Solving for 2023: How the Tables Have Turned

Disruptive Forces in Investing **December 30, 2022**

Martin Steward: Hello, and welcome to the last episode of Disruptive Forces for 2022. My name is Martin Steward, and I'm delighted to be your host today. But fear not, you won't be missing your usual host, Anu Rajakumar, as today she'll be sitting on the other side of the table answering the questions along with our chief investment officer of Multi-Asset, Erik Knutzen. Anu, Erik, welcome to Disruptive Forces.

Erik Knutzen: It's great to be here, Martin.

Anu Rajakumar: Thanks very much for stepping in, Martin. It's good to be here and very interesting to be on the other side of the table for once.

Martin: Well, indeed. And the reason you're on the other side of the table today is because what we wanted to do at the end of the year was really look back over our podcast episodes, as well as some of our key publications from the past 12 months, just to identify some of the year's big themes and discuss how they are setting us up for the year ahead. So that's what we've been doing over the last couple of days in preparation for this podcast. So, what's the defining event of 2022, and what was the defining economic dynamics?

I think these are the two easiest questions for today. So I'm going to take them myself. So I think we can all agree that, um, Russia's invasion of Ukraine has been the defining event of the year. I mean, really exemplified and exacerbated broader existing geopolitical tensions, it turned what was already a growing inflation problem into a full-blown global inflation shock. And that in turn notably sped up, what was a planned tightening of financial conditions, and if I think about, what was the key economic dynamic for the year…again, easy one to answer, I think that's inflation. But of course, Russia's invasion of Ukraine really complicated that picture. We have a structural view on inflation, which is about inflation being higher for the longer term, higher than it's been for the last 10 years, certainly. But now we're facing a situation where inflation has been so high this year that we're probably looking at declining inflation next year.

So, Erik, I wanted to start with you, or with that question, really, if you can update us on the evolution of our view on inflation from the onset of the invasion of Ukraine to the outset of 2023, how has that changed?

Erik: Well, so we totally agree inflation was the most challenging and-and important macro driver we saw this year. And we started 2022 with a strong view that inflation was going to be high and problematic during the year, and problematic, not just because of the challenges that inflation poses to investors, but problematic because we did expect it to remain higher than policymakers and consensus expected during 2022.

In fact, it was higher and more problematic than even we expected. We had a view at the start of the year that inflation would decline through the year, but declining from, say, 8% at the start of the year to 4% might be easy, but 4% to policymaker targets of 2% would be hard. Well, it turns out that going from 8% to 4% was also going to be hard. And that's been the case. Now, we do expect inflation to begin to roll over in 2023 and decline, but likely remain problematic.

And so, as I reflect on our views--we did publish a piece, “The Inflation Inflection” white paper, which we published in mid-February, which was perhaps auspicious timing. And I reread that piece recently. And our three main takeaways for investors was the importance of seeking to mitigate inflation, take advantage of inflation, and diversify programs differently. We said that in February of 2022. And I would say those three key recommendations still hold; that it is important for investors to look at their portfolios and in an environment where inflation, even if it's falling, may be structurally higher going forward than what we've seen over the last cycle, that seeking to mitigate inflation risk within an investment portfolio will remain important, but also looking at your portfolio and seeing how you can take advantage of it with inflation-sensitive assets, whether those are commodities or tips or global linkers or real estate and private real assets: private real estate, private infrastructure.

And then finally, diversifying differently. If inflation is going to be high and higher than policymakers expect and somewhat problematic, then bonds may not be as diversifying for equities and other sources of diversification, uncorrelated assets, uncorrelated risk premia like insurance link securities, which are interesting for a number of reasons right now, other areas of private markets, are going to be very helpful for investors in 2023 and beyond.

Martin: And, Anu, when we were looking back at the episodes of Disruptive Forces from the year, unsurprisingly, this topic came up quite a lot from the inflation dynamic itself to central bank policy to commodities as an inflation hedge, even things like the carbon transition and the infrastructure challenge, you know, all kind of fit into this broader theme. So what would you say you picked up overall from our experts on these subjects over the year?

