



Capital Partners

your partner for alternative investments

A tale of two cycles

Investment outlook 2022

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair.”

Charles Dickens

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Introduction

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness (...)” The opening line of Charles Dickens’ epic 19th century novel *A Tale of Two Cities* lends itself to describe the post-pandemic world we live in today. There are, for example, deep societal rifts, distrust, and misinformation on the one hand, but astounding scientific and technological progress on the other. And the world economy seems to have finally turned the page on anemic growth and deflation risks. But financial markets may be less than thrilled, as they seem to have embarked on a cycle of their own. In this publication, we first look at what the dichotomy implies for long-term investors.

In a second section, we delve into the segments of the alternative investment landscape, where we have been actively engaging as a principal investor over more than two decades. We share our observations and assessments on private equity, private debt, real estate and infrastructure, as well as liquid alternatives and insurance-linked strategies. In particular, we emphasize recent trends, the challenges of the current environment and attractive future investment opportunities. Finally, we provide an update on pertinent issues regarding sustainable investing.

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

A tale of two cycles – investment outlook 2022

Financial markets have always led the economic cycle by anticipating and pricing changes before official statistics could reflect them. But the headstart usually amounts to a few months and is thus compatible with the notion of a synchronous cycle. Now, that may no longer be the case: while the global economy is finally shifting gears, financial markets seem already too saturated to fully soak it in, leaving investors in a two-speed world that is challenging to navigate.

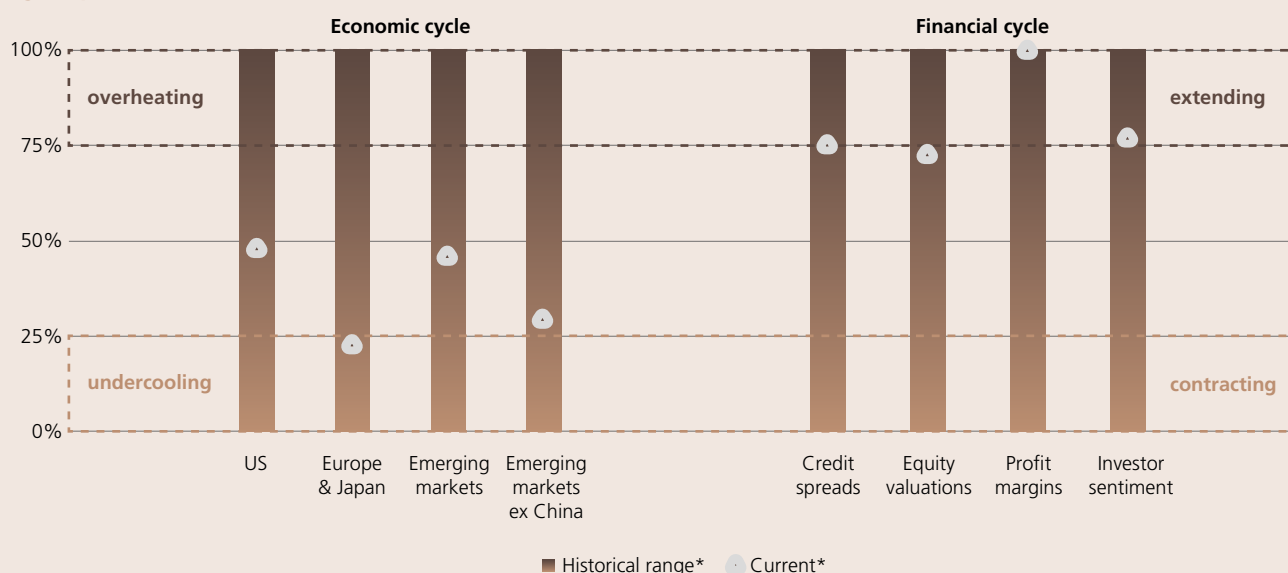
Real economy

A reflationary expansion is our base case for the years to come, with higher economic growth and rising (but not rampant) inflation. Policy stimulus will be reined in very tentatively, leaving real rates low and debt levels high. Large-scale investments and high-speed innovation hold the promise of solving pressing problems and boosting productivity.

Financial markets

After more than a decade of stellar investment returns, market metrics tell the tale of a mature financial cycle. While the economic expansion generally supports risky assets, the transition from a liquidity- to a growth-driven regime is therefore likely to be bumpy and fraught with volatility. More frequent rotations and intermittent corrections could become hallmarks of the next phase.

Ages apart



* historical range are percentiles last 40 years; economic cycle measured by output gap (actual GDP vs. potential) as proxy; current as of October 2021
Source: Refinitiv, LGT Capital Partners

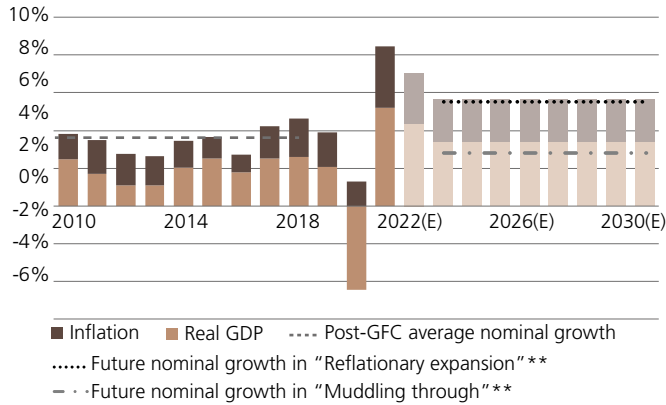
Asset allocation

We recommend staying the course with a growth-oriented portfolio geared toward risk premia that are still relatively attractive and that can be enhanced by skill-based alpha generation. Listed financial assets should be selected with a strong focus on sustainable quality, and private market commitments should be added based on their ability to create value. Assets with inherent inflation-protecting properties also deserve their place, and we advocate holding overall portfolio duration short. We suggest substituting traditional fixed income with alternative lending strategies, as well as emerging market debt that includes frontier markets. To further diversify, liquid alternative strategies should be included for their uncorrelated returns and to provide different exposures in changing market regimes; features that should ultimately help to cushion the potential downside for the portfolio. Anti-cyclical buying should best be institutionalized in the investment process to capitalize on temporary market dislocations in the future.

The global economy: leaping into expansion

“Roaring Twenties?”

