Quarterly Investment Letter – Q4 2017

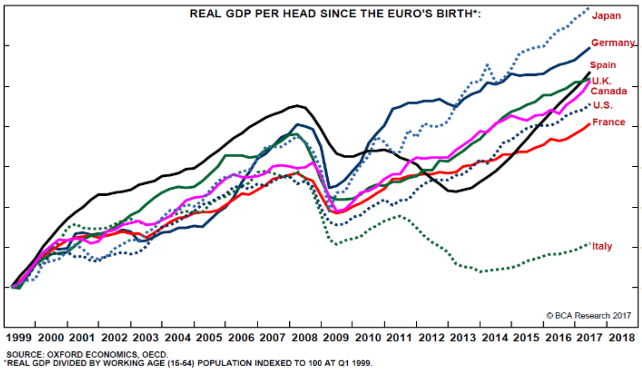
Q4/2017

Global economic growth gains momentum

While we experienced over the last several months geopolitical tensions as well as political turbulences in the U.S., global markets started to ignore them and focused instead on the favorable economic fundamentals. Equity markets bounced the strongest, but credit related assets performed also very well. Government bond yields of major developed countries have on average not materially moved and the yields for Investment Grade bonds have further tightened.

The world witnesses a widespread **synchronized global growth recovery, which is even gaining momentum.** Inflation continues to remain benign and is taking more time than expected to emerge, especially in the U.S. where the economy already reached technical full employment some months ago.

Chart 1: Real GDP per head



Source: BCA

While Central Banks were carefully monitoring growth, inflation and unemployment data, preparing the markets for monetary normalization in the near future, the U.S. President was confronted with a series of leadership testing events both domestically and internationally. His provocative handling of the situations came with a lot of criticism. The White House issues have overshadowed any legislative efforts, leading to the collapse of the new health care bill and to increased tensions within the Republican Party. The next focus is on the widely anticipated tax cut bill.

Summary Points

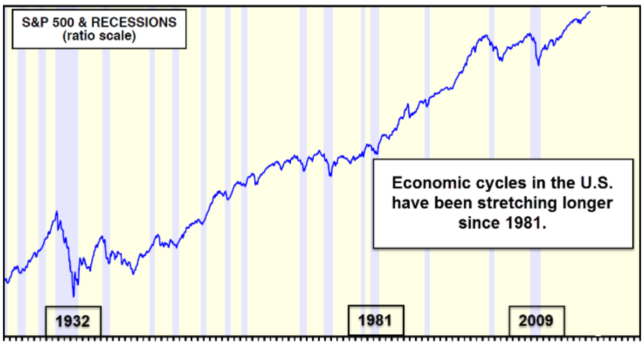
- Continued global growth recovery while inflation remains surprisingly low.
- Equity markets are still leading the way in an environment where all risky assets have done very well since the beginning of the year.
- Investment Grade bonds have lagged the more credit centric investments such high yield bonds or loans.
- Loans in Europe, but also in the U.S. remain our largest allocation within our fixed income portfolios. Thorough credit selection is a key success factor.
- Hedge funds have delivered some alpha lately but their performance is still much linked to the broader markets.
- The U.S. political situation continues to dominate the headlines but markets are no longer reacting to every news flow.
- The FED announced that it will start reducing its balance sheet in the coming months. We expect a further rate hike this December.
- The ECB starts to scale back its Quantitative Easing program in 2018 as the European economy is surprising on the upside, but inflation is still tame.
- Acceleration of economic growth momentum leads to a broader and self-sustained continuation of the business cycle.
- Thanks to the better visibility, companies increase their investments and show more M&A activity to increase corporate revenues and to support (elevated) EPS ratios.
- The current stage of the economic cycle continues to be favorable for equities, whereas credit markets benefit from low expected default rates.

Today, there is much less political and economic uncertainty than 6-12 months ago. This leads to better visibility and investment-/project planning for corporates. Therefore, we currently **benefit from a positive feedback loop between a promising economic outlook and more capital spending as well as M&A activity**. As interest rates will only modestly increase, corporate earnings keep growing and default rates remain tame, we are currently experiencing a very supportive outlook for equities and credit in general. **However, elevated valuation levels do already well reflect the benign market environment.** Hence, already little negative economic surprises can cause market volatility, whereas geopolitical risks need also constantly to be factored in.

