1.0%	Overweight Emerging Markets, with allocations concentrated in Asia and Asian allocations concentrated in China, reflecting one of our core investment themes of benefiting from China's growing middle class and increasingly digitalised economy.
Private Equity	18.0%	18.0%	—	PE remains a reliable source of outperformance through our managers' ability to "create alpha" by making material improvements in the operating performance of private companies. We focus on the lower middle-market where there is less competition and better valuations. Also includes "long innovation" exposure to growth equity and venture capital.
Inflation-Linked Bonds	5.0%	5.0%	—	At weight ILBs/TIPS and +2% overweight to gold. Both gold and ILBs are real assets serving as a store of value that will protect portfolios in the event of higher-than-expected inflation. Both are also highly liquid, allowing for rapid portfolio rebalancing in a market sell-off.
Gold	—	2.0%	2.0%	
Commodities	—	—	—	Commodities (ex-gold) are an unreliable inflation hedge. We are neutral to mildly positive on the outlook for commodities but see the asset class as a blunt and volatile investment tool. We favour more surgical, income-generating investments which stand to benefit more from the same overarching macro trends that might favour commodities in 2021.
Core Property	—	—	—	Structural changes resulting from the COVID-19 pandemic creates both challenges and opportunities. Open-ended property vehicles are less attractive due to risk of a liquidity mismatch. Where possible, clients should gain property exposure via PERE instead where there is greater scope for value-add.
Private Equity Real Estate	7.0%	7.0%	—	
Total	**100%**	**100%**	—	
2021 Expected Return (probability weighted)	**6.1%**	**6.5%**	**0.4%**	
ENEB	**0.67**	**0.67**	—	
Allocation to Illiquids	**30%**	**33%**	**3%**	

Source: *Partners Capital*

[1]Partners Capital are not a tax advisor. Tax treatment will depend on the individual circumstances of each client and is subject to change. Clients should consult their own tax advisors to understand the tax treatment of a product or investment.

Exhibit 3 shows the weighted duration resulting from nominal and inflation-linked bonds as well as from any credit investments. We are currently targeting look-through duration of 0.5 years in our USD and EUR-denominated portfolios relative to the SAA duration of 0.8 years and 0.9 years, respectively. For GBP denominated portfolios the TAA portfolio-weighted duration is 1.2 years compared to a benchmark duration of 1.7 years. The longer duration of GBP portfolios is largely a reflection of the long market duration of the Inflation-Linked Gilt All Stock index of 22 years.

Given that we perceive inflation to be a major potential risk in the medium-term, our allocation to interest rate duration is achieved predominantly through our allocation to inflation-linked bonds. However, if nominal yields rise to a level which provides better return prospects relative to other asset classes we may increase the allocation to nominal bonds. Intuitively, both Gold and Property have some embedded sensitivity to interest rates. However, the beta of property to the 5-10 year Treasury Index is not statistically significant over the last 5-years, while gold has had a beta of 1.5 to the US 5-10 year Treasury index (0.32 R-squared), suggesting a duration of close to 16 years. However, given the weakness of the relationships, we tally up portfolio duration excluding gold and property.

Asset Class Investment Strategies: 2021 Tactical Asset Allocation Recommendations

While we track underlying client risk in terms of seven betas, we think in terms of the distinct asset classes discussed below. The expected return of each asset class will vary depending on the scenarios described in the Macro Scenarios section. Having examined the expected risk/return profile for our core betas and probability-adjusting the outcomes in each of our economic scenarios, we summarise the investment implications for each asset class over the year ahead:

1. Cash

We continue to recommend keeping cash balances as low as operationally possible, with an allocation of just 1% in 2021. Cash offers near-zero or negative returns depending on the currency and is a poor use of capital in investment portfolios.

For portfolios with small cash allocations of 2% or less, we continue to prefer the simplicity of investing in money market funds or bank accounts, although these options offer near-zero to negative returns depending on the currency. For larger cash allocations we recommend short-duration investment-grade corporate bonds as a risk-bearing cash substitute, but one with an acceptable level of risk for roughly 50 bps of additional yield and good liquidity.

