Capital Partners

your partner for alternative investments

Bridging troubled waters

Investment outlook 2020

“If you would lift me up you must be on higher ground.”

Ralph Waldo Emerson

Cover picture: Naruto whirlpools in Pacific ocean, Osaka, Japan

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Introduction

The year 2019 turned out to be one of the best yet for investors in the decade-long bull market. However, something does not quite feel right, for the stellar financial performance was driven neither by stronger growth nor by receding policy risks. Rather, central banks had to save the day once again by opening the monetary spigots and adding to the flood of liquidity that lifts the many boats in financial markets, from bonds to equities to gold.

Looking forward, this deluge could create some troubled waters. Lofty valuations on many traditional assets and ever-higher policy dependency could well translate into an unpleasant swim. In highest-grade bonds, for instance, losses are practically guaranteed in good times, while their diversification benefit in hard times is increasingly doubtful. In this publication, we would like to present a few investment alternatives to help your portfolio avoid the potential maelstrom and reach higher ground.

We hope that you find the following pages insightful and invite you to share your views and ideas with us.

Bridging troubled waters – investment outlook 2020

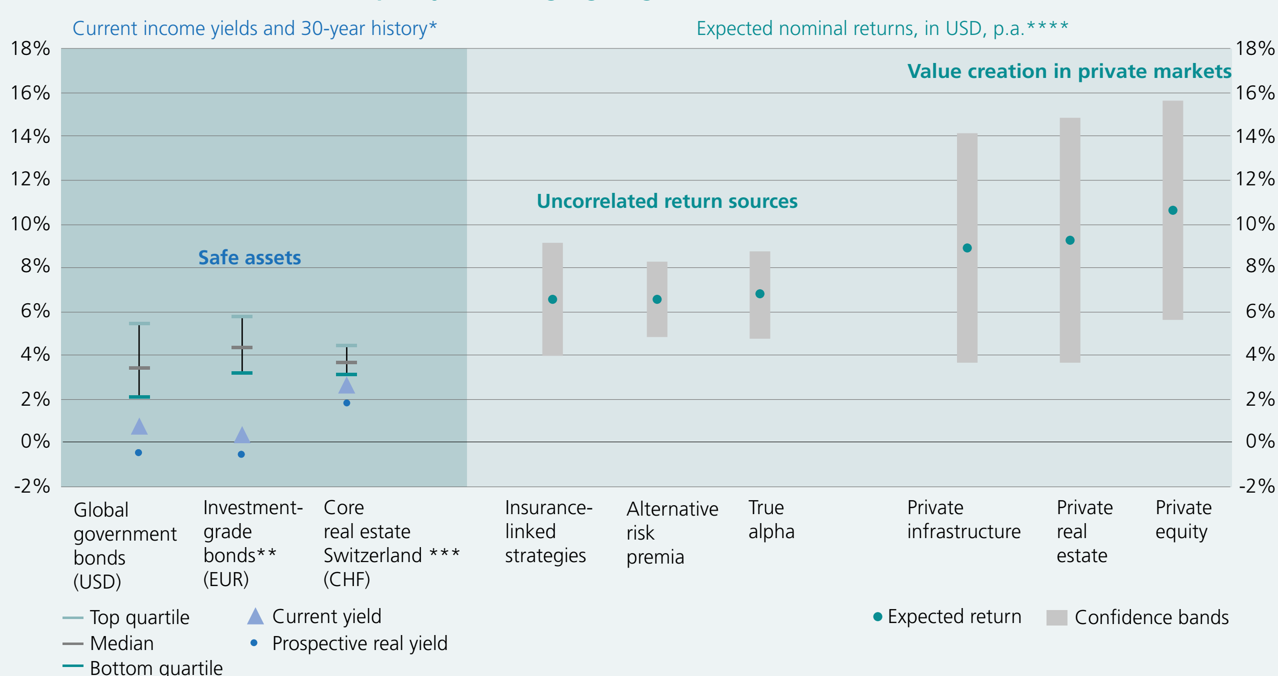
Global economy: sluggish but resilient recovery to continue

As the world suffers from a liquidity trap, new fiscal spending programs should absorb some of the overhang in savings and push for higher real growth. Global monetary and fiscal support will likely outweigh more harmful national policies, allowing the record-long economic recovery to extend further.

Financial markets: exuberance in safe assets and passive investing

A decade of hunting for yield has created bubble-like conditions in traditional safe assets – a space we would avoid and replace by a combination of liquid alternative strategies and private market investments. In addition, the massive drive into passive products has created opportunities for active management and controlled value creation.

Traditional assets are drowned in liquidity... reaching higher ground with alternatives



* September 1989 to September 2019, weekly data
** Prior to 1998; proxy used
*** Prior to 1990; proxy used

Source: Datastream, LGT Capital Partners

**** LGT Capital Partners capital market assumptions are market, or beta, geometric return expectations gross of any fees over a horizon of approximately five years. The confidence bands represent the 25th and 75th percentiles of the potential future return pathways. This data is purely indicative and is not a guarantee of future results, and there can be no assurance that the fund or portfolio will achieve comparable results.

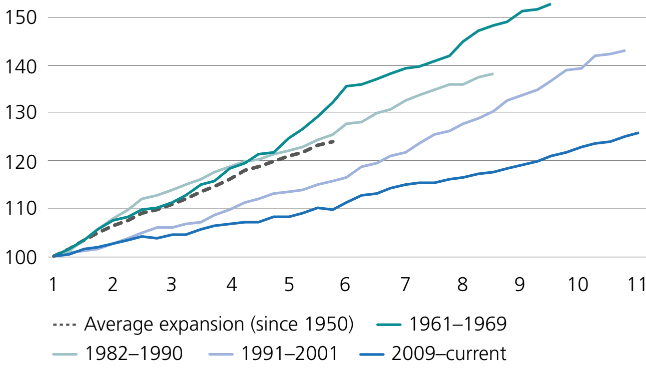
Portfolio positioning: building blocks to bridge troubled waters in 2020 and beyond

