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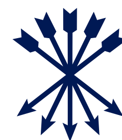

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Rothschild & Co
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FOREWORD

“Au milieu de l’hiver j’ai découvert en moi un invincible été”

— Albert Camus

For many of us the last six months have required us to dig deep and in the sentiment of Albert Camus, search for summer. As the season arrives we are encouraged to see pre-pandemic patterns of economic activity re-emerge, albeit we expect setbacks.

For now, with bars and restaurants, holidays and travel in sight and a summer of sport and live entertainment already under way, we take the opportunity in this Mosaique Insights to explore what it means to return to leisure.

Following on from our announcement to acquire Banque Pâris Bertrand in December 2020, we also take the time in this edition to highlight the benefits of the acquisition from a strategic and investment perspective. Expect to hear more on this topic in the coming months.

Our Insights would not be complete without a review of how portfolios have performed and a closer look at those market trends which we think deserve your attention. With that in mind, we bring you our Notes from the Manager and view from our Fixed Income team as we look at recent market trends and what the future might hold.

We wish you *un bon été, einen schönen Sommer*

Laurent Gagnebin
CEO, Rothschild & Co Bank AG

Dr. Carlos Mejia
CIO, Rothschild & Co Bank AG

Cover image: Many aspects of our lives are beginning to return to the way they were before the pandemic as social distancing measures relax, including live music festivals.

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The summer season

New opportunities

Rothschild & Co
Wealth Management

INTERVIEW

Banque Pâris Bertrand

A complementary acquisition allows us to offer an even wider range of investment services

Gary Powell
Executive Chair of Wealth Management, Rothschild & Co

Pierre Pâris
Founding Partner, Chairman of the Management Board, Banque Pâris Bertrand

Olivier Bertrand
Founding Partner, Vice-Chairman of the Management Board, Banque Pâris Bertrand

Interviewed by:

Ivona Linder
Head of Regulatory and Corporate affairs, Corporate Secretary

Gary, in December we announced that Rothschild & Co had entered into an agreement to acquire Banque Pâris Bertrand. Why did we decide to take this step?

Gary: Wealth Management is a core business for Rothschild & Co. While we remain focused on our strong track record of organic growth, we continually look for acquisition opportunities in the several European markets in which we operate. For some time, we have been of the view that if we could find the right opportunity to consolidate our position as a key player in the Swiss wealth management market we would try and take it. Of course, finding the right deal is not easy. Fortunately, we have known of Banque Pâris Bertrand's excellent reputation in the Swiss market, and some of the key people involved, for several years.

We also knew that we had a like-minded approach to business, a similar strategy and, above all, the similar desire to provide the best possible service to our clients. Therefore, we were delighted when Banque Pâris Bertrand agreed to join our group. This is a highly complementary acquisition for Rothschild & Co, with shared values and mindset, and an important step in extending and developing our unique offering. It will strengthen our position in Switzerland and, in particular, in Geneva. It will open up new opportunities with a new location in Luxembourg and finally also reinforce the strategic role of Wealth Management for the Rothschild & Co Group.

Pierre and Olivier, for our readers, can you tell us a bit about Banque Pâris Bertrand's past and why you made the decision to face the future together with Rothschild & Co?

Pierre: We founded Banque Pâris Bertrand in 2009 in Geneva, in the middle of the financial crisis. One could say not the best moment for a new bank, but we thought this is the perfect time to return to a traditional private banking model with its trust-based values. We were guided by our determination to offer a selected number of clients a flexible response that best suits their needs. From the beginning we offered them truly tailored objective and independent advice, along with a personal and trustworthy client relationship, and soon became well known for our excellence, performance, and quality.

Olivier: Over the years, we extended our offering, multiplied our staff, and widened our presence with the opening of a subsidiary in Luxembourg in 2015. Our success confirmed that we followed the right vision, but we've realised recently that we reached a point where, in order to be able to onboard more clients, while maintaining our highest standards on client service, we need a strong partner for the future. With its entrepreneurial DNA, unique global brand, international credibility and complementary markets, locations and products, Rothschild & Co was an obvious choice.

What will the acquisition bring to the clients of Banque Pâris Bertrand?

Olivier: Our clients will receive full access to the wide network of Rothschild & Co group. They will also benefit from a unique brand, complimentary product offering, strong in-house research, top-rated IT platform, and a strong Balance Sheet with potential for extended lending offering.

Pierre: And this all, while maintaining Pâris Bertrand's DNA, and its entrepreneurial client-oriented approach.

Gary, what will the acquisition bring to clients of Rothschild & Co?

Gary: The acquisition is primarily about expanding our footprint in Geneva. However, our clients will benefit too from a wider selection of products and services. Our CIO, Carlos Mejia is the best person to elaborate the details (see A broader investment offering on page 6).