(Nominal GDP growth rates, historic and expected*, YoY in %)

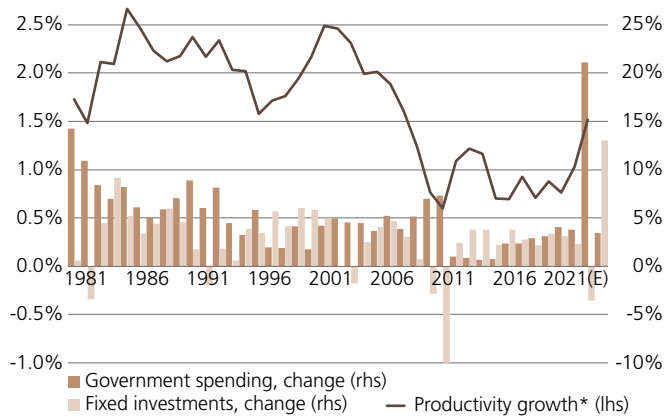


* for the US and Europe, from year 2023 on expected average p.a. rates
 ** based on LGT Capital Partners’ scenarios; future data are purely indicative
 Source: Refinitiv, LGT Capital Partners

Ironically, it took one of the deepest recessions in history to lift the global economy to higher ground. In the aftermath of the Great Financial Crisis (“GFC”), much of the world had been mired in anemic growth, dithering at the brink of a deflationary slump. Meanwhile, policy stimulus was dispensed in a piece-meal fashion and only to avert the worst, a period that was dubbed as “muddling through.” The pandemic seems to have changed that. The confluence of uninhibited government spending, pent-up consumer demand and revived animal spirits has jolted the world economy into a reflationary expansion that may well last beyond the initial rebound phase. For the years ahead, we will likely see stronger economic growth linger, and higher, albeit largely contained, inflation rates. The risks to this base case lie in a fallback to pre-pandemic doldrums or, conversely, in an overheating with a late but abrupt policy tightening.

Reinventing productivity

(Productivity, public spending, investments, G7*, YoY in %)

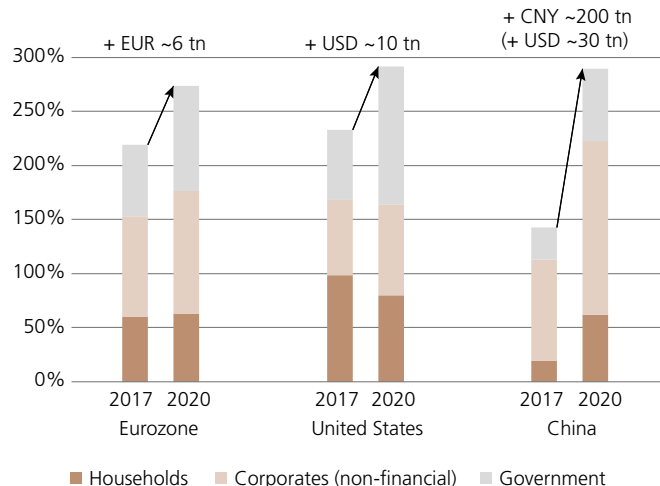


* productivity growth is change in real GDP per hour worked, average for G7
 Source: Refinitiv, OECD, S&P, LGT Capital Partners

Technology undoubtedly plays a pivotal role in shaping our future. Innovation is also what drives overall productivity, a key factor in determining an economy’s growth potential. In that regard, we may well live in the best of times. The pandemic’s “stay-at-home” orders have triggered an unparalleled private IT-infrastructure build-out. In addition, vast sums in fiscal spending plans have been earmarked for the transition towards a greener economy, for classic infrastructure and for basic research and development. Digitalization is connecting and integrating the world while decarbonization goals boost renewable energy and resource efficiency, creating new opportunities for companies to innovate and prosper. Naturally, these major shifts may bring frictions too: scarcity of critical materials and skills, for instance, or the risk of stranded assets, as well as misguided investments in a rapidly changing world.

Credium in perpetuum

(Total debt composition, in % of GDP)



Source: Refinitiv, LGT Capital Partners

But the biggest risk to the upbeat economic outlook comes from an old acquaintance: debt. Largely ignored as of late, the (future) costs of accumulating too much debt continue to tally up. Central banks have become instrumental in holding these costs down, diluting their formal independence from government treasuries and softening their stance on guaranteeing price stability. Lessening the debt burden will require lower real rates for longer, and likely increase taxes and other levies over the coming years. The debt issue is most imminent in China, however, where a credit cycle took off just as the West experienced a crunch. Now, Beijing is burdened with the delicate balancing act of reducing the cost of housing and indebtedness under its plan for “common prosperity” while at the same time avoiding a “hard landing” in its raving property and ailing banking sectors.

Financial markets: extending a mature cycle

But too tired to party?

(Select financial market metrics in different market phases)

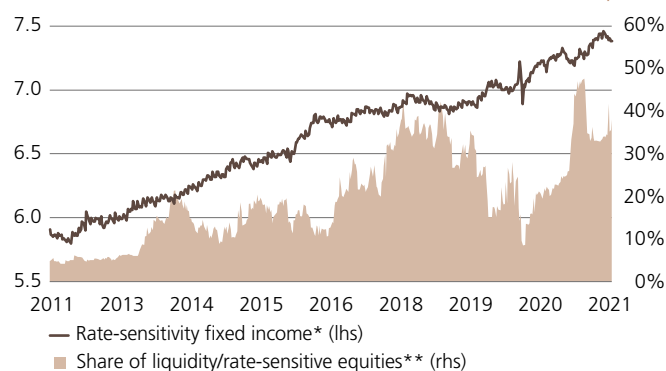
	Begin bull market (Q1 2009)	Pre-pandemic (Q4 2019)	Now (Q3 2021)
Credit risk premium	16.8%	3.5%	2.8%
Equity risk premium	7.1%	5.2%	3.8%
Margin debt/income	1.2%	2.0%	3.3%
Large buyout multiples*	8x	11x	12x
Investors "overweight" equity (net %)	-20%	1%	50%

* average Enterprise value/EBITDA on large private equity buyout transactions
Source: Refinitiv, BofA ML, LGT Capital Partners

This time, it really was different. The downturn of 2020 was deep but brief, and the economic fallout backstopped by governments. Consequently, any potential financial imbalances built up during the previous 11-year bull run were not washed out. If anything, they were exacerbated as the incumbent market regime went into overdrive. That is why, today, we find ourselves facing investment choices ridden with late-cycle issues, despite an apparently early stage of expansion for the real economy. Top-line growth will likely continue to support asset prices, although rising costs could erode profit margins, and valuations—at times already rich—are susceptible to bouts of volatility. Monetary policy will likely stay accommodative and thus underpin easy financing conditions. Nonetheless, it might eventually have to lean against rising inflationary pressures and tighten policy.