Exhibit 3

Estimated look-through portfolio duration exposure by client currency

Asset Class	SAA	TAA	US		UK		Europe	
			Default Benchmark	Duration	Default Benchmark	Duration	Default Benchmark	Duration
Government Bonds	5.0%	0.0%	Barclays Treasury 5-10 Years TR	7.6	FTSE A British Govt All Stocks TR	11.3	Citigroup EMU GBI TR	7.5
Liquid Credit - IG	0.0%	0.0%	Barclays US Corporate BBB	7.5	Barclays Global Corporate BBB	6.6	Barclays Global Corporate BBB	6.6
Liquid Credit -HY	0.0%	0.0%	Barclays US Corporate High Yield TR	4.2	50/50 Barclays Global HY / CS Leveraged Loan	2.4	50/50 Barclays Global HY / CS Leveraged Loan	2.4
Private Debt	5.0%	8.0%	Partners Capital Private Debt Vehicle	1.3	Partners Capital Private Debt Vehicle	1.3	Partners Capital Private Debt Vehicle	1.3
Inflation-Linked Bonds	5.0%	5.0%	Barclays US TIPS TR	7.6	FTSE A (Index Linked) British Govt All Stocks TR	22.4	Barclays Euro Govt Inflation-Linked TR EU	8.1
Total	15.0%	13.0%						
SAA Weighted Duration				**0.8**		**1.7**		**0.9**
TAA Weighted Duration				**0.5**		**1.2**		**0.5**
Difference				**-0.3**		**-0.5**		**-0.4**

Source: *Barclays, Bloomberg, Partners Capital*

2. Government Bonds

We continue to recommend an underweight allocation to nominal government bonds, with a 0% allocation relative to our model portfolio SAA of 5%. In our base case scenario, we expect the US 10-year yield to reach 1.7% by the end of 2021 compared to a yield of 1.1% as of 31 January. This is higher than the 1.3% priced into the 1-year forward curve as of 31 January and reflects our expectation of a strong rebound in growth over the year. We expect bond yields in the UK and Europe to rise by similar magnitudes relative to what is discounted by the market. The 10-year Gilt yield is expected to rise from 0.3% as of 31 January to 1.0% by year-end, and the 10-year Bund to rise from -0.5% to 0%.

Given the low yields and high interest rate sensitivity of longer-dated nominal bonds, even a modest increase in yields beyond what is already discounted in the forward curve would result in nominal bonds underperforming cash or Inflation-Linked Bonds. As a result, we recommend a weighted portfolio interest-rate duration that is below that of the SAA benchmark, with most of the portfolio's duration gained via an allocation to inflation-linked rather than nominal bonds. We may seek to reduce this duration underweight if yields were to rise sharply in 2021, for example if the US 10-year Treasury yield reached 2.5%. In the near-term, investors should hold a diverse mix of safety assets rather than defaulting to a large nominal bond allocation.

Over the last 30 years, government bonds have served well as diversifiers by providing both income and capital appreciation. However, very low yields have increased the opportunity cost of holding bonds. A 10-year Treasury bond with a starting yield of 1.1% and standard deviation of 6% is expected to produce a negative nominal 12-month total return roughly 43% of the time (assuming a normal distribution). In Europe where yields are negative, investors are more likely than not to suffer a negative nominal return. In short, investors must adjust to a new normal where they are required to pay for the portfolio protection that bonds provide, rather than being paid for such benefit as they were in the past.

3. Credit (Liquid Credit and Private Debt)

We recommend an overall 8% allocation to credit in 2021, relative to our SAA of 5%. This is allocated entirely to Private Debt with 0% in Liquid Credit investments. Long-term Investors with an ability to tolerate higher levels of illiquidity should default to holding Private Debt over Liquid Credit. Within Private Debt, we focus more on the superior risk/return profile of specialist lending strategies and uncorrelated alternative alternatives. For clients who are unable to accept the illiquidity of Private Debt, we still see attractive risk-adjusted returns in structured credit and short-duration lending strategies.

Corporate credit spreads narrowed significantly in the second half of 2020 and early 2021, with the yield-to-worst of the Global High Yield index dropping to a record low of 4.3% in February. As such, the asset class is increasingly unattractive from a valuation standpoint given limited room for capital appreciation, evidence of deteriorating covenant protection for lenders, vulnerability to higher inflation and limited scope to generate excess risk-adjusted returns from either beta or alpha.

