IMCO WORLDVIEW

Investing to capitalize on the long-term trends shaping our future

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Introduction and Outline

After decades of relative global stability and ‘predictable’ economic policy, the world appears to be shifting towards a more volatile regime. Sources of economic and geopolitical disruption are surfacing everywhere, from the global pandemic, to the war in Ukraine, climate change, the rise of populism, and tensions between the West and China. Macroeconomic policy is also undergoing a profound revolution as frameworks that were once viewed as unflappable are starting to come under growing scrutiny. At IMCO, we believe that these global trends are leading us towards a new era of investing – one where it becomes increasingly difficult to rely on the past as a predictor of the future.

IMCO’s research group has been speaking with our Investment teams, senior management and external research partners to help formulate a view on where the future may be headed. We focused our efforts on defining and better understanding the trends that will have the most impact on our clients’ asset exposures, and working through these trends’ implications for asset markets and portfolio management.

This document, which represents the results of our work, is divided into two sections. The **first section** lays out the main high-level themes that we expect to play a significant role in driving returns over the coming decade and beyond. Many of these themes represent an “inflection point” or reversal of previously-entrenched trends. Examples include the end of “low for long” (rates, inflation, etc.), a shift away from globalization towards on-/friend-shoring, and increased reliance on the fiscal policy lever (over monetary almost exclusively).

The **second section** examines the economic and market implications of these themes, along with a brief description of what IMCO can do in response to these macroeconomic outcomes. For example, an economic implication of de-globalization, the Green energy transition and the greater use of fiscal policy is that inflation is likely to be higher than it was in the post-GFC/pre-COVID era. In that new world, IMCO’s clients would stand to benefit from a greater exposure to inflation-sensitive assets such as regulated infrastructure, inflation-linked bonds, and commodities. Other economic and market implications include greater volatility, an expected capital-intensive investment “boom” and the scope for unintended or undesired passive exposures – all of which IMCO can respond to at the strategic and/or active levels. Although the paper will focus on strategic implications, opportunities within the value-add space are also noted.

Section 1: Themes

Theme 1: Addressing Inequality

A defining characteristic of developed market economies over the past several decades is their shared reliance on neoliberalism – the social philosophy that looks to competition, market forces and free-flowing capital to allocate society's resources and the fruits of economic activity. This approach gained traction in the wake of the inflationary 1970s, which many observers pinned – at least in part – on cost-of-living provisions within union contracts and wage-price spirals more generally. The response to these inflationary dynamics was multi-fold, and included the rise of free trade agreements, increased cross-border flows (including labour), declining union membership, lighter regulation, fiscal restraint on the part of governments and inflation-targeting central banks. In sum, it tilted the playing field back in capital's favor at labour's expense.

Although the neoliberal era has coincided with significant efficiency gains and unprecedented wealth creation, the distribution of these spoils has been very uneven. Domestic labour, for example, has not participated as fully as has capital or foreign labour, resulting in an all-time low share for wages and salaries in US GDP (**Chart 1**). At the same time, the benefits have been accruing to an increasingly-concentrated group, to the point where the top 1% of American earners until very recently had surpassed the entire middle class (i.e., middle 60%) in terms of wealth (**Chart 2**).

Against this backdrop, it is no surprise that we are now seeing growing discontent and pushback socially as well as politically: the Occupy Wall Street movement; the rise of populist politicians beyond their usual emerging market stomping grounds (e.g., Trump in the US, Le Pen in France, Meloni in Italy); calls from both sides of the aisle in the US to support domestic labour; the growing willingness to support incomes via fiscal policy; even China has shifted away from its pursuit of growth-for-growth's sake in favor of a "common prosperity" strategy that emphasizes the quality and distribution of the resulting gains. In our view, these are all signs that the pendulum may have swung as far as it can in neoliberalism's direction, potentially marking a secular inflection point and the advent of a new social and economic "supercycle".

Chart 1: Corporate profits' share of income is at record highs

Share of National Income (%, smoothed line is 5yr average)

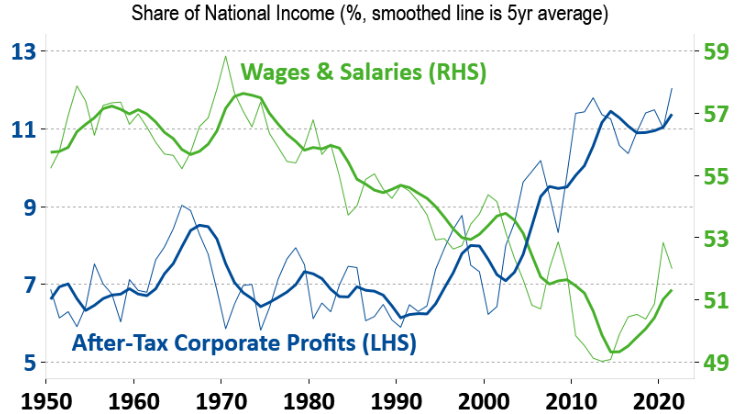
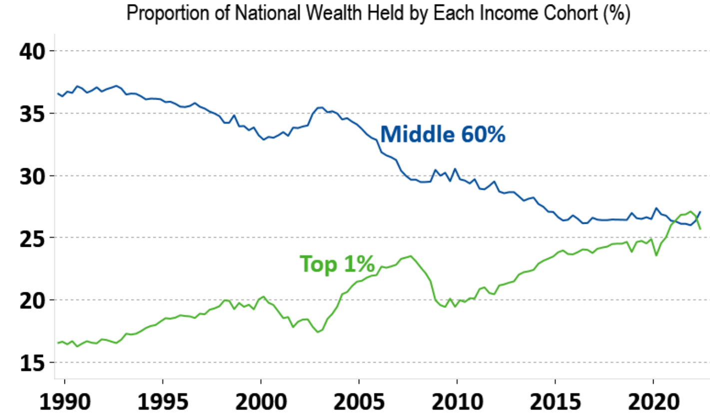