Sense and sensitivity

(Global fixed income duration and rate-sensitive share of US equities)

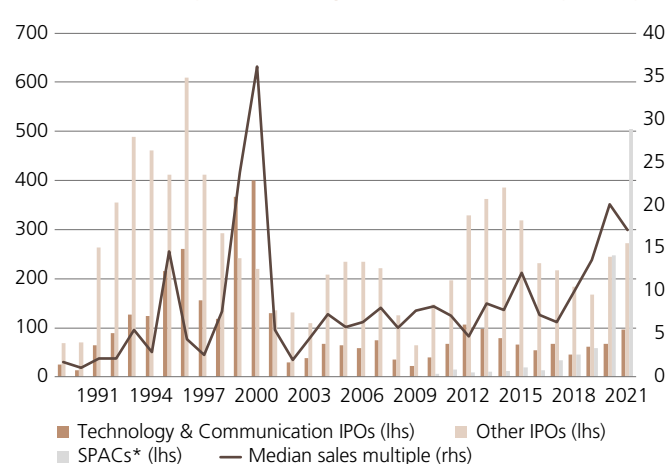


* duration on global investment grade and high yield bonds
** US large caps trading at an equity risk premium below 2%, proxy only, for illustrative purposes
Source: Refinitiv, LGT Capital Partners

One trait of these mature markets is that they are probably highly prone to changes in liquidity conditions. Although policy stimulus will be withdrawn only gradually, a small rise in rates, for instance, will likely have a much bigger effect on financial markets than on the real economy. Ultra-low yields and an extended maturity profile have, by definition, raised the duration of fixed income as an asset class. Interest rate sensitivity has presumably risen in other market segments as well, although the mechanics here are less straightforward. But with secular growth stories and investors hunting for yield for more than a decade, larger parts of the equity market may be vulnerable to changes in base rates. The good news is that—if the change comes on the heels of a roaring economic expansion—it could be more of a healthy rotation of styles and regions rather than broad-based weakness.

Rational exuberance

(Number of initial public offerings and sales/market cap multiple)



* Special Purpose Acquisition Companies (SPAC)
Source: Refinitiv, Bloomberg, spacinsider.com, LGT Capital Partners

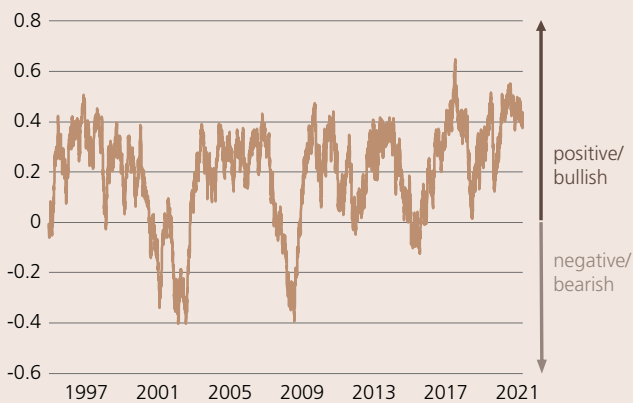
While valuations in some high-growth areas may face headwinds, the fundamental environment remains as strong as ever in our age of innovation. Venture capital seeks out and nurtures both the next disruptors of existing industries and the leaders in emerging fields. Public offerings have increasingly been met with great expectations, but by many metrics we are still a long way from the hyperbole of the heady 1990s. The companies that are being brought to market nowadays are more mature and often backed by professional private equity firms that may even opt to keep a stake in the listed entity. The broader popularity of venture investments has recently led to a boom in so-called SPACs, blank-check public companies with the purpose to acquire a privately held firm for its shareholders. The initial euphoria has already cooled, however; a welcome development for the potential longevity of the bull market.

Alternative insight: taking stock of market sentiment

John Maynard Keynes, the brilliant economist and passionate speculator, once famously said: “successful investing is anticipating the anticipations of others.” Properly gauging investors’ sentiment goes a long way towards deciphering groupthink and deducing investment decisions. But the most commonly used direct measures of market sentiment rely on surveys, which are, by their nature, probably flawed with regards to extracting the true state of an investor’s mind. Market data on fund flows and hedging activities can also add valuable information, but these indicators require much interpretation and thus mean different things to different observers.

You are what you read

(News-based market sentiment indicator)

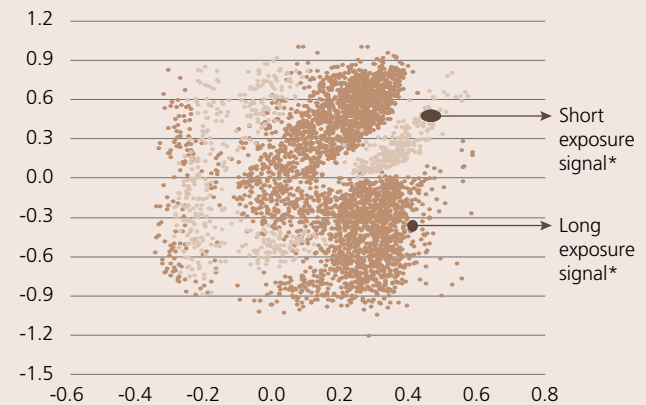


Source: LGT Capital Partners

Our team of quantitative scientists has taken a different approach by modelling the process of how an investor, and by extension, the overall market, forms expectations based on the flow of news. For this, global and local news items from hundreds of outlets, agencies, and financial blogs are parsed and processed at a high frequency. Natural language processing, machine learning and dynamic modelling are used to translate the news flow into investors’ expectations and predictions on price changes. The model is nonlinear and captures the dynamic interplay between news, sentiment and price action in financial markets and thus provides precious insight on the state of the cycle.

Painting a sentimental picture

(News-based phase portrait)



* news-based trading signals are based on patterns of sentiment evolution over different time horizons
Source: LGT Capital Partners

Asset allocation: laying portfolios across cycles

The LGT Group Endowment's approach

Optimal portfolio construction has always been challenging, and the endeavor is now further complicated by diverging cycles. In today's environment, macro-economic developments may not always translate into financial markets the way one has come to expect. For example, strong nominal growth may, at times, fail to boost risk assets if concerns over already lofty valuations and rising rates dominate. Or the negative equity-bond correlation may no longer hold in an environment in which elevated inflation is perceived to hurt both asset classes. Therefore, our risk and return assumptions, while generally still optimistic, needed adjustments to account for changing sensitivities, rising volatility and shifting co-movement patterns in this two-speed world.

For the LGT Group Endowment (see page 21), we have implemented the following core convictions and portfolio measures to position ourselves for the coming years:

- Maintain exposure to equity risk premia, but integrate a defensive tilt by focusing on sustainable quality. This focus is applied both in the selection of securities or co-investments, as well as when mandating external best-in-class managers.
- Maintain exposure to private markets for their extra return on illiquidity, complexity and skill. Access technology and innovation through commitments to seasoned partners in venture capital.
- Include flexible strategies that provide varying exposures depending on the prevailing market regime. Liquid alternative strategies, with both systematic and discretionary approaches, capture existing and emerging price trends as well as relative value and other alpha opportunities over a vast area of global financial markets.
- Keep portfolio duration short. As a growth portfolio, the Endowment has only a small quota of G7 government bonds and has replaced much of the high-yielding bond allocation with private debt and alternative lending strategies.
- Emerging market sovereign debt that includes frontier markets is a yield-enhancing portfolio addition that also provides diversification across diverse economic development stages and different business cycles.
- Include assets with inherent inflation-protecting properties such as infrastructure, real estate or the equity of companies with strong pricing power. Consider the inclusion of inflation-linked bonds and gold as additional inflation hedges for the portfolio.
- Add alternative diversification to the portfolio that does not solely rely on negative equity-bond correlations. For that purpose, we implemented a dynamic protection program as a portfolio overlay. The program systematically trades in many different asset categories and liquid instruments.
- Institutionalize anti-cyclical deep-value buying on volatility spikes and market dislocations. To that end, the Endowment has set up a monitor that provides 'buy' signals on various asset classes, if and when value opportunities arise. Periodic and ad-hoc portfolio rebalancing is an additional anti-cyclical measure.

