Edwards Wealth
Management AG
Switzerland

Investment Policy

December 2018

Our market view in a nutshell – December 2018

- As we approach the end of the year, **most asset classes show a negative performance**. The only **exceptions** are **US stocks and short-term corporate bonds** in US dollars, which are barely in positive territory. This poor result reflects investors' concern about the **progressive withdrawal of the monetary stimulus**, as well as the extraordinary **duration of the current economic expansion** in the United States, which will soon become the longest cycle that has been recorded

- Investors have been **calibrating, alternatively**, both **higher interest rates** due to the robustness of an economy approaching its maximum capacity, and the **risk of an economic slowdown** caused by the tightening of financial conditions, a waning impact of fiscal stimulus in the US, and a possible trade war

- However, **from a valuation perspective**, recent corrections in both the equity and credit markets offer one of the most **attractive entry points** of recent years. Obviously, these valuations depend on companies fulfilling their earnings projections. Cheap valuations can become expensive if, as is the case when the economic cycle turns, corporate profits decrease considerably

- So far, **macroeconomic data show no visible sign of recession** in the US. However, **bond markets** seem to be assessing an **increasing probability of a slowdown** in economic activity. This is revealed both by the current form of the **yield curve** and by the widening of **corporate spreads**

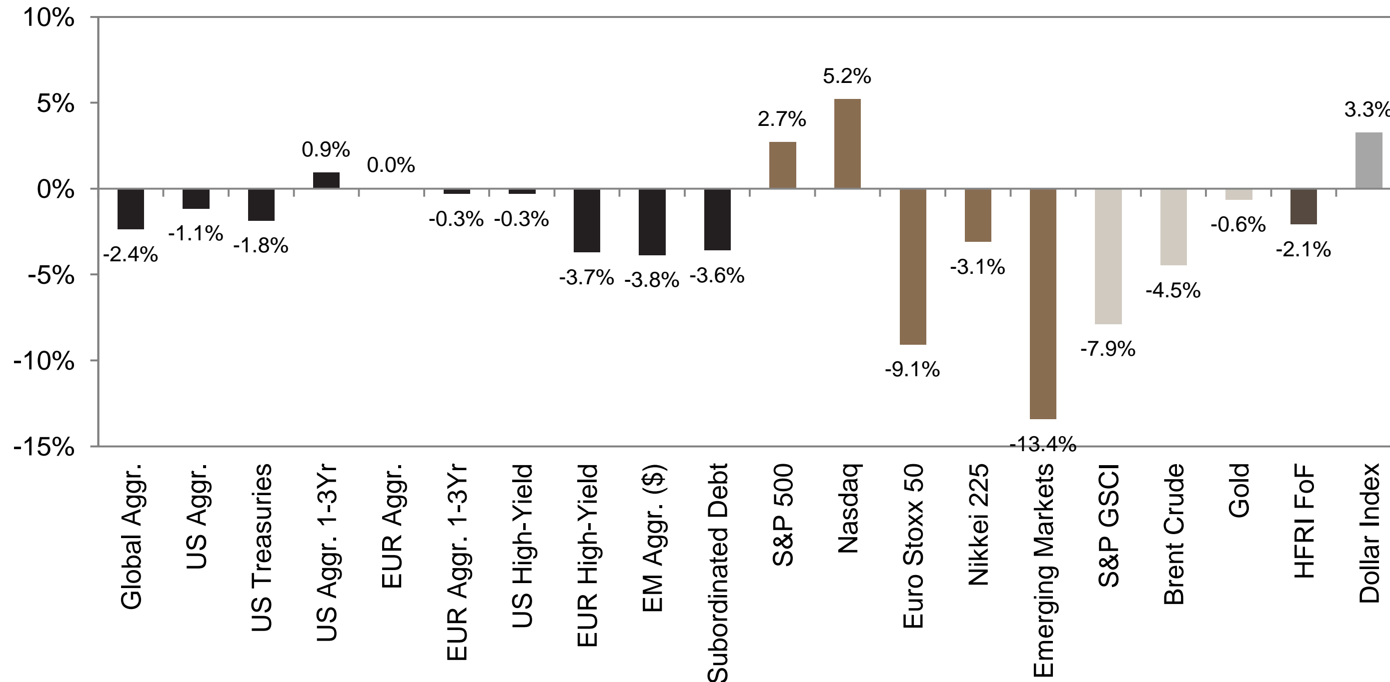
- For the coming year, the interaction between economic **"hard data"** (unemployment, earnings, inflation, etc.) and **"soft data"** (confidence and sentiment indicators) will be decisive both in the way the Federal Reserve will follow as for the investors' faith in a continuation of the current economic cycle. Given this situation, we continue to advocate a **conservative approach**, favoring quality stocks and bonds, short maturities and the purchase of portfolio insurance

EWM Investment Policy

Asset Class		View	Rationale
Fixed Income	US Treasuries	+	Treasuries offer protection from a slowdown in growth – although this less likely with the fiscal stimulus in the US – whilst TIPS offer protection against rising inflation as a consequence of reflationary policies
	US Credit	+	Corporate debt and High Yield currently offer the best combination of risk and return. We prefer medium maturities as the yield curve has flattened considerably and there is little term premium to compensate for taking interest rate risk
	European Sovereign	–	High quality debt in Euros presents a very unattractive combination of risk and return as current yields offer very little cushion to weather potential interest rates increases
	European Credit	=	In European credit we only see value in subordinated debt, asset-backed securities and short-duration high yield
	Emerging Markets	–	We avoid Emerging Markets until there is more clarity on the new US administration trade policy, and the effects of a stronger dollar and higher financing costs for Emerging Markets are calibrated by the market
Equities	US	+	After the recent market corrections, valuations have improved substantially. We have therefore increased our exposure to US equities, mostly through quality and growth oriented companies
	Europe	=	From a relative valuation perspective, we like European stocks as they trade at lower multiples, and we expect profits to pick up as economic activity accelerates
	Japan	+	Japanese stocks are the cheapest in developed markets, but have suffered recently due to sluggish growth, and concerns about global trade
	Emerging Markets	+	Emerging markets have corrected sharply since the beginning of the year affected by a strong dollar and trade concerns. We deem the correction suffered has been excessive, and continue favoring India and Frontier Markets within EM
	Sectors & Themes	+	Amongst others, we favor Biotechnology and listed Real Estate
Alternative Investments	Commodities	=	A diversified commodities allocations, further help us to increase diversification and to protect the portfolios against a scenario of rising inflation
	Multi-Strategy Hedge Funds	–	Multi-strategy / multi-manager hedge funds with daily liquidity are having a disappointing performance, particularly when compared with other less risky alternatives, like short-term corporate bonds
	Private Equity	=	Investing in late-stage private equity provides access to the asset class with liquidity provision up to a certain degree