Anu: Yes, Martin, you're absolutely right. Almost all of our guests on the podcast in 2022 shared their views on the higher inflation environment and its implications to their respective areas of the investment opportunity set. And you know, that started really off in the first quarter when we began to see and feel the inflation surge, and we had Hakan Kaya, portfolio manager for commodities come on, focusing on the role that commodities has as an inflation hedge.

And in that episode, he touched on how high inflation impacts stock and bond correlations and diversification in asset allocation. And that's a topic that we, on the Multi-Asset team, have really been discussing year-round. In that episode and in others, we touched on more structural or long-term elements of higher inflation like decarbonization. You know, later in the year, I had a conversation with Robert Gephardt on the current and long-term energy landscape and how that was linked to geopolitical issues and ESG issues.

And finally, as you alluded to, Martin, several of our macro-oriented colleagues came on the show weighing in on central bank action from the Fed to the Bank of England to the Bank of Japan. So we had experts on really explaining what was happening in the world and sharing their outlook on rates, inflation, and volatility. So with all that said, some of the common threads were, you know, number one, moderating but structurally higher inflation in 2023 and beyond, two, an expectation for continued volatility, which, three, leads to the importance of active management, having experts on the ground to really help navigate what will likely be quite a challenging period ahead for traditional betas.

Martin: Okay, so we've thought about, uh, the-the invasion of Ukraine and how that's impacted the-the broader inflation view we had. Um, Ukraine wasn't the only, uh, big political event of 2022, however, I would also point to what's happening in China at the moment and what has been happening in China in the last 12 months, which is its ongoing struggle with COVID-19 while the rest of the world has been reopening, and the zero-COVID policy that it's been pursuing, a political decision, a political policy with enormous economic ramifications.

But what I find interesting about this is that when we think about what was going on in China in 2021, that we were all talking about, we were talking about their policy pivot towards common prosperity as they put it. And I think it's interesting that both what they were doing in 2021 and what China has been doing in 2022 it kind of marks a second year running in which China has pursued policies, uh, away from the growth model of the 30 years, which also has implications for the trend in globalization, or de-globalization as we've been calling it.

So, Erik, actually, I wanted you to briefly touch on Ukraine again here, because I recall that you wrote a really intriguing CIO weekly perspective piece over the summer; arguing that the invasion of Ukraine was the fourth hammer blow against seven decades of globalization. So I'd like you to remind us, what you meant by that and why we chose more de-globalization as I think our third solving for 2023 theme this year. And let's then circle back to China specifically after you've talked about Ukraine.

Erik: Yeah, indeed. De-globalization is a major trend and it's been in place for some time. This is not a new concept. De-globalization is merely one of a number of key drivers of higher structural inflation in our view going forward including power between labor and capital, between changing demographics with increased retirement and the need to decarbonize the global economy.

But digging in on de-globalization, we saw the first, kind of inflection point in de-globalization occur during the great financial crisis where there was an increase in protectionist policies by governments in response to the growth shock that was experienced there. And that's when we first saw the peaking and begin to decline of trade as a percent of global GDP. The next, major hit on globalization was the elections in 2016: first Brexit, second in the US, where you saw major, constituents of the trend towards globalization begin to move away from globalization due to rising populism. And those trends have manifested more broadly.

The third major hit was COVID where you saw companies and countries need to change supply chains, and make sure that they had access to key products and key inputs and resources that was localizing and robustifying supply chains, friend-shoring, et cetera, and that led to a decline in this trend to kind of untrammeled globalization.

And then with the invasion of Ukraine by Russia, you saw not just an impact on major sources of commodities and sources of global trade but also the increasing, kind of re-segmentation of the global economy in two blocks, and we're seeing that more with challenges between the US, China, and more broadly.

Martin: And I recall your perspectives post on Ukraine specifically. What was really intriguing that you really traced incredibly deep historical geographical roots to all of this.

Erik: Yeah. Looking back in time, it was interesting to find quotes from classical antiquity in the time of the prominence of Athens, that area, the Black Sea and access to the steps was open for trade, and that led to broad trade exposure. And then, you know, 500 some years later during a period of Roman history, another writer is talking about how that area was controlled by barbarians, and as a result, there was no trade going through the Black Sea. So this notion of Ukraine and that, you know, major nexus of east-west, north-south trade in Central Europe into Asia being a source or the opposite of a source of trade and globalization has been with us for millennia.

