

# Panorama

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Investing in 2019 | UBS Asset Management



## Navigating volatile markets

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big picture

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landscape

In this edition of Panorama, our senior asset class and allocation experts assess the potential challenges and opportunities for investors in the year ahead.

The following pages bring you distinct viewpoints, drawn from the full breadth and depth of our global capabilities, to help meet your investment challenges.

For additional content and previous editions of Panorama, including 'Mid-Year 2018: Opportunities in a maturing cycle', visit [ubs.com/panorama](https://ubs.com/panorama).



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**Suni Harford**  
Head of Investments

# Riders on the storm

The double digit drawdown in global equities in October provided investors with compelling evidence, if it were needed, that the challenges they face globally as 2019 approaches have increased in both number and significance. The aging cycle, reduced support from monetary policy, higher equity market volatility, trade wars, Brexit, European political risk and rising bond yields, to varying degrees all threaten risk assets. Throw in the perception of heightened emerging market (EM)

vulnerability to desynchronized and moderating global growth drivers, higher US funding rates and a stronger US dollar – and the quandary facing asset allocators looks stark.

So how should investors approach the coming year given those challenges? In the Mid-Year edition of Panorama, we argued that investors would have to think differently, be more precise in their risk-budgeting and work harder for risk-adjusted returns than they have done for the majority of the post-financial crisis period. Six months later, that view remains unchanged.

As ever, genuinely diversified risk premia should, in our view, remain the bedrock of investors' portfolios. And as Ryan Primmer, Head of Investment Solutions, points out in our macroeconomic outlook, above-trend global demand growth, robust corporate earnings and more attractive valuations are still likely to support positive returns for global equities in 2019. In our view, this is not yet the end of the equity bull market. But on a risk-adjusted basis global equity returns are likely to be constrained by a continuation of the higher volatility regime and investors' understandable reluctance to pay peak multiples for what might prove to be peak earnings.

Genuinely diversified risk premia should, in our view, remain the bedrock of investors' portfolios.

## Flexibility and staying nimble are likely to be important qualities as opportunities and dislocations ebb and flow both across and within asset classes.

Within the traditional asset classes we would highlight once again that higher individual security dispersion within equity and bond universes is likely to go hand in hand with higher volatility. This therefore remains an environment in which active managers should prosper on a relative basis. Flexibility and staying nimble are likely to be important qualities as opportunities and dislocations ebb and flow both across and within asset classes. We therefore continue to advocate a bias to high conviction, active investment styles.

After a difficult year in 2018, the outlook for Chinese equities specifically and for emerging market asset classes more broadly is likely to remain a key focus for investors well into 2019 and beyond. The main takeaway from the views of our EM equity and fixed income teams is that the longer-term

fundamental story for EM remains intact. We accept that there are headwinds that are likely to mean continued volatility across EM asset classes in the short-term – but for patient investors current entry points look attractive in a long-term context. Bin Shi, Head of China Equities, argues that investors have not yet fully appreciated the changes made by the Chinese authorities to support the economy and equity market, nor recognized that in recent weeks China has opened up key industrial sectors to investment from overseas companies – an issue that had previously been a source of major disagreement with the US.

In our view, the case for alternative assets also remains compelling in the current market environment. In the following pages we outline the outlook across real estate, private equity and infrastructure markets. With greater flexibility and the ability to reduce and neutralize market beta, the rationale for selective hedge fund exposure is a logical extension of the case for high conviction, active long-only mandates. Bruce Amlicke, CIO of UBS Hedge Fund Solutions, outlines what he sees as a potentially very positive environment for a number of hedge fund strategies.

After a year characterized by mega-deals, we see an evolving opportunity set within the merger arbitrage space. Our merger arbitrage team highlights

the low beta opportunity for skilled managers created by continued geopolitical and regulatory uncertainty.

Amidst the breadth of medium-term investment insight across traditional and alternative asset classes, this 'Investing in 2019' issue of Panorama focuses on an increasingly important structural investment theme: sustainability. As a global leader in this space, sustainability factors are an integrated part of our investment processes across asset classes and across both active and passive approaches. We take the opportunity to highlight the potential for innovation in rules-based, carbon-aware equity strategies, and, separately, the vital role that stewardship and active corporate

engagement can play in achieving sustainable investing targets. As our sustainable and impact investing team makes plain, long-term drivers of corporate performance overlap considerably with sustainability issues in general and stewardship in particular. The relationship between active corporate engagement and long-term financial metrics is, in our view, hardly coincidental. It is also a timely reminder of the benefits of focusing on long-term drivers of return, even when the short- and medium-term challenges to risk assets are dominating headlines.

We look forward to our continued partnership with clients in the year ahead.

In our view, the case for alternative assets remains compelling in the current market environment.

# The big picture

## Global macroeconomic and tactical asset allocation outlook



**Evan Brown**  
Head of Macro  
Asset Allocation  
Strategy



**Dan Heron**  
Senior Investment  
Strategist



**Ryan Primmer**  
Head of Investment  
Solutions

We highlighted in the Mid-Year edition of Panorama that the rate of acceleration in the global economy had moderated and that growth rates by country and region had become more differentiated and less synchronized.

Those trends have largely continued in recent months, with the stark relative strength of the US amplifying investor concerns about the vulnerability of emerging market (EM) economies with high current account deficits, the outlook for lower growth in China as global trade tensions shift higher, and the prospects for economic growth in the developed world outside of the US. Meanwhile, with the populist Italian government on a collision course with the European authorities over fiscal spending and the outcome of the Brexit negotiations still uncertain, European geopolitical risks have also returned to the fore and are likely to stay high as we move into 2019.

Higher trade tariffs, rising bond yields, policy uncertainty and higher geopolitical risks all raise understandable

concerns about the outlook for global GDP into 2019. But without a more violent shift in expectations for any of these themes, we expect the combined impact to be moderate. Global growth in 2019 is therefore likely to be relatively solid and well above long-term trend growth for at least the first half of the year. Indeed, we see the potential for global growth drivers to partly resynchronize in early 2019 as recent China stimulus feeds through to demand and as the impact of the fiscal stimulus in the US starts to wane.

In the US, while the Federal Reserve (Fed) is raising short-term interest rates, it is doing so relatively gradually and with data dependence. Real policy rates remain very low by historical standards. Overall financial conditions in the US therefore appear far from restrictive and





still supportive to growth. Consumption remains supported by very strong labor markets, accelerating wage growth and by a prudent savings rate that has room to fall without being unduly concerning. Solid capital investment is likely to be driven by profits' growth and by recent tax incentives. The breadth of this demand suggests that the cycle may extend further than many economists currently believe, even if the pace of recent growth moderates into 2019 as the fiscal stimulus starts to fade.

Outside of the US, the monetary policy stances of the European Central Bank and Bank of Japan remain unequivocally stimulative to demand. Economic data in both regions year-to-date was disappointing. We see the potential for both regions to reaccelerate later in the year ahead – mainly due to rising consumption growth as wages tick higher. In Japan, a continuation of 'Abenomics' and support to the economy via structural reform, loose monetary policy and fiscal stimulus to offset the scheduled October 2019 VAT hike look

## Global growth in 2019 is therefore likely to be relatively robust and well above long-term trend growth for at least the first half of the year.

likely following the victory of prime minister Abe in his party leadership election.

In Europe, consumption growth appears relatively well supported by strong labor markets. We see scope for investment spending to pick-up from a low base and see the principal threats to growth as being continued political uncertainty in Italy, a hard Brexit and slower global trade. The European parliamentary elections are likely to provide important insight into the rise of populist parties. The unwinding of emergency policy conditions in both regions, which we already believed would be gradual, may now take place over an even more extended period.

In emerging markets, the backdrop remains widely varied. In our view the structural demographic story is far from over and continues to support long-term growth potential that is significantly greater than the outlook for the developed world. Given the improvement in fundamentals since 2013's Taper Tantrum, we believe concerns about a full blown emerging market crisis that began in August with the very sharp depreciation of the Turkish lira are overblown.

Nonetheless, a stronger USD dollar, higher USD funding rates and slowing global trade are all material short- to medium-term headwinds to the EM story – particularly for countries with



significant current account deficits, external funding requirements and limited FX reserves such as Argentina, Colombia and South Africa. Tighter US monetary policy and a stronger USD are also pressuring some EM central banks into a difficult decision – tighten policy in-line with the US or allow currencies to weaken and drive inflation higher through higher import costs. For Asian economies there have been additional drags on growth in the shape of higher oil prices and meaningful exposure to a slowing Chinese economy.

Recent data from the world's second largest economy has been disappointing as the Chinese authorities' crack down on pollution, excess capacity, high debt levels, inefficient capital allocation and financial sector risks continues apace. But the Chinese authorities have also been responding to the resultant threat to growth via a whole series of steps across fiscal, monetary and regulatory policy channels.

This more balanced policy approach provides strong evidence that China has learnt from policy mistakes of the past and is able to navigate the unquestionably difficult balance between short-term growth and long-term financial stability. While further measures to support Chinese demand are likely, we do not expect the authorities to engage in the sort of inefficient reflationary stimulus that has at least partially prompted the boom/bust cycles of the past.

**We believe that core inflation globally is likely to tick higher in 2019.**

We believe that core inflation globally is likely to tick higher in 2019, paced by the US, as output gaps close, higher input costs including oil prices are passed on to consumers and as wages rise in the developed world. Economic nationalism, deglobalization and protectionism continue to threaten higher prices globally.

However, we do not expect a violent shift higher in inflation given structural deflationary forces. We expect technology advancements, the continued rise of e-commerce and its associated price transparency, aging populations and low neutral rates across the developed world to continue to limit the upside for nominal bond yields and inflation.

Against this backdrop of above-trend global growth and generally muted inflationary pressures we remain positive on global equities going into 2019. We believe recent concerns about



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tightening US monetary policy and rising US bond yields are overdone. Historically, equity markets have struggled when real 10 year US Treasury yields approach real GDP. We are still some distance from that milestone. With global equity valuations in aggregate now below average on traditional earnings-based valuation measures – and attractive when compared to either government or investment grade corporate bonds – we remain comfortable that the bull market in equities still has further to run.

Nonetheless, returns from equities are likely to be more muted on a risk-adjusted basis. As the cycle matures, the range of potential growth, inflation and interest rate outcomes is broadening. We expect that this increasing degree of uncertainty will result in an increase in the overall volatility regime for all asset classes.

Other drivers to potentially higher volatility include continued US dollar strength and the gradual withdrawal of central bank liquidity. Finally, growing geopolitical risks including trade protectionism, Brexit and the current Italian budget stand-off are all likely to continue to impact markets globally and drive a higher volatility regime for risk assets. While some of these issues may be resolved relatively quickly, we see the overall growth in economic nationalism as reflective of structural trends that are unlikely to abate anytime soon.

At a regional level, US equity markets appear more expensive than their international counterparts. But they are

supported by a strong earnings and economic outlook. With less dependence on global trade, the US also appears less vulnerable than other markets to the impact of tariffs. Rising M&A and further capital returns to shareholders are also likely to remain key supports to US equities in the coming months.

Emerging markets appear increasingly attractive on valuation grounds relative to history and to international peers. But the near-term path looks volatile amid potential for a stronger USD and further trade war escalation. Elsewhere, we have become more constructive on Japanese equities in recent months.

Rising M&A and further capital returns to shareholders are also likely to remain key supports to US equities in the coming months.

We expect 2019 to offer investors a rich tactical asset allocation opportunity set.

Ongoing structural reforms support a higher rating while building economic momentum suggests the outlook for profits growth is stronger than markets are currently factoring.

