KTS CAPITAL MANAGEMENT

KTS Investment Horizon

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EXECUTIVE SUMMARY

- The global economy seemed to finally reach a more broad-based and synchronized improvement.
- We expect the positive trend of the world economy to remain unscathed in 2018.
- Despite the optimistic perspective and that investors anticipate those conditions to continue, the risk of equity markets to disappoint is high with fears about the sustainability of high valuation.
- The biggest risk out there is the interest rate risk and central banks around the world were inclined to unwind their monetary policy to normality.
- Therefore, **we have applied a more cautious investment strategy for 2018**.
- As for our fixed income part, we are still hesitant about the traditional fixed income securities such as government or investment grade bonds as interest rates are more likely to rise. **We prefer to invest in interest bearing securities such as the catastrophe bonds (Cat bonds) and factoring (invoice financ ing) due to their uncorrelated and stable returns** to the general interest rate market with a much lower risk.
- As for our equity allocation, we are currently pursuing a more prudent view focusing on **Biotechnology stocks, dividend stocks, and through the Megatrend investment** we position ourselves to capture the positive trend in consumption of certain demographics such as the Millenials and the Silver Generation.

OUTLOOK

On the back of the strengthening global economy in 2017, risky assets such as equities and non-government bonds continued to generate positive returns. With the ongoing monetary and fiscal stimulus, chiefly in the Euro zone and Japan, the global economy seemed to finally reach a more broad-based and synchronized improvement in growth rates. As the populism risk abating in Europe during early 2017 with the Dutch populist Geert Wilders failing to retain the general election in the Netherlands and Emmanuel Macron defeating Marine Le Pen, the National Front leader, the Euro zone economy started to show some signs of changes for the better. After a protracted ECB monetary policy to support the Euro zone economy with historically low interest rates, Mario Draghi, the head of the ECB, was able to harvest the better-than-expected result; the Euro zone, astoundingly, registered stronger economic growth rate which could be 2.4% in 2017. Also, the Japanese economy was a surprise on the upside and expanded at the fastest pace for more than two years with low unemployment and accelerating domestic spending.

Due to the positive financial market conditions, we were able to generate a positive performance for our managed portfolios. We have been pursuing an innovative way of asset allocation, which avoids the traditional fixed income space for quite some time, as we believe the heightened bond prices will likely drop as a result of interest rates moving higher, sooner or later. **In our equity allocation, we were also able to add value through our opportunistic investment approach in Biotechnology stocks, Orocobre Ltd, and UrtheCast Corp.** We took a position in Orocobre Ltd, a mineral exploration company to develop lithium-potassium brine, to benefit from the increasing demand in lithium as the automobile sector will move to electric cars sooner than expected. We made profits as the stock price surged by more than 60% in just 6 months. In the commodity space, our investment in oil generated approximatively 10% profit in one month as oil prices increased after the OPEC meeting to rebalance the oil market. In doing so, we were able to achieve an absolute return for our clients with much lower risk versus the benchmark and the peers, meaning we have achieved a better risk-adjusted return.