Review

A lot happened in the last quarter but at the end of the day, the main conclusion is that the investment landscape has now improved, to a point where after 9 years since the great financial crisis of 2008, we finally can say that the global economy is on average almost back to normal. Central Banks still have to normalize their monetary policy and shrink their balance sheet in the upcoming years, but the need to actively support the Developed Economies with massive monetary stimulus is over. What is now left is a new "normal" where inflation and global growth might stay relatively low for many years to come, with economic cycles stretching longer than in the past. We have to accept this new reality and embrace the opportunities that it brings. Investment returns might be on average lower, with valuations being richer than in the past but there should also be less volatility around economic cycles.

Chart 2: S&P 500 & Recessions

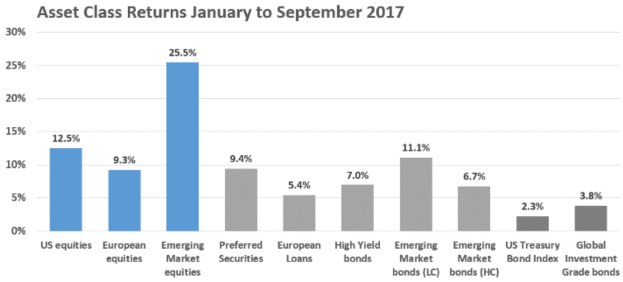


Source: Yardeni.com

We had prepared for a more challenging summer period, having crystalized some gains in our conservative Absolute Return portfolios, while keeping a relatively steady risk profile in our long only mandates, which can afford to go through some additional volatility. While the risk reduction was a prudent action for conservative portfolios and caused some limited "opportunity costs", the traditional portfolios benefited from the ongoing positive markets across most asset classes.

Over the last few months, equity markets creeped higher with US equities for example reaching new historical highs. Over the year, our over-weight Emerging Market equities allocation (+25% performance) was partially dragged by our overweight European equities (+9% performance). While European equity indices lagged other markets, we were significantly compensated by our active European managers delivering much better results. Since January, our equity investments across our range of model portfolios have outperformed the main global MSCI World Index.

Chart 3: Asset Class Returns Jan – Sept 2017 in USD



Source: Bloomberg / Alpinum Investment Management

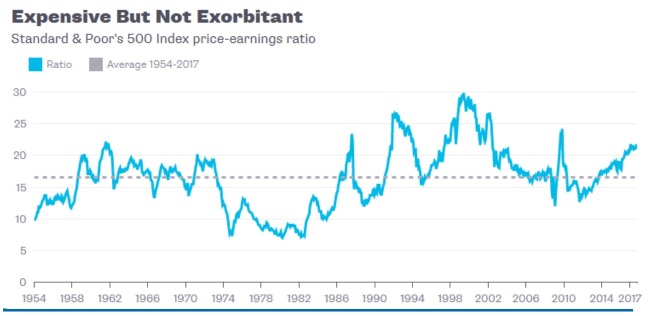
On the fixed income side, our overweight allocation to high yield bonds/loans, Emerging Markets and preferred bonds have proved the right place to be in an environment where USD and EUR yield curves have started to normalize upwards during the year, creating some headwinds for Investment Grade and Government bonds. This view is supported by the recent action by the ECB, which will start to reduce its QE program in 2018. It will be a (very) slow process, but it will ultimately lead to higher rates. On the other side of the Atlantic, we expect the FED to raise rates one more time this year, most likely during its December meeting.

Given that global economies are cyclically reflating and re-synchronizing, corporations are globally growing their revenues and improving their margins, which is supportive for their earnings and their credit quality. The Emerging Market bonds have also significantly benefited from a depreciating USD between May and September, relieving any potential pressure on these economies and helping the bonds outperform. The preferred securities investments, mainly focused on financial institutions requiring subordinated and convertible bonds helping their capital requirements, had a great performance this year. This strong showing came on the back of stronger U.S. and European economic growth and on the basis that the overall banking sector is improving with many banks having taken steps to improve their capital ratio, leading to the improving risk profile of their capital structure.

