Edwards Wealth Management AG
Switzerland

Investment Policy

June 2018

Tactical positioning

- We remain cautious in **fixed income** favoring **short to medium** maturities due to the very unattractive combination of risk and return in longer maturities. We have maintained **High Yield** and **subordinated debt** exposure as we think that the current economic cycle will be further elongated. **High quality bonds in the US** – particularly **corporate investment grade** – remain attractive in relative terms, and **Treasury bonds** could protect portfolios from a slowdown in growth, although the latter is now less likely. We also have a significant position in inflation-linked US Treasury bonds (**TIPS**) to give protection against an increase in inflation as a consequence of reflationary policies. Finally, we have maintained our allocation to **convertible bonds**, as a way to further diversify our portfolios

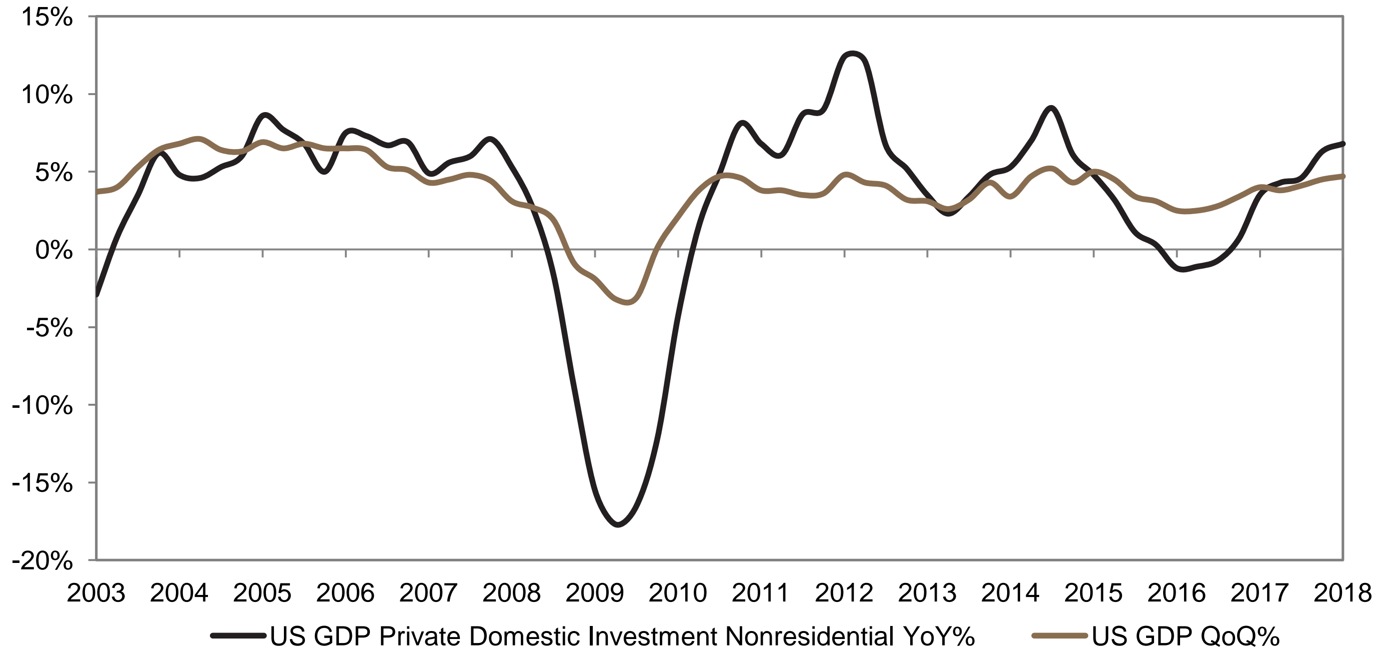
- **Equity valuations in the US** remain very high, mostly **supported by low interest** rates, **tax reform** and **deregulation**. Combined with positive macro data from other main developed markets, we see a **greater chance of a reacceleration in global economic growth.** However**,** with the **Fed potentially normalizing interest rates at a faster pace**, there is a risk of returning to lower valuation multiples. Therefore, we recommend to take equity exposure in a **non-directional way**. From a relative **valuation** perspective, we favor **European, Japanese and emerging markets equities**, **quality growth stocks**, **biotechnology** and **listed real estate**

- Our **diversified commodities** and **gold** allocations further help us to **increase diversification** and to position the portfolios for a scenario of **rising inflation**

- **Alternative investments** offer a much needed source of **diversification**. Besides **cat bonds** and **private equity**, we have recently increased the allocation to **hedge-funds** by investing into liquid and low cost **multi-manager/multi-strategy** fund of funds

- We have **reduced our cash allocation** as **negative interest rates** have been introduced in some of our reference currencies. We have also **reduced** the allocation to **short-term high quality bonds** that we held as an alternative to cash and increased credit exposure instead, with the aim of increasing the yield of the portfolio