Martin: Mm-hmm.

Anu: I was going to say, just jumping here, if you don't already know Erik, he is not only a jeopardy champion, but he is also a massive history buff.

Martin: [laughs]

Anu: So that post is definitely right on track for Erik. [chuckles]

Martin: It was definitely a post that reminded us all, that it's definitely worthwhile to read history and look at maps, as often as we possibly can.

[laughter]

Martin: Turning back to China specifically, I recall when we were working on the asset allocation committee outlook for the first quarter of last year, there was an up for debate section in there where some of the members of the committee were pretty bullish on China, and especially on China tech because they felt like the impact of the policy change that I was describing earlier on from 2021 had been felt and that now there was a value opportunity there.

But there was a lot of divergent opinion on the committee. And hence it ended up in the sort of up for debate section that we have in the AAC outlook. Anu, I know you spoke to our general manager for NB China, Patrick Liu, back in late 2021 on this topic. Uh, I wonder if either of you actually, Anu or Erik, if you can share a sense of how the outlook for China has developed over the course of the last 12 or 18 months, from the people you've been speaking to.

Anu: Yeah, sure. I'll kick off here. And, um, you know, when I spoke to Patrick back in September 2021, it was at a stressful time for Chinese markets, which had just experienced a quite a significant selloff amidst a backdrop of really heavyweight policy changes. And at that time when I talked to Patrick, he predicted that 2022 would likely be volatile and chaotic for Chinese markets, but he was very clear that he was quite optimistic about the longer-term opportunities in China.

And then fast forward a few months to earlier this year, Marco Spinar, portfolio manager for emerging market equities, came on the podcast. And we had a series discussing supply chain issues and he really focused on discussing China's evolution to a more domestic, consumer-oriented economy. And interestingly, he explained that this evolution was pre-pandemic and even pre-trade tensions with the US administration at the time. So, for a number of years, China has been trying to move up the value chain and has been intentionally shifting away from the lower-end manufacturing roles to position itself for longer-term growth and prosperity.

Now with that said, the prolonged zero-COVID policies in China have, of course, been really damaging to the economy and general morale in China it appears. So looking forward, you know, I think it's still a bit of a coin toss to see what the path ahead really looks like for China.

Erik: Yeah. And to build on that, from an asset allocation committee standpoint, we're neutral on-on Chinese equities. And that reflects what still remains a number of major headwinds on-on one side when thinking about Chinese equities in terms of the-the concerns around what could be a more chaotic reopening, after the zero-COVID policy, as well as challenges in the property sector and-and regulatory impact in China.

While at the same time there are potential tailwinds including significant, policy stimulus, both monetary and fiscal, a loosening of some of the regulatory concerns on key sectors of the economy. And it leads us to reflect that China is ultimately a policy-driven market, and we believe will continue to. We think it's investible. We think it represents an important part of investor portfolios.

And finally, we also recognize that it can be a very interesting source of excess return through security selection. It's a large and heterogeneous stock market. And we believe going forward that it will remain a very rich source of security selection, and idiosyncratic opportunities in the future.

Martin: So, China is a policy-driven market. I think that we all understand what that means, but I think everywhere has been a policy-driven market in a different way this year, in a sense of the rapid rise in risk-free rates. If Ukraine was the defining event of the year and inflation was the defining economic dynamic of the year, then the astonishing rise in risk-free rates has, I think, been the defining financial market dynamic of 2022.

A whole raft of our *Solving for 2023* themes center on this interest rate dynamic. If I were to put it in a nutshell, I think I'd say that the story is that 2022 saw rates adjust higher and 2023 will see the economy adjust to those higher rates. So Erik, can you give us a sense of how that adjustment might play out, and especially how that informs our view on credit risk, but also on bonds as a diversifier?

