Rothschild & Co
Wealth Management

Insights

ISSUE 12 | AUTUMN 2023

Cover image: aerial view of winding mountain road through autumnal forest © Getty Images.

Values: all data as of 31 August 2023.

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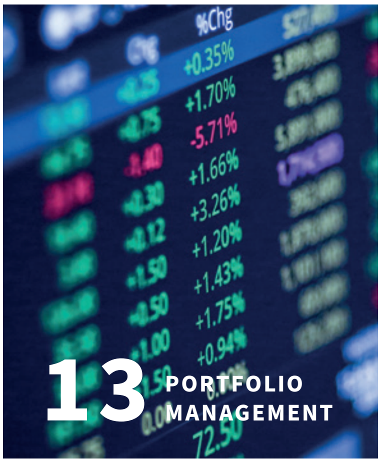
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From summer into autumn

As summer draws to a close and the first hints of autumn appear on the horizon, we present to you a new edition of *Insights*.

In this edition we take a closer look at the macroeconomic events that have significantly shaped the global financial landscape in recent months, resulting in significant changes in our asset allocation. Within this context, we explore the role of dividend stocks as a potential strategy for effectively navigating the challenges posed by inflation and recessionary conditions.

We are also delighted to bring you an interview featuring our Front Office Heads in Geneva and Zurich, Gabriel Gascon and Andreas Feller. They share their experiences of preserving wealth in an ever-changing world. Additionally, we spoke to Jonathan Levy and Giovanna Lagutaine, respectively our art curator and Market Head Swiss Onshore, as we delve into our remarkable in-house art collection and the latest in the art markets.

Shifting gears, our equity research team takes us on a road trip to the US, unveiling the potential and prospects of various industries.

Lastly, we venture into the realm of private markets, which has become a staple element of a well-diversified portfolio.

As the pages of this publication turn like the changing seasons, we hope you enjoy this edition of *Insights* and wish you a wonderful autumn.

Warmest regards,

Laurent Gagnebin
CEO, Rothschild & Co Bank AG

Autumn is a second spring
when every leaf is a flower

— Albert Camus

Climbing the wall of worry

Kevin Gardiner — Global Investment Strategist

As an economist, I go to meetings and people tell me about the economy. Everybody has a view; most people have several. Those views are usually pessimistic.

There have been many things to worry about recently.

Geopolitical tensions are more troubling than for many years. Not so much because of the attrition in Ukraine, grim though it is, but because China and the US seem to be flirting with mutually assured economic destruction over Taiwan.

Domestic politics looks dysfunctional in several major Western countries, most visibly in the US.

Then there have been the covid-related lockdowns and the more recent cost of living squeeze, and their impact on young people and poorer families in particular.

Yet the business cycle, and the more structural wall of economic worries that pundits have built, may be less troubling than people realise.

Ronald Reagan said he didn't worry about the US budget deficit because it was "big enough to look after itself". Arguably, the same could be said for the wider global economy. Bright ideas – inappropriate tax rises, inappropriate tax cuts, rent controls and financial suppression – often don't help. There should be a sort of Hippocratic oath for economic advisers: first, don't make things worse.

We face some pressing issues. Monetary policy has been poorly administered recently, not least because central banks themselves were captured by the groupthink noted above. It may even be flawed in design. If the lags between interest rates rising and economies responding are as "long and variable" as they seem, we have to ask if there might be a better way of managing aggregate demand – or of living with the fallout if it goes unmanaged. The answer should not be more active fiscal policy or credit controls.

But we have been around the inflation, interest rate and recession course many times, if not recently, and the current inflation episode does not look as threatening as it could have.

Labour markets have in fact been remarkably flexible as workers have effectively traded real wages for job stability: the much-feared "wage price spiral" has not materialised, at least not yet. Monetary overkill can be kept at bay.

Meanwhile, in the developed world, household net worth may have fallen from its early 2002 highs, but it is hugely positive, and will remain well above its historical trends. Balance sheets generally – governments' as well as consumers' – do not pose the structural threat that many pundits imagine; nor do ageing populations (at least in the West).

Currently, business surveys are weak, but not dramatically so. Harder data on output looks resilient. The US is strongest now, with Europe lagging and China disappointing. Later in the year, however, hard-pressed European consumers are likely to benefit as lower energy costs make themselves felt, while China's negligible inflation is allowing policy to turn more supportive there.

Technical recession cannot be ruled out. Resumed banking stresses – and financial accidents generally – are always possible given how far interest rates have risen. But a more dramatic economic downturn still seems neither necessary nor likely.

If business can adjust to "old normal" levels of interest rates, however, as we think it eventually will, investors will need to adjust too.

Nominal policy rates may be close to their highs, but they may not come back down in a hurry. Real interest rates may return to positive territory, even in Europe, and stay there. Many bond prices will not regain highs quickly, if ever. However, their yields will once again be delivering a meaningful source of investment income.

After the trauma of 2022, bonds will not be viewed as offering "risk free returns" again any time soon, but they are at least no longer offering "return-free risk".

Old normal levels of interest rates may also restrain equity valuations, and make high dividend sectors more attractive, but as yet these considerations are not affecting our tactical asset allocation for Mosaique portfolios. US corporate profitability has been remarkably robust now for perhaps three decades, and not just because of the low interest rates of recent years. In our view, global stocks never priced in those low rates fully to begin with.

Indeed, as global GDP shifts further towards services and digital output, balance sheets too may become less tangible and perhaps smaller, underpinning profitability structurally. The product cycle may be as important as interest rates in shaping stock market leadership, and helping it climb that wall of worry.

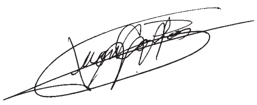
A positive second half

The first half of 2023 saw a reversal in market sentiment, with markets rallying significantly from the lows seen in the fourth quarter of 2022, albeit concentrated in a small number of companies. The lack of significant adverse economic impact resulting from central bank tightening measures, coupled with noticeable indications of inflation easing, contributed to this robust reversal.

China reopened in January 2023 after a three-year period of isolation, expecting that private investments would help boost its economic recovery. However, the most recent data indicates that private investment is not picking up as expected. As a result of this, China's economic recovery is facing further challenges, with the situation exacerbated by the recent downturn in the property market.

On a more positive note, at a global level, corporate earnings proved much stronger than expected, especially for high-quality large and mega-cap companies. With inflation cooling down and the economy having so far evaded setbacks, we see positive signs for the second half of the year. While short-term setbacks and corrections are always possible, we think a wider cyclical rebound to new highs may still lie ahead, and further declines in inflation may prove the catalyst.

Dr. Carlos Mejia
Chief Investment Officer



Mosaique asset allocation

Dr. Carlos Mejia — Chief Investment Officer
Kevin Gardiner — Global Investment Strategist

Economic strength is most visible in the US, where annualised growth as we entered the third quarter seems to have accelerated markedly. Against this backdrop, the US Treasury note yield rose briefly to its highest levels since 2007 in August.

Economies look most fragile in Europe, particularly in the euro area, though unemployment is still historically low, and there is a marked divergence between weak subjective survey data and more resilient data on output and spending. China continues to disappoint, but growth there remains comfortably higher than in most Western economies, and policymakers have a lot of room to support the economy if they wish to do so.

Inflation continues to trend lower, but at varying speeds. The trend is best established in the US, despite its more robust economy, whereas in Europe core inflation rates in particular have yet to peak convincingly. China faces negligible inflation, which is one of the reasons its authorities are able to reduce interest rates while those elsewhere are still raising them.

Overall, our view of the wider economic cycle remains unchanged. A technical recession is still possible in the major economies, as the full effects of monetary policy have still to make themselves felt, and it would be surprising if there were to be no further financial accidents after such a rapid tightening. However, we continue to believe that a more significant downturn is neither necessary nor likely.

In Europe in particular the fall in energy costs is starting to support spending power in the face of those higher interest rates. But we doubt that economic growth will be strong enough to prevent spare capacity from starting to grow again. This, together with the fading of earlier bottlenecks, and labour markets that remain remarkably well-behaved (despite cost of living pressures and those low unemployment rates), is likely to allow inflation to continue slowly to roll over. That said, we do not see US and European inflation rates returning sustainably to target, but see them likely sticking in the 2–4% region.

Investment conclusion

Economies are thus soft enough to suggest central banks have nearly finished raising interest rates, but not sufficiently weak to suggest interest rates can soon start falling again. Against this backdrop, the last month has seen both bond and stock prices fall.

In late July we moved overweight on stocks, and despite August's setback we think this remains the right stance. The risk of monetary overkill has faded, and expectations for corporate profitability are stabilising at healthy levels. Stock prices have already risen significantly from last Autumn's lows, and are not cheap, but we think that a substantial "risk on" rally may still lie ahead (aided perhaps by some further improvement in US–China tensions around Taiwan). We cannot predict the timing with confidence, but moved overweight in anticipation.

Bonds are no longer expensive, and more bonds in the US and UK are once again offering yields that seem likely to exceed even the above-target inflation we expect to continue. However, with the final instalments of monetary tightening still uncertain, and with resumed rate cuts only a remote prospect, we think it is perhaps premature to turn more positive – particularly in Europe, where real yields remain lower, and where we only returned to neutral in July.

