Long-Term Outlook

Our Thesis for Major Asset Classes.

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Asset Class Convictions

The goal of assigning a conviction level to an asset class is to distill the attractiveness of an investment opportunity into a single rank. The term "conviction" derives from the Latin verb "convincere," which means *to argue*.

In assigning an asset class conviction, our investment team trades off the aspects of an investment opportunity that argue for and against it, culminating in the expression of a conviction level. The conviction level is expressed on a five-point scale (Low, Low to Medium, Medium, Medium to High, and High), and serves as a key input into our asset allocation process.

Our conviction scoring system is based on four criteria: absolute valuation; relative valuation; contrarian indicators; and fundamental risk.

The story of 2020 can so far be captured in just six words: *Market extremes against a vulnerable economy.* The market conditions certainly remain demanding, requiring a steady hand to empower investor success. In this document, we will follow our usual format—a summary of our convictions, a market wrap and our thesis of individual asset classes.

Source: Morningstar Investment Management, conviction levels confirmed at October 23rd, 2020. For illustrative purposes only. References to specific asset classes should not be viewed as a recommendation to buy or sell any specific security in those asset classes. Conviction is subject to change at any time without notice.

○ Previous Year's Conviction

At a Glance

- Since the COVID-19 panic, we've witnessed a shaky "risk-on" environment, with global stocks rising (but with continued dispersion) and riskier bond prices increasing.
- The economic backdrop remains vulnerable, with many investors facing a wall of worry. It seems some investors are buoyed by vaccine expectations and a potential 2021 recovery.
- Performance differences continue, with "new economy" stocks still demanding lofty premiums above established businesses. This creates a contrarian opportunity, we believe.
- ESG investors continue to benefit from sector composition differences and increasing demand.

Important Perspective

Imagine waking up as an investor in the 1980s, 1990s or 2000s. How would you make sense of today's dynamics? You would see debt levels at all-time highs, economic output at multi-decade lows, widespread job losses, a global pandemic halting most human interactions… yet global stock prices are at or near record highs. If you are left scratching your head, you're not alone.

A meaningful part of the narrative is attributable to record levels of stimulus. Let's not forget that interest rates are sitting down at all-time lows for the foreseeable future (at least, that's what market participants are expecting). Frankly, investors have their hands tied if they want/need to generate returns – and equity exposure is one of the few probable areas that positive outcomes can be achieved.

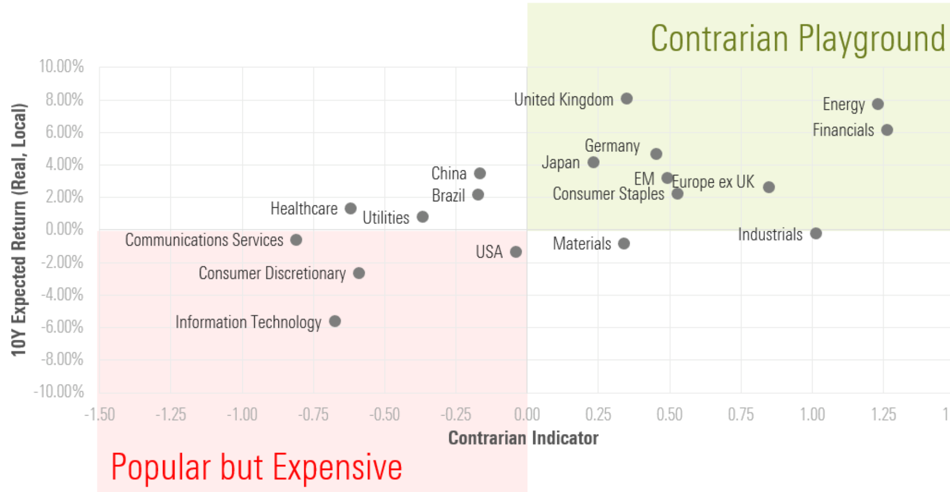
The challenge, of course, is that investors are also being asked to climb a wall of worry. Here are just a few current investor concerns: U.S. election nerves, Brexit negotiations, the vaccine waiting game, inflation uncertainty, US/China tensions, political division, and the potential for a rise in corporate defaults. Offsetting this, some participants—including professional and retail investors—appear buoyed by vaccine progress and a growing expectation for a 2021 recovery.