Outlook

The US equities bull market has been on its second-longest winning streak since 1896, being so far the 3rd largest in cumulative performance. While this bull market is longer than most investors can relate to and valuations are clearly higher than in many previous cycles, it is also the first time in decades that interest rates and inflation are at these low levels globally.

Chart 4: S&P 500 Index price-earnings ratio



Source: Bloomberg

U.S. equities are by no mean cheap but the earnings growth has been sustainable and steadily improving, with the energy sector also staging a comeback from a very negative 2014/2015 and helping push stocks higher. We still believe that investors will be rewarded holding onto their equities and market volatility should be used to add exposure.

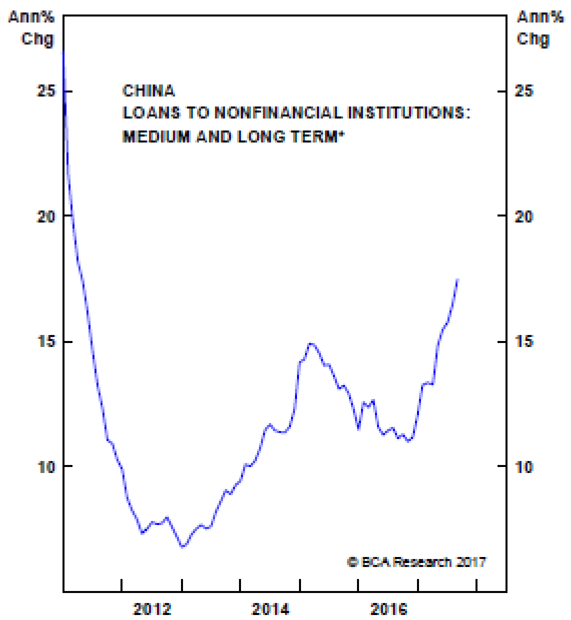
Most equity markets are expensively priced. On a relative basis, Emerging Market equities offer better upside potential, as valuations are not as stretched and opportunities to improve margins and revenues are more abundant. Although we were right in forecasting a surprisingly stronger European growth, the equity indices for the region did not benefit as much as we had anticipated, being held back by the increasing EUR, which investors gladly bought to reflect their constructive views on the region. We still believe that investors will catch-up to the somehow compelling valuations and consequently, we will maintain our investments, using a blend of passive instruments, combined with more niche active managers, who have so far delivered significant value over the year.

On the fixed income side, we expect that the **USD and with some lag also the EUR yield curves will continue to slowly move upwards**, putting some pressure on Investment Grade bonds. Global economies still offer decent nominal and real growth and the environment continues to favour high yield loans and bonds. We focus on keeping our duration very short with these instruments, to allow reinvesting the cash flows at higher rates and limit the negative price impact of rising rates. Some areas of the credit market have delivered above expected returns and look less attractive. However, compared to the alternative of flattish to negative expected returns for most developed markets' Government and Corporate High Grade bonds, High Yield credits still offer better value to investors.

Risks

What are the biggest risks to the global economy and especially to risky assets, already trading at elevated levels and vulnerable to any negative shock? The first answer is linked to **geopolitical risks** involving countries **like North Korea**. An escalating crisis between the U.S and North Korea leading to a military conflict could be catastrophic in many ways. No investor can really predict and easily manage this risk. One could decide to stay on the sidelines. However, we do not see North Korea ever giving away its nuclear capabilities, so such a drastic decision could be very costly in years of missing investment opportunities.