Erik: Yeah, so this is one of our probably two most important themes for 2023, along with the challenges associated with slowing economic growth. And that is that as an investor, risk-free rates, investing in cash has been really, very much of a non-starter for a long, long time. The central banks have been pursuing non-traditional monetary policy, which has kept risk-free rates with a negative real yield, so risk-free rates below the level of inflation, for over a decade. Really, since before the great financial crisis.

And so, investors were strongly incented to look elsewhere for their opportunities, look into riskier assets. That was part of the central bank policy's objective. Well, that's changed. We can buy a portfolio of short duration, you know, treasury bills and get a four-plus-percent return. The Fed has made it clear that they are forecasting and expect to see the Fed funds rate well above the inflation rate within the next year, and that they intend for that to persist. So we believe that indicates that we're going importantly into a quite different environment over the coming years than what we've seen over the last 10 to 15 years, which is that, you know, like in the majority of time that there have been investments in capital allocators, a positive real yield for risk-free investments.

And that is very important. It is going to be quite disruptive. It's going to lead to challenging short-term situations for investors, but ultimately it should lead to a more healthy investment and capital allocation environment. But that may take a year or two or longer to sort out. Uh, in the meantime, what it also presents is that the risk-free rate is finally a pretty challenging competitor to other investment opportunities.

And, you know, if you can earn 4% to 5% essentially in cash, in government-backed, short-term securities, that's all of a sudden a challenging competitor to other assets including very risky assets like equities and other more volatile assets. And that's reflected in our capital market assumptions where our capital market line over the coming five to seven years has risen, not surprisingly, as assets have fallen in '22, but has flattened as the lower risk end has risen quite a bit more than the expectations for riskier assets.

And what that leads us to is to find interesting risk-adjusted opportunities in shorter duration fixed income, in higher quality investment grade credit, in structured product, and even short duration high yield and short duration, emerging markets debt, where if you can generate 5% or 6% return in short duration investment grade credit or 7%, 8%, 9% return in shorter duration higher yielding securities, that's a pretty interesting return to be able to put in the bank with relatively mitigated risk compared to what we think is still a fairly challenging environment for equity and riskier assets in 2023.

Martin: And earlier on, you were talking about the importance of alternative assets when bonds are failing as a diversifier against equities. But now we've got these yields available, does that give us a bit of a cushion, in an equity downturn situation where that correlation might become negative again, or because we're in a situation where the central banks just want to tighten financial conditions, is there a limit to how low the bond yields can go even though now they're at higher levels?

Erik: Well, I think the key opportunity here is for investors who can be liquidity providers in this environment. And that includes both public and private markets. If we are, as we expect, going to see more volatility in 2023 and you see, you know, liquidity provision shifting from being ample, from central banks in quantitative easing and corporations in share buybacks, to perhaps more constrained as central banks move to quantitative tightening and higher risk-free rates and higher yields on corporate credit, cause corporate CFOs to reframe their assessment of share buybacks, for debt and vice versa than being a liquidity provider in an environment where we may see stress and shocks to the system, and being able to provide a marginal dollar of capital to private debt strategies, for example, to be able to take advantage of higher yields and a less competitive, lending environment in private equity or private real assets that are able to take advantage of dislocations in markets and buy assets at better entry points, we think will be an incredibly important opportunity for investors.

Martin: And thinking about this adjustment we're talking about to this world of higher rates, here in the UK we saw it in that remarkable week of the ill-described, mini-budget from the UK government, which brought a very swift end to a new government in Westminster. But perhaps the most intriguing case, and this is unexpectedly very topical now, is Japan: where inflation was above target, and the yen had collapsed, but the central bank was-- well, it still is pursuing its yield curve control policy, but unexpectedly, there's been a change in that policy. Maybe, Anu, if I can start with you, because you recently hosted Fumi Kato on the podcast to discuss Japan as the G-10 outlier as the podcast put it. What did you learn from Fumi in that podcast and, what are your thoughts on what's happened since then?

Anu: Yes, Martin, I was going to say, the one thing I learned is that even though we endeavor to make these podcast episodes somewhat evergreen, the truth is that the world is very fast. And indeed, shortly after publishing that podcast with Fumi, who spoke very eloquently on the Bank of Japan, and some thoughts about what-what may happen in the coming months, the Bank of Japan came out with a surprising policy shift in the direction of possibly ending its aggressive monetary easing policy, which has been in place for a number of years.