Chinese equities remain vulnerable in the short-term to any broadening of the current trade stand-off with the US. But after recent falls, a gradual economic

slowdown is already priced in and the Chinese authorities have already shown themselves willing to boost liquidity to help smooth the ongoing economic transition. Longer-term we see the liberalization of China's capital markets and the resultant technical bid as a powerful catalyst to higher prices. The inclusion of onshore Chinese equities and local bonds in widely followed global benchmarks marks a significant milestone in that journey.

We remain underweight sovereign nominal fixed income globally but are neutral on US Treasuries. We believe Treasuries offer a comparatively attractive yield and provide protection against a potential flight to safety. In US high yield, current default rates are very low by historical standards and given the relatively positive economic backdrop, this is likely to remain the case. Nonetheless we do not see the risk/

reward as sufficiently compelling and within a portfolio context see underweight high yield as an effective hedge against our overweight global equity stance. Elsewhere within credit, emerging market real yields are approaching historical highs and appear attractive for investors with a long time horizon. But as with their equity counterparts, the near-term path is likely to be bumpy.

With a number of powerful big picture macroeconomic themes driving markets, we expect 2019 to offer investors a rich tactical asset allocation opportunity set.

Emerging markets appear increasingly attractive on valuation grounds relative to history and to international peers.





# Key investment views

Changing allocations Q2 2018 – Q4 2018

## Traditional asset classes

**Evan Brown**, Head of Macro Asset Allocation Strategy, **Dan Heron**, Senior Investment Strategist and **Ryan Primmer**, Head of Investment Solutions

Over the past six months our overarching views of the tactical outlook for major risk premia have remained largely unchanged. Against a backdrop of moderating but still above-trend global growth and generally strong corporate earnings, we have retained a positive view of global equities in aggregate. Meanwhile, with gradually rising inflationary pressures we have maintained a negative view of developed world duration.

Within each major asset class universe, changes to our preferred country or regional exposures have been subtle rather than significant. Within equities the largest change has been a downgrade to neutral for our expectations for Eurozone equities. While attractively valued, we believe that the return of more significant geopolitical risks in the shape of Brexit and the Italian populist government are likely to limit the upside in the short-term.

Within fixed income we have broadened our universe to include a standalone position in an asset class that is likely to garner significant focus as 2019 progresses: Chinese bonds.

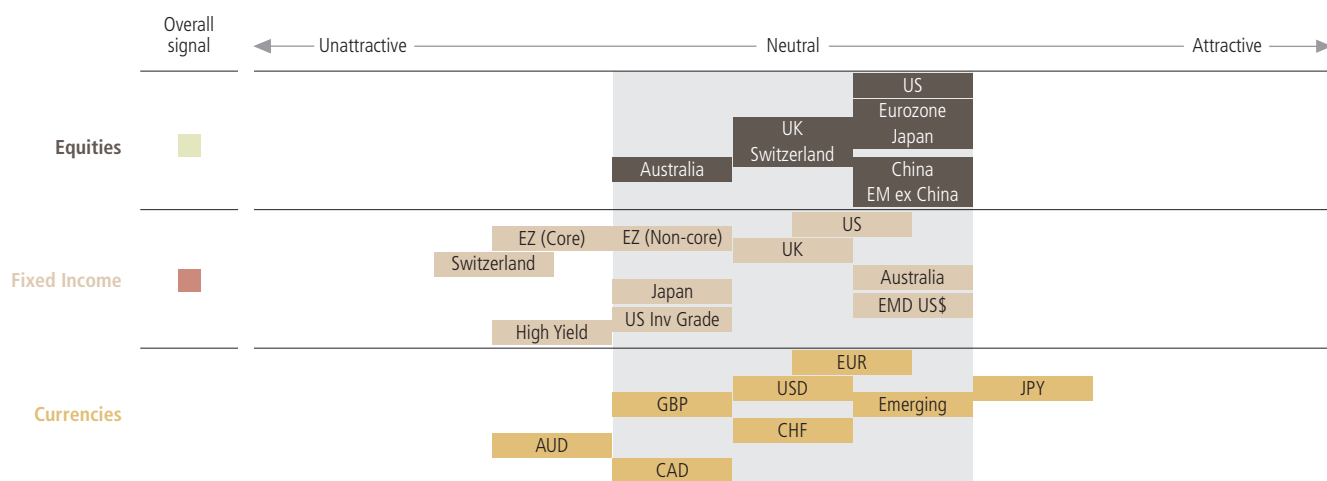
While unheralded by many institutional investors, China's bond market is already the third largest fixed income market in the world – and is soon to be the second. The attractions are straightforward. Chinese bonds have the highest nominal yields among the 10 largest fixed income markets yet have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. Slowing economic growth and the inclusion of local Chinese bonds in a number of key global indices in 2019 are likely to continue to push demand higher and so yields lower over the coming year.

Within currency markets we anticipate capital will flow from the US into earlier-cycle economies as 2019 progresses, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for JPY – which also offers attractive defensive characteristics in a wider portfolio context as a 'risk off' currency.

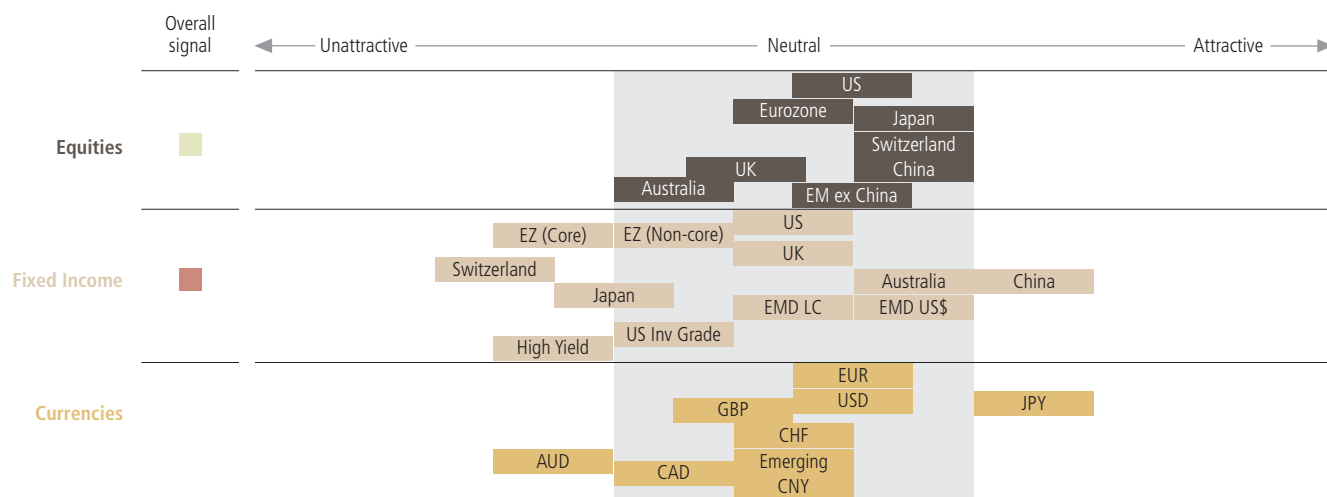


Overall signal =  Positive  Negative 

### Traditional asset classes, and currencies—as of 30 June 2018<sup>1</sup>



### Traditional asset classes, and currencies—as of 31 October 2018<sup>1</sup>



<sup>1</sup> Source: UBS Asset Management's Asset Allocation and Currency team, as of 30 June 2018 and 31 October 2018 respectively. Views are provided on the basis of a 12–18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change

## Multi-manager hedge funds

**Bruce Amlicke**, Chief Investment Officer of UBS Multi-Manager Solutions

We've previously remarked about our caution on the investible landscape in light of monetary tightening and the geopolitical backdrop, despite a buoyant US economy. Recent market volatility has validated some of our concern that the economic cycle is in its latter stages of productivity. Additionally, while earlier in the year we looked forward to the easing of geopolitical concerns (Brexit, trade wars, etc.), it seems those topics will continue to weigh on investors' minds as we move in to 2019.

Regardless of investor perspectives, markets have behaved more technically around crowded trades and liquidity. We continue to witness these events with the latest coming in the form of further systematic de-risking across the hedge fund universe in early October 2018, when quantitative futures strategies and Risk Parity funds reduced net equity exposure. While the sell-offs have been technical in nature, market participants await further fundamental news on corporate earnings and economic data to hopefully resume the trends set out earlier this business cycle.

Despite the technical backdrop, the economic picture remains strong. For perhaps the first time, markets are digesting whether some pockets are too strong. US markets have enjoyed a combination of strong fundamental data, robust employment numbers (the number of job openings now outnumbers the unemployed) and the tailwinds of fiscal policy – all of which, in theory, should be inflationary. Recent Fed statements indicate that the terminal FOMC rate in this cycle could well be higher than the widely discussed 2.75–3%. This has caused investors' mindset to shift – and markets to reprice higher rate expectations. It is this repricing coupled with the waning impact of fiscal policy in 2019 that gives us pause to reassess the market outlook.

While not showing the same robustness as the US, economic data continues to be relatively resilient in Europe and Asia. Nonetheless, higher uncertainty is reflected by European and Asian hedge funds having reduced their net exposures considerably compared to earlier in 2018, and in some cases toward their historical lows. Tariffs and trade war talk with China have exacerbated US divergence versus Asia, and there remains an overhang in European sentiment from Brexit and Italy's budget proposals. That said, the ECB will still look for opportunities to normalize monetary policy if growth permits, which would add to our concerns on liquidity and market technicals.

As market conditions continue to adjust to these new 'late cycle' data points, we look forward to seeing asset classes reprice and new flows catalyze. Such events support a desirable forward-looking outlook for hedged assets. While market volatility and risk re-pricing will undoubtedly affect strategies and geographies differently, we are excited about the coming opportunities and dispersion that markets will offer to the hedge fund universe.

Looking at equity hedged, we've generally seen sustained momentum in long exposures to growth stocks in general and technology in particular year-to-date, even if the sector rotation in early October saw a partial reversal of that trend. In recent quarters, we already positioned ourselves with lower beta, tactical managers and select sector specialists. Since managers are actively adjusting exposures and positions, we are likely to maintain our current sub-strategy profile. In Asia, where we've shifted some of our exposure to avoid crowded trades in the US, managers have generated alpha while notably reducing net and gross exposure due to the build-up of negative sentiment. Going forward, we believe Asia-focused managers could be poised for outperformance if headlines stabilize.

On the credit/income side, we remain purposeful in our allocations. Generally speaking, risk premia across credit is priced to perfection; therefore, we continue to avoid broad corporate exposure. The US real estate market is also divided, not unlike the labor market; while lower-priced homes are in short supply and prices are well supported, the upper end of the market is under pressure. We still favor Residential Mortgage Backed Securities, but must remain targeted and cautious. Finally, these conditions support our positive view on the uncorrelated reinsurance strategy where we plan to roll exposure another year, albeit at a reduced size.