Chart 5: Credit to the real economy in China is accelerating



Source: BCA / PBoC

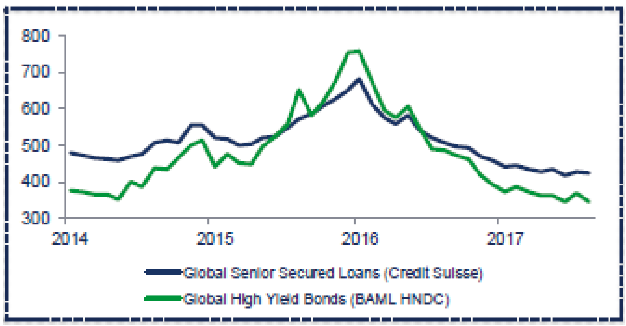
From a financial or **credit risk** point of view, **China will remain for many years a constant threat**, given that its economy is highly dependent on massive credit growth. We were always in the camp of those believing that the Government had the levers and the willingness to steer its economy around the challenges that the credit and real estate bubbles were posing. So far, that has been the case with the PBoC also helping, by carefully balancing restrictive and loosening targeted policies.

From a **political standpoint**, the **Italian election**, most likely to be held in early 2018, could bring turbulence into the Eurozone, if we were to witness a strong socialist party like the Five Star Movement, turning against the Eurozone. Italy has not been benefitting from the Euro introduction and has also never recouped its 2008/2009 economic highs. Italy is too large an economy to simply exit the Euro, without creating a massive negative impact and much uncertainty. We still believe that Italy will not cause a surprise, but there is always a risk in such uncertain political times as we also experience it at the moment in Spain with Catalonia.

Model Portfolio Positioning

The global economic landscape remains positive for risky assets and in particular for equities. **However, with valuations creeping higher across most asset classes the risk of an interim correction is rising in tandem**. As the current global economic momentum is very strong, such a correction would offer an opportunity to add exposure at cheaper levels.

Chart 6: Loans offer now a higher yield vs high yield bonds

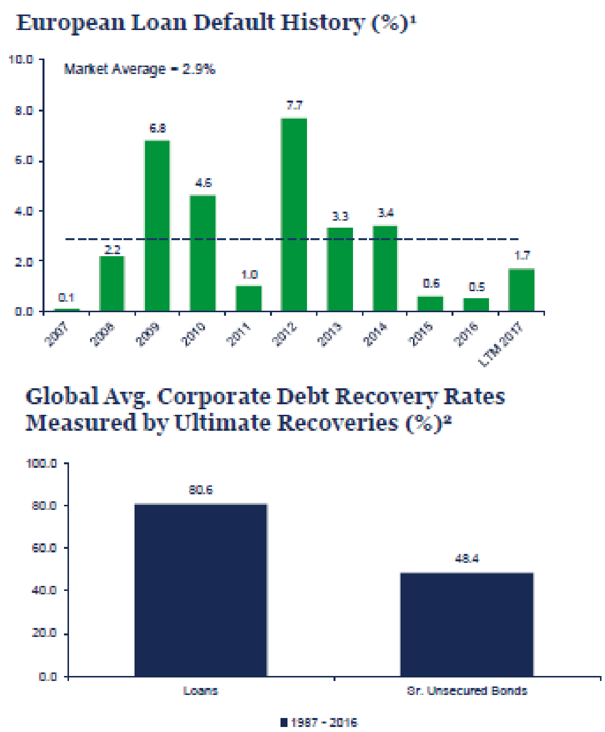


Source: BoAML / Credit Suisse / Barings

From an **asset allocation standpoint** we continue to overweight credit or equity related securities - as we described in the sections before. At the other end, we are **negative on duration sensitive assets** such as government or investment grade bonds as the potential negative impact from rising rates is not compensated anymore by the meagre coupon income.

On the fixed income side, we continue to hold a structural **overweight position in short term high yield bonds and loans**. These investments bear on the one hand low or no duration risk. On the other hand, bonds with a nearer maturity are on a relative basis (vs longer bonds) less risky as the visibility when assessing the credit risk of a company is higher. Lately, we have even increased our allocation to loans as we believe we are better compensated for the risk taken versus high yield bonds chart 6 does well demonstrate the current yield advantage of loans on a relative basis. In addition, loans bear on average a lower risk as compared to high yield bonds as default rates are lower and recovery rates higher. Please see the following chart 7 as illustration. With an average annual default rate of 2.9% and a recovery rate of approximately 80%, the average historical loss rate is surprisingly low with 0.6% (2.9% x [1 - 80.6%]).