+ Overweight – Underweight = Neutral

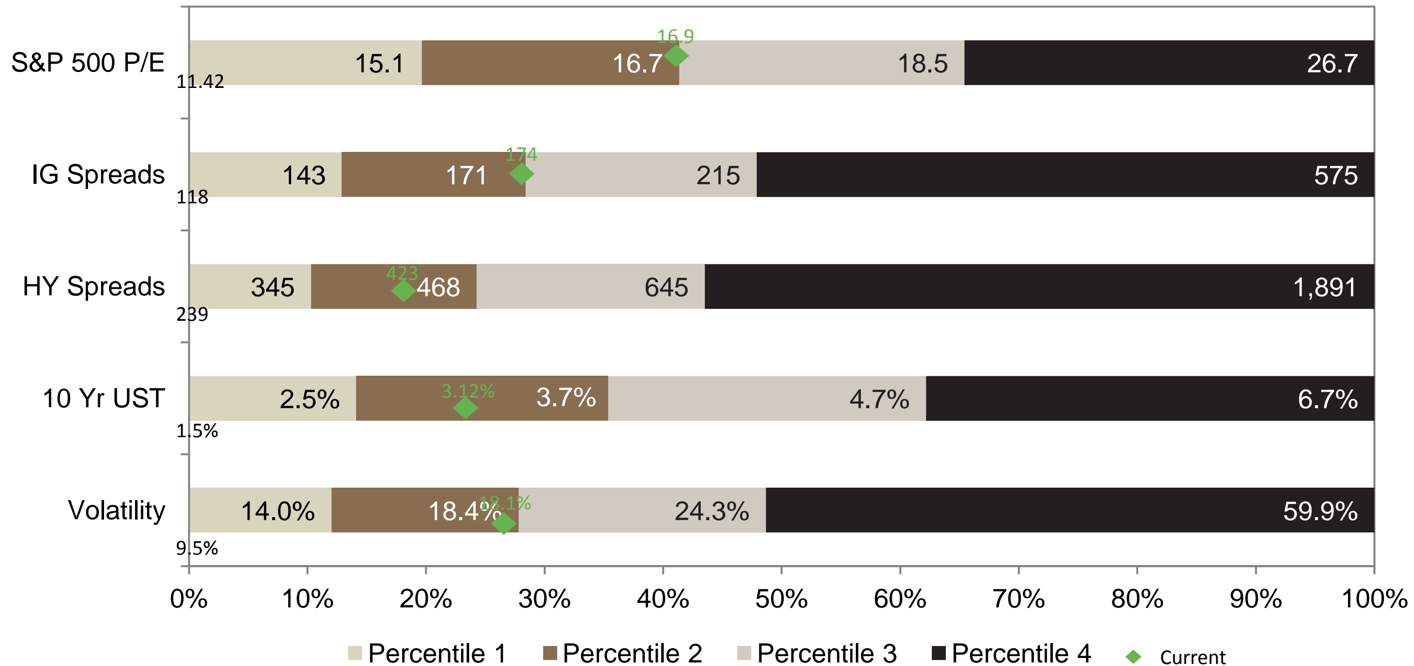
A (difficult) year in review



- With **rising interest rates**, and **widening spreads**, most areas in fixed-income had a negative performance this year. Only the **shortest parts of the yield curve** offered positive returns
- **Equity markets**, one more time, showed a **divergence between the US and the rest** of the world
- **Commodities** and **gold** suffered from **higher real interest rates** and a **stronger US dollar**

Source: Bloomberg, as of December 7, 2018

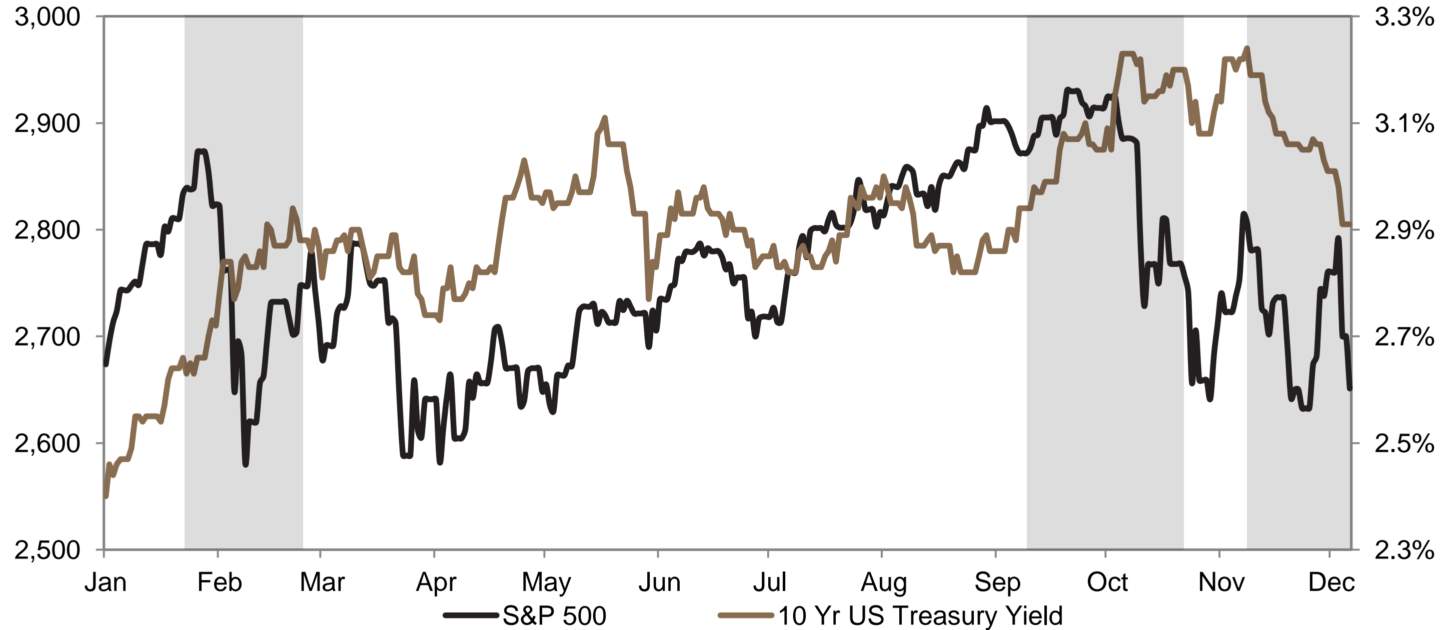
Looking forward into 2019



- From a **valuation perspective**, the **suppression of volatility** engineered by central banks since the financial crisis can still be felt in a number of indicators, like **corporate spreads**
- Only **equity markets** seem to be more **attractively valued**, particularly **if low interest rates are not to revert to their historical mean** as a consequence of structural factors (demographics, globalization and technological disruption)

Source: PIMCO and Bloomberg as of December 5, 2018

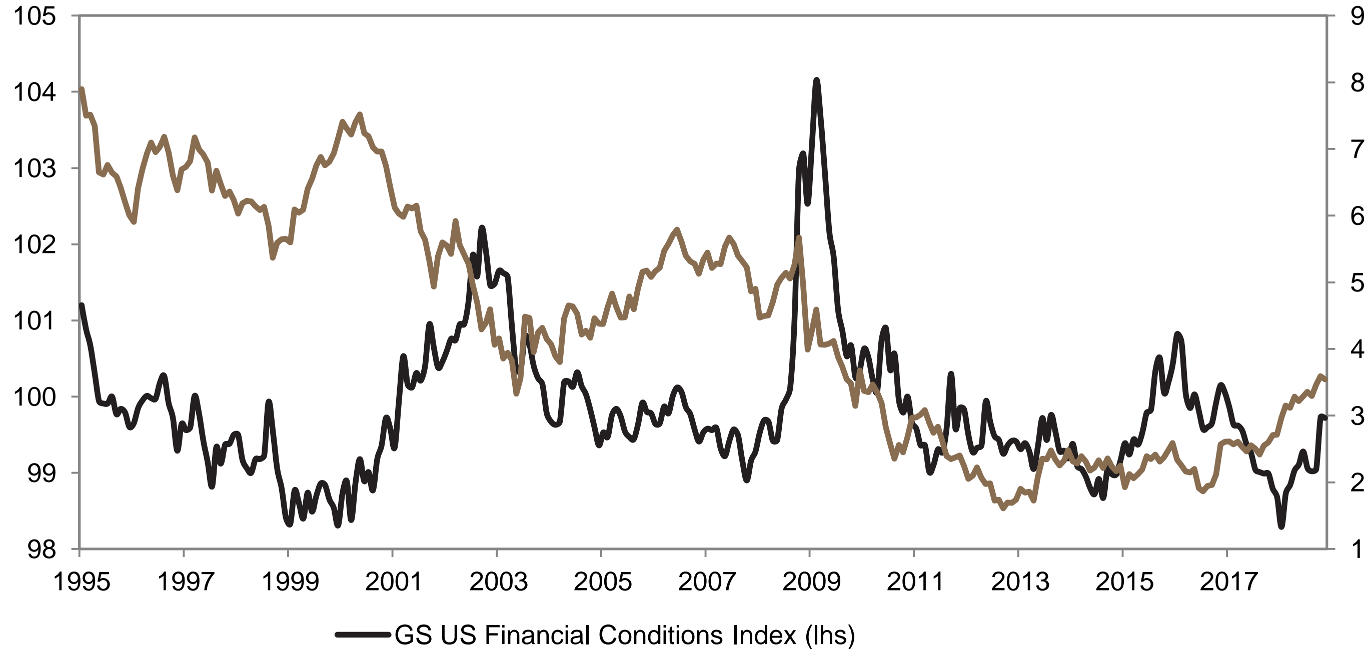
Rising investor anxiety about the economic cycle