- Steadily commit to active ownership in private equity; selectively add secondaries to gain diversified exposure and profit from increased transaction volume
- For a balanced mix of current income and future growth, consider value-add strategies and select niches in real estate and infrastructure
- Implement systematic strategies to harvest alternative risk premia and combine them for market-neutral portfolio returns
- Focus on genuine alpha managers with proven ability to generate skill-based returns, independent of style factors and market direction
- Capitalize on a premium turnaround in insurance-linked strategies
- Add a small portion of gold as a portfolio diversifier
- Integrate ESG considerations holistically to achieve truly sustainable investing

The global economy: in need of a jolt beyond liquidity

Longer, but not stronger

(Real GDP* for the US in past economic expansions; years duration)

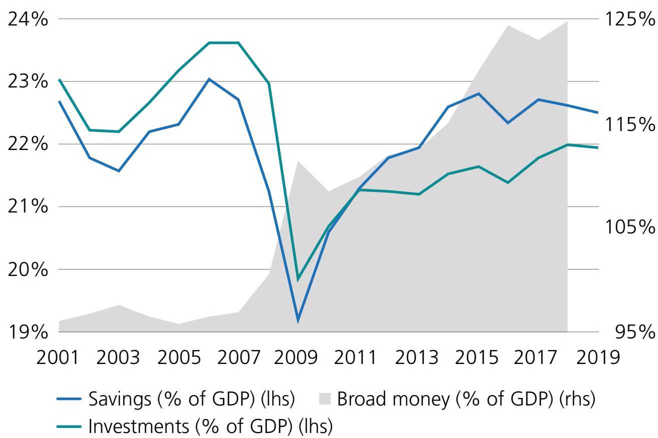


* Real GDP US is indexed quarterly data
Source: Datastream, LGT Capital Partners

The year 2019 made it evident that there is no escaping from the "new normal." Central banks have no choice but to keep policy highly accommodative in the face of tepid growth and absent inflation pressures. Thus, the "longest economic recovery" may continue as it has: with much lower real growth than in past upswings, propped up by zero-interest-rate policies and an occasional shot in the arm from fiscal programs. Lately, tariff rounds and other newly implemented barriers to trade created headwinds for global economic growth. These policies are one particular expression of a more general trend to combat inequality. Therefore, uncertainty around rising state intervention and redistribution policies is here to stay and is bound to influence both the real economy and financial markets in 2020 – especially as the US presidential election gets under way.

Savings glut, investment dearth

(Savings, investments and broad money*, all in % of global GDP**)

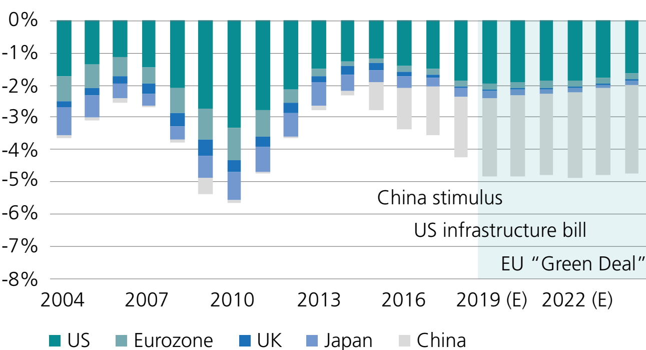


* Broad money is a measure of a country's money supply and encompasses all liquid holdings and assets of households and businesses
** Advanced economies for savings and investments (IMF), world for broad money (World Bank)
Source: Datastream, LGT Capital Partners

At the core of the economic malaise lies the fundamental mismatch between savings and investments. Part of this gap has been cyclical. Households had to save more and pay down debt in the wake of the Great Financial Crisis, while corporations shelved investment plans and hoarded cash. Long-term structural factors are at play as well. In most of the developed world, an aging population has to save more for retirement that also lasts longer. Conversely, the need for fixed-asset investments is lower in today's sharing economy and with the emergence of "asset-light" business models. Consequently, trillions of dollars, euros and yen of excess liquidity are sloshing around the globe, depressing yields on existing financial assets and competing for a few new investment opportunities.

How to deficit-spend it

(Government structural balances as % of potential global GDP*)



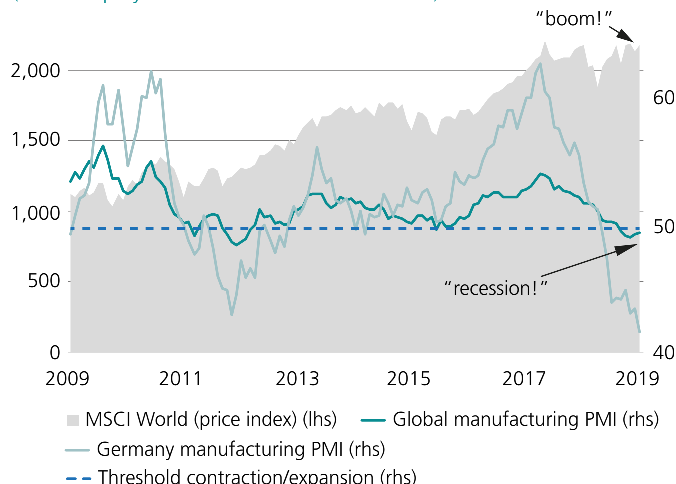
* Cyclically adjusted national fiscal balances; aggregated by purchasing power parity share of global GDP, all from IMF World Economic Outlook
Source: Datastream

Central banks around the world have tried to set policy rates low enough to erode the savings overhang and spur corporate investments – with limited success. Thus, new policy options are needed, especially if the economic recovery should stall. To many, this means that fiscal policy should step up, fill part of the investment gap and provide jobs and incomes for a larger share of the population. For the future, several such packages are envisaged in various jurisdictions. Infrastructure programs, social benefit build-out and measures to avert climate change are among the areas that evoke big spending plans. Of course, not all of these will be realized in the end. However, political obstacles are eroding as there is no crowding out of private investments and central banks are willing and able to help keep the bill of budget deficits as low as possible.