Chart 7: European loan loss rates averaged at 0.6% p.a.

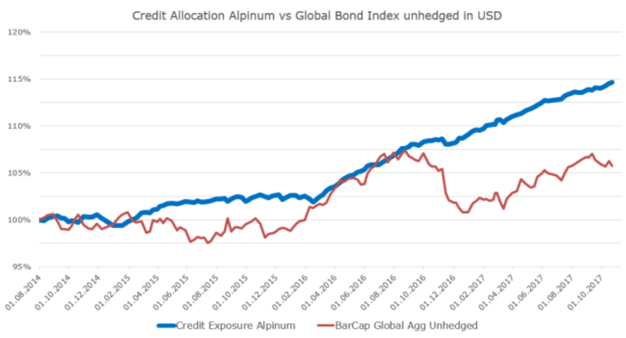


Source: BoAML / Credit Suisse / Barings

We have lately increased our exposure to European loans as we are positive that default rates remain low as the economic momentum in Europe is positive and the ECB has just given guidance that companies can count on low interest rates for longer.

We also believe loans provide a good balance between the different potential outcomes. If economic growth is weaker than expected, loans get supported by their senior secured collateral position, high current income and attractive relative valuation. If economic growth is stronger than expected, loans benefit from their floating rate feature if interest rates and inflation expectations rise.

Chart 8: Credit long-only Exposure vs Global Bond Index

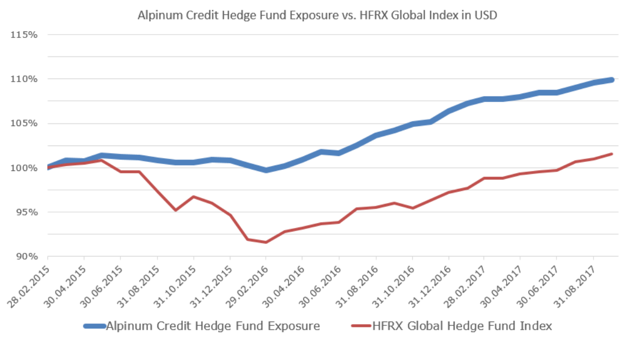


Source: Bloomberg / Alpinum Investment Management

Besides our structural exposure in short term high yield bonds and loans, we complement our fixed income portfolios with opportunistic themes. This **opportunistic bucket includes for example structured credit, namely US RMBS non-agency bonds and a CLO allocation** with a focus on Europe. We also continue to selectively like emerging debt exposure, whereas we hold a significant portion in short term bonds denominated in USD. In addition, we hold also a small allocation in local bonds, which is tilted towards Indian government bonds. These positions are opportunistically traded, taking profits at times and re-investing when relative value comes back. A few other themes and our **"alternative income" bucket complement our fixed income portfolio**, which has generated mid-single digit returns over the last three years with very limited drawdowns as chart 8 above does well illustrate.

We use **alternative investments** in such a way that we are able to deliver significantly **better risk-adjusted returns** to our investors. Equity dispersion has not increased enough, especially in Developed Markets, to allow equity long-short managers to harvest significant extra performance (or alpha) this year and most managers are making most of their performance with their long positions. On the flip side, there are more opportunities to discriminate between bonds for fixed income and credit managers. Credit spreads across the rating classes (no matter whether we refer to Investment Grade or High Yield bonds) are trading at tight levels, what increases the "hunting ground" for short opportunities. We should therefore benefit from continued steady performance from our long-short credit funds and new fixed-income arbitrage funds we are implementing in our portfolios.

Chart 9: Credit centric HF exposure vs HFRX Global Index



Source: Bloomberg / HFRX / Alpinum Investment Management

We typically form hedge fund portfolios with low market correlation and low drawdown profiles. For illustration purposes, please see in above chart 9 our credit centric HF exposure vs the HFRX Global index.