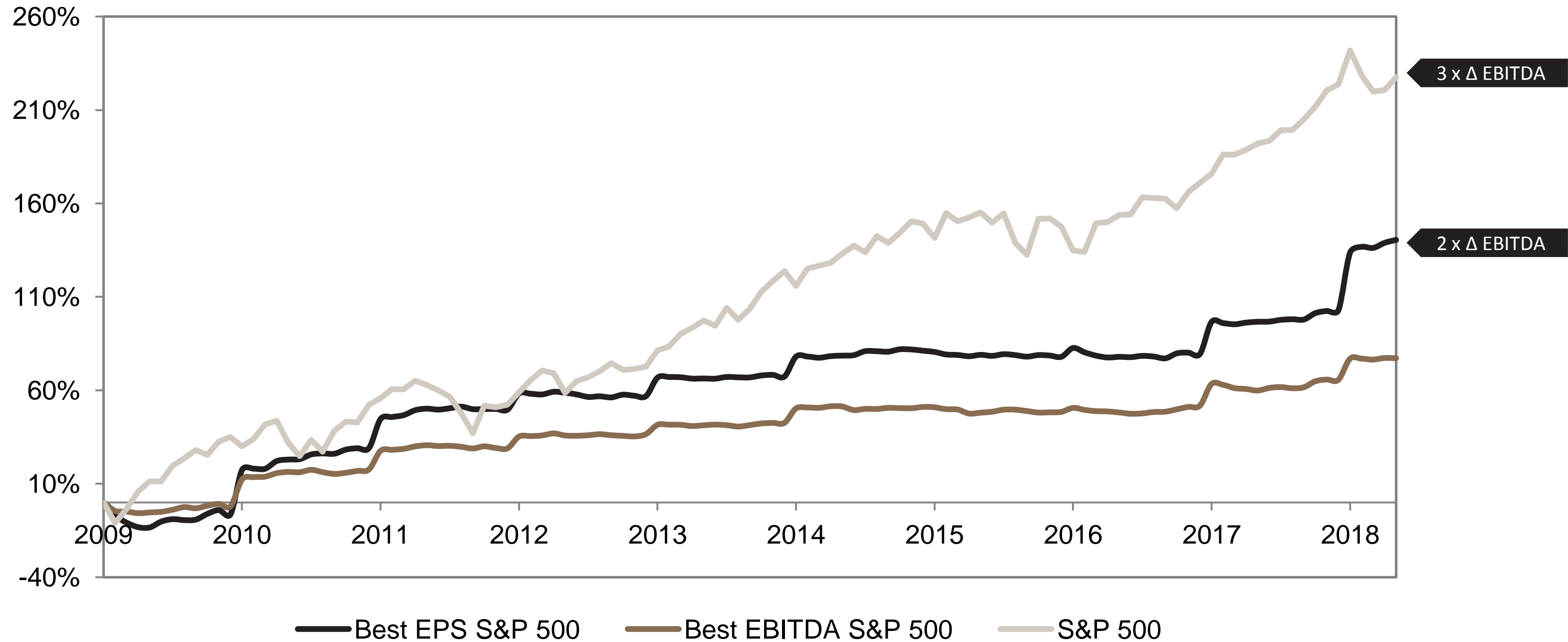
Towards the longest economic cycle



- Despite the **length of the current economic cycle** – second longest on record – economic activity remains robust and the main **leading economic indicators do not point to an immediate turn**
- In fact, the effects of **tax reform** in the US are starting to be felt in the **pickup in corporate investment**. The risk however is that this sort of **late-cycle fiscal expansion** – with unemployment currently at 3.8% – may cause an **overheating** of the US economy that prompts the **Fed to be more aggressive** in rising rates

Source: Bloomberg

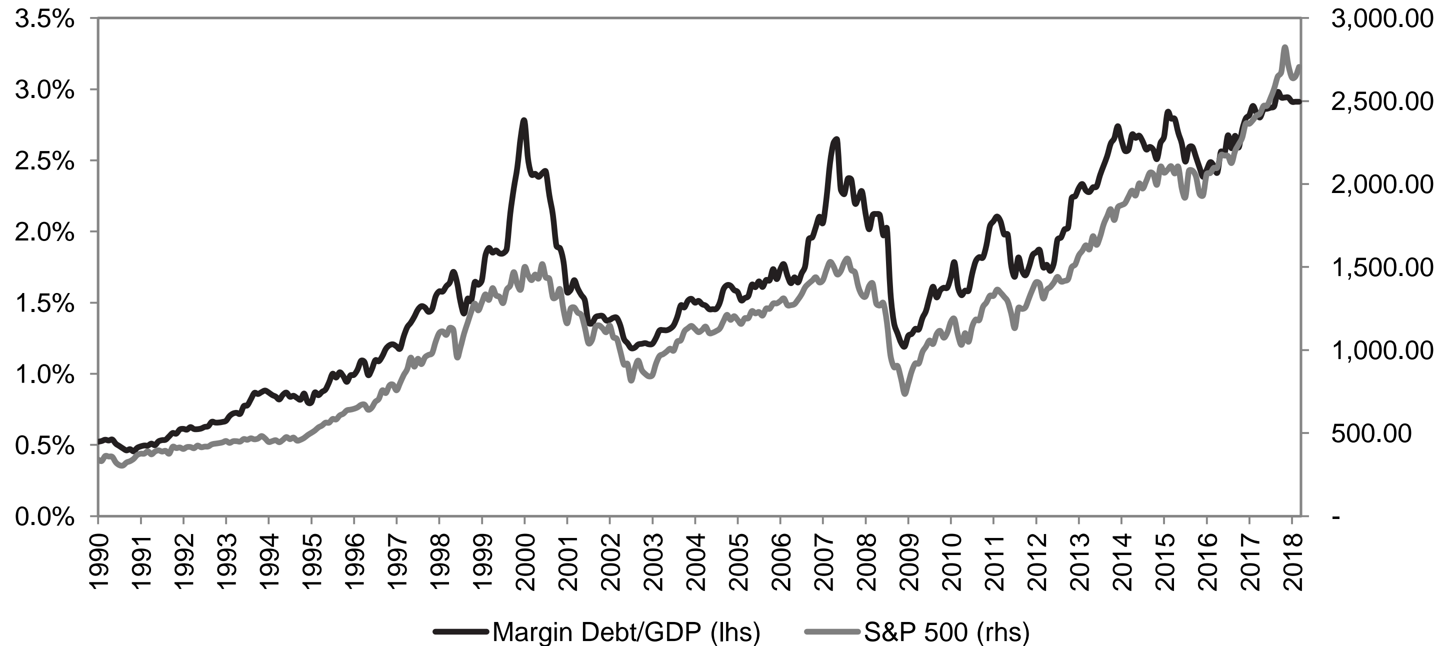
And the longest bull market...



- If January's peak is surpassed, this will be the **longest bull market on record**. However, contrary to what we see at macro level, we perceive more **signals of fatigue in the current market cycle**
- One of them is the **quality of earnings**, which tends to deteriorate in the later stages of a cycle when companies find it harder to grow revenues organically and resort to **accounting gimmicks**. This pattern can be observed when comparing **EPS vs. EBITDA** (although the last jump corresponds to the effects of the **tax reform** and not to financial engineering)