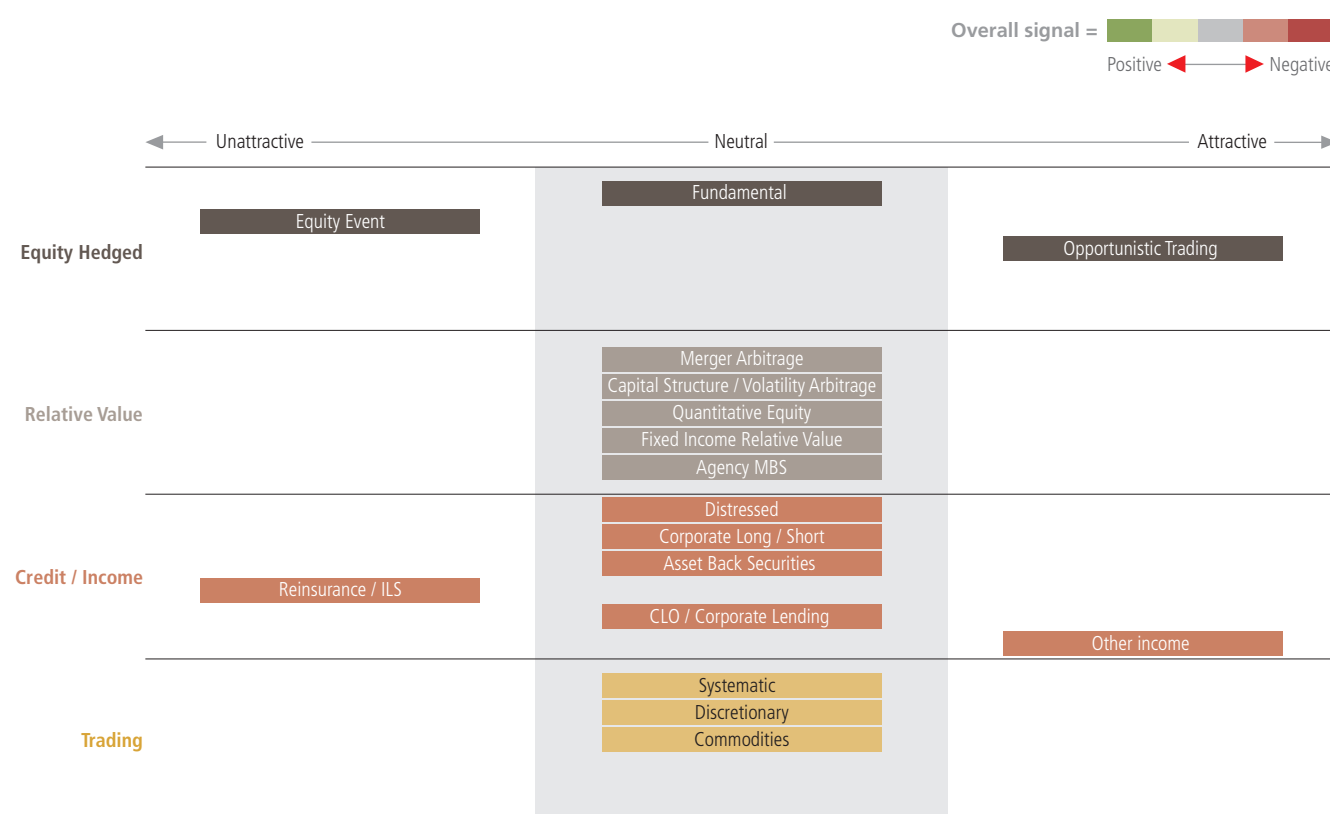
Relative value would benefit the most from a pick-up in volatility. Though returns were quieter over the summer months and capital has increased in the space, we will largely maintain our Fixed Income Relative Value (FIRV) allocations as we expect increased rate market volatility and dislocations from central bank activity. In merger arbitrage strategies, we've become a bit less bullish following some politically-related deal breaks, tighter spreads, and uncertainty presented by geopolitics and domestic politics. Going forward, we believe opportunities still exist in a smaller set of complex deals. We are maintaining our exposure to top tier merger arbitrage managers, but will actively adjust our exposure in response to changes in market volatility and deal spreads.

Elsewhere we may increase exposure to trading funds to take advantage of the strategy's diversification benefits and its potential to add long convexity to our portfolios. However, there is a crowding effect among traders' market views and a

consensus reflationary tilt in some portfolios: short US (and other DM) rates, oftentimes long equities. The case for EM-focused strategies is a little cleaner after two quarters of de-risking, though long-biased or beta-dependent approaches may still be challenged in Q4. As such, we prefer tactical managers with strong portfolio construction and dynamic risk management.

We continue to see consolidation within the hedge fund industry and bottom-up divergence between winning and losing funds in a year where the competition for alpha is fierce. We believe this phenomenon will ultimately benefit large hedge fund allocators like Hedge Fund Solutions (HFS) and our clients. The largest managers are upping bids for a finite pool of investment talent, while smaller firms are getting washed out of the market. This is especially true in quant equity, where large research and data teams are required for a strategy engaged in an arms race, as well as in fixed income relative value and trading, where the post-Volcker dealer desk landscape cannot engage in prop trading and is minting fewer experienced traders. Many multi-PM equity platforms, luckily, seem able to nurture their own analyst talent over time. These same firms have formed a habit of returning capital to LP investors – whether year-to-date gains or larger amounts, whether on a pro-rata basis or not – to preserve their limited capacity in an effort to increase returns. This also benefits their aligned partner capital.

## Multi-manager hedge funds—continued

Hedge Fund Strategies—Forward looking view as of Q4 2018<sup>2</sup>

<sup>2</sup> Source: UBS Asset Management's hedge fund team, as of Q4 2018. Views are provided on the basis of a 12–18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.



# Assessing the landscape



As we move into 2019, our industry experts assess the global investment landscape. Read more over the following pages on the challenges and opportunities in their respective asset classes.

## Focus areas explored:

China equities	Emerging markets equities	European equities	Fixed income	Emerging markets fixed income	Single manager hedge funds	Real estate, infrastructure and private equity	Systematic and Index	Sustainable and impact investing	Strategic asset allocation
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# An improving outlook

Renewed government efforts to support the Chinese economy represent opportunity

**Bin Shi**, Head of China Equities

While 2018 has been a challenging year, we believe recent policy developments constitute a turning point for China's stock markets and that the current environment presents investors with an opportunity to add to their China equity allocations.

## **China's policy stance has changed**

We moved to a more cautious stance to the market earlier in 2018. This decision was driven by the Chinese government's tough approach to broader regulation and to debt deleveraging in particular, as well as the US/China trade dispute.

But looking at a series of recent policy statements and news announcements, we believe there has been a significant change in the Chinese government's attitude, making a compromise on US/China trade issues more possible going forward. BMW's recently announced move to take majority control of its local joint venture with Brilliance Automotive, a China-based automaker, shows that the Chinese government has opened up key industrial sectors to investment from overseas companies, reversing a position of limiting investment into China that has been a key source of disagreement in the US/China trade dispute.

## **But policy changes haven't yet been fully absorbed by the market**

Additionally, the Chinese government has reversed a series of tough policies introduced earlier in 2018, such as a social security tax and taxes on private equity investments, demonstrating a concerted effort to step up support for the economy.

These changes in domestic policy are highly significant because the government's previous policy attitude has hurt investor confidence and has been the biggest influence on the market this year. As noted earlier, some of these policy changes provide hope for a reduction in US/China trade tensions, which have also been a contributing factor to market volatility.

Though we have seen a lot of government announcements, we feel that the new policy support has not yet been fully understood or absorbed by the market. However, we believe it will positively impact investor sentiment going into 2019.

Significantly, the change in policy attitude, and the increased possibility of a resolution to trade issues, means that systemic risk in the Chinese equity market has diminished significantly.

## **We are putting cash to work**

As such, we have turned more positive on the outlook for China equities.

During the first half of 2018 our cash levels increased because of weaker sentiment and heightened volatility in the market but recently we have deployed some of that cash.

Going forward, we expect to put more cash to work because we believe that current valuation levels in China's equity markets are attractive and we see many opportunities in which to invest.

### Staying disciplined, focused on long-term winners

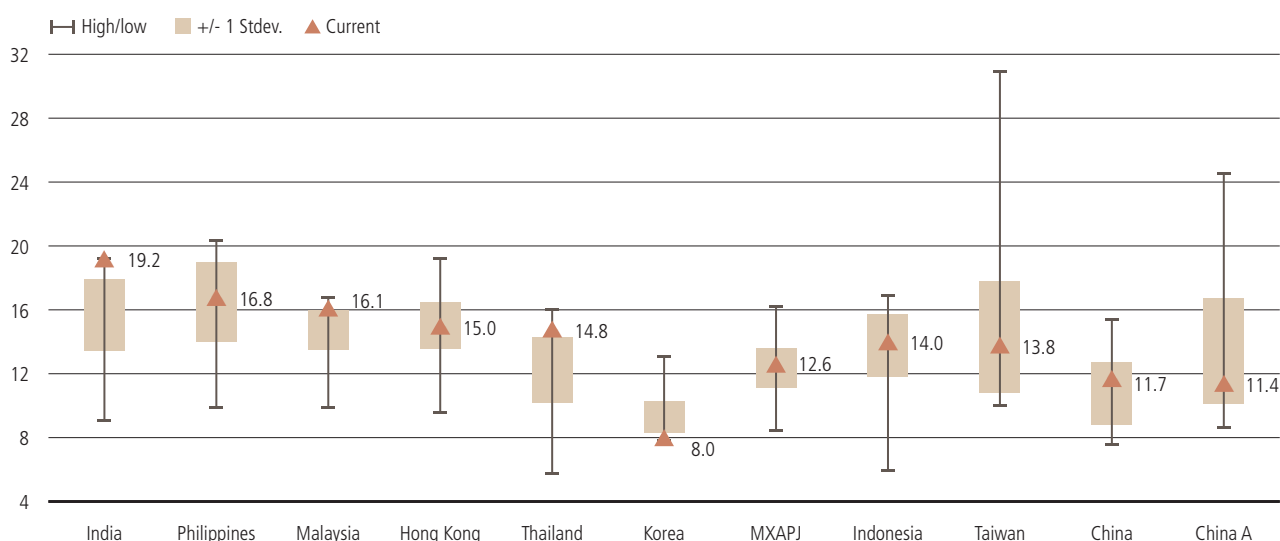
Though we have turned more positive on market prospects and we will likely be less defensive in our equity allocations in the near future, we'll remain disciplined in our investment approach.

We will maintain our focus on companies that we believe will deliver growth over the long-term. We continue to be positive on 'new economy' companies in sectors like consumer, IT, and healthcare.

We'll most likely add to sectors highly impacted by government regulations, like online gaming and education, because we expect some of these regulations to be relaxed in the future.

In summary, we think that investors have reason to be more optimistic on Chinese equities and, as we see an improving outlook for the market, we believe it is a good time for investors to take action.

**Exhibit 1: 10 years' History: 12M forward P/E Ratio**



Source: FactSet, MSCI, UBS Asset Management, data as of end September 2018.

# Still in a long-term upcycle

After a perfect top down storm in 2018, there are now large opportunities in emerging markets equities

**Geoffrey Wong**, Head of Emerging Markets and Asia-Pacific Equities

Our positive stance on emerging markets (EM) since 2016 was predicated on the growing economic growth gap between EM and developed markets, plus a favorable cycle for EM accompanied by improving fundamentals at both the country and company level. This was driven in large part by a reduction in capex over the past few years, which contributed to a recovery in margins and profitability, China's continued rebalancing into services and consumption, and fair valuations, which are much cheaper than the US.

## **Tighter financial conditions**

Given the strong domestic economic backdrop in EM countries, equity markets were well placed to withstand the rise in US bonds yields until early 2018. But the strength of the US economy, growing US/China trade tensions and the softening of growth prospects outside the US created a number of headwinds to EM equity performance.

Significantly higher US Treasury yields and a stronger US dollar have tightened financial conditions in EM and placed fresh pressure on EM currencies. Meanwhile, despite the increase in intra-EM trade in recent years, EM economies are still more exposed to global trade than their developed counterparts.

These combined factors triggered particular problems in small economies with large current account deficits and high net external debt such as Argentina and Turkey – and increased investor concerns about widespread contagion across the EM universe. This knee-jerk reaction and nervousness was more in-line with historical views of EM vulnerabilities. These developments caused outflows from fixed income markets and EM ETFs, which in turn created downward pressure on EM currencies and upward pressure on rates. With the drawdown even hitting companies with strong fundamentals, we believe the sell off to be overdone.

## **Chinese authorities to soften slowdown**

All of this comes as China's efforts to reduce systemic risk by stabilizing leverage in its economy is inevitably creating near-term headwinds to the outlook for growth in Asia in particular.