Absolute Return Mandates	Comments
Equities	
▪ We have started to slowly increase again our U.S. smaller cap exposure as the U.S. now will discuss approving a tax cuts bill, benefiting these smaller domestically-focused firms. We also now consider U.S. energy-related MLP providing high cash flow yield and some potential capital upside based on infrastructure spending plans and also tax cuts. ▪ Increase global equities following any meaningful market correction.	▪ Equities are clearly not cheap, especially in the U.S., but we still have reasons to believe that they offer more upside on stronger earnings. ▪ European equities still have some valuation gap versus the U.S. that it can partially bridge, as the economic recovery is stronger than anticipated. Same story for many Emerging Markets where opportunities are still abundant, although investors need to be careful as we expect a lot of dispersion between countries.
Credit / Fixed Income	
▪ Do not yet consider Government bonds unless yields on Treasury 10-year reach close to 3% levels. Buy some US Investment Grade bonds if yields increase and credit spreads are generally slightly wider. ▪ Focus the allocation mainly to US/European loans or to called bonds (to be repaid within a month). European High Yield bonds are currently very rich. Favour U.S. short term maturities and add longer term bonds on weakness only. ▪ Emerging Market bonds still offer pockets of opportunities, with local currency bonds being favoured over hard currency bonds. ▪ Financials via investing into their lower-ranked bonds (for example: preferred securities) still offer good relative value (although the recent performance makes them less attractive nowadays) as banks are recapitalizing and the expected fiscal and de-regulation policies are also positive factors.	▪ U.S. interest rates should continue to trend higher, but we expect some retracements when they move upwards too quickly versus the fundamentals, as was the case during the first quarter. ▪ Pro-growth policies in the U.S. will continue to support high yield bonds/loans, as these companies will be able to grow their businesses, while default rates remain low. Loans offer better value vs High Yield Bonds. European credit markets also enjoy strong tailwind by low rates and an accelerating economy. ▪ Selective Emerging Market bonds in local currency offer investors dual income sources with the yield of the bond and the currencies' potential appreciation. However, this will be a "rocky" path. ▪ Consider harvesting the illiquidity premium from direct loans in corporate debt.
Alternatives	
▪ Credit Long-short strategies identify plenty of relative value trades, both long and short. Fixed-Income arbitrage starts to offer more opportunities, as global interest rates move as Central Banks are normalizing their policies. Equity Long-Short should benefit from the increasing performance dispersion and the continued support of their long-book helped by continued positive equity markets.	▪ With the FED normalizing rates, Fixed-Income Arbitrage and Credit Long-Short managers will experience increasing price dispersion between different interest rates instruments and bonds. This will lead to more relative value opportunities and also credit short opportunities to generate attractive risk-adjusted returns. ▪ Global macro managers should also have more opportunities with the diverging global monetary and fiscal policies between countries.
Real Assets	
▪ On the back of rising inflation expectations and continued geopolitical tensions, we expect gold to slowly trade higher, while keeping a range between 1275 and 1375.	▪ Should inflation start to meaningfully accelerate in the coming months/quarters, we expect the gold price (and other industrial commodities) to trend upwards. However, the path will be volatile.