Beyond traditional fixed income: investing in frontier market debt

Expanding the investable universe

In today's mature financial cycle, income-oriented investments with an attractive yield are notoriously hard to come by. In reality, this view is very much centered on the developed world, and the problem can easily be alleviated by including bonds issued outside industrialized nations. Emerging market debt—denominated in hard or local currency—has been attracting yield-seeking international investors for decades. The move to include lesser-known but rapidly developing frontier markets is a natural evolution in the expansion of the investable universe. Roughly 140 countries are categorized as “frontier,” and are in themselves a very heterogeneous group that spans from the least developed nations of Sub-Saharan Africa to relatively advanced economies in Southeast Asia, Latin America and Eastern Europe. Although they are generally less mature, and in some cases also less transparent and more difficult to access than the well-covered emerging markets, it can be highly beneficial to add them to a diversified portfolio. However, researching, selecting and combining the right financial instruments from the countries with the most promising outlook is key and requires in-depth knowledge and investment experience in this specialized field.

A tale of many cycles

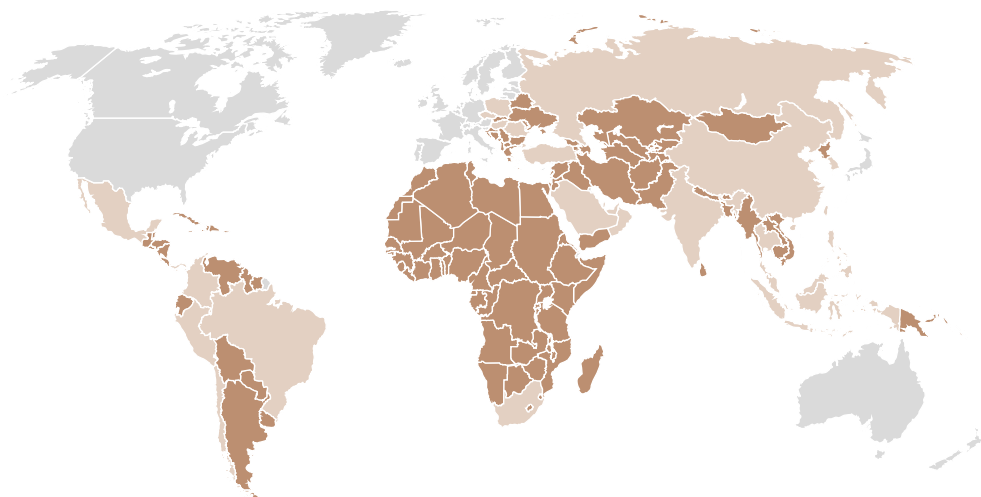
The investment case for sovereign debt from frontier markets is indeed compelling. In aggregate, nominal yields on local currency government bonds are running just above double digits. The bias of frontier currencies to weaken on inflation differentials usually shaves off a few percent, but leaves total real returns for foreign investors at very attractive levels. In addition, the inclusion of a wide set of new creditors helps diversify the portfolio in a number of ways. Owing to their different structures and development-

stages, the economies of frontier markets are not all exposed to the same influences and vulnerabilities. Some countries reliant on the export of base metals or energy, for example, may be sensitive to the global economic cycle, while others that are tilted towards agricultural commodities or the domestic service sector may be much less intertwined with the G7 nations. In fact, with frontier market debt, the dominating risk factors are mostly local and idiosyncratic in nature: population growth, level of education, structural reforms, financial regulation, or national fiscal and monetary policies are some of the key drivers for long-term returns for creditors.

The hitherto sparse presence of international investors, in effect, adds to the diversification benefits. Local debt is still mainly held by domestic institutions, such as pension funds and insurance companies, and those are much less prone to selling their holdings at the whim of faltering global risk sentiment. Thus, investors in frontier markets are perhaps somewhat shielded from the volatility stemming from contagion in global financial markets.

Frontier market debt's value proposition thus consists of enhancing the income yield component of an investment portfolio while at the same time diversifying the exposure away from the dominant economic and financial cycle of the developed world. When considering the outlook for lasting suppression of real income yields and the potential for more market volatility and rising asset-class correlations in investors' home markets, this opportunity to expand the investment horizon should not be left untapped.

Market universe



■ Developed market ■ Emerging market ■ Frontier market

Source: CIA World Fact Book, LGT Capital Partners

“It takes both sides to build a bridge.”

Fredrik Nael

“Exploration is the engine that drives innovation. Innovation drives economic growth.”

Edith Widder

“At some risk of oversimplification, I suggest that the usual reason a business cycle turns into a monster is an overdose of government policy.”

Edgar Fiedler

“Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.”

Sam Ewing

Private equity

The growth and velocity of private equity are currently at a pace unlike in any other period in the history of the asset class. Deal-making and exit activity have been robust, while the scale and scope of managers themselves have broadened. The rapid sophistication of the market has come with a growing number of tools that private equity firms can use to react to, and capitalize on, changing market dynamics. The asset class continues to adapt, and has experienced tremendous tailwinds despite the pandemic, inflation concerns, and geopolitical uncertainty. Private equity has managed to “transcend the cycle”, and managers continue to adapt to maintain what has been an unprecedented run.

Deal-making

Digital transformation

The trend of digital enablement has been a theme for many years, but its relevance has grown significantly over the past two years. Technology adoption rates are years ahead of previous forecasts as the pandemic has forced companies to prioritize digital transformation projects for optimal value creation.

Managers are increasingly developing competencies to invest a growing share of their capital in such businesses. The rise in innovation has been a boon to both the growth equity and venture capital landscape. We are coming to a point where “technology” is no longer a sector, but an integral part of how many businesses—across sectors—operate.

Corporate carve-outs

Private equity firms are increasingly carving out businesses from larger corporations because of their significant value potential on a stand-alone basis. Additionally, by merging them with existing portfolio companies they can develop a platform while taking advantage of higher multiples for scale businesses in the event of an exit.

Exit activity

Continuation vehicles

While for many years the private equity business model was to execute on business plans within a fund over four to five years, managers are increasingly using tools to hold their strongest assets longer. Managers put more resources behind operational improvements and expansion opportunities, which naturally take more time and often require continuation vehicles given the limited term of closed-ended funds. A vibrant market has developed around continuation vehicles, which allow the same manager to continue to add value to assets, while offering liquidity to existing investors.

IPOs

Exit activity, in previous years very dependent on appetite of strategic buyers, has been fueled by exceptionally strong initial public offering (“IPO”) markets. Over the course of the past 18 to 24 months, this has led to numerous portfolio companies emerging victorious from distinct, pandemic-related tailwinds as well as emerging industry-specific trends. In the current cycle, it comes in addition to the enduring strong appetite of strategic buyers and financial investors.

