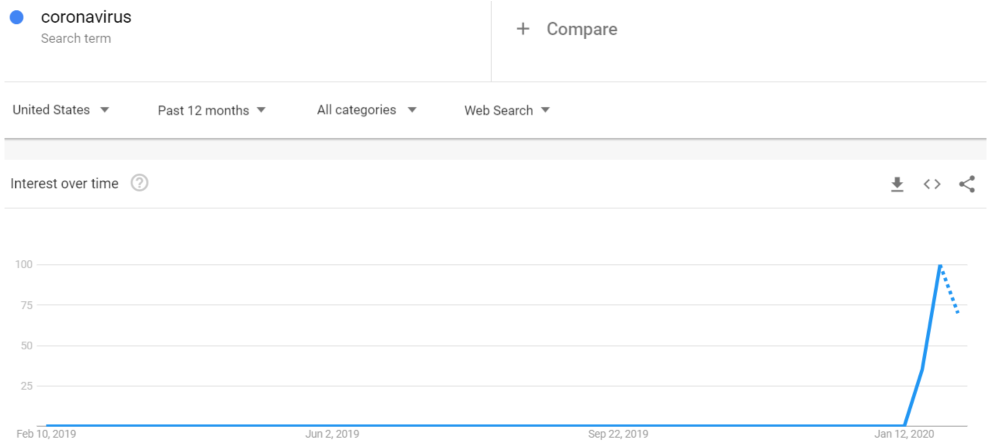
Investment Update
February 2020

Coronavirus!

There is nothing like the prospect of dying to get people's attention. Indeed, if we consider internet searches as a proxy, "coronavirus" came out of nowhere from 12 January.



Numerous measures are being implemented as a response. We see governments doing things from temperature scans to lockdowns, and individuals wearing masks or holing up at home. Some measures serve to rightfully mitigate actual contagion, some more out of perceived risk.

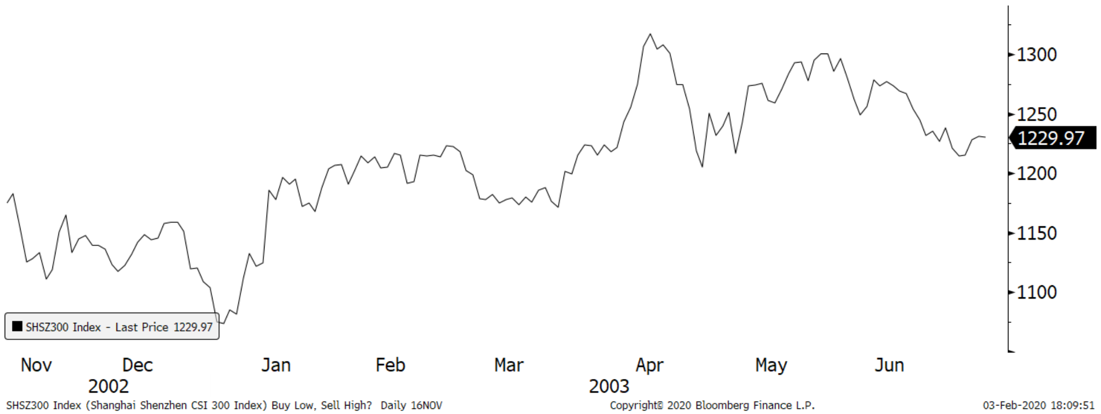
We have been asked: Since we are studying markets all the time, why aren't we cutting portfolio risk due to the coronavirus?

Ray Dalio, CIO of Bridgewater, one of the oldest and largest hedge funds, said that he is a "dumb s***" when it comes to pandemics*. **It's not because his 1500 employees are not smart, but there is not enough data to make an informed decision on pandemics.** As one of our clients eloquently conveyed "you know as much as I do, I know as much as you do".

