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CIO Strategy Bulletin

Seeking Outperformance Post-Pandemic

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Summary

- **The performance of financial markets since late February 2020, the moment when pandemic fears paralyzed the world, has been nothing short of spectacular. We believe the outlook for 2022 will be not be so dramatic.**
- **We believe potential long-term returns in equity markets may be enhanced by focusing on two corporate attributes.**
  - **Investing in firms that consistently lead their industry and within industries that grow as a share of the overall economy; and**
  - **Investing in firms that sustainably grow income distributions to shareholders.**
- **We also believe portfolios should be aligned toward sustainable return drivers. Accelerating global healthcare spending is one such long-term potential opportunity. Digitization is another. Think of digital as the "main stream economy" with traditional industries adapting to it or fading against it.**
- **What oil and coal was to the industrial revolution, data is to the digital revolution. As with any vital resource, data needs to be protected against increasingly brazen attempts to compromise it.**
- **Data defense is a strong opportunity for investors. Global expenditure on cyber security is estimated to reach $269bn by 2026, up from $187bn in 2021[1]. While valuations trade at a premium to the broader technology and software indices, we believe cyber security investments are justified by their stable revenue and earnings prospects.**

[1] Source: Forbes as of Nov 18, 2021

Seeking Outperformance Post-Pandemic

The performance of financial markets since late February 2020, the moment when pandemic fears paralyzed the world, has been nothing short of spectacular. From Jan 31, 2020 until today, the S&P 500 is up 39% (figure 1) and the Nasdaq composite is up 69%. While there are still some COVID-impacted industries and depressed emerging markets, we believe the transition from "recovery" to "expansion" in financial markets is largely over. Governments, scientists and technologists managed to support incomes, developing vaccinations and methods to preempt a global collapse in record time. These were so effective that market optimism has soared.

We believe the outlook for 2022 will be nothing so dramatic. In 2022, we foresee neither a recession, nor a boom. Investors who missed buying "COVID cyclicals[2]" such as hospitality shares, or entire country markets like Brazil, cannot expect such dramatic opportunities on the horizon. (see figure 2). Many of the assets that posted strong gains (such as the 120% annualized gains since April 2020 in hotels, resorts and cruise line operators) were possible because of their plunge into the brief abyss of the COVID recession.

Figure 1: S&P 500 Year/Year % Change

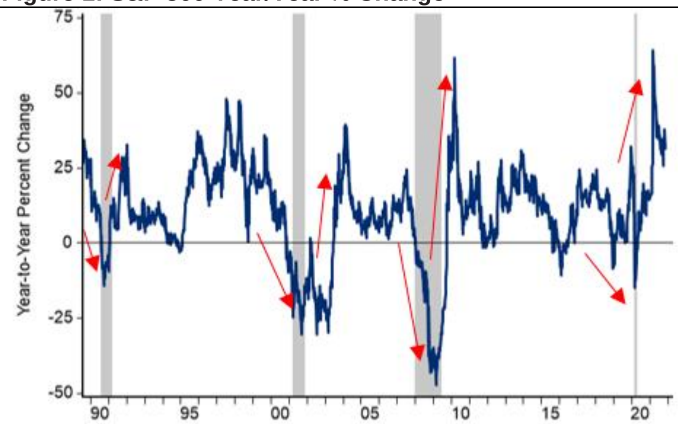
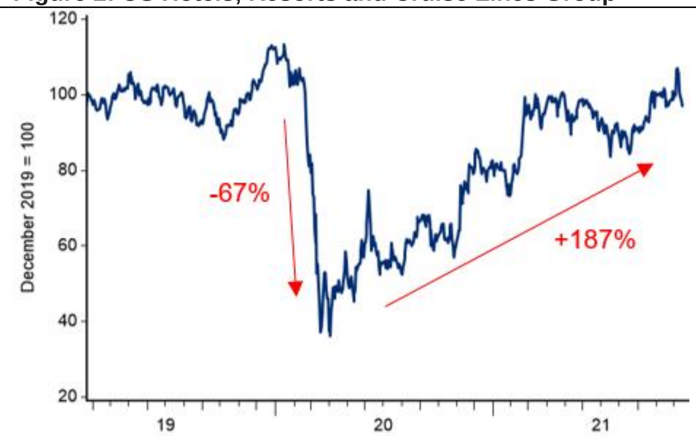


Figure 2: US Hotels, Resorts and Cruise Lines Group



Source: Haver Analytics as of November 15, 2021. Note: Gray shared areas are US recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