SPACs

A notable aspect in the past 24 months was the substantial increase in special purpose acquisition companies (“SPACs”). Private equity played an important role in that development and managers are raising significant amounts of capital by listing portfolio companies in such transactions. While being an attractive tool to create liquidity in a portfolio, SPACs continue to create skepticism in market participants regarding how sustainable the businesses are and how they are valued.

Market participants

Asset managers, mergers and acquisitions

Private equity’s attractiveness and scalability has led to massive mergers and acquisitions activity among large, diversified asset managers. The lines between direct private equity investors and pure solutions providers have blurred, with a decreasing number of independent firms of scale.

GP stakes

GP stakes investments are direct equity investments, typically representing a minority, non-voting ownership position in the management company of a private equity firm. The phenomenon has transformed numerous small and mid-sized firms into multi-product platforms. This trend has been observed for a few years already but 2021 will likely set records for GP stakes deal-making. The market is beginning to see exit routes for such transactions, albeit still limited—but as private equity has demonstrated, wherever there is a primary market, a secondary market can develop.

What is here to stay 2022 and beyond?

Private equity has “stepped into the spotlight” over recent years. While funds continue to remain the driving force around deal-making, the tools at the disposal of investors and managers to operate within, and adjacent to, the fund construct has changed dramatically. This has arguably made the asset class more resilient—and while certain trends may ebb and flow, complexity is the new normal.

Key themes in private markets

Investments	Sector trends	<ul style="list-style-type: none"> ■ Tech and healthcare are on the rise, in particular with assets that have been resilient during the COVID-pandemic. ■ Energy and certain consumer sectors are facing cyclical and/or secular headwinds.
	Deal structures	<ul style="list-style-type: none"> ■ SPACs are becoming mainstream: it is too early to say whether this is a point-in-time market phenomenon or here to stay. ■ “Continuation funds” and single-purpose vehicle (“SPV”) transactions are increasing in favor as a way to capitalize on hallmark, market-leading assets, creating a sizeable opportunity for co-investments and secondaries.
Divestments	Exit pacing	<ul style="list-style-type: none"> ■ Resumption of private equity exit activity in the US, Europe, and Asia; it is some comfort that private markets have demonstrated ability to generate liquidity amid a market shock. ■ Real estate exit activity has been more muted, with a more pronounced bifurcation of “winners” (healthcare, tech-related) and more challenged sectors (hospitality, retail) relative to private equity and credit strategies.
	Exit types	<ul style="list-style-type: none"> ■ IPOs are strong for the most prestigious companies (tech and growth) at the upper end of the market. ■ Secondary buyouts continue to grow with managers reinvesting out of new funds that have substantial dry powder.
Deal activity	New deal activity	<ul style="list-style-type: none"> ■ Investment pipelines of managers are full again, and they are comfortably executing even through market uncertainty—across buyouts, growth, venture, special situations, credit, and to a lesser extent, real assets and distressed assets. ■ Private markets are able to transact “virtually,” particularly across private equity and credit. ■ Having the ability to conduct due diligence on assets and assess management of new deals is a key success factor.
	Financing	<ul style="list-style-type: none"> ■ Leverage levels are down on average by 0.5-1.0x EBITDA equivalent. ■ Interest rates continue to be at record lows. ■ Large inflows of capital into private debt lead to abundant availability of attractive financing.
Market participants	General Partners	<ul style="list-style-type: none"> ■ Fundraising activity is at pre-COVID levels among the strongest funds. ■ An increasing number of managers are raising smaller funds as part of platform extensions. ■ There is continuous monetization of management companies, partly to prepare for generational transitions.
	Limited Partners	<ul style="list-style-type: none"> ■ A general increase in private markets exposure is expected to be a continued trend into 2022 and beyond. ■ It is expected that LPs will only increase in their active management of portfolios, including secondary sales. ■ There is a trend toward a concentration of investments with fewer managers who can provide multiple solutions for clients.
	Other areas of focus	<ul style="list-style-type: none"> ■ Virtual diligence, monitoring and annual meetings have become “routine”, but long-term implications are unclear. ■ ESG, diversity and inclusion are themes that are being driven by both investors and managers.

Source: LGT Capital Partners

Private debt

The private credit market has experienced sustained expansion since 2010. Private credit managers' AuM have grown from under USD 500bn in 2013 to over USD 800bn in 2020. At the same time, the universe of private credit managers and underlying investment strategies has expanded significantly. Prior to the Great Financial Crisis ("GFC"), the landscape comprised mainly of distressed debt and mezzanine funds.

Today, investors can access a wide range of private credit strategies with different risk/return profiles, including traditional corporate strategies—such as direct lending—or stressed and distressed corporate credit and non-corporate strategies—such as asset-backed lending.

The opportunity set for private credit managers has enlarged due to the retrenchment of banks post-GFC and ever-increasing private equity deal activity fueling demand. Investors' interest has been driven by several factors: as the asset class is maturing, a number of managers have delivered consistent returns across multiple funds and evolving market environments, which increases investors' confidence to allocate to the asset class. At the same time, managers are making significant progress in incorporating ESG considerations in their investment activities. The key impetus, however, has been the search for yield in a continuing low interest rate environment, with spreads on investment grade and high yield bonds at continued low levels. Private credit offers a return premium over more liquid strategies, which has led to a sharp increase in investors' private credit allocations at the expense of more liquid strategies.

Investors' interest and the influx of capital has led to intensified competition in certain private credit strategies, such as direct lending. In this market environment, we favor established direct lending managers with long-standing sponsor relationships and incumbency advantage (lending to the same borrower multiple times, often across multiple sponsors). While valuations and leverage levels have been on an upward trajectory, equity cushions have remained stable or even increased over time.

Direct lending generally has proven its resilience through the pandemic with supportive private equity sponsors and default rates at rather low levels. Prospects for direct lending remain strong in light of private equity dry powder being at record levels. Despite some yield compression, there remains a significant illiquidity and complexity premium over publicly traded debt. In a market environment characterized by inflation concerns and potential tapering by central banks, we favor floating rate instruments and managers lending to high-quality sponsors and high-quality borrowers with healthy interest coverage ratios and the necessary pricing power to pass on potential supply chain price increases to their customers.

Beyond direct lending, private credit strategies generally have performed well through the pandemic and the volatility caused by COVID-19 created significant buy side opportunities for some opportunistic credit strategies, for example in the Collateralized Loan Obligation ("CLO") markets as ultimately CLOs demonstrated their resilience again.

As the asset class enters its next phase of growth, the market appears to be on the verge of a huge opportunity. Private credit benefits from borrowers' growing demand for more flexible sources of capital. Growth prospects for many non-corporate private credit strategies including infrastructure, real estate and non-correlated strategies are strong. Given the potential for further market volatility through monetary policy, geopolitics, global supply chain disruptions, change in behavior patterns or the ongoing global pandemic, it is key for investors to build diversified portfolios that balance attractive annual yield and downside protection with the ability to capture upside optionality caused by potentially volatile credit markets.