Financial markets: troubled waters in safe assets

"It's the liquidity, stupid"

(World equity index and economic indicator)

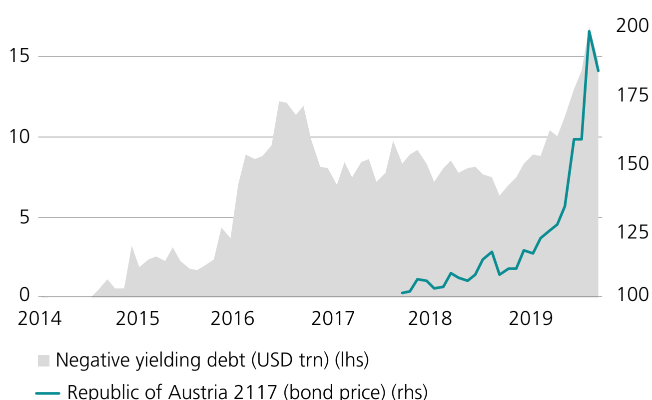


PMI: Purchasing Manager Index
Source: Datastream, JPMorgan, LGT Capital Partners

After reigning for more than a decade, the bull market may be getting old but not necessarily tired. Case in point: during 2019, global economic growth slowed, while markets rallied. The ongoing trade war pushed the manufacturing sector into contraction – which is often a precursor for a broader economic recession. Financial markets, however, proved resilient to bad news for two main reasons. First, investors generally viewed the headwinds as temporary, operating from a base case that the US and China would eventually come to an amiable accord and remove barriers to trade. Second, central banks fully reversed course and instead of normalizing and slowly tighten monetary policy, they opened the spigots of liquidity once again.

Safe and sorry

(Negative yielding debt and 100-year Austrian sovereign bond)

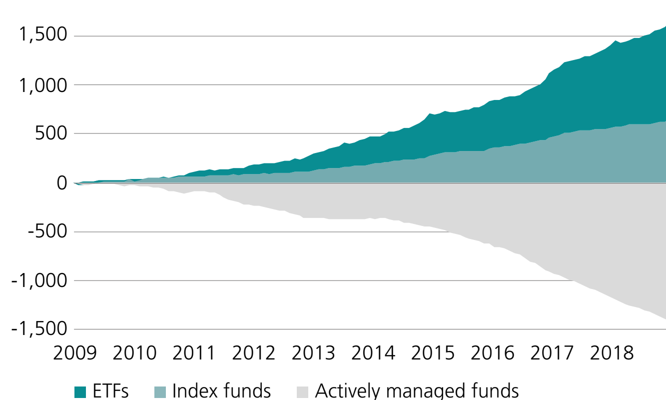


Source: Datastream, Bloomberg, LGT Capital Partners

Evidently, the curative effects of lower rates still outweigh any concerns regarding real growth, allowing equities and bonds to rally simultaneously. The results are astounding: around a third of government bonds globally have negative yields. Even corporate bonds are increasingly joining the club of "return-free" risk assets. This development spells trouble because even the smallest increases in interest rates translates into big (temporary) losses for bondholders. For example, for the 100-year Austrian government bond that recently doubled in price, a 1% rise in rates would entail a mark-to-market loss of more than 50%. While we do not believe that interest rates are about to rise significantly, we would still avoid a space that yields nothing at best and bears many hallmarks of a classic investment bubble.

Passive aggressive

(Cumulative fund flows in/out of mutual funds/ETFs*, USD bn)



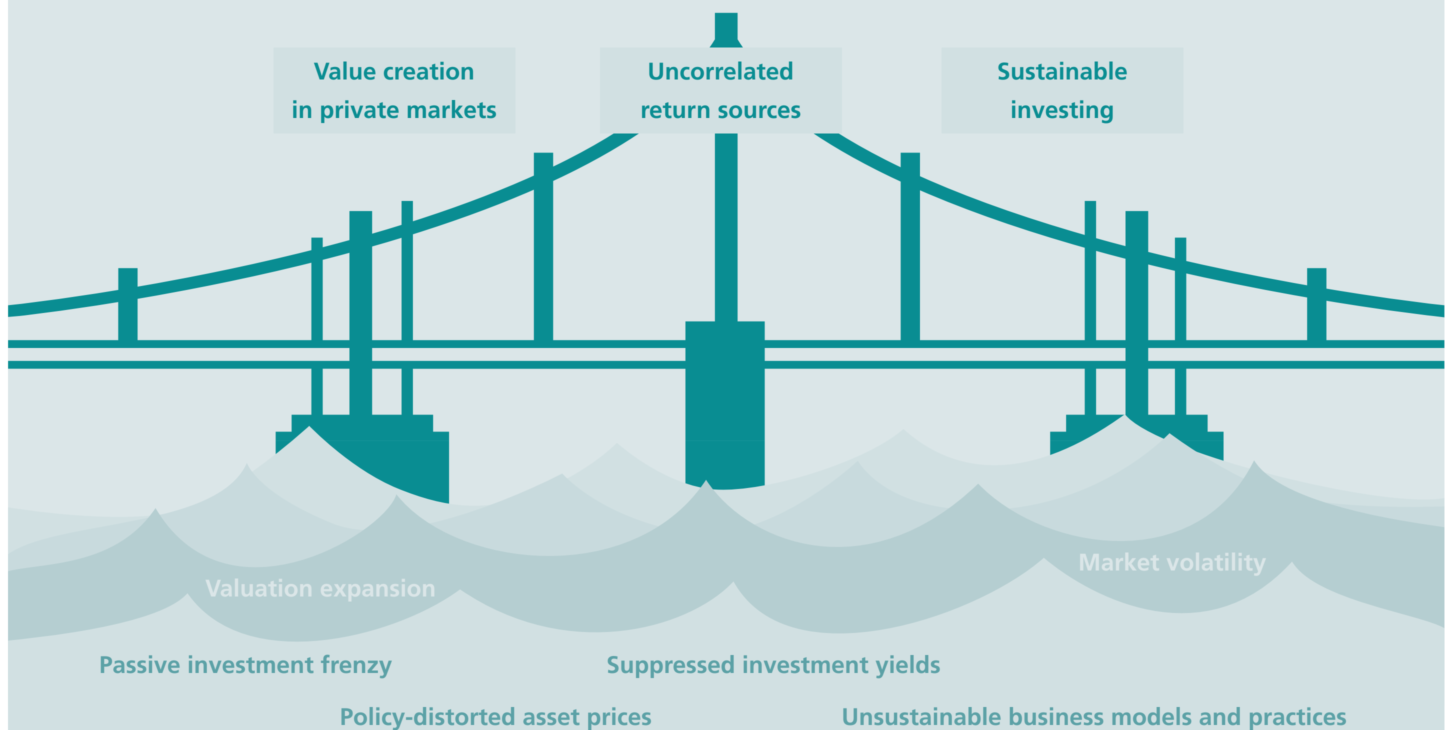
* US-domiciled domestic equity funds only
Source: 2019 Investment Company Fact Book, LGT Capital Partners

Another trend that warrants scrutiny is the massive drive to passive investment vehicles. Over the last decade, investors flocked into ETFs and other index products at the expense of actively managed funds. This is understandable, as the latter category was associated with poor relative returns and high costs. However, the sheer size and rapid growth of the ETF market may pose hidden liquidity risks in terms of potential mismatches between the trading volumes of the listed fund versus its underlying securities. Moreover, equity market-cap-based passive investing, by definition, bets on past performance by allocating heavily to today's largest companies. In fixed income, indebtedness is rewarded rather than punished, as indices are tilted towards the major debtors. We therefore prefer an active investment approach that retains control over portfolio composition, value creation and sustainability considerations.