Source: Bloomberg

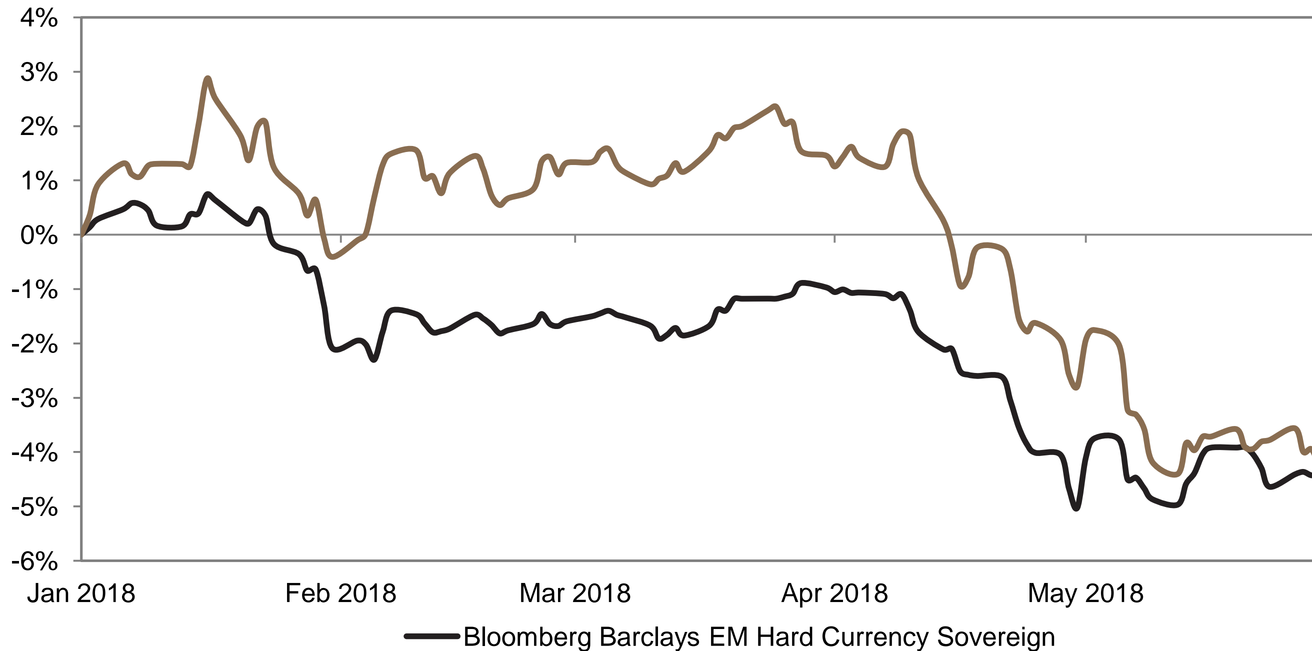
Greed pervails over fear



- The length of the bull market, coupled with central banks' largesse, has **transformed investors' attitudes towards risk** as the **"buy the dips" mentality** has been rewarded by an unprecedented number of equity markets rebounds
- This is encouraging **speculative investing**, which renders the market more vulnerable to a sudden correction – in the words of H. Minsky: **"stability breeds instability"**

Source: MFS and Bloomberg

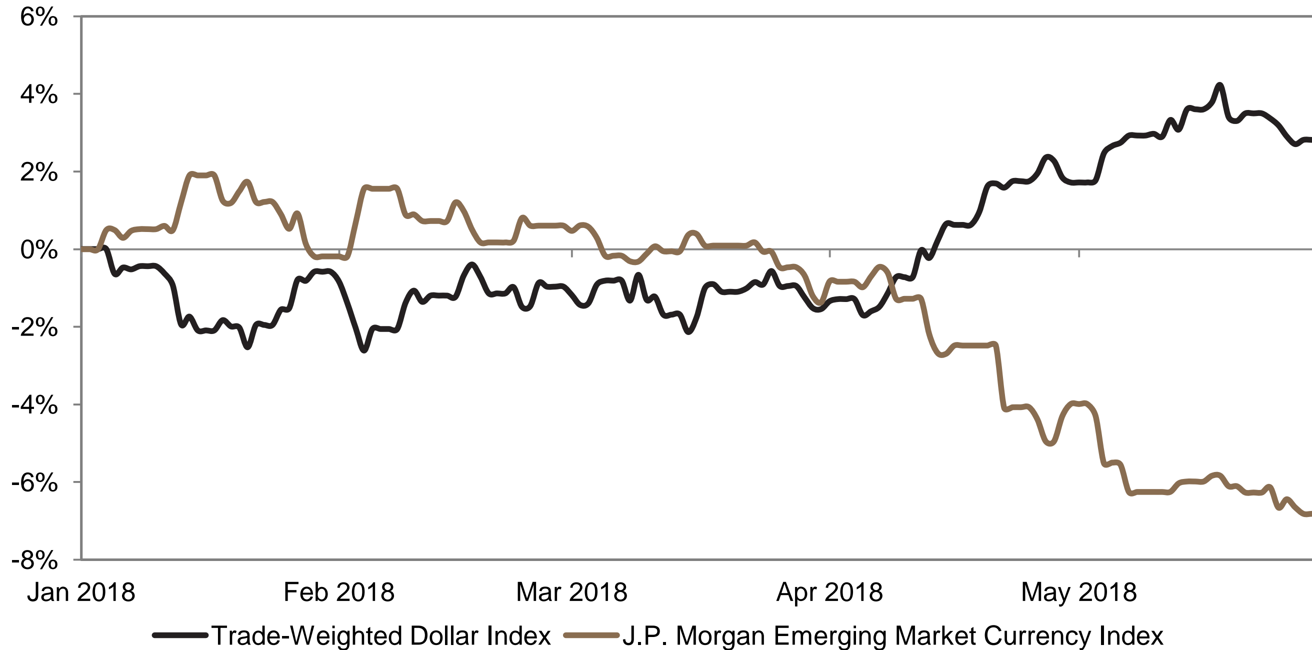
Early withdrawal symptoms from dollar liquidity



- As the Fed continues making progress in the **normalization of monetary conditions**, its consequences are starting to be felt in financial markets. The first tremor occurred at the **end of January**, when bond and equity markets corrected in tandem as market participants recalibrated the number of interest rate hikes
- This was followed in April by a correction in **emerging markets bonds**, both in hard and local currency

Source: Bloomberg

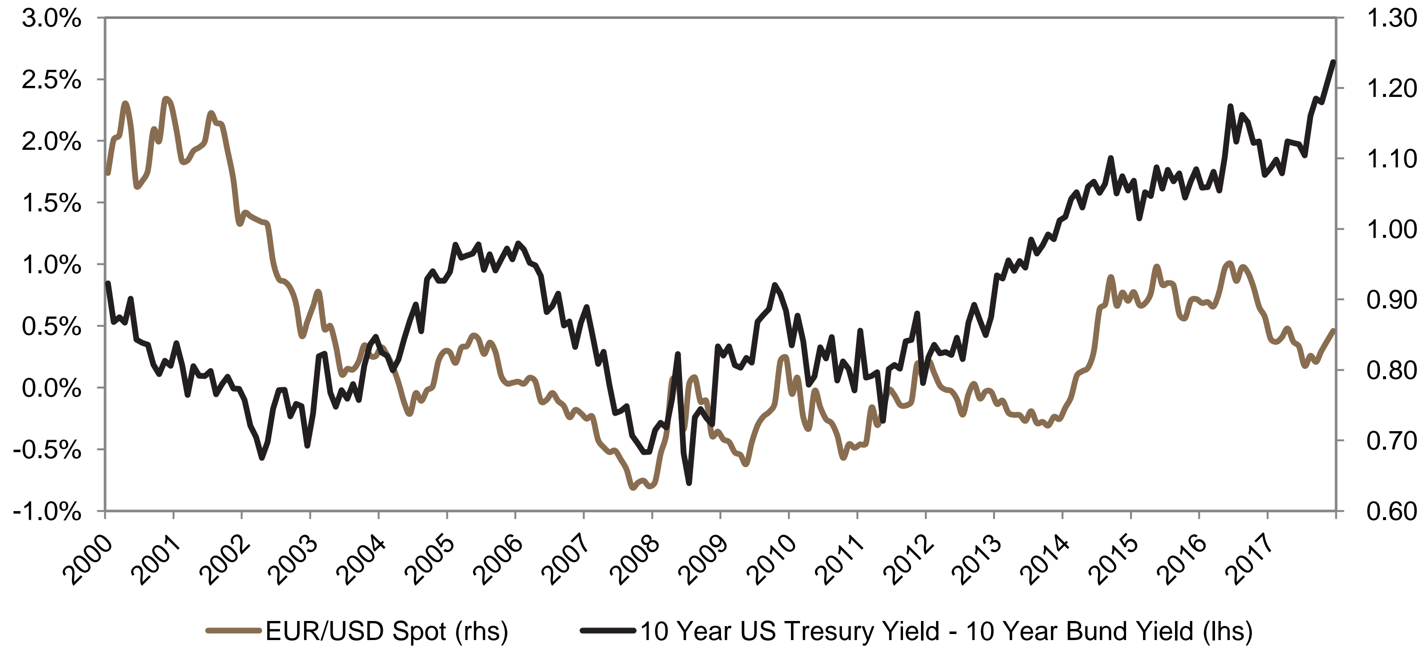
Causing the US dollar to strengthen



- Currencies have acted as a **transmission channel** reacting to higher dollar interest rates, and **emerging market currencies** in particular have experienced a significant depreciation, most notably in the case of the **Argentine Peso** and the **Turkish Lira**
- All this is reminiscent of the **"tapper tantrum"** and shows the growing influence that the Fed will exert on financial markets going forward