For clients who require liquid credit investments, we recommend avoiding plain vanilla high yield bonds or leveraged loans and instead focusing on areas where the potential for further spread tightening remains, or where economic uncertainty creates opportunities for security selection. Examples include structured credit, where we are focused on residential mortgage-backed securities and mezzanine tranches of collateralized loan obligations ("CLOs"), which we believe offer insulation from further economic weakness and the potential for further price appreciation. We have reviewed a range of different niche private lending strategies and are focused on specialized bridge lending strategies where the weighted average life of the loan portfolio is typically 12 months or less. We believe these strategies can deliver high single-digit total returns, which translates to expected alpha of roughly 3-5% over the expected return of a 50/50 benchmark of high yield and leveraged loans.[1]

For clients who are not liquidity-constrained we view private debt as offering access to superior yield-based return streams with potential upside from call protection and equity participation through warrants. While we continue to find opportunities we perceive to be compelling in specialist lending and uncorrelated strategies, the dispersion in fundamental outcomes created by the COVID-19 crisis has also generated attractive opportunities in rescue lending and distressed private assets. We expect the continued economic impact of the crisis to create refinancing and restructuring opportunities over the next 12-18 months which will allow managers with available capital to benefit from improved pricing and better structural and legal protections. We plan to take advantage of these opportunities both via fund commitments and directly via an increased allocation to co-investments. Despite rising fund flows into private debt, we continue to find attractive opportunities with sector specialists and niche strategies which we believe can deliver a 10-15% net return.[2]

[1]These estimates of performance returns are based upon certain assumptions which should not be construed to be indicative of actual events that will occur. There is no assurance that the performance presented will be achieved. Please see important Disclaimers at the end of this document

[2]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.

4. Absolute Return

We recommend an at-weight allocation to Absolute Return. Following a banner year for performance in 2020 we believe the opportunity for alpha generation will persist into 2021. Uncertainty surrounding the impact of the COVID-19 crisis has led to elevated market volatility and high dispersion between market "winners and losers", which we believe will continue to provide ample trading opportunities for a wide array of hedge fund strategies.

Absolute return strategies with low correlations to traditional capital markets and which target high levels of alpha will continue to play an increasingly important role in portfolios given the more challenging outlook for traditional beta returns. Alpha generation within absolute return strategies has remained strong and we believe the forward-looking opportunity set is robust, driven by elevated economic, policy, and political uncertainty.

Within the asset class, we remain focused on maintaining diversified allocations that incorporate the use of cash-efficient vehicles. As a result, we have grown our investments via managed accounts (vs. commingled funds) to achieve greater capital efficiency, improved transparency, the ability to tactically manage exposures and reduced fees. At the strategy level, we continue to see opportunities for skilled managers in "core" areas such as merger arbitrage, equity market neutral, macro and fixed income relative value.

5. Public Equities

Public equities consist of developed market (DM) equities, emerging market (EM) equities and hedged equities. We recommend an overall public equities exposure of 47% in our policy portfolio, which is in line with the SAA benchmark, but with a differing composition. We recommended a 27% allocation to Developed Market equities (-5% vs SAA), a 5% allocation to Emerging Markets (+1% vs SAA) and a 15% allocation to Hedged Equities (+4% vs SAA) with a particular focus on specialist managers.

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 (22% of model portfolio). While our investment themes will naturally result in deviations to our exposures relative to global equity indices, we constrain such deviations to maintain a balanced portfolio across style factors, industry sectors and geographic regions.

Long Equities (DM + EM)

For 2021, we are recommending a -5% underweight to DM versus the SAA, and a 1% overweight to EM. This reflects a preference for the compelling investment opportunities within EM and Hedged Equities rather than an outright negative view on DM equities.

We are constructive on the outlook for global equities in 2021, with a base-case expected return of c. 10% in 2021.[2] We expect market returns to be driven by strong global growth coming out of the COVID pandemic, low interest rates with no expected near-term upward pressure and reasonable equity market valuations in the context of these two factors.

Within our long equities allocation, we favour long-duration strategies (10% allocation), co-invest (10%) and quantitative strategies (4%), de-emphasizing 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.

Our overweight in Emerging Market equities is primarily driven by a favourable view of the pan-Asia region. China in particular remains a focus. Capital market reforms along with the ongoing economic rebalancing continue to present interesting investment opportunities, particularly in the local A-shares market which represents just under half of Greater China's market capitalization. China has also proven to be fertile ground for manager alpha given the significant dispersion in the quality of domestic companies and recent periods of short-term volatility.

Hedged Equities

We are maintaining our 15% allocation to hedged equities, compared to 11% in the SAA benchmark. This +4% overweight reflects confidence in our managers' continued ability to generate returns well in excess of risk-adjusted equities, particularly in the current environment of low inter-stock correlation.

