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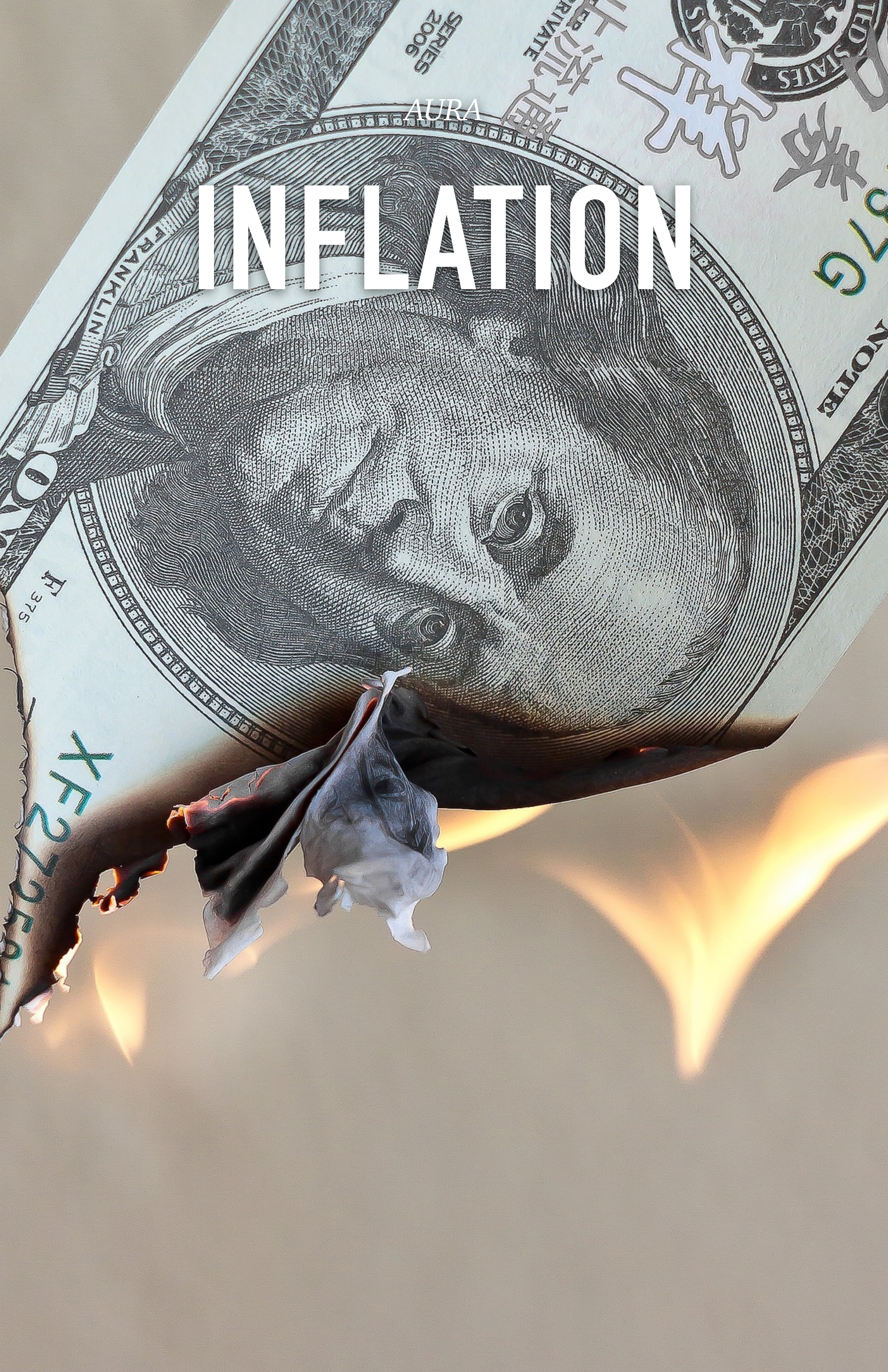
INFLATION



WE PROVIDE INVESTMENT MANAGEMENT SOLUTIONS ACROSS ALL MAJOR ASSET CLASS TO DIVERSE SET OF INSTITUTIONAL AND INDIVIDUAL CLIENTS

Understanding Inflation Risk: What Investors Need to Know

Inflation risk refers to the risk that the value of an investor's assets will be eroded over time due to rising prices. Inflation can reduce the purchasing power of money, which means that the same amount of money will buy fewer goods and services in the future. This can have significant implications for investors, particularly those with long-term investment goals.

