1

Executive Summary

A New Paradigm calls for a Return to Fundamentals

The coming decade will feature a paradigm shift to a more volatile inflation backdrop. This presents challenges for policymakers as they will struggle to thread the needle between managing inflation while delivering stable growth. Policy errors from both monetary and fiscal authorities will result in more frequent boom/bust cycles. This ever-changing macroeconomic landscape will be in sharp contrast to the 'Great Moderation' experienced in previous decades.

This context creates a more complex and riskier environment for investing that will need to be carefully navigated to deliver outperformance.

Executive Summary

A Return to Fundamentals

The renowned historian and philosopher Thomas Kuhn introduced the concept of a *"Paradigm Shift"* in his seminal 1962 publication, *'The Structure of Scientific Revolutions'*. Kuhn's great insight was that all scientific fields undergo periodic paradigm shifts rather than solely evolving in a linear manner. The same reasoning can be applied to economies and financial markets; they often do not progress linearly. They are subject to episodic shifts which define patterns of behaviour for many years to come.

In 2022, after several decades, investors re-acquainted themselves with the concept of inflation, and the possibility that interest rates could rise and remain significantly above the zero bound. This was not a particularly natural shift given that many of today's investors were not even born the last time inflation was a serious issue. Although this risk had been flagged by some experts (including most notably by former US Treasury Secretary Larry Summers and less notably by our own *Insights 2021* publication), many other experts including central banks considered such risks to be 'transitory'. In fairness, the unforeseen event of the Russian invasion of Ukraine, as well as the puzzling stubbornness of China to maintain economic shutdown well after the deployment of vaccination drives, served to compound and extend the initial inflationary impulse of economic reopening in western economies. However, even considering the relative transience of the above events, it does appear that something fundamental has changed since the post-GFC decade of near-zero interest rates.

Investment is a behavioural science as much as it is a quantitative science. Investors latch on to themes and fashions which tend to conform to the narratives of the day. In the previous decade, near-zero interest rates were thought to be a semi-permanent fixture which in turn supported investment in many areas that would not be considered economically viable at a higher cost of capital. Cryptocurrencies, speculative capital in SPACs, and other compelling long-duration 'stories' found ample investment capital.

While it is possible, and even likely, that today's inflation pressures will subside in the near term, we believe longer-term risks are biased toward a moderately higher level of inflation than experienced in the last decade. More importantly, the volatility of inflation will itself remain elevated as both monetary and fiscal policymakers struggle to calibrate their policies in a global economy that will be subject to increased costs from 1) the energy transition, 2) changing trade patterns as unrestricted globalisation evolves towards forms of 'near-shoring' or 'friendshoring' and 3) populist pressures demanding wealth redistribution from the owners of capital to labour.

This backdrop of volatile inflation presents challenges for policymakers as they will struggle to thread the needle between managing inflation while delivering stable growth. Policy errors from both monetary and fiscal authorities will lead to over- and undershoots in growth and inflation, resulting in more boom/bust cycles reminiscent of the 1980's, 1990's and even 1940's. This ever-changing macroeconomic landscape will be in sharp contrast to the 'Great Moderation' experienced in previous decades.

This overall macro constellation creates a more complex and riskier environment for investors. This is not just because interest rates will be higher and more variable, but also due to risk premia embedded in various asset classes being subject to large moves. For some investments, higher premia will be justified, for others it will be an unwarranted knee-jerk reaction that will create exceptional buying opportunities.

Turning to how to invest in this new paradigm, we answer this question within the framework of our overall approach. As you know, our investment philosophy has evolved from the Yale Endowment Model into what we term the 'Partners Capital Risk Managed Endowment Approach' or PRMEA. This approach is best visualised as a twin-engine plane with two distinct performance drivers in any portfolio. Engine 1 is the 'beta' engine that delivers the base return of the portfolio derived from market exposures, while Engine 2 is the 'alpha' engine that delivers the outperformance from active management.

With respect to the 'beta engine', while the initial impact of rising yields is clearly negative across most asset classes as we saw in 2022, higher yields will set the foundation for higher long-term nominal returns in both fixed-income and risk markets. However, in a higher inflation environment, we expect that the real returns available from traditional equity/ bond portfolios will be muted compared to the previous decade. As a base case, we expect a traditional 65/35 equity/bond portfolio to return c. 4%[1] in real terms over the next decade, versus a historical real return of c. 6.8% between 2010 and 2020.