Source: Bloomberg

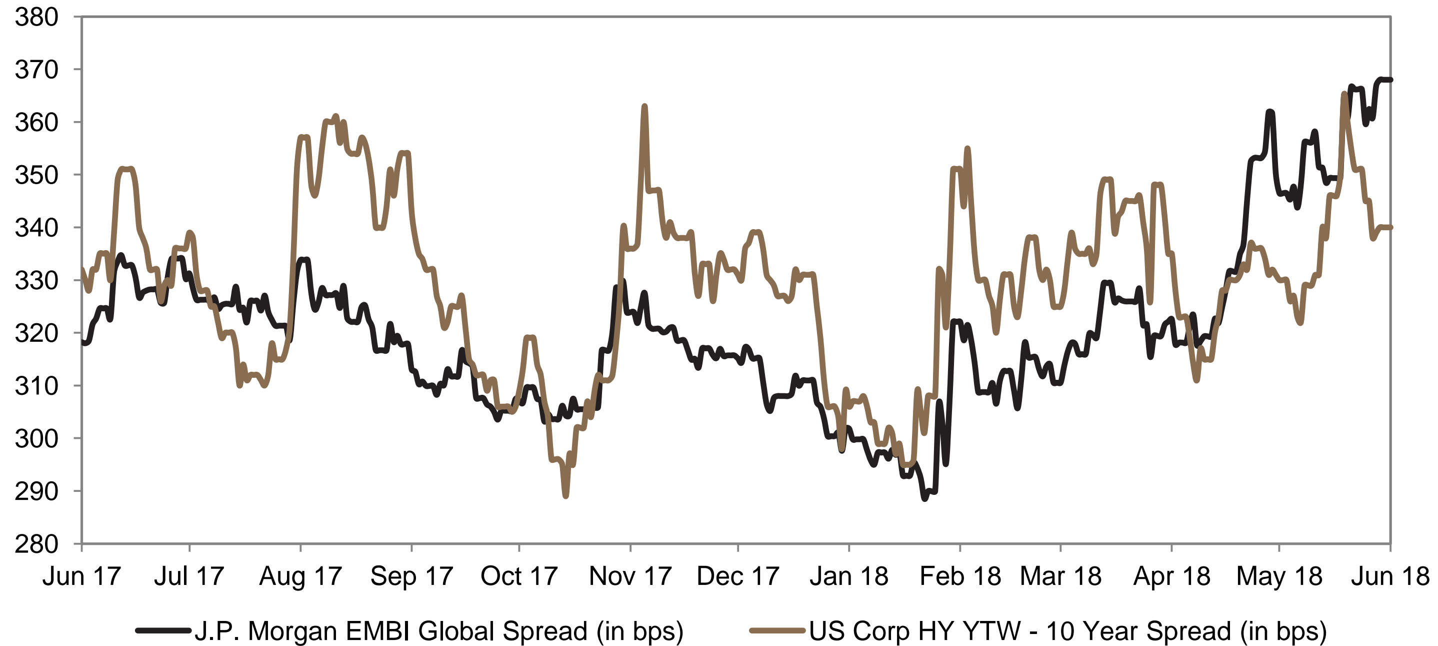
Dollar strength to remain



- The **interest rate differential** between US Treasuries and German Bunds has reached **all-time highs**. The recent widening in the spread has caused the Euro to depreciate from the highs earlier in the year
- Although we see potential for further dollar appreciation, an **earlier than expected exit from the QE program** in Europe will cause the Euro to strengthen

Source: Bloomberg

Credit spreads trend higher but remain content



- **Higher interest rates** have also **had a toll on high yield spreads**, which have widened in tandem with emerging markets
- However, we interpret this move as a **reversion to the mean,** rather than a correction driven by a **deterioration in economic fundamentals**

Source: Bloomberg

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	30%	40%	30%

Short-term catalyzers

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

Other risks

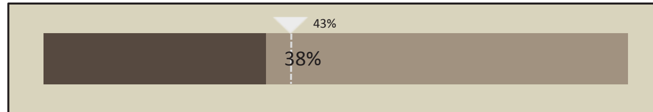
Trade wars, Spread of populist political parties, China slowdown, Terrorism

EWM Investment Policy

Cash

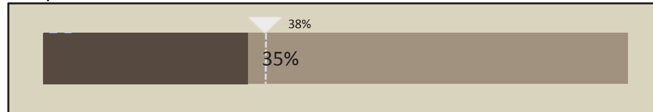
- In the current environment, waiting for good investment opportunities is a sensible investment strategy. However, holding cash is becoming costly due to low interest rates.

Fixed Income



- Corporate and high yield debt currently offer the best combination of risk and return. Treasuries can benefit from a slowdown in growth, although this less likely with the expected fiscal stimulus in the US, whilst TIPS offer protection against rising inflation
- We will avoid emerging markets until there is more clarity on trade policy by the new US administration

Equities



- The expected fiscal stimulus in the US will accelerate growth and postpone the fear of deflation, which will be supportive for equities as the top line will increase. However, it remains to be seen to which extent this comes along with an increase of interest rates, which will be a drag on valuations
- We favor investments in non-directional strategies as well as in preferred companies and sectors

