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Seeking balance

Investment Outlook 2024

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Front cover: www.gettyimages.ch,
Balancing stones in river

Introduction

In economics, the concept of a stable equilibrium is merely a theoretical one. In real life, the best we can hope for is that the constant changes we encounter will not be too abrupt or drive us further off course. But that is precisely what has happened in the past few years: Major crises and extreme policies have culminated in exceptionally strong macro volatility. Worse still are the social inequities and geopolitical rifts that have emerged, leaving the world in a dangerously unbalanced situation. This will eventually change for the better. And as the world seeks a new balance, market regimes will alter and investment paradigms will change.

In this publication, we first consider how long-term investors should set up their asset allocation to endure and thrive in a world that is in the process of rebalancing. In the second section, we look in detail at the segments of the alternative investment landscape where we have been active as a principal investor for over two decades. We share our observations and assessments on private equity, private credit, real estate and infrastructure, as well as liquid alternatives and insurance-linked strategies. In particular, we highlight recent trends, challenges in the current environment and attractive future investment opportunities. Last but not least, we provide an update on pertinent issues regarding sustainable investing.

We hope that you will find this publication to be both insightful and informative and we invite you to share your views and ideas with us.

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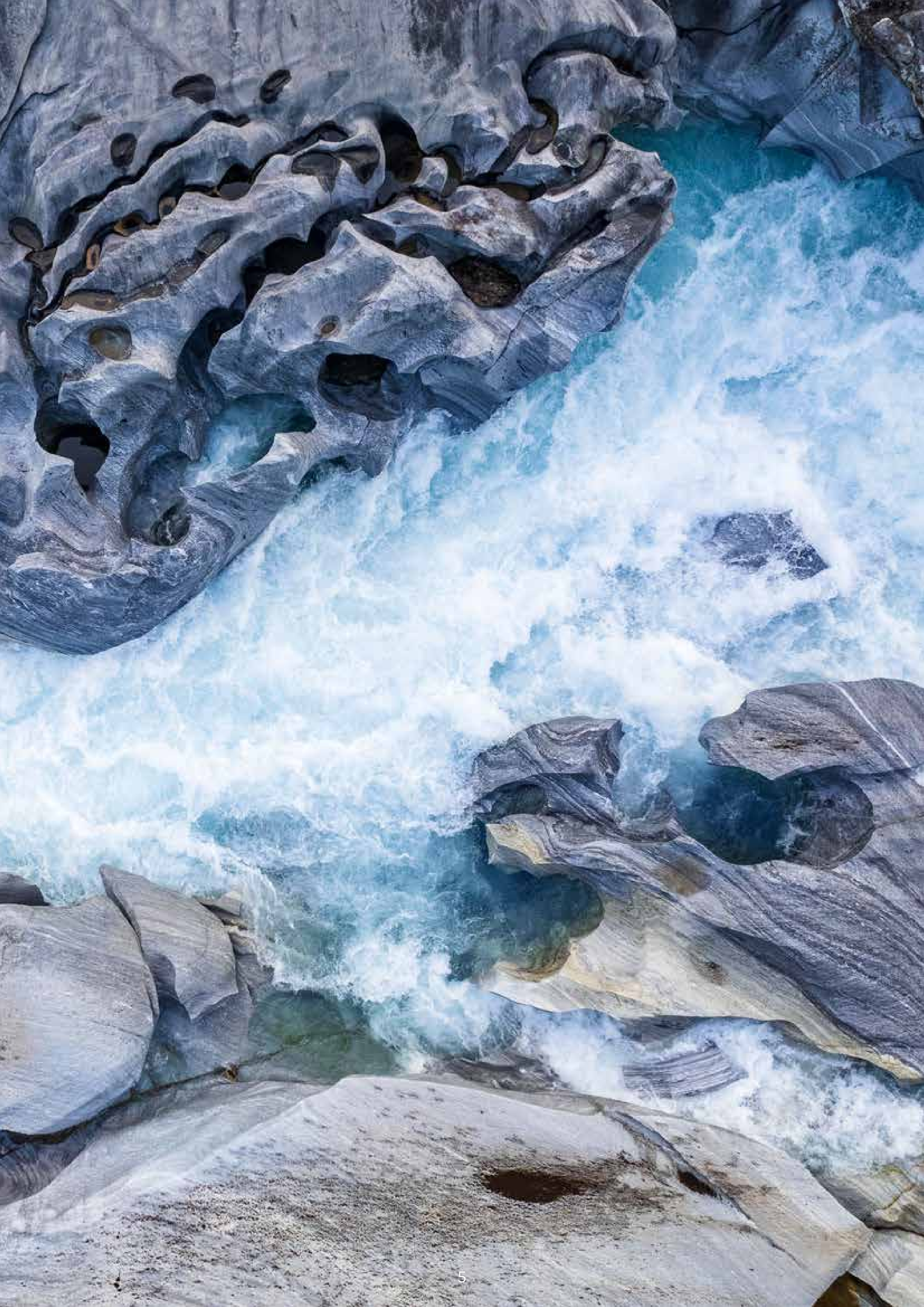


Seeking balance–
Investment Outlook 2024

In past years, we experienced major economic and social disruptions involving extreme policies and distorted markets. Together, they have caused new imbalances or exacerbated old ones. Today, we are in the process of seeking a new equilibrium. The forces behind these developments will drive trends and shape events in politics, economics and markets in 2024 and beyond.

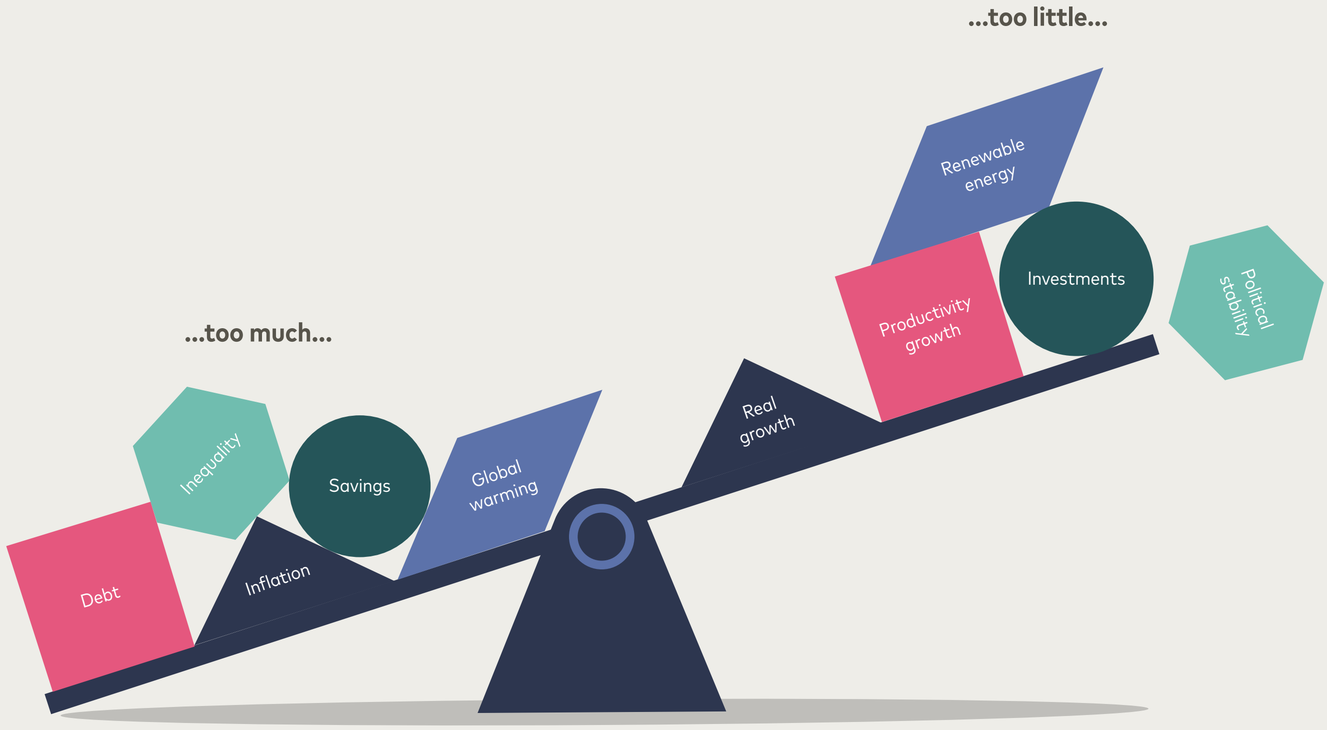
Real economy

Cyclically, the global economy is beset with too much inflation and too little real growth, while suffering structurally from a high debt burden, under-investment and tepid productivity growth. A boost in capital investment and advances in technology should change all that. However, politics–with their internal divisions and frayed international relations–remain a source of instability.