Equities

We restored our equity stance to overweight in late July, having cut it to neutral after Russia's invasion of Ukraine, but left our regional and sectoral preferences unchanged. We continue to favour the US and emerging Asia, China's short-term difficulties notwithstanding, and remain underweight in defensive Switzerland and the UK, while tilting portfolios towards a mix of growth and cyclical sectors, at the expense of defensiveness. We funded this move by reducing liquidity.

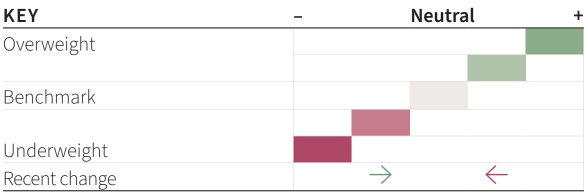
Fixed income

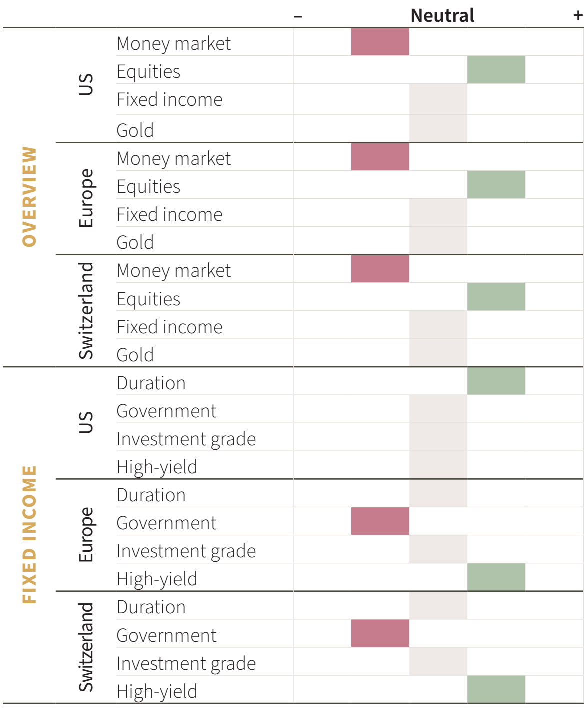
Last month we closed our long-standing underweight, in European portfolios, in bonds. That left our fixed income positioning aligned more closely with that in the US (the remaining divergence being that in European portfolios we still favour high-yield credit, whereas in US portfolios we are neutral on credit quality). As with the equity move, we funded this addition to bonds in European portfolios from liquidity.

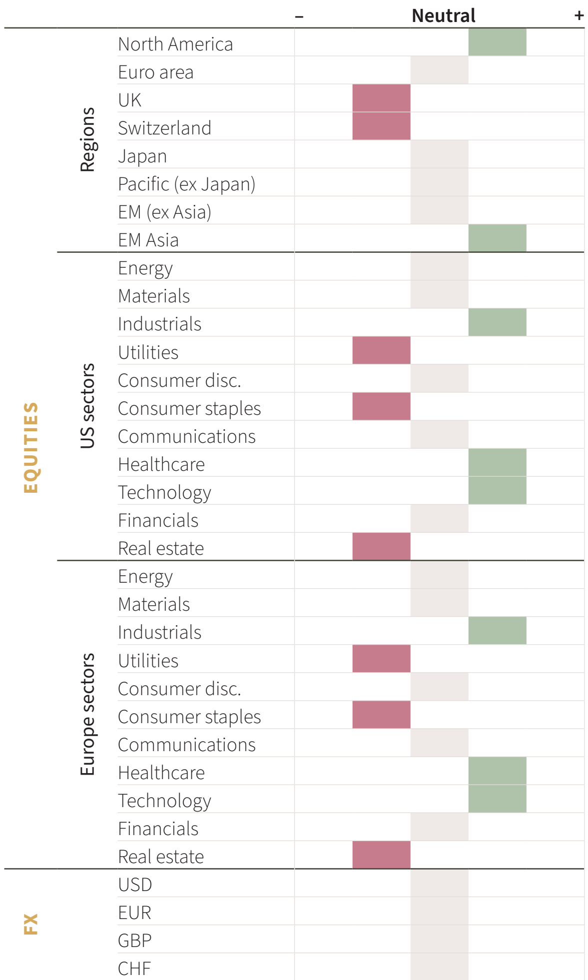
These changes left our overall asset allocation similarly positioned in US and European portfolios: we have a single overweight in equities, a single underweight in liquidity, and a neutral position in bonds. We can imagine being overweight in both asset classes at some stage, but that likely requires (even) greater confidence in a favourable inflation/growth mix – and the prospect of lower interest rates.

Currencies

We continue to have little conviction on the major currencies – a view that has served us well in the recent low-volatility foreign exchange climate. The dollar's underpinnings are arguably less robust than of late: the Fed looks closest to completing its monetary tightening, and a resilient global economy and improving risk appetite are arguments for dollar weakness, not strength. The US currency also looks expensive. But this is not a strongly-held view, and it has not carried through to our regional equity positions. Currency conviction is low at the best of times, or should be, and it is equity volatility that dominates returns from most balanced portfolios.





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Market musings

Clément Boisson, CFA — Portfolio manager

This year has witnessed a significant shift in market sentiment. Unlike in 2022 when growth was viewed as the least preferred equity investment style, it has emerged as the most successful approach in 2023. Moreover, our preference for companies displaying high-quality attributes has proven advantageous – we have concentrated on investing in cash-generating firms with robust balance sheets, especially those falling within the large and mega-cap category.

A recap

The spring brought significant developments to the financial landscape. Some banks started to feel the impact of the rapid interest rate hikes implemented by central banks, resulting in weaker banks being acquired by competitors boasting strong balance sheets, both in Europe and the US. Despite these changes, overall market conditions improved, dispelling concerns of a full-fledged banking crisis. At the same time, positive economic indicators emerged, with a decline in inflation and sustained high employment levels. Companies reported robust earnings, bolstering market sentiment. The primary drivers of this upswing were the 'magnificent seven',[1] the largest US technology-related stocks, which accounted for the majority of market gains during the spring. While some expressed reservations about the sustainability of this rally in the short term, broader stock market participation soon materialised, contributing to a more robust market environment.

[1] Apple, Microsoft, Amazon, Google, Nvidia, Tesla, and Meta (Facebook)

After experiencing significant fluctuations in the first quarter, expectations of rate cuts faded away. With a robust economy and low unemployment, central banks shifted their focus to inflation, resulting in higher rates. Conversely, spreads followed an opposing trajectory, experiencing a slight reduction. The summer then began with a continuation of the prevailing trends, albeit encountering some challenges in early August. However, this minor correction was brief, and markets persevered, with technology and quality stocks still leading the way.

Implications for our portfolios

In terms of portfolio performance, our stock selection played a pivotal role. Our investments in the luxury and technology sectors performed exceptionally well and significantly contributed to our overall performance. On the flip side, our holdings with exposure to Asia (excluding Japan) lagged behind. In July, we adjusted our equity stance, shifting it back to overweight after previously moving it to neutral following Russia's invasion of Ukraine.

However, we kept our regional and sectoral preferences unchanged, maintaining a favourable view of the US and emerging Asia while remaining underweight in more defensive markets like Switzerland and the UK.

Additionally, we tilted our portfolios toward a blend of growth and cyclical sectors, reducing emphasis on defensiveness. To fund this shift, we reduced our liquidity allocation. Furthermore, we addressed our long-standing underweight position in fixed income and opted to increase duration. This decision was made as the Federal Reserve, and subsequently other major central banks, slowed down their interest rate hikes. These adjustments resulted in a similar asset allocation across our US and European portfolios: we now hold a single overweight position in equities, a single underweight position in liquidity, and a neutral position in bonds.

Looking ahead

Our outlook remains predominantly positive. We see an economy that has demonstrated resilience in the face of rising interest rates and a gradual decline in inflation. Corporate earnings continue to be robust, and we maintain confidence in our portfolio's positioning, emphasizing quality companies with solid cash flows and clear visibility. Central banks are approaching the later stages of their hiking cycles, which presents intriguing opportunities for bonds—something we haven't witnessed in quite some time.

While the global landscape may appear challenging, we believe that by maintaining a pragmatic approach in light of hard economic data and remaining steadfast in our long-term strategy of focusing on high-quality companies, we can strive to deliver strong performance for the foreseeable future.

Our outlook remains predominantly positive. We see an economy that has demonstrated resilience in the face of rising interest rates and a gradual decline in inflation.


Market Perspective
Want to read more about the current macroeconomic environment?
Our flagship strategy publication *Market Perspective* gives you the latest market and macro-economic insights from our Global Investment Strategists and explains what they mean for your portfolios.
www.rothschildandco.com/insights

Fine-tuning our approach

Gabriel Gascon — Head Private Banking Geneva
Andreas Feller — Head Swiss Onshore and Deputy Head Private Banking Zurich

There are many myths surrounding private banking, an industry that has not only witnessed significant developments in recent years, particularly with the emergence of artificial intelligence, but also grappled with evolving client needs in an ever-changing complex financial landscape. In this interview with Andreas Feller (AF) and Gabriel Gascon (GG), we find out whether these myths are justified, explore the key changes likely in the years to come and discuss how we can assist our clients with navigating complex market environments.