- Investors have been **calibrating, alternatively**, both **higher interest rates** due to the robustness of an economy approaching its maximum capacity, and the **risk of an economic slowdown**
- In this interplay, corporate **earnings**, **inflation** and **growth** data will be key to determine the future direction of equity markets

Source: Bloomberg

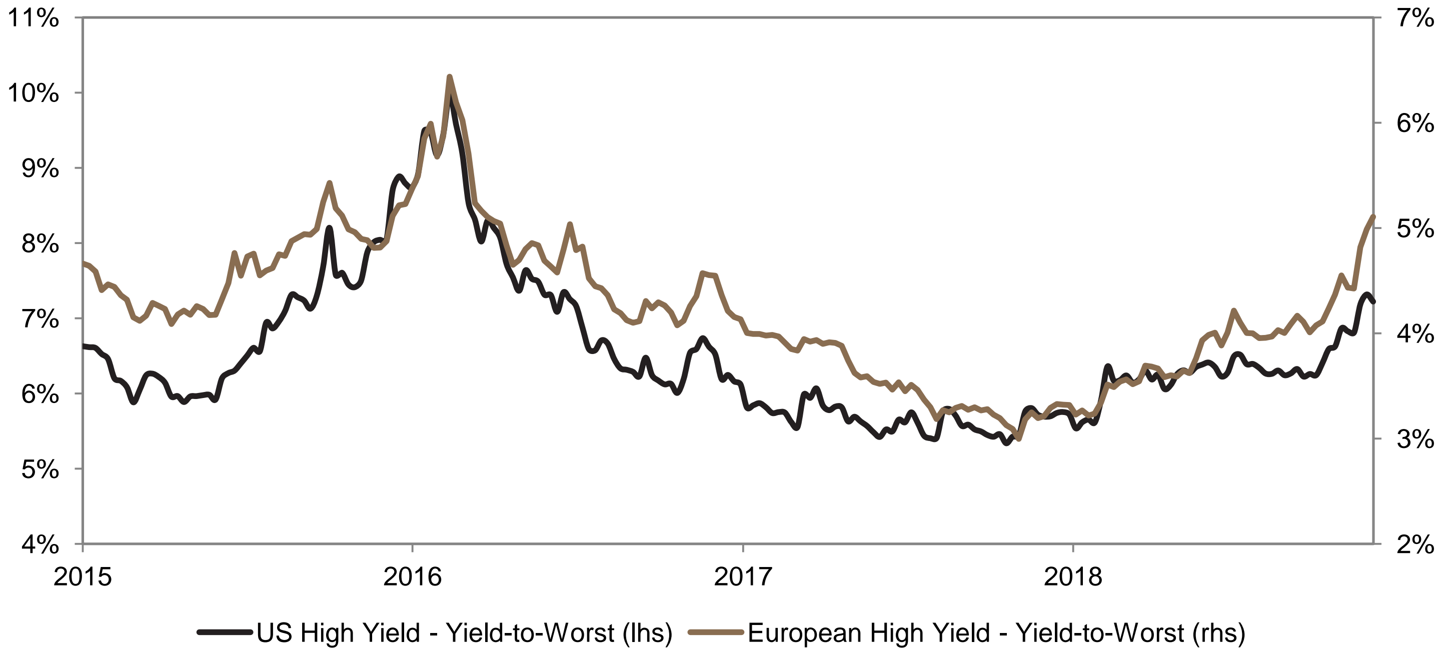
Where is the neutral rate?



- **Financial conditions have tightened** to levels close to its historical average, despite the still **low levels of interest rates** from a historical perspective
- This **complicates further the task of the Federal Reserve**, as the **risk of a policy mistake** has considerably increased since the lift-off in 2015

Source: Bloomberg

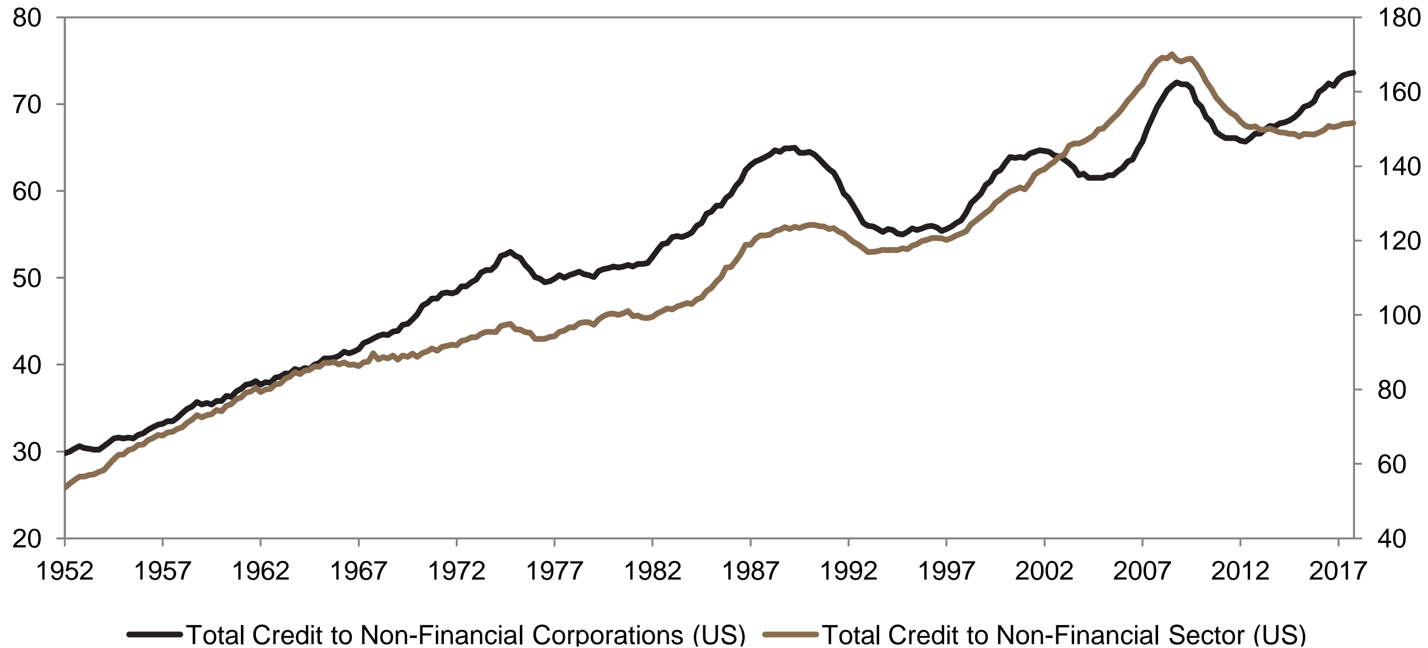
First cracks in credit are emerging



- **US High Yield spreads**, which have remained **relatively immune** to stock market volatility bouts, have **widened** significantly in November. **European High Yield** have fared significantly worse, and spreads are now approaching levels close to the **2015 sell-off**
- As we consider **credit markets** to be one of the best **leading indicators of a recession**, this is an indicator to monitor more closely in the future