Financial markets

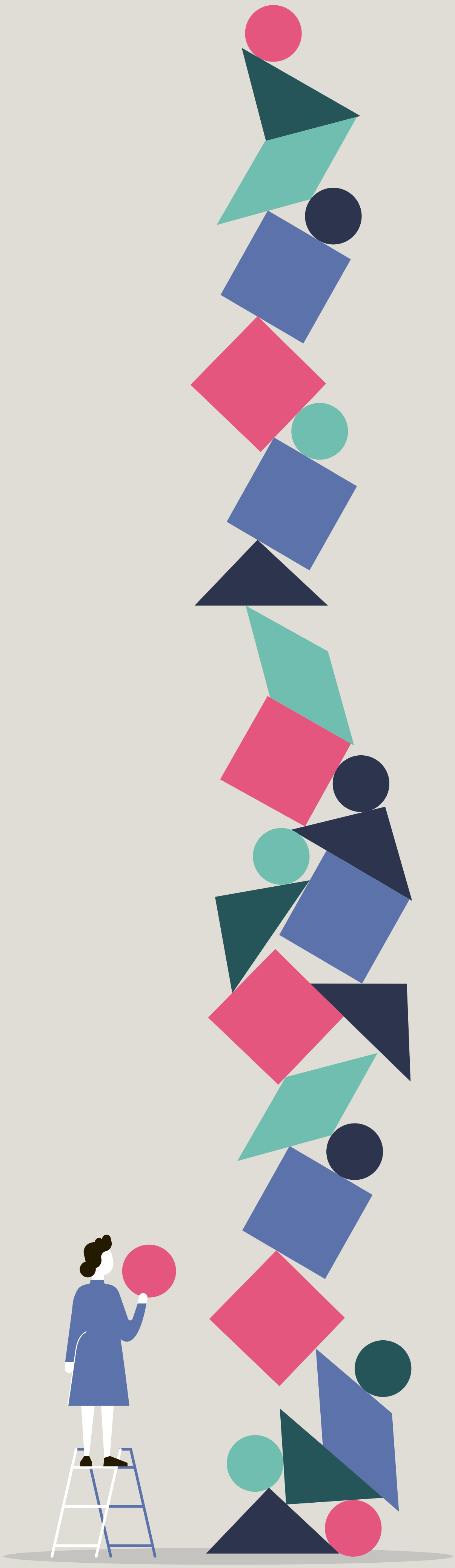
With the economy and politics in flux, markets are struggling to preempt any future equilibrium. The adjustment to higher interest rates has been uneven, for example, and still has further to go. The heterogenous market structure is likely to mean more volatility, temporary dislocations and frequent changes in trends. An endowment-like asset allocation is an ideal response to counter this imbalance.

The current imbalance state has...



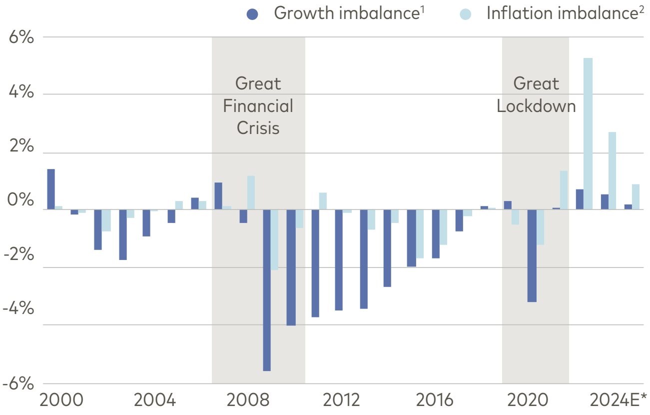
A rebalancing world in 2024 and beyond

- After initial undershoots in growth and inflation on the back of tighter liquidity conditions, the global economy could enter a buildout phase that would absorb accumulated savings and put them to work in transformational investment projects.
- Unfortunately, there is no sign of political polarization and geopolitical uncertainty abating, as a new balance has yet to be found in terms of wealth and income distribution as well as in international politics with the ominous return of the "Great Power Rivalry".
- Financial assets will continue to adjust to higher interest rates – a rebalancing process that can progress gradually but may also entail periods of stress and dislocations, particularly in leveraged and mismatched structures.
- An endowment-like asset allocation with a balanced mix of public and private market assets, complemented with liquid alternatives and a contrarian tactical overlay, is likely the best approach to prepare for the future market environment.
- Additional investment portfolio measures that we are implementing in a timely manner include:
  - Reducing overall equity risk and shifting towards cash plus and fixed income asset classes
  - Focusing on money market-based and repriced assets, such as insurance-linked strategies or private debt
  - Committing to private credit solutions and private equity secondaries to capitalize on future dislocations
  - Limiting overall exposure to Greater China and investing through active and highly flexible managers only
  - Strengthening portfolio diversification with systematic trading strategies and high-grade bonds
  - Hedging foreign exchange risks but maintain some holdings in US dollars and Japanese yen for diversification purposes



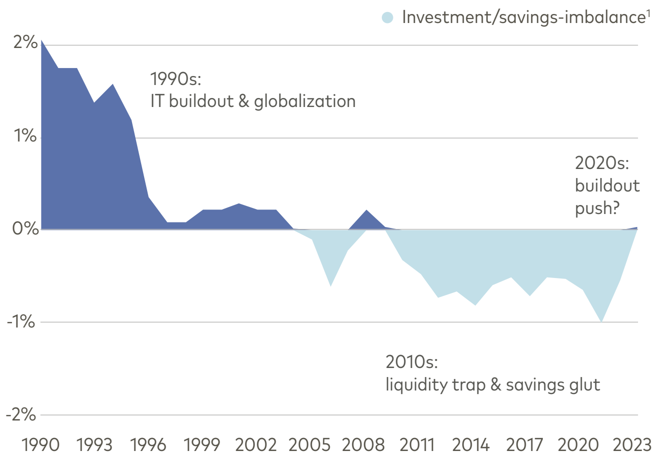
The global economy: In search of a new balance

Origins of asymmetry



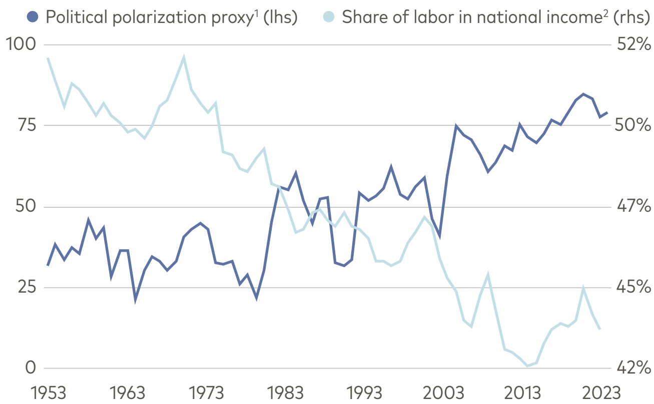
¹ Growth imbalance: output gap in % of potential GDP; for G7 nations
² Inflation imbalance: average consumer price changes versus 2%-target; for G7
* Expectations from IMF World Economic Outlook
Source: Refinitiv, LGT Capital Partners

Entering a new buildout phase?



¹ Yearly investments minus savings; in % of World GDP
Source: Refinitiv, LGT Capital Partners

Social contract in need of renewal



¹ BCA's indicator is based on differences in US President approval by party affiliation
² Share of employee compensation (paid wages & salaries) in total Gross Domestic Income; for the US
Source: Refinitiv, BCA, LGT Capital Partners

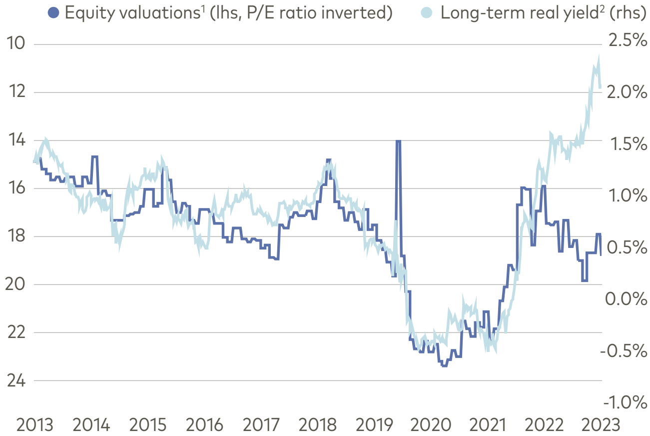
The current cyclical imbalance is firmly in the spotlight and is perhaps attracting even more attention than it ought to. Although the past couple of years have certainly been extreme, the wild swings in macroeconomic aggregates are now diminishing. The easing of supply chain issues, the satisfaction of pent-up demand, and swift monetary tightening are all helping to restore the balance within economies. For 2024, a moderate undershoot is a likely scenario, with real growth sliding below potential expansion rates for advanced economies. Even headline inflation could fall below the critical 2%-mark, at least temporarily. One aspect that warrants close monitoring is whether non-cyclical inflation and wages will also cool materially, or whether these pricing pressures will continue to smolder and rekindle the fire later on. In any case, the challenge of restoring and maintaining stability continues.

A more structural economic imbalance stems from the post-Global Financial Crisis era. At that time, tepid growth and record low interest rates led to a flood of savings and an investment drought–a scenario that could now finally be reversed. And there is an undeniable need to put these dormant funds back to work in transformational projects. The latter include the energy transition to mitigate climate change. But other projects, such as the reconfiguring of global value chains or the further buildout of physical and digital infrastructure also require vast sums of capital spending. Governments are already doing their part to galvanize the private sector into action. We could therefore be on the verge of an investment-led upswing. This would presumably result in a high-pressure economy from here onwards–with the "lost decade" of secular stagnation being left behind for good.