Q1: In your opinion, what distinguishes Rothschild & Co (R&Co) from other banks?

GG: We are a family-owned bank and this fact truly sets us apart. At R&Co, corporate and family interests are seamlessly aligned, complemented by the high-quality service we deliver. We have been advising families with substantial wealth for over 200 years, and we grant access to an unparalleled global network of expertise, including our Merchant Bank[1] and Global Advisory[2] businesses, which are an integral part of our heritage.

AF: What also truly distinguishes us is our core area of expertise: providing advice. Whether it's in advisory services or investment banking, our DNA is deeply rooted in the art of counsel, which is a tradition passed down through generations. This sets us apart from many of our peers that primarily focus on launching financial products and funds.

Q2: In what ways has artificial intelligence transformed private banking?

GG: I believe artificial intelligence (AI) will have a similar transformative power as the internet had in the early 2000s. It will reshape our work processes and require us to invest in new technologies to ensure we offer our clients the highest level of service. At the same time, I don't anticipate it altering the fundamental way private banking forges client relationships. Private banking is a people-centric industry, rooted in personal relationships and trust. While technology is a powerful tool to support and enhance our service, it will not replace the human interaction.

AF: I agree with Gabriel. Technology can never replicate the depth of a human relationship built over years of trust and meaningful interactions. I have personally navigated through numerous global financial crises in my career and while technology may produce superior charts and data analysis of the 2008 financial crisis, it cannot convey what it was like to live through it. I managed portfolios, experienced the emotions and supported clients, and today I can offer valuable advice to my clients based on those lessons learnt. This is where technology inevitably falls short.

Q3: What shifts do you foresee in the next years?

GG: Due to shifting demographics, we anticipate a significant wealth transfer in the upcoming years, resulting in a new generation of clients. This new generation is very tech-savvy and expects a seamless digital experience with swift access to information and support. They are well-versed in digital tools, conduct thorough due diligence on pricing and services, and place a huge emphasis on transparency in fee structures, investment options, and the advisory process. At the same time, with financial markets becoming more complex, there is an opportunity for us to empower our clients, particularly the younger ones, by enhancing their financial literacy and equipping them with the necessary investment strategies to navigate this complex environment.

[1] Merchant Banking is the investment arm of Rothschild & Co which deploys the firm's capital, alongside that of a select set of leading institutional and private investors.

[2] Global Advisory offers mergers and acquisitions, debt advisory as well as equity markets solutions.

AF: I foresee three significant shifts. Firstly, there's a gradual consolidation within the industry, driven by regulatory pressures. Secondly, there's a changing landscape of client and prospect expectations: Today, our clients demand a comprehensive approach, seeking a 360-degree banking service that moves away from transactional dealings towards holistic solutions. This shift is particularly evident among clients whose wealth and businesses span international borders encompassing multiple jurisdictions and generational wealth transfers. To address these evolving dynamics, we've strengthened our expertise in areas like financial, wealth, and retirement planning. Thirdly, as Gabriel rightly mentioned, the anticipated substantial wealth transfer that will require adaptation to cater to the needs and preferences of the younger generation. However, while discussions about engaging with the younger generation are obviously very prevalent, in the context of wealth transfer, this discussion still happens a generation earlier. To put this into numbers: on average, our Swiss clients tend to pass on their wealth in their 70s and 80s to their children who are frequently already in their 40s or 50s, rather than directly to millennials and younger.

Q4: In June, Switzerland committed to achieving net-zero greenhouse gas emissions by 2050. Are your clients expressing greater interest in environmental, social and governance (ESG) investment options, and how are you addressing their needs?

GG: As environmental awareness grows globally, there is increasing recognition of the significance of ESG investments. To succeed in this realm, we must adopt a long-term perspective. ESG principles are not novel, and there exist numerous sustainable companies that are both environmentally responsible and highly profitable. As ESG gains more prominence in the listed market, identifying opportunities becomes more challenging. However, we are very well-equipped to tackle these challenges through our comprehensive array of solutions and advisory services.

AF: Our bank adheres to all relevant standards, and we embrace a transitional mindset. This means that our corporate philosophy isn't solely based on excluding certain companies; instead, we focus on firms striving to drive positive change. It's also important to acknowledge a growing sense of scepticism among clients regarding whether companies genuinely follow through on their ESG commitments and whether the initiatives being undertaken will truly yield anticipated benefits by 2030 or 2050. This is a factor we need to consider when doing our research.

Q5: R&Co clients have access to a wide range of asset classes. Do you observe changing preferences among clients, and are there any particular asset classes you are keeping an eye on in the near future?

AF: Client preferences are constantly evolving, and we've noticed distinct shifts towards three asset classes – cash, fixed income and private markets. Just two years ago, the focus was on markets like venture capital, cryptocurrencies, automobiles, watches and real estate. However, with the recent normalisation of interest rates, it has become evident that these asset classes had entered into a speculative bubble. We are now returning to fundamentals, where cash and fixed income, which took a backseat over the past decade, are making a comeback. While some might find them less exciting, they offer significant benefits from both a risk management and return optimisation perspective.

GG: The current situation in the bond market is exceptional, offering appealing yields, which have been absent for quite some time. Our clients have shown increased demand for bonds, particularly corporate bonds with an average maturity of three years in the euro market and five years in the US market. Private debt[3] presents another highly attractive investment opportunities for many borrowers seeking refinancing. This asset class can yield exceptional internal rates of return. How can our clients invest? This ties back to what I previously mentioned about what truly distinguishes us from the rest: our Merchant Banking. The R&Co Group, along with Rothschild family members and employees, represents 13% of the total commitment of the assets of the Merchant Banking, reflecting an extraordinary alignment of interests.

The current situation in the bond market is indeed exceptional, offering appealing yields, which have been absent for quite some time.

[3] Do you want to know more about Private Markets? Read the interview *Navigating private debt and private equity: a conversation with our Swiss specialists* on page 40.

Q6: We already touched on the next generation. Are their requirements distinct from those of the previous generation, and how do you provide support?

GG: The next generation has indeed a unique perspective, largely influenced by their education and the continually evolving financial landscape. We place considerable emphasis on comprehensive trainings to equip them for these changing dynamics. Interestingly, younger clients exhibit a keen awareness of pricing. At the same time, there's a fascinating twist – they yearn for a sense of security. Once a strong rapport is established, they seek the tangible presence of a bank, the dependable vault, and a personal connection with their banker. For them, it extends beyond mere numbers; it hinges on trust and a genuine human bond.

AF: In my opinion, the investment behaviour of the next generation isn't as distinct as some might assume. Obviously, they are technologically highly knowledgeable, but at the same time, they highly value the human relationship with their banker. While they often manage smaller amounts of money themselves, such as through online trading, they seek professional advice from a seasoned banker when dealing with substantial investments. They also aspire to grow as individuals and expect timely feedback which we are able to provide them with.

Q7: In your experience, what are some common misconceptions or myths surrounding private banking that you frequently encounter, and how do you go about dispelling them?

GG: Private banks are often perceived as secretive and lacking transparency, partly due to scandals in the industry that have fueled such beliefs. In contrast to many industry players, we take a different approach by openly disclosing our cost structure when discussing it with our clients and prospects. This complete transparency is of the utmost importance because our relationship is fundamentally rooted in trust.

AF: A significant misconception revolves around the notion that Private Banking solely entails "wine and dine", which is just a fraction of the overall experience. Clients now seek "content and community building". We invest significant time and effort in curating content that aligns with their interests and ensure that the right individuals are actively engaged in these interactions. Our service is not a one-size-fits-all approach – it is meticulously crafted to cater to each client's unique needs.

Andreas Feller

Andreas Feller joined Rothschild & Co as Head of Swiss Onshore and Deputy Head of Private Banking in Zurich in 2022 and has been a member of the Executive Committee at Rothschild & Co Bank AG since 2023. Previously, he served as Head of Private Banking for German speaking Switzerland and was a member of the Regional Management Committee at Bank Julius Bär AG in Zurich. He completed his studies with a focus on Finance at Hochschule Luzern.

Gabriel Gascon

Gabriel Gascon has been serving as the Head of Private Banking in Geneva and has been a part of the Executive Committee at Rothschild & Co Bank AG since 2017. He joined Rothschild & Co Bank AG in Geneva as a client adviser in 2012 and later became the team leader for Swiss clients in 2015. Previously, Gabriel worked as a client adviser at Credit Suisse Geneva in the Special Service division (for international UHNWI clients) in 2009. Gabriel holds a degree in finance from the University of Paris Dauphine.

Bonds 2.0

Bastian Freitag — Portfolio manager, fixed income

After a year of record losses of well over 10%, bond markets have been moving sideways since the beginning of 2023.

One example is the yields on 10-year US government bonds, which have risen by around 20 basis points since January. This is a moderate increase in view of the rising key interest rates and the rather hawkish stance of the leading central banks.