Source: Bloomberg

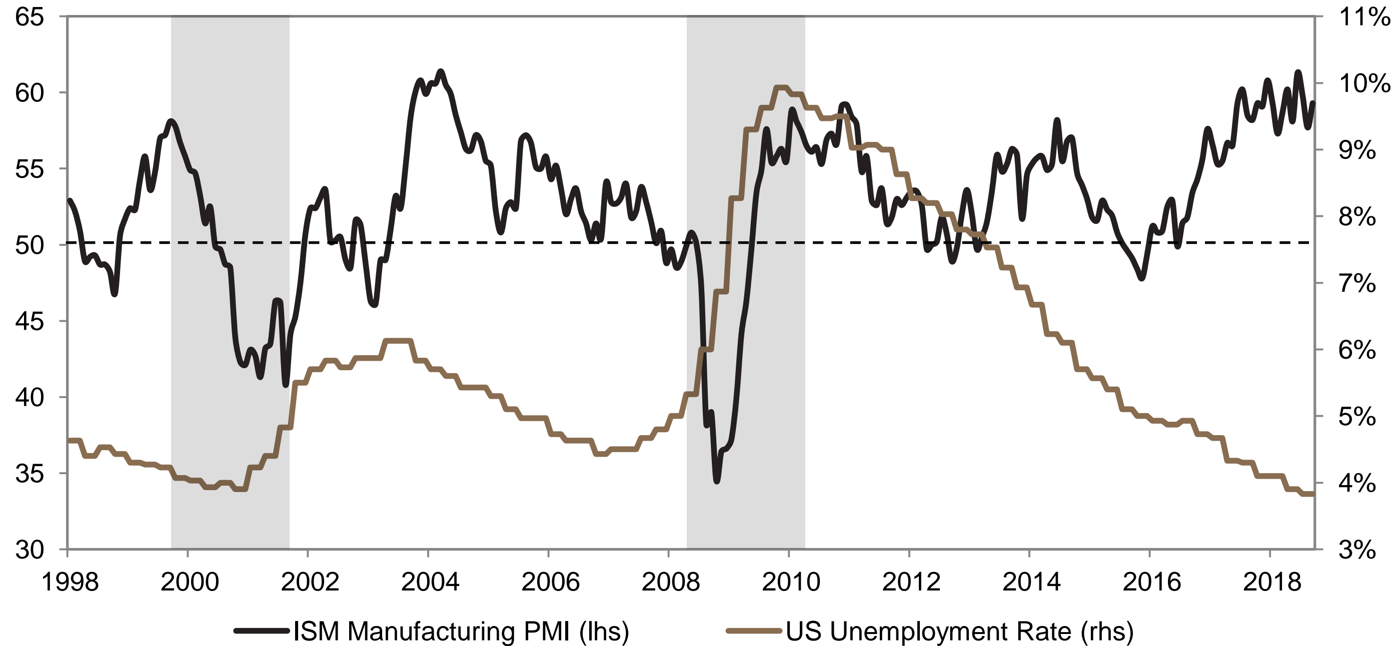
Leverage remains an area of concern



- Concerns about credit markets are compounded because of the **increase of financial leverage** experienced by the corporate sector in the US since the financial crisis
- However, **debt affordability is relatively ample** at current interest rate levels, and there is no immediate **"debt maturity wall"** that needs to be refinanced

Source: Bloomberg

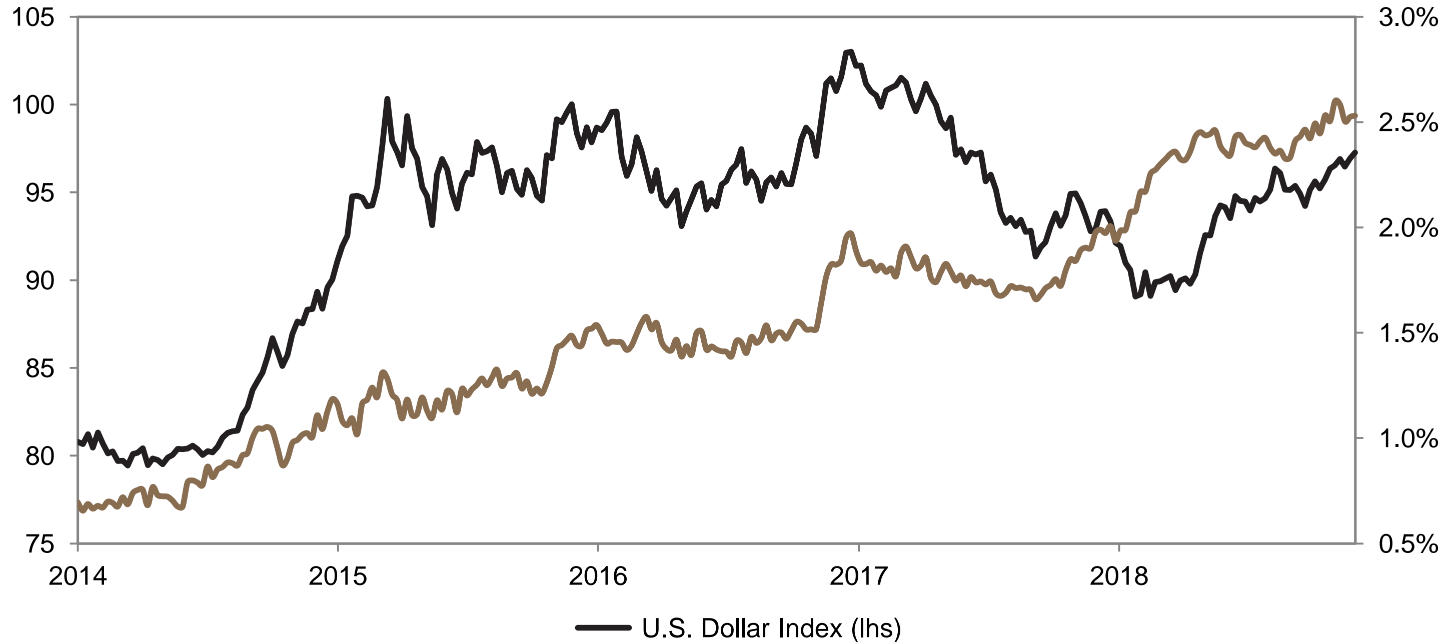
No signs of recession, but turns are sharp



- Despite the unease observed in credit markets, the main **leading indicators** continue pointing to a **continuation of the current economic expansion**
- However, it is important to be cautious and remain vigilant, as the **deterioration in economic conditions can be very sudden**