Incidentally, a prolonged buildout phase could help to alleviate another major imbalance: Socio-economic inequality. This phenomenon has been on the rise for a long time, especially in China and the US, where it has already led to significant shifts in domestic and foreign policies. And in Europe, unions are regaining power and fiercely renegotiate collective labor agreements. There are myriad factors at play, but the shrinking labor share, loss of job security and compounding of social injustices are arguably at the heart of political polarization. Unfortunately, the upcoming US elections once again look set to reflect this: Moderate, centrist candidates remain conspicuously absent as the division over contentious issues eclipses any common ground. In foreign policy, a détente with China to repair the frayed ties between the two nations is still a possibility but will likely prove to be short lived.

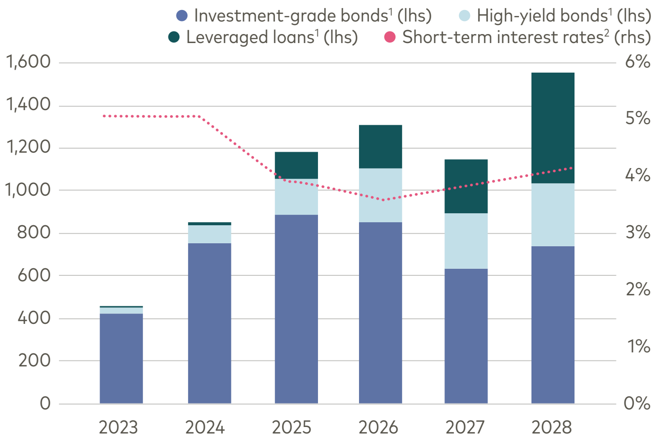
Financial markets: Regime changes in the making

Adjustment disorders



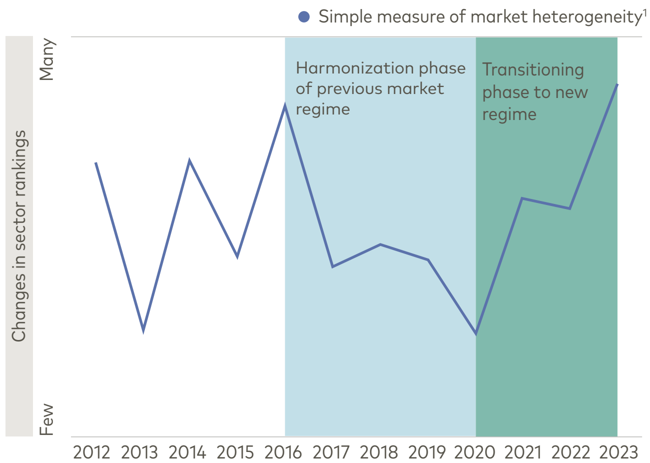
[1] 12-months forward price-earnings-ratio for US equities
[2] Real yield of 30-year US Treasury
Source: Refinitiv, LGT Capital Partners

"Long and variable lags"



[1] Aggregate debt maturities per calender year in USD bn
[2] Future interest rates based on Fed funds futures pricing (as of November 2023)
Source: Bloomberg, Pitchbook, Refinitiv

Redefining market anatomy



[1] Yearly squared sums of ranking changes in sector performances for US equities
Source: Refinitiv, LGT Capital Partners

Like the global economy, financial assets too are in need of rebalancing. This process has so far been anything but uniform. Spiking interest rates and a volatile business cycle have already led to significant adjustments in the pricing of credit. Conversely, equity valuations have refused to align with the rise in bond yields recently. Similarly, private market valuations have seen only marginal markdowns overall. An optimistic view on future earnings growth may be justified by technological breakthroughs and the forthcoming infrastructure buildout. Nevertheless, other aspects that need rebalancing, such as labor's share of value-add may yet exert pressure on profit margins and market valuations–albeit primarily in the US. In stark contrast, an onerous rebalancing of the Chinese economy, as well as domestic and foreign policy, have already weighed heavily on asset valuations in China.

But what is the largest imbalance in financial markets? That simply must be debt. Absolute and relative metrics of indebtedness had been climbing steadily long before they went parabolic during the pandemic. Today, the world's debt burden looms particularly large considering the sharp rise in interest rates. Undoubtedly, this will raise questions around affordability or even viability. The US regional banking crisis in the spring of 2023 is a case in point. More incidents of financing stress will surely follow, creating both risks and opportunities for investors. But if these adjustment pains occur sequentially and are decisively addressed by policymakers, we will probably be spared a contagious global credit crisis. In addition, households and corporations have not yet felt the full impact of higher rates, as many have long-term borrowings and thus still have some time to address future maturities.

It is yet unclear where the new center of gravity for the economy and politics lies. As long as this uncertainty persists, financial markets are likely to face a period with competing narratives. Looking back at the old market regime, it took years to build market consensus. It was only at its peak that almost everyone aligned behind the same paradigms, such as "TINA"–which involved replacing low-yielding bonds with other, riskier assets–or the "platform economy" favoring very large technology companies. Today, we have novel paradigms emerging, while some of the old ones linger. Time will tell which ones will prevail and define the anatomy of the next market regime. As investors, we need to stay open-minded and embrace the changes rather than clinging to an outdated playbook. Our section on asset allocation has some investment recommendations to position portfolios for the years ahead.

Asset allocation: Portfolios that endure and thrive

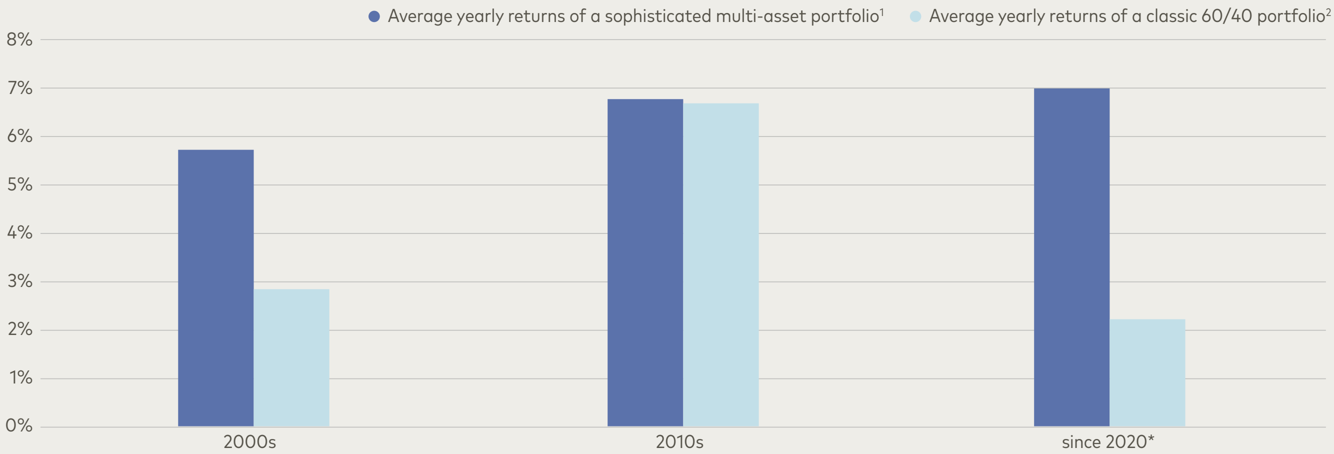
The LGT Endowment's approach

At first sight, markets often defy simple forward-looking logic. Take the decade after the Global Financial Crisis, for example. Back then, the real economy only just muddled through (see first chart on page 8), as fears of debt defaults and deflationary recessions reigned supreme. But in hindsight, this turned out to be a golden period for investors, particularly those with a plain combination of equities and fixed income. Today, we can see that this old market regime has been clearly disrupted, and many of the former tailwinds have vanished or even turned into headwinds.

We therefore believe that a more sophisticated and balanced investment approach is needed to thrive in the coming years.

On the page opposite, we list a few measures that we consider crucial when preparing for and adapting to a world that is in the process of rebalancing. As always, we have implemented these convictions ourselves in our flagship portfolio, the LGT Endowment (see also "How we invest our own money" on page 25).

The enduring relevance of the endowment model (Past performance does not predict future returns)



[1] LGT Endowment (see page 25), average annual returns per decade, in USD, gross of all LGT fees, net of fees and all costs charged by the underlying funds.
[2] Classic 60/40 is 60% developed markets equities and 40% government bonds; all index-level returns, no fees applied.
Fees and other costs will reduce the performance to the investor. Returns may increase or decrease as a result of currency fluctuations.
* Performance data per 30 September 2023
Source: Refinitiv, LGT Capital Partners

Entering the "Roaring Twenties"? (Stylized facts of past and future(?) decades)

	2000s	2010s	2020s (?)
Economy	Classic business cycles (boom and bust)	Low growth, low inflation ("secular stagnation")	Secular buildout push and return of business cycles?
Society/politics	Rapid globalization but rising terror and instability in the Middle East	Increasing inequality and political polarization	"Great Power Rivalry" and rising geopolitical risks?
Companies	Growth-optimism on emerging markets integration Overexpansion and corporate governance crises	Margin expansion on lower costs of labor, debt and taxes Financial engineering and shareholder returns	Margin pressures rising? Rising labor costs vs. productivity growth?
Markets	Dotcom bubble fallout Emerging markets, commodity, and real estate boom and bust	Post-Global Financial Crisis uncertainty New paradigms: Hunt for yield, hunt for secular growth, central bank put, etc.	Volatile adjustment to changed macro-realities? New market regime? (real return focus, credit & liquidity provision, etc.)
Investment portfolios	Growth assets and alternative strategies	Perfect world for traditional portfolios	Resilient growth with endowment-like asset allocation?