Commodities

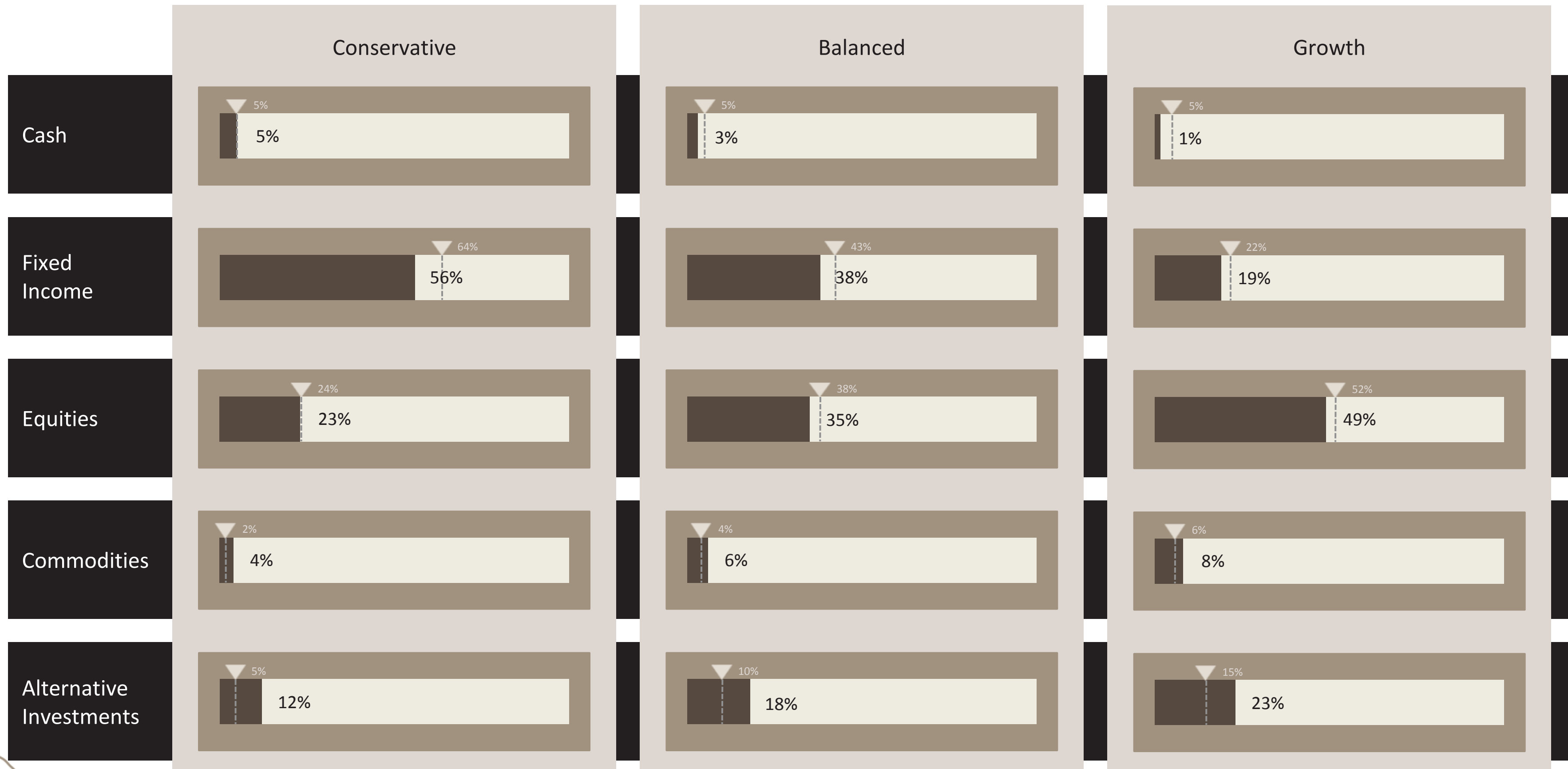
- Commodity prices have recently stabilized. Reflationary policies, and in particular a boost in infrastructure spending, will further support energy and industrial metals
- Gold and precious metals will be dependent on the relative pace of increase in both inflation and interest rates, but offer good diversification for the portfolio

Alternative Investments

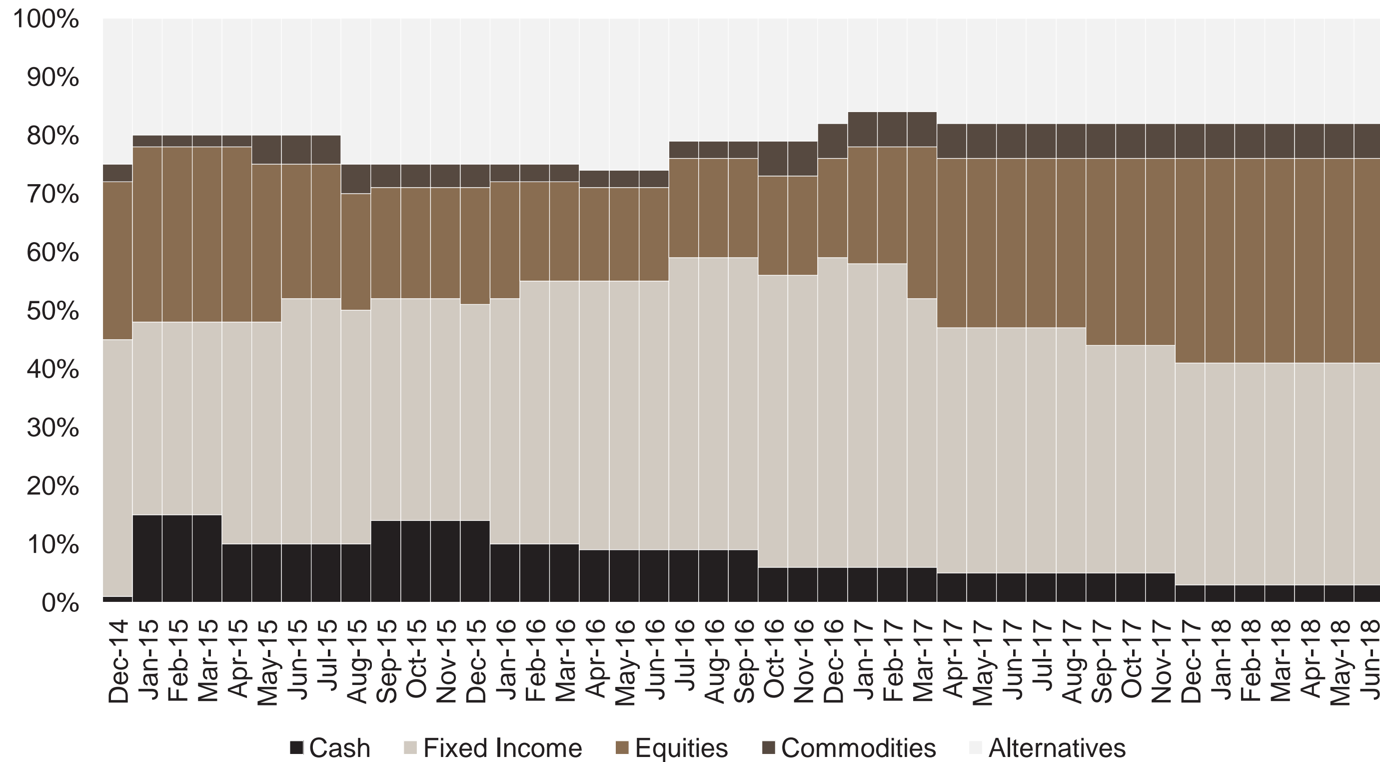
- Alternative investments, as a source of low volatility and uncorrelated returns, are more attractive than ever in the wake of the current latent risks in the market
- However, there is always a certain degree of correlation with traditional asset classes and double digit positive returns cannot be expected in the current environment