Chart 2: The top 1% holds nearly as much wealth as the entire middle class

Proportion of National Wealth Held by Each Income Cohort (%)



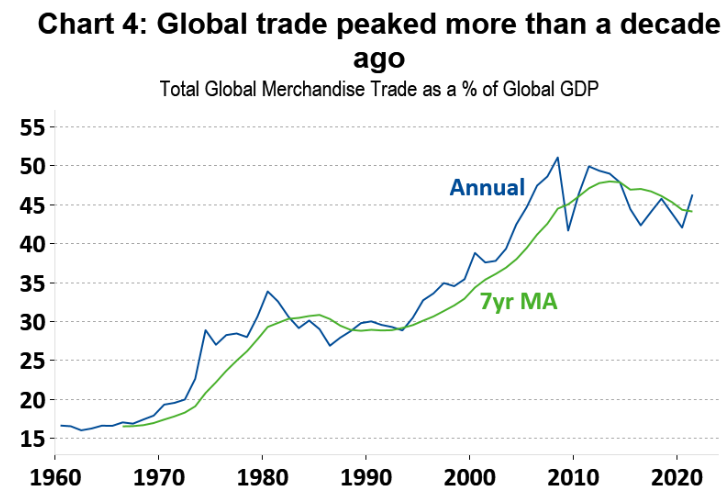
Theme 2: Deglobalization

The neoliberal tenets discussed under ***Theme 1 – Inequality*** played a big part in promoting the globalization of economic activity and commerce over the past several decades. Since the 1980s, businesses have seen their production processes and supply chains become much more efficient, thanks in good part to the reduction of trade barriers and the emergence of technologies that allowed goods, services and information to flow around the world more easily. These developments also allowed businesses to access vast new pools of labour in China, India and Eastern Europe as these countries became more integrated into the global economy. Efficiency became the chief arbiter and organizer of economic activity, bumping other considerations – such as implications for domestic workers and security of strategic supplies – further down the list.

The tides appear to now be shifting, however, as addressing inequality via employment opportunities at home becomes an ever-important political priority. Moving production to domestic shores will be an easier sell to global businesses now that emerging markets' labour cost advantage has waned after decades of relative wage gains (**Chart 3**). Security issues have also grown in importance, with rising geopolitical tensions throwing sand in the gears of free-flowing commerce. An obvious driver of these tensions is the economic and military rise of China, which presents challenges for the US' status as the sole global superpower. While these tensions have thus far been limited to the realm of trade in the form of protectionism, tariffs, etc., there is a growing possibility that they eventually morph into more direct physical conflict, with Taiwan providing an obvious potential flashpoint. Against this backdrop, it is natural to expect the economic ties between these economic heavyweights and their related spheres of influence to fade, thus reversing the decades' long trend of increased globalization.

The numbers bear this out, with some measures of economic integration suggesting that globalization has stagnated since the GFC (**Chart 4**). This trend has received further impetus more recently from the COVID pandemic and Russia's invasion of Ukraine – both of which provided stark reminders of the need to ensure greater domestic, or at least "friendly", access to essential goods and resources. In the case of the pandemic, some countries were unable to adequately source masks, ventilators and vaccinations due to hoarding and prioritization of domestic supplies on the part of producers/exporters. Related shutdowns also limited access to other key productive inputs such as semiconductors. More recently, Russia's invasion of Ukraine triggered price surges and shortages among key commodities, further highlighting the risks that go along with relying on specific countries for critical imports such as food and energy.

Taken together, the above developments have shaken individual nations' "trust" in the global economic system's ability to provide their citizens with what is needed, when it is needed. As a result, countries are likely to accelerate their move away from global economic integration in the years to come, choosing instead to onshore production processes (or, at the very least, "friend-shore" them amongst strategic allies). Currently-growing populist support of nationalism and anti-globalization sentiment add further fuel to this process. The resulting disruption will likely be more severe for China and its sphere of influence than for the US-centered bloc, as the latter is currently much less reliant on the rival bloc for imports and external demand. Given that globalization was an integral force behind the steady decline in global costs and prices over the past several decades, its reversal (or even slowing) could impart inflationary tailwinds as we head further into a new macroeconomic regime.