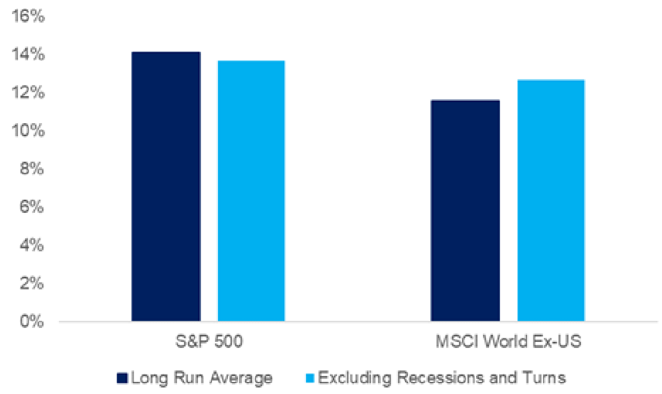
Resetting Expectations

When you take away the markets dramatic moments, the years of crashes and booms, you can see that the returns that follow have historically been attractive. It turns out that markets are resilient and that the world as a whole grows far more than it shrinks. Such is the human condition of creative disruption and innovation. It is a "lifting up" process that, while uneven and often unfair, is equally unrelenting. It is why we featured technological disruption in the energy sector (see CIO Strategy Bulletin | The Environment for Bonds and Humans), the financial sector (see CIO Strategy Bulletin | The Fear and Loathing of Inflation: Portfolio Impacts and Opportunities) and the "health of the digital economy" through investments in cybersecurity this week (see Special Section that follows the main Bulletin).

In summary, when investors stay invested, they tend to capture the economic progress that can generate real wealth in portfolios (see figure 3).

[2] Energy, Materials, Consumer Discretionary (ex-E-Commerce), Industrials, Financials, Real Estate

Figure 3: US and Global Equities Annual Total Return Since 1960: Average and Excluding Year Before through Year After Recessions



Source: Bloomberg as of November 15, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Staying Invested Is Not Standing Still

While one can buy an index and potentially grow wealth, portfolios can seek a better risk-adjusted return, through diversification and by being savvy about when to overweight and underweight certain sectors and elements for longer-term potential opportunities. Given the specific steps we took to invest in "recovery," we must transition portfolios for "expansion." Failing to do so would leave portfolios exposed to short-term portfolio drivers that were unique to the COVID rebound period.

We believe potential long-term returns in equity markets can be enhanced by focusing on two corporate attributes.

1. **Invest in firms that consistently lead their industry and within industries that grow as a share of the economy.** Leaders in sectors that are growing disproportionately provide a "one-two" punch that creates shareholder value.

   Unstoppable Trends such as the secular rise in healthcare demand or the transition of the economy from tangible to digital are macro-level examples of "secular growth industries." We would see traditional autos or oil drilling as the opposite, sectors with gradually diminishing growth, with periodic, cyclical booms and busts (see figures 4-5).

Figure 4: S&P 500 Revenues vs FAAMG Revenues

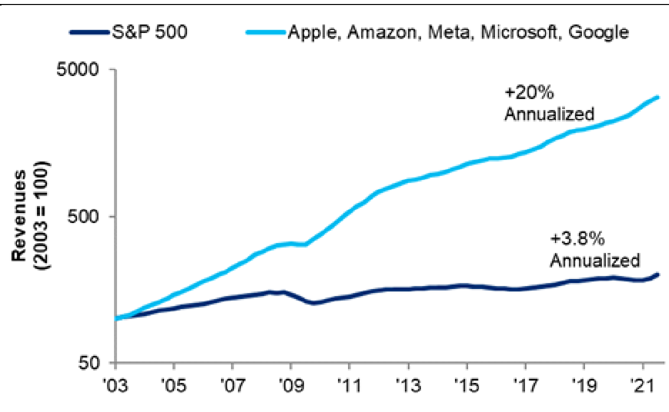
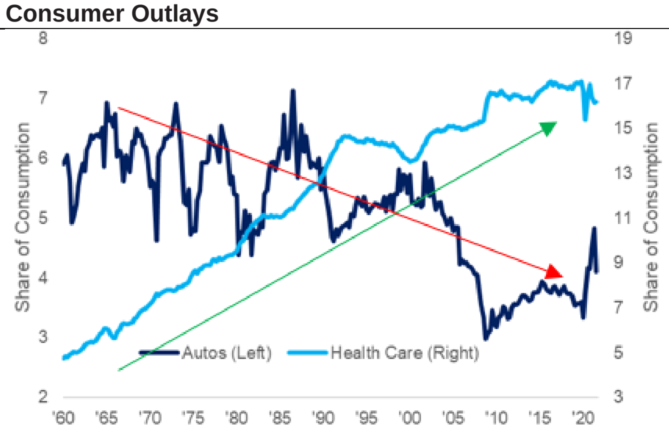


Figure 5: US Healthcare vs Autos Spending as a % of Total Consumer Outlays



Source: Haver Analytics as of November 15, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. FAAMG stands for Apple, Amazon, Meta, Microsoft and Google. This should not be construed as an offer of, or recommendation of companies discussed.