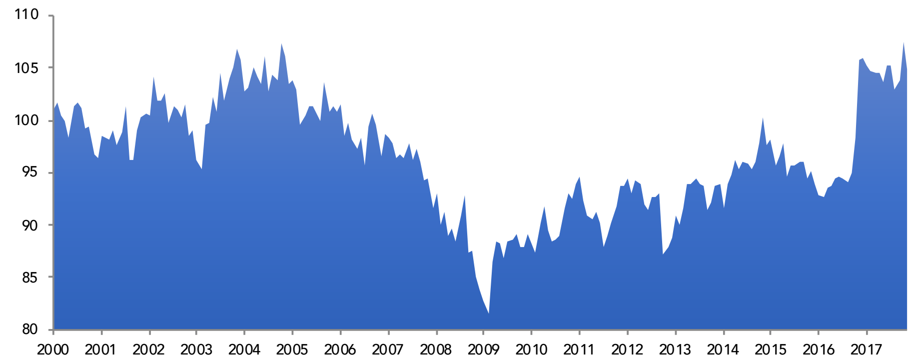
For 2018, the positive trend of the world economy should remain unscathed for several reasons. First of all, the Trump tax reform plan should provide a temporary fiscal stimulus for the US economy. **The pro-growth policy of President Trump lead to a rise in small-business confidence; the NFIB Small Business Optimism Index surged to a level not seen in more than a decade, see Exhibit 1. This is good for the real economy, because the improved small-business confidence would translate into more hiring and capital expenditures of small-businesses in the U.S.** Secondly, with core inflation remaining below the target of 2% and economic growth rate below historical average, we do not expect interest rates in general to rise too quickly and drastically going forward. One of the reasons why inflation is quiescent, could be that unemployment rates continue to fall, but wage pressure has been muted. Furthermore, until recently, funding rates have fallen and the global debt levels have soared to a record high of USD 230 trillion in the third quarter of 2017, according to the Institute of International Finance (IIF). From 2016 this would mean an increased debt of USD 16 trillion, or a worldwide debt accumulation of USD 88 trillion from 2007 (according to the Bank for International Settlement total global debt was USD 142 trillion in 2007). **With such a high debt level, the government policy is to keep interest rates low for a longer period of time**, because higher interest rates would normally translate into higher interest burdens for the government which they cannot embrace with the current lower than average growth rate. The Federal Reserve is expected to have three interest rate hikes in 2018 which could bring the key rate to 2.25% from today level of 1.5%, which is still low compared to historical standards. In Europe, the ECB decided to keep interest rates unchanged at zero. Also the Bank of Japan maintained its short-term interest rate at -0.10%. And lastly, business and consumer confidence reached its highest level, suggesting that earnings and personal income were strong to encourage for more investment and consumer spending.

However, going forward the key question is to understand the repercussion of the lengthy monetary stimulus program commencing after the outbreak of the financial crisis. For a long time after the implementation of Quantitative Easing (QE) programs, the abundant liquidity generated by central banks went primarily on the balance sheet of banks rather than finding its way into the real economy. Instead, due to depressed business and consumer sentiment, investment and private consumption were reluctant to circulate money back into the real economy. This was also the reason why growth rates in most countries were rather muted over the last 8 years. After several years, gradually QE has eventually arrived in the real economy. First in the U.S., and since last year, also the Euro zone and the Japanese economy. **To understand how effective the monetary policy has been in the real economy is to enquire into the rule of money velocity**, the pace of money circulating or changing hands in the real economy during a particular period of time. **Hyperinflation depends on the acceleration of money velocity, therefore we do not expect an overshoot of inflation.** Bank lending activities in the Euro zone area are indeed rising, but the loan growth rate is still modest, according to the bank lending survey (BLS).

Despite the optimistic perspective and that investors anticipate those conditions to continue, **the risk of equity markets to disappoint is high with fears about the sustainability of high valuation**, coupled with rising interest rates in the future. According to Bloomberg, equity markets continued to rise during the first 10 days of trading and has already added $2.1 trillion of market capitalization worldwide in 2018, which we believe to be a sign of complacency amid investors who keep the equity valuation rising further to an even higher level. This can only be compensated by a stronger-than-expected earnings consensus.

In addition to overstretched stock valuations globally, **the biggest risk out there is the interest rate risk**. In 2017, albeit interest rates were still low, **central banks around the world were inclined to unwind their monetary policy to normality**. The Federal Reserve was the first central bank to end its stimulus program by raising its key interest rate by 0.25% in December 2015 as a result of the improving U.S. economic growth with the falling unemployment rate. Not too long ago the ECB also unveiled that it will reduce its asset purchase program from EUR 60 billion to EUR 30 billion, starting in January 2018. In Europe, the QE program could end in September and then the ECB could start the tightening process.

Exhibit 1: NFIB Small Business Optimism Index in the U.S.



Other factors which could also derail the markets this year are the geopolitical risks in Iran; the political environment in the USA with the midterm election in November; and the tensions with North Korea. In Europe, there will be the Italian general election on March 4, 2018. We do not expect any negative outcome of this election, but if the populist Matteo Salvini is elected the next Prime Minister, this could shed a negative light on the future of the EU and spark another Brexit-like referendum.

