Investment Update

February 2022

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Market Review

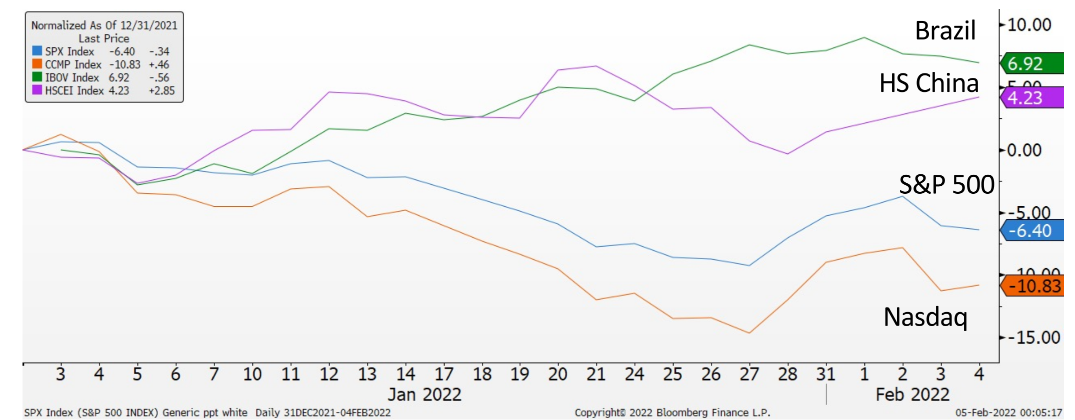
Asset markets had a volatile start to the year, with global equities dropping -4.89%, and global bonds -2.05%. The main reason cited for this is the increased likelihood that the Fed would raise interest rates soon, a milestone in unwinding years of QE that started from the 2008 Global Financial Crisis. To be clear, the Fed has not raised its Fed Funds rate since March 2020, but bond and equity markets have already started to price in the impact of higher rates. That is why for investing, it is **more important to be positioned for an eventual policy or economic outcome, rather than being able to predict when it happens.**

The Bloomberg Global Aggregate Index was down 2.05% in January. This has familiar echoes of Q1 last year when bonds sold off due to similar rate hike pressures. Some market commentators are forecasting that for the first time, **the world's bond benchmark may be down two years in a row**. Unprecedented, but never say never. With a base case return of 1.61% going forward, if markets were to price in a 1% rise in interest rates, it will have a price impact of -7% on the Global Agg, which will bring it into negative territory for the year.

Even if one can predict when central banks will actually raise rates, that is not enough to mitigate the impact on a portfolio. While one may seem impressive by waxing lyrical about the number of hikes the Fed the likely to make, such rhetoric is often just that, rhetoric. The practical way is to **structure the portfolio so that it is less affected by rising interest rates**.

One such structure in our portfolios is short duration, or lower sensitivity to interest rates. This played out well in January when our shorter duration fixed income exposures did better than the benchmark investment grade and high yield markets that have longer duration. With short duration credit, one does not compromise on the return while mitigating the impact of interest rate movements. Thereby **reducing the need to predict** when central banks will change policy, and more importantly, when markets will start pricing these effects in. This is why it is important to position by preparing not predicting.

In last month's commentary, we discussed the bifurcation between DM (developed markets) and EM (emerging markets) in 2021 i.e. EM underperformed DM by a wide margin. This bifurcation is something that happens infrequently, and tends to be followed by EM outperforming DM markets. We also wondered last month if EM markets would bounce back from the stresses of 2021. The chart shows a DM-EM bifurcation in January, this time in reverse, with the likes of Brazil and China outperforming the S&P 500 and Nasdaq by quite a margin. Certainly, we would not read too much into a month, but when things are stretched as they were in 2021, some reversion is bound to happen.