Theme 3: Policy Inflection

The economic policy landscape of the past several decades has been dominated by central bankers, with politicians' spending and taxation decisions relegated to a secondary role. The "hands off" philosophy underlying this approach – in which a single policy rate is deemed sufficient to steer the economy towards a desirable growth and inflation outcome – is consistent with the broader neo-liberal, market-oriented approach that has characterized this era of globalization and free-flowing capital. As the only game in town, central bankers have felt compelled to offer support whenever the economy and/or markets faltered. And with inflation low and stable, there was little need for commensurate tightening during the booms – the net result being a one-way ride downwards on the rates front since the 1980s (**Chart 5**).

After many years of below-target inflation and stagnant growth, however, this approach has come under intensifying doubt and scrutiny, including amongst central bankers themselves. Consistent with this recognition of a need for change, several major central banks have reviewed – and in some cases altered – their monetary policy frameworks. This includes the US Fed, which recently revised its decision-making criteria in ways that make inflation overshoots (and undershoots for that matter) more likely than had previously been the case. While lower-than-desired inflation was the main challenge for central bankers in the post-GFC world, this has been supplanted by concerns at the other end of the target range, jeopardizing the multi-decade policy rate tailwind mentioned above. Note also that the revised framework elevates the role of employment in shaping monetary policy, thus forging a closer link between the Fed's objectives and developments in the real economy.

Recognizing the limits of their toolkits, central bankers also became increasingly vocal in their calls for greater support from fiscal authorities through the low growth/low inflation years leading up to the COVID crisis. No such encouragement was needed once the pandemic hit, however, as the resulting unprecedented shuttering of the global economy was met with an equally unprecedented fiscal policy response (**Chart 6**). Governments around the world stepped up with trillions of dollars' worth of spending programs, thus limiting the economic damage and staving off what could have otherwise morphed into a depression-like scenario. This experience provided a stark reminder of "the power of fiscal" and could set the stage for greater use of this policy lever going forward. Although still early days, the spate of inflation following in the wake of the COVID-19 pandemic and Russia's invasion of Ukraine does not appear to have limited the appetite for further stimulus. In fact, many governments have actually responded with more fiscal support, especially in Europe where households and businesses have been provided with financial relief from rising energy prices.

Chart 5: Interest rates have been on a steady decline since the 1980s

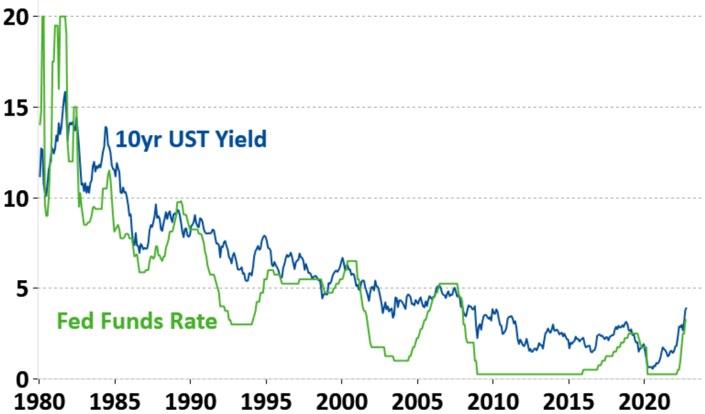
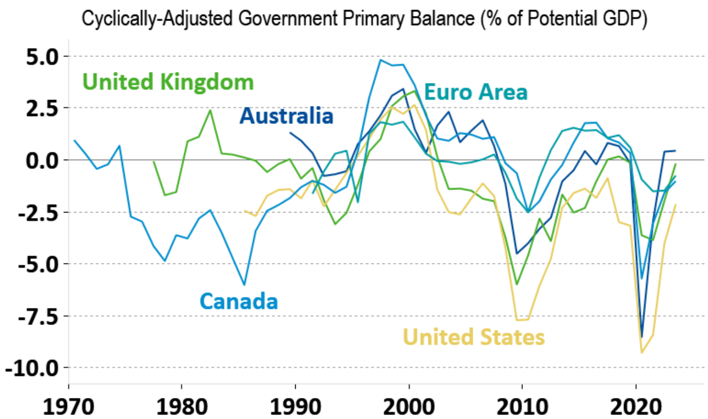


Chart 6: Governments spent significantly during the COVID crisis



Looking further out, fiscal policy will likely be called upon to help navigate additional secular trends, including the energy transition and other climate-related initiatives, the growing desire to ensure domestic supplies of strategic goods and materials, and the increasingly-recognized need to address inequality. As recent experience has shown us, fiscal policy can have a much more direct impact on growth and inflation – particularly to the upside – than monetary policy's more arm's length channels such as financing costs, discount rates, and wealth effects. Central banks' willingness to stimulate via these levers will likely be dampened if inflation replaces deflation as their primary concern, thus putting even more onus on fiscal policy.

Taken together, these developments suggest that the policy stage looks set to inflect – possibly dramatically – over the coming years, with fiscal levers and real economic priorities (e.g., employment, inequality, securing of strategic supplies, infrastructure etc.) taking growing precedence over monetary policy and its financial variables of focus (e.g., nominal prices, financing costs, asset values, etc.).

Europe in particular stands to see the greatest potential change, as it continues to address its original inherently unstable institutional structure – namely, that of a shared currency without a monetary backstop nor corresponding fiscal and banking unions. While the former shortcoming has since been largely addressed via Draghi's "whatever it takes" pronouncement and subsequent QE programs, progress continues to be made on the fiscal front as evidenced by recent joint bond issuance and the growing flexibility around deficit limits. Further advances here will improve European policymakers' ability to pursue specific goals such as addressing inequality, enhancing energy security, reducing carbon, etc. as well as their ability to provide counter-cyclical support to their economies more generally.