Just to bring this topic alive, and to the practitioner side, later that day on December 20th, the firm had its quarterly asset allocation committee meeting, and this group of senior investors convened, and this topic was a key one. It was a lively discussion amongst senior investors around the firm, which really focused on the implications for a number of different asset classes, so the US dollar, Japanese equities, global fixed income, et cetera. And so it turned out that this topic, which Fumi and I discussed just a few days earlier on, the G-10 outlier certainly lived up to its name of being a disruptive force.

Martin: So we've spoken quite a lot about, uh, fixed income markets and rates markets so far. Let's move on to talking about equities. Coming into 2022, we had a view favoring value investing over growth investing essentially. That turned out to be a really good call as long duration growth stocks got pummeled really by these rising rates we've been talking about. By mid-year, we were talking about how the valuations of equity markets had adjusted downwards in line with real rates going up. But we were saying that this would be a two-leg bear market in effect -- where the earnings expectations hadn't adjusted yet. And all we'd seen is a correction in the valuation of the same set of earnings expectations we had at the beginning of the year. So we were still bearish mid-year when the market became bullish. And indeed, I think we're still bearish now. So Erik, can you give us a sense of where we stand on the value versus growth topic now, and also this two-leg bear market topic?

Erik: Well, I'll start with the two-leg bear market. We have been identifying that there were two elements that had to correct to normalize prices for equity markets globally from where they stood, which was, in our view, quite overvalued and quite vulnerable at the start of 2021. One leg, as you identified, was a need for valuations to correct as rates rose, as policymakers normalized rates and real rates increased. And we've seen a large portion of that move, although frankly some of it's been retraced in the last couple months.

The second leg, in our view, was a decline in earnings growth and even, earnings growth turning negative associated with dramatically dropping economic growth and the increasing risk of recession in major economies. We have seen less of that second leg so far in the US bottom-up forecast for earnings growth still are indicating positive growth in 2023 for S&P 500 earnings, despite a near consensus view that we're going to be in recession or at the very least see dramatically slowing growth in 2023. The Fed is forecasting 0.5% GDP growth in '23. At the same time they're expecting rates, the Fed funds rate, to be in the 5% range. This is quite an extraordinary setup and one that would likely lead to margin compression and earnings being less than what is being forecast and priced into markets. And we can extrapolate that into Europe, into Asia, more broadly into emerging markets, which is the key reason why we remain quite cautious on equities in the short term.

When we consider value versus growth, one of the key drivers of our underweight on growth in '22 was the notion that as rates rose, the value of future earnings would be less, and importantly, money now would be valued quite a bit more than money in the future. And that has important implications across assets, but we think that is a theme that will persist into 2023 as rates remain elevated, particularly shorter rates. And also as economic growth struggles, that higher quality, lower beta, higher dividend yielding names will outperform higher beta, and that leads us to really want to continue to be oriented towards value, which still, on a long-term basis, has quite a bit of a gap to close from a relative performance standpoint compared to growth, but really biased towards quality growth in that segment of the market. And we see that as being one of the more attractive areas to play equities in 2023.

Martin: Mm. Whenever I see all of the evidence appear to stack up on one side and the market doing something different, I like to think that there must be some explanation why the market thinks the way it does. And we just had the asset allocation committee meeting, Erik. Um, is there anyone on that committee who gives a contrarian view to the consensus on the AAC? And if not, you know, are you able to play devil's advocate and explain why the equity markets seem so optimistic at the moment?

Erik: Well, the range of views range from even much more bearish than what I just described to saying, well, I'm still cautious on equities, but we might not see the kind of headwinds that we're concerned about until the second half of 2023.

And that is that, in the short term, there could continue to be impetus for improved equity performance; based on the fact that there are still elements of the economy that are quite strong. Looking at labor, looking at consumption, there's still a fair amount of liquidity on the sidelines that can support equities. And that the kinds of challenges that we're looking at for equities, that could cause a revaluation of earnings, may take some time to play through to the system.