*Source: https://www.linkedin.com/pulse/our-early-thinking-coronavirus-pandemics-ray-dalio/

There was a reason why Sun Tzu said to pick your battles wisely. Fighting certain battle do not help to accomplish the ultimate objective. Post-mortems of financial blow ups point to persons who overestimated their abilities to the detriment of clients. It would be a disservice to investors if we were to respond to spurious data or fear. **To quote from our recent investor letter "For matters beyond our control, and to stay sane in the face of seemingly irrational markets, we seek the serenity to accept the things we cannot change, courage to change the things we can, and wisdom to know the difference."**

For those who still feel something can be done, let's look at SARS, one of the few historical analogs available. The World Health Organization (WHO) officially chronicles the SARS timeline from the first case on 16 November 2002 to 5 July 2003* when the outbreak was contained. Throughout this period, China 'A' shares were volatile; initially dropping and then ending with gains of 4.7% at 1229. By the way, 'A' shares are currently at 3688, so one can decide if it is effective to get out and back into investing based on pandemic data.



*Source: https://www.who.int/csr/don/2003_07_04/en/

Market Review

January was off to a strong start with global equities rising 2.5% but saw a reversal thereafter. What was the cause? Many would immediately point to the coronavirus that has occupied minds and headlines in the past weeks. Was Mr. Market looking to correct on the recent strong rally, and the virus just happened to be a timely excuse? Could any other event be picked as a negative catalyst for a correction? Actually, corrections are the market's way of going on it's natural course. **If we need to pace ourselves and slow down during a run to make sure we can last the distance, it's fair to let irrational markets do that as well.**

To put things in perspective, markets broke historical highs in October last year and continued upwards to cap off a strong year. In light of the recent strength, any recent bad news such as virus or war would have been used as a reason to sell.

Global equity market performance from 3rd Feb 2015 to 2nd Feb 2020

Imagine if the recent markets were flat i.e. no strong rally and no correction. Would investors react with the same alarm?

Global equity market performance with simulated "flat" returns from 16 Dec 2019

That's the funny asymmetry with how market moves are perceived: rallies no matter how irrational are treated as God-given, and any correction creates anxiety. It's also funny how memories of "market shaking" events are short. Hands up anyone who remembers the name of the Iranian General who was killed by US drones in December?

Amid the volatility, **currency-hedged fixed income** exposures rose 1.8% while unhedged investment grade bonds lagged with 1.28%*. Our USD centric positioning in "shield" assets continues to play out.

In **credit markets**, Asian high yield bonds were resilient with gains of 0.52%, reflecting how one invest in China and benefit when equities are correcting. Our tactical allocation to Emerging market debt from US high yield debt in January also paid off with returns of 0.73% and -0.04% respectively.

*Source: Bloomberg, Month-to-date returns Bloomberg Barclays Global Aggregate, Asia USD High Yield Bond, US High Yield 350mn Cash Pay 0-5 Yr 2% Capped Bond, EM USD Aggregate 1-5 Year Total Return. As of 31/01/2020