INVESTMENT STRATEGIES

As a family office, our primary objective is to protect and to create wealth for our families and clients for the long term; for that reason we pursue an innovative way to our investment strategies and evaluating different market scenarios on a frequent basis to mitigate the downside risk of our managed portfolios. Due to the central banks' hefty intervention in the financial market, **we believe that the diversification effect between bonds and equities no longer exists and that the capital asset pricing model (CAPM) expected return has moved much lower since the implementation of QE**, see Exhibit 2. In searching for higher returns, most traditional private banks recommend investment portfolios with much higher risk than they believe, due to the inclusion of the bank's complex structured products, like the reverse convertible bonds, and exposing long positions in interest rates bearing long maturing bonds, which is currently high risk in a historical depressed interest rate level even with negative yielding bonds.

Implementing our earlier outlook of expecting the global economy to continue to be on the mend, together with the risen risk of disappointment, we have applied a more cautious investment strategy for 2018. We believe that equity markets ran up too much and overall valuations are high at this point. Since October 2017 until recently, we have gradually reduced our equity exposure, and as a result taking profits. We will maintain a high cash position in our managed portfolios and look to deploy it when stock valuation corrects from today's high level.

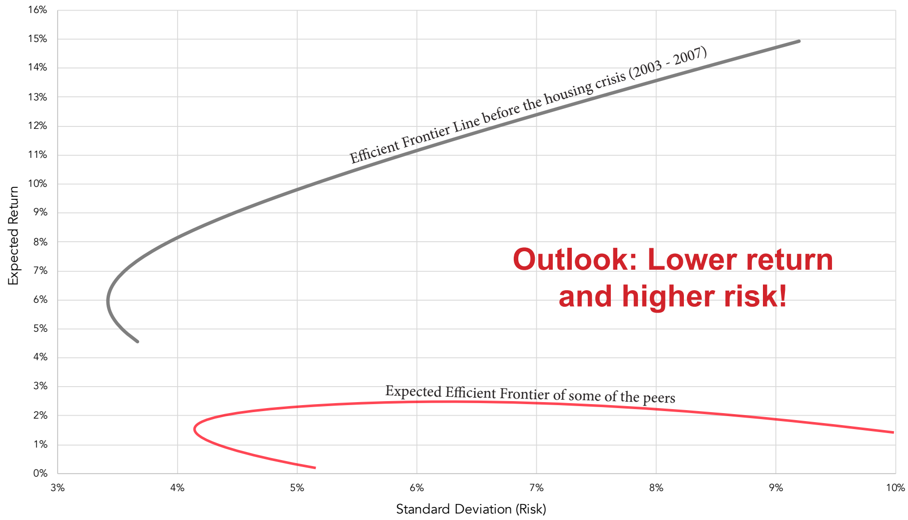
As for our fixed income part of the portfolios, we are still hesitant about the traditional fixed income securities such as government or investment grade bonds. Interest rates are more likely to rise than fall from this historical low level; and the risk-reward trade-off for these securities is not quite as attractive. **We prefer to invest in interest bearing securities which are not exposed to the general interest rate risk, such as the catastrophe bonds (Cat bonds) and factoring (invoice financing).** Due to its low risk with consistent returns, our dynamic managed Cat bond certificate with 2-time leverage should add value. The manager of the dynamic certificate could reduce the risk of the Cat bonds to zero if there are signs of increasing natural disaster risk, mostly in the U.S. **Our fixed income strategy should achieve a much lower risk which is not correlated to the general interest rate risk** with a long term absolute and stable returns.

As for our equity allocation, we are currently pursuing a more prudent view and have reduced our equity exposures since last October. Our equity allocation consists of our best-in-class active managed equity funds which will be evaluated on a monthly basis to maintain our conviction. **We still favour dividend stocks and biotechnology stocks in our strategy.** As long as dividend yields from a solid company with a strong balance sheet and a sound management are higher than the 10-year bond yield, dividend stocks will provide a better investment than bonds. **Biotechnology stocks, on the other hand,**

have the highest upside potential due to the fact that the large capitalised pharmaceutical companies hold large amounts of cash to be deployed to acquire much smaller biotech companies with promising product pipelines. Due to maturing patents, pharmaceutical companies lack in growth rates. In order to return to profitability, these companies need to grow again. Biotech companies, on the other hand, can provide the needed growth with their promising products. Further, through our investmetn in the Megatrend theme we are positioning ourselves to capture the positive trend in consumption of certain demographics, Millenials and the Silver Generation represent more or less 50% of the world population. They will obviously shape the economy for decades to come and innovated technology will play a pivotal role in their spending. Speaking of technology, the global auto industry is about to be challenged. Many car producers like Volkswagen and Volvo announced that they will replace their combustion engines with more "eco-friendly" electric cars sooner than expected. Since last year, Tesla's market capitalization has become more valuable than General Motors or Ford. As a result of this, the demand for lithium and cobalt is likely to stay strong. **Another commodity that we believe to be in undersupply is zinc**, the fourth most widely consumed metal. Zinc spot price has already risen more than 100% since its low in 2015.