Source: Bloomberg

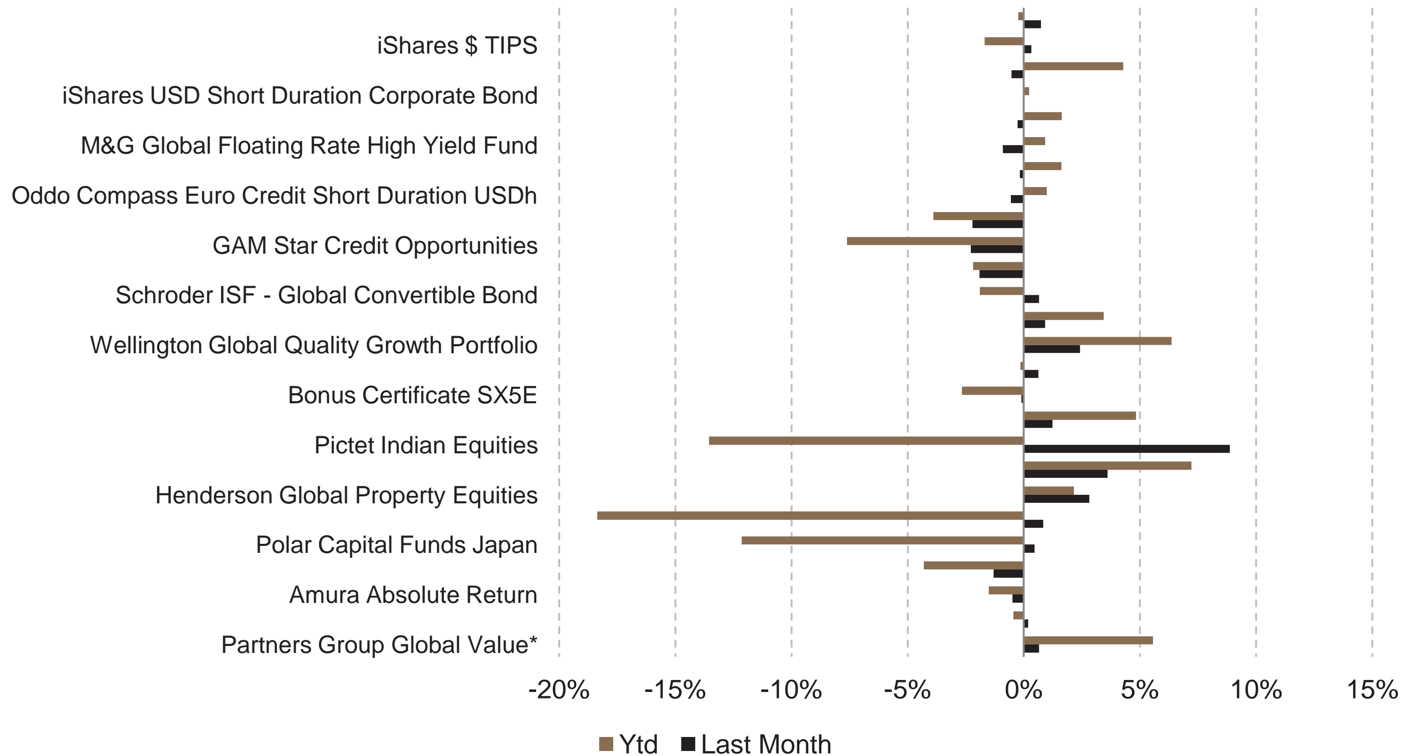
Dollar strength to remain



- As long as dollar-denominated bonds continue yielding significantly more than those of the major currencies, the **US dollar will remain strong**
- Although a large part of the increase in interest rate differentials **was priced in at the onset of the Fed normalization process**, the latter has become more pronounced than initially anticipated by the market

Source: Bloomberg

Model portfolio evolution



Source: Bloomberg as of December 1, 2018
* Fund publishes monthly NAV with a 1 month of delay

Investment scenarios

	Scenario 1 Recession by political/policy accident	Scenario 2 Goldilocks	Scenario 3 New regime
Drivers	• Global economic slowdown caused by political accidents or policy errors (Trade war with China, EU breakup, a too aggressive Fed, etc.) • Deflationary scenario due to a combination of low growth and structural factors, although the rise of protectionism would be inflationary • The Fed will have to reverse curse, which would be complicated if inflation is rising	• The fiscal stimulus in the US provides a short-term impulse to the global economy, but not enough to attain a higher growth trajectory • Inflation, particularly in the US will pick-up, but remains subdued globally due to structural factors (demographics, low aggregated demand, deleveraging) • The Fed will continue its normalization path	• Growth concerns dissipate, with economic activity accelerating in US, Europe and Japan • Inflation in the US increases, as a consequence of president Trump's fiscal stimulus, and pulls other developed economies off deflation • The Fed will have to step up the pace of rate increases and/or reduce balance sheet
Market impact	• Correction in credit due to a rise in defaults and a widening of corporate spreads • Correction in equities due to lower projected earnings, though low rates will offer support • Sovereign and IG credit to profit due to flight to quality and the continuation of an ultra-loose monetary policy globally • USD neutral to weak as flight to quality is counterbalanced by low interest rates • Commodities will fall	• Equities appreciate moderately, with Europe and Japan catching up with the US • Credit spreads remain stable as the credit cycle is further elongated • Sovereigns suffer as monetary policy is progressively normalized • USD appreciate moderately due to higher interest rate differentials • Commodity prices will rise in the short-term, normalizing once the impulse vanishes	• Impact on equities will depend on how much real economic growth is sustained, and how accommodative the Fed remains • Sovereign and IG bonds will face steep losses due to higher rates, particularly if long-term inflation expectations rise • Corporate credit will correct moderately if inflation comes together with higher growth • The USD will appreciate, particularly against those currencies facing deflation • Commodities will gain from higher inflation
Probability	40%	30%	30%

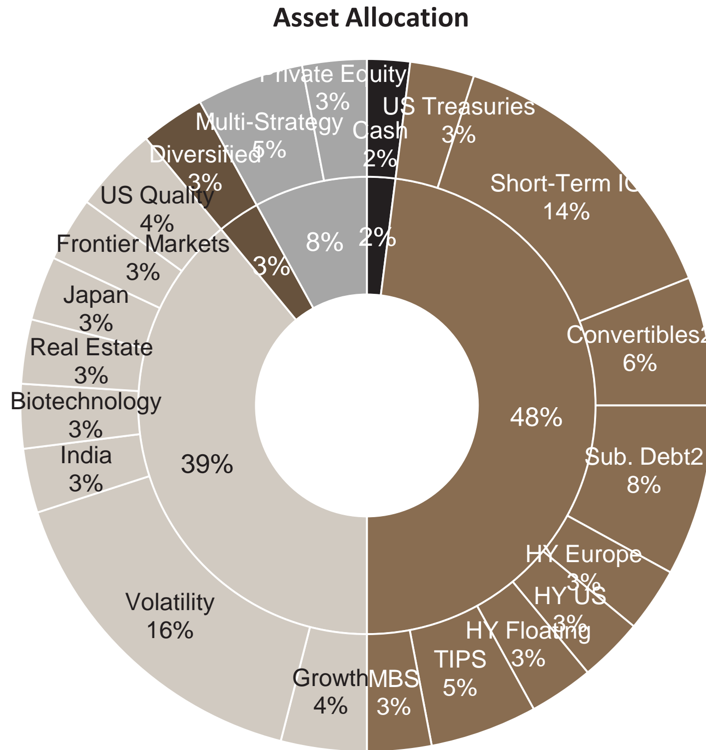
Short-term catalyzers

Fiscal stimulus in the US, improvement in macro-data globally, lower geopolitical tensions