But the Chinese authorities have responded to soften the growth slowdown by stepping up both monetary and fiscal policy support – all the while maintaining the long-term commitment to deleveraging and reforms. The result should be more sustainable and higher quality growth down the road. We believe there are still many levers the Chinese authorities can pull to successfully manage a gradual slowdown and avoid a hard landing.

The long-term investment case in China remains centered around the rebalancing of the economic structure toward services and the ensuing investment opportunities across sectors such as e-commerce, e-payments, social media, education and insurance. We are, however, closely watching the increased regulatory interventions in areas such as education services and gaming which have served to dampen recent investor sentiment.

## **Despite near-term risks, large opportunities exist in various sectors**

Looking forward, it seems unlikely that the US-China trade tensions will dissipate in the short-term. In our view, the escalation of the US/China trade conflict has increased the risks around an EM economic recovery.

But while investor concerns are understandable in light of recent events, the real long-term impact of all of the above across EM remains fairly limited in terms of economic growth and company earnings. Against this backdrop the market reaction appears to have been driven by a sharp change in sentiment and subsequent outflows.

Yet history tells us that this is an asset class prone to short-term swings in both sentiment and market prices. In part we believe that this reflects that for many global investors, EM equities remain a tactical rather than a strategic allocation.

We believe that the current risks are already largely discounted in current valuations, which have fallen to 1.6x on a Price to Book (P/B) basis from 1.9x in January. Current valuations



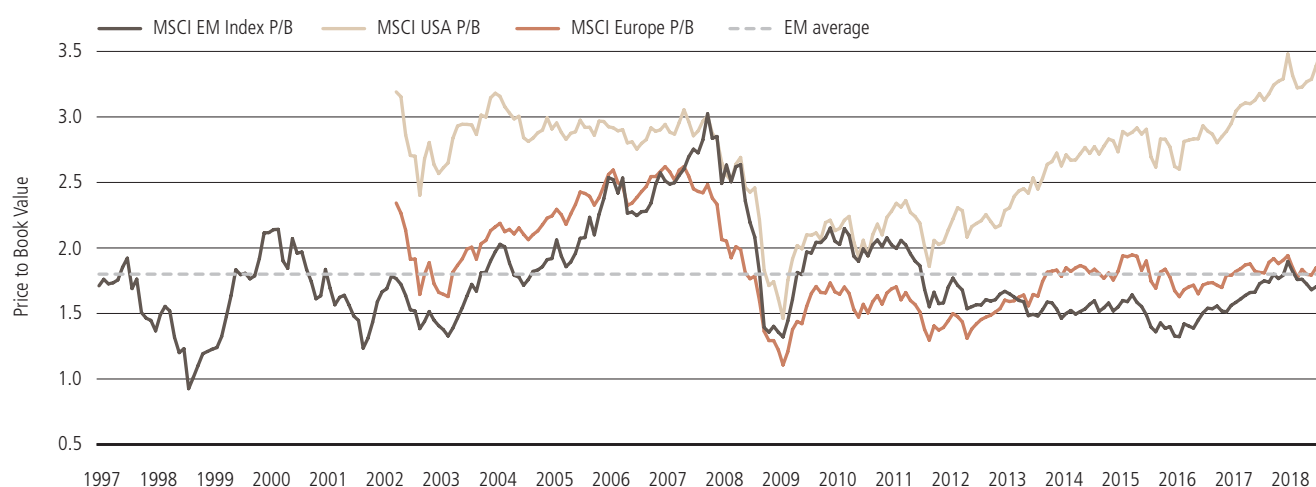
now sit well below the long term average of 1.8x P/B. EM currencies have also corrected meaningfully this year and we believe are undervalued.

Our positive mid- to long-term outlook for EM equities therefore remains unchanged. EM assets look attractively valued. Looking at current account balances and net external debt levels we maintain our view that most EM countries are fundamentally healthy. At the company level, we believe profitability and earnings growth prospects remain generally robust.

Our analysis shows that large opportunities exist in various sectors, including consumer, internet/e-commerce, and financials. While there are some small vulnerable spots in EM, we are mindful of these risks and have very limited exposures to these areas.

However, while near-term risks remain, a combination of the following catalysts could prompt a swift change in investor sentiment to EM: any improvement in rhetoric between the US and China over trade, reduced regulatory intervention in China, and perhaps most important of all – a stabilization in recent USD strength.

#### Exhibit 1: EM valuations are inexpensive



Source: FactSet, MSCI. Data up to 30 September 2018.

# Focusing on fundamentals

## Slow but positive growth expected

**Maximilian Anderl**, Head of Concentrated Alpha Equity and **Nicole Lim**, Equity Specialist/Analyst

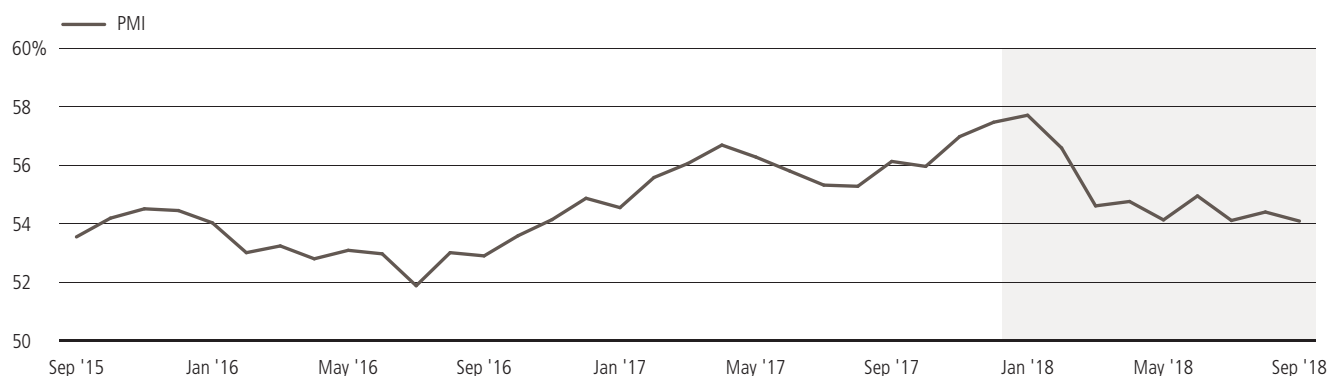
Strong macroeconomic fundamentals and positive sentiment served as a bullish backdrop for European equities in 2017 which continued into the start of 2018. More recently, the sell-off in October left many investors with a sense of déjà vu, reminiscent of the global market falls earlier in 2018. In our view, this correction was largely driven by the spike in US long-term bond yields. While we recognize that rapid moves in yields can be temporarily destabilizing and damaging for equity markets, we do not think the level of yields is enough to see a substantial fall in the market or fundamentally undermine the case for European equities. Instead, given strong fundamentals, this opened up opportunities at a single stock level for investors.

Looking ahead into 2019, the overall global economic picture is less clear. We saw a slowdown in 2015, followed by a recovery in 2016 and synchronized growth in 2017. We believe global growth will be less synchronized going forward as

growth in some countries is slowing down. In Europe, we have already seen some signs of this, as indicated by declining leading economic indicators (Exhibit 1). However, it is important to remember that these indicators have fallen from very high levels and still remain healthy.

Despite an uptick in political risks, most notably Brexit and Italy, and rising interest rate costs this year, we believe that there are no meaningful indications that the slowdown will lead to a recession, either for the European or the global economy. We are merely experiencing slower but still positive growth. In addition, while there has been much talk about inflation, realized core inflation in Europe remains muted and below forecasts. So far, there is not yet any indication of sharply falling profits. European EPS growth forecasts are below the US but this is not unexpected considering the effect of the US tax cuts.

**Exhibit 1: EU Composite Purchasing Managers Index (PMI) (%)**



Source: FactSet, as of 30 September 2018.

In terms of valuation, the European market has become less expensive relative to recent years, as shown in Exhibit 2 by the price-to-earnings ratio that has fallen below its long-term median. With earnings now at more reasonable levels, the likelihood of a downturn has also diminished. We believe the current economic environment presents investors with opportunities to find names with good risk/reward.

Just as the Brexit vote in 2016 was difficult to predict, the final outcome for the UK seems equally difficult to judge. The situation remains fluid. We suggest that investors avoid taking large risks around the outcome. In the event of a hard Brexit, it is inevitable that there will be some damage to European companies, given that the UK is one of Europe's biggest trading partners. We believe companies that have a higher proportion of international sales exposure versus domestic

sales will benefit in the current environment. The Italian budget negotiations remain an overhang for risk taking activity in European equities. Both of these political risks are partly priced in and reflected in valuations.

Large central banks, with the exception of Japan, have started to reduce their loose monetary policy with the Fed tightening monetary policy. This should make it an interesting environment for stock pickers. Stable growth companies and defensive companies in the IT and healthcare sectors will continue to do well in this environment. Banks, which are susceptible to any increase in political risk, remain a difficult sector, while insurance offers better and more stable yields. The outlook for industrials and capital goods companies continues to be uncertain and valuations are still not attractive.

**Exhibit 2: MSCI Europe 12-month forward price-to-earnings**



Source: Morgan Stanley, as of 23 October 2018.

# The power of income

## Opportunities exist in a rising rate environment

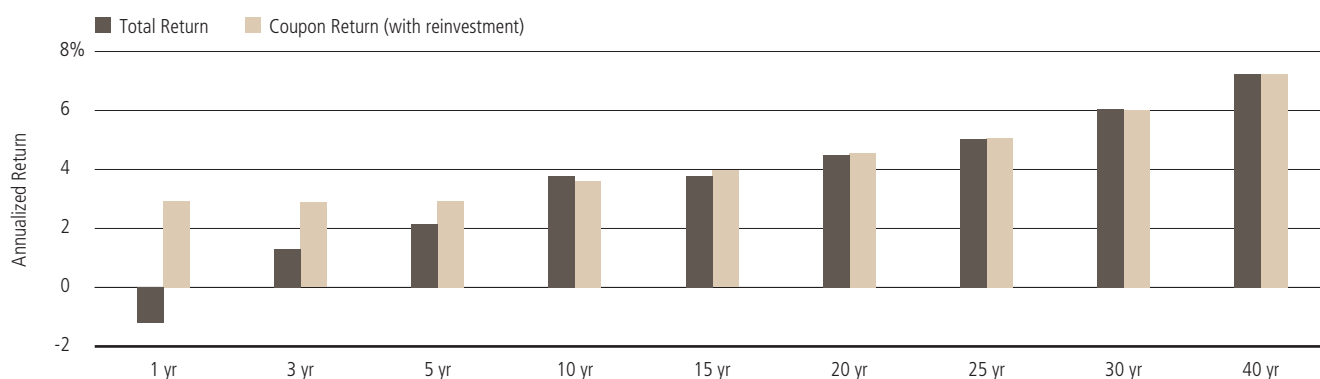
**Jeff Grow**, Senior Portfolio Manager, Fixed Income

We are mindful that bond investors face constant trade-offs, particularly when seeking to balance their need for both income generation and capital preservation. With the era of ultra-accommodative policies nearing an end and as interest rates increasingly diverge across markets and volatility increases, we believe the importance of income will become ever more prominent in investors' minds.

In the short run, coupon income serves as the core foundation for total returns, making a positive outright contribution, and absorbing the negative price returns that have resulted as bond yields moved higher. Over the longer run, coupon returns tend to approximate total returns, as most capital-induced volatility fades into the background. Exhibits 1 and 2 illustrate the outsized contributions made by coupon income, relative to the total returns generated over time by the Bloomberg Barclays US Aggregate Index and the Euro Aggregate Index.