2022 year to date performance of Brazil, Hang Seng China Enterprises, S&P 500, Nasdaq equity indices

Many asset allocation strategies are comprised essentially of equity and fixed income investments. Another structural feature of our portfolios which is less commonly used elsewhere is alternatives to complement equity and fixed income investments. Where equity and fixed income investors had few places to hide in January, alternatives (trend following) had positive gains, demonstrating their value within a portfolio. Again, this was **not predicated on us being able to time the markets, but being able to structurally diversify the portfolio with a wider range of tools.**

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Key Themes: Positioning For Economic Growth

Source: Financial Times

US stock markets endure worst January since global financial crisis

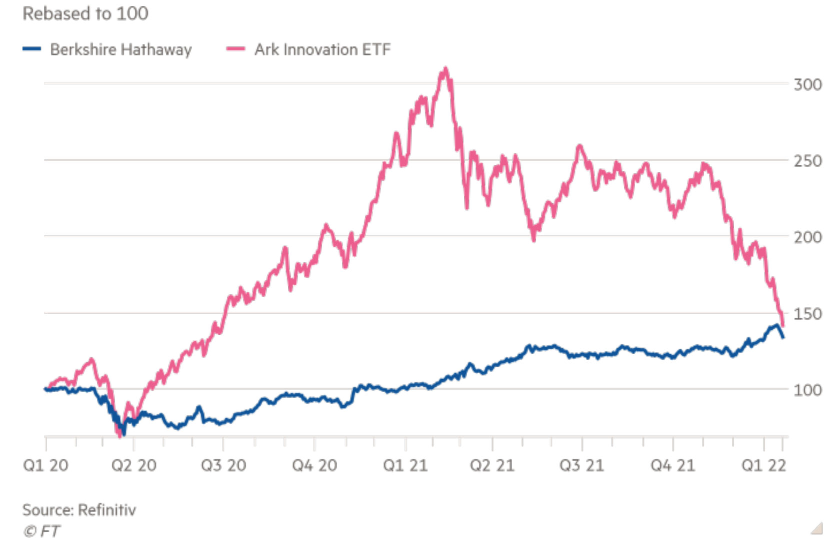
With such ominous headlines coming out fast and furious alongside volatile market declines, some may be wondering if we should be positioning more defensively rather than for economic growth. Being evidence-based, let's refer to some data to inform us:

To start off, market declines are part and parcel of investing. According to Goldman Sachs, there has been 33 S&P 500 corrections of 10% or more since 1950, and most turned out to be good opportunities to buy. Importantly, **corrections seldom turn into dreaded bear markets (declines of more than 20%) outside of a recession.**

The question then becomes: are we still in economic growth or going into another recession? According to the Conference Board Leading Economic Index (which comprises of 10 economic components used to signal changes in the overall economy), a recession is highly unlikely in the near-term unless there is a black swan event. We continue to monitor our economic indicators closely but are cautiously optimistic that recent declines may be close to presenting another opportunity for long-term investors.

Our readers would know that we do not just advocate 'buying the dip' in every or any investment. **We tend to avoid areas that have overshot their fundamentals or where there is excessive optimism - these investments have limited upside and a lot more downside**. Take the following chart (top-right) that has been making its rounds on social media: the popular ARK ETF which saw strong performance in 2020 has since given back much of its outperformance. Over the past 2 years, ARK investors have performed similarly to Warren Buffet despite two distinct investment approaches. But investors who had only chased after 2020's strong performance would have lost money – we prefer getting in before the strong rally or after it has declined to more reasonable levels.

Warren Buffet's Berkshire Hathaway vs Cathie Wood's ARK Innovation ETF



In our recently published investor letter, we said markets behave like nature - with market winds constantly changing direction and intensity; confusing investors and even blowing them off course. The good news is that we do not need to be at the mercy of such unpredictable winds. Like sailors on the ocean, we can cut through the wind by positioning ourselves to ride on ocean currents which are stronger and are more dependable forces at work. This is why we utilise FVT (Fundamental, Valuation, Technical) to invest. Akin to ocean currents, this allows us to **invest on market patterns that are repeated, persistent, and predictable.**

Where does this lead us today? An underweight in US large-cap equities where high valuations imply low future returns. We prefer US small-caps and Europe equities as valuations are less demanding and expected to do well alongside a continued economic expansion. Similarly, positions in China and Emerging Market equities have better recovery potential especially as Chinese credit conditions are expected to improve further.