Source: LGT Capital Partners

Five portfolio measures to endure and thrive in a rebalancing world

1

Maintain exposure to long-term growth.
As the global economy rebalances from secular stagnation to a buildout phase, significant exposure to growth assets will be key in driving investment performance over the long run.

Implementation:
- Implement an endowment-like approach with balanced exposures in liquid alternatives, public and private markets
- Select managers best placed to benefit from lasting change and secular growth themes

2

Focus on risk-adjusted real returns.
With inflation, interest rates and volatility all having staged a comeback, asset classes need to be judged on what they deliver above and beyond the risk-free rate and general loss of purchasing power.

Implementation:
- Shift portfolio towards asset classes that are further along in the rebalancing process, such as high-yield bonds or insurance-linked strategies
- Add implicit and explicit inflation hedges, such as real estate, infrastructure or inflation-linked bonds

3

Reduce leverage and prepare to provide liquidity.
The times of magnifying low returns through debt leverage and complex structures are over. Providing liquidity and credit rather than taking them on is the way forward.

Implementation:
- Focus on sustainable quality businesses with healthy balance sheets when selecting investment securities
- Commit to private credit, including the programs of distressed debt managers, to profit from future supply-demand imbalances in debt markets

4

Adopt a value-based framework for contrarian buying opportunities.
Markets will be volatile in the future and are likely to offer contrarian investment opportunities in publicly traded securities and private market assets.

Implementation:
- Build an anti-cyclical value monitoring system for liquid asset classes and set up a framework to expeditiously execute on future buying signals
- Already increase commitments to private credit solutions and private equity secondaries programs

5

Mitigate macro-volatility and (geo-)political uncertainty.
Volatility and uncertainty are an inevitable part of the major rebalancing processes. Mitigating their impact on the investment portfolio is important in order to stay on course and reach long-term goals.

Implementation:
- Limit overall exposure to Greater China and add strategies that help to diversify the portfolio and increase its resilience to market stress, such as managed futures and dedicated dynamic protection programs
- Separate currency views from asset allocation decisions, hedge most non-diversifying foreign exchange risks but keep a residual quota in US dollars and the Japanese yen

Private equity

Today's macro dynamics have broad implications for private equity fundraising, deal flow and exit activity, and they will continue to shape the investment environment into 2024.

Sustained high inflation challenges portfolios

Businesses with pricing power are best placed to withstand the current environment and may even capitalize on it to further increase margins. Portfolio companies with a limited ability to pass on costs will, however, struggle to maintain margins, especially if consumer spending softens. These dynamics require investors to be more strategic, thorough and tactical when accessing deals. It is crucial to focus on high-quality assets and managers with mission-critical businesses that are positioned to weather an uncertain market that may potentially remain challenging over the long term.

High rates impact transaction financing

High inflation and interest rates are affecting how investors access leverage as well as financing terms. Leveraged buyouts are being impeded by the increased costs of debt, as General Partners (GPs) find themselves compelled to put down higher shares of equity from their own funds. Significantly increased interest costs require portfolio companies to shoulder an additional burden on top of existing debt. This further exacerbates the financial strain and underwritten returns, particularly for heavily leveraged businesses struggling to sustain margins in a deteriorating earnings environment.

(When) will deal activity bounce back?

Alongside financing difficulties, valuation gaps persist between buyers and sellers. Since reaching its peak in the fourth quarter of 2021, the private equity exits volume has almost halved, with the number of deals dropping to below pre-Covid levels[1].

In this slower M&A environment, private equity firms shifted their focus towards identifying and executing bolt-on size acquisitions. Such acquisitions remain a viable strategy for small companies seeking an exit, allowing GPs to wait for lending markets to support larger buyouts and take-privates. Add-ons have the potential to enhance both revenue and profit margins, produce cost synergies and deliver value to both the private equity owner and potential buyer. They are also generally more straightforward to finance.

Looking ahead, it is also important to remember that many fund managers are sitting on a historically elevated number of portfolio companies with longer holding periods due to the pullback in exits. Investor demand for consistent distributions for reinvestment and the need for liquidity among funds can serve as catalysts for deal activity. Looking at the first half of 2023, the median entry valuation decreased by one turn, falling to 2019 levels[2] . This could facilitate deal-making if the trend continues. Further, strategic investors and larger buyout funds have near-record levels of dry powder, providing a solid footing for a potential recovery in M&A activity in 2024.

Within the secondary market, while discounts have narrowed since 2022, they still exceed recent mid-term levels. More robust deal flow is affording secondary buyers an opportunity to be more selective and to focus on asset quality, attractive transaction dynamics, GP alignment and more reasonable pricing. The secular trend of increasing GP-led transactions is being driven by liquidity needs and may persist in a scenario of sustained higher interest rates. This is in addition to the growing trend of GP-led transactions being more accepted as an exit route for businesses.

[1] Source: Preqin, data as of 30 September 2023
[2] Data as of 30 June 2023 based on overall LGT Capital Partners invested universe

Resilience through long-term value creation

In an investment universe where it is no longer possible to rely on rising markets to drive multiple expansion, operational value creation will be the most important driver of returns. Changing macro conditions have significantly altered how private equity firms evaluate their portfolio companies' growth strategies. As GPs await signs of economic stability, they are taking inventory of their existing investments, focusing on operational excellence and efficiency improvements, evaluating performance and assessing the remaining upside potential in their portfolio.

Private equity has helped drive innovation in multiple sectors like technology, healthcare and e-commerce. Entrepreneurs in these sectors are improving their digital capabilities and creating opportunities for long-term value extraction in areas such as AI, automation and robotics, cybersecurity, e-commerce and cloud software. GPs themselves are also innovating and have started to use insights from AI and analytics in deal sourcing to gain an edge in the intensely competitive market to source deals. Digital transformation has the potential to generate both risks and opportunities for existing portfolio companies, with certain sectors more vulnerable to disruption. The education sector, for example, saw private equity-backed deal values jump by 47% year on year in the second quarter of 2023[1], mostly driven by activity in the ed-tech space.

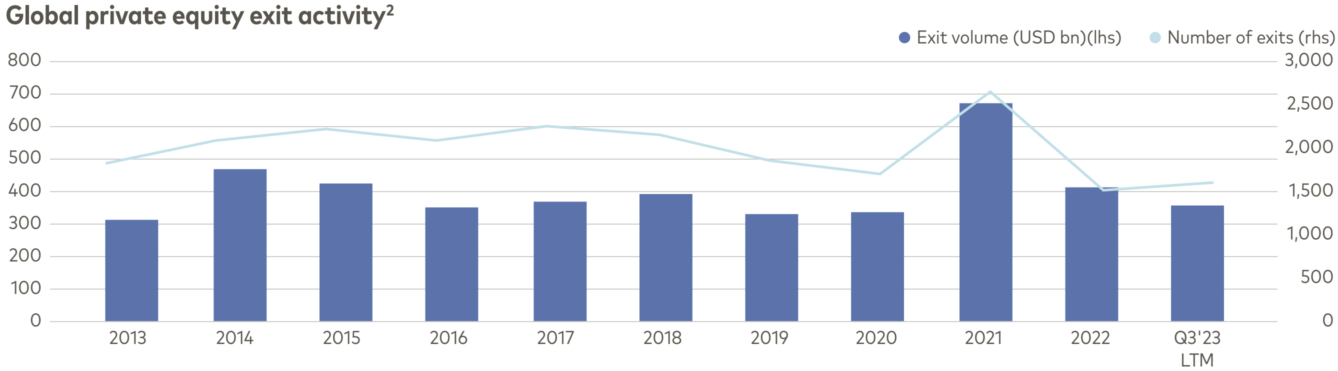
Where do we go from here?

The private equity landscape is constantly evolving, marked by the interplay between positive and negative forces. Numerous unresolved factors persist and are poised to play pivotal roles in shaping the trajectory of the industry throughout 2024. Private equity has demonstrated its resilience during previous market downturns, evolving to better protect existing portfolio companies and capitalize on market dislocations. Going forward, prudent manager and asset selection will continue to play a crucial role in portfolio construction – rather than relying on market tailwinds. Managers will need to work harder to generate the same returns as in recent years. Investors that demonstrate resilience by staying nimble and adapting to market conditions across cycles will be best placed to generate continued returns.

The year ahead is likely to bring opportunities for discerning investors to take advantage of attractive entry points, increased liquidity needs and a less competitive market. Overall, we expect buyers to continue to push for favorable deal terms and to take advantage of the discounts on offer. Investors who are more comfortable with portfolio complexity may see opportunities in mid-market and special situations funds that target undervalued segments of the industry. While liquidity and fresh capital are limited, there continues to be a strong demand for alternative liquidity solutions.

Global private equity assets continue to grow at a steady pace, and dry powder as a share of total private equity AuM remains relatively constant compared to the past decade. As funding conditions become more stable and IPO markets slowly regain momentum, we anticipate a positive shift in sentiment that can build upon the recent green shoots of recovery in private equity activity.