In the current environment, we believe there are a number of areas that can offer investors the economic return they require in the form of a regular stream of coupon income. This includes floating rate bonds which see their cash flow increase in a rising rate environment while maintaining a relatively low price sensitivity to changes in interest rates because their coupon rates mirror the market interest rate. For investors concerned about a sustained increase in interest rates, credit exposure at the front end of the yield curve continues to look attractive. Given the flattening of the US yield curve this year, short dated credit exposure looks particularly interesting on a risk-adjusted basis. We believe carry (coupon earned) provides a solid income stream with limited downside risk given fundamentals in corporate credit continue to look healthy. Further, for bondholders that have benefitted from traditional corporate credit over the last several years, incorporating securitized assets into a broader portfolio construct can potentially help reduce volatility and enhance risk-adjusted

**Exhibit 1: Returns for the US Aggregate Index**



Source: UBS; Bloomberg; Barclays. Data as of 31 September 2018.

returns with securitized bonds exhibiting moderate correlation to investment grade and high yield corporate credit. In the current environment, one of the more important and underappreciated attributes is the diversification these assets can provide.

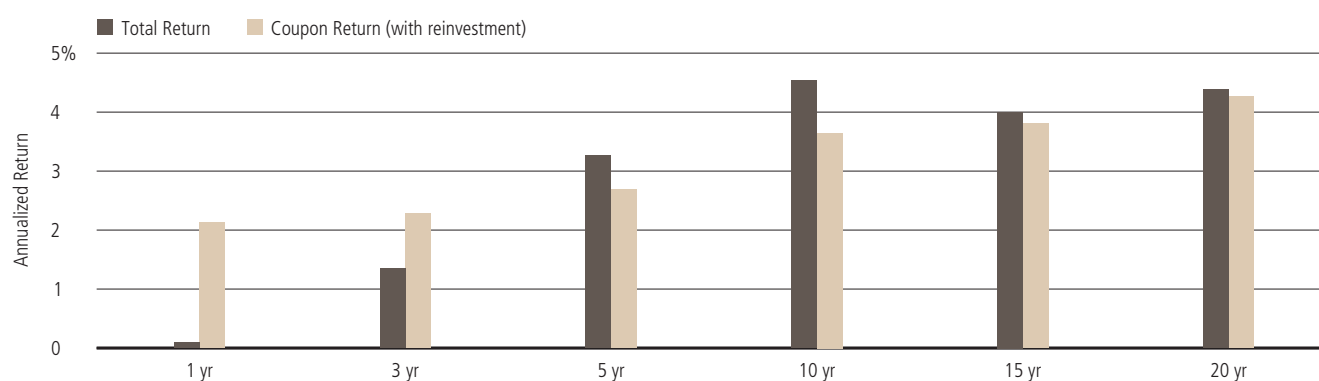
#### Pursuing opportunities across all fixed income return drivers

With a mindset that places income squarely as the key element of total return, we approach the prospect of rising global interest rates with perhaps a slightly different perspective than others. We believe that higher bond yields will be translated into higher coupon rates, which will subsequently be translated into higher income returns. This is a positive development for all income-dependent investors over the medium term.

Looking into 2019, we see the Federal Reserve continuing on their gradual path of normalizing rates. The European Central Bank, eyeing a sustained but moderate growth and inflation path, will taper their asset purchases in late 2018 and are expected to start preparing to lift the discount rate late in 2019. We believe that the beginning of the end of negative/ ultra-low cash rates is a very positive development for fixed income markets and investors which will increase the search for income across the asset class.

Having this medium-term focus on total return allows our portfolio managers to direct their efforts towards maximizing value within each of the key drivers to total returns in fixed income portfolios: coupon income, currency, price and paydown, but also to control the risks within each of the key drivers to enhance and smooth the returns from the market. To do so, first and foremost, requires a commitment to active portfolio management.

**Exhibit 2: Returns for the Euro Aggregate Index**



Source: UBS; Bloomberg; Barclays. Data as of 31 September 2018.



# Volatility presents opportunities

Selectivity in current markets is key

**Federico Kaune**, Head of Emerging Markets Fixed Income

There is no question that emerging market (EM) debt investors face a number of headwinds in the short to medium term. Desynchronized global growth, tighter monetary conditions and idiosyncratic issues are likely to continue to weigh on investor sentiment. But we also see a number of the headwinds to EM debt reducing over the coming months and have a constructive bias ahead of those improved dynamics. Amidst the negative headlines, the core fundamentals for EM debt overall remain favorable and corporate fundamentals continue to reflect improving long-term growth prospects. For investors with a long-term horizon, current yields appear to be an attractive entry point.

The recent volatility in EM debt has been fueled by a number of factors. These include moderating and less synchronized global growth, rising geopolitical and trade uncertainty, and poor policy responses to financial pressures in EM countries including Turkey and Argentina. The increase in volatility across EM credit, FX and rates has seen EM debt values fall amid limited liquidity and persistent outflows. Political uncertainty in Brazil, a strengthening US dollar, the threat of sanctions in Russia and potential land grabs in South Africa have all further impacted investor sentiment.

But while the global growth impulse has moderated, the residual rate remains above trend. With ex-US growth stabilizing, we see less pressure going forward on EM debt from global growth concerns or the US dollar. Meanwhile, after a number of policy measures aimed at cushioning the growth slowdown, we expect China to show better activity data going forward. New investments and higher spending announced by the Chinese government are likely to support demand growth, albeit that they come with the risk of increasing already high leverage in China.

Intensifying trade tensions between the US and China make the economic outlook for emerging market countries somewhat more cloudy. But sentiment regarding trade policies is already extremely negative. And while it seems unlikely that the combative rhetoric between the US and China will evolve into something significantly more conciliatory in the short-term, on balance we believe that a great deal of bad news is already priced in. So while it is unclear whether the stage is set for a more positive 2019 in terms of trade rhetoric, or more of the same of what investors witnessed in 2018, we believe that the balance of risks is to the upside given the degree of current negativity.

On the supply side, we expect net corporate issuance to increase, but to manageable levels. Supply from China has been lower than expected and is likely to remain low while political tensions between the US and China remain.

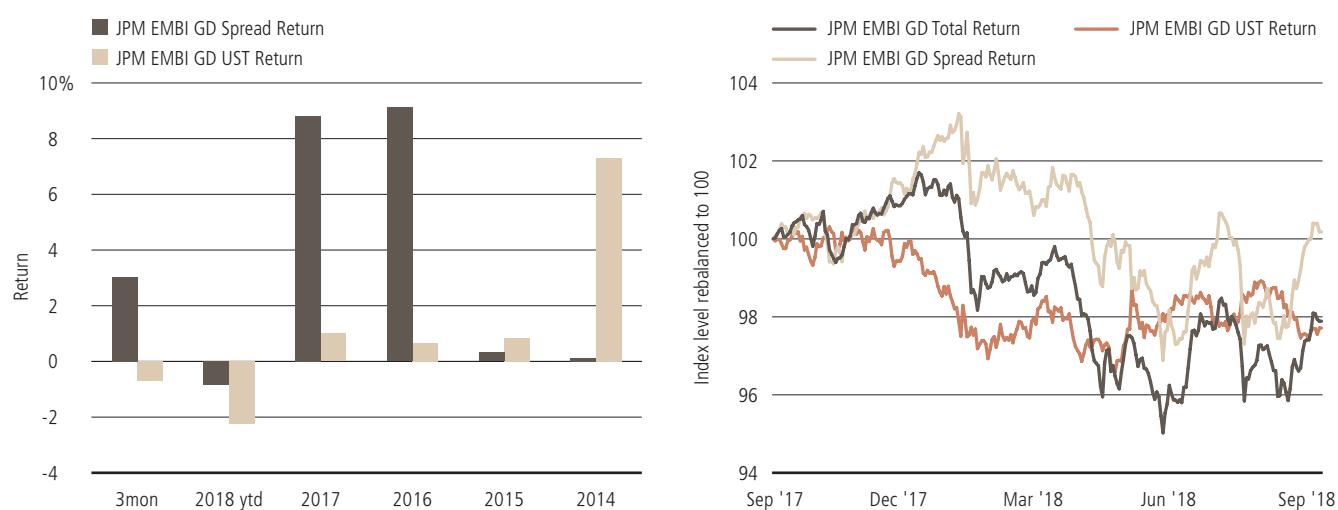
On the other hand, caution is warranted in countries like Turkey where we expect to see continued volatility, economic slowdown and stress on financial institutions and domestic-oriented issuers. Selectivity in current markets is key.

Lower economic activity and still-high leverage metrics in China argue for continued caution. However, we retain our positive stance toward systemically important state-owned enterprises in China, especially energy-related and financial institutions.

There are pockets of value in sovereign EM credit including several high yielding countries that are likely to get financial support from multiple sources. We remain broadly cautious in EM sovereign credit on a short-term horizon but see the longer-term story as robust and retain exposure to several high yielding countries.

Risk appetite in emerging market credit continues to be driven by headlines. We will continue to monitor trade disputes and tariffs between the US and China along with continued stress in Argentina post an IMF bailout, additional sanctions on Russia, policy responses in Turkey and the behavior of the new governments in Mexico and Brazil later this year.

**Exhibit 1: Sovereign debt – Q3 posted high volatility on both sources of return**



Source: JP Morgan monitor, 28 September 2018. Rebalanced to 100 as of 31 September 2017.

# Valuable trades

## Strong M&A continues to support merger arbitrage strategies

**Blake Hiltabrand**, Head of Merger Arbitrage Research and Senior Portfolio Manager

### A robust deal environment

Over time merger arbitrage has produced attractive risk-adjusted returns with low beta relative to other asset classes irrespective of the macro environment for mergers and acquisitions (M&A). Today, we consider the current environment to be very supportive of the strategy due to historically high levels of M&A activity, heightened complexity in regulatory/trade policy and a relative imbalance in supply vs. demand.

M&A benefits from the cyclical and structural forces that are driving corporate management teams and boards to pursue acquisitions:

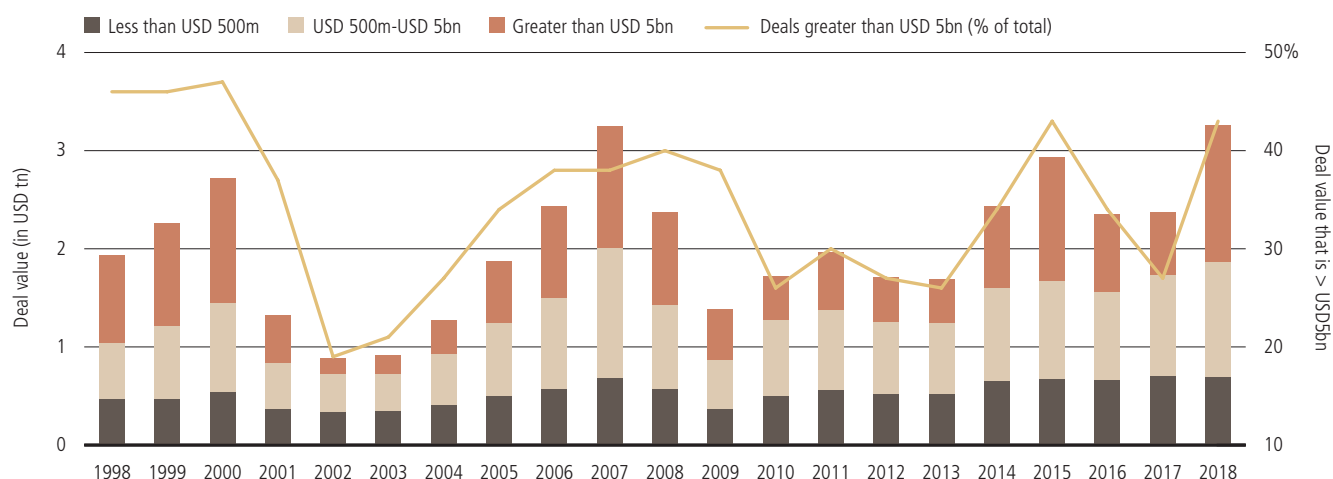
- Despite strong economic growth in the US, organic corporate growth remains subdued across many sectors and geographies globally.
- Continued low interest rates have created accommodative financing in both credit and equity markets.
- Corporate confidence remains strong, buoyed by economic strength and policy changes in developed markets.