Overall, I'm certain that our clients will benefit from best practices from both organisations. With Pierre and Olivier both staying on board and, together with the highly qualified and motivated team of Pâris Bertrand, we will be working together as a team for the benefit of all our clients.

In any acquisition there are often challenges regarding integration – how have we been working to ensure that this acquisition and integration run smoothly?

Gary: You are right that in many ways the hard work starts only after the transaction has completed, and the inevitable integration of people, process and systems has the possibility to be disruptive. Some change is inevitable, and people often find change to be challenging.

Right after the signing of the agreement in mid-December 2020, we set up a transition committee with the most senior people from both banks involved. Under its guidance a series of workstreams have spent the six months we have been waiting for completion planning in

detail the future operating model of the business and the migration path to get from where we are today to our destination. That journey will take the next 18 months. Our over-riding objective is to make the experience as seamless as possible for our clients.

Having a structured approach with clear deliverables is one of the key success elements. Another, more difficult one, is achieving a cultural synthesis. Pierre and I have noted that one indication of success will be the day we don't know if someone is ex-Rothschild & Co or ex-Banque Pâris Bertrand.

In all of this it is vitally important that we have transparent and clear communications – towards our clients, our employees, and, in particular, between the two organisations. The way we communicate with each other at all levels already today makes me feel confident that the integration will be a full success.

Looking ahead, what is Rothschild & Co's strategic view on growing the Wealth Management business?

Gary: As I said at the beginning, Wealth Management is core for the Group. We remain committed to our strategy of being the best financial partner for successful families in the markets in which we operate. We believe there is significant opportunity for growth in all our current operations and are investing to take advantage of that opportunity, through acquisitions like Banque Pâris Bertrand, but also through recruitment and investment in our infrastructure. Our focus is and will remain Europe and Switzerland is a key part of that.

With Banque Pâris Bertrand joining us, our presence in Geneva will experience strong growth and we are confident that, together with our current staff, we will be able to grow our business there further. It is important to understand that this deal is not the end of our ambitions in Switzerland more generally and in the rest of Europe. We are always on the look-out for talented people and teams who can strengthen our offering.

Outside Switzerland there is still ample opportunity for growth in our larger offices in the UK and France, a number of exciting opportunities in our smaller offices in Germany, Italy, Belgium, Luxembourg, Monaco and, most recently, Spain, where we are investing heavily.

More generally I think the coming years will see a number of challenges. The cost and complexity of the business keeps rising which will prove challenging for the smaller and less profitable banks. Clients will continue to expect more of us, and to interact with us in new digitally-enabled ways, as well as enjoying their personal relationships with their bankers and the exceptional service they offer. I think we are very well positioned to address these challenges and can look optimistically to the future.

Rothschild & Co Bank AG's Geneva office which can be found at Rue de la Corraterie 6, 1204 Geneva

FROM THE CIO

A broader investment offering

How our palette of products and services is expanding in the coming year

Dr. Carlos Mejia
CIO, Rothschild & Co Bank AG

With the acquisition of Banque Pâris Bertrand recently announced, our Chief Investment Officer, Dr. Carlos Mejia sets out what clients can expect from an expanded investment offering in times ahead.

Broader offering, same approach

With the recent acquisition of Banque Pâris Bertrand, our palette of products and services will expand to provide a more comprehensive service; one which is faithful to our approach to preserve and grow our clients' real wealth over the long-term.

High conviction funds, systematic strategies and thematic investments will complement our existing offering. We will also gain additional access to private markets. Once embedded, the new offering will put us in a stronger position to help clients achieve their financial objectives.

Traditional investments with a refreshing approach

Our new platform will continue to provide our clients with access to traditional assets like global equities, bonds, gold and currencies and will include both benchmarked and unconstrained strategies. These strategies will be suited for different clients' needs and characteristics.

Our new platform will continue to provide our clients with access to traditional assets like global equities, bonds, gold and currencies and will include both benchmarked and unconstrained strategies. These strategies will be suited for different clients' needs and characteristics.

We believe that a flexible and agile approach will make a significant difference to a world dominated by demographic imbalances, climate change, digitalization and innovation. In pursuing this approach, we will continue to research, identify and gain access to those market players that are shaping the future of our society and the world we live in. We will propose thematic investments to gain access to such opportunities.

Those with a longer time horizon and higher appetite for risk, will also gain access to high conviction equity strategies and income-generating precious metals vehicles.

Our institutional clients will have access to quantitative, proprietary, multi-asset class strategies that aim to profit from trends and market dislocations through systematic algorithms. We will be able to adapt these strategies to cater to specific needs.

Additional access to private assets

We have offered our clients access to private debt and private equity investments for generations. The Rothschild family's tangible track record stretches back to the opening of France's first passenger railway in 1837 and the development of its first mainline railway. One of the most appealing features of private investments is that the interests of clients, senior employees and the Rothschild family have always been aligned. With the recent acquisition of Banque Pâris Bertrand and our strategic partnership with Hermance Capital Partners (see All eyes on private debt on page 13), we will expand our private market offering and offer new opportunities to access asset classes such as real estate investments. Some of these opportunities will also be accessible to clients via Luxembourg structures.