Global private equity exit activity[2]



[2] Includes deals as defined by Preqin only, data as of 30 September 2023, data retrieved on 13 October 2023.
Source: Preqin, LGT Capital Partners

[1] S&P, October 2023

Private credit

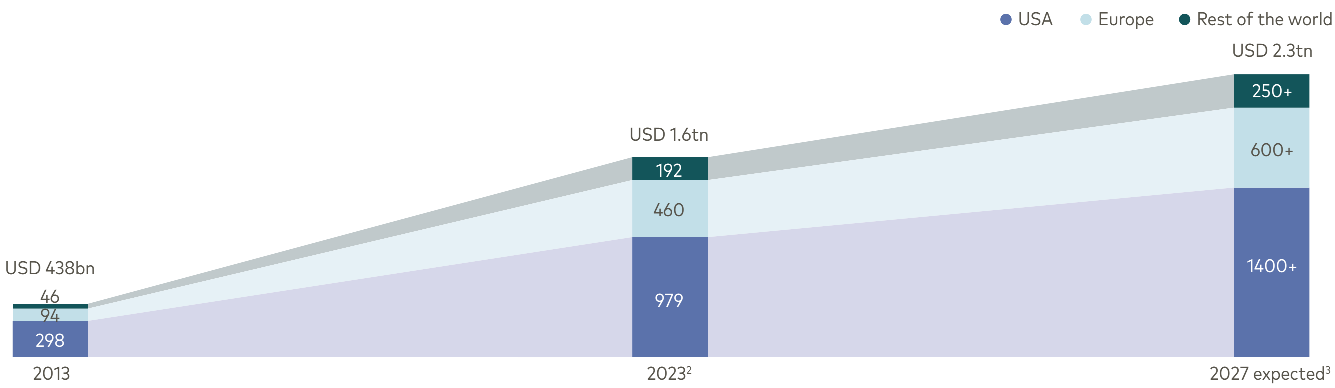
The private credit asset class continues to see sustained growth and robust demand from investors. The size of the private credit market at the start of 2023 was around USD 1.6 trillion, compared to USD 1 trillion in 2020, and it is expected to grow to an estimated USD 2.3 trillion by 2027[1].

During the recent period of volatility in liquid credit securities, private credit has shown its resilience and reliability for borrowers and their sponsors*. In the senior direct lending segment, an increasing number of leveraged loans that previously would have been underwritten by banks are now being financed by private credit managers.

Senior direct lending remains very attractive, with strong risk-adjusted returns that have benefited from base rates more than doubling since June 2022, as well as from rising spreads and upfront fees in a stable credit quality environment. This backdrop provides a "new normal" with senior direct lending achieving low double-digit gross return profiles, the highest in over a decade. This also compares favorably to long-term public equity returns. We expect these return profiles in senior direct lending to persist as long as liquid credit market activity remains at low levels, with US leveraged loan issuance in 2023 (year to date as of October) at its lowest level since 2010. However, senior direct lending is seeing lower new deal volumes as private equity deal-making continues to stall and companies that enter into new financing transactions exhibit lower leverage capacity. Looking ahead though, with bank balance sheets remaining under pressure, senior direct lending will play an important role as growing businesses still require finance for further expansion and investment.

From a macrodynamic perspective, inflation is abating in developed economies and interest rates are now at or past their peak for the current cycle. This has the potential to kickstart leveraged buyout (LBO) activity, providing a tailwind for direct lending.

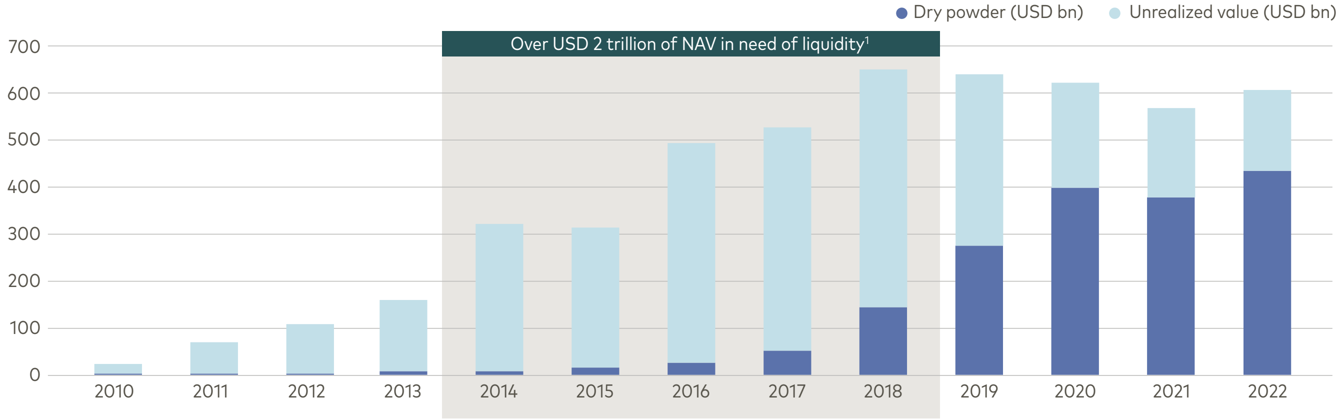
Development of assets under management (in USD bn)



[2] Preqin – data as of 31 March 2023
[3] Estimate for 2027 from Preqin Special Report: The Future of Alternatives in 2027
Source: Preqin, LGT Capital Partners

[1] Source: Preqin
* Sponsors are a borrowing entity's owners; often private equity firms

Private equity AuM by fund vintage year (in USD bn)



[1] Covers net asset value of private equity funds with 2014–2018 vintage years, private equity includes the following categories: buyout, growth, co-investment, co-investment multi-manager, turnaround (as defined by Preqin), as of 31 December 2022; data retrieved on 03 November 2023
Source: Preqin, LGT Capital Partners

Sponsors* have so far remained supportive of portfolio companies that took on higher leverage ratios in the previous low-rate environment. However, we expect to see more stress conditions going forward, with the current low default rate likely to rise in 2024 and beyond. The most significant growth in corporate lending transactions in 2023 has been for general corporate purposes (GCP), followed by refinancing. While proceeds from GCP loans are typically used to support growth, the need for such loans may, in some cases, indicate that the borrower is under pressure.

Driven by ongoing liquidity constraints from private market participants, innovative private credit managers have helped to accelerate the supply of liquidity to sponsors and Limited Partners alike by providing NAV-based loans to private equity funds. This market has seen tremendous growth over the last couple of quarters and we expect this trend to continue. In addition to NAV-based loans, we continue to see the emergence of new market opportunities and innovation, including the move from closed-end to evergreen fund solutions, private credit CLOs, and credit secondaries, as well as the growth of non-sponsored lending that targets the 95% of the middle market not backed by private equity.

Another area where we expect to see continued growth in private credit is the asset-based finance (ABF) lending market. This offering is seeing a secular shift away from regional banks and represents a critical part of the credit ecosystem. The regional banking turmoil and retrenchment in spring 2023 have further catalyzed this trend. These developments illustrate the evolution and increased sophistication of the private credit asset class.

We expect private credit to continue on its sustainable growth trajectory, with the asset class becoming a permanent and growing allocation within investors' portfolios. Further, we believe it is important for investors to maintain a diversified portfolio that is resilient and can perform well in a dynamic and evolving market environment.

* Sponsors are a borrowing entity's owners; often private equity firms

Real estate

Rising interest rates create a market bifurcation

Since market prices peaked in March 2022, real estate values have declined overall, with pricing differences varying by sector or region and prices still rising in selected areas. While values are expected to continue on a flat-to-downward trend as the market adjusts to higher interest rates, there is optimism given the generally conservative capital structures that exist, supported by strong fundamentals. This dislocation–or new phase of price discovery–will lead to a fork in the road for deals with imminent maturities: Deals that can support a higher interest rate will do so with revised loan terms or maturities; if they cannot, we anticipate that such deals will recapitalize with "bridge" or "rescue" equity, sell at market clearing prices (closer to the price of the loan) or even "hand back the keys" to the bank.

The good, the bad and the niche

Overall, supply and demand fundamentals in most sectors are largely in check, with annual completions of new real estate forecasted to be relatively modest as a percentage of existing stock, with the exception of data centers. But here, new stock is expected to be absorbed, as increased use of technology and artificial intelligence drives demand. And other sectors are being supported by strong growth in market rent that is expected to exceed inflation. For sectors with lower rent growth or even negative numbers (e.g. retail and office space), the supply story is still moderately positive, i.e. it is not expected to lead to a period of overbuilding. However, the abundance of existing stock in those asset classes, especially in more regional markets, is showing clear signs of struggle from a capital structure perspective as well as due to Covid-induced changes in work models and consumer behavior.

The multi-family residential sector continues to perform relatively well, with certain gateway markets expected to outperform over time. The industrial sector still presents opportunities, particularly in the light industrial or last-mile segments, as countries look to diversify supply chains and to onshore production capacity. Interestingly, submarkets with a live-work-play mix are doing well and capturing a greater share of market-wide office leasing. The other core sectors, i.e. traditional office and retail, are now being replaced by alternative or niche sectors with strong demand drivers. These sectors often comprise smaller asset sizes (e.g. self-storage) or real estate that requires a specialized operational focus (e.g. cold storage).