2. **Invest in firms that seek to sustainably grow income distributions to shareholders.** This sounds easy, but is rather hard to do over long periods of time. It requires management discipline to both invest in the future of a company as an industry evolves *and* to plan for the growth of payments to shareholders. US firms with the most consistent dividend growth have outperformed the S&P 500 by about 60 percentage points in the last 30 years (see figure 6).

   Firms with the strong growth opportunities can invest 100% of their cash flow to drive returns. However, when a firm's balances growth and tangible, growing dividends, the combination becomes a highly valuable asset for investors (see figure 7). In other words, firms must work harder or have growth opportunities to ask investors to forego dividends that have cumulatively driven half of long-term equity market returns.

Figure 6: S&P 500 Dividend Aristocrats, MSCI Quality Index and All US Shares

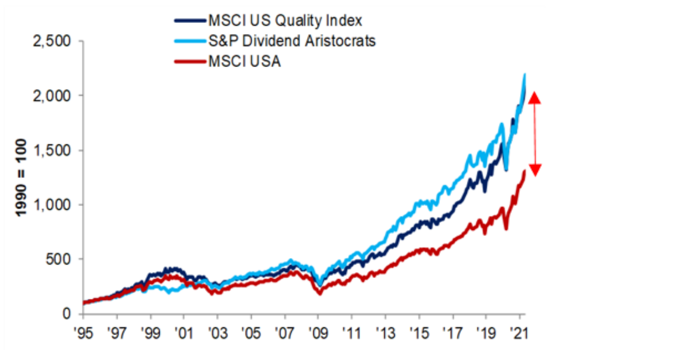
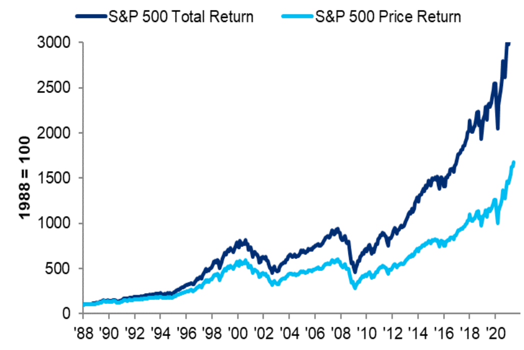


Figure 7: S&P 500 Price Index vs Total Return Index with Reinvested Dividends



Source: Bloomberg and FactSet as of November 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Tactical Portfolio Tilts

This past week, our Global Investment Committee (GIC) kept its asset allocation unchanged with Global Equities 6% overweight. Fixed Income and cash remain 6% underweight. Over the course of 2021, we've reduced risk assets from a peak overweight of 11% as we see equity returns in the coming year moderating toward high-single digits. This follows a 26% gain over the past 12 months. With even larger equity market gains in COVID-impacted sectors, we've migrated holdings toward consistent dividend growers and less cyclical areas (see figure 8 and our latest *Quadrant*).

Figure 8: Global Investment Committee allocations

LARGEST OVERWEIGHTS	
+3.0%	Global Healthcare
+1.7%	Developed large equities ex-US
+1.5%	US Large Cap Equities
+1.0%	US mortgage REITS
+0.5%	China equities
+6.0%	**Total equities and REITS (vs +8% prev)**
+4.0%	US TIPS, Intermediate Treasuries, IG Corporates
+3.0%	High yield debt (loans) and emerging market debt

10% of total asset allocation in US/Non-US dividend growth strategy

LARGEST UNDERWEIGHTS	
-6.5%	European government bonds
-3.2%	Japan government bonds
-2.9%	Cash, short-term US treasuries
-1.0%	Global SMID
-6.0%	**Total fixed income and cash (vs -8% prev)**