Business with humanity

As with existing investment strategies, our extended offering will also integrate environmental, social and governance (ESG) principles at the core of the investment process. We keep our focus on real wealth preservation at the same time as we seek to make a positive impact on the planet, our society and the way companies are governed. For more on responsible investing, see our series on Combining Business with Humanity here.

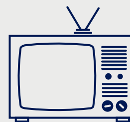
Our size, position and active engagement with companies puts us in a privileged place to make a real difference. With this in mind, we look forward to continuing to help you to achieve your financial goals, just as we have been doing for generations.

Notes from the manager

Our half-year portfolio performance review reveals strong returns across all strategies

Benjamin Meier, CFA
Portfolio Manager

Watch: A half-year in review



For a 10-minute review of half-year performance and views from our CEO, CIO and Global Investment Strategist, please click here and enter the password: *investmentupdate*

The first six months of 2021 have been mostly about patience and, in particular, vigilance. Exuberant economic data and market performance have accompanied the long march in developed economies to finding a post-Covid-19 normality. For the portfolio management team, the market rebound over the first half has called for extra vigilance. While we do seek tactical opportunities in portfolios, we are resisting the temptation to chase low-quality investments in the market for short-term gains as such behaviour threatens portfolios' long-term stability. We view this strategy as key to preserving and growing your wealth over the long term.

With that in mind, we took incremental steps early in the year to add some cyclicality to portfolios, which allowed us to participate in the 2021 market rally. At an asset class level, we maintained our long-held overweight in equities against fixed income, which helped deliver robust results (figure 1). Major equity indices ended the half at record highs, while investors shunned fixed income markets with yields rising and prices falling.

That said, within **fixed income** markets, our preference for investment grade credit over government debt has paid off, performing well during this year's economic rebound. Meanwhile, our reduction in duration across fixed income has shielded portfolios from inflationary pressures and rising yields in 2021.

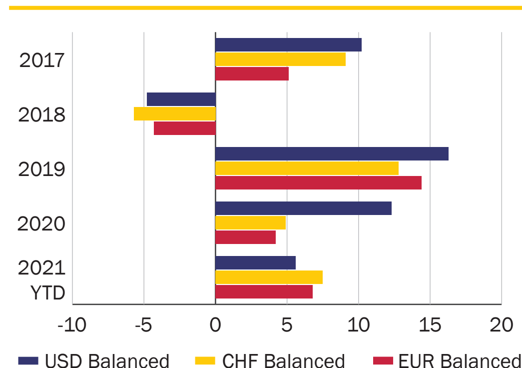
Turning to **equities**, we have avoided some rebounding sectors during 2021's largely cyclical rally, such as **energy**. We believe this sector faces longer-term structural and regulatory challenges as the world shifts away from fossil fuels. Chasing these trades in the short term is not part of our long term wealth preservation strategy.

Instead, we gained cyclicality through exposure to **financials**, **industrials** and **materials**. All these sectors have performed well, benefiting from the reopening of economies and the prospect of powerful fiscal stimulus, particularly infrastructure spending. Meanwhile, we reduced our position in regions and sectors such as **Emerging Asia** and **US communications**, where returns this year are unlikely to match those in 2020. For more on our latest positioning please see our Mosaique Views on page 15.

How did our positioning play out in terms of performance? The first half of 2021 saw robust results across CHF, EUR and USD mandates. By the end of June, balanced portfolios were up by 5% (USD) and 7% (EUR and CHF). On a relative basis against industry peers as measured against ARC Private Client indices (figure 2), we believe our portfolios' outperformance over the last few years should continue – currently standing at 6–8% across CHF, EUR and USD mandates.

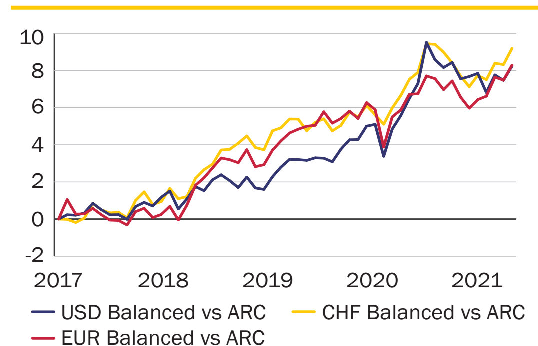
However, strong performance must not lead to complacency. Looking ahead, we will continue to navigate the turning of the economic cycle and the opportunities it will present with the patience and vigilance that has guided us through the past six months. We look forward to updating you at the end of the year.

Figure 1: Absolute performance of Mosaique portfolios (%)



Source: Rothschild & Co

Figure 2: Relative performance of Mosaique portfolios (%)



Source: ARC (Wealth Management Private Client Indices), Rothschild & Co.
Note: Past performance is not indicative of future performance and the value of investments and income from them can fall as well as rise.