Theme 4: ESG and Climate Change

Environmental, social and governance (ESG) considerations are becoming increasingly prominent and consequential for investors. There are many factors driving this Theme including increased global tensions, better access to information and forms of measurement, and evolving societal values and priorities. Climate change, however, is the single most important driver of this trend.

Shifting weather patterns will continue to alter human activity and systems at the local, regional, and global levels. The economic impact of climate change will arise both directly via changes in the climate itself (e.g., migration due to rising sea levels) and indirectly from policies that are being put in place to help mitigate climate risk (e.g., investments in energy efficiency following the introduction of carbon pricing).

As cleaner technologies and energy sources are increasingly adopted at the expense of legacy ones, the potential for "stranded assets" will rise as governments, companies and consumers adapt to the new reality. This could result from new environmental rules and/or changing societal preferences that, for example, put conventional oil production at greater risk. This notion of climate-related winners and losers is also likely to arise in terms of geographies, with some locations better able to withstand and/or adapt to changing temperatures and weather patterns. As an example, ideal conditions for some agricultural activities might shift to relatively cooler areas, while at the same time real estate along coastal areas could face elevated risks from rising sea levels relative to those located further inland.

The government push to decarbonize economies as part of climate change mitigation efforts will be expensive, requiring significant capital investments as well as new technologies. Government interventions in support of these efforts, including carbon pricing and other policy measures, are also likely to push energy prices higher, thus adding further tailwinds to the global inflationary trend. There may also be knock on-effects in terms of energy security issues and geopolitical power.

Beyond climate change, ESG-focused investors will face further risks via exposures to certain non-democratic countries, with China being a prominent candidate. Recent experience supports this likelihood, as illustrated by the sanctions placed by the US, UK, European Union and Canada on Chinese officials and firms in response to 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 is increasingly challenging to decipher the relationship of the authoritarian regime and the Chinese private sector.

This increase in ESG concerns is bringing about a new era of investing, where the real and reputational risks associated with holding certain assets goes well beyond traditional financial metrics. It is also feeding into macroeconomic and geopolitical dynamics more than it has in the past, implying a growing need for investors to monitor and respond to ESG-related developments.

Theme 5: Disruptive Technologies

Advances in computing, automation, and other technologies have continued to accelerate. The increase in innovation has become global in nature, with both advanced and emerging countries pushing technological frontiers. Further, tightly-integrated and -digitized global supply chains have allowed these innovations to propagate quickly. Technologies today are also merging, impacting both the physical and digital worlds.

This technological disruption is no longer confined to a limited number of market segments such as the software, hardware, and pharmaceutical industries. Many industries that were not considered ripe for disruption have also been impacted. 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.

The entertainment and technology industries are another market where there have been very rapid changes, with companies such as Netflix rising to large valuations only to be disrupted a few years later by increased competition and new business models such as TikTok. Due to the dominant position of some of these tech stocks and their relatively high weights in the broader market index, these types of disruptions can have strong impacts on markets.

A key example of potential disruptive technological developments is provided by electric vehicles. Driven by tightening global fuel emissions standards and the push to decarbonize, electric vehicle technologies are disrupting the ways that automobile companies do business and will have knock-on effects to other connected industries. At the same time, the value of the vehicles themselves is being increasingly driven by software, technology and information embedded in the vehicle, rather than its physical components. We are only starting to witness some of the disruption that this will bring to this large part of the global economy.

More generally, these technological advancements have coincided with the concentration of gains amongst a narrowing group of firms, consistent with the rise in importance of network effects within many emerging – often digital – sectors and the increased prevalence of winner-take-all competitive dynamics. When such economics are at play, the related value creation tends to flow to first movers and/or those who manage to become the "standard" setters. While technological advances and digitalization can certainly generate productivity gains, research suggests they also risk worsening Inequality by accruing to the already-wealthy and those who are relatively highly skilled.[i]

We expect this heightened rate of technological disruption and innovation to continue for the foreseeable future, supported by ongoing capital investments. These developments will, in turn, continue to shape the ways that value creation, investment opportunities and risks are generated and distributed across markets.