▼ Strategic Asset Allocation

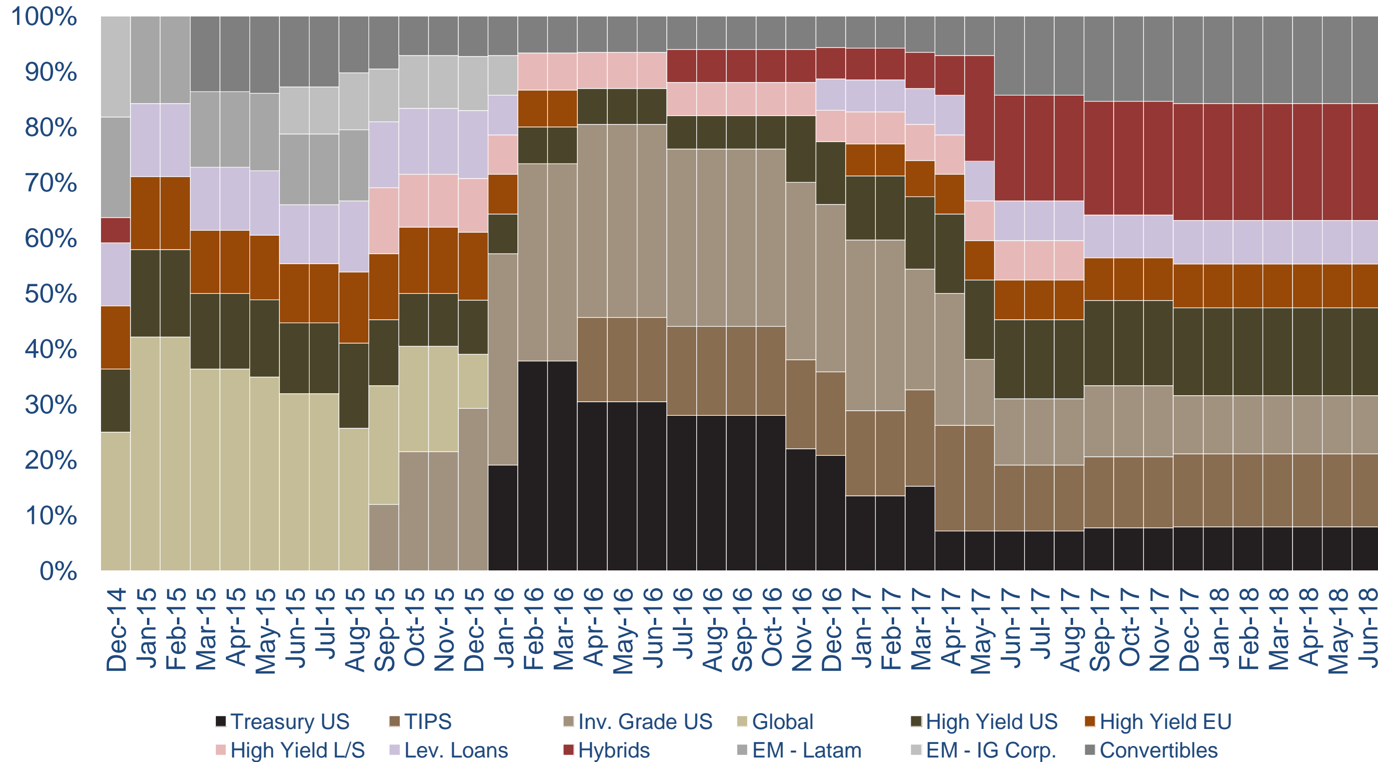
EWM Investment Profiles



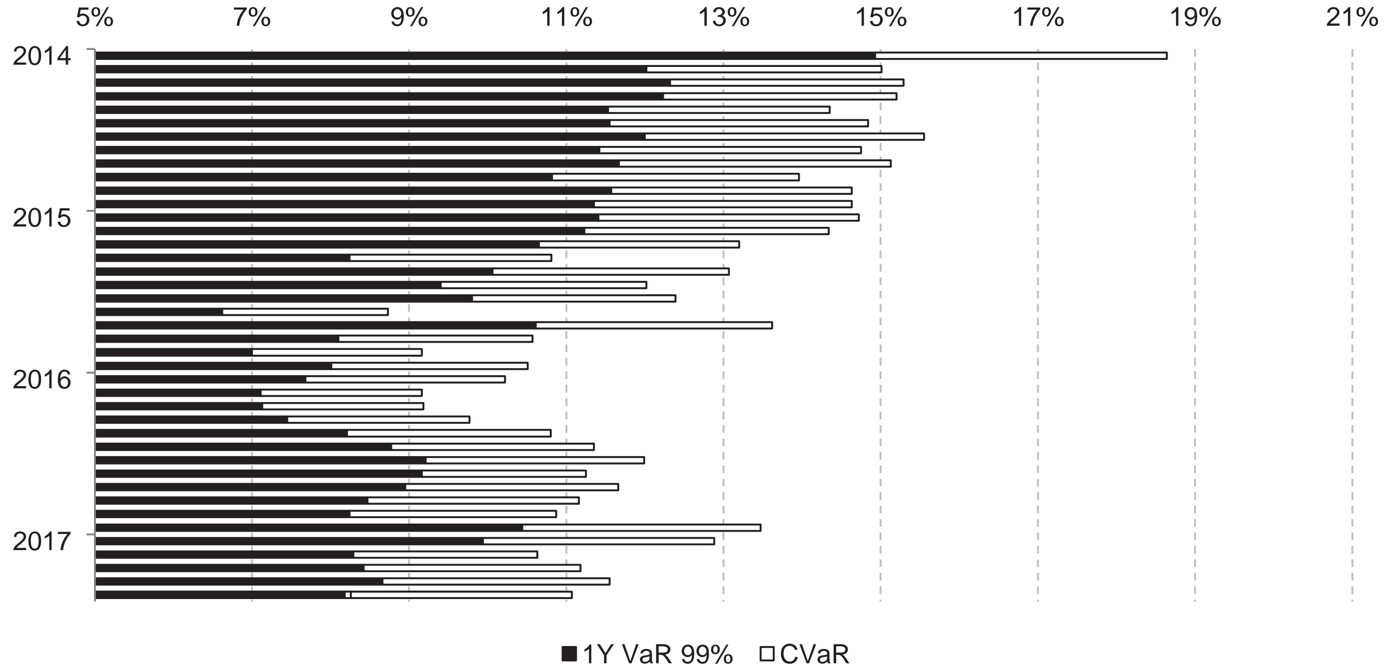
EWM Model Portfolio – Asset Allocation evolution