The summer season

A return to leisure

Rothschild & Co
Wealth Management

INSIGHTS

The shape of music

How the Montreux Jazz Festival and the music industry emerged stronger from the pandemic

Mathieu Jaton
Director, Montreux Jazz Festival

Interviewed by:

Laurent Gagnebin
CEO, Rothschild & Co Bank AG

William Haggard
Head of Investment Insights

Mathieu Jaton started his career with the Montreux Jazz Festival in 1999 as the Festival's Head of Marketing & Sponsorship. Fast forward to 2013 and Mathieu became the Director of the Montreux Jazz Festival Foundation, Artists Foundation and International SA.

Since 2013, Mathieu has guided the Festival over eight eventful years, ensuring continuity in the values that make Montreux a unique fixture in the global music calendar whilst addressing the challenges that the entertainment industry has faced in the light of the Covid-19 pandemic. In the following interview, we discuss how one of the world's most prestigious music festivals is preparing itself for a return to leisure.

Mathieu, for our readers, the scope of the Festival goes far beyond the world of Jazz music. Since launching in the 1960s with globally acclaimed jazz artists such as Miles Davis, Nina Simone, Jan Gabarek and Ella Fitzgerald, the Festival has showcased a wide variety of musicians and genres.

Can you tell our readers a bit about this evolution and how the Festival has managed to stay true to its values over time?

The values of the Montreux Jazz Festival lie in the spirit of Jazz music itself. We tend to forget in a world driven by labels that Jazz music was and is about the improvisation and sharing of music, about extending musical hospitality and intimacy to its audiences. When Claude Nobs founded the Festival in 1967, it was these values which shaped our trajectory. To this day, the Festival gives artists and audiences an intimate and personal setting in which to enjoy world-class music, set against the backdrop of Montreux's breathtaking scenery and heritage in delivering hospitality.

In keeping with the spirit of jazz, the Festival does not believe in boundaries but has from its earliest days sort to champion those artists seeking to break down barriers and draw on the spirit of Jazz in creating and delivering new music. As early as 1971, the Festival drew on US-Latino musical roots by inviting Carlos Santana to perform in the same year as the "Queen of Soul" Aretha Franklin. Claude Nobs was criticised by the media who considered Santana's presence a departure from Jazz. Claude would go on with American record producer and artist Quincy Jones to challenge this archaic notion of Jazz as a pre-determined, stylised form of music. Defying its critics, the Festival's partnership with US record-label giant Atlantic Records, drew upcoming and established musical stars to Lake Geneva's shores keeping the experimental spirit of jazz alive in new and innovative programming.

Several decades on and the Montreux Jazz Festival remains an intimate and world-class setting to see a wide variety of musicians and styles, from hip-hop's Run-D.M.C to glam-rock's Aerosmith, rapper Terrace Martin to neo-jazz pianist Robert Glasper. Uniting artists like this is their love of breaking musical boundaries whilst drawing on musical traditions which have gone before them, something we uphold and cherish at the Montreux Jazz Festival.

Over the years the Festival has withstood plenty of challenges. How has the Festival responded to the current crisis posed by the pandemic?

The Covid-19 pandemic has obviously hit the music and events industry hard – we should not forget that the live music industry is only 60+ years old and this pandemic is arguably the biggest challenge which it has faced since then. In many ways we were fortunate; the Montreux Jazz Festival has a multi-decade brand with a clear purpose, great musical content and loyal audiences. In particular, the Festival's history in recording performances helped us transition to a digital festival in 2020 with relative ease. When Claude Nobs in the 1960s decided that live performances should be filmed, little did we know that the Festival would end up contributing over 5,000 hours of musical footage to UNESCO's Memory of the World, including jam sessions with Marvin Gaye as well as Miles Davis' last performance in 1991.

Building on this audio-visual heritage we built out the 55th Festival in 2020 with live-streamed performances, bringing music to our listeners at home. The transition was also made easier by the fact that we are an intimate festival – our largest concert venue has a capacity of 4,000 and most stages are much smaller. When you consider that some of the big music festivals like Coachella or Glastonbury bring together over 100,000 fans per day, switching to a virtual or hybrid festival with a mixture of live and recorded events was never going to be as challenging for us. That said, we've missed doing what Montreux

Jazz Festival does best – hospitality. Inviting musicians to both perform and stay by Lake Geneva and meet other world-class musicians in a beautiful and intimate setting is something which can't be replicated online. We look forward to getting back to creating these moments with our audiences and artists in the near future.

As a leader in the field of organising music festivals, how can the music industry adapt to the pandemic and what measures are event organisers taking to engage with audiences in the coming months / years?