Despite this development, our outlook for global bond markets has gradually improved in recent weeks. The three main arguments for our more optimistic view on bonds are:

1. The inflation outlook is steadily improving.

2. Major central banks rate hike cycle is coming to an end.

3. Bond valuations have become more attractive again.

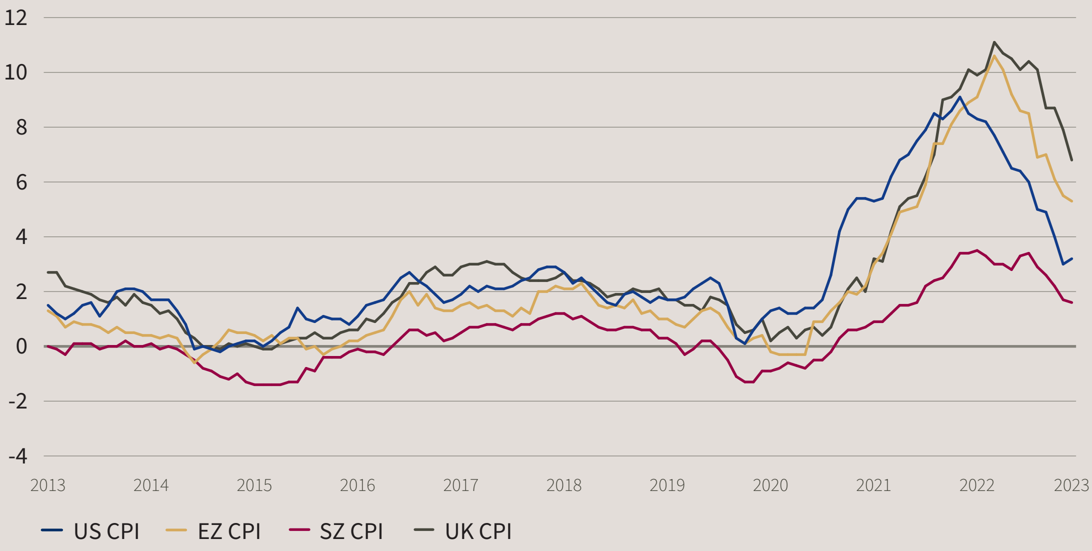
Inflation rates have passed their peak

Since the beginning of 2022, inflation rates have been by far the most significant factor in bond market assessments. For many decades and for the first time since the creation of the euro area, inflation rates have clearly exceeded the leading central banks' target of 2%. Furthermore, headline inflation rates[1] for most major economies have declined significantly since the middle of last year (figure 1). This trend has had a positive impact on bond markets and contributed to their stabilisation.

[1] Headline inflation shows the change in the price level of all goods and services.

FIGURE 1: HEADLINE INFLATION RATES HAVE DECLINED

Rate of change of headline inflation in the US, the euro area, Switzerland and the UK (%)



Source: Rothschild & Co.

[2] If we exclude goods that are currently particularly hit by inflation, such as energy and food, when calculating inflation, we obtain the core inflation rate.

[3] Influence of unusual or extreme changes in the price index/sub-index during the base period on the changes in the annual inflation rate. A base period represents the period on which the calculation of annual rates is based.

Even though the core inflation rate[2] is (still) clearly above the headline inflation rate, the general decline in inflation rates is positive for the outlook on bonds. In this context, the decline is not only due to base effects[3], but also in particular due to the strong decline in commodity prices, especially energy. In addition, the easing of global supply chains, which were under enormous strain during the Covid pandemic, is reducing inflation rates.

Interest rate hike cycle nears end

Until recently, many central banks have continuously raised interest rates. But gradually this cycle is coming to an end, as falling inflation rates and the uncertain economic outlook should allow central banks to adopt a wait-and-see attitude. For the euro area, we expect one more rate hike from the European Central Bank (ECB), and for the UK, at least one more hike from the Bank of England. Concerning the Federal Reserve (Fed), it is uncertain whether there will be another rate hike later in the year. One thing is almost certain, however: by the end of 2023, many central banks in the developed world are likely to pause their rate hike cycle, which is expected to have a positive impact on bond markets. How interest rates develop after this expected pause is uncertain, in our opinion. However, short-term rate cuts are unlikely unless the economic outlook deteriorates significantly.

Valuation of bonds significantly more attractive

Another factor positively influencing the outlook for bonds relates to their valuations, which have improved significantly since the beginning of 2022. Yields on global bonds are currently more attractive than at any time since the global financial crisis of 2008/09 (figure 2).

Even though the core inflation rate is (still) clearly above the headline inflation rate, the general decline in inflation rates is positive for the outlook on bonds.

FIGURE 2: GLOBAL BOND YIELDS LOOK ATTRACTIVE

Yield of the Bloomberg Global Aggregate Index (%)

Source: Rothschild & Co, Bloomberg.

The current yield on bonds is the decisive factor influencing expected returns over the investment period. Compared to the low/zero interest rate period before the outbreak of the Covid pandemic, bonds appear much more attractive again. Now, investors can once again achieve attractive annual returns regardless of what happens in the interest rate performance on the bond markets, by selecting bonds with high coupons.

What are the risks to our more positive outlook for bonds?

We are currently focusing on two main threats to bond markets:

1. **The possibility of a second "inflation wave", similar to that of the 1970s.** The decline in inflation so far is concentrated in headline inflation. Core inflation remains (still) significantly too high. In addition to the risk of a rise in commodity prices, there is a risk of a wage–price spiral. Such a development would force the central banks to raise interest rates further instead of pausing as expected.
2. **An abrupt crash of the real economy due to the strong interest rate hikes that would impact corporate bonds.** A so-called "hard-landing scenario" would impact corporate bonds, especially of poorer quality, with price losses. Such a recession would clearly support AAA-rated government bonds, as the central banks would cut interest rates sharply.

Neither scenario can be ruled out, but they seem unlikely at this point.

How do we position ourselves?

Our more optimistic outlook for bonds is also reflected in our current asset allocation. We have recently changed our underweight bond allocation and are now neutrally positioned. In the US, we have also upgraded duration to overweight.

It is possible that we will further increase our positioning with regard to bonds in the future, both in terms of allocation and duration extension.

Andreas Schulze, Untitled (9), 2007

A moving narrative

Giovanna Lagutaine — Managing Director and Market Head Swiss Onshore
Jonathan Levy — Curator and art expert

Building on our firm's rich history of supporting the arts, our latest curated exhibition explores themes around history, historiography and storytelling. We take a look behind the scenes, as well as at the broader state of today's art markets.

Q1: Let's talk about *Moving Narratives*, the latest exhibition that's on display in our Zurich office. Can you explain the overall theme and concept of the exhibition and also the inspiration behind curating this particular exhibition?

Jonathan Levy (JL): *Moving Narratives* is the second curated exhibition in our annual series here at Rothschild & Co in Zurich. The exhibition explores themes around history, historiography and storytelling. Through our artists' various perspectives, the exhibition looks at how history is recorded, processed and passed on. When we selected the artists for this exhibition a pattern emerged. On one hand, the exhibition features artists whose work engages conceptually with historical material and critically examines how history is packaged and transported. On the other hand, the exhibition includes work by artists who act as storytellers, drawing on inspiration from the aesthetics and methods of children's books and other universally familiar sources. In all our curated exhibitions, we follow three guiding principles: (1) to showcase art that is relevant and representative of our times; (2) to produce exhibitions that connect with the history of the Rothschilds; and (3) to provide a platform for the promotion of contemporary artists, whose work we admire and want to collect.

Q2: What do you hope visitors will take away from the experience?

Giovanna Lagutaine (GL): We want to create exhibitions that visitors find enriching, enabling them to either discover exceptional new artists or delve further into their existing knowledge of artists they might already be familiar with. Our aim is to captivate and inspire visitors, raising an awareness of themes that hold both universal significance and particular relevance in today's world. It is our aspiration for our exhibitions and the Rothschild & Co Switzerland art collection to become significant in a wider art historical dialogue.

Q3: What does your curatorial process look like when organising an exhibition?

JL: Our three key principles influence the way we go about researching and developing a concept for our exhibitions. One aspect is to grow our knowledge and understanding of the Rothschild history, while a second is to try to keep up with current social and economic debates. The last and most important thing is to closely follow developments in the contemporary art scene. We're always looking for artists that have a connection to the five Rothschild countries (Germany, the United Kingdom, France, Italy and Austria), are particularly relevant in today's wider discourse and could fit into our collection. This involves wide research and in-depth interactions with various artists, galleries and other art institutions.

Right: Andreas Schulze, o.T. (Knoten), 2007

Left: Julian Irlinger, expiration: 11/1/1921 (II), 2021

GL: I find it fascinating to see how Jonathan's original vision gradually shapes and evolves into a concrete exhibition proposal. The extensive research is followed by in-depth discussions with the artists and their galleries, well ahead of any production or logistical planning. The entire underlying process is incredibly inspiring.

Q4: How has technology influenced the curation and presentation of art in recent years?