The rise in short rates, as we all know, monetary policy works with long and variable lags, may take some time to manifest. And that may also include when a recession would hit. So I think the consensus out there seems to be that the first half is going to be sloppy, and then there'll be a pivot, and things will get better in the second half. We're struggling with that and thinking that the first half may see some continued strength in the equity markets, and then more concern and more volatility in the second half of the year.

Martin: Mm. Okay. I want to go back to the value versus growth question because, Anu, you've posted quite a few podcasts over the past 12 months on thematic investing, uh, whether it's been about the space economy or the connected consumer. There was one titled, I think, *Forgo FOMO: Growth Investing for the Long Term*, which is a great title for the podcast. What did you hear from, I think it was Jason Tauber, what were you hearing from him in terms of how he justifies growth investing in the kind of environment we're in at the moment with these rising real rates?

Anu: Yeah, you know, it was very interesting to bring in a growth portfolio manager on the podcast in a year when so many were rotating away from growth and towards value as Erik highlighted. But, you know, on the episode with Jason, he really laid out his value proposition, which essentially is that he and his team were looking for companies where they're quite positive about what those companies are going to look like three to five years out, regardless of the macro-environment. And I think that hearing his high conviction was an important reminder that active management when driven by bottoms-up fundamental research with a focus on quality companies is really going to be crucial going forward in this new regime, particularly given the wide valuation gaps and the wide return dispersion that we're seeing and will likely continue to see. Investors like Jason and others who can find those diamonds in the rough, we think are likely to be the winners over passive investments going forward.

Erik: And I'd like to add that one key message that Joe Amato, our head of equities, likes to point out is the importance of balance within portfolios. And many equity portfolios became unbalanced towards growth stocks, because of the dominance of a number of large growth stocks in the major indices. And so that led us to remind investors to make sure they had exposure to value regardless of a shorter-term view. And now as many investors seek value equities, we do want to remind investors of the importance to maintain that balance in portfolios. And one theme that kind of runs through, whether we want to allocate to value or growth, is that notion of quality and quality earnings that Anu highlighted. And so I think that's an important theme along with the balance that we're seeking to build in client portfolios.

Martin: Yeah, absolutely. It's so important to remember that growth doesn't necessarily mean wildly speculative, and also, it's important to remember that when the valuations of growth stocks come down, then you can get growth at decent value and the line starts to become a little bit blurred.

As we're talking about growth investing, that's a good opportunity to move us onto private markets, I think, which tends to be a little bit more growthy for obvious reasons. I look at private markets, and I think, is this the last shoe to drop in the markets? I--especially I look at listed private equity, and I look at the big adjustment in prices there and the big discounts to NAV at which these-- some of these listed private equity stocks are trading at, and I'm thinking, is this the way that the private equity universe is going next year, and should people be worried about that? Erik, how are you looking at private markets at the moment?

Erik: Well, when we indicate our views on private markets as part of our multi-asset framework, we are thinking about the marginal dollar of allocation, the new dollar of allocation to private markets as opposed to the embedded NAV, or Net Asset Value, of private markets investments. Our private markets team would agree that there are likely to continue to be price adjustments in the existing, private markets portfolios and that is typical of any kind of extended drawdown in public markets that those prices lag, and we would expect to see some further markdowns in private equity and private real estate portfolios. As we think into 2023 and beyond about marginal dollars of capital, you know, we start by observing that the best vintage years in private equity tend to be early in business cycles where allocators are able to deploy capital over a three-year timeframe in general, at the start of a business cycle, often after major market drawdowns and price adjustments. And they are able to take advantage of that environment to buy assets at attractive valuations and build portfolios that have very strong outlooks for expected return. In private credit and other areas of markets including secondaries, I refer to my earlier comment about being a liquidity provider. There is a potentially generational opportunity to provide liquidity in markets right now where banks have pulled back, where some allocators, due to the denominator effect, are able to allocate less to this area, and so being able to, for example, buy private markets interest in the secondary market, whether private equity or real estate or other assets, is very attractive right now, and there's less capital pursuing those opportunities than there has been traditionally.