The pandemic is not the first market disrupter for the broader music industry. The last great shake-up came in the 2000s, after the CD boom of the 1990s and the initial shift to digitally downloaded music. This period saw the collapse of record-labels and the rise of agents who became all-powerful in marketing and giving access to artists. It was also a period fraught with difficulty for artists and their ability to capture revenue in an online world where music piracy and copyright issues were rampant.

This has changed with the rise of digital streaming platforms and social media in the last few years. Both need music content and the right to use that content legally. This has led to partnerships between record labels and social-media giants such as Tencent or TikTok. Meanwhile the rise of smartphones, music streaming platforms such as Spotify and live music broadcasting platforms such as Stingray Music are all breathing new life into the music industry. This trend will long outlast the current pandemic (see 'The shape of music').

Returning to the fate of festivals, organisers are clearly going to have to embrace online streaming channels. I personally believe that smaller more intimate festivals are better placed to deliver high-quality online musical experiences than mega-festivals. As impressive as large crowds are, it's very hard to ensure audio quality for a virtual audience in such settings.

To read the full interview in digital format, please click here.

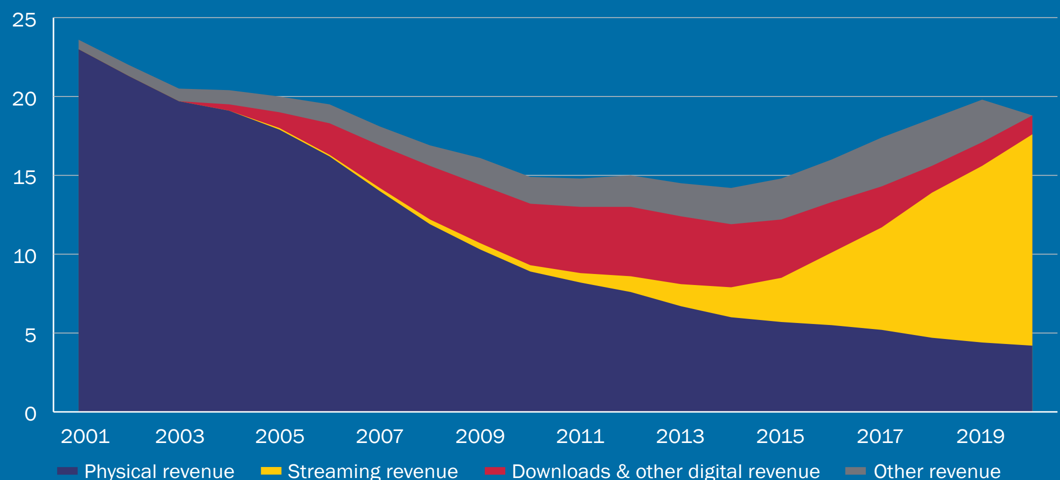
The shape of music

"As the world contends with the Covid-19 pandemic, we are reminded of the enduring power of music to console, heal and lift our spirits."

IFPI Chief Executive Frances Moore

Despite the obvious impact of the pandemic on live performances, 2020 actually saw the global record music market grow over 7%,[1] its sixth consecutive year of growth with 2030 revenue forecasts upgraded. This is due in large part to the rise of streaming music on smartphones and tablets with *Millennials* and *Generation Z* being the biggest annual spenders on music of any age group. The growth in smartphone music streaming over the next decade is set to be biggest in emerging markets where internet connectivity is bringing music to new audiences.

Listeners meanwhile are locking into music streaming platforms via subscription models which help secure long-term revenues for artists and businesses through the likes of Spotify or Apple Music (read more about this in '**Subscribe and Stay**'). The recent rise of streaming music over physical or downloaded channels is clearly visible in the chart below.



Source: Statista 2021

[1] *IFPI Global Music Report 2021*

ADVISORY

Streaming wars

The battle between media companies for our attention online is only just getting going

Amaya Gutiérrez, CFA
Investment and Portfolio Adviser

William Therlin
Investment Insights and Portfolio Advisor

When Neil Armstrong and Buzz Aldrin in 1969 left the Apollo Lunar Module Eagle and took those small steps on the lunar surface, millions of families cramped together in front of their dreamy televisions to watch history in the making.

At present, the ways in which we consume media and entertainment could hardly be more different from that Sunday in 1969. From black and white TV to colour, from single channel to cable, from few houses with one TV to a majority, and, most recently, from fixed content to over-the-top streaming (OTT, see Uncovering TV lingo).