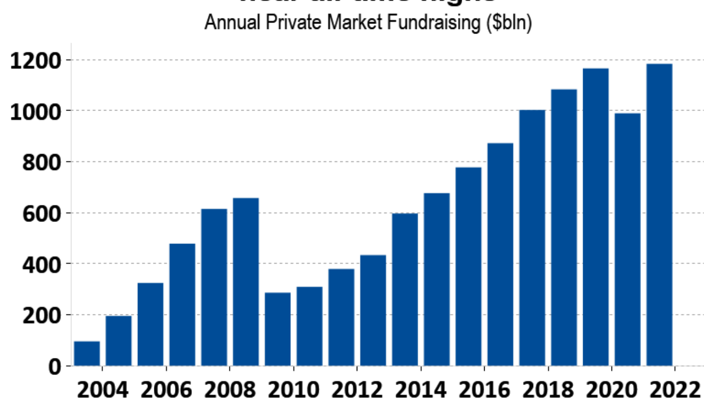
Theme 6: Evolving Market Structure

Private markets have been growing dramatically (**Chart 7**), with assets under management more than doubling to around $9 trillion over the last six years (by way of comparison, the market capitalization of the S&P 500 is around $32 trillion). This increase has largely been driven by the potential for superior risk-adjusted returns for investors who are able to withstand the lower levels of liquidity that most private investments exhibit (such as investors with long time horizons). In addition, low interest rates globally have led investors to turn to alternative sources of yield in an effort to meet their return objectives. This trend is expected to continue as investment managers grow their allocations to private investments at the same time that access to such investment is made easier. As an example, Prequin projects private capital AUM to increase at a rate of nearly 15% per year to approximately $18 trillion by 2026. Additionally, the ways in which private companies are being financed has changed, with post-GFC regulations contributing to a move away from bank-based financing towards more market-based forms.

As private markets have grown, so too have the institutions dedicated to those markets. The largest global private market investors, such as Blackstone, KKR, Brookfield, and The Carlyle Group have experienced considerable growth in recent years and today these four firms collectively have approximately $2.5 trillion assets under management. Additionally, many traditional asset managers such as pension funds have substantially increased their private market allocations.

Another key structural development within markets is the continued rise of index investing. Due in part to a growing focus on investment fees – and the realization that, net of fees, many investment managers have been unable to beat their benchmarks, this method of gaining access to markets has become increasingly popular over the last 20 years for both retail and institutional investors. In fact, this approach has become so prevalent that, as of the end of 2021, passively managed index funds owned more of the US stock market than did actively managed funds. More broadly, a recent study estimated that passive investors held around 38% of the US stock market in 2020. The proliferation of products allowing for passive exposure globally beyond the US will add further fuel to this trend.

Chart 7: Private market fundraising continues to sit near all-time highs



Source: McKinsey

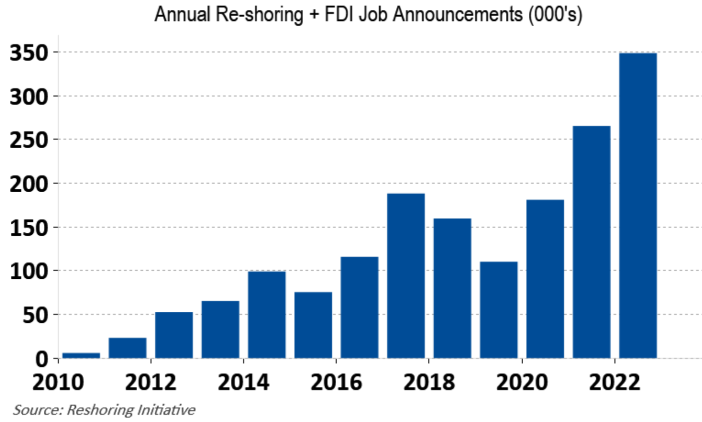
Section 2: Economic and Investment Implications

Implication 1: End of low for long

A confluence of factors laid out in Section 1 will likely mean the end of the "low for long" environment that defined the post-GFC, pre-COVID era – a time characterized by relatively low growth, inflation and interest rates. In this new world, inflation looks set to be higher and more volatile than we have become used to, with growth similarly experiencing higher steady state levels. Taken together, these developments raise the likelihood of higher interest rates and yields going forward, thereby reversing one of the prevailing market tailwinds of the past few decades.

As was laid out in Theme 2, Deglobalization looks set to play an important role in driving inflation going forward. Globalization was largely led by the relocation of manufacturing processes to lower-paying regions; "re-shoring" will therefore involve the production taking place in higher-paying regions (**Chart 8**), which could ultimately feed through to consumer prices. Redundant supply chains will also increase demand for both labour and raw materials globally, driving up input prices. And if politically-popular "buy domestic" policies gain further traction, local businesses could see increased pricing power as global competitive pressures wane.

Chart 8: Companies are increasingly moving production to the US



Decarbonization efforts will provide additional inflationary tailwinds through a few different avenues. One of the most important will be the substantial investments in infrastructure required to facilitate the net-zero transition, which will boost inflation both via the impact on raw materials required for such investment, as well as the knock-on effects of higher capital spending (i.e., additional incomes earned, etc.) Additionally, commodities used as inputs in the green energy transition are set to see increased demand amidst tightening supply – the ideal recipe for price increases. Lastly, Green energy is generally currently more expensive than traditional sources, so a transition at prevailing relative cost structures will be inflationary via higher spending on energy inputs. Strategies to discourage energy generation from fossil fuels such as carbon taxes will exacerbate this dynamic.

Both monetary and fiscal policy will also likely contribute to elevated inflation. Fiscal policy, however, should provide a greater thrust as it is better-suited to tackle the issues governments currently face (climate change, the want/need to onshore manufacturing, and inequality) and was proven as a very effective lever during the COVID crisis. As governments direct spending towards expanding domestic production capacity, developing new sources of clean energy, and alleviating income inequality, the additional income this will create will be a boon for demand and act as an inflationary tailwind. It will also help drive up the cost of the materials needed for such projects, exacerbating the inflationary impulse.