[2] these estimates of performance returns are based upon certain assumptions which should not be construed to be indicative of actual events that will occur. There is no assurance that the performance presented will be achieved. Please see important Disclaimers at the end of this material.

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 remain focused on manager alpha as the core source of outperformance in public equities. We continue to believe that the managers with the best chance of generating consistent alpha are those specialist funds with a unique expertise in their respective market segments and ability to leverage specific management engagement or investment structuring capabilities. We expect to see continued progress from our efforts in securing disproportionate allocations to scarce capacity in such managers and reducing fees on the back of our growing scale and influence. We start 2021 with specialist managers invested in a diverse range of market niches, including life sciences, disruptive technologies, utilities, community banks, consumer growth-oriented businesses and Chinese onshore companies.

6. Private Equity

We recommend a Private Equity (PE) allocation of 18% which represents the largest component of an overall illiquidity budget of 33% in the TAA. This reflects our conviction that Private Equity will continue to play its role in boosting overall portfolio returns by contributing the highest returns of any asset class.

Our recommended 18% allocation reflects our assessment of the quality and accessibility of the opportunities likely to be in the market in 2021 and beyond. However, Private Equity valuations remain at elevated levels and sponsors have a large pool of dry powder, now at $1.5T compared to $1.4T a year ago. This excess supply of capital can potentially have an adverse impact on returns due to intensified competition for attractive investments leading to higher purchase prices. We confront this headwind by focusing on investment managers that we view as "off the beaten path", as we have advertised for nearly 20 years now. This includes managers with operationally proactive strategies, particularly those that are targeting middle market businesses, leveraging industry expertise to identify value levers that others might not.

7. Real Estate
(Core and Private Equity Real Estate)

We recommend an at-weight allocation to Real Estate for 2021, with an emphasis on opportunistic and value-add private equity real estate ('PERE') investments which we believe will continue to offer better risk-adjusted returns with a greater opportunity for generating alpha compared to core property. For conservative investors, we favour core-plus investments over core, as the value-add component provides an additional margin of safety for skilled managers.

Real estate plays an important role in client portfolios given the income yield, the potential hedge against inflation, and the opportunity to generate incremental returns by repositioning assets. In 2021, we continue to favour managers with deep local expertise, who can generate proprietary deal flow, and are vertically integrated, i.e. those with in-house asset management and development expertise. We find this value-added approach can reliably generate strong returns in any market environment. We believe there are several sectors, including logistics and multifamily, which will be resilient in the post-COVID environment and in which there are clear value-added opportunities for specialist managers through modernising and repositioning assets.

The distressed opportunity set, while not yet widespread, has increased over the past year. We expect to be active on a selective basis and are focused on strategies targeting high-quality, well-located assets with short-term cash flow challenges, such as new construction with upcoming debt repayments, or forced sales from open-end funds with major redemptions. However, we are also mindful that there may be sectors of real estate which are facing increased uncertainty given the potential medium to long-term effect of COVID-19 on sectors such as urban office and hotels catering to business travel.

8. Inflation-Linked Bonds

We recommend a 5% allocation to ILBs, which is in line with the SAA benchmark. More accommodative monetary and fiscal policy combined with supply pressures suggest that developed market inflationary pressures are likely to increase over the medium term, and ILBs or TIPS are one of the best means to protect real spending power.

In our base-case scenario, developed market inflation is expected to increase from 0.7% in 2020 to 2.0% in 2021. Inflation will rise rapidly in the US but take longer in the UK and Europe. Over the next five years, there is a risk that DM inflation could approach 3% or higher, but much will depend on the political agenda. Factors supporting higher inflation would include the degree of political appetite for ongoing fiscal spending beyond the pandemic, continued easy monetary policy, increased supply chain friction as a result of both greater protectionism and post-pandemic supply chain localisation, and finally policies aimed at income redistribution.

9. Gold

We recommend clients allocate +2% to gold in 2021. Gold is not in the SAA as we do not consider it a structural asset to hold for the long-term, however investors currently face a wider than usual range of risks at a time when other traditional forms of portfolio protection are expensive. Such an environment merits a thorough analysis of the optimal trade-offs of safety assets for individual portfolios and favours holding a more diversified mix of protection.

We consider Gold to be materially different from other commodities with unique safety characteristics. It is a recommended allocation in client portfolios mostly as a hedge against a scenario of higher-than-expected inflation resulting from a policy mistake and/or monetary debasement.