Martin: Mm-hmm. And when you talk about the denominator effect, do you mean you've got public assets in your portfolio, you've got private assets in your portfolio, the valuations of the public assets have gone down in the market, and so your allocation has gone down, and so now your private assets look like a much bigger part of your portfolio than they did before?

Erik: Indeed. And that's going to adjust somewhat as private marks catch up with public markets. But it is likely to be a challenge for some investors into 2023. So investors who are able to commit or provide liquidity can be in very advantaged situations.

Martin: Anu, did you delve into private markets in the podcast this year? I don't recall it being that prominent.

Anu: Yeah. We did here and there. You know, I'll just highlight one episode in particular, with Maura Reilly Kennedy. That episode was titled *The Private Equity of Yesterday, Today, and Tomorrow*, and really delved into the evolution of private equity as an asset class. And I think that episode has lots of great nuggets of information that I recommend.

And I'll also give a quick plug to Erik who wrote an excellent article for *The Journal of Investing*, earlier this year, reflecting on a couple of decades worth of where we've come in private equity, and how that fits into multi-asset public-private portfolios. So yes, it was touched upon this year, and I imagine it'll be a key feature next year as well.

Martin: One topic that certainly was prominent in the podcast was ESG and sustainable investing and the climate transition and the energy transition. And indeed this pops up in the Solving for 2023 themes as well, where we acknowledge that this has become a controversial area in 2022 in a way that it really wasn't in 2021 and that investors and regulators we think will need to step back and think about how they define the terms within ESG and sustainable investing. Anu, in the course of the podcast, what kind of topics were coming up? What were you discussing there?

Anu: Yes, Martin, ESG was a topic that was probably discussed in almost every episode. You know, back in June, I'll highlight that we had George Serafeim on the show, he's a member of Neuberger Berman's ESG Advisory Council, a professor at Harvard Business School, he's the author of a book, *Purpose and Profit*, which launched this year. And he covered a lot of these topics, from regulatory issues to his impact measurement initiative.

But one area in particular that he talked about was the importance of engagement versus divestment. And that's something that we at Neuberger Berman are very intentional about. And you heard more about this in a number of episodes. But we really focused on this practice during the August episode with Chris Kocinski, who's the Co-Head of US High Yield, and Sarah Peasey, who's the Director of European ESG Investing, where Sarah really talked through how we construct engagement goals in alignment with UN Sustainable Development Goals, and Chris walked us through an example of what authentic and constructive engagement looks like from his seat as a portfolio manager, where his team and others at the firm are having specific engagement, objective conversations with management teams where Neuberger has been invested for a number of years. And he really described how portfolio managers like himself, and research analysts communicate and indicate to management teams how we're going to track progress on that engagement over time. So that topic of engagement is something that we've seen throughout the year and will continue to be a key focus.

And I thought the conversations both with George Serafeim and Chris and Sarah were excellent outlines on that engagement framework, which was a feature of a number of episodes.

Martin: Erik, do you have anything to add on those topics?

Erik: One important continuing effort that we think will be important over time is the enhancement and development of tools to improve the understanding of material environmental, social, and governance inputs into every level in a process. And so, we launched a strategic asset allocation tool where we incorporate the impact of climate change and the carbon transition into expectations around outcomes for various investment categories. And taking it to that highest level of strategic asset allocation in client portfolios on down to being able to be thoughtful from a fundamental research perspective in terms of incorporating those material factors into individual stock and bond research.

Martin: Yeah, I think, in a way, this brings us all the way back to Ukraine. This was a year which taught us that the energy transition, energy security is incredibly financially material, and it needs to be accounted for in your risk management. I think 2022 has taught us that, and it's a lesson that will be in our minds for a long time, I think, going forward.

To round off, I'd just like you to leave our listeners with your final thoughts, your summarizing thoughts as we move into 2023. Maybe, start with you, Anu.

Anu: Sure, Martin. From my perspective, I'm a member of the Multi-Asset Investment team, and I also get the great privilege of being the host of this podcast series. And I would just like to say, you know, through both of these roles, I'm frequently reminded how incredibly vast, complex, and frankly confusing the investment landscape can be at times.