Inflation risk is a concern for all investors, but it can be particularly challenging for those who rely on fixed income investments, such as bonds, as their primary source of income. As inflation rises, the fixed income payments from these investments may not keep up with the rising cost of living, leading to a decline in purchasing power.

Investors can take several steps to mitigate inflation risk, including:

1. Investing in assets that have historically performed well during periods of high inflation, such as commodities, real estate, and stocks of companies that have pricing power and can pass on cost increases to consumers.

2. Investing in inflation-protected securities, such as Treasury Inflation-Protected Securities (TIPS) or inflation-indexed bonds, which are designed to keep pace with inflation.

3. Diversifying their portfolio across asset classes and geographies, which can help to reduce overall risk and provide some protection against inflation.

4. Maintaining a long-term investment horizon and avoiding short-term market timing strategies, which can be difficult to execute successfully and may increase overall risk.

5. Staying informed about economic and market conditions, including inflation trends and government policies that may impact inflation.

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SOFT LANDING

- The Federal Reserve's ongoing fight again inflation could result in a soft landing in 2023.
- Mortgage-backed securities, high-yield bonds and emerging-markets debt could benefit in this environment.

The Federal Reserve's 2022 efforts to address skyrocketing inflation by tightening monetary policy was a key driver of asset prices, and that dynamic is likely to continue this year. One of the biggest questions for 2023 is: Will the Fed be successful in its attempt to keep inflation between 2% to 2.5%, while maintaining a balance between employment and price stability?

As the Fed has noted, rate hikes work, but there are often "long and variable lags" between changes in monetary policy action and their impact on the economy. Among the risks, Fed policy has the potential to erode U.S. corporate earnings, increase defaults, widen credit spreads and increase the chances of a recession. But after strong economic data releases and comments from the Fed in early 2023, the market is positioned for the Fed to continue to raise rates in the first half of 2023, albeit at a slower pace than in 2022. This will likely usher in a range-bound price action for U.S. Treasury bond yields, and with the labor market so tight it may be hard to have a deep recession.

A soft landing, in which the Fed can slow the economy and bring down inflation while avoiding recession, is becoming more and more possible. The labor market still seems pretty strong, which will likely keep credit default risks low on credit cards, autos and everything else. This environment also favors higher-beta fixed income, including asset-backed securities, high-yield bonds and emerging-markets debt. These are all sectors that would benefit from a more stable interest rate environment and a soft landing.

Three Fixed-Income Opportunities in 2023

If the Fed's plan to durably stem inflation works, asset valuations may benefit over the longer term, offering several considerations for investors' fixed-income portfolios.

- Asset-backed securities: Particularly in agency mortgage-backed securities (MBS) and some securitized credit products, yield spreads (the difference in the rate of return between these assets and U.S. Treasuries) have stayed wide compared to high-yield and investment-grade issues. Investors may still want a little extra yield compared to Treasuries, which would make MBS and securitized credit products attractive and draw asset flows.

- High-yield credit: Without a major recession on the horizon and with high-yield indexes yielding around 8-9%, there is ample room for yield spreads (the difference in the rate of return between high-yield bonds and Treasury bonds) to widen and still generate mid-single digit returns, if not higher. Moreover, it would also be highly unusual to have two years of negative high-yield returns in a row, after a -11% return in 2022.[1]

- Emerging markets (EM) debt: We see EM debt as an attractive option for investors comfortable with a riskier asset class, particularly for debt issued in local currencies. While the U.S. dollar has started to weaken, it is still at very strong historical levels. If it continues to weaken in 2023, that would certainly be good for EM debt priced in non-dollar local currencies. Additionally, EM corporate debt —credit sectors—typically do well in a weak-dollar environment.

In sum, certain fixed-income assets could benefit in 2023 from a less aggressive Fed, a slowdown in the U.S. economy and improvements in various supply-side constraints.

We're living in an era of unforeseen events that give rise to risks, including geographic conflicts and a "black swan" event—something so unpredictable that it's not on anyone's radar—a global pandemic with far-reaching economic and social consequences. While a company can't always anticipate what might be around the corner, strong risk oversight by the board can help the company respond with more rigor and agility. The number and types of risks the board oversees continue to grow, even as their nature changes. Some become more likely as businesses are more interconnected. Some are likely to impact just a certain area of the business. Others could severely impact the entire brand.