Netflix, founded in Scotts Valley, California in 1997, blazed a trail in the early 2000s, when it changed shape from an online DVD rental provider to delivering video on demand, online to paying customers. With the number of internet users growing by more than four billion in 20 years and the quality and speed of internet greatly improving, the OTT market has reached US$129.59 billion as of 2021.[1] Central to this trend has been:

The OTT market is now projected to grow 10% annually and set to reach US$210 billion by 2026 – supporting the thesis that growth is here to stay.

i. the growth of smart phone and tablet use by households;

ii. the tendency for consumers to unbundle the content they purchase; and;

iii. the adhesive power of subscription models which have been central to accessing streaming platforms – see our separate article *Subscribe and stay*.[2]

Given these three factors, the OTT market is now projected to grow 10% annually and set to reach US$210 billion by 2026 – supporting the thesis that growth is here to stay.[1]

[1] *Statista, Video Streaming OTT TV and video revenue worldwide, 2021*

[2] *Rothschild & Co, Instant Insights: Subscribe and stay, 2020*

[3] *Forever changed: Covid-19's lasting impact on the entertainment industry, UTA, June, 2021*

Uncovering TV lingo

OTT refers to content – subscription-based or ad-based – which is delivered on a digital platform to a final user, available via downloading or streaming (watching it online) at any time, on any device, anywhere in the world.

The power of data

Retaining and attracting new subscribers to these platforms brings advantages beyond the immediate financial impact from revenues generated. As an example, 200 million worldwide Netflix subscribers generate an abundance of insights such as: time spent on the platform, popularity of content and viewer demographics. Such invaluable datasets are essential in the process of purchasing and creating new content.

Streaming beyond the pandemic

With the pandemic creating stay-at-home captive audiences, one might wonder whether the brightest days of streaming services are behind us. The industry is still in search of an equilibrium, but the twin effects of increased internet usage and diversified streaming platforms have transformed both video and audio entertainment industries.

The Covid-19 legacy has, if anything, bolstered new subscriptions, podcasts and streaming platforms for consumers to enjoy. Consuming entertainment via these channels is forecast to remain strong, as the latest study by the United Talent Agency shows. In this survey, 67% of those exploring entertainment intend to spend more time, consuming online videos, movies and TV shows post Covid-19 than they did before.[3] As such, it seems that a post Covid-19 world is a place for both online and offline entertainment – even when consumers once again are able to actively choose.

To read the full article on Streaming wars in digital format, please click here.

A year of yields

A case for higher interest rates and how they are likely to affect returns from capital markets

Sudip Roy
Fixed Income Portfolio Manager

Just when we thought interest rates couldn't move lower, the Covid-19 crisis struck and yields fell to all-time lows. As the pandemic rolls on, yields have started to rise as economies rebound, societies reopen and consumers start to spend.

This upward trend in yields started at the beginning of 2021 and has continued at pace in recent months across advanced economies.

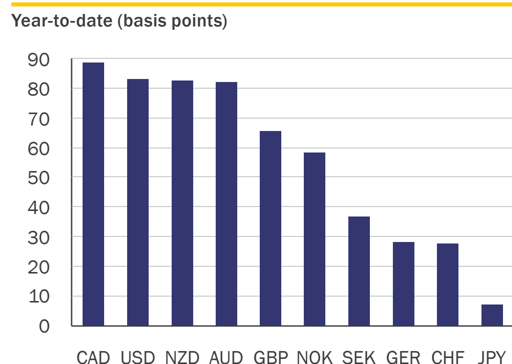
Amongst G10 countries, the upward trend in yields has fallen into two groups – one that includes the US, Canada, the UK, Australia and New Zealand, where 10-year yields have risen by 60–90 basis points, and another that mostly includes countries in continental Europe, where 10-year yields have risen by a more modest 30 basis points (figure 1).

The rise in 2021, however, is still short of those moves seen in 2013 during the 'US taper tantrum'. Unlike that episode, where the selloff in bonds and rising yields was the result of perceived monetary policy tightening, current repricing is reflationary in nature, reflecting a strong economic recovery from the pandemic.

Several factors are supporting this economic recovery, from unprecedented government fiscal spending, reopening consumer services and a restoration of near-normal consumer spending. In addition, high saving rates during the pandemic and cheap credit from a low interest rate environment have fuelled the recovery.

Figure 1: 10-year benchmark yield

Year-to-date (basis points)



Source: Rothschild & Co, data as of June 2021

Lately we have also seen another trend emerge alongside rising yields. Inflation rates in the US saw the core CPI witness its biggest jump in 40 years in April, while a sharp increase in a measure of long-term household inflation expectations and an ongoing rise in commodity prices all point to building inflationary pressures. June's CPI revealed the headline index rising 0.9% month over month, hitting 5.4% year-on-year, the highest since August 2008.

At its June FOMC meeting, the US Fed delivered a hawkish surprise. In the meeting it made clear that it looks at the backward-looking average level of inflation implying that the 2021 inflation spike has more hawkish implications than markets anticipated. Risks now lean towards an earlier start to raising interest rates with markets predicting two interest rate rises in 2023.

Meanwhile, wage inflation remains well contained in a few industries suffering from labour shortages. The expiration of emergency unemployment benefits, increased immigration and opening of schools should replenish labour supply. Many key input prices have already rolled over, suggesting producer price inflation has peaked.

