SEVEN TRENDS THAT WILL SHAPE OUR FUTURE

INTRODUCTION: OUR VIEW ON NAVIGATING LONG-TERM INVESTMENT TRENDS.

At IMCO, we believe that one of the keys to better long-term investment results is successfully navigating long-term trends. Long-term trends are powerful economic, demographic, policy, technological, and capital market forces that can impact investment returns and risk in material ways.

For us, successfully navigating long-term trends does not mean correctly identifying and capitalizing on trends before others. It means doing the hard work of adapting our clients' asset mix and our investment strategies to reflect often relatively obvious, powerful, and sometimes evolving long-term phenomena.

The last few years have been turbulent, to say the least. The COVID-19 Pandemic coincided with the decline of certain long-term trends while at the same time increasing the importance of others (and in some cases, precipitated them).

The following outlines IMCO's high-level thinking on the trends we believe long-term investors need to focus on today, as well as some of the steps we are taking to adapt our investment strategies and client advice to navigate these trends.

1. Periods of potentially higher-than-expected inflation should be considered in client asset mix design.

We believe that the forces that weighed on inflation over the last 40 years (including debt levels, public policy and demographics in the largest economies, technology, globalization, and income inequality) will be balanced and offset over the coming decade by several forces that will promote inflation (including decarbonization, deglobalization, populism, and shifting public policy). While we do not believe we can accurately predict the level of inflation going forward, we do believe there is a greater risk of periods of heightened and more volatile inflation than in the recent past. Therefore, and in particular for clients, with inflation-linked liabilities, we recommend a strategic asset mix that provides a balance of inflation-linked and nominal bonds, and greater exposure to real estate and infrastructure (where many of the investments have either short-term or longer-term inflation protection).

2. Investors will need to be nimble to capture increased investment opportunities resulting from market volatility and more constrained central bank support.

For some time, investors have been able to rely on central banks to intervene and provide liquidity when markets declined materially. For example, there was intervention by the US Federal Reserve after Black Monday in 1987, multiple bouts of quantitative easing (QE) followed the Great Financial Crisis of 2008 (GFC) and supporting rate cuts occurred during the sell-off of the recent global pandemic. Because central banks will need to be more cautious around the risks of stoking inflation, this previously quick and reliable support for markets will be less certain going forward.

The silver lining for investors, is that this is likely to create investment opportunities. For instance, simple systematic investment techniques like rebalancing between asset classes and within asset classes (including buying public versions of private assets) can be used to create long-term value. Additionally, fundamental investors can buy high quality, long-term assets at discounts. At IMCO, we look to generate value over the long term from market volatility using both systematic and fundamental investment strategies.

3. Private investment opportunities will grow, with partnerships and direct investment capabilities being the keys to success.

Private markets have expanded tremendously in the last six years, as assets under management have more than doubled in size to nearly $9-trillion US. (For perspective, consider that the market capitalization of the S&P 500 is approximately $36-trillion US.) Continued growth is expected with current estimates indicating that private capital assets under management are expected to double again by 2026.

There are many diversification and accounting benefits to owning private assets. But the reasons for owning private assets go beyond more favourable or lagged valuations. For instance, many promising business strategies will generally be better financed in the private markets than in the public markets (e.g., those that involve significant changes in capital structures or strategies) and these can represent very good opportunities for investors with longer investment time horizons. As well, many high-quality investment opportunities that were formerly financed by banks are now available to other investors, as banks continue to adjust their investment activities in light of post-GFC regulations.

As private markets have continued to grow, so have the institutions dedicated to those markets. The largest global private market investors, such as Blackstone, KKR, Brookfield and The Carlyle Group have seen considerable growth in recent years and today, these four firms collectively have approximately $2.5-trillion US in assets under management.

Size matters when it comes to investing, and that is also true for investing in private markets. Large organizations dedicated to private investments enjoy both economies of scale and related cost advantages as well as the ability to build up dedicated operational expertise in a wider array of value enhancement strategies, all of which leads to the potential for superior returns.

For long-term investors, with the ability to access private assets on an efficient basis, the continued growth in private markets' investment opportunities represents a way to diversify and enhance long-term returns. Therefore, IMCO will continue to recommend that clients (with long-term investment time horizons) continue to increase their exposure to private assets. We will also continue to deepen our relationship with a core set of strategic private asset partners and increase our ability to invest alongside them.

4. Continued investing in China will require a measured approach.

Over the last 20 years, China has grown to become the world's second largest economy and is expected to overtake the US in the next decade. Over that same period, the opportunities for investment in China have also expanded, as the total market capitalization of Chinese equities (as a share of global market capitalization) has grown from less than 2 percent to over 10 percent.

We believe that China is too big to ignore, and a well diversified portfolio should have exposure to this region. However, there are risks associated with investing there.