Key investment topics

Building a bridge over troubled waters

More than a decade into the recovery, the world economy is still mired in a lackluster and policy-dependent environment that has become known as the "new normal." For investors, this means dealing with scarce growth opportunities and low prospective returns on financial assets that have been flooded by the surge in global liquidity. To reach higher ground, we would advocate an asset allocation with an emphasis on value-creating strategies in private markets and uncorrelated return sources from liquid alternatives. Finally, to avoid troubled waters and contribute to a better tomorrow, all investment activity must incorporate a sharp focus on sustainability.



At LGT Capital Partners, we firmly believe that an endowment-like investment approach addresses many of the challenges outlined here. A long-term commitment to a strategic asset allocation that accounts for several future economic and policy developments through scenario planning should ensure a robust investment portfolio.

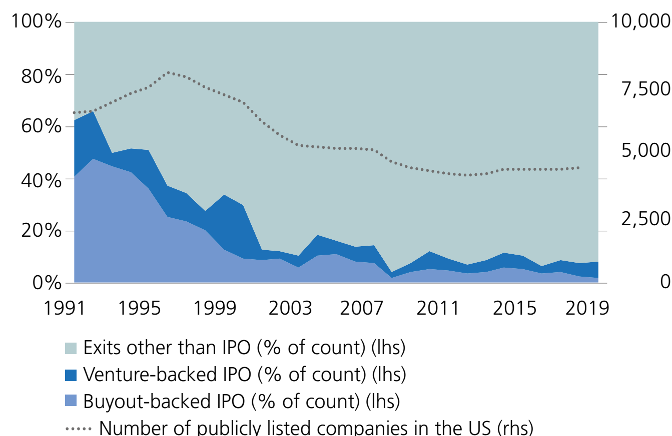
As long-term investors, we emphasize sustainable value creation in private markets. This includes transforming companies in private equity, structuring loans in private debt or moving beyond core strategies in real estate and infrastructure. The aim of our liquid alternatives, which include style premia, insurance-linked strategies and true alpha managers, is to provide uncorrelated, market-neutral returns. As such, they help to diversify the portfolio and balance its overall liquidity profile.

On the following pages, we briefly present the recommended investment strategies that should help build a bridge for the year 2020 and beyond.

Value creation in private markets

Shy of the public eye?

(Share of PE-backed IPOs; number of public companies in the US)

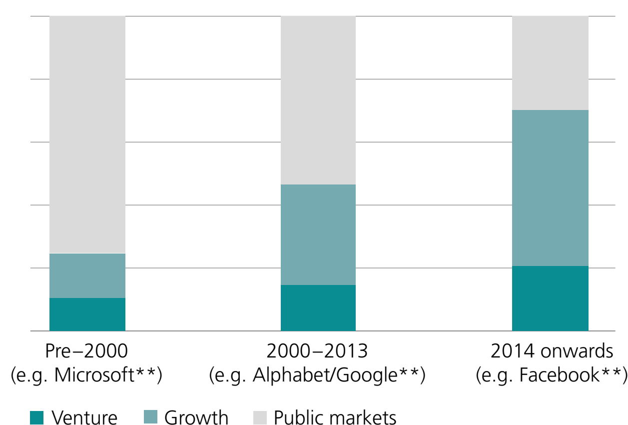


Source: Preqin, Datastream, LGT Capital Partners

Despite a decade-long boom, public equity markets have actually been shrinking. How so? For one, the number of listed companies has been steadily declining in the US and elsewhere. For a long time now, mergers and acquisition have outweighed initial public offerings, reducing the count of firms in stock markets. In addition, many corporations took advantage of record-low costs to borrow and buy back their own shares. In terms of performance, this so-called "de-equitization" has been a pleasant tailwind for investors. The caveat, however, is that the best of it may be behind us and that this development has arguably increased market concentration. Passive equity investors, in particular, are implicitly banking on few incumbent firms maintaining their competitive edge. This may be a bold assumption in a world where many traditional business models and industries are being so profoundly disrupted.

Exclusive growth

(Illustrative evolvement of value creation stages*)

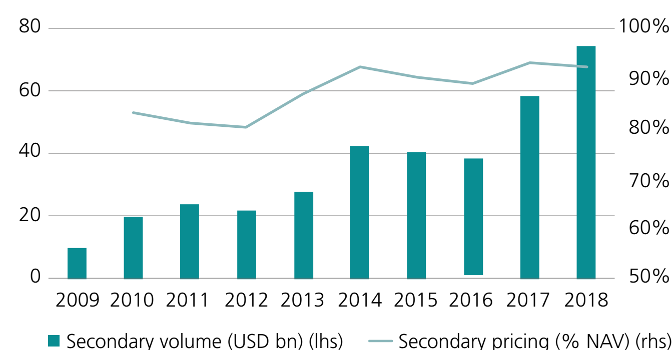


* Illustrative share of total value creation in private venture and growth phase vs. period as a publicly listed company
** References to specific securities should not be construed as an investment recommendation
Source: LGT Capital Partners, Bloomberg

Private equity, on the other hand, derives much of its return through controlled value creation. A struggling company may be bought out in order to actively reshape and reposition it to be successful again. Such transformational changes are harder to engender with the scattered ownership of a public company. Moreover, venture and growth capital have taken a firmer hold in the development of promising new companies. Today, private capital funds up-and-coming businesses for the better part of their growth phase. Take Microsoft for instance: although financed by venture capital as a start-up, it only became a leading software firm as a listed entity, after its IPO in 1986. Conversely, Facebook was already a dominant social media platform and exceeded USD 100 billion in market cap at its IPO. This trend is bound to continue as private capital is readily available and companies opt to delay a public listing.