Key Developments

Looking within equities, it is clear that not all is equal. What we've witnessed lately—and Q3 saw an extension of this—is diversity of outcome, with "new world" growth demanding a curiously high premium while "established" businesses fall out of favour (this is true across developed and emerging markets). Understanding this dispersion has become one of the biggest talking points among investors.

To get practical, we offer the graphic below, which shows how prevalent this dispersion currently is. Ultimately, it is unpopular stocks that tend to outperform popular stocks in the long run, as validated in several academic studies. Therefore, while 2020 has so far proven to be an outlier in this sense, it is the contrarian investor that has the upper hand probabilistically. This popularity/unpopularity conundrum should not be understated in these extreme times.

Exhibit 1 Global Equity Markets are Split Between the Popular and the Unloved.



Source: Morningstar Investment Management. Data as of August 31st, 2020. Expected return estimates are annual valuation-implied inflation-adjusted performance over the next full market cycle (about five to 10 years). Contrarian indicator combines several inputs, including flows, positioning and sentiment. For Illustrative purposes only.

Speaking of popularity, interest in ESG (environmental, social and governance) investing continues at pace. This has been undoubtedly supported by sector performance differences, with ESG-friendly sectors generally doing better than some of the "dirtier" industries such as energy (obviously not all of the energy sector is "dirty", but the composition is an important factor here).

Defensive Considerations

Looking for risk offsets, it is the typical safe-haven assets that investors are looking towards. Gold, despite all its faults, has taken the lion's share of the headlines in this space. Yet, unsung heroes in times of stress—such as cash and longer-dated bonds—continue to play their role as a defensive ballast. Turning to bonds, the narrative is really about balancing credit risk versus the extra return that you can achieve. This spread between higher-risk holdings (such as lower-quality corporate bonds) and safer exposure (such as government bonds, which tend to offset equity risk) saw a big spike in early 2020, but has narrowed once again, as corporate bankruptcies have remained low to date. Emerging market debt remains an area of interest given the high yields on offer.

Circling the investment landscape, we can't forget the importance of currency, which is one of the first places investors express their geopolitical views. This space continues to be important from a risk management perspective too, although a lot of negative news is still seemingly priced in. In fact, we've seen pro-cyclical currencies improve more recently, perhaps acknowledging the extent by which investors sought safety.

Our Message to Clients

Taken together, balancing capital growth and capital preservation is undoubtedly demanding at present. This requires a steady hand. There are the simple things to get right, such as keeping costs low, focusing on the long term, and diversifying the return/risk drivers. But to excel in today's environment, it also requires advanced analytical and behavioural skill—including the ability to rationally assess the market extremes against your goals, then sensibly execute on those observations. We continue to drive this agenda in earnest, for the benefit of all investors, and thank you for entrusting us.

Our Valuation-Driven Asset Allocation Views (as of October 1st, 2020)

EQUITY MARKETS

Asset Class	Conviction	Rationale
U.S. Equities ► Consumer Staples ► Healthcare ► Energy Infrastructure	Low to Medium Low to Medium Low to Medium Medium to High	**Backdrop** U.S. stocks have been one of the best performing asset classes for several years now, supported by a technology-heavy composition of market leaders. This has created a tailwind of investor demand, resulting in lofty premiums in certain sectors. The challenge is that such outperformance comes with heavy expectations, which have been tested more recently. **Outlook** At current prices, U.S. equities still look expensive overall, on our analysis, especially relative to international markets. Challenges aside, there are pockets that we do like. One issue we face is that these opportunities tend to cluster in more cyclical areas of the market—including energy and financials. For example, we continue to believe integrated energy companies with diversified business models and strong balance sheets should be able to weather the downturn and provide significant potential upside for investors at today's prices. Our research also leads us to believe that large U.S. banks are attractively valued. They are much better positioned than during the previous crisis, and we think they will be able to withstand a severe economic downturn, even if it includes mounting job cuts. Outside of these contrarian sector opportunities, much of our concern is the implied growth rate of "new economy" stocks, many of which are clustered in the U.S. technology sector. These have become untenable in our view, with implied growth expectations that are extremely difficult to sustain. Against any measure of corporate history, meeting these expectations looks improbable, leading us to a cautious stance regarding these companies. Taken together, we see the current landscape as a story of "dispersion creating opportunity". Perhaps the easiest way to reference this dispersion is the valuation gap between growth and value, which is still near historical extremes.
Europe ex-U.K. Equities ► European Communications ► European Energy ► European Financials ► European Healthcare ► Germany	Medium Medium to High Medium to High Medium to High Low to Medium Medium to High	**Backdrop** European stocks are living up to their reputation as "old world" laggards, despite being a diverse region with several underlying opportunities. In aggregate, the European continent is still underperforming the likes of the U.S., creating negative sentiment. **Outlook** We have a contrarian stance on Europe, and on a comparative basis, believe valuations look to be on a much more durable footing than the U.S. market. For example, European financials look very attractively priced, on our analysis, as do European telecoms, which have undergone an extended period of weakness relating to concerns around future revenues, changing business models and a heightened regulatory environment. Elsewhere, we still have a positive view on European energy companies, a shining contrarian investment opportunity in our analysis. .