So far, the current increase in inflation has not put extended pressure on Treasury yields. Contrary to expectations, a rally in treasuries saw yields fall to touch lows of 1.3% for 10-year Treasuries. Markets though maintain their base-case view, and still have 10-year yields moving towards the 1.90s in the autumn of 2021. A quick correction though would need a catalyst such as a heavy US 10-year Treasury supply. The question remains how much of the incoming economic data is of a transient or permanent nature. The move higher in US and other G10 yields alongside rising market inflation expectations raises the prospect of a larger shift in all segments of capital markets after a decade of subdued inflation.

Higher bond yields and inflation expectations have supported a rotation towards more cyclical and value-oriented parts of the market. We invested into the latter through subordinated debt, which we implemented in our portfolios via investments in JP Morgan, Allianz and Enel hybrids.

Returning to the economy, the recovery is synchronized as follows: (1) the private sector is starting to spend what it has saved during the pandemic; (2) the public sector continues to be committed to expansionary monetary and fiscal policy for longer; and (3) commodities have entered 2021 in a bull market.

In a year where yields are in the spotlight, asset allocation with respect to fixed income weighting and selection of bonds/equities remains important to mitigate the prospect of rising yields.

All eyes on private debt

A new partnership with Hermance Capital Partners brings fresh insights into private markets

Jacques Chillemi
Co-founder & Managing Partner, Hermance Capital Partners

Hermance Capital Partners is an investment boutique specialising in private markets. In the following article we hear from its co-founder and managing partner, Jacques Chillemi on private debt and how this asset class is emerging from the Pandemic.

Private Equity has deservedly been the focus of the private markets industry for decades, dominating investor interest and news headlines alike. Recently however, private debt has emerged into the spotlight as investors turn to this lesser known asset class for its yield generation and attractive risk return profile.

Private debts' relatively low rate of default means that direct lending can offer a superior risk-adjusted return compared to other fixed income alternatives.

Born from the ashes of the financial crisis and the subsequent changes in banking regulation, private debt – a substitute for traditional bank credit – has proven its resilience. As banks stepped away from corporate lending, private debt players stepped in providing invaluable liquidity to corporates. The industry has tripled in size over the past ten years.

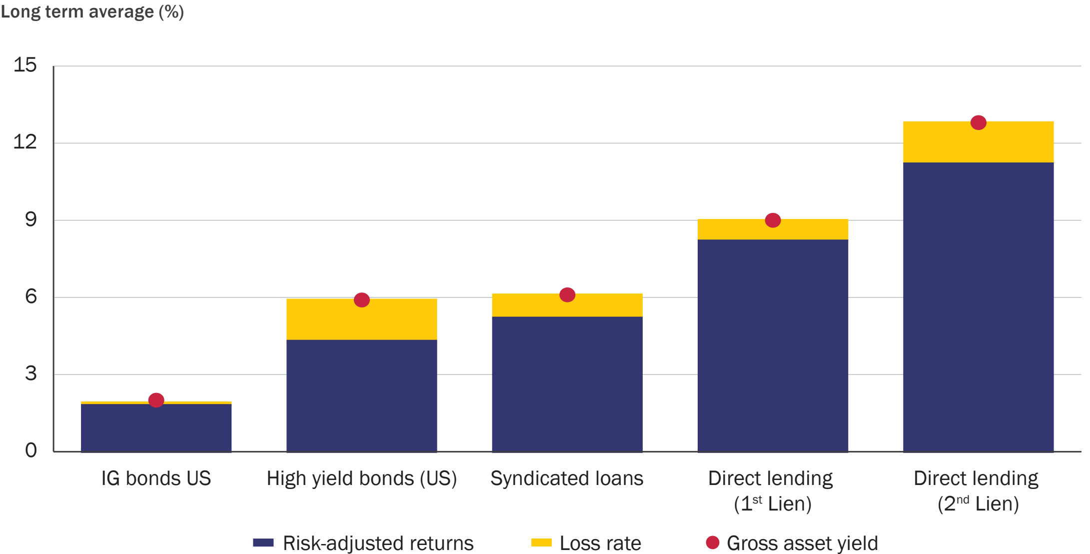
Compared with the bond market that has struggled to generate yields in excess of 5% per year over ten years, private debt has delivered a performance of 8 to 11% gross per year. Given the hunt for yield, private debt has seen a significant increase in inflows pushing investor allocations in the asset class to a range of 5 to 10% of their total invested assets.

As seen in figure 1, private debt has significantly outperformed its fixed income peers. Most importantly, its relatively low rate of default means that direct lending offers a superior risk-adjusted return than other fixed income alternatives.

As explored by our Rothschild & Co colleagues in this interview, Private Debt offers several strategies to investors, with the best known being direct lending. Within the direct lending market, there are two main segments, the sponsored market and the sponsorless (see Sponsored vs sponsorless box on page 14).