Monetary policy could also play a role in the coming inflationary environment. The Fed's shift to elevate full employment as an objective on par with price stability, as well as their tolerance for inflation overshoots (to make up for past shortfalls), means that monetary policy should be looser than it otherwise would have been under the previous framework. The spectre of inflation overtaking growth as the primary risk at the top of the Fed's mind, however, could limit its ability to take advantage of this added policy leeway, somewhat offsetting the impact from fiscal policy.

When it comes to investment implications, these trends favor greater exposure to inflation-sensitive assets. For example, a mix of **fixed income assets tilted more toward inflation-linked vs. nominal bonds** will likely perform well, especially given the relatively low levels of long-term breakeven inflation rates. Additionally, commodities should enjoy a relative boost in an inflationary environment. Thus, **adding**

commodity-linked assets (such as natural resources, mining royalties, etc.) **and/or increasing exposure to real assets such as real estate and (regulated) infrastructure investments** in an asset mix should be considered where appropriate. 'Growth' equities, including some major tech-related names, were relatively greater beneficiaries of low rates in the post-GFC era thanks to their anticipated cash flow stream being further off into the future (thus amplifying the effect of low discount rates). This was reflected in **growth equities' high valuations, which are now at increasing risk** as rates continue their rise. In addition, the correlation between stocks and bonds may not be as reliably negative as it has been over the past 20 years as inflation supplants the growth cycle as the dominant risk to markets, potentially reducing fixed income's ability to be a risk diversifier vis-à-vis equities.

Implication 2: Heightened volatility and greater dispersion

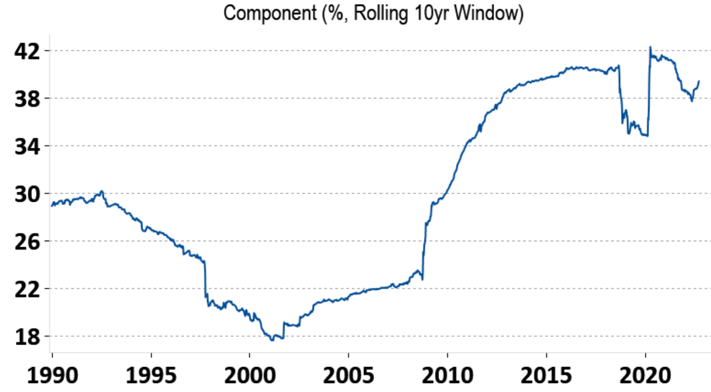
In the pre-COVID era, markets were largely driven by developments related to growth, with inflation playing a lesser role thanks to its relatively muted volatility and its tendency to remain in line with central banks' targets (or lower). Going forward, however, both the level and volatility of inflation (and possibly growth) are expected to remain higher than was experienced in the pre-COVID era. This, in turn, could very well usher in an era of greater market volatility than investors have grown accustomed to. One way this could manifest is via a decreased willingness and/or ability on central banks' part to step in and provide the type of policy support that was commonplace when markets experienced significant volatility over the past couple of decades (i.e., the Fed 'put'). Consequently, markets could experience more frequent and significant bouts of volatility, both from the initial reaction to more varied economic data as well as the consequential policy responses (or lack thereof).

To the extent that the latter are motivated by concerns around inflation, the ensuing tightening will have the knock-on effect of slowing growth and injecting additional volatility into markets. Once a given bout of inflation is brought under control, however, the underlying inflationary drivers could very well remain, thus prompting central banks to once again start thinking about tightening policy. Under these dynamics, higher inflation can be seen to lead to shorter cycles (and higher market volatility) as central banks switch back and forth more frequently between acting to slow growth and combatting high inflation. This would also likely translate into higher interest rate volatility, which should have a knock-on effect to equity market volatility.

In addition to these impacts at the asset class level, the above conditions would also likely coincide with greater dispersion across sectors, segments, individual securities, etc. within asset classes themselves. Shorter/more extreme economic cycles are intuitively more conducive to a broader spectrum of return outcomes, as opposed to the "rising tide lifts all boats" dynamic that characterized the post-GFC era (**Chart 9**).

Chart 9: Equities have experienced low dispersion since the GFC

Proportion of S&P 500 Members' Variance in Returns Explained by 1st Principal Component (%, Rolling 10yr Window)



Companies that previously relied upon persistently low interest rates and inflation will also face a particularly heightened set of new challenges.

From an investment perspective, these challenges also present opportunities. For example, higher market volatility can increase the window of opportunity for us to take advantage of market dislocations when they arise. **Rebalancing** already allows for this, and a more robust rebalancing program could further enable us to do so. The ability to purchase **public versions of private assets** – such as real estate – also allows us to take advantage of temporary discounts in public markets that may not yet be visible in private market valuations. And despite the potential for positive correlation between stocks and bonds going forward, **bonds will retain a valuable role (and thus asset allocation)** within the portfolio as a source of liquidity; higher volatility means more transactions/rebalancing, and the liquidity of bonds will allow us to undertake these activities without being forced to sell other assets (potentially at a discount).