U.K. Equities	High	**Backdrop** The U.K. arguably faces some of the biggest macro headwinds, with Brexit still a major issue along with high COVID-19 infections and a weak economy. This has knocked sentiment for a prolonged period, with U.K. stocks underperforming global peers by a significant margin. That said, a large portion of this underperformance relates to the sector composition, with energy and financials strongly represented. **Outlook** U.K. shares are one of the few opportunities that we consider to be "cheap", due in part to energy and financials companies which are heavily represented on the FTSE100 index. As such, we continue to view U.K. equities being among the most attractive investment prospects. In fact, we have upgraded U.K. equities to a “high” conviction given its attractive relative valuation compared to other development markets. Beyond sector considerations, investor sentiment has also encountered a one-two punch, with a long-winded Brexit transition flowing straight into COVID-19 lockdowns. This has meant sellers have outnumbered buyers for an extended period, which we believe represents a contrarian opportunity supported by inviting valuations. Most of these businesses derive their revenues from other regions—with as much as 70% of the FTSE100 coming from abroad (25% coming from emerging markets)—so it is hard to argue for a U.K. demise as the main reason for the underperformance over the past decade. Said another way, we believe that investors are being well compensated for the risk of investing in U.K. stocks. Granted, certain scenarios pose significant risk to corporate profitability, but U.K. corporates remain high-quality businesses with diverse revenue sources, in aggregate.
Japan Equities ► Japan Financials	Medium Medium to High	**Backdrop** Japanese stocks experienced a strong bounce from the March 23 lows, with significant stimulus and a more upbeat outlook for their ability to contain coronavirus. This saw a swing in sentiment, with prices nearing pre-COVID prices, despite the abrupt resignation of Prime Minister Shinzo Abe for health reasons. **Outlook** We continue to see merit in Japanese holdings. For the most part, our conviction in Japanese stocks was built on some major structural change taking place at a corporate level. While some of this structural tailwind is now behind us, we see scope for a continuation of improving shareholder interests, rising dividend payouts and board independence. Therefore, expected future returns from this asset class appeal to us, with Japanese equities still among our preferred major equity markets. With this in mind, we maintain a preference for domestic-facing companies, most notably financials. Sentiment toward Japanese financials has also been hindered by the Bank of Japan’s prolonged quantitative easing program that has driven down longer-term yields, making it difficult for banks to make money (and lowering investment income for insurers).
Emerging-Markets Equities ► EM-Asia	Medium Medium	**Backdrop** Emerging markets have oddly stayed away from the headlines. Perhaps part of the reason is that they have struggled to keep up with developed world peers.

► EM-Europe	Medium to High	
► EM-Latin America	Medium	
► Russia Equities	Medium	
► South Korea	Medium to High	
► South Africa	Medium to High	
► Mexico	Medium to High	
► EM Info Tech	Medium	

Obviously, this is quite nuanced, making it problematic bundling emerging market countries. For example, China has done quite well, however higher coronavirus case numbers across Brazil, India, Russia and Mexico have impacted the prospects of a procyclical economic recovery.

Outlook
Emerging-markets equities are considered among our preferred equity regions (alongside U.K., European and Japanese equities), with South Korea, South Africa and Mexico standing out. Sector opportunities also exist, with technology offering a reasonable reward for risk—especially relative to U.S. peers.