Long Only Mandates	Comments
Equities	
▪ We have started to slowly increase again our U.S. smaller cap exposure as the U.S. now will discuss approving a tax cuts bill, benefiting these smaller domestically-focused firms. We also now consider U.S. energy-related MLP providing high cash flow yield and some potential capital upside based on infrastructure spending plans and also tax cuts. ▪ Increase global equities following any meaningful market correction.	▪ Equities are clearly not cheap, especially in the U.S., but we still have reasons to believe that they offer more upside on stronger earnings. ▪ European equities still have some valuation gap versus the U.S. that it can partially bridge as the economic recovery is stronger than anticipated. Same story for many Emerging Markets where opportunities are still abundant, although investors need to be careful as we expect a lot of dispersion between countries.
Credit / Fixed Income	
▪ Do not yet consider Government bonds unless yields on Treasury 10-year reach close to 3% levels. Buy some US Investment Grade bonds if yields increase and credit spreads are generally slightly wider. ▪ Focus the allocation mainly to US/European loans or to called bonds (to be repaid within a month). European High Yield bonds are currently very rich. Favour U.S. short term maturities and add longer term bonds on weakness only. ▪ Emerging Market bonds still offer pockets of opportunities, with local currency bonds being favoured over hard currency bonds. ▪ Financials via investing into their lower-ranked bonds (for example: preferred securities) still offer good relative value (although the recent performance makes them less attractive nowadays) as banks are recapitalizing and the expected fiscal and de-regulation policies are also positive factors. ▪ Residential mortgage-backed securities are still offering attractive yields over traditional corporate bonds.	▪ U.S. interest rates should continue to trend higher, but we expect some retracements when they move upwards too quickly versus the fundamentals, as was the case during the first quarter. ▪ Pro-growth policies in the U.S. will continue to support high yield bonds/loans, as these companies will be able to grow their businesses, while default rates remain low. Loans offer better value vs High Yield Bonds. European credit markets also enjoy strong tailwind by low rates and an accelerating economy. ▪ Selective Emerging Market bonds in local currency offer investors dual income sources with the yield of the bond and the currencies' potential appreciation. However, this will be a "rocky" path. ▪ Consider harvesting the illiquidity premium from corporate and personal direct loans.
Commodities / Forex	
▪ On the back of rising inflation expectations and continued geopolitical tensions, we expect gold to slowly trade higher, while keeping a range between 1275 and 1375. ▪ Given the continued global growth and our view that inflation expectations will slowly emerge, we now think that oil (Brent) may start to trend in a higher range between 50 to 65 USD.	▪ Should inflation start to meaningfully accelerate in the coming months/quarters, we expect the gold price (and other industrial commodities) to trend upwards. However, the path will be volatile. ▪ The oil price is supported by OPEC-related cuts while the recovering global growth is also positive. However, there is a lot of potential supply (mainly from U.S. shale oil) which is ready to hit the market, limiting the upper-limit price of oil.

Asset Class Conviction Levels for Absolute Return Mandates

The below conviction table reflects the investment team's view of the absolute expected return of an asset class/strategy in relation to "cash".

Equities	Valuations	Corporate Profitability	Index Momentum	Underweight		Conviction Level over 6 Months Neutral		Overweight
North America	Rich	Stable	Neutral	☐	☐ →	☑	☐	☐
Europe	Fair	Improving	Positive	☐	☐	☐	☑	☐
China	Cheap	Improving	Positive	☐	☐	☑	☐	☐
Japan	Fair	Improving	Positive	☐	☐	☑	☐	☐
Asia - Emerging Markets	Fair	Improving	Positive	☐	☐	☑	☐	☐
Others - Emerging Markets	Fair	Improving	Positive	☐	☐	☑	☐	☐

Fixed Income	Central Banks Policy	Credit Spreads	Expected Default Rates	Underweight		Conviction Level over 6 Months Neutral		Overweight
US - Treasury Bonds	Tightening	-	-	☐	☑	☐	☐	☐
Euro - Government Bonds	Stimulating	-	-	☑	☐	☐	☐	☐
US - Investment Grade Bonds	Tightening	Rich	Rising	☑	☐	☐	☐	☐
Europe - Investment Grade Bonds	Stimulating	Rich	Stable	☑	☐	☐	☐	☐
Emerging Market Local Currency	Mixed	Fair	Rising	☐	☐	☐	☑	☐
Emerging Market Hard Currency	Mixed	Rich	Rising	☐	☐	☑	☐	☐
US High Yield / Loans	Tightening	Fair	Rising	☐	☐	☐	☑	☐
European High Yield / Loans	Stimulating	Fair	Stable	☐	☐	☐	☑	☐

Commodities	Cost of Production	Market Sentiment	Price Momentum	Underweight		Conviction Level over 6 Months Neutral		Overweight
Gold	Neutral	Positive	Positive	☐	☐	☑	☐	☐