JL: There are numerous tools that have made our lives much easier. Nowadays, when putting together an exhibition, we have the capability to plan with digital models of our building and easily share high-resolution images of artworks that may be many kilometres away from where we are. We can manage many curatorial tasks from the comfort of our desks, and we don't have to travel as much to select artworks or to get an up-to-date impression of the status of an artwork that may still be in production. Communication about exhibition content has also become much easier to generate and update. At the moment we use an animated and interactive web-based presentation to share our past and present exhibitions, thereby keeping interested parties up to date with no unnecessary delays. The same applies to our collection management software, which allows us to keep comprehensive records and track movements whenever we rehang or lend out artworks from our collection.

GL: Another example is the production of the booklets that we create for our exhibitions. Thanks to new technology, we can now produce them in-house. This might seem like a minor detail, but it has made our operations smoother and much faster. Thanks to the various technologies that we have at our disposal we can plan, organise and communicate about our exhibitions with greater ease and speed than ever before.

Q5: Can you share some highlights from previous art exhibitions on display in our office premises and what upcoming exhibitions we can look forward to in the near future?

GL: We distinguish between two types of exhibitions: Our 'hosted' exhibitions run from the beginning of the year until the summer. During this time of the year, we invite other collections or present artists whose work may go beyond the parameters that we have defined for our collection.

This is followed by our 'curated' exhibitions, which run from June until the end of the year. Opening the week before Art Basel, these curated exhibitions are designed to showcase contemporary art around a specific theme, while also forming the basis for our art committee's annual acquisitions.

JL: One example is the solo presentation of artworks by the Ivorian American artist Ouattara Watts, from a private collection, which we hosted in our Zurich office at the beginning of this year and which will now be traveling to our office in Geneva. In Zurich we are still very much enjoying the ongoing *Moving Narratives* exhibition. Meanwhile we are coordinating the next hosted exhibition, which will feature two interesting artist estates: the late Neapolitan artist Salvatore Emblema, whose works were recently shown at Haus Konstruktiv in Zurich, together with the Czech artist and master printmaker Pravoslav Sovak. As soon as our next exhibitions are installed in Zurich and Geneva, we will begin to plan and organise the next curated exhibition, which will open in summer 2024.

Q6: How would you describe the current state of the art market and have there been any noticeable trends or shifts recently?

JL: So far this year, we have observed several trends in the art market:

1) Uncertainties in geopolitics and the economy have an impact on how demand and supply operate in the art market. In the past, there was a notable time lag between shifts in politics, economics, and monetary markets and their effect on the art world. This gap is narrowing, and people are more cautious about how they invest their money. This caution is also reflected in how often major artworks come up in public auctions.
2) Today more and more buyers see art as a way to diversify their investment portfolios. There's an increasing number of companies that analyse the market, offer investment advice and provide access through shared ownership models.
3) Auctions, which provide the only publicly available art market data, have shown strong results for so-called blue-chip art. At the same time, the market has become more selective and complex for younger, emerging artists, who have less-established demand.
4) Artists who have been marginalised because of their race or gender are finally receiving recognition and experiencing the long overdue adjustments in their market prices.

GL: At the end of our curated exhibitions, we organise a finissage along with a review of the year in the art market. This is important for our clients since art has become more and more valuable and has begun to form a substantial part in people's asset allocation and – for some – even for their investment strategies. Whatever their personal motivations, today's clients want to stay informed about the ongoing developments of the international art market.

Julian Irlinger, expiration: 3 Months After Public Notice (II), 2021

All pieces: Peter Wächtler

Ouattara Watts, dedicated to Gerda Meyer-Bernstein

Q7: How does Rothschild & Co assist clients with their art collections?

GL: We started off by organizing the curated exhibitions and are now gradually adding new artworks to the company's collection. We quickly noticed that there was strong interest and a real need for art services from our colleagues, clients and prospects. With the help of our network of external advisers, we can meet the need and satisfy the growing demand for art services along the life cycle of any art collection.

Giovanna Lagutaine

Giovanna joined Rothschild & Co in 1994. In her capacity as Market Head Swiss Onshore, she and her team provide a range of tailor-made financial services to key clients and families across Europe. As part of a range of special projects, Giovanna leads a philanthropic initiative within Rothschild & Co and launched the bank's new art initiative in 2020. Giovanna is a qualified Italian Lawyer.

Jonathan Levy

Jonathan is the curator and art expert at Rothschild & Co in Zurich. After completing his Master's degree in Art history at the University of Edinburgh, Jonathan worked as an expert in modern and contemporary Art at Christie's and renowned galleries in London. Previously, he worked at AXA Art Insurance as an art expert and underwriter.

The power of dividends: rewards for capital and trust

Margot de Ziegler – Investment and Portfolio Adviser

When the Dutch East India Company paid a dividend in 1610, it was the first time a publicly listed company distributed wealth to investors. However, the first dividend distribution was paid in spices.

More than 400 years later, dividends continue to provide meaningful income for investors. To put this into perspective: the world's 1,200 largest public companies collectively issued a record amount of $326.7billion in dividends in the first quarter of 2023.[1]

For income conscious investors, investing in dividend stocks represents an interesting strategy among others. Following the recent hiking cycle, fixed income strategies now also offer a real alternative for investors in both the US and Europe (figure 1).

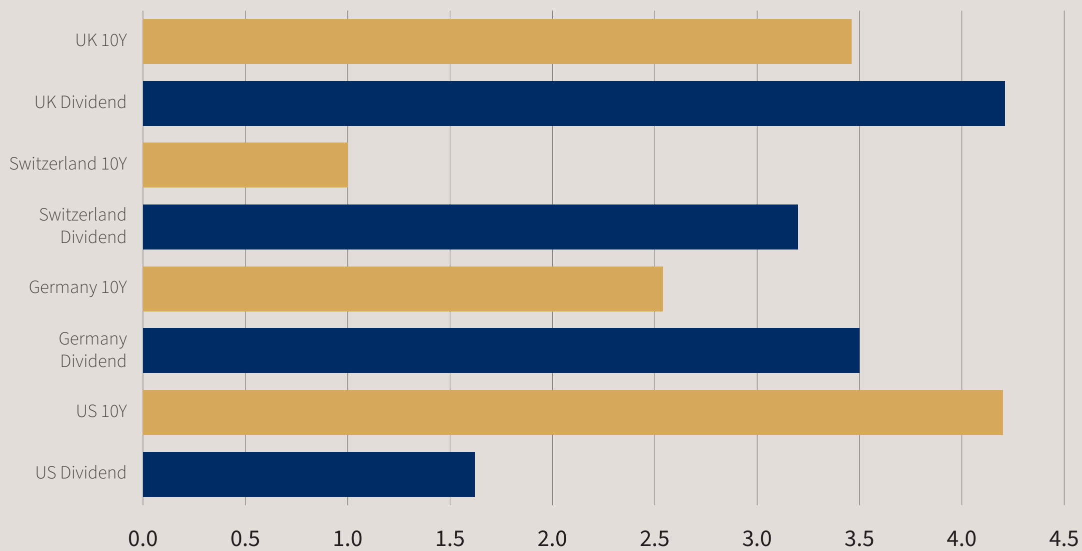
While in some regions, like the US, bond yields currently offer superior income returns than pure dividend yields, a portfolio should include multiple income strategies to maximise returns over the long run.

How does the distribution of dividends work?

A company can distribute a share of its profits or retained earnings to investors mainly via cash dividends or share buybacks. While the latter have taken prominence in the US over the past few years, cash dividends remain a more dependable source of capital return to shareholders.[2]

FIGURE 1: BOND YIELDS HAVE EDGED HIGHER, BUT SOME MARKETS STILL SEE HIGHER DIVIDEND YIELDS

Comparing dividend yields with bond yields (%)



Source: Rothschild & Co, Bloomberg. Data as of 25 August 2023.

[1] 'Dividends from largest companies hit record $326bn in first quarter', Arjun Neil Alim, *Financial Times*, 24 May 2023.

[2] 'Dividends and Share Buybacks Could Fuel High 'Total Yield'. How to invest.' Lawrence C. Strauss, *Barron's*, 9 February 2023.

To evaluate and compare the potential income return from a stock, investors look at the dividend yield as calculated below:

$$\text{Dividend yield} = \left(\frac{\text{Annual dividend per share}}{\text{Stock price per share}} \right) \times 100$$

A driver for total equity returns

To fully understand the inherent power of dividends, we can decompose total equity returns into three parts:

i) dividend yield

ii) earnings growth

iii) valuation changes

Each of these parts plays a different role according to the investment horizon we consider. On average, valuation changes represent the majority of total returns for global equities held up to one year. When we expand the investment horizon, however, we see a significant shift in the drivers of returns. For global equities held long term (here we assume 10 to 30 years), earnings growth and dividend yields are increasingly significant contributors to total returns (figure 1). As such, dividends and earnings growth are intertwined and are more important for investors with long-term investment horizons.