At an asset class level, increased dispersion within asset classes will generate opportunities for outperformance via security selection (i.e., **active investment management outperforming passive**). We will therefore continue to build out best-in-class investment teams to take advantage of alpha generation opportunities via security selection and portfolio construction. Lastly, heightened volatility will elevate the **importance of currency hedging** approaches to improve portfolio risk/return trade-offs.

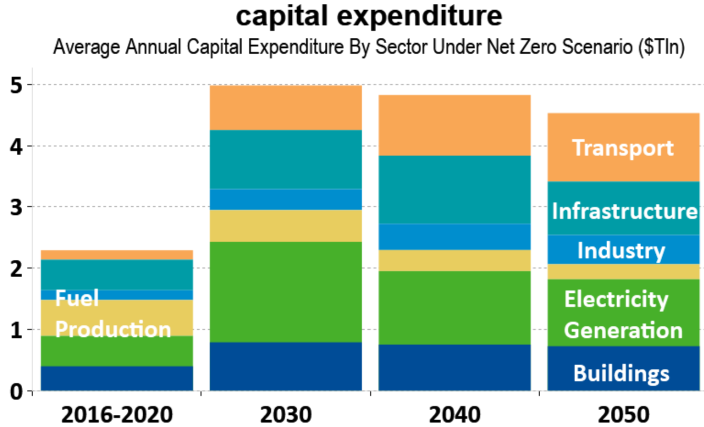
Implication 3: Capital investment boom

After more than 20 years of under-investment across industries, the coming decade appears to be poised for an investment boom. A key potential driver is the pursuit of government priorities (e.g., decarbonization, Green infrastructure, securing of strategic supplies, etc.), with further impetus to be provided by the private sector's efforts to shorten supply chains, on-shore production facilities and revamp their aging capital stock.

One of the most important drivers for the coming wave of investment will be the push across developed countries to onshore manufacturing processes. Such a process necessitates significant capex, as it involves the creation of an entire manufacturing base that is more self-sufficient across the value chain. Already, the US government has pledged $280bln to boost the domestic chip-making industry and scientific research. The bipartisan nature of the related Bill highlights the fact that the desire to shore up domestic manufacturing capabilities is strong across the political spectrum.

Climate change is also likely to spur further capital investment in support of the transition to lower emissions (**Chart 10**). The International Energy Agency projects that global clean energy investment will reach $1.4tln in 2022, accounting for almost three quarters of the growth in overall energy investment. Still, however, these numbers are expected to be below what is necessary

Chart 10: Net zero transition will require significant capital expenditure



Source: IEA

for countries to hit their climate targets, and as such should be expected to grow significantly in the coming decade. Energy security concerns (stoked by the Russian invasion of Ukraine) will accelerate the urgency with which domestic energy sources are developed.

Governments, however, are not the only ones who will drive capital expenditures. Due in part to both the strong nominal growth environment and ongoing labour shortages, companies are expanding productive capacity at record levels. Housing also looks primed for sustained investment activity, given the significant underinvestment seen in the sector following the GFC (especially in the US and Canada). Millennials entering prime home-buying age will require large amounts of additional housing to be built and will act as another driver of capital expenditure.

The significant capital investments – public as well as private – required in support of these new objectives should lead to an expanded opportunity set within capex- and infrastructure-related investments. An area where we see particular **opportunity is in assets that facilitate the energy transition**, rather than assets that are already low carbon (a "crowded trade" in our view). As a result, we will **continue building our ability to deploy capital directly and through external funds that have demonstrated expertise in funding transition investments**.

Implication 4: Growing role for/complexity of private investments

There are many benefits to owning private assets for long-term investors, including the potential for some promising business strategies to be better financed in the private markets than in public markets (e.g., those that involve significant changes in capital structures or strategies). Additional benefits can accrue to those who have the luxury of patience and ability to wait for these strategies to be implemented and deliver value. The changing nature of how private companies are financed (i.e., from bank-based previously to market-based financing more recently) means that there are a growing number of high-quality investment opportunities within private markets. We therefore will recommend that clients **continue to increase exposure to private investments, in line with the growing investable universe**.

In addition, size matters when it comes to investing generally, and especially so for investing in private markets. Large organizations dedicated to private investments (such as those mentioned in Theme 6) enjoy economies of scale and related cost advantages, better access to potential deals and origination opportunities, and the ability to build up dedicated operational expertise in a wider array of value-enhancement strategies, all of which lead to the potential for superior returns. Simple access is not enough, however, as the standard fees charged by large private asset managers can more than offset many of the advantages of investing in these types of assets. Therefore, we will continue to ensure we **partner with best-in-class large private asset managers and use our size to negotiate preferable fees.** We will also leverage and continue to **expand our internal operational expertise** to invest alongside these partners across various industries/sectors (in particular to take advantage of the Themes laid out above, such as energy transition assets). This will allow clients with long investment time horizons to take advantage of private market opportunities to generate favourable risk-adjusted returns.

Lastly, given a higher and more volatile interest rate environment, we see greater chances of success for **private investing opportunities that de-emphasize financial leverage** as a driver of investment returns and instead rely more heavily on fundamental value-creation levers.