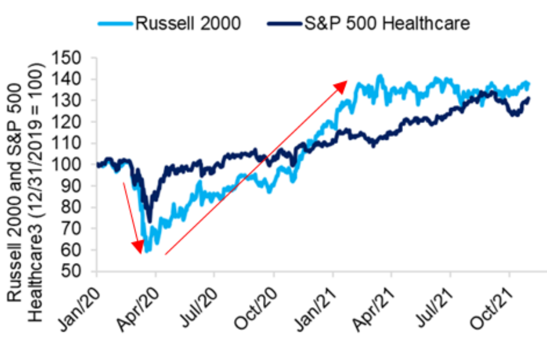
Source: Citi Private Bank Office of the Chief Investment Strategist through November 19, 2021

Sustainable Return Drivers

Another challenge is to realign portfolios toward sustainable return drivers. Over 2021, we altered many of our allocations to capture the drivers of returns. For example, we reduced holdings of volatile, leveraged small cap firms that enjoyed an exaggerated recovery from depressed levels. We reinvested in the generally more stable growth and value offered in the healthcare sector (see figure 9).

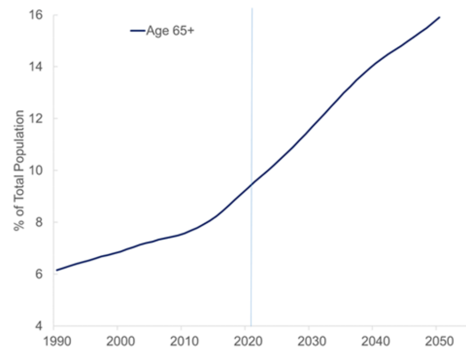
Accelerating global healthcare spending is a long-term return opportunity. The drivers are an aging world, with the United Nations projecting a doubling in the size of the over-65 population in less than 30 years. The growth of this demographic is more than 4x faster than the growth of the world's population. With science delivering longer lives – and people spending more for longer on services and healthcare itself -- it makes "Increased Longevity" a Citi Global Wealth Unstoppable Trend (see figure 10).

Figure 9: US Small and Mid-Cap Shares vs Large Cap Healthcare Sector



Source: Factset as of November 18, 2021

Figure 10: Share of Global Population Aged 65+: UN Projection



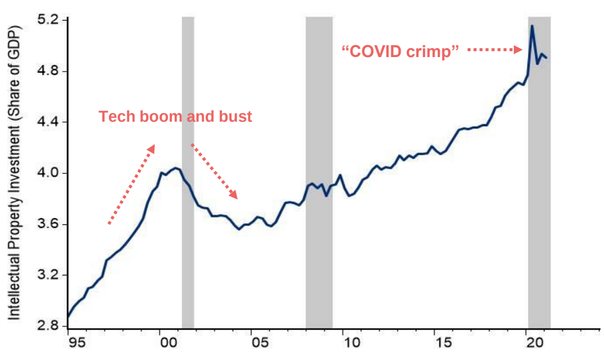
Source: Haver as of November 18, 2021

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Investing in smaller companies involves greater risks not associated with investing in more established companies Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. The projection is an expression of opinion are not intended to be a forecast of future events or a guarantee of future results.

Sustainable Means Digital

The dot.com bubble period was a classic "boom and bust". Our present digital boom seems quite different as COVID provided a glimpse into our future (see figure 11). Post-pandemic, the "demand for digital" will very likely remain at high sustained level. Digitization helped the world adapt to COVID, saving millions of jobs with mobility and flexible work arrangements. With social distancing helping slow the spread of COVID, digitization saved lives, too. Beyond the extremes and distortions of this period, think of the digital world as the "main-stream economy" with traditional industries adapting or fading within it.

Figure 11: Intellectual property investment (ex: software) as % of US GDP



Source: Haver Analytics as of November 17, 2021. Note: Shaded areas are periods of recession. COVID crimp: a period of intellectual property investment acceleration driven by shifting needs during the COVID pandemic.

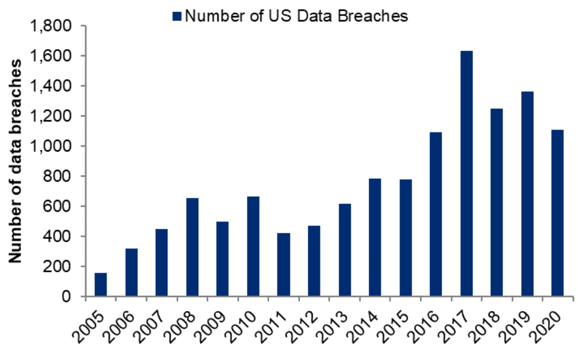
CIO Special Section: Inflation-Proof Cybersecurity

According to the United Nations Conference on Trade and Development, Global e-commerce reached $26.7 trillion in 2020. In parallel with its growth, the theft of data and assets online now represents a major industry in its own right. According to Cyber Ventures, a cyber research organization, the annual impact of cybercrime has already reached an astounding $6 trillion this year.