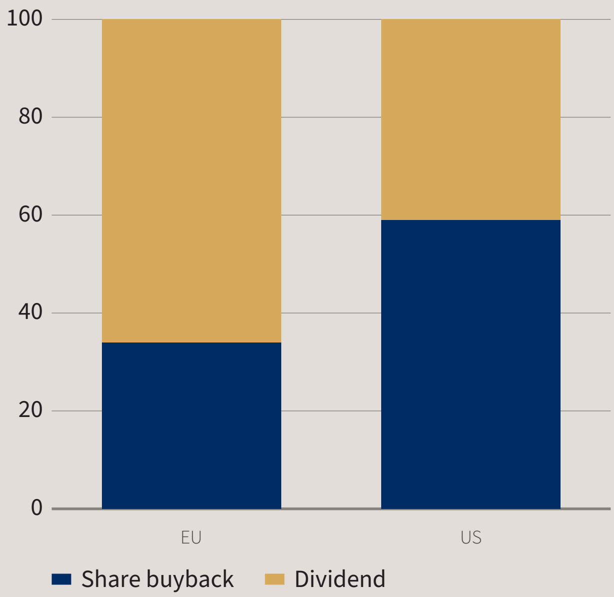
The art of not treating all dividends equally

A high dividend yield should not be viewed in isolation. Companies with unsustainably high dividend yields have not been the best performers historically. The reason? Fundamentals matter.[3]

[3] 'High Yield, Low Payout', Pankaj N. Patel, Souheang Yao, Heath Barefoot, Credit Suisse, 15 August 2006.

FIGURE 2: SPLIT OF EQUITY DISTRIBUTION

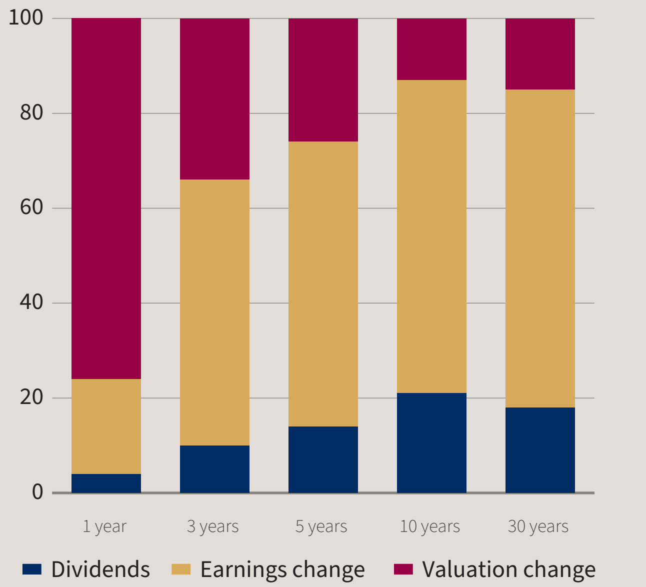
Comparing dividend and share buyback split in the US versus the EU (%)



Source: Rothschild & Co, Bloomberg.

FIGURE 3: DIVIDENDS ARE A KEY DRIVER OF LONG-TERM EQUITY RETURNS

Decomposing global equity returns over different time horizons (%)



Source: Rothschild & Co, MSCI Research, decomposition of MSCI ACWI Index total return.

Dividend sustainability is closely related to a company's profitability. Inevitably, persistent and growing earnings are prerequisites to sustain a stable dividend yield over time. In light of this, it should come as no surprise that owning companies with above average and also consistently growing dividends, has generally outperformed the broader market on a risk-adjusted basis. One way to review this is looking at its payout ratio, a measure of dividends paid relative to net income. A high, but not the highest, dividend yield combined with a low pay-out ratio, improves the prospect of dividend sustainability (figure 4).

Not all dividends are equal, and several aspects must be taken into consideration. An investment strategy only focused on selecting the highest paying dividend stocks can lead to an unwanted bias in the portfolio towards a specific region, sectors or style (figure 5).

[4] 'Best Dividend Stocks to Beat Inflation in 2023', Forbes, May 2023.

The toolbox to fight high inflation

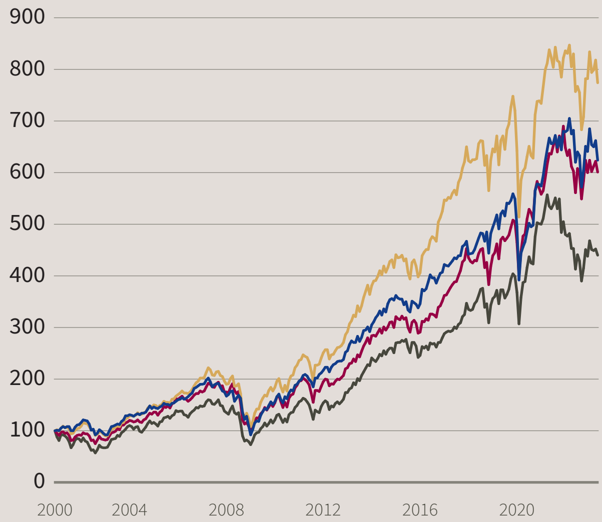
Dividend stocks can also help to navigate an inflationary environment such as the one we are currently experiencing in two ways:

i) Dividend stocks act like short-duration financial instruments: instead of waiting for inflation to subside, investors receive cash that they can reinvest today and compound over time.

ii) Dividend-paying companies can often increase their payout rates faster than the rate at which inflation rises. This means they are likely to perform better than fixed income securities, such as corporate or government bonds.[4]

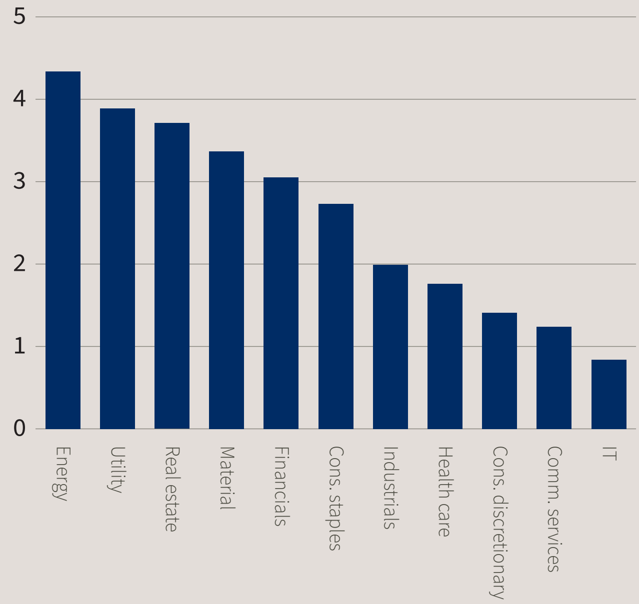
Not all dividends are equal, and several aspects must be taken into consideration.

FIGURE 4: DIVIDEND YIELD AND PAY-OUT RATIO
Returns of S&P 500 equities split into four categories by dividend yield and payout ratio (100 = 31 December 2000)



Source: Rothschild & Co, Bloomberg data as of 31 May 2023.

FIGURE 5: FAVORING VALUE OVER GROWTH
MSCI World dividend yield per sector (%)



Source: Rothschild & Co, Bloomberg data as of 25 August 2023.

Resilience through a recession

During recessions, dividends per share have contracted less than earnings per share, emphasising that management teams reduce such shareholder distribution only in case of last resort. When analysing the S&P 500 dividend aristocrat index,[5] dividend stocks display resilience in times of recessions. With a performance of +2.4%, the dividend index is the top performer one year after the start of a recession (figure 6).

What does this mean?

Dividends are an integral part of the modern investor's portfolio. At the same time, they offer investors useful insights into companies by being an important proxy for identifying strong management teams that allocate capital efficiently.

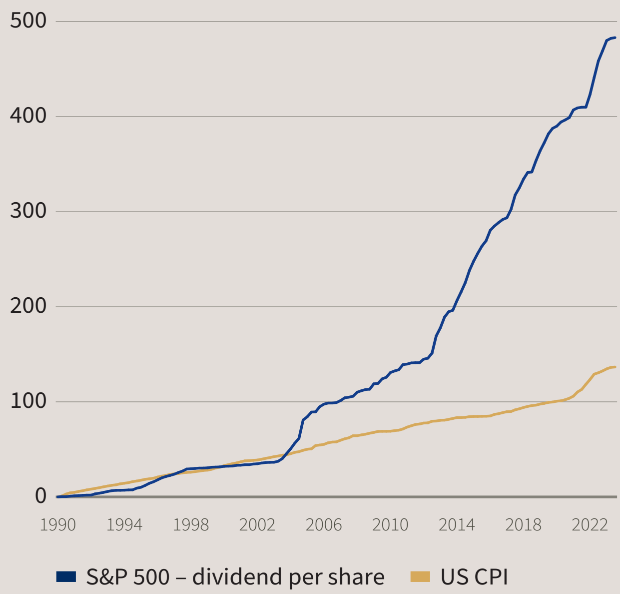
As a result, investors should focus on a high – but not the highest – dividend yield and look for companies with a sustainable and persistent dividend over time, while keeping a vigilant eye on unintended biases.

[5] S&P 500® Dividend Aristocrats® measures the performance of S&P 500 companies that have increased dividends every year for the past 25 consecutive years. The index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.