From a creditor's perspective, the sponsored private debt market displays several advantages: an alignment of interests, a growth strategy over a short-term horizon (three to five years) and better financial support in case of difficulties.

Figure 1: Fixed income risk-adjusted yields



Note: 1st Lien = senior with average leverage of 4x EBITDA. 2nd Lien = subordinated debt with average leverage of up to 6x EBITDA.
Source: As of June 30, 2020. Cliffwater, Bloomberg Barclays High Yield and the S&P/LSTA Leveraged Loan Index.

The Covid-19 crisis has highlighted how a strong shareholder can bring agility and flexibility to the table:

- **Agility:** Private debt investors witnessed first-hand the ability of private equity sponsors to step in, cut costs, inject capital and make strategic decisions in order to avoid default.
- **Flexibility:** Private debt funds helped companies, heavily impacted by the pandemic to limit the damage and deal with temporary liquidity problems.

Private debt transactions in the sponsorless segment are also attractive but for slightly different reasons. Requiring a higher level of due diligence on the firm, the sponsorless segment offers a risk premium of 200-300 basis points relative to the sponsored segment, but also carries higher risk as the underlying owners of the company do not typically have pockets as deep as financial sponsors.

Turning to today's market, we should also consider the work of opportunistic credit funds. Typically, these funds thrive in volatile and uncertain environments which offer multiple pockets of opportunities. These players are by nature very flexible and can be involved in a variety of lending transactions such as bridge lending, distressed credit, and relief funding. They also have the particularity to invest across the capital structure in senior, junior debt, and even preferred equity or buy discounted assets on the secondary market.

Sponsored vs sponsorless

The sponsored market refers to companies where a private equity firm is involved in their ownership whereas the sponsorless market includes firms who are primarily family held, with no private equity involvement. In the sponsored market, private equity managers have quickly filled the void left by banks post 2008 by investing in private debt. These players are often able to underwrite loans in a matter of weeks.

Despite a relatively short-lived period of volatility in 2020, there still exists a strong disparity between sectors. As a result, strategies such as bridge lending or rescue financing, make all the more sense today. Many companies with healthy fundamentals are still in need of temporary liquidity to finance working capital and growth via short-term loans. Private debt funds are well positioned to help them. In the longer term, as and when government support is removed, the possibility of an increase in defaults and non-performing loans will no doubt favour distressed credit strategies.

To conclude, private debt has become an interesting element in investors' portfolios given its maturity, variety of strategies and risk-return profile. The Covid-19 crisis also poses an interesting entry point for this asset class. First, banks are less active in this market and overall competition is reduced, increasing returns. Second, the number of sectors offering credit opportunities and demanding financing is stronger than ever. This has been fuelled by considerable private equity funds and increased M&A activity. If we look back at the 2008 financial crisis, private debt funds which launched after that crisis – on the whole – enjoyed a solid jump in returns. We believe the same can come true in a post Covid-19 world.

Our Mosaique Views by asset class, region and sector

We moved maximum overweight equities, and maximum underweight bonds while remaining neutral cash and gold in the spring of 2021.

Key	–		Neutral		+
Material overweight					◉
Benchmark weight			◉		
Material underweight	◉				

	–		Neutral		+
Equities					◉
Fixed income	◉				
Money market			◉		
Gold			◉		

Fixed income

	–		Neutral		+
EUR					
High-grade	◉				
IG low-grade				◉	
High-yield				◉	
Duration		◉			
USD					
High-grade		◉			
IG low-grade				◉	
High-yield			◉		
Duration		◉			
CHF					
High-grade	◉				
IG low-grade				◉	
High-yield				◉	
Duration		◉			

Gold

	–		Neutral		+
Gold			◉		

Currencies

	–		Neutral		+
USD			◉		
EUR			◉		
GBP			◉		
ROW			◉		

Equity regions

	–		Neutral		+
North America				◉	
Eurozone			◉		
UK			◉		
Switzerland	◉				
Japan			◉		
Pacific (excl. Japan)			◉		
EM EMEA			◉		
EM Asia				◉	
EM Latin America			◉		

Equity sectors

	–		Neutral		+
US					
Energy		◉			
Materials					◉
Industrials				◉	
Utilities	◉				
Consumer discretionary				◉	
Consumer staples	◉				
Communications*			◉		
Healthcare			◉		
Technology				◉	
Financials				◉	
Real estate		◉			
Europe					
Energy		◉			
Materials					◉
Industrials				◉	
Utilities		◉			
Consumer discretionary				◉	
Consumer staples	◉				
Communications*			◉		
Healthcare			◉		
Technology				◉	
Financials			◉		
Real estate		◉			

** Formerly the Telecoms sector.*

Note: Our Mosaique Views are taken as of 1 July 2021 and are updated at every asset allocation meeting. For the latest Mosaique Views, please contact your client adviser. Graphical positioning is for illustrative purposes only.

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