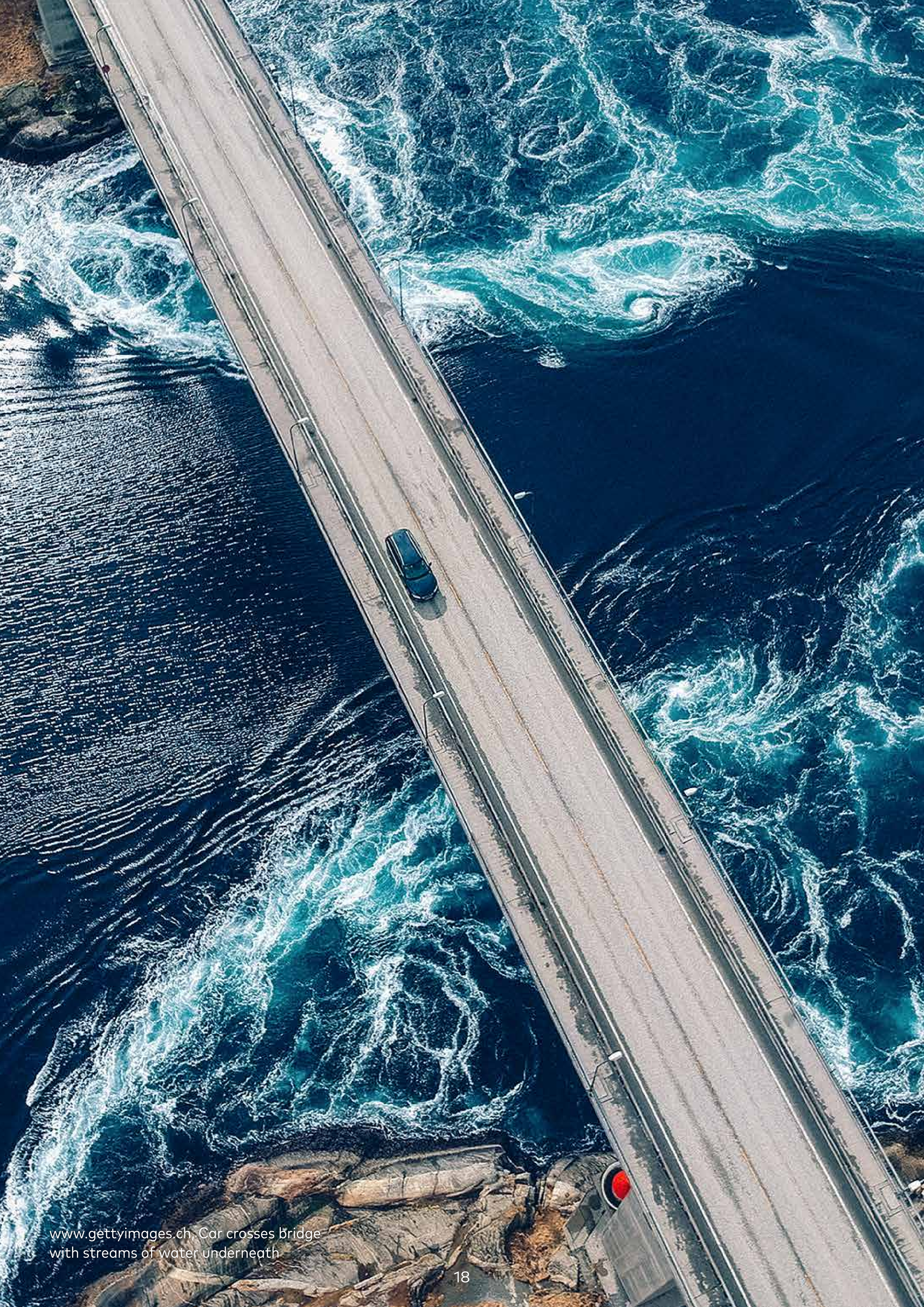
2024 will be a "stock pickers′ market"

We view the next 12 to 24 months as a "stock pickers' market", where knowledge and insights into local supply and demand fundaments are key. During this time, we expect to see interesting opportunities arise due to the above-mentioned loan maturity dislocation, the exploitation of demand drivers in niches, or other selected developments. Maturity dislocations should provide a steady diet of deals for investors with capital at their disposal and enable them to acquire assets at a low basis. Niche opportunities should prove attractive as they often emerge in a market segment that is not overloaded with institutional capital. The development angle is an interesting one: Given the slowdown in lending, construction financing will be increasingly difficult to come by, resulting in fewer new construction starts and leading to a further supply imbalance in certain sectors. This creates an advantageous situation for those that are able to step in and deliver new properties that are sought after both in tight supply markets and on the other side of any recession.

Embracing technology, adapting to climate change

Finally, a variety of factors will influence commercial real estate and its underwriting in the near term, both positively and negatively. On the positive side, the development of AI initiatives in real estate can lead to real productivity gains in many aspects of owning and managing properties. Additionally, advances in construction technology will result in increasingly (energy) efficient buildings. On the other hand, we are seeing a mounting number of 100-year climate events that are impacting not only real estate but also insurance costs. This is resulting in one-time capital expenditure requirements and continued hikes in insurance premiums that were not part of original business plans. If there is a silver lining to climate events, it will be the ESG-related changes to physical assets, which–in addition to strategies focused on ESG-related transformative changes–should result in better, more efficient assets for investors and consumers.

www.gettyimages.ch, Bulldozer
unloads rubble at a construction site



www.gettyimages.ch, Car crosses bridge
with streams of water underneath

Infrastructure

Infrastructure as an asset class navigated the macro environment in 2023 relatively well, especially those sectors with a focus on essential services. Looking ahead, three main themes continue to shape investment opportunities in infrastructure: Demand for digitization, the need for decarbonization and the process of deglobalization.

Demand for digitization

Data remains the fastest-growing major commodity, with global data volume increasing five-fold from 2016 to 2022[1]. This rapid growth is expected to continue and may even accelerate further in the years ahead, driving global capital requirements of approximately USD 1 trillion in the area of digital infrastructure over the next decade. This large capital requirement stems from three structural trends: First, a once-in-a-century investment cycle to upgrade global copper networks to fiber. Second, incremental towers are required to support the buildout of the 5G infrastructure, AI solutions and internet-of-things applications. And third, a lot more of incremental data center capacity will be needed in the next three years alone.

Global need for decarbonization

As the global economy decarbonizes, the energy transition represents a multi-trillion, multi-decade investment opportunity–with an estimated USD 100 trillion in clean energy investment required to achieve net zero by 2050. According to the International Energy Agency, the bulk of the required investment–i.e. around USD 74 trillion–will be in renewable power, energy storage and the buildout of electricity grids. The remaining USD 29 trillion will be needed for hydrogen, biofuels, renewable fuels and carbon capture. Further, the transportation sector is under pressure to decarbonize as it accounts for almost one-quarter of global carbon emissions, of which approximately 70% is generated by road vehicles. The need to reduce carbon footprints will impact all transport subsectors and is expected to generate opportunities in the supporting infrastructure.

Shift towards deglobalization

Trade as a percentage of global GDP peaked in 2008. Since then, a multi-year structural stagnation in trade has been witnessed for the first time since World War II. Amid a shift towards deglobalization, supply chain resilience has become a top priority for nations around the world as a result of the pandemic and geopolitical challenges. As supply chains become increasingly local, near-term onshoring initiatives are focused on critical industries such as semiconductors, electric vehicles and batteries, biomedicine, aerospace and defense. Due to the capital-intensive nature of onshoring, private capital is expected to play a major role in this transformation as government balance sheets become strained. This provides sizeable investment opportunities for infrastructure funds, which can work with investment-grade corporate partners and apply traditional infrastructure financing concepts to new critical sectors.

While the macro outlook remains uncertain, the infrastructure asset class has historically proven to be crisis resilient and is supported by structural trends that are expected to play a critical role in the future. We remain focused on building a diversified portfolio of assets that provide essential services and create long-term value.

[1] Source: Cisco

Hedge funds

In recent years, hedge funds have generally coped well in a volatile market environment. They also provided diversification during the most challenging of periods such as the start of the Covid-19 pandemic in early 2020 or the broader market correction in 2022.

The outlook for hedge funds in general remains positive. For discretionary long/short strategies, the higher interest rate environment is causing more dispersion both on the equity and the credit side. There are plenty of strong companies with healthy balance sheets that have been able to invest ahead of the competition. However, there are also firms with flawed financials that are suffering from the fading Covid tailwind. Convertible arbitrage managers are also profiting from the higher interest rate environment. More high-grade US companies are piling into the convertible bond market, which was traditionally tapped by junk-rated issuers. High-grade firms are seeking to contain the rising cost of borrowing caused by the aggressive tightening cycle.

The outlook for event-driven strategies is also solid. Capital markets for both equity and credit issuance are showing a healthy level of activity, which is key for the acceleration of corporate activity, including mergers and acquisitions (M&A). In many cases, M&A spreads are at elevated levels, reflecting regulatory complexity and higher interest rates.

Increased market uncertainty also benefits actively traded systematic strategies. Thanks to their highly diversified and dynamic asset class allocations, these approaches can simultaneously capture opportunities across multiple asset classes and thousands of markets. Alongside equities and bonds, investors can gain significant long/short exposure to the global commodity and currency markets. Further, systematic approaches primarily use derivatives to take market positions and hold a significant amount of unencumbered cash. In today's elevated interest rate environment, these approaches also earn a return on this cash allocation.