Bridging the exposure gap

(PE secondary market transaction volume and pricing)



Source: Greenhill, LGT Capital Partners

There are, of course, drawbacks of private equity's rise to prominence. As ever more funds compete for the existing opportunity set, valuations on deals grind higher. In our view, this is unlikely to change in an environment of negative rates and scarce growth. We thus recommend committing regularly to proven primary funds and selectively consider add-on direct investments. Furthermore, transacting in the continuously growing secondary market has numerous advantages. Buying a stake in an already mature portfolio, possibly at a discount to fair value, can alleviate concerns regarding the timing and concentration of exposure to private equity. In any proposed sale, a thorough bottom-up analysis can reveal value opportunities for the buyer. To that end, we rely on our strong relationships with private equity managers around the world and focus on leverage-free small and mid-sized transactions.

Beyond bridges in infrastructure

Infrastructure as an asset class sits at the intersection of two major developments: the need for more fiscal stimulus packages and the push for a more sustainable economy. McKinsey, a global consulting firm, estimates that the world needs approximately USD 3.7 trillion in infrastructure investments per year through 2035, just to keep pace with currently projected economic growth and urbanization trends. An additional USD 1 trillion would have to be spent annually to meet the United Nations' sustainable development goals, with the bulk designated for the generation, storage and distribution of renewable energy.

In the past, governments often funded less than was needed, leading to a situation of overstrained and outdated infrastructure. However, there is a good chance that this will change going forward. Calls for budget spending to jolt anemic economic growth are getting louder. In addition, averting climate change has moved up to the top of many policymakers' agenda, increasing the chances of a government-supported transition to cleaner energy sources. All of this will require significant private capital as well, in order to ease public debt burdens. Infrastructure may therefore be one of the few investment spaces where the supply-demand balance still tilts in favor of the investor. Core infrastructure assets boast cash yields with low volatility and high visibility – owed to their long operational life and often-regulated revenue stream. A more hands-on approach that focuses on value enhancement can lead to materially higher total returns on investment. Modernizing existing or developing new assets are examples of active ownership. Investing in volume- and growth-dependent infrastructure in emerging markets is another such possibility.

Exploiting niches in real estate

Real estate is a well-understood and widely held asset class. Given the healthy fundamentals, core real estate continues to attract a large number of investors, pushing income yields to record lows. Investors seeking potentially higher returns are thus evaluating a number of strategies. One option is to move away from the central districts of major cities to include select mixed-used projects on urban transit hubs in second-tier locations. Another is to invest in alternative real estate sectors, such as healthcare or hospitality. However, yield-starved investors have already pursued some of these strategies; most notably, the areas favored by demographic trends and low exposure to economic growth seem well occupied already. Examples of these popular themes include senior living, student housing or self-storage. We therefore prefer niche strategies in subsectors with market depth and exposure to structural as well as cyclical growth. Examples of these include data centers, last-mile industrial (e.g. fulfillment centers) and creative office space. Moreover, there are value-add strategies in classic office and select retail properties: refurbishment and repositioning or the renegotiation of an unfavorable lease contract, to name a few possible courses of action for return enhancement.

The common trait to our strategy in real assets is to go beyond the "plain vanilla" implementation by focusing on active strategies and attractive niches that balance current income yield and future capital growth. Of course, this entrepreneurial approach demands specialized knowledge plus a tolerance for illiquidity, and should therefore only be considered with an experienced partner. For our portfolios, we prefer to combine an array of alternative subsectors and value-add approaches. Access to real assets is attained through commitments to best-in-class primary funds, direct co-investments and occasionally transacting on select opportunities and special situations in the secondaries market.

A rich menu in real assets

(Generic strategies and subsectors in real estate and infrastructure)

Income-oriented	**Return focus**	**Growth-oriented**
Core	**Core plus/value add**	Opportunistic
Brownfield		Greenfield
Developed markets		Emerging markets
Direct	**Ownership**	**Indirect**
Co-investments	**Primaries** **Secondaries**	Listed equity Debt

	Low	**Exposure to economic cycle**	**High**
Infrastructure	Hospitals/schools **Water treatment** **Energy pipelines** **Regulated renewables**	**Power generation/ transmission** **Transportation** **Telecomunication**	Airports Seaports Toll roads
Real estate	Residential Student housing Senior housing Self-storage	**Logistic centers** **Data centers** **Specialized retailers** Hotels/leisure	**Office** Retail Industrial

Preferred subsectors/strategies (marked in bold)

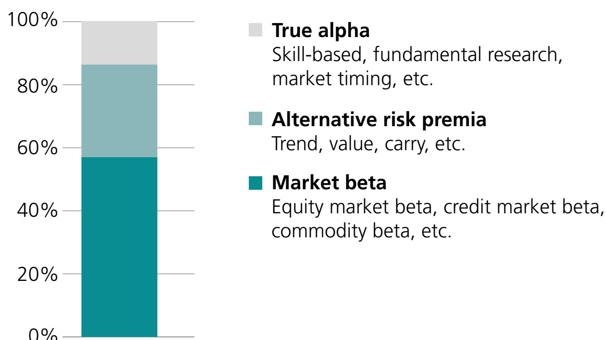
Source: Deutsche Asset Management, LGT Capital Partners

Uncorrelated return sources

It has always been difficult to find, but alpha became even rarer after the Global Financial Crisis. Active managers have struggled to perform in a decade marked by anemic growth and market-distorting policy interventions. What's more is that our understanding of alpha has evolved. Instead of only measuring performance against market returns, it is now common to adjust for any style biases a manager might have. While it may be desirable to collect these alternative risk premia, it makes more sense to do this in a controlled and cost-efficient manner (see below). From our alpha managers, we demand that the returns predominantly stem from their investment acumen ranging from research-driven security selection in a long/short-portfolio to active positioning based on macro views. As these skills can be applied consistently in different market environments, they provide a source of genuinely uncorrelated returns.