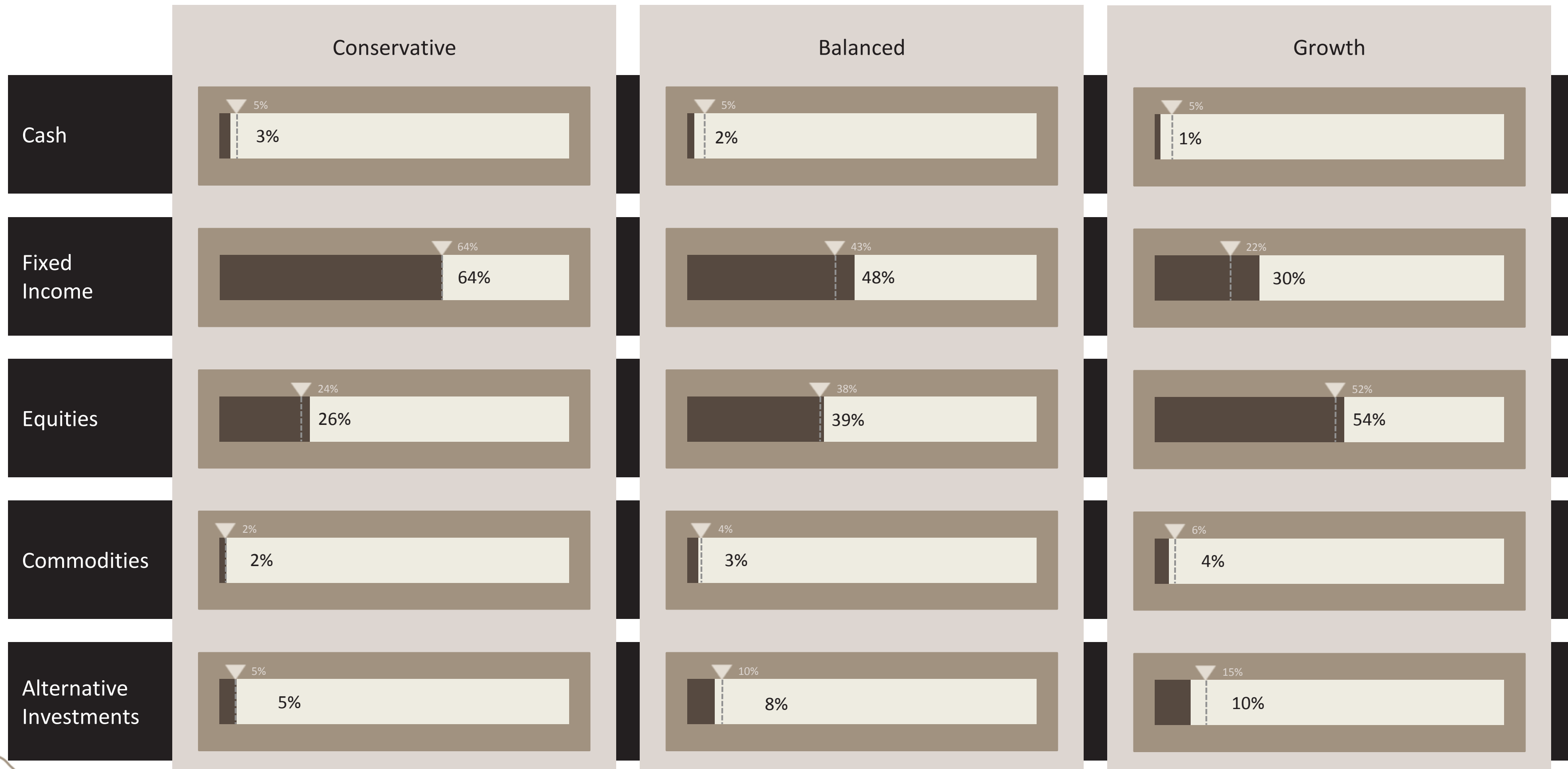
Other risks

Trade wars, Spread of populist political parties, China slowdown, Terrorism

EWM Model Portfolio Balanced USD

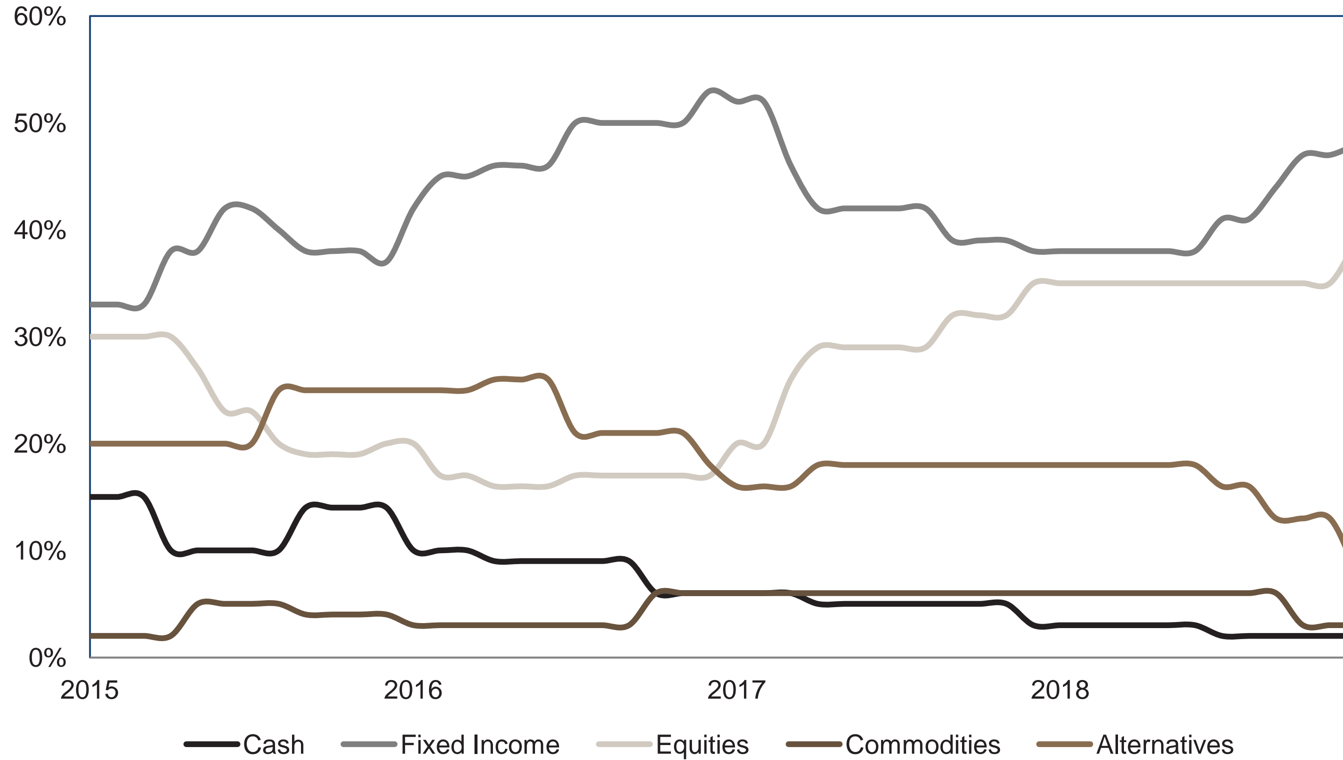


EWM Investment Profiles

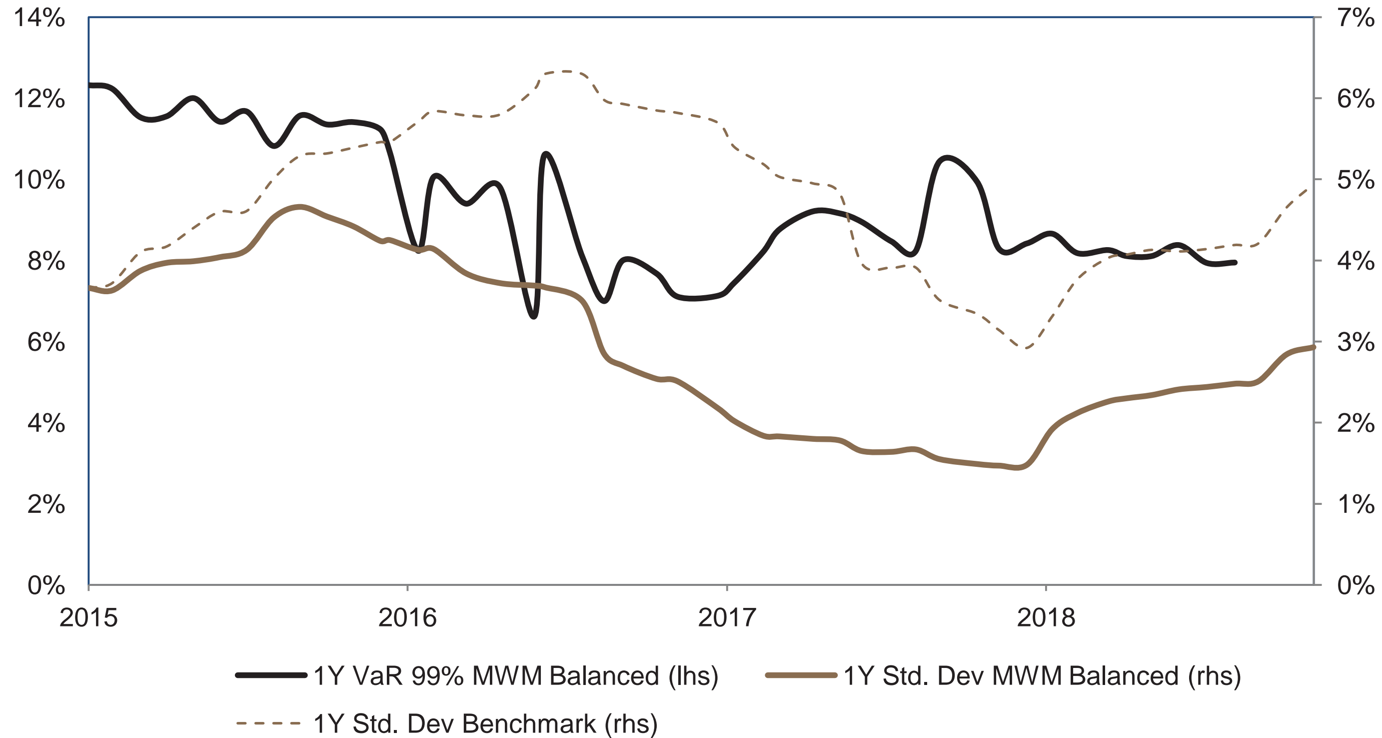


Strategic Asset Allocation

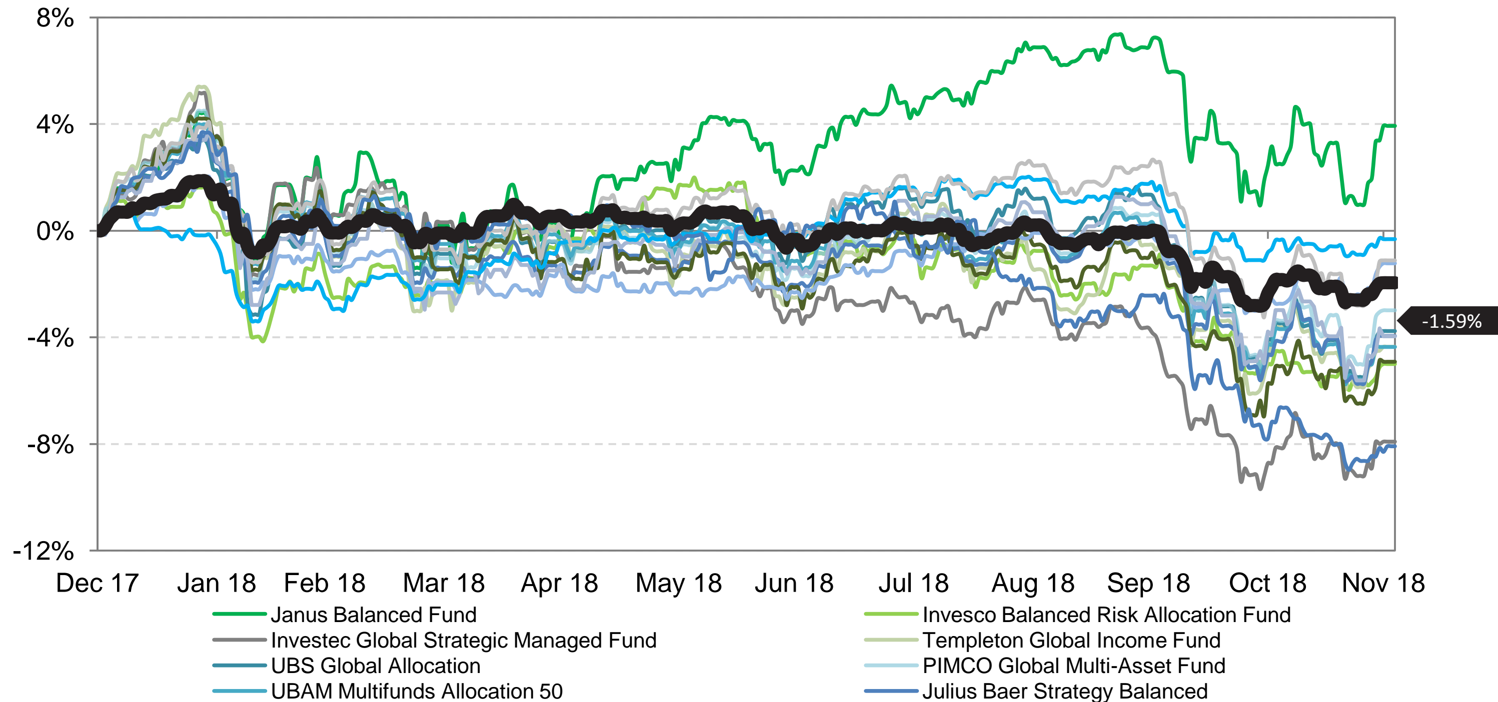