The gold price continues to be negatively correlated to changes in US real yields (i.e., gold rises in value when bond yields fall or inflation expectations rise). For the price of gold to rise significantly in 2021, real yields would need to become more negative. The most likely scenario in which this occurs is further fiscal stimulus driving higher inflation expectations while central bank quantitative easing continues to suppress nominal bond yields.

10. Commodities

We recommend an at-weight allocation to Commodities (excluding gold), relative to the SAA benchmark. For most clients this will mean maintaining a zero allocation to the asset class. For those clients seeking inflation protection, we continue to view a combination of Inflation-linked Bonds, Gold, Real Estate and certain equity sub-sectors as a more efficient means of achieving this.

We expect commodity prices to continue to move higher in 2021, driven by renewed global demand, higher global fiscal spending, an upswing in corporate capital expenditure and investment which culminates in rising inflation expectations. Nevertheless, we continue to prefer more targeted investment alternatives which better exploit the opportunities created by these trends, rather than simply buying commodity futures which come with significant idiosyncratic risks and volatility.

As outlined in our macro view, a key medium-term risk is that of higher inflation. Commodities are typically thought of as an inflation hedge. However, empirical evidence for this relationship is weak. A study published in the Financial Analysts Journal found that of the 12 commodities that traded continuously in the futures market between 1970 and 2010, only 3 had modest positive correlation to inflation at a 95% confidence level - heating oil, cattle and copper. We prefer more dependable sources of inflation protection, including Inflation-linked Bonds, Gold, Real Estate and certain equity sectors.

Sub-asset class positioning

Tactical Asset Allocation also occurs at a sub-asset class level. Within each asset class, we favour particular strategies or skews. Exhibit 4 below summarises our sub-asset class skews across each asset class.

In the liquid asset classes, you will see skews in favour of specialist hedged equities, Chinese equities, and gold, while we steer clear of nominal government bonds and corporate credit. In illiquid asset classes, we are overweight lower and mid-market buyouts with a skew toward sector specialists most often in software and other tech sectors and are always on the look-out for specialist niche direct lenders. Across all asset classes, we are looking to increase allocations to direct mostly fee-free co-investments.

Exhibit 4
Partners Capital sub-asset class positioning

Asset Class	Strong Underweight	Moderate Underweight	At Target	Moderate Overweight	Strong Overweight
Cash, Fixed Income, ILBs, Gold,	— German Bunds — UK Gilts — US Treasuries		— Cash — Inflation-Linked Bonds	— Gold	
Liquid Credit	— High Yield Bonds — Investment Grade Bonds — IG Munis	— Consumer Lending — Short Duration — High Yield — Leveraged Loans	— CMBS — EM LC/USD Bonds — Mezzanine CLOs	— Opportunistic Credit — RMBS — Short duration lending	
Private Debt and Alternative Alternatives	— EM Direct Lendin — Mezzanine Lending	— MM Direct Lending — Insurance — Royalties — Life Settlements	— CLO equity and debt — Distressed/ Special Situations — Real Estate Lending	— Asset-backed Lending — Drug Trial Funding — Litigation Funding	— Co-Investments — Capital Solutions and Rescue Lending — Sector Specialist Lending
Absolute Return	— Managed Futures/ CTAs — Reinsurance	— Risk Premia — Event/ Distressed	— Macro/Trading — Long-Short Credit	— Convertible Arb — Fixed Income Arb — Stat Arb — Fundamental Equity Market Neutral	— Merger Arbitrage — SPACs
Equities	— EM (ex-Asia, commodity exporters)	— Developed Markets — Defensive — Energy	— Value — Generalist Hedged Equities — Quant / Systematic	— Consumer Specialists — Cyclicals and Financials — Quality — Activist Small Cap	— Specialist Hedged Equities (tech, biotech) — China — Sustainability
Private Equity	— Emerging Markets (ex-Asia)	— Asia LBO/ Special Situations — Large Cap Buyout —Distressed / Turnaround	— European Buyouts — Growth Equity — Venture Capital (late stage)	— Small & Lower Mid-Market Buyouts — Venture Capital (early stage)	— Sector Specialists (e.g. tech, healthcare, consumer) — Co-investments
Real Estate	— Emerging Markets (ex-Asia)	— Core Property — REITS — Infrastructure	— Asia PERE — UK PERE — European PERE	— US PERE — Distressed — Logistics — US Multifamily	

Source: *Partners Capital*

Taxable Client Asset Allocation[5]

All changes discussed above reference our central benchmark policy portfolio for a large non-taxable institutional investor denominated in USD. The direction of these changes will be relevant to our taxable clients as well, but with different starting and ending allocations based on each client's tax situation.