In order to diversify and to reduce the aggregate risk of our portfolios more effectively, we allocate nearly 20% of the portfolio in alternative strategies. One of the strategies is **the merger arbitrage strategy, which, in our opinion, has the most attractive risk/reward ratio**. Managers of merger arbitrage strategy usually seize a position in the friendly acquired company to make a safe profit once the merger will be completed in the future. Fundamentals remain strong with an improving economy, companies globally piled-up sufficient cash reserves to be deployed for more growth. As a result of this, we feel confident to take a position in the Merger Arbitrage certificate with a maximum leverage of 2.75-times to capture the consistent stable returns with much lower risk. This is a dynamic certificate and the manager could drastically reduce the risk position to zero, if it requires. Another strategy that should be beneficial to our portfolio construction moreover, according to a proven track record and to achieve a reduced level of risk, is a fully automatised **quantitative strategy**, using a complex algorithm to capture the behavioural finance. We are currently investing in a fund with a quantitative strategy that has a long track record. **The advantage of this strategy is that it has very low to negative correlation to equities; it**

Exhibit 2: Historical Efficient Frontier vs Expectation



Note: Efficient frontier line created with two assets (Barclays Aggregate Global Bond Index and MSCI World Index)

will likely generate positive returns during an increasing volatility with falling equity prices, but also when markets continue to go up. Lastly, we still believe that **gold should be part of the asset allocation because there are no strong currencies in the world**, except for the Swiss Franc. A small allocation in gold will likely provide a cushion in our portfolios should the markets turn sour.

All in all, **we maintain our cautiously optimistic view of economic and financial market perspectives**. Our investment strategy is well diversified to minimise the downside risk and to generate stable returns.

For more economic data and financial market indices see Exhibit 3, respectively, Exhibit 4 on page 4.

Exhibit 3: 5 Years Global Multi-Asset Class Return (%)