EWM Model Portfolio – Asset Allocation evolution



EWM Model Portfolio – VaR evolution



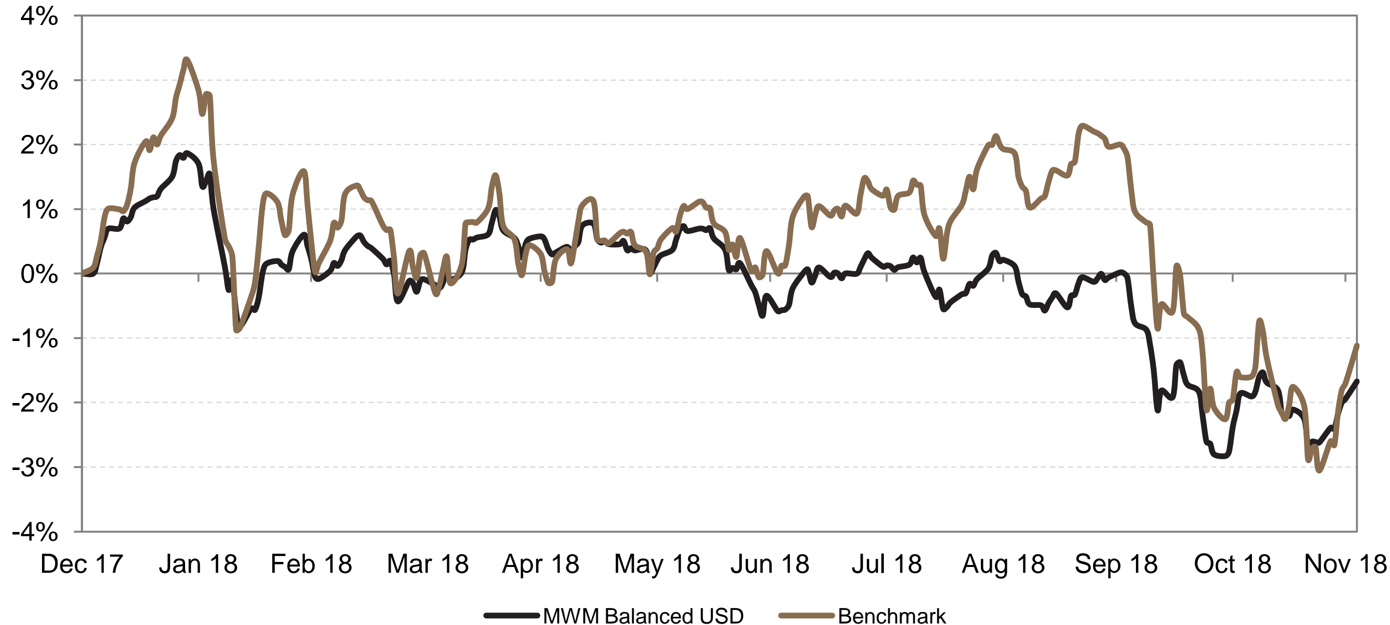
EWM Model Portfolio – Peer comparison



- **Total Return** (Ytd[1]): **5th out of 15**
- **Standard Deviation** (1 year[1]): **1st out of 15**
- **Downside Risk** (1 year[1]): **1st out of 15**
- **Sharp Ratio** (1 year[1]): **n/a**