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Key Themes: Stability Amid *VUCA*

VUCA is used to describe environments with **Volatility**, **Uncertainty**, **Complexity**, and **Ambiguity**

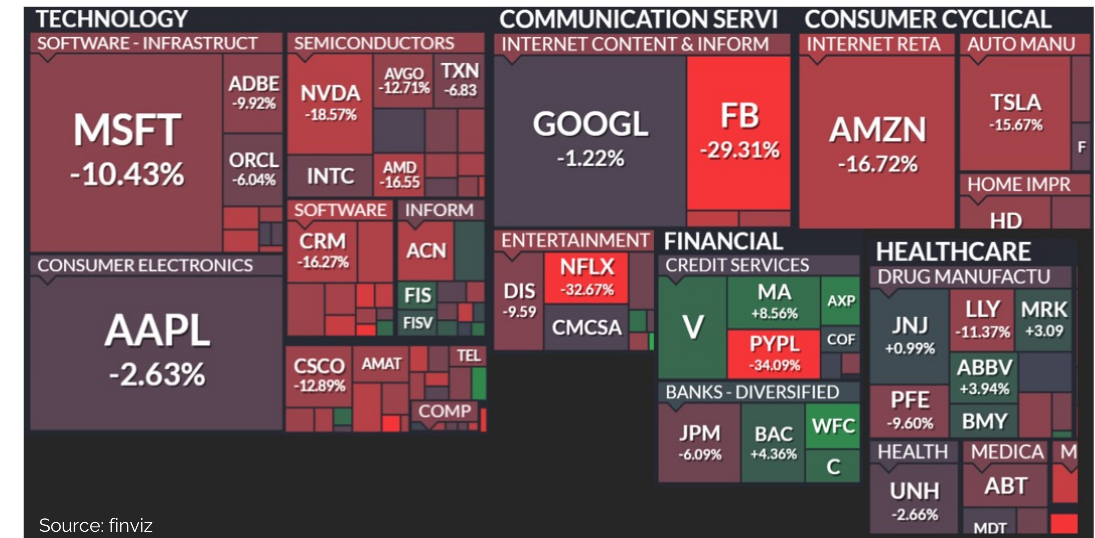
It's been some time since we first introduced the *VUCA* theme into our portfolios. To re-cap, the characteristics of the current *VUCA* environment include:

- **High valuations**: valuations of the major global equity and bond indices continue to be unattractive, especially within the broader US markets as mentioned before.
- **Shift in central bank policy**: the US Fed is widely expected to begin hiking interest rates in March. While they do not want to overtighten and risk another recession, market participants may remain jittery as the Fed embark on the normalization process.
- **Transition from economic expansion to (eventual) slowdown**: we showed last month that higher volatility is to be expected as economies transition from one phase to another.
- **Pandemic**: even as the world gradually adjusts to living with the virus, Covid-19's own cycle of transitioning from pandemic to endemic can throw a spanner into global growth.

Uncertainties on the above points are expected to contribute to more volatility, which can blow unprepared investors off course. This is why we **place a strong emphasis on constructing portfolios that can withstand interim shocks** and declines so that we can focus on compounding medium to long-term returns that we have more clarity on.

An important pillar of our portfolio construction is diversification, which is always useful in volatile markets. Refer to the following year-to-date performance heat map (top-right). Even established mega-cap stocks like Microsoft (MSFT) and Facebook (FB, now Meta) saw steep declines of -10.4% and -29.3% year-to-date. In fact, Meta's stock declined -26% in one day on 3rd February – can you withstand losing a quarter of your portfolio value in a day?