Noteworthy drivers include recent changes in US tax policy, improving economic conditions and business confidence in Europe, the need for legacy businesses to adopt new technologies, increasing shareholder activism and record levels of available capital held by private equity investors.

### Larger transactions present greater opportunity

Over the past 12 months the merger headlines have been dominated by 'blockbuster' deal announcements, frequently surpassing USD 30 billion in size. Mega-deals such as Disney/Fox, Takeda/Shire, CVS/Aetna, and Cigna/Express Scripts tend to have a higher degree of business and regulatory complexity and consequently offer higher implied risk and higher potential return. However, while large deals have attracted media attention, there has also been an increase in small- and mid-sized transactions, providing a universe of diverse opportunities to capitalize on deals across industry sectors and regions.

**Exhibit 1: Riding the wave of megadeals**



Source: Refinitiv, data as of 30 June 2018. Used with permission.

**Supply/demand imbalance continues to create attractive pricing**

Historically, merger arbitrage was one of the most popular strategies of bank proprietary trading desks, dwarfing individual hedge funds in the space. In 2011, the Volcker Rule banned proprietary trading, eliminating the largest buyer of merger deals from the market. This handed a significant structural advantage to merger arbitrage hedge funds by shifting the supply-demand dynamic. Today's record number of deals creates a vast amount of shares coming to market after a transaction is announced, as fundamental investors exit positions. Facing this wall of supply are fewer arbitrage dollars intermediating the market, which has resulted in more attractive pricing, wider deal spreads, and potentially higher returns for investors.

**Geopolitical complexity and regulatory uncertainty create opportunity**

The geopolitical landscape has changed considerably over the past two years, particularly across US trade policy with China and Brexit in Europe. Recently we have seen China's regulator, the State Administration for Market Regulation (SAMR), become more politically motivated in their approval process as US trade rhetoric has become more strident. Within the US, regulatory agencies such as the Department of Justice and the Federal Trade Commission have become more unpredictable in their interpretation of policies and precedents used in

approving transactions. This increased uncertainty has led to a widening of spreads, particularly in cross-border transactions and those requiring approval in China, placing skilled managers at an advantage to effectively manage the risks around deal breaks. The increased risk in the current opportunity set can be outweighed by higher potential returns.

**Portfolio construction and research: a global perspective**

The M&A space is global in nature, and we believe merger arbitrage is best pursued through a geographically agnostic approach that allocates capital purely based on the most attractive risk-weighted opportunities globally. This is particularly important given the current trend of cross-border transactions and multi-jurisdictional regulatory approvals. Over time both our investment horizons and research capabilities have expanded to best take advantage of merger transactions around the world, allowing our investors to benefit from the greater complexity of these situations.

Going into 2019, we believe M&A deal flows will continue to be driven by strong structural and cyclical factors, which provides a robust investible opportunity set across a range of geographies and sectors. Additionally, we feel the more complex regulatory/political environment globally will likely provide enhanced opportunity for dedicated merger arbitrage managers to continue to generate strong absolute and relative risk-adjusted returns going forward.

# Alternatives remain resilient

Increasing allocations to alternative assets set to continue in 2019 amid search for higher yields

## Real estate

**Paul Guest**, Lead Real Estate Strategist

The positive momentum continued in 2018 for real estate investments and market activity remained healthy. According to preliminary data from Real Capital Analytics, total transacted income-generating property (i.e. excluding land sales) came to USD 627 billion for the first nine months of the year.

Activity is just north of the long-term average and was slightly higher than in the first nine months of 2017. Broadly speaking we have a healthy, stable level of activity. Investment volumes slowed sharply from late 2015 led by the US, troughed in 1H 2017, and then picked up slightly courtesy of Europe. Pricing dynamics remain positive: substantially more markets are seeing yield compression, rather than expansion, but the pace of price growth continues to slow.

Looking ahead, we expect the narrowing of risk premia as a result of rising long-term interest rates to ultimately put upward pressure on property yields. In the case of retail, however, it is structural. Whether in listed real estate, institutional portfolio valuations, or in the prime data, we are beginning to see the adjustment in retail pricing, particularly of lower quality assets, reflecting ongoing structural change in the sector. We expect this to continue into 2019. In contrast, logistics properties continue to benefit from some of the same trends afflicting retail, surprising on the upside both in terms of rent and value growth.

## Infrastructure

**Declan O'Brien**, Senior Analyst, Research & Strategy Infrastructure

Institutional investors are allocating increasing amounts of capital to infrastructure – largely due to its low correlation to other asset classes, stable cash-yield and inflation protection qualities. The OECD estimates that global infrastructure investment needs USD 6.3 trillion per year until 2030 to support growth and development and to meet demand. In the private infrastructure equity market, fundraising set a new record in 2016 which saw USD 66 billion raised. This momentum continued into 2017 which saw USD 65 billion raised. The attractiveness of infrastructure has been driven by its strong returns in a low-yielding environment. The level of dry powder is at record levels as demand for high yielding assets exceeds investment opportunities. Growth in this sector means that investors now have a choice of managers across the risk-return spectrum.

There is a growing secondary market for infrastructure assets, which has supported the strong overall performance of infrastructure. As capital-growth strategies are reliant on successful exits to meet return targets, a healthy secondary market supported by strong liquidity from new inflows is paramount. However, the record fundraising has also led to an increasingly competitive market, fueling rising valuations and a focus on non-core strategies.



At the same time the investable universe of infrastructure assets continues to grow. Over the past few quarters, we have seen strong transaction activity in the communication sector. Investments have been in fiber optic networks, data centers as well as mobile towers. Other areas of growth are social infrastructure as well as distributed energy. While some investors are concerned about rising interest rates, we believe that the attractiveness of infrastructure for investors is still high. According to Preqin's 2018 Global Infrastructure Report, 90% of investors are expecting to deploy at least the same amount or more capital to infrastructure over the next 12 months; 93% felt infrastructure had met or exceeded their expectations, which is a large increase from previous years.

#### Private equity

**Markus Benzler**, Head of Multi-Managers Private Equity

Against a backdrop of still positive global macroeconomic conditions and a generally strongly performing public equities market, private equity continued to attract strong inflows globally and across various investment strategies. As in prior years, this was driven by investors' appetite for strong risk-adjusted returns and portfolio performance drivers as well as portfolio diversification. Some investors are, at the expense of public equities, further increasing their overall allocation to alternative asset classes such as private equity.

Undoubtedly, the equity bull market witnessed has been partly fueled by the quantitative easing (QE) program undertaken across much of the world. As this tapers, as is expected, global growth may slow to the point of a downturn. While increased prudence and additional caution is advised, we do not think private equity will drop off significantly. We maintain our conviction that growth activity, including small and medium-sized buyouts, is better positioned to reap the upside of a continued growth scenario in to 2019. In the case of a downturn, if private equity firms are properly structured and well managed, they should continue to grow without the greater risk that high leverage and lower GDP growth causes for larger companies.

A key ingredient will remain selecting differentiated fund managers that can add real value, such as operational and transformation to their portfolio companies, and that apply leverage sensibly without using it as the dominant value driver. Going into 2019, the global environment of high public market valuations will be a cause for concern as private equity players fret over the availability of upside and the pressure it puts on private market valuations.

# Changing times

## Incorporating carbon risk within asset allocation

**Ian Ashment**, Head of Systematic and Index Investments, **Rodrigo Dupleich**, Senior Quantitative Analyst, **Boriana Iordanova**, Index Analyst and **Xiaochen Zhao**, Quantitative Analyst

Climate change is one of the most significant and yet misunderstood risks that companies and financial organizations face today.<sup>3</sup> The short- and long-term potential impacts are physical, regulatory and technological. Investors must find ways to adapt to the coming challenges.

A key event for investors occurred in April 2016, when 174 countries and the European Union officially signed the UN Climate Change Paris Agreement to reduce greenhouse gas emissions, limit global average temperature to a maximum of 2°C above pre-industrial levels and accelerate the transition to a lower-carbon economy.<sup>4</sup> Many countries followed up by tightening sustainability reporting requirements for companies and large investors.

In October, the 2018 Nobel Prize in Economics was awarded to two economists for their research integrating climate change into macroeconomic analysis. William Nordhaus of Yale University was recognized for his pioneering work on climate change research. His research aimed to explore the relationship between climate change resulting from an increasing level of carbon dioxide concentration in the atmosphere, the effect it has on economic growth and the health of society and the need to take strong actions to address carbon reduction goals. This transition to a 2°C target will create both risks and opportunities and will affect all business sectors and industries across the globe. Investors who simply exclude the high-carbon sector will be unable to exert any influence on the means and timing of such a transition.

An alternative and, arguably from a big picture perspective, more responsible approach is for investors to mobilize behind worldwide efforts to reduce carbon reliance. We see this trend accelerating into 2019 and beyond.

We believe that an approach that relies solely on historic carbon emissions data and exclusions has deficiencies, including:

- Unintended exposures to sector, country, style factor, beta, etc.
- Failure to consider the multi-dimensional aspects of climate change and carbon data itself. For example, large carbon emitters can be adjusting their business to the low carbon economy, investing in renewable energy, or disclosing their data.
- Possibly leading to unintended risks by focusing only on carbon risk. While much of the risks related to climate change might be removed, some opportunities related to transition could be missed at the same time.
- Failure to acknowledge the uncertainties of climate change.

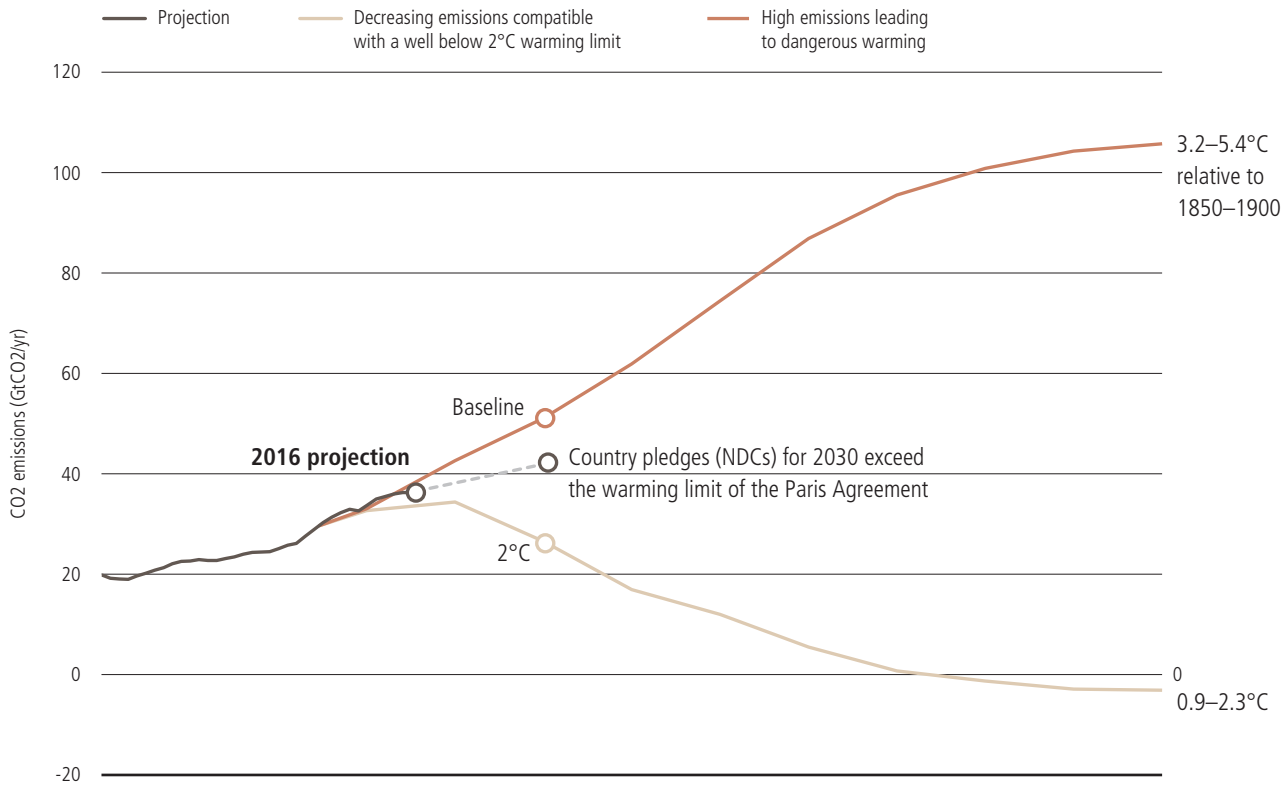
The last point is very important and not often discussed, in our view. *Brock and Hansen*<sup>5</sup> analyze the social cost of carbon under uncertainty, distinguishing three forms of uncertainty: risk, ambiguity and misspecification. Intuitively, risk is related to an approach (model) unlikely to fit future events. Ambiguity is the uncertainty associated with how to use alternative approaches (models). Misspecification is related to the use of models that are not perfect. Our approach aims to manage the uncertainties around incorporating carbon risk into a portfolio.