Podcast

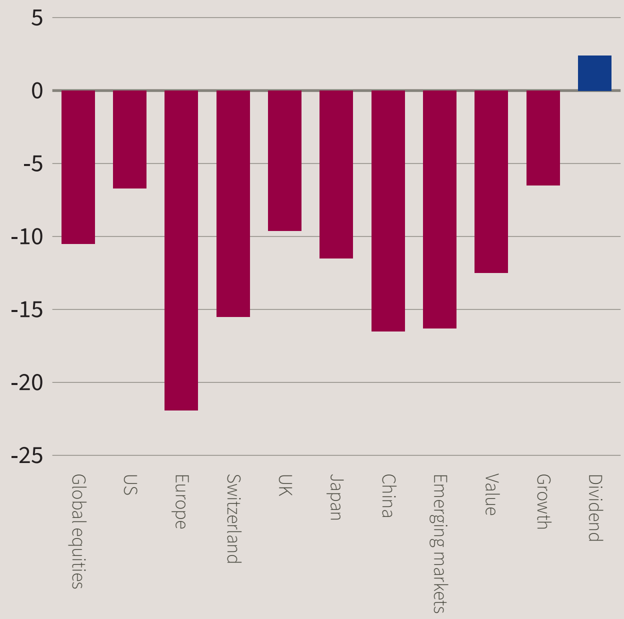
Listen to the podcast with Amaya Gutiérrez, Head of Investment & Portfolio Advisory, and Laura Künlen, Investment Communications, on our advisory offering.

FIGURE 6: US DIVIDEND VERSUS INFLATION
(% appreciation, normalised)



Source: Rothschild & Co, Bloomberg, data normalized as % appreciation.

FIGURE 7: RETURNS AFTER THE START OF A RECESSION
Median return six months after the start of a recession (%)



Source: Rothschild & Co.

Across the pond: views from the analysts

David Windisch – Equity analyst

In early May, we embarked on a research trip to the US. The timing was perfect to escape the early summer rains in Switzerland. At the same time, it also provided an opportunity for a short private stint to Omaha, Nebraska.

Now, you might be wondering what could possibly attract someone to Omaha, Nebraska? The answer is simple: every year (excluding the Covid years), more than 35,000 people make their way to this town of around half a million residents in the very centre of the US. Their goal? To participate in the annual meeting of Berkshire Hathaway and be privy to the wisdom of Warren Buffett and Charlie Munger. Despite their ages of 92 and 99 during the time of the AGM, their intellect remains remarkably intact. Could this be attributed to their habitual consumption of Peanut Brittle and their staggering intake of Coca-Cola? Only time will tell.

Energised by experiencing the real America and assured that there remain many decades of investment opportunities ahead, I met my colleague Beat in New York, where we started our actual research journey.

Over the course of two weeks, Beat and I attended an industrials conference, engaged with company representatives, spoke to industry experts and shared ideas and insights with fellow investors.

Here are some of our notable interactions during the trip.

Otis: tracking the ups and downs of the elevator industry

The head of investor relations at Otis discussed with us the ups and downs of the elevator industry. In his view, the next big growth driver for the industry will be the modernisation of existing elevators in China. At the same time, Otis has limited involvement in China due to its previous connection with a conglomerate that had ties to the defense sector. This history restricted its business activities in China. While this might initially sound disadvantageous, it currently actually helps Otis avoid the uncertain fluctuations in the Chinese real estate market.

Berkshire Hathaway AGM, May 2023


Left to right: B. Keiser, Head of Equities, J. Furlong, President Belimo Americas, D. Windisch, Equity Analyst

Belimo benefits from new construction and renovation projects, as the trend leans towards optimising building climates for occupants while reducing energy consumption.

In our view, Otis stands out as the best-managed elevator company and is set to benefit tremendously from losing its former conglomerate shackles. In our meeting, we talked about several different topics and also took the opportunity to learn how to identify elevator brands in the US. This is particularly relevant since American building owners frequently permit only their own logos to be displayed. Apparently, identification can be achieved through the button shapes or labels on the electronic box, which is usually placed above the elevator door and only visible when the door opens.

We wanted to find out whether this is true and provoked as many elevators stops as possible. The outcome? Unfortunately, despite our best efforts, our investigation remained somewhat incomplete. One incontrovertible fact remains however: elevators are of utmost importance in tall buildings, and we were undoubtedly pleased when we did not have to climb all those stairs to the 50th floor for our next rendezvous with representatives from Visa.


Belimo's North American headquarters in Danbury, Connecticut, US

Visa: swiping into success

Our meeting with Visa reinforced our conviction in the remarkable value proposition of credit card companies, their expansive networks and complementary services. Networks continue to grow by adding new nodes. Nowadays, almost any mobile device can serve as a payment or acceptance point, with mobile wallet transactions just starting to take off. Take, for instance, the ability to pay for a subway ride in New York by simply tapping your phone – a development that boosts wallet transactions.

That's just the tip of the iceberg. There's a plethora of services, spanning from fraud detection and prevention to retail consultation. Interestingly, barely any bank is exclusively tied to only one credit card provider, leaving ample space for many providers to coexist and flourish. To further our insights, we also met with Visa's main competitor, Mastercard, at the company's headquarters in Purchase, Connecticut – what a fitting name!

Belimo: an innovative mission

On the day we left New York, we also went to see Belimo's North American headquarters in Danbury. James Furlong, the head of the firm's North American operations, together with his Swiss colleagues who joined via video conferencing, provided us with an overview of Belimo's year so far and its prospects.

Belimo's mission is to enhance the indoor climate of commercial buildings for their occupants, fostering a more comfortable and healthier environment. The firm benefits from new construction and renovation projects, as the trend leans towards optimising building climates for occupants while reducing energy consumption – both of which can be achieved through Belimo's valves, actuators and in-room sensors. We were then taken on an extensive tour of their facilities, and we were left in awe by the meticulous automation, well-planned layout and state-of-the-art amenities.

New York City, New York, US

Other intriguing insights came from our many other meetings and discussions with executives, investor relations teams and experts hailing from various financial and business services companies. These included Moody's, S&P Global, Accenture, Gartner, Verisk and MSCI. Equipped with these newfound insights, we are now looking at two new companies in more detail, conducting a comprehensive investment review on them.

Overall, these research trips are invaluable, because they provide us with the unique opportunity to network and connect with industry peers and experience more closely the culture of the companies we invest in.

We will be back.

Navigating private debt and private equity: a conversation with our Swiss specialists

Clement Schappler — Private Debt Investment Director
Axel Favre — Investment Director

An allocation to private markets has become a staple element of a well-diversified portfolio, offering an attractive return stream and diversification benefits. In the following interview, led by Sara McDonald, Private Markets Distribution, alongside Axel Favre, Private Equity Investment, and Clément Schappler, Private Debt Investment, we delve into the current market environment, discuss why we're concentrating on the mid-cap sector and give a glimpse of what investors can expect over the next few years.

Q1. To begin, can you both provide an insight into the current environment in private equity and private debt in terms of deal volumes, deal entry multiples and investor appetite?

CS: The private debt market is quite attractive in the context of high inflation, rising interest rates and tepid economic growth. In this environment, many borrowers are inclined to seek the appropriate funding solution from private debt funds. To provide you with some numbers – yields in the US middle-market segment are now at close to 14%, which is over 750 basis points higher than 18 months ago. Furthermore, private debt fundraising stood at close to $100bn in H1 2023, which is a 21% increase from H1 2022. We expect this trend to accelerate as H2 is often the stronger period in terms of fundraising.

AF: For the private equity (PE) industry, the situation is a bit different. It is still grappling with the high interest-rate environment, which makes the cost of borrowing and servicing floating-rate[1] debt expensive. This is the reason why capital deployment remains down by almost 50% from the quarterly peak reached in Q4 2021, while realisations are down by two-thirds from the Q2 2021 peak. PE fundraising also remains challenging, tracking for the first half of this year up to 25% below the first half of 2022, particularly impacting strategies like venture. Numerous investors might be lamenting their involvement in the recent years' high-valuation frenzy and could be more cautious about new commitments this year. However, we may actually be heading into a more normalised environment where private prices decrease. This adjustment could enable fund managers to identify companies at more favorable valuations with potentially less competitors.

[1] **Floating rate**: a floating rate is an interest rate that changes periodically. The rate of interest moves up and down, or "floats", reflecting economic or financial market conditions. The most commonly used floating rates are Secured Overnight Financing Rate (**SOFR**) and the Euro Interbank Offer Rate (**Euribor**).

Euribor: a reference rate that is constructed from the average interest rate at which eurozone banks offer unsecured short-term lending on the inter-bank market.

SOFR: a benchmark interest rate for dollar-denominated derivatives and loans that replaced the London Interbank Offer Rate (LIBOR).

Given the large performance gap between private and public companies, along with the poor exit environment, we are expecting further markdowns of assets held in fund portfolios this year.

Q2. Axel, given the ongoing trend of stricter financing and the overall market outlook, investors are puzzled as to how private equity valuations have remained stable or slightly down. How do you view this?