First, successfully investing in China involves accurately anticipating and navigating public policy decisions, which is often hard to do in non-democratic countries. For example, in 2021 the government banned for-profit tutoring companies, putting close to 90 percent of companies in the for-profit education sector out of business. The government has also intervened in Alibaba and Ant Group in ways that have significantly impacted the value of these companies.

Second, there continues to be growing tension between China and the US, as both countries have been at odds over allowing American regulators to audit Chinese companies listed on US Exchanges. This has resulted in a number of large state-owned companies to delist. The US Government has also imposed tariffs on approximately 66 percent (or $350 billion) annually of Chinese imports. Investors may not be able to avoid the impacts of this tension and the era where investors could ride the growth in the Chinese economy and globalization may be over.

Third, for investors who prioritize environmental, social and governance considerations (ESG), there are also real risks of investing China. For example, Canada, US, UK, and the European Union have sanctioned both officials, as well as firms, associated with the mass repression and state-led human rights violations against the mostly Muslim Uighur minority group in the Xinjiang region. Due to the structure of the Chinese Communist Party, it's increasingly challenging to decipher the relationship of the authoritarian regime and the Chinese private sector.

As a result of these risks, we will take a measured approach – and certainly not overweight China. We will continue to avoid investing material amounts in illiquid Chinese assets so that we can maintain flexibility to adjust our exposure over time as risks evolve. We will not pursue passive management in Chinese equity strategies, and we will ensure that all our external managers comply with our ESG policy to avoid unintended inconsistencies between our investments and our ESG beliefs.

5. Benefiting from the move to decarbonize many economies will require specialized expertise.

We expect that over the coming decade, many economies will take steps to lower their carbon emissions. The pace at which this change occurs, and the technologies that will emerge, cannot be predicted. Many large asset managers have already committed to net zero portfolio greenhouse gas (GHG) emissions by 2050 or sooner, including the 273 signatories of The Net Zero Asset Managers Initiative, representing approximately $61-trillion US in assets under management.

Buying low carbon assets will certainly reduce the risk in investors' portfolios associated with this trend. But if not done well, it could also negatively impact returns given the substantial amounts of capital that will be pursuing lower carbon assets. The real opportunity to increase long-term returns and reduce risks will flow from investing in companies and assets that facilitate the energy transition as opposed to companies and assets that are already low carbon. This is why we are continuing to build our ability to deploy capital directly and through external funds with expertise in funding energy transition investments.

6. Bonds should continue to provide protection against deflationary episodes.

Over the last three years, long nominal bonds, the traditional "safe harbour" for many portfolios, generated highly volatile returns. This occurred as central bankers first drove rates to all-time lows to combat the deflationary risks of shutdowns and the pandemic, and then quickly pivoted to quell multi-decade high levels of inflation. This kind of gyration in macroeconomic conditions, combined with central bank involvement in the markets and volatility of bond returns is highly unusual. This experience may have caused some investors to question whether long nominal bonds should continue to serve as the ballast in their portfolios.

It's important to keep in mind that bonds are not intended to protect investors from all macroeconomic events. They are included in portfolios to protect against deflationary events but won't perform as well in periods of rapid growth or inflation. With that in mind, bonds have generally performed as expected in recent years. When markets were stressed in 2020, they rose in value and when inflation ran at levels that were much higher than expected in 2022, they fell in value.

We believe that bonds will remain one of the most effective means of protecting investors against periods of deflation. Particularly for investors with portfolios that are dominated by growth assets, bonds will continue to provide important diversification and we will typically recommend an allocation to mitigate the potential volatility of growth-oriented portfolios and provide both a reliable source of liquidity and borrowing collateral.

7. All asset classes will need to consider the impact of technology disruption.

Technology has the ability to disrupt and reduce the returns for many companies and assets. Technology disruption is no longer confined to a limited number of market segments such as the software, hardware, and pharmaceutical industries. For example, because of the increase in on-line shopping and home delivery over the last decade, many established retail companies went bankrupt, and retail real estate suffered dramatic reductions in value. In many cases, these assets served as the anchor for many portfolios, generating reliable returns over decades.

There is no asset class that is immune to this kind of potential disruption, so we are establishing and fostering a culture that encourages our investment teams to be nimble and supports investing in things that either do not fit neatly into pre-existing market segments or that have the potential to disrupt existing asset classes.

CONCLUSION: NAVIGATING LONG-TERM TRENDS IS CRITICAL.

The last few years have been a good reminder for all investors that the future is very hard to predict. Investors went from worrying about a "lower for longer" investment environment, to navigating the first pandemic in our lifetime, to enduring the highest level of inflation in decades, to witnessing the emergence of war in Europe.

Many long-term trends appear to have become less powerful in recent years and other long-term trends appear to have become more powerful. But it continues to be important for investors to have a plan to navigate the long-term trends that appear set to influence investment returns and risk over the coming decade.