<sup>3</sup> According to the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD).

<sup>4</sup> A key element of the deal negotiated at the 2015 Paris Climate Change Conference was a long-term goal to limit the increase in global average temperatures to "well below" 2° C, while pursuing efforts to limit the temperature increase to 1.5° C above pre-industrial levels.

<sup>5</sup> Brock, W. and Hansen, L.P., *"Wrestling with Uncertainty in Climate Change Models"*, Working paper University of Chicago, (2017)

Exhibit 1: Global carbon emissions by target



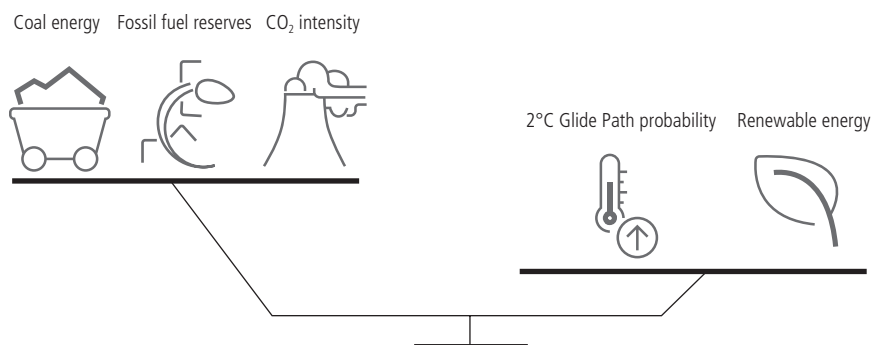
Source: Future Earth, CDIAC/GCP/IPCC/Fuss et al 2014/ Rogelj et al 2016. For illustration purposes only.

Based on our scenario analysis related to the 2°C target, we recommend a different approach for equity index investors who understand the need to adapt to this changing scenario: a rules-based strategy that continues to invest in carbon-emitting companies, but that engages with companies appearing less well positioned for the needed transition, and supports companies developing new technologies necessary for the transition.

Via a series of positive and negative tilts, illustrated schematically in Exhibit 2, we have constructed an innovative, forward-looking approach which aims to achieve several objectives:

- Substantially reduce the carbon (CO<sub>2</sub>) footprint<sup>6</sup> of a global index equity portfolio while increasing the exposure to forward-looking metrics related to the transition to the low carbon economy.
- Materially increase investment in companies that are best placed to benefit from the growth in demand for renewable energy and associated technologies.
- Achieve long-term returns broadly in line with the returns of the underlying index.

## Exhibit 2: Positive and negative tilts



Source: UBS Asset Management. For illustrative purposes only.

<sup>6</sup> In this context CO<sub>2</sub> footprint includes the six greenhouse gases covered by the UN Framework Convention on Climate Change and its Kyoto Protocol: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulfur hexafluoride.

Below we outline some of the innovations for best practices for implementing a tilted approach, which we believe will differentiate it from more conventional approaches.

- Based on a probabilistic structure that explicitly recognizes the uncertainties related to CO<sub>2</sub> emissions data.
- Incorporating carbon-related, forward-looking measures that reward companies moving towards an absolute target figure of 2°C set by the United Nations at the 2015 Paris Climate Change Conference.
- Incorporating qualitative insights, e.g. source and quality of reported data, disclosures on implementation of policies, objectives, and initiatives related to carbon efficiency metrics.
- Another key concern for investors in this era of climate change is developing a robust voting and engagement element. Our voting and engagement approach aims to encourage companies to:
  - Report carbon emissions data.
  - Have clear strategies and goals for reducing emissions and to commit to regular reporting on progress.
  - Comply with best practice in reporting on their governance, strategy, risk management, metrics, and targets, in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).
  - Undertake scenario testing and report implications in their annual reporting.

In addition, dialogue with companies allows for the verification of company performance with additional information collected before and after the dialogue. It also means we can collect feedback, explicitly communicate objectives for change in corporate practices and further enhance the model used to inform the under/overweights positions.

As we go into 2019, climate change remains an evolving and dynamic process. Investors should thus keep pace with both the problem itself (for example, carbon as a core risk related to climate change) and the available data/research/innovations. To that end, we have set up an advisory group that aims to keep abreast of climate-related trends and developments that impact listed companies, monitors the ongoing voting and engagement activities and continuously enhances the methodology applied by our approach.



# The significance of stewardship

## Enhancing the value of clients' assets through engagement

**Christopher Greenwald**, Head of SI Research, Sustainable and Impact Investing and **Valeria Piani**, Strategic Engagement Lead

Globally, there has been a growing need for greater insights into sustainability and long-term investing and this has seen the business case for stewardship come to prominence. Across both active and passive equities, as well as investments with sustainability targets, stewardship has been proven to favorably impact business outcomes.

The reason for this is clear. At its core, stewardship equates to responsible ownership, with corporate engagement and proxy voting activities playing a key role in sustainability integration. This is a trend which we see gaining further traction in 2019 and beyond.

The many significant positive features of engagement have strong academic backing as several studies have demonstrated the financial benefits of stewardship through engagement. One study revealed that companies which investors had successfully engaged with experienced improved profitability as measured by returns on assets. In contrast, companies where engagement objectives had not been met saw no change in return on assets.<sup>7</sup> A second study highlighted the communicative, learning and political benefits linked to shareholder engagement.<sup>8</sup>

Based upon this evidence, we believe stewardship activities are an important mechanism for adding value to clients by driving better long-term investment returns.<sup>9</sup>

### A unique approach

Alongside academic research that clearly supports the benefits of stewardship, we believe our significant body of work across active and passive strategies as well as our industry-renowned leadership in sustainability, provides a strong

foundation in enabling clients to benefit from a well-developed stewardship strategy.

We do not work in isolation. We are signatories to stewardship codes of best practice such as the International Corporate Governance Network (ICGN) Global Stewardship Principles and the investor-led ISG Stewardship Framework in the US. We are also members of the United Nations Principles for Responsible Investment initiative which strongly encourages investors to be active owners by engaging with companies and voting at annual general meetings (AGM) (as outlined in Principle 2).

Our stewardship activities are currently organized according to four types of engagement: thematic, reactive, proxy voting-related and proactive (i.e. analyst led). Additionally, we are open to collaboration in situations where we think that the effectiveness of engagement can be increased. We believe that with a unified voice, it is possible for investors to communicate their views in an efficient, targeted manner. We also see voting as a key aspect of impactful engagement and effective stewardship. On average, in a 12-month period, we vote on 10,000 meetings. We see this process as essential in complementing and supporting engagement activities with companies. Further, in the case of passive strategies, it is often our only tool to voice opinions and encourage boards to address our concerns.

### Pro-active asset management

With greater resources dedicated to engagement and voting activities, active managers are able to engage directly with companies, rather than basing investment decisions solely on

<sup>7</sup> The sample referenced 225 investors involved in 30 coalitions. See Elroy Dimson, "How institutional investors' collective engagement on ESG issues create value for investors and corporations: A configurational analysis", Judge Business School, Cambridge University, London Business School; Chair of Strategy Council, Norwegian GPF; Director of FTSE International, 2017.

<sup>8</sup> See Jean-Pascal Gond, "How ESG engagement creates value for investors and companies", Cass Business School, City University, 2018.

<sup>9</sup> For a summary of additional work on the added benefits of engagement on positive external and financial performance, see UBS Wealth Management CIO, "Education Primer: ESG Engagement Equities", August, 2018.

the analysis of reported results. By establishing longer-term relationships with investee companies, active asset managers are able to work with them to improve long-term drivers of value.

These intense, analyst-led dialogues have direct impact on the business strategies of companies, as they are directly linked to investment cases. Interactions conducted by our financial analysts and portfolio managers, working closely with sustainable investment research and stewardship teams, create consequences that extend across all actively managed strategies.

Going into 2019, we plan to continue developing our strategic engagement program, which focuses on the most material sustainability risks and opportunities. One area which we expect to be the subject of ongoing attention is that of climate – a topic with which we are already closely involved – along with gender equality and impact aligned to Sustainable Development Goals. The publication of the latest Intergovernmental Panel on Climate Change report, and the growing raft of legislation and directives from bodies such as the EU, support the need for large scale investors to drive dialogue in a bid to effect change.

#### The 4 pillars of our stewardship strategy

1. Thematic	2. Reactive	3. Proxy voting related	4. Proactive
Engagements on specific sustainability topics, including climate change and impact	Engagements on topical events and UNGC breaches	Engagements centered around shareholder meeting research	Engagement following identification of material ESG risks and opportunities



Active and Passive holdings

Source: UBS Asset Management.

# A new SAA paradigm?

## Should long-term institutional investors incorporate mega trends into their strategic asset allocation thinking?

**Massimiliano Castelli**, Head of Global Strategy, Global Sovereign Markets

Amidst the ‘noise’ that impacts markets and returns over the short- and medium-term, which key factors should truly long-term investors prioritize in their investment framework?

The traditional approach relies heavily on discounted cash flows and on assumptions about long-term economic growth, inflation and interest rates. But we believe that truly long-term investors should give more weight to those factors that have the potential to fundamentally affect nations, regions, industries and companies over the long-term.

Academic research shows that factors such as regulation, political change, technology and systematic risks account for between 20% and 70% of a company’s performance in the long run measured by stock prices, profitability, and market share.<sup>10</sup>

From an investment standpoint, global factors should be a cause of special concern today because they are becoming less and less predictable and are notoriously difficult to measure. Such uncertainty, even when the ultimate outcome is benign, in itself is likely to have a big impact on the world economy and investment decisions going forward, both at country and sector level. Therefore, navigating such global phenomena and understanding them is paramount for investors in the 21st century.

### Time to think differently

But which global factors are the most relevant ones for large institutional investors over the next decades? Our approach to long-term analysis based on global trends requires moving away from traditional macroeconomic ‘scenario-thinking’; positive scenarios are never positive enough, and negative scenarios are never negative enough. It is also important to acknowledge that such factors are not static. We therefore propose a set of global trends and factors, and follow them over time, building resilient strategies around them.