		YTD 2017	2016	2015	2014	2013	2012	MTD	3 months	3 years	5 years	Annualized Return (2013-2017)	Standard Deviation (2013-2017)
Equity	2017 P/E												
MSCI World Index	17	20.1	5.3	-2.7	2.9	24.1	13.2	0.0	5.1	23.0	57.1	9.5	10.3
Standard & Poor's 500 Index	18	19.4	9.5	-0.7	11.4	29.6	13.4	0.0	6.1	29.9	87.5	13.4	10.2
DJ Stoxx 600 Index	15	7.7	0.7	3.8	1.2	17.9	13.8	0.0	0.3	13.6	39.2	6.1	6.3
Nikkei Index	17	19.1	0.4	9.1	7.1	56.7	22.9	0.0	11.8	30.5	119.0	17.0	20.0
CSI 300 Index	14	21.8	-11.3	5.6	51.7	-7.6	7.6	0.0	5.1	14.1	59.8	9.8	23.0
MSCI Asia ex Japan Index	n/a	21.2	6.1	-9.8	4.9	2.0	20.8	3.6	6.3	9.6	6.7	4.4	9.9
MSCI EM Latin America	n/a	34.3	31.0	-31.0	-12.3	-13.4	8.7	0.0	7.1	21.1	9.8	-1.6	26.2
Fixed Income													
Bloomberg Barclays US Treasury TR Unhedged		2.3	1.0	0.8	5.1	-2.7	2.0	0.0	0.1	4.2	6.5	1.3	2.5
Bloomberg Barclays EU Gov All Bonds TR		0.2	3.2	1.6	13.1	2.2	10.9	0.0	0.6	5.1	21.5	4.0	4.6
iBoxx US Liquid Investment Grade Index		7.3	6.4	-0.7	8.7	-2.4	11.8	0.0	1.4	13.3	20.1	3.7	4.5
iBoxx US High Yield Corporate Bond Index		6.3	17.4	-3.5	1.6	6.6	14.9	0.0	0.1	16.4	26.0	5.4	6.9
JPM EMBI Global Core Index		10.5	10.2	0.8	7.6	-6.4	18.6	0.8	1.2	22.6	23.5	4.3	6.5
Hedge Funds													
HFRX Global HF Index		5.9	2.5	-3.6	-0.6	6.7	3.5	0.7	1.6	4.9	11.4	2.1	3.9
Alternative Investment Indices													
S&P GSCI Total Return Index		5.8	11.4	-32.9	-33.1	-1.2	0.1	0.0	9.9	-20.9	-47.7	-12.2	19.2
DBLCI-OY Agricult Index		-6.0	-2.7	-16.0	3.3	-12.3	-2.1	0.0	-1.0	-23.2	-30.4	-7.0	6.8
Gold Spot Price		12.5	8.1	-10.4	-1.4	-28.3	7.1	0.0	1.8	10.1	-21.3	-5.1	14.5
Bloomberg/WTI Cushing Crude Oil Spot Price		12.4	45.0	-30.5	-45.9	7.2	-7.1	5.3	16.9	12.7	-33.5	-8.0	32.4
CBOE SPX Volatility Index		-21.4	-22.9	-5.2	39.9	-23.9	-23.0	0.0	16.1	-42.5	-38.7	-9.3	24.3
Currencies (vs USD)	Spot Rate												
Euro	1.2005	14.4	-3.2	-10.2	-12.0	4.2	1.8	0.0	1.6	-1.2	-9.2	-1.8	9.7
British Pound	1.3513	10.2	-16.3	-5.4	-5.9	1.9	4.6	0.0	0.9	-12.9	-16.3	-3.5	8.8
Canadian Dollar	1.2571	7.4	3.0	-16.0	-8.6	-6.6	2.9	0.0	-0.8	-7.4	-20.7	-4.5	8.4
Swiss Francs	0.9743	5.0	-1.7	-0.8	-10.2	2.5	2.5	0.0	-0.6	1.6	-6.2	-1.2	5.2
Japanese Yen	112.69	4.3	2.8	-0.4	-12.1	-17.6	-11.3	0.0	0.1	6.3	-23.1	-5.0	8.7
Chinese Renmimbi	6.5068	6.9	-6.5	-4.4	-2.4	2.9	1.0	0.0	2.2	-4.3	-4.2	-0.8	4.9
Brazilian Real	3.3125	-1.8	21.7	-32.9	-11.1	-13.1	-9.0	0.0	-4.5	-18.3	-38.2	-9.1	17.7

Data as of 31.12.2017, Source: Bloomberg

Exhibit 4: Historical and Forecasted Economic Data of Major Economies; 10 Years (%)