The costs of cybercrime extend beyond the theft itself, often resulting in reputational damage or worse. Hacked companies may also face regulatory sanctions if their data is found to be inadequately protected. Cyberattacks that target vital infrastructure can result in economy-wide harm. Even national security and human life is threatened now as the IoT governs transportation and other vital public systems.

There were over 1100 data breaches in the US alone last year, up from below 500 in 2012 (see figure 12). In one incident, hackers carried out a highly sophisticated attack on a US technology company whose clients include the US government and various major companies. In May 2021, the Colonial Pipeline, a fuel network in the Southwestern US, was disrupted for several days after a ransomware attack on its software systems. The problems can be even more acute outside the US and particularly in emerging economies, where technology ecosystems are often less secure.

Figure 12: Data breaches rising over time



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Defending Data

What oil and coal was to the industrial revolution, data is to the digital revolution.

As the rollout of fifth generation (5G) mobile technology continues, we expect a vast increase in the number of devices connected to the internet. This will result in an unprecedented increase in generated data much of which will be stored in the cloud (see figure 13). As with any vital resource, data will need to be protected against increasingly brazen attempts to compromise it. As we saw with Equifax's data breach in 2017, a public attack can potentially lead to significant loss of market share (see figure 14).

Figure 13: Data generation is growing rapidly

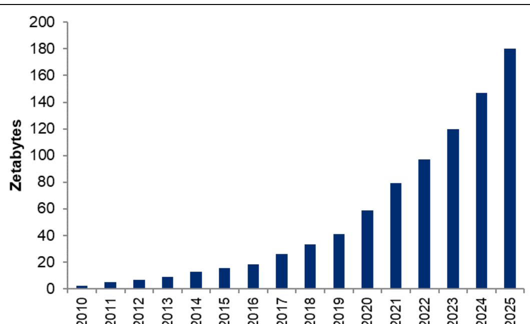
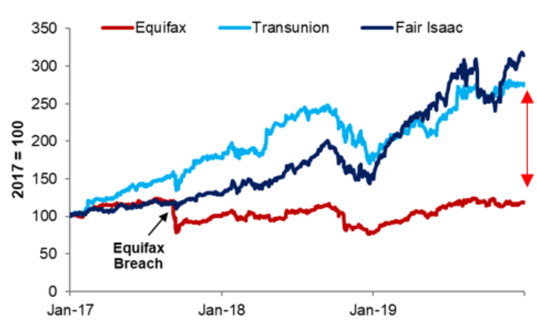


Figure 14: Equifax and its competitors following 2017 breach



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Data Defense is a Strong Opportunity for Investors

Global expenditure on cyber security is estimated to reach $269bn by 2026, up from $187bn in 2021. A recent survey of companies' chief information officers in the US revealed that cyber security was their number one priority for investment (see figure 15). The majority of their incremental spending is likely to go to specialized external cyber security providers rather than to companies' in-house teams, as we believe such specialists tend to have state-of-the-art expertise and can provide scalable solutions (see figure 16).

Figure 15: Top Chief Information Officer investment priorities

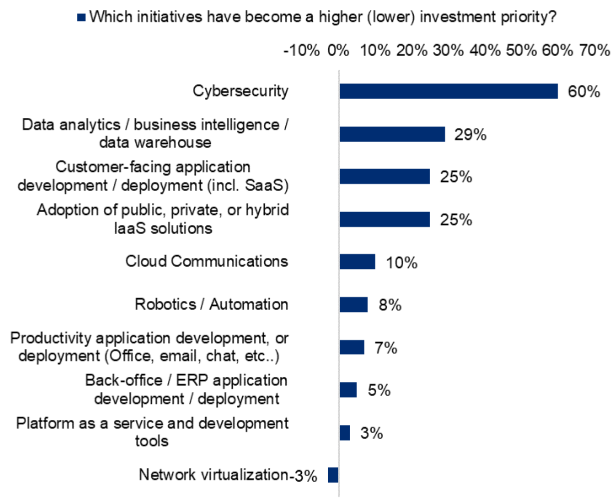
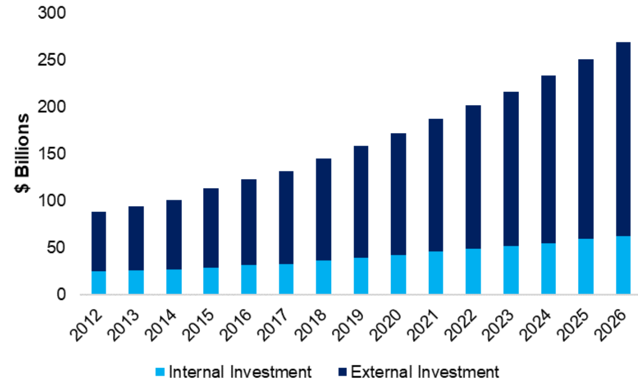