Year-to-date performance (S&P 500) as of 3rd February 2022



We also ensure that we are invested into positions with different performance drivers. While our recovery positions on the previous page are more dependent on robust economic growth to do well, we have positions within the 'Stability' theme that can perform regardless. For instance, we allocate to Healthcare equities which is primarily driven by secular trends such as an aging population and enjoys relatively stable and growing earnings independent of the broader economic climate.

Our Quality Value position is also grouped within the 'Stability' theme to better reflect their more resilient nature in the current climate. While Quality Value is also expected to benefit from strong economic growth, the focus on undervalued and high quality (strong profitability, balance sheets, etc.) businesses allows it to be more resilient in the face of rising interest rates, or even as growth stumbles from time to time. In short; **a more resilient way to participate in the ongoing economic expansion**.

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Key Themes: Search For Yield

Some have asked, in this day and age where there is so much available information, isn't the man on the street equipped with sufficient means to invest independently?

Let's take a look at what was available in March 2020, during the throes of the covid crisis and recession. A Google search for "high yield bond" from 24 March 2020 includes a free Yahoo Finance article on how "A Wave Of Downgrades Has Hit The U.S. Oil Patch".
https://finance.yahoo.com/news/wave-downgrades-hit-u-oil-210000427.html

Say you were paying an annual subscription of S$468 for the Wall Street Journal, you would read details about how "Investors, Fearing Defaults, Rush Out of Junk Bonds". A more committed personal investor might shell out S$1140 per year for the Financial Times, and read about how the "Ford downgrade consigns $36bn of its debt into junk market"
https://www.wsj.com/articles/investors-fearing-defaults-rush-out-of-junk-bonds-11585215004
https://www.ft.com/content/95035b47-f4ab-479e-a79c-2d0d981e658f

None of these seem helpful to make a case for investing in high yield bonds. In fact, one might be prompted to liquidate whatever credit investments they had upon seeing such news. **Yet US high yield bonds went on to rally 33% in the one year from 24 March 2020, much more than their long term buy & hold return of 6.6% per annum.**

What does one get when they google "high yield bond" today? The FT will cover how "Chinese property group Shimao feels chill of sector's liquidity crisis" while Bloomberg news reports that "U.S. Corporate-Credit Risk at Highest Since November 2020 as Stocks Plunge"
https://www.ft.com/content/cf2df2c8-d4b7-4f88-a317-2f057ed3a1e7
https://www.bloomberg.com/news/articles/2022-02-03/u-s-credit-risk-at-highest-since-november-2020-as-stocks-plunge?sref=uinoKNE3

These recent headlines do not seem to bode well for high yield investors. Yet we see plenty of return opportunity in high yield markets.

We see that high yield markets have stabilized after going through a very tumultuous 2021. How do we know that high yield markets are at levels that will compensate investors to take on such risk and be rewarded going forward?

We invest in data, analytics, and research that aid in our decision making. Despite the flood of information in the public domain, there is data and research that cannot be Googled. These resources cost into the six figures. Even if one was investing full-time for themselves, they would be hard pressed to invest in these resources to obtain such information and analytical edge. In fact, the **sheer abundance of information out there now makes it even more imperative to be able to filter the noise, and use data and information that is helpful for investment insights**.

If media reports are the winds that keep changing direction, the resources we invest in are the tools that help us identify the stronger currents that determine investment outcomes better. For more on how winds and currents apply to investing, refer to our latest investor letter.

The table below summarizes the yields of major fixed income markets globally. If current yields are a good indicator of future return, and an investor is able to sit through volatility as part of the journey to higher return, which of these would you choose?