With respect to the 'alpha engine', the environment active managers will face can best be described as a **'Return to Fundamentals'**, which will sit in sharp contrast to the broad thematic investing trends we witnessed since the Global Financial Crisis (GFC). Successful active management will require deep fundamental analysis of specific securities, situations and companies, and nimble execution to exploit valuation discrepancies created by macro volatility. We are particularly positive about the ability of our active managers to exploit opportunities in certain Absolute Return strategies, structured credit, non-cyclical/less-correlated illiquid alternatives, and innovation. We continue to expect certain strategies within private markets (across private equity, venture capital, private debt, non-cyclical alternatives, and opportunistic real estate) to provide a compelling source of excess returns given the long-term orientation, better alignment, improved governance, and scope for operational value add. Taken together, a well-diversified 'alpha engine' invested in these opportunities is expected to add 2-3%[2] outperformance per annum (net of fees) to our client portfolios over the long run.

Turning our attention back to 2023, we will evolve our client portfolios to take advantage of the long-term paradigm shift we describe above. In addition, we will tactically position portfolios to take advantage of potential mispricing of risk premia. Given the more attractive yield levels available today in shorter-duration fixed-income and credit relative to public equities and longer-dated bonds, we are increasing exposure to these shorter-duration assets. As markets adjust, we will aim to re-adjust exposures if the risk premia moves in favour of riskier and longer-duration assets.

In the rest of this Executive Summary, we provide a snapshot of likely Macroeconomic Scenarios over the near-term, outline our Investment Themes and describe how we expect our Tactical Asset Allocation would perform in various scenarios.

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1 These returns do not reflect actual results. Such forecasts are not a reliable indicator of future performance. They are based primarily upon applying assumptions retroactively to certain historical financial information relating to the investments. There is no assurance that the performance presented will be achieved.

2 The outperformance presented are hypothetical returns which do not represent actual trading and is based on simulations, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Simulated past performance is not a reliable indicator of future results.

Macroeconomic Scenarios

The macroeconomic views below help us arrive at what we consider to be the most likely 'base case' over the next two to three years, with a focus on where we expect to be at the end of 2023. We also outline a plausible set of outcomes on either side of the base case which we refer to as the 'downside' and 'upside' cases.

Building a portfolio just for the base case is rarely optimal. Rather, the optimal portfolio will both weather the downside and benefit from the upside, but in doing so may give up some return in the base case. The tactical asset allocation and asset class strategies all seek to reflect the optimal allocation given the weighted probability of various scenarios. To that end, we lay out our three key scenarios below.

While there has been much media discussion around the binary question of recession or no recession, we think this detracts from a more granular analsyis of the quantum of economic growth (positive or

Exhibit 1

Summary of Partners Capital 2023 Macroeconomic Scenarios

	'Policy-Error Recession'	'Growth Dips'	'Soft Landing'	Expected Value
Probability	20%	60%	20%	
US	• The lagged impact of cumulative interest rate rises severely impacts consumer spending and business confidence, leading to rising unemployment. The Fed avoids easing sharply due to persistent inflation fears. • The congressional debt ceiling impasse restricts fiscal spending, leading to a government shutdown and creating fears of a 'technical default' on US treasuries with knock-on effects in credit and equity markets. • A US recession begins in H2 2023.	• Price pressures from 2022 supply shocks fade and global inflation continues to cool. • Falling inflation boosts consumption, also supported by cumulative savings. Housing market cools, but declines are limited by low private sector leverage. • Fed tightens policy to just above c. 5.3% in 2023 before pausing. • Congress eventually agrees on a compromise budget after some brinkmanship. • US GDP growth dips from 2.0% (2022) to 1.5% (2023)	• Diminished Covid concerns and reduced savings cause workers to re-enter the labour force. The rise in participation eases wage pressures. • Energy and global supply chain pressures ease. • Inflation falls giving Fed greater leeway to pause earlier in the year at c.5%. • US GDP growth stays at 2.0%	
Europe	• Policymakers fail to agree on a coherent bloc-wide energy plan. Energy prices surge again to punitively high levels due to ongoing war and increased demand from China. • Domestic consumer spending and exports decline. • EU falls into recession in H2 2023.	• Milder than average winter and voluntary demand destruction limit need for energy rationing by industry. • Brussels agrees on an EU-wide energy security/transition plan • Reasonable growth in US and China combined with weak Euro helps support demand for European exports. • EU GDP dips from 3.5% (2022) to 0.7% (2023).	• War in Ukraine cools as a partial truce is reached, allowing Russian gas exports to rise. • Domestic consumption rises, while stronger China/global growth lifts exports. • EU GDP at 2.5%	
China	• Easing of Covid restrictions are partially reversed as the absence of any material natural immunity sees cases spike and health systems are overwhelmed. • Disruption in labour supply and self-imposed restrictions cause growth to disappoint. • China GDP holds at 3.0%	• Covid cases rise as restrictions are eased, but vaccines and self-imposed restrictions "flatten the curve". • Policy continues to focus on 'common prosperity', but not wholly at the expense of growth. • Further stimulus measures are used to ease pressures in the property sector and boost urban job creation. • China GDP growth rises from 3.0% (2022) to 5.2% (2023)	• Fading virus potency and rising vaccination rates fully neutralise the impact of Covid even as restrictions are lifted. • Further stimulus measures ease pressures in property sector, boosting job creation and domestic consumption. • Government refrains from further regulatory policy tightening and seeks to improve relations with the West, particularly with Europe. • China GDP at 7%.	
Global GDP Real Growth (PPP, 2023)[2]	**1.0%**	**2.9%**	**3.5%**	**2.7%**
DM Inflation (23Q4/22Q4)	**2.0%**	**3.0%**	**4.0%**	**3.0%**
Expected UST 10y (at Jan 2024)	**2.5%**	**3.8%**	**4.5%**	**3.7%**
MSCI World (12m to Jan 2024)	**-20%**	**5%**	**15%**	**1.5%**