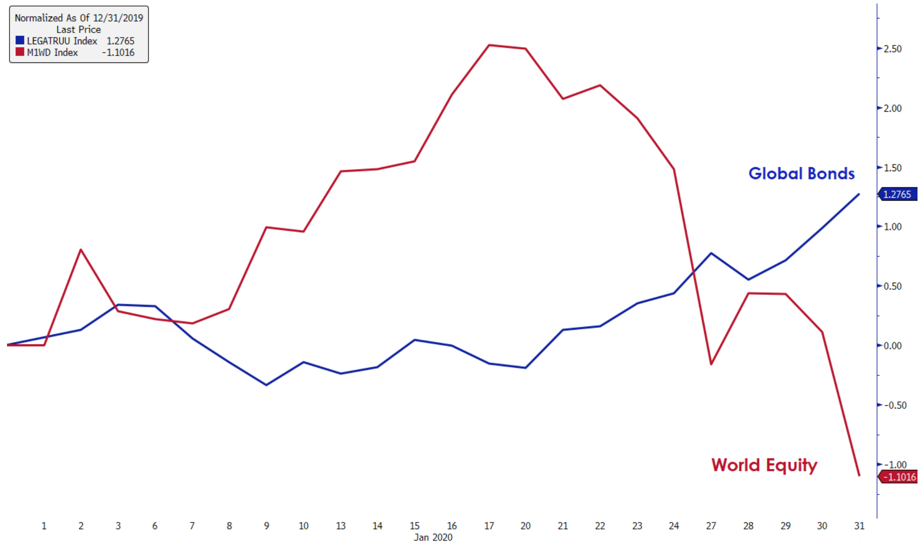
Market Review

How did equity markets fare in such a volatile month? While fixed income exposures were more resilient, equities went on a mini roller-coaster ride – this performance is typical of what investors should expect in volatile markets, and which is why they (equities and bonds) work well together as part of a diversified portfolio.

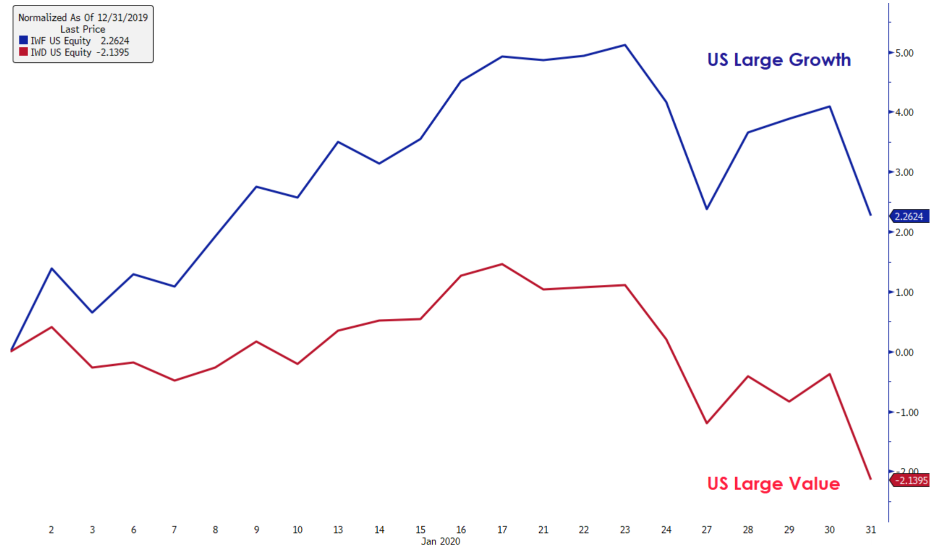
In the **US**, growth-stocks were more resilient than economically-sensitive value-stocks; rising more as markets rose and also declining less as markets gave back gains towards the end of the month. Indeed, the Quality Growth funds that we hold across our portfolios managed small gains even as the broader S&P 500 Index went flat in January.

Emerging and Asia markets corrected the most, largely driven by China and Hong Kong. **China**, being the epicentre of the coronavirus, declined close to 10% when markets opened after the Lunar New Year holidays. We expect China 'A' equities to go through some short-term pain, but as long term investors the correction may very well present a good buying opportunity – here it may be useful to refer to the ad-hoc Market Update that we published on 24th January 2020, where we covered the impact of previous pandemics on markets.

Diversification: Bonds gained as equity markets sold-off



US growth-stocks rose more, and declined less in January



Source: Bloomberg

Key Themes: Late-Cycle Extension

As we entered 2020, we asked ourselves a simple yet often difficult question: 'How will markets look like for the year?'. In the past year, governments and central banks around the world embarked on policies to try and keep recession at bay. At the end of 2019, our view was that barring any further deterioration in economic fundamentals, accommodative policies are likely to lead to a prolonged economic expansion.

More recently, with the rapid spread of the new coronavirus, there have been questions on what the potential economic (and market) fallout may look like. So far, the general consensus is for short-term growth to be negatively impacted; and if the 10% decline of the China 'A' market is anything to go by, some of the expected slowdown has already been priced into the market. Any secondary impact on China's (and the world) longer-term growth is a larger unknown. That said, **going by previous cases of virus outbreaks the base case is for the negative impact to be more temporary; and we continue to maintain our allocation to China 'A' equities for now.** The Chinese government has already pledged to support the economy and financial markets, and valuations are not expensive (and even compelling when compared to some of the more developed markets such as US equities today).