For our tax paying clients, our goal is to maximize expected after-tax results from a multi-asset class portfolio with a relatively high level of certainty. To do this, we have developed the following four Golden Rules of Tax Efficient Investing:

1. Increase portfolio risk to reflect the dampening effects of taxation
2. Allocate across asset classes based on after-tax returns, volatility and correlations
3. Select asset managers based on a range of after-tax expected returns
4. Utilize tax efficient structures

The practical implications of the above golden rules will vary depending on the underlying investor's status, location and objectives.

US Taxpayers: To improve the overall tax efficiency of our US taxable portfolios we bias them toward advantaged asset classes such as public equities, private equity and real estate. In addition, we consider municipal bonds in place of Treasuries and structured inflation-linked municipal bonds (municipal bonds plus a return swap linked to the Consumer Price Index) in place of traditional inflation-linked bonds. Conversely, we avoid tax-inefficient asset classes with low manager outperformance (alpha) potential such as liquid credit and are highly selective on absolute return and hedged equities. The least tax efficient asset classes are yield-based including liquid credit, inflation-linked bonds, traditional fixed income (such as Treasuries) and private debt because the income stream is subject to the higher ordinary income tax rates. Note that we have elected to replace inflation-linked municipal bonds with a 2% allocation to gold given the tax efficiency of gold and skew away from most assets with interest rate duration. We do invest with tax free ILBs in the US, but the vehicle's fee burden pushes us in the direction of holding gold as part of the US taxpayer's safety net allocation[1].

U.K. Taxpayers: Unlike some other European tax regimes, the UK taxes capital gains, dividends and income differently. At time of writing, UK additional rate tax rates for income, dividends and capital gains respectively are 45%, 38.1% and 20%. Strategies appropriate for non-tax paying entities such as charitable endowments may not be appropriate for a tax paying investor and vice versa. It is for this reason that we strongly recommend UK taxpayers invest via our Master Portfolio B, which is optimised for UK tax investing and structured in a manner that facilitates the offsetting of fees and expenses against income, the roll-up of capital gains within the portfolio and allows income to be taxed at the lower dividend tax rate. Please note that the 2021 UK TAA shown below in Exhibit 5 reflects a direct portfolio (not The Master Portfolioallocation which avoids private debt, nominal bonds and other liquid fixed income other than inflation linked gilts due to their UK tax inefficiency. As with the US taxpayer portfolio, the allocation is very skewed toward equities given capital gains tax treatment combined with a good menu of reporting status funds. Absolute return hedge funds feature as they provide better after-tax returns than fixed income where we find reporting status funds and/or truly exceptional performers where we don't mind paying the tax.

If you would like further information of optimising your portfolio for after-tax returns, there are recent whitepapers on this subject available on our website. We are also actively monitoring potential tax changes across regions and will let clients know as soon as there if confirmation of what the likely changes may be.

[5] Partners Capital are not a tax advisor. Tax treatment will depend on the individual circumstances of each client and is subject to change. Clients should consult their own tax advisors to understand the tax treatment of a product or investment.

Exhibit 5

Illustrative 2021 Tactical Asset Allocations depending on Tax Status

	USD Investors		GBP Investors
Asset Class Weights	**TAA (non-taxable)= Insights Default**	**US Taxable TAA**	**UK Taxable TAA**
Cash	1.0%	1.0%	1.0%
Government Bonds	—	3.0%	—
Liquid Credit	—	1.0%	—
Private Debt	8.0%	2.0%	—
Absolute Return	12.0%	6.5%	9.0%
Hedged Equities	15.0%	14.5%	18.0%
DM Equities	27.0%	29.0%	23.0%
EM Equities	5.0%	4.0%	6.0%
Private Equity	18.0%	20.0%	25.0%
Inflation-Linked Bonds	5.0%	2.0%	6.0%
Gold	2.0%	2.0%	2.0%
Commodities	—	—	—
Core Property	—	5.0%	—
Private Equity Real Estate	7.0%	10.0%	10.0%
Total	**100%**	**100%**	**100%**
ENEB	**0.67**	**0.69**	**0.70**
Allocation to Illiquids	**33%**	**32%**	**35%**

Source: *Partners Capital*

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