And in my frequent engagements with clients, I can see firsthand how crucial it is for investors to have access to trusted experts with deep domain knowledge across all asset classes, both public and private because, as Erik said, they're becoming increasingly interrelated. And so related to that, and I mentioned this earlier on, but I think the argument for passive investing in the new economic regime is really dwindling.

And it really does appear that in the intermediate term over the next few years, I think active management really will be integral to generating long-term value for investors. So I'll wrap up by saying that it's my hope that the listeners of this podcast walk away with a few new bits of information with every episode and also the knowledge that if a particular episode piques their interest that we, at Neuberger Berman, are here and would certainly love to continue the conversation and connect.

Erik: And as we think about 2023, the key themes we're focused on are the rising importance of the positive risk-free rate will affect investments going forward, as well as the likelihood of meaningfully declining economic growth in a still high interest rate and inflationary environment that we expect this to mean that volatility will persist in 2023 and it's likely to be another challenging year, and a year of inflection points and pivots of major policymakers and, as a result, we remain more cautious on equities, seeing opportunities in shorter duration, higher quality fixed income and very focused with clients on how to diversify client portfolios more effectively. And also be ready to take advantage of that opportunity by being perhaps able to be opportunistic, and exploit volatility when it arises and stress in the system as that manifests.

Martin: Okay. I'm going to--I've saved the toughest question until last. It is obviously that time of year when we start to think about our New Year's resolution. So my question to you both is what is the New Year's resolution that you're going to make that you are most determined to keep?

Who should go first? Whoever goes first is at a bit of a disadvantage. So I'm going to give it to Erik first [laughs].

Erik: [laughs] Well, uh, okay. I had to have some surgery to deal with a chronic issue. And so I have allowed myself to get into about the worst shape that I have been in physically in many, many years, maybe ever. And so I have to get back into shape in 2023. So I need to be hitting the gym and being diligent about that. You know, it's kind of one of those resolutions that's always there, but, boy, is it important in 2023 for me. It probably also helped with the stress of volatility in markets.

Anu: [laughs] Yeah. That's excellent, Erik. And, you know, we wish you a speedy recovery from your surgery. For me, I'll start off with one light one and then another one as well, but for me, one resolution I have in the new year is to, first of all, potty train my two-year-old son, which is-

[laughter]

Anu: -tri-tried once, it was a massive failure, so that is high on the agenda for New Year's resolutions for 2023. But maybe in more of a reflective mode in our end-of-year discussions and planning for 2023, one of my colleagues made a really good suggestion which was at the end of every week, take some time to reflect and ask yourself, "what have you done this week to help others and whether that's, again, professionally or outside the office?" I think that's a really good way to end the work week and just take a little bit of time for some self-reflection. That's something that I'll be incorporating into my weekly habits in 2023.

Martin: Well, that's a-- that's an excellent resolution, but, uh, I'm going to focus on the potty training one. I think, uh--

Anu: [laughs] Oh, I'd rather not. [laughter]

Martin: Uh, I think it's always useful for investors to remember that, you know, stuff happens. And-

Anu: [laughs]

Martin: -so going into 2023, that's a good thought to leave us with. Erik, thank you very much for your insights, Anu, thank you for your insights as well, and also for letting me sit in your chair. It's been super fun. So I've really enjoyed it. It's been great to hear from you both.

Erik: Oh, a pleasure.

Anu: Martin, thank you very much for having me on the other side of the mic room for the first time. And, before you wrap up, I do want to thank our listeners and all of the guests who joined me this year, and I look forward to surpassing 100 episodes in 2023. And finally, I just want to take a moment to thank my brilliant colleagues behind the scenes who worked tirelessly to produce this show, so thank you to everyone in marketing and production, and particularly to Nick and Lilah. Thank you very much.

Erik: Indeed.

Martin: I'd second that. And finally to you, our listeners if you haven't already done so, I would encourage you to subscribe to the show via Apple Podcasts, Google Podcasts, or Spotify, or indeed you can visit our website, www.nb.com/disruptiveforces, and there you can find previous episodes as well as, uh, all sorts of other information about our firm and our offerings. So it only remains for me to say, wherever you are and whatever you're doing, we wish you a happy and healthy holiday season.

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