Real estate

Over the last year, capital has flowed into real estate in a search for yield, resulting in broad-based capital appreciation. While there continue to be pockets of dislocation in sectors undergoing secular shifts—for example shopping centers negatively impacted by continued e-commerce sales—the markets generally are supported by healthy demand and supply fundamentals. Moreover, capital inflows are creating new sub-sectors in asset classes, for example outdoor industrial storage, furthering the “institutionalization” of real estate.

To navigate the shifting landscape, we continue to adhere to the key investment principles that have worked well for us, including during the pandemic. These principles consist of a focus on specific markets or real estate sectors where there is the ability to “grow” the bottom line; a focus on strategies that generate solid contractual rental cash flow early on in their business plans; and finally, the flexibility to look at business plan optionality should things not go as initially expected. In an increasingly competitive investment landscape, we seek investments where we see opportunity to grow cash flow—either through demand drivers that support the durability and/or duration of lease contracts or through active asset management.

Case study: affordable housing in Canada

Our investment in the multifamily sector in Canada is a good illustration of putting these principles to work as well as capturing the benefits of an ESG-focused approach. This particular strategy is geared toward the “affordable” market segment (a theme that is applicable in other markets as well). Migration into Canada is creating significant demand, resulting in very low vacancy for clean, affordable housing and supporting our view on the “durability” of the rental income. At that same time, there is a generation of older housing stock, typically owned by families or individuals that do not have the balance sheet to reposition or update their product to meet current market standards, thus creating the opportunity to buy at significant discounts to replacement cost.

The investment consisted of a seeded portfolio of 12 multifamily assets in Ontario and British Columbia, totaling 2,534 units along with fresh capital investment in other assets, resulting in a CAD 1.2 billion portfolio with 6,440 units. The ability to underwrite the initial portfolio, as well as have visibility on the pipeline, provided the opportunity to evaluate the in-place cash flow alongside the business plan to create value.

The initial portfolio and subsequent acquisitions offered immediate rental income as well as potential for additional value creation through the active renovation of vacated units, which would then garner higher rents. Over the last several years, the portfolio has seen some 50% rental income increase on renovated units, resulting in a strong

cumulative rental increase on the entire portfolio. At a moderate loan-to-value level of 52%, the portfolio has also generated a 14% annual cash-on-cash return. In terms of business plan optionality, even without renovation, the investment provided a solid baseline return, supported by the strong inherent demand in the market.

In addition to generating attractive returns, our investment manager has a strong ESG execution focus on the portfolio, in particular when renovating assets. Through the implementation of efficient heating and boiling systems, ultra-high efficiency toilets and showerheads, and detailed energy metering, among other things, the portfolio has seen significant savings in energy and water consumption. The result has been accretive not only to current returns, but to the saleability of the assets going forward.



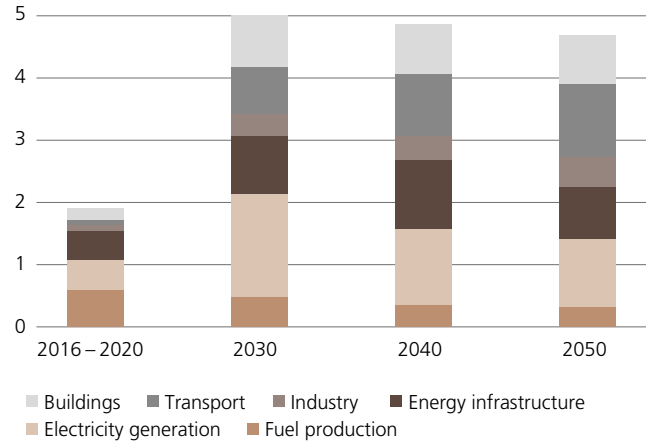
Selected asset from the portfolio

The fund manager is an established, vertically-integrated platform that has the expertise to source, acquire and renovate multifamily projects throughout Canada.

Infrastructure

Climate capital calls

(Average annual energy investments*, USD tn)



* historic and projected under the Net Zero Emission by 2050 scenario
Source: IEA World Energy Outlook 2021, LGT Capital Partners

The green agenda, driven by government policy and changes in consumer preference, has led to a once in a generation energy transition, creating an enormous scale and breadth of opportunities for private sponsors to finance cleaner sources of energy, means of mobility, and connectivity. Sustainability factors will be as important as cost and efficiency considerations when providing for essential services such as energy, transportation, healthcare, and waste management. Technological changes have made connectivity as essential as other forms of utilities (water, gas, power) with the need for faster and more reliable means of transmitting data in cities but also in rural areas. Estimates show that by 2022, 65% of the world's GDP will be digitized. Moreover, corporations under cost pressures and with sustainability mandates demand long-term institutional capital, with utility and energy companies as examples. Finally, governments, which have traditionally financed infrastructure, may see their budgetary constraints intensified. The private sector will therefore continue to play a vital role in sponsoring infrastructure, not only maintaining existing assets but also fulfilling the need for new infrastructure to cope with the changes in the economy and the way we live.

Special topic: how inflationary is the energy transition?

The largest investment project ever

Averting climate change may be the biggest endeavor in human history, as it requires massive efforts from governments, companies, consumers and investors alike. For this to happen, the world needs to decarbonize—that much is clear. It is the “when” and “how” that usually triggers a heated debate. Although numerous nations have already stated ambitious goals, the plans to reach them remain sketchy thus far. Investments towards a greener energy mix, for instance, need to more than double from current rates to between USD 4 and 5 trillion per year (see section on Infrastructure) to get us to a net-zero emission world economy by 2050. Hence, the energy transition may also make for the largest investment project ever, with vast public and private capital needed to retrofit industries, foster new businesses, spur innovation and eventually provide millions of new jobs in the green economy.

And a delicate balancing act

Lately, the notion of “not doing enough” has made way for a new set of worries around the topic of energy security and inflation. The wind-down of burning fossil fuels needs to be balanced with the ramp-up of renewable energy capacity, otherwise price spikes and supply scares are the result. The year 2021 saw perhaps the first of such frictions, as prices on Chinese coal and European gas, among others, suddenly soared. The energy transition may not have been solely

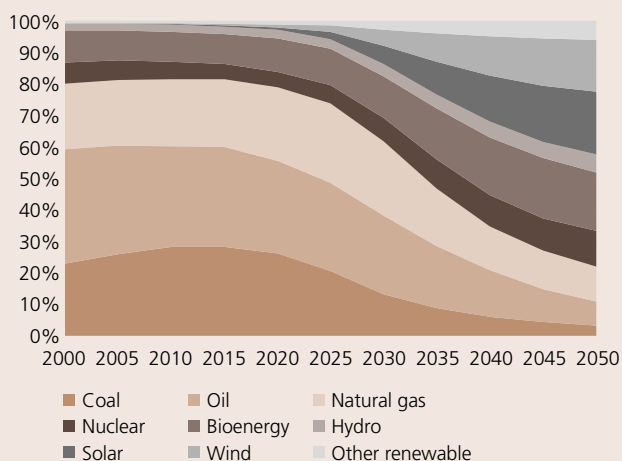
responsible for this episode, but it did arguably play a part. European carbon emission permits also skyrocketed, pricing in tighter climate policy in the Union. Climate change-related regulation is indeed a cost-pushing factor as carbon pricing needs to go global and tougher environmental standards proliferate in the quest of internalizing more external costs.