Valuations are much more attractive outside the US

Source: Bloomberg

Last month's market performance once again reminded investors to have a well-diversified portfolio that can withstand the bouts of volatility that are expected in today's late-cycle environment. Consequently, we continue to have a preference for **Quality-Growth and Healthcare stocks in the US**, as they have a more predictable and durable earnings profile which are expected to be more resilient to any slowdown in global growth. Conversely, we have been avoiding investments that rely on a growth rebound to do well – such as the economically-sensitive value stocks that underperformed in January. At the same time, we maintain a slight underweight to US equities as valuations here are at historically high levels, particularly when compared to opportunities elsewhere.

Key Themes: Central Bank Policy

Markets have an interesting way of frustrating observers. Just as recession risks were abating, the coronavirus threatens to put a dent in the global economy or be the next black swan event.

The coronavirus itself is one example of events that are difficult to size up from an investment standpoint. Ray Dalio emphasized in his article on 30th January "when you don't know, the best investment strategy is to be smartly diversified across geographic locations, across asset classes, and across currencies." The good news is that while we do not know everything, we know what matters to our process. **We have maintained a diversified portfolio with significant active exposures to balance the objective of getting rewarded for our views while not putting all the eggs in one basket.**

The specific precedent of SARS indicates that economic and market impact of pandemics were limited and short lived.

What if this time is worse because of reasons such as greater fear, better connectivity, or China's larger role in the global economy? Citi and Credit Suisse separately assumed more pessimistic outcomes, and both revised China GDP growth expectations to 5.5% for 2020 (Actual GDP growth was 6% as at 31 Dec 2019). Credit Suisse highlighted that it is important to keep in perspective that the virus outbreak is a temporary shock, and the Chinese economy will recover with little impact on long term growth potential.

*Source: Credit Suisse. China: New coronavirus drives down 2020 outlook; Citi. Assessing Economic Impact of Wuhan Coronavirus Outbreak

What if the global economies really slow down? Central banks are also more responsive to slowdowns by using the tools available at their disposal. The Chinese government has room to add stimulus through monetary (more RRR Reserve Requirement Ratio cuts) and fiscal (increased government spending) policy. Over in the US, the Fed added stimulus by ramping up its balance sheet from September last year, coinciding with equity rally.

While we remain cognizant of the long term headwinds for bonds, market volatility creates medium term mispricing that suits our tactical asset allocation. **We maintain short duration primarily expressed through the credit exposures to be more defensive in a downturn, with tactical allocations to more attractive credit markets in the search for yield**. For those who worry about missing the bus, the bus has a habit of circling back for you to get on board. The question is when it comes by again, are you ready to get on board?

We can't predict but we can prepare. In light of the late stage cycle, we progressively allocated to more defensive exposures instead of going to cash over the past year. These defensive exposures allowed the portfolios to participate in the market upside whereas cash would have missed out on the gains.

We also deployed to opportunities that are less dependent on macro-economic conditions for the FGO series funds and EAM portfolios. Alternative exposures benefitted the portfolios in January, having the largest contribution to gains while equities and bonds were choppy. We did not need to predict when markets would get choppy and act, but were able to benefit by setting up the portfolios to be prepared.

For more on how we think about investments, please head to https://finexisam.com/letterstoinvestors.html

Key Themes: Search for Yield

Asian High Yield, US & EM short duration provides attractive yields

	31 Jan 2020
Asia HY	**6.6%**
US HY short dur. bonds	**5.8%**
US HY bonds	5.4%
EM short dur. bonds	**4.9%**
EM bonds	4.7%
Global investment grade corporate	2.0%

Much more attractive than what bank deposits offer today

SGD 1Y deposit	1.5%
USD 1Y deposit	1.9%

Source: Bloomberg

One of the interesting aspects of using valuation to complement fundamental analysis is it can help to side-step corrections or create a margin of safety to allow us to stay in a position. As we continue the search for yield in a low return world, our processes help remind us that not all yields are the same.