Hedge Fund: Strategies	HF Strategy Momentum	Equity Index Momentum	Sector Dispersion	Underweight		Conviction Level over 6 Months Neutral		Overweight
Equity Long-Short	Positive	Positive	Positive	☐	☐	☑	☐	☐
Credit Long-Short	Positive	Positive	-	☐	☐	☑	☐	☐
Event-Driven - Corporate Actions	Positive	-	-	☐	☑	☐	☐	☐
Global Macro	Neutral	-	-	☐	☐	☑	☐	☐

Hedge Fund: Regional Focus	Sector Dispersion	Equity Index Momentum	Corporate Activity Level	Underweight		Conviction Level over 6 Months Neutral		Overweight
Hedge Fund: North America	Positive	Positive	Positive	☐	☐	☑	☐	☐
Hedge Fund: Europe	Positive	Positive	Positive	☐	☐	☐	☑	☐
Hedge Fund: China / Japan	Positive	Positive	-	☐	☐	☑	☐	☐
Hedge Fund: Emerging-Markets	Positive	Positive	-	☐	☐	☑	☐	☐

Asset Class Conviction Levels for Long Only Mandates

The below conviction table reflects the investment team's view of the relative expected return of an asset class in relation to traditional well-recognized benchmarks such as BarCap Global aggregates (bonds) and MSCI World (equities).

Equities	Valuations	Corporate Profitability	Index Momentum	Underweight	←	Conviction Level over 6 Months Neutral	→	Overweight
North America	Rich	Stable	Positive	☐	☐	☑	☐	☐
Europe	Fair	Improving	Positive	☐	☐	☐	☑	☐
China	Cheap	Improving	Positive	☐	☐	☑	☐	☐
Japan	Fair	Improving	Positive	☐	☐	☑	☐	☐
Asia - Emerging Markets	Fair	Improving	Positive	☐	☐	☑	☐	☐
Others - Emerging Markets	Fair	Improving	Positive	☐	☐	☑	☐	☐

Fixed Income	Central Banks Policy	Credit Spreads	Inflation	Underweight	←	Conviction Level over 6 Months Neutral	→	Overweight
US - Treasury Bonds	Tightening	-	Rising	☐	☑	☐	☐	☐
Euro - Government Bonds	Stimulating	-	Rising	☑	☐	☐	☐	☐
US - Investment Grade Bonds	Tightening	Rich	Rising	☐	☑	☐	☐	☐
Europe - Investment Grade Bonds	Stimulating	Rich	Rising	☑	☐	☐	☐	☐
US High Yield	Tightening	Rich	Rising	☐	☐	☑	☐	☐
US Short Term High Yield	Tightening	Fair	Rising	☐	☐	☐	☑	☐
US Loans	Tightening	Fair	Rising	☐	☐	☐	☐	☑
US Municipal Bonds	Tightening	Rich	Rising	☐	☑	☐	☐	☐
European High Yield	Stimulating	Rich	Rising	☐	☐	☑	☐	☐
European Short Term High Yield	Stimulating	Fair	Rising	☐	☑	☐	☐	☐
European Loans	Stimulating	Fair	Rising	☐	☐	☐	☐	☑
US/EUR Preferred Securities	Stimulating	Cheap	Rising	☐	☐	☐	☑ ←	☐
US/EUR Asset Backed Securities	Tightening	Cheap	Rising	☐	☐	☐	☑	☐
Emerging Market Local Currency	Neutral	Fair	Mixed	☐	☐	☐	☑	☐
Emerging Market Hard Currency	Neutral	Rich	Mixed	☐	☑	☐	☐	☐
Emerging Market High Yield	Neutral	Fair	Mixed	☐	☐	☑	☐	☐

Commodities	Cost of Production	Market Sentiment	Price Momentum	Underweight	←	Conviction Level over 6 Months Neutral	→	Overweight
Gold	Neutral	Neutral	Neutral	☐	☐	☑	☐	☐
Oil (Brent)	Neutral	Neutral	Negative	☐	☐	☑	☐	☐

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Contact Information:
Alpinum Investment Management AG
Talstrasse 82
CH-8001 Zurich
Tel: +41 43 888 79 33
Fax: +41 43 888 79 31
alpinumim.com