EWM Model Portfolio – Fixed Income evolution

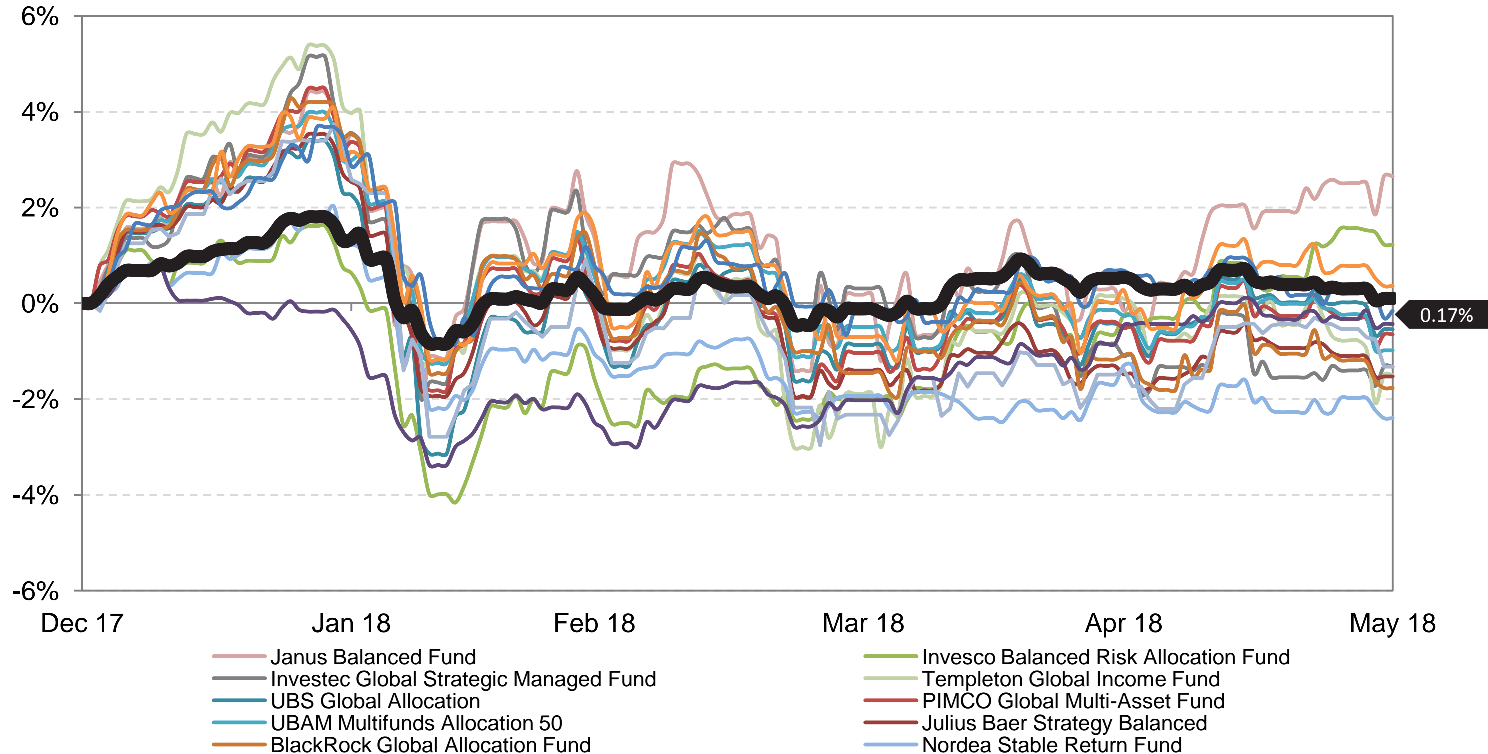


EWM Model Portfolio – VaR evolution



- The **VaR** of the portfolio remains contained, despite the recent rise in volatility, reflecting the conservative positioning of our portfolio

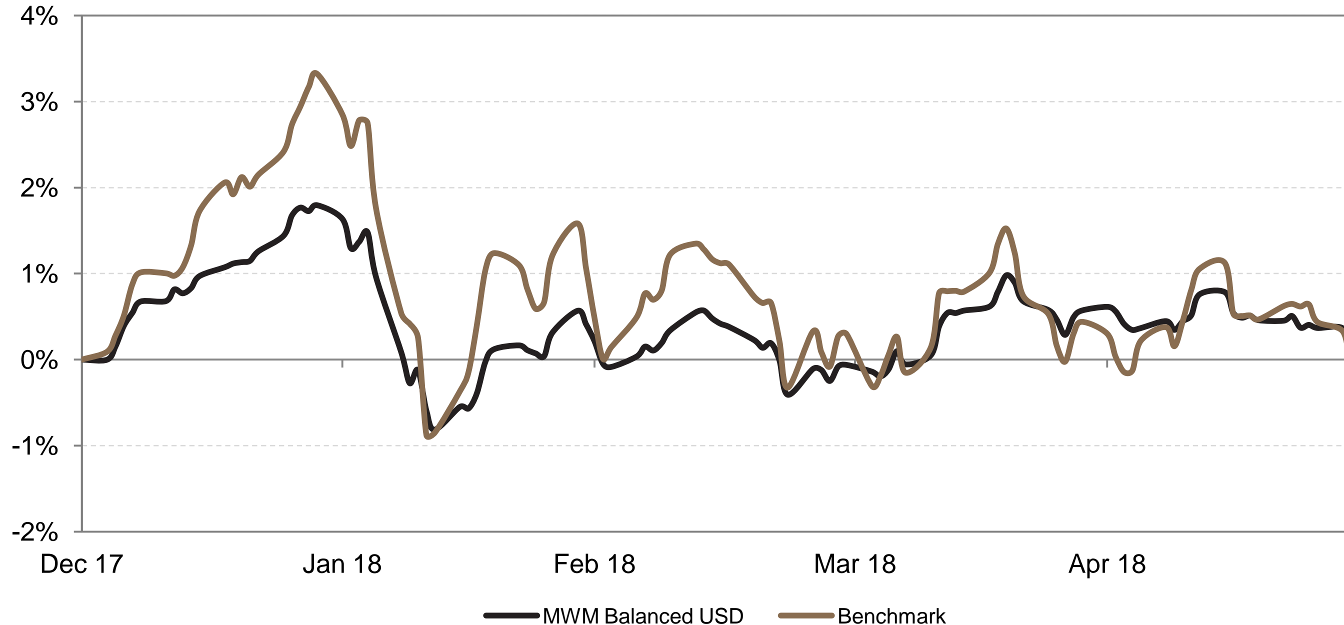
EWM Model Portfolio – Peer comparison



- **Total Return** (Ytd[1]): **4th 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]): **6th out of 15**