Alpha: rare but not extinct

(Hedge fund return decomposition*)

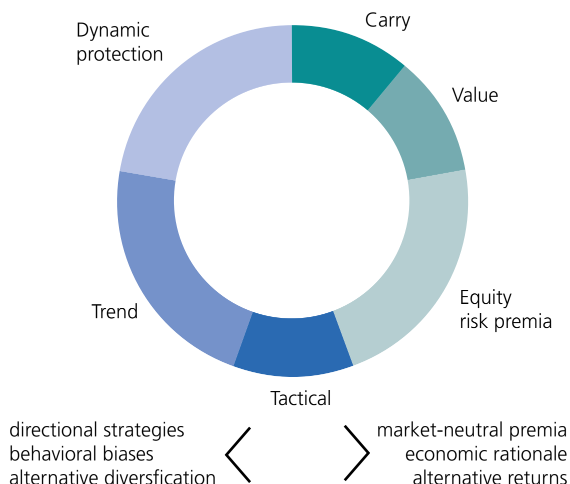


* Based on HFRI Fund Composite from 1999 to September 2019; excess p.a. returns over money market
Source: Bloomberg, LGT Capital Partners

Of course, systematically harvesting alternative risk premia requires skill too. Sensible portfolio construction, efficient execution as well as proper risk management all require significant resources and brainpower. But it all starts with the challenging quest to find persistent return patterns that can be exploited with trading rules. These are often rooted in behavioral biases or have an economic rationale. Among the better known ones are style factors in equity markets, such as "Size" or "Quality." Within "Carry," "Value," and "Tactical," trading signals for relative positions are generated across equity, bond, commodity and currency markets. These are then combined with directional exposures within "Trend" and, upon adverse market conditions, overlaid by our proprietary dynamic protection program. In interaction, these sub-strategies aim to deliver attractive risk-adjusted returns that are largely independent from the broader market's direction.

Alternative risk premia: a systematic combination

(ARP sub-strategies of the LGT Group Endowment)



ARP = Alternative risk premia
Source: LGT Capital Partners

News-based trading is a particularly exciting area within quantitative strategies. In essence, it takes the latest technological innovations, which use artificial intelligence to process large amounts of data at mind-numbing speed, and applies them to finance. However, most players in this field seem to rely on speed only. Their algorithms crawl the internet for news and numbers to trade upon them faster than the others do. As such, it remains mostly a race of IT-infrastructure build-out among them. At LGT Capital Partners, we foster a slower but more sophisticated approach. We use natural language processing, machine learning and laws of physics to capture market sentiment dynamics from news flow. We then take long and short positions based on the analysis of prevailing news-to-market-sentiment mechanisms. The flexible exposure of the strategy allows for uncorrelated returns over the cycle.

News-based trading: will slow and steady win the race?

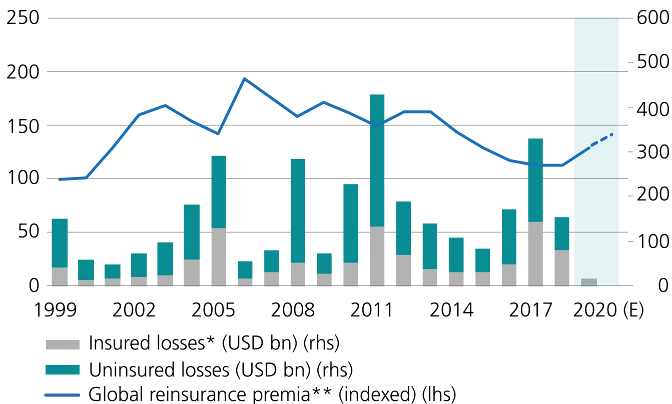
(Approaches in comparison)

	Mainstream approach	LGT approach
Expected news impact	First, "knee-jerk" reaction (seconds, minutes, hours)	Slow sentiment buildup (days, weeks, months)
Relevant framework	Linear news impact: price adjusts quickly to new information	Nonlinear: long-term memory effects via interconnected news, sentiment and price
Key differenti-ating skills	Execution speed	Model for sentiment dynamics

Source: LGT Capital Partners

Insurance-linked strategies: premium turnaround

(Reinsurance premia and incurred event losses)



* Insured loss for 2018 and H1 2019 is based on latest available industry estimates
** Weighted global average Rate-On-Line, indexed 1999 = 100; premium development for 2020 is based on LGT ILS Partners' assessement
Source: Swiss Re Sigma, Guy Carpenter, LGT ILS Partners

By their very nature, investments in insurance-linked strategies are largely uncorrelated with financial markets. In this asset class, returns for investors do not hinge on financial variables but on the occurrence – or rather the absence – of insured events. These insured events commonly include damages from natural disasters, such as earthquakes or windstorms, but can also cover other events such as cyber-attacks. In recent years, investor demand often exceeded the supply of event risks transferred from (re-)insurers, resulting in lower overall risk premia earned. Now the tide seems to have finally turned. After a series of loss-heavy events and subsequently increased demand for reinsurance protection, rates offered on such contracts are on the rise. In the face of meager yields in traditional fixed income and a general scarcity of truly uncorrelated return sources, those are welcomed prospects.

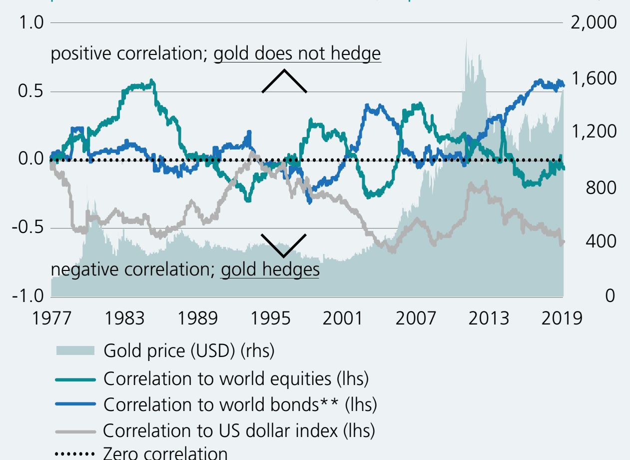
From the perspective of finance, gold is a strange creature. Unlike most investment securities, it does not represent a claim on a productive economic asset. Thus, there are no cash flows or dividends associated with it, and textbook valuation methods are inapplicable. Nevertheless, the precious metal is cherished as a "safe haven" and alternative store of value by many, precisely because of its detachment from an economy based on fiat money.