Figure 16: Projected investment in Internal and External cyber security

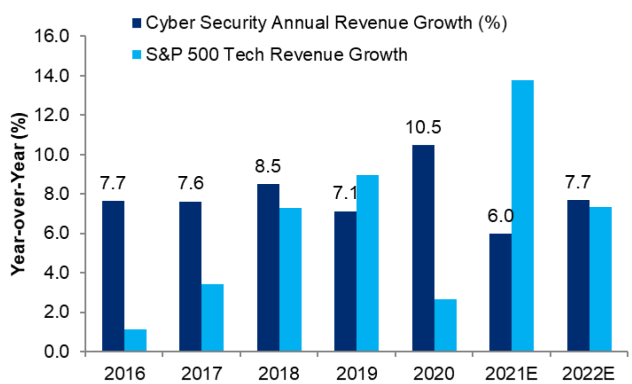


Source: Citi Research and Forbes as of November 17, 2021. For figure 15 – IDG Research CIO survey, net result of response to the following questions: Since the beginning of the year, which three initiatives have become a higher investment priority? The forecast is an expression of opinion are not intended to be a forecast of future events or a guarantee of future results.

Installing Cyber Security in Portfolios

Cyber security firms have delivered steady top- and bottom-line growth over the past 5 years, including through the 2020 pandemic, as our lives became even more digital amid lockdowns and social distancing (see figure 17). The sector has delivered 6% revenue growth in 2021 with expectations of 7.7% in 2022, providing potentially more stable growth than many sectors in the broader technology space**.**

Figure 17: Cyber Security and S&P 500 Technology Revenue Growth



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While valuations trade at a premium to the broader technology and software indices, we believe the fundamental drivers underpinning future cyber security investment globally and their stable earnings profile justify their valuations in the marketplace (see figures 18-19).

Figure 18: Cyber Security Valuations vs Tech and software services

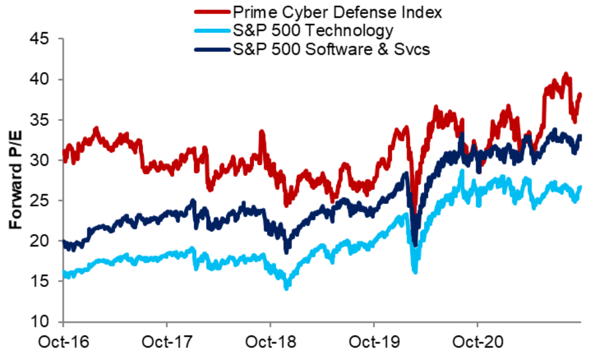
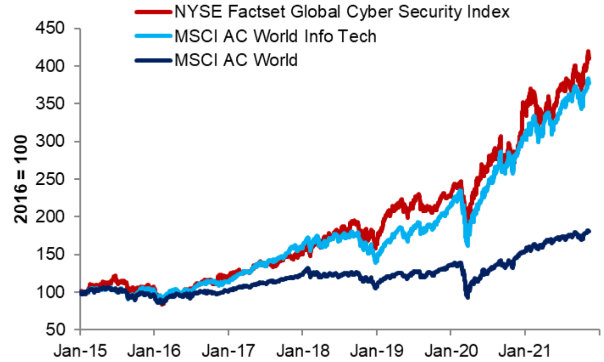


Figure 19: Cyber security returns since 2015



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Conclusion

Digitization is one of our two "umbrella" themes, while "Greening the world" is the other. Cyber-security is only one industry within a larger digital economic migration. While there will be winning and losing firms within these industries, (figures 5 and 11), portfolios exposed to secular growth industries have the potential to generate outperformance. Fortunately, none of this requires a "rebound" from depressed conditions, just a bit of foresight, patience and a willingness to invest for the long-term.