Notes:

1. *Source: Partners Capital*
2. *These scenarios and performance estimates are illustrative and based upon certain assumptions. There is no assurance that the performance presented will be achieved.*
3. *Global GDP growth estimate for 2023. Country weights are based on purchasing power parity (PPP) - the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country. PPP is more stable than market exchange rates, allowing for a better comparison of year-on-year growth in real GDP over time, but does tend to increase the weighting to Emerging Markets in calculations as PPP tends to be higher than the market rate in EM countries.*
4. *Data sourced from IMF, Bloomberg*

negative) which is ultimately what drives investment performance. So in our base case, we expect global growth to dip from 3.9% to 2.9% in 2023, with Europe hovering just above zero and the UK perhaps just above. However, the investment implications of whether growth is marginally positive or negative may not be that fundamentally different, with bond yields broadly unchanged and equities providing low single digit returns as shown in Exhibit 1 below. However, there would be a large impact if either our downside scenario of a deeper 'Policy Error Recession' or our upside scenario of a 'Soft Landing' is realised. The characteristics and expected economic and investment impact of all three primary scenarios are summarised below, with the caveat that there are many more sub-scenarios possible than we can list here.

2023 Investment Themes

Our investment philosophy is rooted in the Yale Endowment Model of investing, but we have made several important enhancements to the original model that we now term the Partners Capital Risk-Managed Endowment Approach (PRMEA). The most important enhancements include the following:

1. Build portfolios around and truly diversify across *market exposures (7 core betas)*, not asset classes
2. Manage total risk to beta not volatility, with the best measure of portfolio risk being aggregate market exposure (equivalent net equity beta or 'ENEB')
3. Embrace tactical asset allocation as a source of additional returns, using extreme market moves to reposition portfolios
4. Disaggregate manager returns into beta and alpha (outperformance), and do not pay high fees for beta
5. Partner with who we believe are exceptional managers to deliver alpha using proprietary structures and co-investments to increase capital efficiency and lower costs
6. Diversify sources of outperformance, ensuring managers are operating across different sectors, geographies, and styles to generate outperformance
7. Identify and **overweight specific long-term investment themes** that could be a source of significant excess returns

We are at a time of profound change across markets and economies. We synthesise the most important changes into the following **macro and market themes** that we believe will shape the investment environment most over the next decade:

1. Paradigm shift: A return to 'Macro Volatility' replacing the 'Great Moderation'
2. Private Equity industry shakeout with returns accruing to firms with demonstrated ability to add value
3. Technological innovation to continue to disrupt entire industries and create new ones
4. Geopolitical concerns, policy risks and supply chain reconfiguration to gradually diminish reliance on China
5. Momentum continues to build behind the sustainability mega-trend

Against this backdrop, successful investing will require a **'Return to Fundamentals'** where a focus on asset quality, valuation and portfolio construction will be of paramount importance. The landscape described by these trends lead us to the following **key investment implications:**

1. Tactically bolster allocations to income-producing assets (shorter-duration government bonds, credit) given slower economic growth and elevated equity valuations. Be nimble on interest rate duration with a view to adding if near-term recession risks build.
2. Add to non-cyclical assets and less correlated exposures to increase portfolio resilience to macroeconomic cycles. Favour select Absolute Return strategies that benefit from macro volatility and add to less correlated Private Debt strategies.
3. Increase commitments to Private Equity, with a sharp focus on adding to value-oriented lower middle market generalists and sector specialists who have proven capability to drive earnings growth in portfolio companies.
4. Maintain liquid exposure to life sciences and emerging technology specialists who can identify companies at the forefront of innovation and at inflection points in their growth. Boost venture capital allocations to capitalise on long-term disruptive innovation.
5. Diversify away from China in favour of markets benefitting from geopolitical shifts including supply chain reconfiguration.
6. Increase exposure to managers with a strong understanding of both the winners and losers of energy transition, and who can identify companies in pivotal positions.

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