Financial investors add gold as a hedge to their portfolio for a variety of reasons, ranging from fear of a stock market crash to concerns of runaway inflation or US dollar weakness. Perhaps the different motivations to buy (or avoid) gold explain why its correlation with financial assets has been anything but stable in the past. Take its co-movement with equities, for example. Gold usually rose when equity markets and other risk assets sharply fell, providing partial insurance in a portfolio context. However, gold sometimes failed to hedge against market corrections, most notably in the early 1980s or in 1998, when gold sold off along with global risk.

Similarly, gold's historic correlation with that other "safe-haven" asset – government bonds – was mostly positive, but not always. More recently, falling real interest rates have lifted bonds, equities and gold simultaneously. If the current regime holds (see pages 6 and 7), then gold may even prove to be the better portfolio diversifier than bonds in the future. With yields already at or below zero, bond prices may resist falling much further in coming bouts of risk aversion. This is because there might well be a limit to investors' tolerance of the holding costs that negative yields imply. A spike in bond yields on default fears or leaping inflation expectations may also entail a flight to gold, although that is an unlikely scenario for now. In either case, we recommend holding a small portion of the precious metal as an alternative diversifier in the context of multi-asset investments.

Gold: a precious portfolio diversifier?

(Gold price and correlation* with bonds, equities and US dollar)



* 3 years rolling correlation coefficient, based on weekly data
** World government bonds from 1986; prior US Treasuries
Source: Datastream, LGT Capital Partners

Sustainable investing

Leaving murky waters behind

Dubious and unsustainable business practices represent a different but increasingly damaging sort of troubled waters. To avoid wreckage, we have to start by setting up and adhering to principles of responsible investing. A disciplined focus on quality, resilience and alignment of interests is certainly critical to ensure long-term investment success. In that sense, the now ubiquitous "sustainable (or responsible) investing" has already partly been here. For example, prudent equity investors have always taken into account how a company is managed and how its business practices are aligned (or not) with society at large. In the long run, poor corporate governance, appalling labor conditions or severe environmental contamination rarely made for a truly viable business.

What is different today is that the aspect of sustainability has gained in significance everywhere, and the depth and breadth of ESG-considerations ("Environmental, Social, Governance") have markedly increased. A new generation of responsibility-conscious consumers is affecting demand for goods and services. Companies have to adjust to these new realities in their end markets. At the same time, they have to comply with new regulations imposed by lawmakers who have heeded the call to protect the environment and ensure resource efficiency.

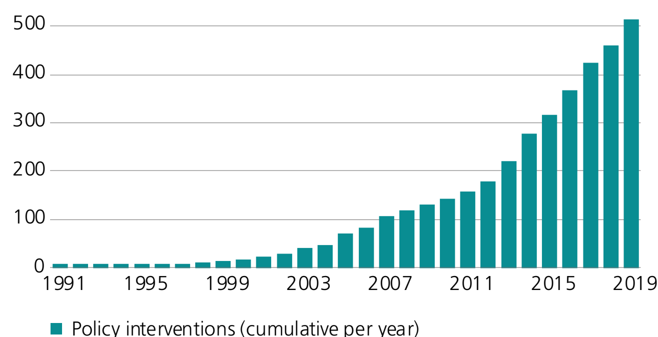
Sustainability has thus become a part of business life that conscience dictates, customers demand and governments command.

The financial industry needs to reflect and catalyze these developments if it wants to be an agent of positive change rather than a target of negative sanctions. According to the Global Sustainable Investment Alliance, an umbrella organization for industry groups, approximately one-third of all managed investments are now explicitly considering ESG-criteria. That is a global average only, with Europe in the lead, where roughly half of all assets are managed responsibly. Today, the methods applied still vary, ranging from a few exclusions (negative screening) to best-in-class (positive screening), themed and impact investing. In recent years, the more comprehensive and impact-oriented approaches have gained ground at the expense of simplistic exclusions that only guarantee a bare minimum of standards.

Ideally, these distinctions will disappear in the future, as full and stringent ESG-integration becomes an industry standard. Sustainable investing will then no longer be a differentiating factor but common practice adhered to by all those managing financial assets.

Just a little push

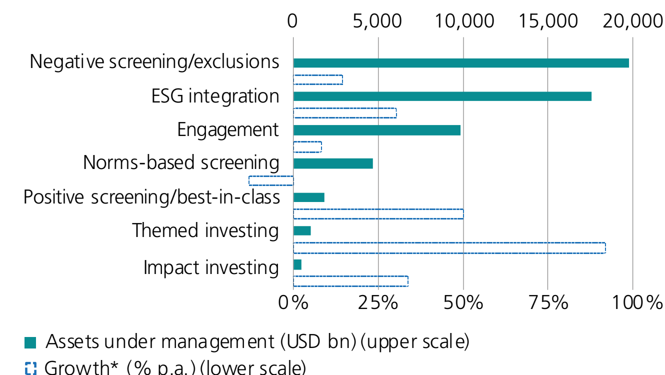
(Responsible investment-related policy interventions per year)



Source: PRI responsible investment regulation database, LGT Capital Partners

Doing the right thing right

(Sustainable strategies AuM, growth* last 3 years)