AF: PE funds continued to slowly mark down portfolio valuations in the first half of 2023. These markdowns, which have been relatively modest since Q1 2022, stand in contrast to the remarkable valuation increases that occurred from Q2 2020 through to the end of 2021. Despite a decrease of 2.6% in the value of investments in 2022, buyout funds in the US have still managed to achieve an overall increase of 81.4% over the past three years.

Q3. What should investors realistically expect over the coming year?

AF: Given the large performance gap between private and public companies, along with the poor exit environment, we are expecting further markdowns of assets held in fund portfolios this year. However, the recovery in public markets during the first half of 2023 implies that PE managers can now be more conservative with markdowns than we previously anticipated as comparable public valuations improve. Better liquidity and credit conditions would also allow PE general partners to retain assets and navigate through the challenges until the exit environment improves.

Q4. Clément, with rising interest rates increasing the cost of debt of companies, what are your current observations and recommended investor strategies?

CS: That's correct. Since the beginning of 2022, floating rates[1] have risen by over 500 basis points and 400 basis points in the US and Europe respectively, which will be positive for private debt portfolios' performance. On the flip side, this rise puts pressure on company cash flows, compounded by the inflationary backdrop that amplifies their cost base (including raw materials, salaries and suppliers).

We believe this is bound to result in an upswing of corporate defaults. However, there exists several methods through which private debt funds can mitigate the risk of losses. One approach involves selecting companies with resilient business models and operating in non-cyclical sectors. Another strategy is to structure loans with robust lender protections, including lower loan-to-value ratios, increased covenants and enhanced collaterals.

Q5. In private equity, in times of illiquidity, the secondary market[2] can thrive. Axel, what is your take on the opportunity set in private equity secondaries and how can investors approach it?

AF: As private equity exits and distributions remain scarce in 2023, more investors are likely to turn to the secondary market. Limited partners (LPs) will seek liquidity to address the denominator effect[3] and rebalance their investments amidst macroeconomic challenges and market uncertainties. Meanwhile, general partners (GP) will aim to offer liquidity to their LPs while retaining ownership of profitable portfolio companies. From an investor's standpoint, investing in secondary funds offers diversification benefits and defensive attributes that are valuable in the current macro environment. Typically, managers acquire stakes in primary funds spanning different geographies, strategies and vintage years. Adding secondary investments to a portfolio can also contribute to reduce volatility.

Q6. As with our presence in the secondaries market, at Rothschild & Co we have a particular focus on the mid-cap sector. Can you elaborate, from both an equity and credit standpoint, on the rationale behind it?

CS: The appeal of this market for our credit strategies stems from a supply and demand imbalance that is favourable to lenders, and it is expected to last given the current credit and liquidity environment. To put it differently, there are numerous high-quality companies in this segment, both in the US and Europe, yet there's a scarcity of investors (including banks) willing to provide financing to them. This situation creates substantial bargaining power for lenders involved in this domain, resulting in terms and documentation that are favorable to lenders.

[2] **Secondary market**: the secondary market is where securities are traded after they go through the primary market.

[3] **Denominator effect**: the denominator effect occurs when one portion of a portfolio decreases dramatically, diminishing the total value of the portfolio.

AF: Medium-sized firms tend to offer more scope for operational enhancement than their larger peers. They are more flexible and better positioned to adapt quickly to changing market environment, readily embracing innovation and seizing growth opportunities to establish a market presence. The value creation drivers are primarily revenue growth and margin expansion. At the same time, companies are less reliant on the use of debt since mid-market transactions consistently entail less leverage compared to buyouts in larger corporations. The availability of acquisitions at lower valuations further contributes to the appeal of middle market[4] private equity funds. Consequently, investing in middle-market buyouts provides the opportunity to generate higher returns than investing in the larger end of the market.

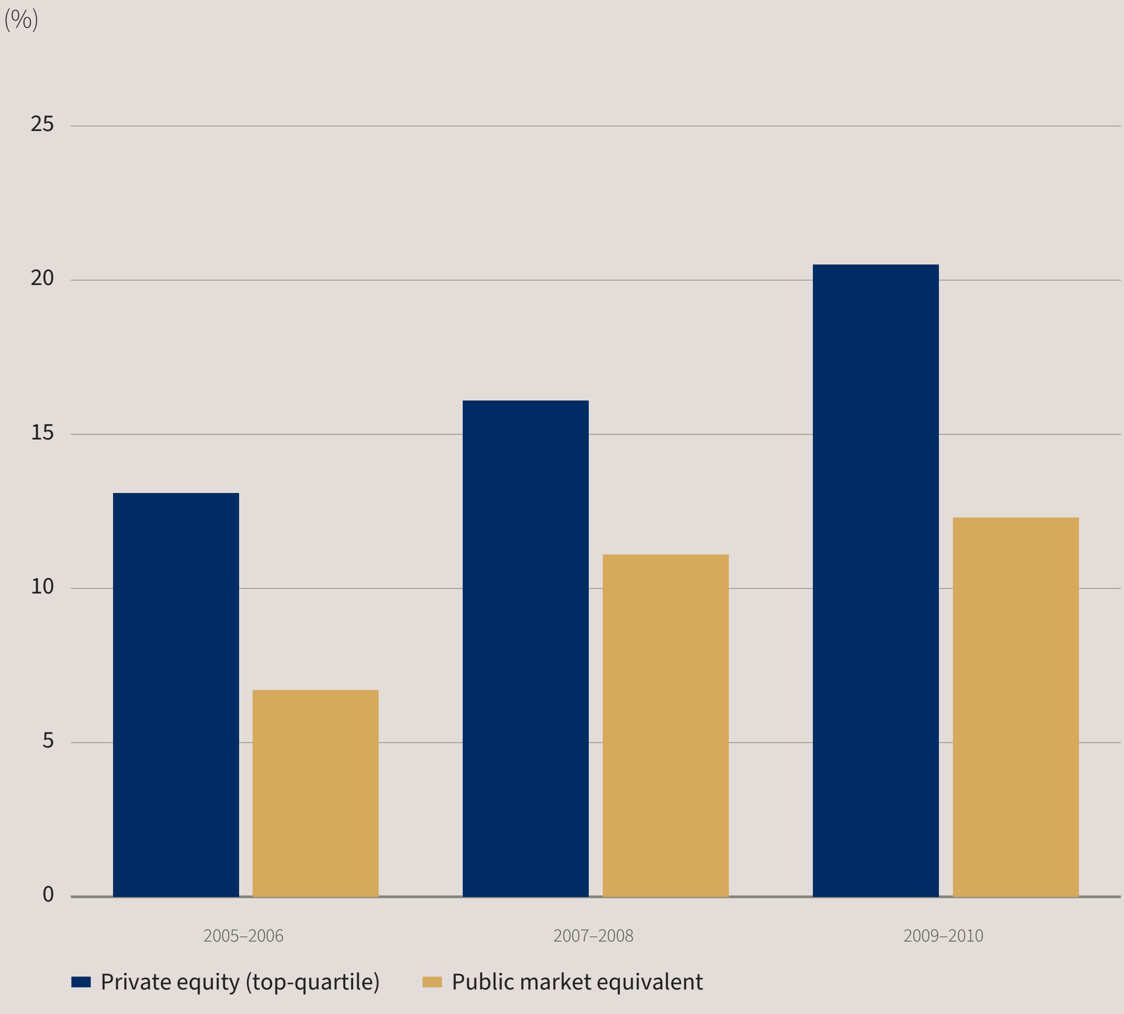
[4] **Middle market**: as per our definition, mid-size companies typically have an EBITDA between USD 15m and USD 100m.

[5] **Vintages**: the year a fund began investing, or more specifically, the date a particular company or project was funded.

Q7. I often discuss the benefits of including private markets in portfolios with clients. Those who invested in the past two decades have seen substantial rewards. What can investors expect from 2023/2024 fund vintages[5]?

CS: Anticipations are high for the private debt vintages 2023 and 2024. Experts widely predict them to be the most promising of all times, owing to the elevated interest rate environment and the exceptionally favourable competitive conditions in the market.

FIGURE 1: PRIVATE EQUITY RETURNS IN DIFFERENT MARKET ENVIRONMENTS



Source: GCM Grosvenor "creating a private equity program for any market cycle", Burgiss, MSCI World, as of 30 June 2019.

AF: With challenging equity markets since the beginning of 2022, many investors are looking to diversify or expand their portfolios in private markets. In addition to the enhanced return potential, an allocation to private markets can offer investors the advantage of having a wider and more varied range of investments. Historical data shows that private equity's outperformance increases during and right after periods of distress (figure 1). This is a logical outcome given the long-term nature of the asset class – buying assets at the bottom of the cycle to sell at the top of the cycle. PE has consistently yielded robust returns, particularly when growth prospects are limited.

Historical data shows that private equity's outperformance increases during and right after periods of distress (figure 1, page 42).

Sara McDonald –
Private Markets Sales and Distribution Director

Podcast

Listen to the podcast with Sara McDonald, Private Markets Sales & Distribution Director, and Laura Künlen, Investment Communications, on private markets.

Clement Schappler —
Private Debt Investment Director

Axel Favre — Investment Director

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