[1] As of June 1, 2018
Source: Bloomberg

EWM Model Portfolio – Ytd performance

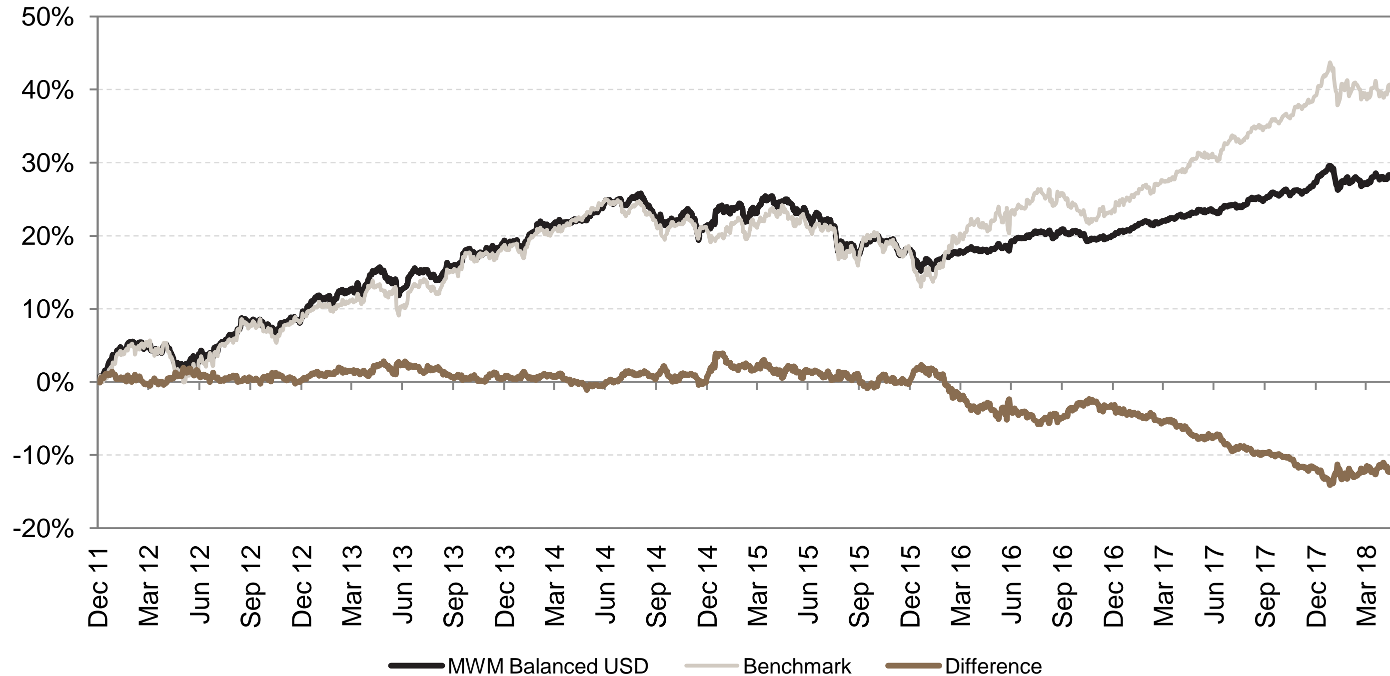


- **Total Return** (Ytd[1]): **0.31%** vs. **0.51%** Benchmark[2]
- **Standard Deviation** (Ytd[1]): **2.98%** vs. **5.46%** Benchmark[2]
- **Downside Risk** (Ytd[1]): **2.38%** vs. **4.28%** Benchmark[2]
- **Sharpe Ratio** (Ytd[1]): **-0.30** vs. **-0.05** Benchmark[2]

[1] As of June 1, 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)

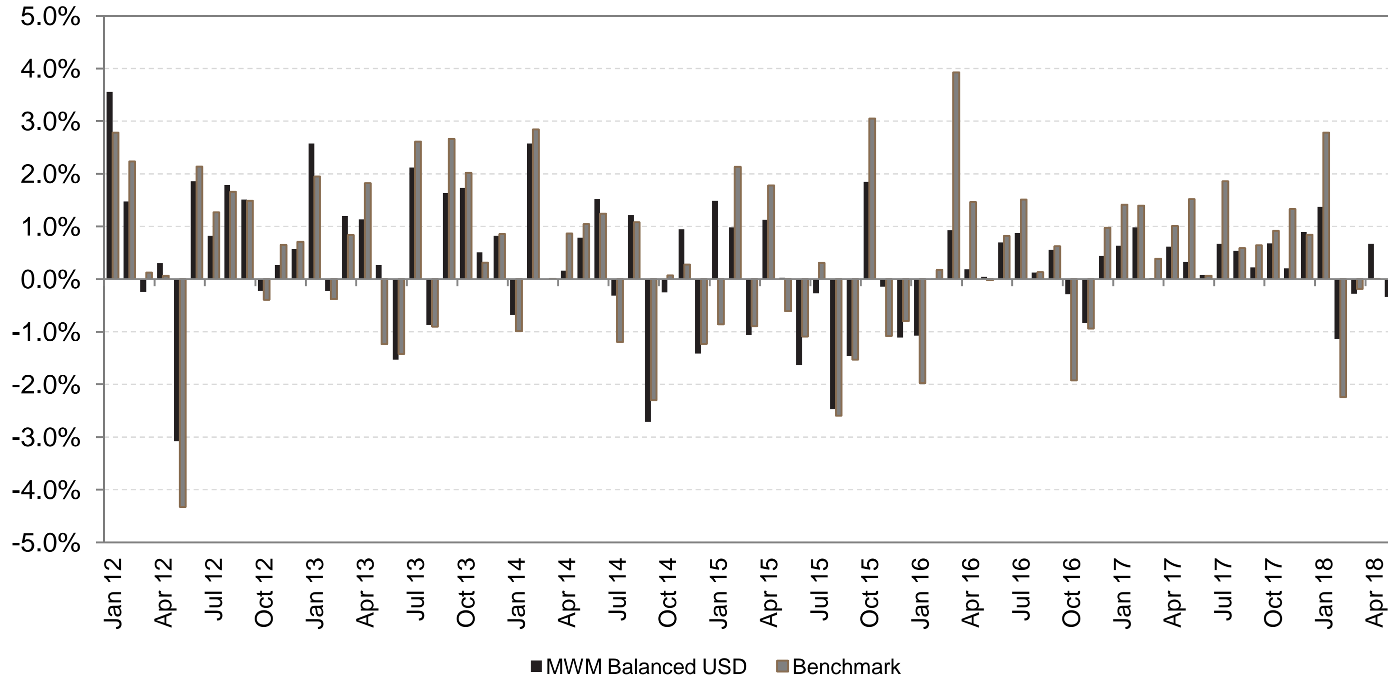


- **Total Return** (1 year[1]): **3.53%** vs. **6.81%** Benchmark[2]
- **Total Return** (3 year[1]): **2.67%** vs. **14.29%** Benchmark[2]
- **Total Return** (Since Jan 12[1]): **27.68%** vs. **33.78%** Benchmark[2]

[1] As of June 1, 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]): **2.29%** vs. **4.12%** Benchmark[2]
- **Downside Risk** (1 year[1]): **1.79%** vs. **3.21%** Benchmark[2]
- **Sharpe Ratio** (1 year[1]): **0.97** vs. **1.35** Benchmark[2]
- **Var 95% - 1day** (1 year[1]): **-0.20%** vs. **-0.41%** Benchmark[2]

[1] As of June 1, 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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