* Compound annual growth rate 2016–2018

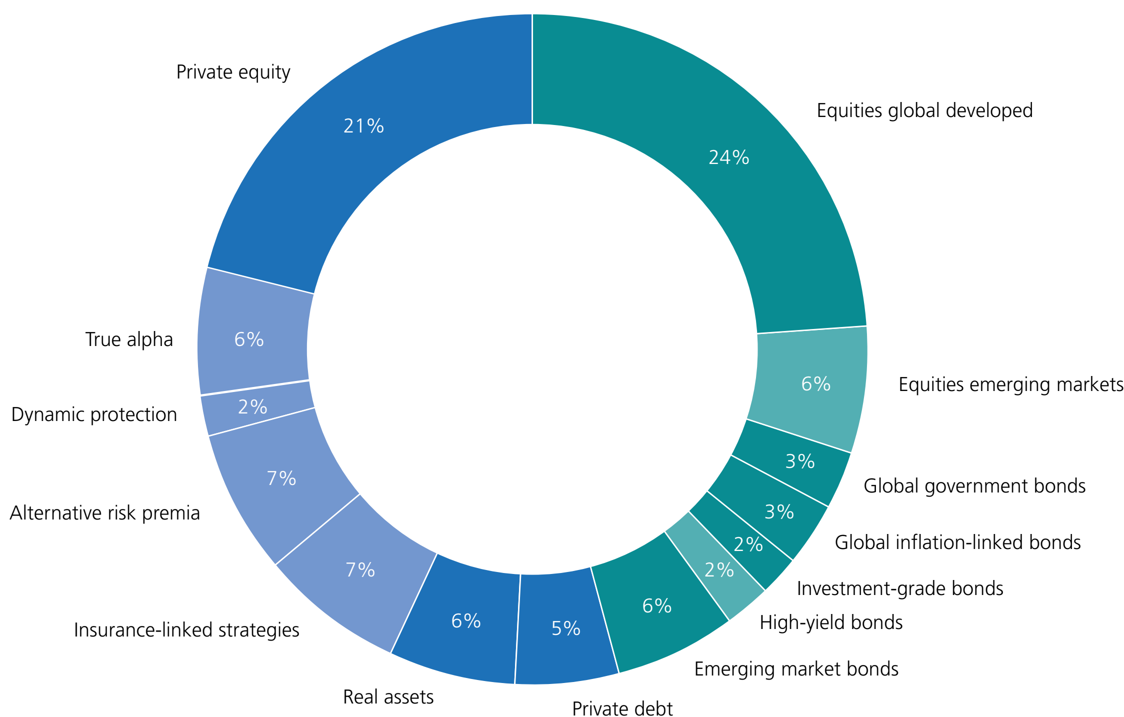
Source: Global Sustainable Investment Alliance, LGT Capital Partners

How we invest our own money

LGT Capital Partners has been managing and investing a combined portfolio of traditional and alternative investments, the LGT Group Endowment, for over 20 years. Today, this strategy has more than USD 12 billion in assets under management.*

The Group Endowment's investment mandate is to achieve sustainable long-term asset growth with moderate volatility. To this end, we developed our proprietary strategic asset allocation methodology. At its core, scenario planning ensures diversification of attractive risk premia across global investable markets. Institutions and families who have preserved and developed wealth over generations are well aware of the central role of diversification. They have gone through times of war, inflation, depression, and may have even witnessed confiscation of assets. We are convinced that diversification is a fundamental concept for long-term investors.

LGT Group currently invests USD 3 billion in this strategy, along with substantial capital from the key investment professionals of LGT Capital Partners, allowing for significant alignment of interests with clients.



Uncorrelated return sources

Skill-based alpha is a rare but genuinely uncorrelated return source. In addition, various alternative risk premia can be combined for market-neutral portfolio returns. Insurance-linked strategies also provide independent returns, while gold may function as an alternative diversifier for the portfolio.

Value creation in private markets

The owner-manager structure of privately held equity allows for controlled value creation over a longer time horizon. This also applies to individually negotiated private debt. In real assets, rising infrastructure demand and attractive new usages of property create opportunities for income and growth.

Sustainable investing**

Integration of ESG-considerations has become a sine qua non as responsible investing is as much about avoiding troubled areas as it is about benefiting from the transformation to a more sustainable economy. Thus, a holistic approach that encompasses the entire investment decision process is required.

* Assets include shareholder, staff and client investments

** Dark shaded areas include internal mandates managed according to LGT's sustainability criteria. ESG integration with our external best-in-class managers is evaluated periodically with a systematic rating and a defined engagement process.

Data as of September 2019

The quota above represent the long-term, strategic asset allocation. The actual, invested asset allocation can deviate considerably from these numbers for tactical and portfolio management reasons.

Source: LGT Capital Partners

LGT Capital Partners Ltd.
Schuetzenstrasse 6
CH-8808 Pfaeffikon
Phone +41 55 415 96 00
Fax +41 55 415 96 99

LGT Capital Partners (USA) Inc.
1133 Avenue of the Americas
New York, NY 10036
Phone +1 212 336 06 50
Fax +1 212 336 06 99

LGT Capital Partners (Ireland) Ltd.
Third floor
30 Herbert Street
Dublin 2
Phone +353 1 433 74 20
Fax +353 1 433 74 25

LGT Capital Partners (U.K.) Limited
1 St. James's Market
London SW1Y4AH
Phone +44 20 7484 2500
Fax +44 20 7484 2599

LGT Private Debt (UK) Ltd.
1 St. James's Market
London SW1Y4AH
Phone +44 20 7484 2500
Fax +44 20 7484 2599

LGT Private Debt (France) S.A.S
37 Avenue Pierre 1er de Serbie
75008 Paris
Phone +33 1 40 68 06 66
Fax +33 1 40 68 06 88

LGT Capital Partners (FL) Ltd.
Herrengasse 12
FL-9490 Vaduz
Phone +423 235 25 25
Fax +423 235 25 00

LGT Capital Partners (Dubai) Limited
Office 7, Level 3, Gate Village 10
Dubai International Financial Centre
P.O. Box 125115
Dubai
Phone +971 4 401 9900
Fax +971 4 401 9991

LGT Investment Consulting (Beijing) Ltd.
Suite 1516, 15th Floor
China World Tower 1
No. 1 Jianguomenwai Avenue
Chaoyang District
Beijing
Phone +86 10 6505 82250
Fax +86 10 5737 2627

LGT Capital Partners (Asia-Pacific) Ltd.
Suite 4203 Two Exchange Square
8 Connaught Place
P.O. Box 13398
Central Hong Kong, HK
Phone +852 2522 2900
Fax +852 2522 8002

LGT Capital Partners (Japan) Co., Ltd.
17th Floor Stage Building
2-7-2 Fujimi, Chiyoda-ku
102-0071 Tokyo
Phone +81 3 6272 6442
Fax +81 3 6272 6447

LGT Capital Partners (Australia) Pty Limited
Level 36 Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Phone +61 2 8823 3301

Legal information
The LGT Group Endowment follows the same investment approach that is used for the Princely Family of Liechtenstein. LGT Group Endowment is not available for investment by US investors.

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LGT Capital Partners Ltd.
Schuetzenstrasse 6, CH-8808 Pfaeffikon
Phone +41 55 415 96 00, lgt.cp@lgt.com

www.lgtcp.com

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