Global Investment grade	Asia IG	US High Yield	Asia HY
1.61%	4.49%	5.28%	10.40%

Yield to worst of bond markets as at 4/2/2022. Source: Bloomberg. Global Investment grade bonds: Bloomberg Global Aggregate Index, Asia IG: Bloomberg Asia Credit, US High Yield: Bloomberg US Corp High Yield, Asian HY: Bloomberg Asia USD High Yield Bond Index

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Key Themes: How Are We Positioned?

Positioning for Economic Growth	Stability Amid *VUCA*	Search for Yield
China 'A' equities	Health Care equities	Asian High-yield bonds
Emerging Market equities	Quality Value	Emerging Market Short Duration bonds
US Small-cap equities		
Europe equities		

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Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States			■			**US Small-caps** as relative valuations attractive and are expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Quality Value** as valuations attractive, and expected to benefit as economies recover. Quality bias to avoid potential 'value traps'
Europe			■			Relative valuations are attractive, and expected to benefit as economies recover.
Japan		0%				Maintaining no exposure as they are less attractive compared to other opportunities.
Asia Pacific ex Japan				■		Maintain **China 'A'** slight overweight as deleveraging cycle has taken its course, with credit conditions expected to improve.
Emerging Markets			■			Neutral as valuations attractive relative to developed markets, but where earnings tend to be less resilient.
Fixed Income	**--**	**-**	**=**	**+**	**++**	**Allocation strategy**
Global		■				Focus on currency-hedged government bonds and unconstrained credit to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	0%					Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments.
US High Yield		0%				Maintaining no exposure due to relative poorer valuations.
Asia					■	Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.
Emerging Market Debt					■	Hard currency short duration focus as a more defensive credit investment amid low rates.

Notes: - - Underweight - Slight Underweight = Neutral + Slight Overweight + + Overweight

Current | Previous

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Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	-4.89%	-4.89%	-4.89%
United States	-5.17%	-5.17%	-5.17%
Europe	-3.81%	-3.81%	-3.81%
Japan	-4.83%	-4.83%	-4.83%
Asia Pacific ex Japan	-3.99%	-3.99%	-3.99%
Emerging Markets	-1.90%	-1.90%	-1.90%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-2.05%	-2.05%	-2.05%
Global Aggregate (Hedged)	-1.57%	-1.57%	-1.57%
High Yield	-2.87%	-2.87%	-2.87%
Asia	-2.19%	-2.19%	-2.19%
Emerging Market Debt	-2.63%	-2.63%	-2.63%

Currencies	MTD	QTD	YTD
USD/SGD	0.17%	0.17%	0.17%
EUR/SGD	-1.01%	-1.01%	-1.01%
JPY/SGD	0.03%	0.03%	0.03%

Commodity	MTD	QTD	YTD
Gold	-1.75%	-1.75%	-1.75%
Oil (WTI Crude)	17.21%	17.21%	17.21%

Equity Markets	MTD	QTD	YTD
Australia	-6.35%	-6.35%	-6.35%
Brazil	6.98%	6.98%	6.98%
China "A"	-7.62%	-7.62%	-7.62%
China "H"	1.39%	1.39%	1.39%
Hong Kong	1.73%	1.73%	1.73%
India	-0.38%	-0.38%	-0.38%
Indonesia	0.79%	0.79%	0.79%
Korea	-10.56%	-10.56%	-10.56%
Malaysia	-3.53%	-3.53%	-3.53%
Russia	-6.29%	-6.29%	-6.29%
Singapore	4.05%	4.05%	4.05%
Taiwan	-2.98%	-2.98%	-2.98%
Thailand	-0.53%	-0.53%	-0.53%

Equity Sectors	MTD	QTD	YTD
Gold	-5.66%	-5.66%	-5.66%
Energy	19.10%	19.10%	19.10%
Technology	-8.47%	-8.47%	-8.47%
Healthcare	-7.36%	-7.36%	-7.36%
Financials	0.06%	0.06%	0.06%

Total return in local currency terms as of **31 January 2022**
Source: Bloomberg

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