Overall, the outlook for hedge funds remains positive. The combination of high interest rates and elevated market uncertainty is benefitting actively traded investment approaches by opening up frequent market timing opportunities. Moreover, uncertainty around inflation and the risk of stagflation have broken the negative equity/bond correlation that prevailed over the last few decades. Diversification is hard to find and hedge funds are attractive as they show low sensitivity to traditional assets. For all these reasons, we believe having a decent hedge fund allocation is key.

At LGT Capital Partners, we invest in a diversified set of discretionary and systematic hedge funds. On the discretionary side, the styles encompass long/short equity, event-driven and relative value. The systematic side covers quantitative macro, trend-following, short-term trading, quantitative equity market-neutral and AI/machine learning strategies. To profit equally from opportunities on the long and the short side, the allocation is implemented without market bias and targets a zero-beta exposure.

Insurance-linked strategies

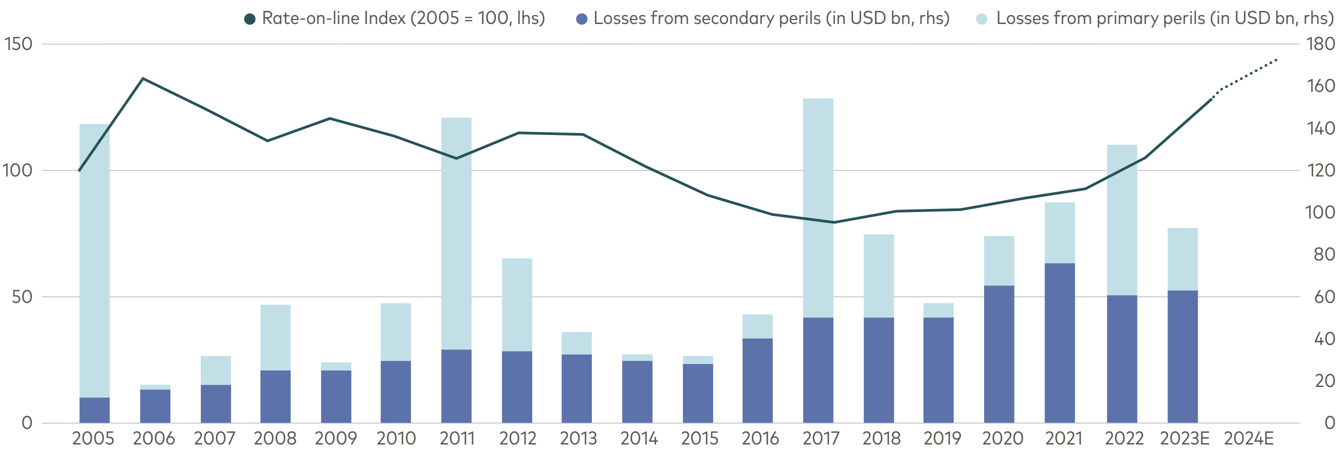
In 2023, investors in insurance-linked strategies (ILS) were finally again presented with fundamentally attractive return momentum. This positive performance is, of course, partially due to the fact that the 2023 hurricane season turned out to be of below-average intensity, most likely due to the El Niño effect. These conditions lead to stronger sheer winds, which disrupt the formation of rotating windstorm systems and also help to push active hurricane systems away from the US mainland and towards the open Atlantic. Despite this, 2023 has likely yet again been a costly year for the global insurance and reinsurance industry: A strong earthquake in Turkey, floods and storms in Europe, and the outbreak of wildfires in Hawaii have pushed the loss burden for the private insurance sector above USD 70 billion, making 2023 another above-average year in terms of loss costs.

To understand why the ILS market still yielded much more stable returns compared to prior years, it is important to consider broader market dynamics in the recent past: In 2017, a series of favorable years with strong performance in ILS came to an abrupt end: In that year alone, the insurance industry faced a massive USD 140 billion loss tally, which eroded the earnings of insurers and reinsurers and put pressure on the performance of ILS funds. 2017 was then followed by a series of years in which market participants continued to suffer from a sizeable pick-up in catastrophe loss activity. And while ILS investors may not necessarily have seen an impact on their allocated principal, their expected earnings were wiped out year after year by a general increase in mostly weather-induced insurance losses. The chart below depicts this loss activity and highlights the increased loss burden from such weather-induced (secondary) perils. This loss activity, combined with the fact that the collateral yield was at an all-time low during the period from 2018 to 2022, ultimately prompted investors to fundamentally question whether ILS is a viable asset class, since the low correlation alone no longer seemed to justify an allocation.

These climate-induced losses ultimately acted as a catalyst for a radical change in the assessment of portfolios in the global insurance market–referred to as "the big re-underwriting". Reinsurers and ILS managers responded by reducing the allocation to lower attaching or aggregate transactions and by refocusing on the true drivers of capital relief in insurance, i.e. extreme catastrophe events such as hurricanes and earthquakes. At LGT ILS Partners, the team substantially de-risked portfolios over the last contract renegotiation cycles in 2022 and 2023 by limiting allocations to transactions exposed to mid-sized and more localized events–a strategy that already paid off nicely in 2023.

And the market outlook remains promising: Whilst the last year may not have presented the market with a single extreme catastrophe event, the level of attritional losses once again eroded a substantial proportion of earnings within the insurance industry, resulting in a continued need for fresh capital. Premium levels for 2024 reinsurance placements, and consequently also the coupons paid for newly issued cat bonds, will likely remain at current strong levels, adding to a positive outlook for 2024 for the asset class.

Attractive outlook after loss-heavy years (Past total insured losses, reinsurance premium ratio)[1]



[1] Rate-on-line is the ratio of premiums paid relative to the loss recoverable in a reinsurance contract and is thus a measure of risk pricing
Source: LGT ILS Partners, Swiss Re Sigma, Munich Re, Guy Carpenter; data as of 30 September 2023; insured losses for 2023 are based on latest available industry loss estimates and assessment of LGT ILS Partners; premium estimation for 2024 is based on LGT ILS Partners' latest market assessment. This data is purely illustrative and is not a guarantee of future results.

Impact investing

In the current market environment, impact investing has stayed the course as a significant trend in the financial sector. More than ever, investors are conscious of the social and environmental implications of their financial decisions. They are increasingly looking for ways to make their capital work harder, not just for themselves but also for the benefit of society and the planet. This shift is catalyzing an increase in the demand for sustainable investment opportunities that generate positive impact. According to the Global Impact Investing Network (GIIN), the size of the worldwide impact investing market surpassed the symbolic USD 1 trillion mark in 2022, signaling the industry's growing maturity and sophistication.

From ESG and responsible investing to impact

The trend of investing with outcomes started well before the recent global geopolitical conflicts. In 2015, the Paris Agreement and the UN Sustainable Development Goals (SDGs) were adopted and presented to the world as global "to do" lists on the path to building an equitable and livable planet. The focus of many ESG efforts has since shifted from processes to outcomes. Clear diversity targets, the use of clean and affordable renewable energy sources and a stronger focus on good governance are just three examples.

New sustainability regulations and government policies are driving the increased focus on concrete outcomes and the growth in sustainable economic activities. For example, the Inflation Reduction Act (IRA) signed into law by US President Biden in summer 2022 is the most significant climate legislation in the country's history. It offers unprecedented funding and incentives to accelerate the renewable energy transition, reduce carbon emissions, promote domestic industrial productivity, and foster research and development. Similarly, the European Green Deal presents a roadmap for making the EU's economy more sustainable by incentivizing a strong focus on climate and environmental challenges across all policy areas and making the energy transition fair and inclusive for all.

Impact investing with private equity

At LGT Capital Partners, our dedicated impact investing aims to address global environmental and social challenges by making private equity impact investments. These seek to generate positive, measurable impact alongside commercial private equity returns. To that end, we invest in buyouts and late-stage growth opportunities worldwide.

The program focuses on three key impact themes: Climate action, healthcare and inclusive growth. Across these areas, it focuses on companies with differentiated business models and sustainable solutions for delivering better social and environmental outcomes within their respective target markets. To assess impact, we use our proprietary, evidence-based impact framework that measures the effectiveness, affordability and scalability of the solution, as well as any impact risks. Some of our investee companies have already made a big difference. Among others, Airtel Money Mobile Banking Services has served 31 million unbanked individuals in sub-Saharan Africa, Intersect Power has developed over 2.2 GW of late-stage solar projects in California and Texas, and Anticimex has sold 375,000 non-toxic pest control units, each preventing the use of around 0.5 kg of biocides per year[1].

All our impact investments are selected based on their capacity to directly contribute to one or more of the 17 SDGs, with their contributions being mapped to at least one of the 169 underlying SDG targets.

[1] Reference to company names should not be construed as a recommendation. There is no guarantee that similar investments will be made in the future.