Another driver of cost inflation lies in potential demand-supply mismatches in needed materials. The global electrification of mobility will require huge amounts of various metals, for instance, leaving them prone to supply squeezes if mining capacity cannot expand fast enough. Or conversely, fossil fuels may temporarily add to inflation if the world exits their extraction faster than their usage. But in the long run, commodity-related inflation should be kept in check by the fact that the polluting and finite energy sources will be phased out and advancements in efficient production and consumption help alleviate potential resource issues.

The biggest climate change-related risk for persistent inflation, thus, does not lie in the energy transition, however smooth or bumpy it is going to pan out. Rather, it is the tail risk of unabated global warming with its accumulation of natural disasters, food shortages, production disruptions, and so on, that would push the global economy into a long-lasting stagflation—a scenario to avert at all costs.

Renewing the energy mix

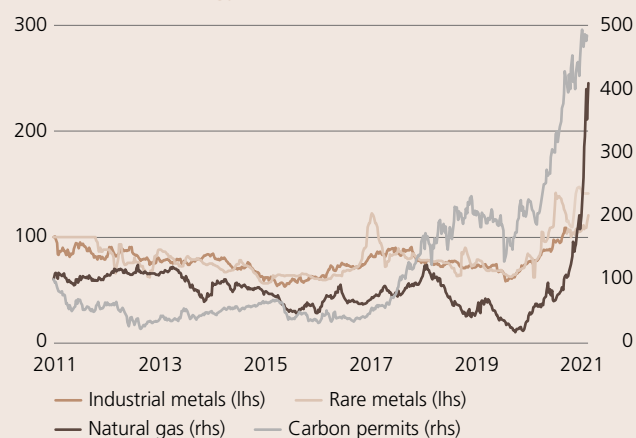
(Total energy supply by source; actual and projected*)



* under the Net-Zero Emissions pathway
Source: IEA Net Zero by 2050, LGT Capital Partners

Transition jitters

(Prices of clean energy relevant commodities*, indexed)



* industrial metals is index basket; rare metals is price of Praseodymium-Neodymium; natural gas is 1st month delivery per title transfer facility in the Netherlands; carbon permits are settlements per ton CO₂ under European emission trading system (EU ETS); all indexed to Q3 2011 = 100
Source: Refinitiv, LGT Capital Partners

Liquid alternatives

With a continued macroeconomic tailwind driven by persistently low interest rates and growing economies, we continue to see liquid alternative investment strategies as important components of institutional investment portfolios. In our opinion, elevated valuations in most asset classes make the case for these strategies even stronger.

For discretionary managers, for example in long/short equity, event driven or relative value, the revival of fundamental factors is finally in sight. After a prolonged period during which the gap between growth and value stocks grew consistently, market participants seem to be taking a closer look at company fundamentals. This leads to a higher dispersion of equity prices, which improves the playing field for discretionary managers. As the liquidity flood provided by central banks is expected to slowly but surely reverse in many markets, we expect the following implications for liquid alternative investment strategies:

- While many long/short equity managers are positioned to achieve upside capture in their long books, we expect short-term volatility swings as markets are trying to find a new equilibrium. Therefore, and while volatility offers opportunities, we continue to favor strategies with a low net exposure, focusing on sectors which take advantage of the current megatrends like digitalization and clean energy transformation.
- In event driven strategies, we expect a robust pipeline of deals in the future as excess liquidity and high valuations contribute to a high frequency of corporate activity. We expect this trend to last in the absence of a market selloff.
- Relative value managers will be able to take advantage of wide valuation dispersions across traditional risky assets like equities. As we expect central banks to continue to suppress fixed income volatility in the future, we favor managers with equity exposure.

As for systematic strategies, the renewed growth and improved performance of quantitative trading is based on a number of factors: accelerated megatrends, inflationary price movements in commodities, and higher price dispersion, sector rotations in equities and higher market volatility, among others. We expect this environment to persist for the foreseeable future and to see a re-emergence of systematic trading strategies. Moreover, investors' potential concerns about inflation and economic stagnation will enhance demand for systematic strategies in general.

In contrast to the last major market downturn around the GFC, proven systematic strategies trade on significantly deeper pools of data and with substantially higher computing power, now and in the future. The positive result of these improvements was already visible at the beginning of the COVID-19 pandemic. We therefore expect "traditional" systematic strategies like trend-following and systematic macro to resurge with higher market volatility.

Therefore, we continue not only to deploy capital into such strategies but to include new markets in our systematic trading portfolios. An example of this is the use of quantitative macro strategies that take advantage of non-price related signals ("big data"). Or capitalizing on China's distinct trends through investments in its specialized commodity segments or budding domestic bond markets—markets which have only recently become accessible for foreign investors.

Insurance-linked strategies (ILS)

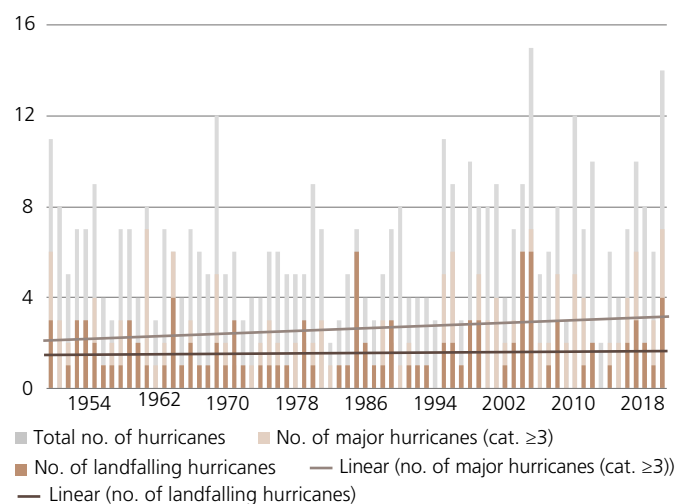
Last year, the outlook for insurance-linked strategies (“ILS”) looked very promising, as premiums have finally started to increase. But in 2021, US-winter storm “Uri”, the severe floods in Europe, and hurricane Ida have again put pressure on ILS returns. The combined insured loss from these three events alone is expected to reach USD 65bn, which is already higher than the long-term annual average.

A common assumption is that climate change affects insured losses due to increasing event count. However, explaining the rising costs by climate change alone falls short of the fact that the main loss drivers are construction and investment activity. Another belief is that climate change leads to more frequent and/or severe hurricanes. Whilst scientific data indicates an increase in major hurricanes (> Category 3), this does not apply to the number of landfalling hurricanes—which are the main drivers of insured losses. On the other hand, experts agree that climate change impacts the frequency and severity of “secondary” perils, for example storms or local flash floods.

Following losses, the typical industry reaction is to increase premiums. But as this measure alone did not lead to better underwriting results, insurers, reinsurers, and ILS managers are now applying a holistic review of the insured perils and individual transactions within their portfolios. This re-underwriting of risks—in combination with higher premiums—is expected to result in a higher resilience against the financial impact from climate-related disasters.