According to this approach, we focus here on three key global factors:

1. Demographics
2. Technology and innovation
3. Sustainability and climate change

### Demography driving long-term shifts in country competitiveness

We believe that the change in demographics worldwide over the next decades will be twofold. On the one hand, we will likely see decreasing birth rates. On the other hand, we should experience an increase in longevity.<sup>11</sup> Both factors may lead to an increase in the number of non-workers, a trend that will probably be amplified by key technological developments. The combined impact of self-driving vehicles and drones as well as smart shopping solutions (e.g. RFID tags or online shops) may deprive low-skilled workers in particular of key ‘default’ jobs that allowed them to make a living in the past, namely driving trucks, taxis or delivery vans, or working in retail.

Beyond the inevitable shifts in demand patterns due to changing demographics, the higher number of non-working people in the economy will likely result in declining GDP growth rate per capita, even if the level of GDP remains the same. Research in the US suggests that a 10% increase in the fraction of the nation’s population aged 60+ is associated with a decrease in economic growth of 8.3%.<sup>12</sup>

Finally, demographics will impact other key economic variables. Academic research suggests that in the US, equity values are correlated to demographic trends. As baby boomers age, they are likely to move from investing in equities to selling equities to fund their retirement. All else being equal, this will put pressure on equity multiples. In addition, research suggests that, given reduced economic growth, the risk-free rate will

<sup>10</sup> Kewei Hou, G. Andrew Karolyi, and Bong Chan Kho. “What Factors Drive Global Stock Returns?” Review of Financial Studies, 2011.

<sup>11</sup> United Nations Department of Economic and Social Affairs/Population Division. “World Population Prospects: The 2017 Revision, Key Findings and Advance Tables.”

<sup>12</sup> See Maestas, Nicole, Kathleen J. Mullen and David Powell. 2016. “The Effect of Population Aging on Economic Growth, the Labor Force and Productivity,” Rand Labor & Population, Working paper: 1063-1.

decline as well. This implies lower expected returns on equities, holding everything else constant.<sup>13</sup> One key uncertainty however will be the risk aversion levels of the elderly.

As a whole, we believe that aging will result in a redistribution of wealth across different generations and will change consumption patterns, with needs for new products and services. This will require new investable projects in infrastructure, healthcare and wellness industries, as well as housing, to mention just a few.

Due to all of these factors, we expect the currently still rather theoretical discussion about 'aging' to manifest more and more in the form of tangible investment needs. Given the number of investable projects that will be required, demographics should therefore be incorporated as a key theme in long-term asset allocation processes.

### **Technology and innovation**

Digitization, or more generally speaking, the process of digital business transformation in companies and industries, is already creating new business models. Consequently, we will soon witness the emergence of new industries which previously did not exist. But how can we, from an investment standpoint, cope with yet unknown sectors?

Digital business transformation is an organizational change via the use of digital technologies and business models to improve performance. This is different from digital disruption, which represents the impact of digital technologies on a company's current value proposition.

As digital business transformation will expand the boundaries of any industry, it will likely also create spillover effects across industries, which are very difficult to measure. Agility is therefore paramount to cope with digital business transforma-

tion and is a measure of the ability to respond quickly to the ideas promoted by them, and the flexibility to adapt a business model to cope with these changes. Agility is also an important concept from an investment perspective: the ability to spot disruptors and the disrupted may generate extra returns or avoid permanent losses on companies unable to adapt.

### **Sustainability and climate change**

Too often, companies confuse 'sustainability' with only 'social responsibility'. Sustainability ultimately refers to a firm's ability to generate long-term value.

We think that an important driver of sustainable strategies will be climate change. This should have different effects across economies and sectors, and therefore across asset returns. As electrification and de-carbonization advance, fossil fuel demand should decline and many countries and industries will likely be disrupted, causing the growth and profitability of some of them to fall.

Countries with a high share of carbon wealth will likely face slower growth and rising political and social tensions. Oil companies, public or private, are an important source of wealth, and those unable to adapt themselves to the new global energy landscape will be impacted negatively by falling oil prices. Furthermore, they may face increasing regulatory risk should the policies against climate change be strengthened as the effects of greenhouse emission become more tangible and social pressure increases.

### **A new paradigm for strategic asset allocation**

Asset allocation is traditionally a top-down approach where some key economic and financial variables are used to generate return and risk assumptions across asset classes. In this approach, asset prices are determined by a set of

<sup>13</sup> See Cornell, Bradford. 2012. "Demographics, GDP, and future stock returns: The implications of some basic principles." *Journal of Portfolio Management*, Summer.

economic and financial variables such as growth, interest rates and other monetary conditions which affect the performance of all asset classes including fixed income, listed equity and alternatives. Given the return objectives and the risk tolerance of an investor, an efficient asset allocation can be sought through an optimization process.

Can megatrends be incorporated into such a top-down approach? The discounted cash flow model often associated with the pricing of assets is very difficult to apply given the complexity and uncertainty surrounding these trends.

A combination of a top-down approach with a bottom-up approach might be more appropriate. Through the top-down approach, the themes are identified and those with the largest disruption potential are prioritized. These themes are used in the bottom-up approach to invest into stocks that may benefit from such themes and to avoid investing in those stocks most exposed to the negative aspects of such trends.

In the new world that we envision for investors, the use of traditional risk measurement and management frameworks is also severely limited. Historically, a typical framework to manage risks started with the classic Markowitz risk-return tradeoff, and was based on the assumption that we can (1) identify, (2) assess, and (3) measure our uncertainties and therefore risks.

But the lessons of the past decade are that the unknowns that have destroyed companies and industries were not easily quantifiable risks but global trends, catastrophes and systemic crises. Diversification should not simply be about asset classes, but about exposures to themes such as technology or climate change which have the potential to disrupt companies, industries and countries.

It's worth remembering that long-term investors such as sovereign wealth funds (SWFs) have some natural advantages when considering this approach. Given their high-risk tolerance, long investment horizon and the wide range of asset classes they can invest in, SWFs have the capability to ride the mega trends and generate and capture the associated risk premia. This trend is already visible, with SWFs channeling an increasing share of their direct investments into disruptive technologies.

The trend towards incorporating global trends and factors such as demography, technology and climate change should raise some important questions. How can investors adopt a global trends investment framework? Can a long-term strategic asset allocation approach that incorporates global trends be defined and translated into executable investment concepts? Or should these simply be additional 'lenses' through which to look at the proposed asset allocation?

We believe that the evolution towards a long-term investment framework based on global themes requires a new mindset, and investors with a long-term investment horizon should adapt to these changes. The changes required are broad and touch upon several aspects of the asset allocation process, governance and the required skills and mindsets; in short, a new paradigm for long-term investing.

*UBS Asset Management welcomes the opportunity to discuss this shifting paradigm with you as we continue to drive the frontier of investment practices in our effort to deliver sustainable positive outcomes for our clients in the future.*



## The past and the future of asset allocation for long-term investors

Traditional asset allocation		Long-term asset allocation
<b>Strong focus on economic and monetary factors</b> Only considered megatrends when they have a clearly measurable impact on economic factors (e.g. demographics).	>	<b>Reflect diverse and interlinked set of trends that will affect society and environment in the future</b> In a truly globalized world, consideration of (geo)political, technological and sustainability challenges are crucial.
<b>Short-termism in the investment and corporate community</b> Trend-following and quarter/year-end effects (window-dressing) prevalent in financial markets. Companies investing in share buy-backs instead of equipment or employee education.	>	<b>Long-term thinking</b> Be guided by megatrends to avoid disruptions for key portfolio holdings and to capture long-term growth opportunities. Do not mix up long-term trends with hypes!
<b>Market-cap based benchmarks and passive replication</b> The broader the index, the more diversified and safe the portfolio?	>	<b>Unconstrained bottom-up approach</b> Diversify not a benchmark, but a pool of good long-term ideas.
<b>Mean-reversion</b> Diversification and rebalancing decisions driven by variance-covariance optimizations and mean reversion.	>	<b>Protect against disruption leading to sudden and permanent loss of capital in your portfolio</b> Assets can mean-revert for a long time – until they don't. Risk management means being aware of disruption risk.
<b>Private/listed markets</b> Diversification across listed liquid equity and fixed market allows investors to position themselves on the efficient frontier given their risk and return expectations. Private markets provide additional alpha.	>	<b>Private markets</b> Capturing the return opportunities provided by disruptive trends requires to invest more in private markets from where new business models often emerge. Capturing the unicorns.
<b>Governance and incentives: Herd mentality</b> Sponsors and clients expecting performance close to popular benchmarks, with tracking errors and drawdowns not exceeding industry standards.	>	<b>Governance and incentives: Look for long-term value</b> Long-term investments are particularly strong when combined with counter-cyclical strategies – but are sponsors prepared to go against the trend? And for how long?
<b>Conservatism</b> Very similar strategic asset allocations (SAA) within comparable institutional sectors leading to very similar and therefore (slightly below) average results.	>	<b>Innovative approaches</b> A (conservative) core tranche has to be augmented with innovative satellites entirely focused on capturing the opportunities of megatrends.

Source: UBS Asset Management.

# About the authors



**Bruce Amlicke** is Chief Investment Officer of UBS Multi-Manager Solutions. His primary role is the creation of a single center of excellence for the selection of third-party alpha managers across traditional and hedge fund capabilities. Before re-joining UBS in 2010, he spent five years as the CIO of Blackstone Alternative Asset Management and Senior Managing Director of The Blackstone Group. Prior to that, Bruce was CIO of the then O'Connor Multi-Manager Program from 2003–2004, which was a predecessor business to HFS. He originally joined the O'Connor Multi-Manager team in 1998.



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### What we offer:

Whatever your investment profile or time horizon, we offer a comprehensive range of active and passive investment styles and strategies designed to meet your needs across all major traditional and alternative asset classes. We also offer platform solutions and advisory support, to institutions, wholesale intermediaries and wealth management clients. We are a truly global firm with principal offices in Chicago, Frankfurt, Hartford, Hong Kong, London, New York, Singapore, Sydney, Tokyo and Zurich. Our invested assets total USD 830 billion<sup>14</sup> and we have around 3,600<sup>15</sup> employees, including over 900 investment professionals, located in 23 countries.

### Who we are:

We are one of the largest managers in Alternatives: the second largest fund of hedge funds manager<sup>16</sup> and fifth largest manager globally of direct real estate.<sup>17</sup> We are a leading fund house in Europe, the largest mutual fund manager in Switzerland,<sup>18</sup> Europe's third largest money manager<sup>19</sup> and the top foreign firm in China.<sup>20</sup> UBS's unique passive offering, encompassing index and systematic strategies, provides smart beta, alternative indices, and other custom solutions to meet our clients' needs. We are the second largest European-based passive player<sup>21</sup> and the fourth largest ETF provider in Europe.<sup>22</sup>



## Past performance is not indicative of future results.

<sup>14</sup> As of 30 September 2018.

<sup>15</sup> Thereof around 1,300 from Corporate Centre as of December 31, 2017.

<sup>16</sup> HFM InvestHedge Billion Dollar Club, March 2018.

<sup>17</sup> Pensions and Investments, October 2018 (based on data to 30 June 2018).

<sup>18</sup> Morningstar/Swiss Fund Data FundFlows, September 2018.

<sup>19</sup> Institutional Investor Euro 100, based on data to June 30, 2017 (based on discretionary assets only, UBS WM and AM combined, excluding fund of funds assets).

<sup>20</sup> Z-Ben Advisors: 2018 China Rankings, April 2018.

<sup>21</sup> UBS Asset Management analysis, May 2018.

<sup>22</sup> ETFGI European ETF and ETP industry insights, September 2018.

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