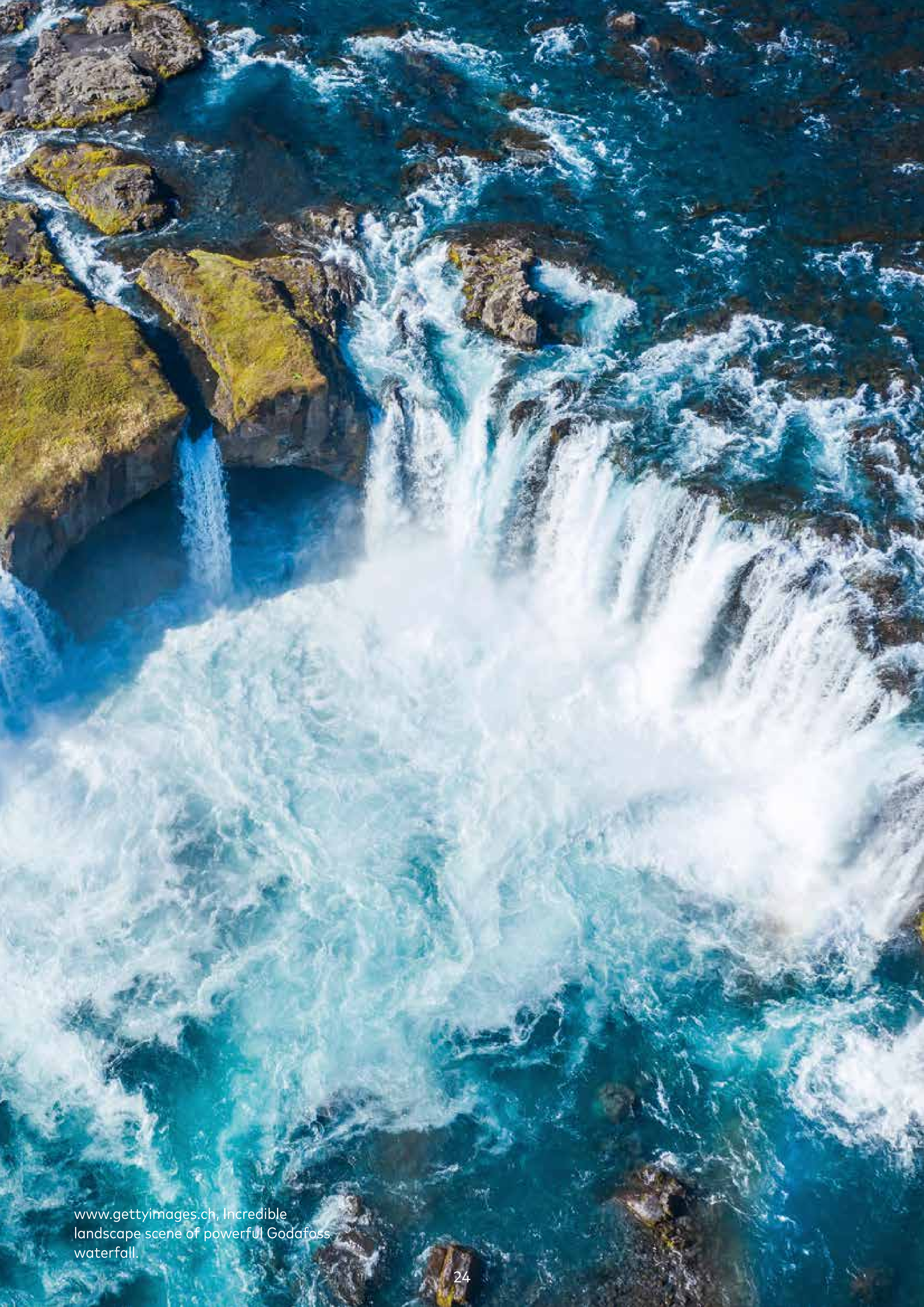
Impact investing is not immune to market shifts

While the continued growth of the impact investing industry is encouraging and urgently needed in the light of persistent social inequalities and accelerating climate hazards, recent macroeconomic shifts have had a material effect on the state of private equity impact investing. Deal volume and exit activity slowed significantly in 2022 and 2023. In addition, the fundraising environment for new funds became more challenging, signaling a turn in the cycle. While these developments amounted to a harsh awakening for many market players, they have also unlocked unique opportunities for experienced investment managers that are well equipped to navigate the new reality with a high degree of caution. Recent years have created a prolific environment for fundraising, fueling the rapid entry of emerging impact managers and companies and encouraging the expansion of existing impact platforms at established conventional private equity firms.

Nevertheless, there are a few proven managers that combine a longstanding financial track record with impact authenticity. Disciplined underwriting, differentiated access, investment expertise and rigorous impact management remain crucial to deliver on the promise of achieving market returns alongside tangible impact. Despite the challenging macroeconomic environment, we continue to see an exciting opportunity set, which is driven by technological disruptions, demographic trends, and evolving business and consumer requirements, as well as regulatory interventions.

How impact investing contributes to a new balance

Impact investments with a focus on the energy transition, e.g. those supporting the rollout and integration of renewable energy, contribute directly to the energy transition and its rebalancing away from harmful fossil fuels. In this regard, we are observing the steady growth of investments in climate solutions. This process initially started on the venture capital side and dates back to even before the Global Financial Crisis. Over the years, climate investments have steadily increased and developed from venture capital all the way up to private equity and infrastructure. The global consultancy firm McKinsey & Company confirmed the rapid deployment of climate-focused capital in an article published in March 2023: Citing Pitchbook, a database of private market deals, it wrote that the global volume of climate-oriented equity transactions in private markets had increased more than 2.5 times, from USD 75 billion in 2019 to USD 196 billion in 2022. We expect this growth to continue in the coming years and to expand, especially in the areas of climate private equity and climate transition infrastructure opportunities.



www.gettyimages.ch, Incredible landscape scene of powerful Godafoss waterfall.

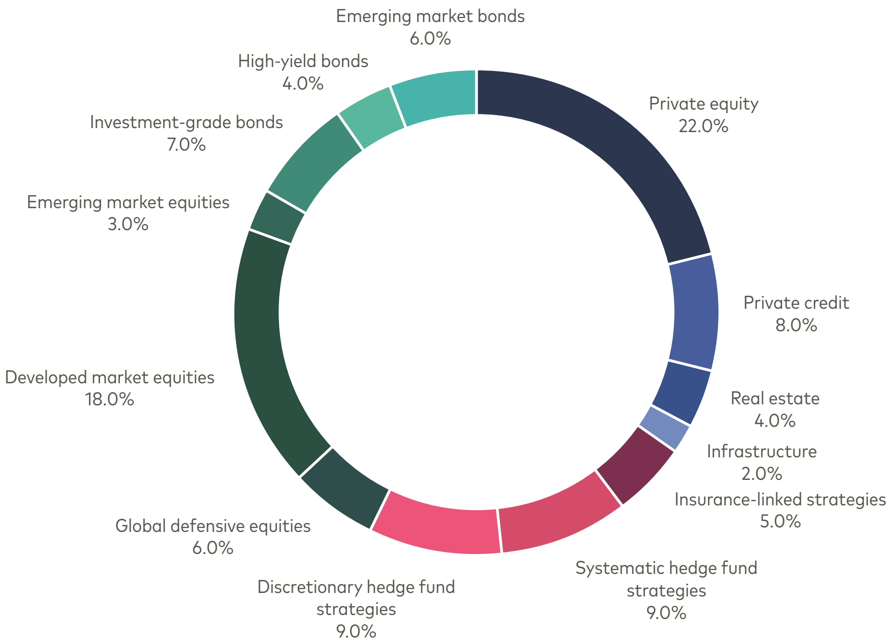
How we invest our own money

LGT Capital Partners has been managing and investing a combined portfolio of traditional and alternative investments, the LGT Endowment, for 25 years. Today, this strategy exceeds USD 18 billion in assets under management,[1] with more than USD 2.5 billion of capital from LGT's sole shareholder and substantial sums of capital from key investment professionals at LGT Capital Partners. This drives the strong alignment of interests between the firm's owner, our investment team and our investors.

The LGT 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. Its core components–scenario planning and robust diversification–help us to build an investment portfolio for an uncertain future and changing market environments with the ambition of generating attractive risk-adjusted returns over the long run.

Seeking balance – preparing investment portfolios for 2024 and beyond

Our latest adjustment of the strategic asset allocation includes a shift from equity risk to investment-grade bonds and attractive cash-plus asset classes, such as private credit and insurance-linked strategies. At the same time, we are increasing diversifying elements such as systematic trading strategies and gearing our foreign currency hedging strategy further towards reducing overall portfolio risk.



Private markets
The owner-manager structure of private equity holdings, together with long investment horizons, allows for active value creation over a full cycle. In private credit, contracts are individually negotiated in close consultation with the counterparties.

Carefully selected infrastructure and real estate deals offer the potential for inflation-resilient income yield and capital growth.

Hedge funds and liquid alternatives
Alternative investment strategies are a source of uncorrelated returns found in the systematic harvesting of alternative risk premia or the generation of alpha from high-quality discretionary managers.

Insurance-linked strategies also focus on generating returns that are independent of the overall market direction. The dynamic protection strategy is specifically designed to cushion market drawdowns in the portfolio.

Specialized equities and fixed income
When selecting publicly traded securities for our multi-asset portfolios and individual mandates, we maintain a strong focus on sustainability and quality. Value-add through active management is another cornerstone of our public market strategies. In addition, we participate in attractive niches such as global inflation-linked bonds or emerging market debt in local currencies.

[1] Assets include shareholder, staff, and client investments.

The quotas above represent the long-term, strategic asset allocation. The actual, invested asset allocation can deviate significantly from these numbers for tactical and portfolio management reasons. Please note that the portfolio has 3% leverage and 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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