Implication 5: Growing scope for unintended exposures

Index investing's growing popularity among retail and institutional investors masks the growing risks associated with these passive exposures. Most indices are constructed mechanically using metrics such as market capitalization, with little-to-no weight given to other criteria that might – and increasingly do – matter to individual investors' goals and values. These could relate to ESG considerations and undesirable country-specific exposures. Recent prominent examples include high greenhouse gas emitting industries, the Russia-Ukraine conflict and China-related risks (e.g., regulatory crackdowns on specific sectors, poor treatment of Uyghur Muslims, rising Taiwan- and trade-related tensions with the US).

Market capitalization-weighted indices also present potential concentration risks, wherein a small number of individual names can influence overall performance in an outsized manner. A current example is provided by US tech stocks, whose relatively outsized gains of the past decade have led to a very heavy representation in market cap-weighted indices. As a case in point, the 5 largest members of the S&P 500 now represent almost 25% of the index, around double where they were just five years ago.

Despite the above shortcomings and risks, there is still a role for the **benefits provided by broad-based liquid exposure** in client portfolios. With that in mind, we continue to build our ability to **provide such exposures in ways that align with clients' ESG beliefs** and **limit the potential for undue concentration risk**, via custom indices for example. We also work to **ensure that all our external managers comply with our ESG policy for such managers**.

Implication 6: The need for innovation and flexibility

We believe that technological, political and societal changes are as dramatic now as they have been at anytime in recent memory. Accordingly, we also believe that innovation and flexibility are key ingredients to effective investing. This includes **investing in asset classes with a broad remit** in order to manage risks and take advantage of opportunities in this fast-changing world, including having the flexibility to invest in public versions of private asset classes.

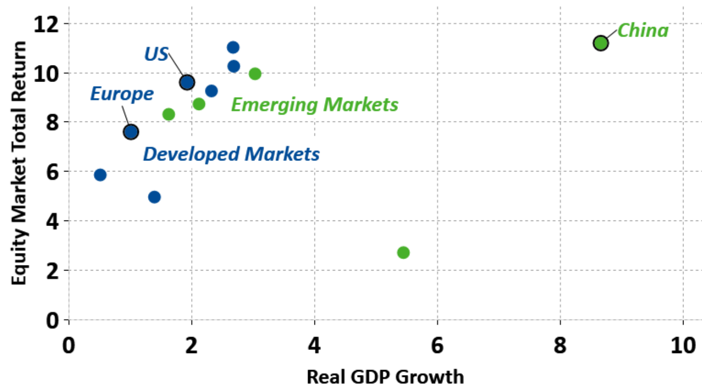
Given the scale of social and economic change underway, the ability to identify and integrate key insights into the investment process has never been more important. At such times of tumult, the past's ability to inform views about the future is diminished. This, in turn, enhances the potential returns from observation and analysis of the current environment relative to the simple extrapolation of history.

Diverging prospects in China and Europe provide a timely example, with China's extremely high economic growth of the past couple of decades masking the many hurdles investors are likely to face in that market going forward, including greater exposure to deglobalization, rising trade tensions with the US, domestic regulatory risks, and ESG issues. Meanwhile, Europe's relatively low growth belies the region's improving investment environment, particularly when it comes to the scope for a more stable and supportive institutional structure broadly (e.g., greater fiscal union, presence of a monetary backstop) and the pursuit of economic goals more specifically (e.g., energy transition, infrastructure improvements, etc.).

These idiosynchratic country drivers highlight the need to look beyond broad, relative economic growth rates – whether past or prospective – when evaluating potential investments. History suggests similar, with countries' GDP growth rates and domestic equity market performance exhibiting only a very loose relationship over the past couple of decades (**Chart 11**). Clearly, other factors also matter and point to the need for a thorough assessment of potential returns, risks, diversification benefits and our own ability to outperform. For these reasons, IMCO focuses on a **research-driven investment process** to monitor and respond to the changing world around us.

Chart 11: There is no clear relationship between GDP growth and equity market returns

20yr Annualized Growth (2001-2021) in USD



And finally, because such change is not only likely but inevitable, it is necessary to **review our assumptions and adjust the asset mix advice we provide to clients annually** while remaining humble and flexible.

Concluding Thoughts

Many of the "certainties" investors have seemingly been taking for granted over the past several decades appear to be fading. On the economic front, globalization, low and stable inflation, and the related one-way ride down in interest rates no longer look to be the slam dunk they once were. Societal priorities also appear to be shifting, with domestic concerns around inequality, security of strategic supplies, and climate change rising up the agenda, thus supporting the use of a more "visible hand" on the policy front. Taken together, these potential structural shifts make it more difficult to rely on hindsight – whether in relation to the recent past or the longer (average) historical experience – to shape forward-looking views.

For investors, effectively navigating these changes will require an elevated level of thought leadership and a willingness to adopt dynamic and innovative approaches to asset management. This document provides a starting point for this ongoing process and is shared with the knowledge that our views on these shifting trends and their related investment implications will be regularly revisited and – if necessary – revised over time. We believe that this flexible research-driven investment process, coupled with IMCO's ability to recognize and respond to the needs of its clients, puts us in a strong position to navigate our changing world.

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[i] Information Economy Report 2017, Digitalization, Trade and Development, UN Conference on Trade and Development https://news.un.org/en/story/2017/10/567612-winner-takes-all-dynamics-digital-economy-could-widen-income-gap-un-report