The key challenges of the industry are now being addressed by all market participants. It is in the interest of all players to establish a greater resilience against losses from natural disasters and the impact of climate change, and to generate sustainable positive returns. The ILS asset class represents a genuine investment alternative in today’s challenging environment, as it is one of very few asset classes that delivers truly uncorrelated returns and resilience against economic or political shocks in a portfolio context. In addition, ILS provide some form of inflation-hedge through their floating rate component and through the short contractual terms.

Hurricane activity in the Atlantic basin



Source: LGT ILS Partners, NOAA; data covers period from 1950 to 2020

Sustainability update

Two of the biggest trends in sustainable investing that continue to rise in importance are regulations and an increased focus on outcome orientation. These trends appear distinct at first glance but are, in fact, deeply intertwined.

On the regulatory side, we will focus on EU-specific regulation. Of course, this is most relevant to the EU and investors who are active in this jurisdiction, where these policies will have a very deep and lasting impact. However, as other jurisdictions are closely watching steps taken by the EU, it is possible that similar frameworks could be seen emerging elsewhere.

The adoption of the EU action plan on sustainable finance has led to the classification of investments that embrace environmental, social and governance (“ESG”) aspects into two distinct categories (referred to as Article 8 and Article 9). The first category is perceived as “light green”, which means that these investments take ESG criteria into account, among other aspects. It is really the latter category that is, at least from the view of the regulator, truly green or “dark green”, and can genuinely be called “sustainable investment”. One of the distinguishing features of a sustainable investment is the existence of a clear sustainability objective, together with a framework that shows how the individual investments help to achieve this objective. Hence, sustainable investing is ultimately tied to a tangible outcome. Here is where the second large building block of the EU action plan fits in—the so-called EU taxonomy. In essence, this defines what should be regarded as “sustainable investments” by outlining a distinct set of economic activities that could be seen as sustainable, taking into account further specific criteria. Again, these activities all focus on outcomes: they have to contribute to individual environmental or social objectives. This taxonomy is a huge endeavor and far from being comprehensive, but the driving idea behind it is clearly visible.

Another drive towards outcome orientation results is from global frameworks that have been adopted to fight the most pressing challenges humanity is facing. Two very prominent examples are the Paris Agreement to restrict global warming

and the UN sustainable development goals (“SDGs”). The first framework puts the focus on the outcome of limiting global warming to preferably not more than 1.5 degrees Celsius compared to pre-industry levels, and has become one of the most prominent, if not the strongest, individual considerations of sustainable investments. This is evident from the large investor alliances contributing to this goal by putting pressure on investee companies to adopt transition strategies, to align their investment portfolios with the goal of the Paris Agreement, and to allocate capital to transition activities. The SDGs have a broader scope, but also focus on well-defined outcomes regarding a number of environmental and social challenges. Both of these frameworks, together with regulations, raise the bar for asset owners and asset managers to show how sustainable investment practices contribute to real-world outcomes.

How can asset owners now tackle these challenges? New frameworks have to be set up, both for internally and externally managed assets—the latter presumably being a more daunting task. But as typical institutional investment portfolios comprise many different asset classes, developing a holistic framework to assess outcome orientation for complex portfolios poses a significant challenge.

At LGT Capital Partners, we have already made significant progress as we have started to implement a climate action strategy for LGT’s endowment fund. This strategy has several objectives, one of which is to align the overall portfolio with the goals of the Paris Agreement. Here, we have used well-established scientific approaches, together with our own thinking, and combined this with innovative concrete implementations of those concepts in a portfolio context. We have adopted frameworks for both listed and private company investments, not only for long-only investments, but also for hedge fund strategies. With our proprietary ESG Cockpit, we are in the comfortable situation of having a tool at hand that allows us to analyze and control the relevant data for the overall portfolio as well as for specific investments.

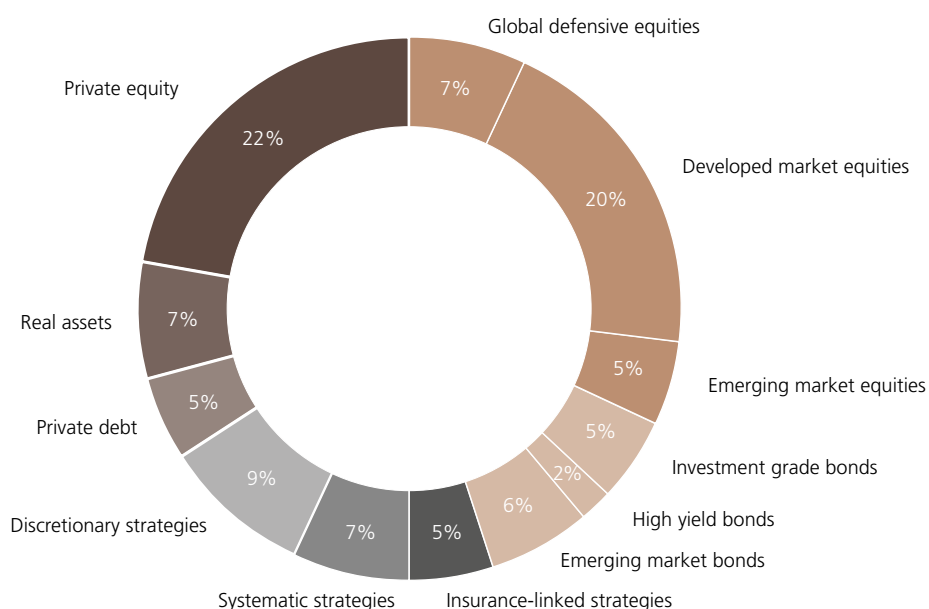
How we invest our own money

LGT Capital Partners has been managing and investing a combined portfolio of traditional and alternative investments, the LGT Group Endowment, for 23 years. Today, this strategy has more than USD 17 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 around 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.



Private markets

The owner-manager structure of private equity holdings, together with long investment horizons, allow for active value creation over a full cycle. In private debt, contracts are individually negotiated in close relationship with the counterparties. Carefully selected infrastructure and real estate deals offer the potential for income yield and capital growth.

Liquid alternatives

Alternative investment strategies are a source of uncorrelated returns found in the systematic harvest of alternative risk premia or the generation of true alpha from proven discretionary managers. Insurance-linked strategies too, focus on returns that are independent of overall market direction. The dynamic protection strategy is specifically designed to cushion market drawdowns in the portfolio.

Specialized equities & fixed income

A strong focus on sustainability and quality permeates all our efforts in the selection of publicly traded securities for our multi-asset portfolios and individual mandates. Value-add through active management is another cornerstone of our public market strategies. In addition, we engage in attractive niches such as global inflation-linked bonds or emerging market debt in local currency.

* Assets include shareholder, staff and client investments.

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.

Please note that the 3% allocation to the dynamic protection strategy is an overlay strategy and is thus not added to the overall sum of assets allocated.

Source: LGT Capital Partners

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