	2010	2011	2012	2013	2014	2015	2016	Forecasts 2017	2018	2019	Average Chng. (2010-2016)
United States											
Real GDP Growth	2.5	1.6	2.2	1.7	2.6	2.9	2.9	2.3	2.6	2.2	2.3
Inflation	1.6	3.2	2.1	1.5	1.6	0.1	0.1	2.1	2.1	2.2	1.5
Unemployment Rate	9.6	8.9	8.1	7.4	6.2	5.3	5.3	4.4	4.0	3.8	7.2
Industrial Production	5.6	3.1	3.0	2.0	3.1	-0.7	-0.7	1.8	2.5	2.3	2.2
Current Account	-2.9	-2.9	-2.6	-2.1	-2.1	-2.4	-2.4	-2.5	-2.5	-2.6	-2.5
Budget (% of GDP)	-8.4	-7.9	-6.5	-3.3	-2.7	-2.6	-2.6	-3.5	-3.6	-3.7	-4.9
Government Debt (% of GDP)	60.9	65.9	70.4	72.6	74.2	73.3	73.3	76.5	77.1	78.0	70.1
Money Supply (M2, YoY)	3.6	9.8	8.2	5.4	5.9	5.9	5.9	4.7	4.7	4.7	6.4
Central Bank Interest Rate	0.3	0.3	0.3	0.3	0.3	0.5	0.5	0.8	1.5	2.2	0.3
China											
Real GDP Growth	10.6	9.5	7.9	7.8	7.3	6.9	6.9	6.8	6.5	6.2	8.1
Inflation	3.3	5.4	2.7	2.6	2.0	1.4	1.4	1.6	2.3	2.2	2.7
Unemployment Rate	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.0	4.1	4.1	4.1
Current Account	3.9	1.8	2.5	1.5	2.3	2.8	2.8	1.4	1.3	1.5	2.5
Export Trade (YoY)	17.9	13.4	14.1	4.3	9.7	-1.6	-1.6	7.7	5.0	4.5	8.0
Import Trade (YoY)	25.6	11.8	6.0	8.3	-2.4	-7.4	-7.4	15.2	6.2	5.0	4.9
Budget (% of GDP)	-1.6	-1.1	-1.6	-1.8	-1.8	-3.4	-3.4	-3.5	-3.5	-3.7	-2.1
Government Debt (% of GDP)	27.1	28.1	29.8	32.3	38.6	36.5	36.5	36.7	36.7	36.7	32.7
Money Supply (M2, YoY)	19.7	13.6	13.8	13.6	12.2	13.3	13.3	9.5	9.2	9.0	14.2
Central Bank Interest Rate	5.8	6.6	6.0	6.0	5.6	4.4	4.4	4.4	4.4	4.4	5.5
Euro Area											
Real GDP Growth	2.1	1.6	-0.9	-0.2	1.3	2.1	2.1	2.3	2.1	1.8	1.2
Inflation	1.6	2.7	2.5	1.4	0.4	0.0	0.0	1.5	1.5	1.6	1.2
Unemployment Rate	10.2	10.2	11.4	12.0	11.6	10.9	10.9	9.1	8.5	8.1	11.0
Current Account	-0.1	-0.1	1.4	2.2	2.4	3.2	3.2	3.0	3.0	2.8	1.8
Budget (% of GDP)	-6.2	-4.2	-3.6	-3.0	-2.6	-2.1	-2.1	-1.2	-1.1	-1.0	-3.4
Government Debt (% of GDP)	83.8	86.1	89.4	91.3	91.8	89.9	89.9	88.9	88.9	88.9	88.9
Money Supply (M2, YoY)	1.4	1.7	3.5	1.2	3.6	4.9	4.9	5.0	5.0	5.0	3.0
Central Bank Interest Rate	1.0	1.0	0.8	0.3	0.1	0.1	0.1	0.0	0.0	0.0	0.5
United Kingdowm											
Real GDP Growth	1.7	1.5	1.5	2.1	3.1	2.3	2.3	1.5	1.4	1.4	2.1
Inflation	3.3	4.5	2.8	2.6	1.5	0.0	0.0	2.7	2.5	2.1	2.1
Unemployment Rate	7.9	8.1	8.0	7.6	6.3	5.4	5.4	4.4	4.5	4.6	7.0
Current Account	-3.8	-2.4	-4.3	-5.5	-5.3	-5.2	-5.2	-4.6	-4.0	-3.7	-4.5
Budget (% of GDP)	-9.1	-7.1	-7.6	-5.7	-5.3	-4.1	-4.1	-2.5	-2.4	-2.1	-6.2
Government Debt (% of GDP)	75.6	81.3	84.5	85.6	87.4	88.2	88.2	88.3	88.3	88.3	84.4
Money Supply (M4, YoY)	-1.5	-2.5	-0.9	0.2	-1.1	0.3	0.3	4.1	4.1	4.1	-0.7
Central Bank Interest Rate	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.3	0.5	0.7	0.5
Japan											
Real GDP Growth	4.2	-0.2	1.5	2.0	0.4	1.4	1.4	1.6	1.3	1.0	1.5
Inflation	-0.7	-0.3	0.0	0.4	2.7	0.8	0.8	0.5	0.8	1.0	0.5
Unemployment Rate	5.1	4.6	4.3	4.0	3.6	3.4	3.4	2.8	2.7	2.7	4.0
Current Account	3.9	2.1	1.0	0.9	0.8	3.1	3.1	4.0	4.0	3.9	2.1
Budget (% of GDP)	-8.3	-8.8	-8.7	-8.5	-7.7	-6.7	-6.7	-4.8	-4.4	-4.6	-7.9
Government Debt (% of GDP)	199.7	205.5	219.1	226.1	231.9	230.0	230.0	222.2	222.2	222.2	220.3
Money Supply (M2, YoY)	2.3	3.2	2.6	4.2	3.6	3.1	3.1	4.0	4.0	4.0	3.2
Central Bank Interest Rate	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.1

Data as of 31.12.2017, Source: Bloomberg

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