As part of this, we need to remember that emerging markets are heterogeneous. Investors tend to bucket emerging markets as one, but often the real opportunities present themselves at a country, sector, or regional level.

FIXED INCOME

Asset Class	Conviction	Rationale
Developed-Markets Sovereign		
► U.S. Treasuries	Low to Medium	
► Europe ex-U.K.	Low	
► U.K. Gilts	Low	
► Australia	Low to Medium	

Backdrop
Interest rates are extremely low and inflation is subdued—keeping government bond yields at historically low levels. As a general observation, governments are borrowing more money for longer periods, which makes sense for them, but increases the sensitivity to interest rates for bond holders. That said, investors continue to flock to these assets during times of stress, creating a ballast against equity exposure.

Outlook
While this is an uninspiring space, government bonds continue to play a role in a total portfolio context. In this regard, we recently affirmed our U.S. Treasury position at "Low to Medium". This acknowledges the Federal Reserve's commitment to supporting and stabilizing the bond market, with aggressive and unprecedented amounts of Treasury bond purchases, and a verbal commitment to maintain interest rates at a zero bound until they are confident about an economic recovery.

That said, updated language regarding the Fed's inflation targeting policy could put pressure on nominal bonds in the future as they will tolerate overshoots of its 2% target. On a relative basis and despite the significant decline in yields, U.S. Treasuries still offer a premium to other non-U.S. developed market, albeit much smaller than in recent history. Finally, despite yields at record lows, should yields move lower if we encounter another bout of risk aversion, scenario analysis suggests that U.S. Treasury exposure still offers some return potential in that environment.

We note that the timing of any weakness in this asset class is unknowable. Much of the current market debate is really about the depth and duration of the expected contraction and the feedback into the real economy through credit markets. Central bank intervention is also an issue, as it keeps government bond yields low to entice spending and reduce the interest burden of governments.

Investment-Grade Credit		
► U.S.		

Backdrop
Despite glaring corporate vulnerabilities, we've witnessed yields move back lower (especially credit spreads relative to government bonds). In this sense, investment-

► European Corporates	Low to Medium (from Medium)	grade bond prices have become more volatile in 2020, but the asset class has held up reasonably well given the uncertainties.
► U.K. Corporates	Low to Medium	**Outlook**
	Low to Medium	

We have recently downgraded our conviction level for U.S. investment grade corporates to "Low to Medium". The primary reason for this change is valuations on both an absolute and relative level. Yields have plummeted to all-time lows, giving investors low expected returns over the long run.

Additionally, due to U.S. rates converging with the rest of the world, other non-US assets look relatively more attractive than they did before the crisis. Finally, corporate spreads (the difference between the corporate bond yield and the government bond yield) have fallen below "fair value" on our analysis. This provides less margin for error and opens the door to a greater permanent loss of capital if credit downgrades were to occur.

In this regard, one should be aware of the high percentage of BBB-rated issuers in this space. This "credit quality" development needs to be monitored carefully, as a heightened default cycle can't be ruled out either.

From a fundamental standpoint, the Federal Reserve's increased involvement in this asset class will provide a backstop in the short term and gives us confidence that this asset class will hold up better than it has historically if another sell off were to occur in this pandemic. However, increasing leverage ratios combined with the possibility of higher yields is a cause for concern over the medium to long term.

In summary, we don't see much inherent appeal for investors in the investment-grade space, but for the time being, extensive Fed support is complicating this picture. For instance, we see some remaining attraction as a middle ground—providing some extra yield versus government bonds, and a duration profile that could help in portfolio construction, especially as we feel remaining headroom in the central banks stimulus program would be employed to constrain credit-related weakness if we see markets conditions deteriorate meaningfully.

High-Yield Credit	Medium	**Backdrop**

High-yield credit has experienced a wild ride in 2020, but investors are likely to be satisfied given the circumstances, with liquidity again moving freely.

We note this type of volatility is not uncommon for high yield bonds, which sit at the riskier end of the bond universe—sometimes moving with equity markets. This has been the case in 2020, although conditions seem to have settled more recently.

We have also witnessed record levels of bond issuance, meaning companies are trying to source additional funding to shore up their balance sheets.