[1] As of December 3, 2018
Source: Bloomberg

EWM Model Portfolio – Ytd performance

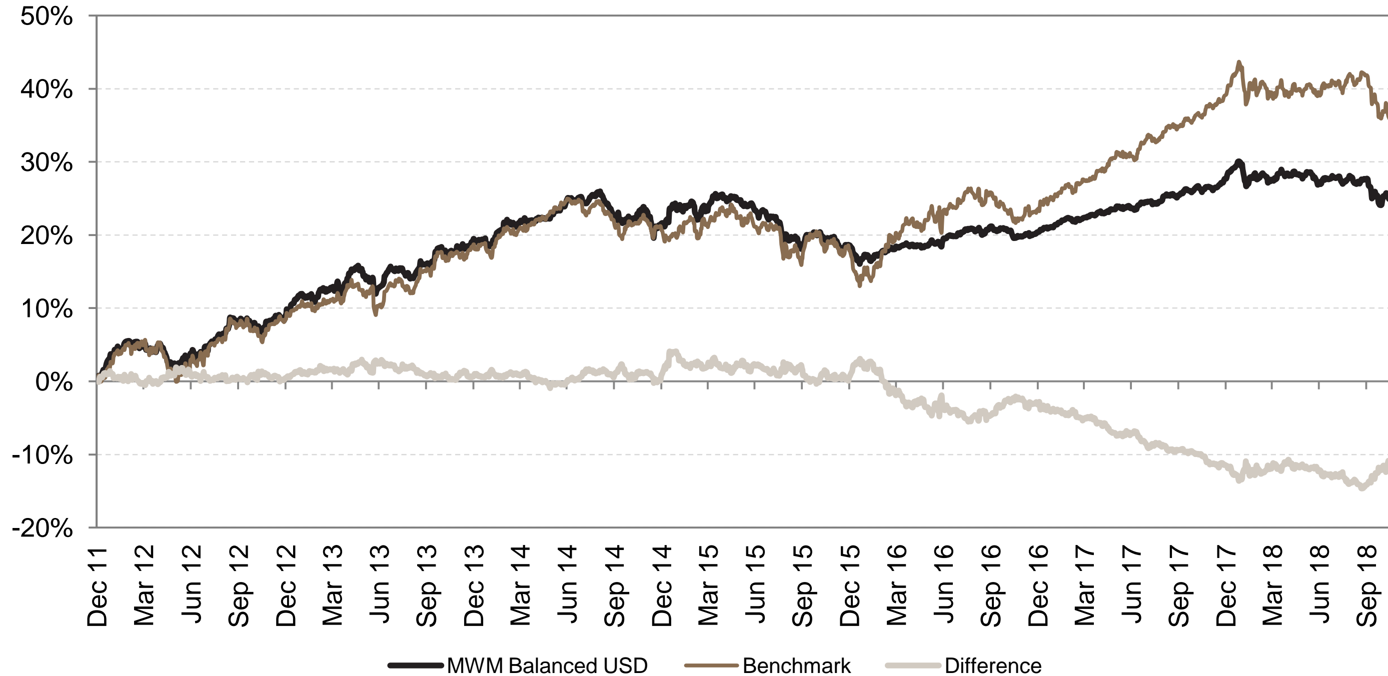


- **Total Return** (Ytd[1]): **-1.59%** vs. **-1.12%** Benchmark[2]
- **Standard Deviation** (Ytd[1]): **3.01%** vs. **5.09%** Benchmark[2]
- **Downside Risk** (Ytd[1]): **2.33%** vs. **3.89%** Benchmark[2]
- **Sharpe Ratio** (Ytd[1]): **-1.20**vs. **-0.59** Benchmark[2]

[1] As of December 3, 2018

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

EWM Model Portfolio – Historical performance (1)

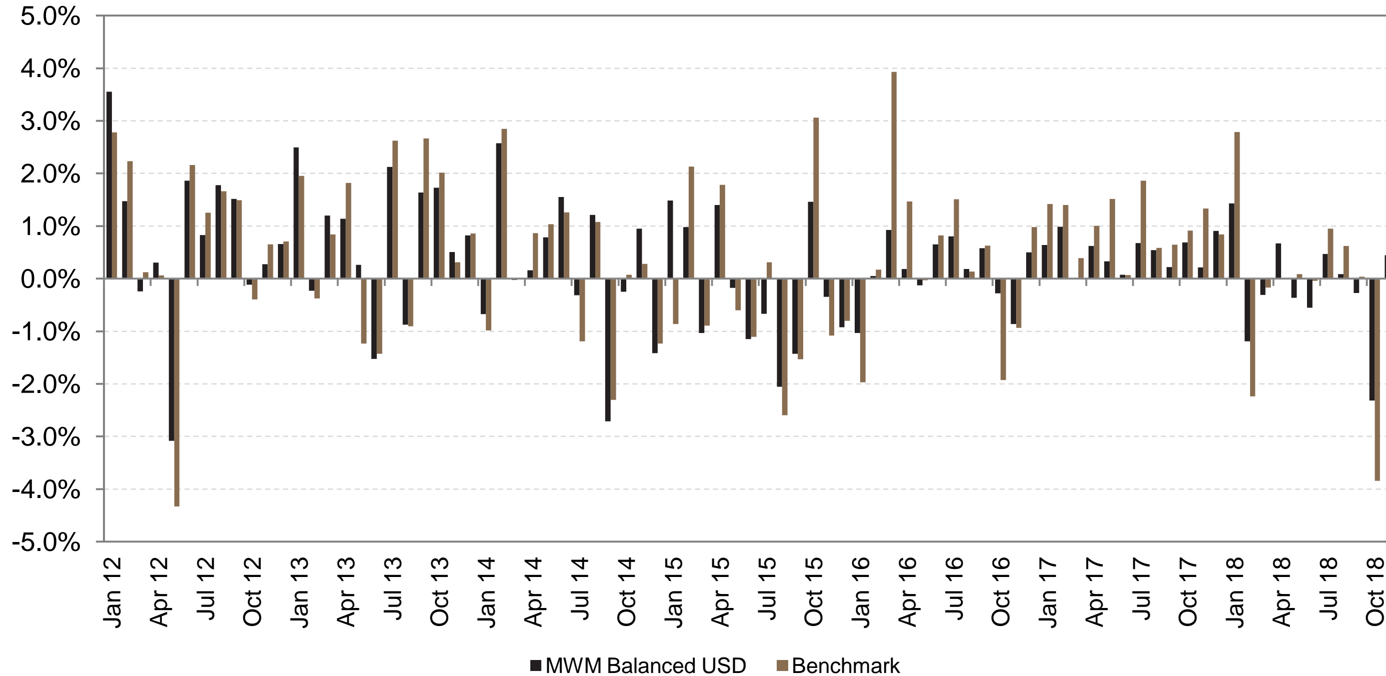


- **Total Return** (1 year[1]): **-0.69%** vs. **0.22%** Benchmark[2]
- **Total Return** (3 year[1]): **5.26%** vs. **16.06%** Benchmark[2]
- **Total Return** (Since Jan 12[1]): **25.66%** vs. **37.52%** Benchmark[2]

[1] As of December 3, 2018

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

EWM Model Portfolio – Historical performance (2)



- **Standard Deviation** (1 year[1]): **2.93%** vs. **4.94%** Benchmark[2]
- **Downside Risk** (1 year[1]): **2.28%** vs. **3.79%** Benchmark[2]
- **Sharpe Ratio** (1 year[1]): **-0.86** vs. **-0.40** Benchmark[2]
- **Var 95% - 1day** (1 year[1]): **-0.34%** vs. **-0.52%** Benchmark[2]

[1] As of December 3, 2018

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

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