The past three years provide a long list of events outside the control of corporate leadership and outside the traditional value chain that nonetheless have presented serious risk to enterprise value. COVID and Ukraine are the obvious global examples. In the US, civil unrest over racial injustice, the January 6 attack on the capital, election law changes, political fights over education and LGBTQ+ rights, and the recent decision by the Supreme Court to overturn Roe v. Wade are all socio-political issues on which employees, customers, investors, and communities want the companies they associate with to take action that aligns with their own beliefs. That call from stakeholders is a strategic issue for companies, as well as a moral one.

Aura's most recent Consumer Intelligence Series shows that more than 80% of consumers/employees are more likely to buy from/work for a company with strong performance on climate issues. More than 70% are more likely to buy from/work for companies with strong performance on social issues and the same for governance issues. Employees and the customer overwhelmingly see environmental, social, and governance (ESG) issues as a reason to connect with a company. And the link between trust and ESG is strongest among young people.

STRATEGY

The link between strategy and risk

Large institutional investors have been pushing for more information about how a company’s statement of purpose is linked to its long-term strategy and success. Let’s use ESG risks to illustrate this. For many companies, these risks were already on their radar— somewhere. But the recent focus by large institutional investors, combined with an increase in shareholder proposals seeking disclosure, have brought these risks to the forefront. Large institutional investors are suggesting that ESG risks could have an impact on the long-term sustainable value of the company.

First things first: board composition

Risk oversight is a full board responsibility. Having diverse skills, backgrounds, and experiences on the board is vital to understanding the broad range of risks a company can face. It is important to have some board members with deep expertise in the industry who can help anticipate what's to come. On the other hand, it is also important to have fresh perspectives—whether it's new directors, those with experience in different industries, or different skill sets—to view risk through different lenses. Directors who have specific risk management expertise can also bring real value.

In conclusion...

In a business risk environment that is becoming more complex and interconnected, boards play a crucial role in overseeing risk and keeping shareholders informed.

- To begin, boards can start by looking around the table. Is there diversity of experience, thought, gender, and race to bring different perspectives on risk?

- Boards will also want to understand their company's ERM program and how they can contribute to that program.The board will also want to spend time on its own structure for oversight.

- And finally, boards will not want to forget about the company's various stakeholders—what information is provided to them about the company's risk management programs and activities?

By examining and refining its approach to risk oversight, a board can deliver enhanced value to the company and its shareholders.

The war in Ukraine is a human tragedy. From a business management perspective, it is also an example of old-school "global geo-political risk." But the fast, overwhelming exodus from Russia and support for Ukraine isn't driven primarily by old-school operational risk concerns over raw material costs and supply chain disruptions. For most companies, the primary enterprise risk of continued engagement with Russia, or the failure to support Ukraine, is to stakeholders' trust that the company shares their personal values.

The market data frames a simple question at the heart of nearly every company's strategy: How do we become the company that everyone between the ages of 15 and 35 wants to work for, buy from, and identify with on social media? Getting the answer wrong can: make it impossible to recruit and retain talent; damage the brand and platform; increase capital costs by driving away socially responsible investors; and end executive careers.

ESG and ERM

Some aspects of ESG-related risks fit into the models that have long been used by companies for risk management and boards in meeting their Caremark oversight duties. Risks to supply chain or physical plant from extreme weather or rising seas are fundamentally operational in nature, even if they are difficult to quantify. Regulatory uncertainty arising from political dysfunction is similarly familiar. But the trust risks posed by ESG issues are different and extremely difficult to manage because of four key characteristics:

What should the board's role be?

There are two steps companies should take to mitigate trust risks relating to ESG, and the board has a role in both:

- Set a risk appetite level that considers ESG risks and allocates capital and structures operations accordingly

This is a part of all risk management, but it is particularly important with respect to trust risks. For example, to what extent should a company pursue lower labor costs by offshoring manufacturing to a country that has weaker environmental and labor laws? The risk to reputation, brand, and platform needs to be considered in making that decision. So too does the risk of increasing the firm's cost of capital in the event that ESG focused investors are unwilling to hold company equity or debt. Not all questions of this nature—perhaps not even most—will make it to the board. But all should be informed by risk appetite parameters that the board has reviewed, tested, and approved.

Build a reservoir of trust to draw on in difficult moments

This isn't easy. It means devoting time and effort to stakeholder engagement to understand the values that the community of people who create and sustain the long-term value of the company expect the company to demonstrate. It means taking action on those priorities, measuring progress, correcting mistakes, and being accountable to your corporate community. The best response to the latest act of political grandstanding, or tragic event, or social upheaval is to respect the full range of views of your diverse corporate community by sticking with the values you have set together. Neither company management nor the board should need to figure out the company position on an emergent social issue in the heat of intense public pressure.