Outlook

The case for investing in this asset class has fluctuated and currently sits with a "medium" conviction. For example, it has improved compared to the record low spreads seen at the beginning of the year, but it has dampened since the COVID-19 breakout. Of course, risks remain elevated and the key here is to watch for default and liquidity risk.

The current economic crisis has created a two-speed market, where some sectors have done much better than others. Still, so far defaults have remained low. Also, short-term funding/liquidity has remained stable. The good news is that the policy response has been focused on providing funding to companies and supporting credit markets with the Federal Reserve stepping in and buying credit bonds for the first time.

Taken together, we must be careful about sizing, but continue to see some merit in allocating capital here.

Emerging-Markets Bonds

- Local Currency — Medium to High
- Hard Currency — Medium

Backdrop
Emerging market debt comes in two forms—bonds issued in the currency of the home country (local) or in US dollars (hard)—and can perform quite differently.

Local-currency emerging market debt has arguably been more of a currency story than a yield story. Bond yields in this space have been relatively stable, not moving nearly as much as high-yield debt or other credit assets such as hard-currency emerging-markets bond.

Part of this is likely to be the transformation of emerging-markets economies to adopt orthodox monetary policy during the COVID-19 crisis. Specifically, emerging-markets central banks broadly cut rates into the crisis, whereas historically they would be trying to defend their currency. Together, nominal yield levels remain at historically low levels, albeit much higher than developed world peers.

Hard currency emerging-markets bonds saw severe stress as spread levels ballooned in March, but they have quickly and meaningfully recovered from their high points. They remain attractive relative to history but do not offer the clear value that they did at the end of the first quarter.

Outlook
Our view was that emerging-markets sovereign fundamentals were broadly stronger than in the past coming into this crisis (improved current account balances, enhanced reserves, movement to orthodox monetary policy, build-out of local investor base allowing for a shift to local currency funding) with some ongoing concerns surrounding an increase in debt levels and a lack of fiscal discipline in some countries.

Yet even under rather pessimistic assumptions, our research reveals that investors could earn a decent premium over similar-duration developed-world government bonds if they're willing to risk short-term loss. Said differently, we think investors are likely to be compensated for this risk.

Global Inflation-Linked Bonds

- U.S. TIPS — Low to Medium

Backdrop
Perhaps the biggest news in this space is the Federal Reserve's inflation targeting policy change, where they will tolerate overshoots of the 2% target. However, the impact on performance has been reasonably subdued.

Keep in mind that the key to inflation-linked bonds is any change to inflation expectations. To date, most participants seem to have a consensual view, where the short-term involves deflationary pressure and the longer-term involves modest inflationary pressure. One important note is duration risk, where inflation-linked bonds are often longer-dated securities which increases the sensitivity to interest rate changes.

Outlook

A key consideration in a multi-asset context is whether inflation-linked bonds can help us diversify our risk drivers. This goes beyond questions about the economic downturn or whether inflation may rise during the recovery period.

On this, we see the opportunities in inflation-linked bonds to be two-fold. First, the market is pricing in a persistently low inflation rates over the next five to 10 years, so an inflation spike needs to be protected against. Further, inflation-linked bonds behave differently though the cycle, offering diversification in risk drivers.

Keep in mind that with inflation-linked bonds, the value of the principal rises (or falls) with changes in inflation expectations. Inflation expectations are notoriously difficult to forecast, however inflation-linked bonds continue to offer protection against an inflation shock at reasonable prices. Therefore, while valuations are uninviting in absolute terms, this asset class may still play a role in a total portfolio context.

Cash

We currently have a balanced view regarding cash levels. On one hand, the economic vulnerabilities are worth protecting against, but our research points to some meaningful dispersion across asset classes—which presents an opportunity for investors. The key is to selectively allocate to the most attractive asset classes, rather than take widespread market exposure.

Ultimately, we see our cash reserves serving three purposes. First, cash helps reduce the sensitivity to interest rate rises, especially relative to long-dated bonds, which we believe is an important risk to manage. Second, cash should help buffer the portfolio from any future volatility resulting from a fall in equity markets. And third, cash provides us with ample liquidity to take advantage of investment opportunities as they arise.

Source: Morningstar Investment Management as at October 1st, 2020. Note: References to specific asset classes should not be viewed as a recommendation to buy or sell. Asset allocation views are subject to change at any time without notice.

A Reminder of Morningstar's Investment Principles

These principles are the back-bone of the organisation and are intended to guide our thinking, behaviour and decision making. The process has been inspired by a number of the most experienced and successful investors in the last century and also aligns with the history and founding purpose of Morningstar. The investment principles that guide our way of thinking are listed below:

We put investors first. We believe the firms that put investors first win in the long term because their investors win.

Since 1984, Morningstar, Inc. has been helping investors reach their financial goals. Our fiduciary duty to our principals is paramount.

We're independent-minded. To deliver results, we think it's necessary to invest with conviction, even when it means standing apart from the crowd.

Our research shows that making decisions based on fundamental analysis, rather than short-term factors and sentiment, delivers better long-term investment results.

We invest for the long term. Taking a patient, long-term view helps people ride out the market's ups and downs and take advantage of opportunities when they arise.

Investing with a multi decade horizon aligns with investors focus on increasing their purchasing power over their lifetimes. The long term is the only period where fundamental, valuation driven investing works.

We're valuation-driven investors. Anchoring decisions to an investment's fair value—or what it's really worth—can lead to greater potential for returns.

Valuation-driven investing through a long-term focus on the difference between price and intrinsic value enables investors to get more than they're paying for.

We take a fundamental approach. Powerful research is behind each decision we hold, and we understand what drives each investment we analyse.

Fundamental investing incorporates a focus on the future earnings of an investment and not its prospective price change.

We strive to minimise costs. Controlling costs helps investors build wealth by keeping more of what they earn.

Investment returns are uncertain, but costs are not. Lower costs allow investors to keep more of their returns.

We build portfolios holistically. To help manage risk and deliver better returns, truly diversified portfolios combine investments with different underlying drivers. Portfolios should be more than the sum of their parts.

True diversification can have a powerful impact on a portfolio's risk-adjusted returns – but simply holding more investments isn't the same as true diversification.

Glossary

Valuation driven asset allocation

Our asset allocation process focuses on identifying ‘undervalued’, ‘under-owned’ quality assets that we believe will offer the greatest potential for strong returns over the longer term. Importantly, this process includes not only an assessment of return expectations for each asset class, but also a strong focus on capital preservation, with the aim to avoid losing money that can’t be made back during an investor’s investment timeframe. If the reward isn’t worth the risk, we will avoid that asset class. Once we have identified the preferred asset classes through this disciplined approach, we apply portfolio construction principles to ensure that the resulting portfolio is adequately diversified.

Credit spreads

This relates to the difference in yield between two bonds that are identical in all respects (e.g. maturity, fixed/floating payments) except for creditworthiness. Generally, this refers to the premium that a corporate bond investor expects to receive over the ‘risk-free’ benchmark (e.g. a treasury bond, which is considered ‘risk free’), as he/she needs to be compensated for taking on additional risk. Widening credit spreads generally indicate growing concerns about the ability of ‘non-government borrowers’ to service their debt. On the other hand, tightening credit spreads generally indicate the opposite – improving creditworthiness.

Intrinsic value

This relates to what we perceive as the actual or true value of a company or an asset based on all aspects of our analysis (in terms of both tangible and intangible factors). We consider an asset to be mispriced (that is, trading at a premium or discount) if the intrinsic value does align with the current price in the market.

Yield curve

A line on a graph that plots interest rates (y-axis) of bonds (of equal credit quality) against different maturity dates (x-axis). The yield curve is considered a ‘lead indicator’ because it conveys investor expectations of future economic growth and inflation. There are three main types of curves:

- Normal: lower yields for shorter term bonds – investors generally expect normal economic conditions and require higher yields to compensate for time.
- Flat: shorter and longer-term yields are very close (e.g. there is little benefit in holding the longer-term bonds) – generally, this indicates that investors are uncertain of the economic environment and are willing to tie up their money for longer periods with little additional compensation.
- Inverted: higher yields for shorter term bonds – investors generally expect poor economic growth (e.g. recession) and lower inflation (and thus lower interest rates). Essentially, investors are willing to tie up their capital for the longer term as they expect shorter term yields to fall significantly in the near term.

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