US High Yield: We took down US high yield exposures in early January, and in a rare moment, managed to get out before markets reversed. This was not us forecasting "Will the markets drop?" or "Is this a good time to get out?". Indeed, for us, it was a good time to get out, but not in the way that many investors would like to hear. It was a good time to get out based on our assessment of valuations that the odds of staying in this segment were not favourable. Around such valuations, markets could have peaked earlier, or even later, **it is not for us to know when is the best time to get out but we know it is too expensive for us to stay.** It can be a frustrating wait for valuation-minded investments as valuation assessments improve the odds but do not define the timing. We continue to work on our range of FVT metrics to understand significant and sustainable drivers of the markets that we invest in.

Asian High Yield and EM bonds: EM bonds seemed oblivious to the concerns of the world or markets in January; rising initially and holding up while other global markets corrected subsequently. This was helped by two tailwinds: favourable valuation and correlation. Favourable valuation provided EMD with margin of safety in that it did not have much room to get even cheaper during the sell-off in January. **One of the lesser understood but yet powerful concepts in investing is correlation: a measure of the strength of relationship between two objects.** In a diversified portfolio, what we like is low correlation. So long as we have positive return expectations on our investments, low correlation means that different investments do not go up and down at the same time, while maintaining an upward trajectory. Simply put, we do not put all our eggs in the same basket. Correlation is one of the key properties of any investment opportunity we assess. If we can't pin down the correlation, we pass on the opportunity. If we can, it becomes a valuable component of the portfolio.

Key Themes: How Are We Positioned?

Late-Cycle Extension	Central Bank Policy	Search for Yield
US Quality Growth equities	Currency-hedged government securities	Asian High-yield bonds
Health Care equities	Short Duration credit	Emerging Market short duration bonds
Japan equities		
China ‘A’ equities		

Asset Allocation Strategy

Equity Region	--	-	=	+	++	Allocation strategy
United States		■				Large cap growth to capture late business cycle growth, and where large caps are more resilient to rising financing and wage costs. Health Care as earnings are less dependent on the broader economic cycle.
Europe	■					Maintaining no exposure as economic activity lags other regions, and as valuations are rich.
Japan				■		Slight overweight as economy is supported by corporate reforms, and equities at attractive valuations.
Asia Pacific ex Japan					■	Overweight to China 'A' as valuations are attractive and supported by earnings growth.
Emerging Markets			■			Neutral as valuations attractive relative to developed markets, but where earnings have moderated.
Fixed Income	**--**	**-**	**=**	**+**	**++**	**Allocation strategy**
Government			■			Focus on currency-hedged global government fixed income to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	■					Maintaining no exposure as low incremental yield and long duration exposure are less attractive than other segments.
High Yield	■					Maintaining no exposure as there is an elevated risk of a price decline due to optimistic valuations.
Asia				■		One of the most attractive yields across major fixed income markets with room for capital appreciation.
Emerging Market Debt					■	Hard currency short duration focus as a more defensive credit investment for the late-stage economic cycle.

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

Current **Previous**

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	-1.08%	-1.08%	-1.08%
United States	-0.04%	-0.04%	-0.04%
Europe	-1.16%	-1.16%	-1.16%
Japan	-2.14%	-2.14%	-2.14%
Asia Pacific ex Japan	-3.70%	-3.70%	-3.70%
Emerging Markets	-4.66%	-4.66%	-4.66%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	1.28%	1.28%	1.28%
High Yield	-0.21%	-0.21%	-0.21%
Asia	1.50%	1.50%	1.50%
Emerging Market Debt	1.54%	1.54%	1.54%

Currencies	MTD	QTD	YTD
USD/SGD	1.40%	1.40%	1.40%
EUR/SGD	0.33%	0.33%	0.33%
JPY/SGD	-0.24%	-0.24%	-0.24%

Commodity	MTD	QTD	YTD
Gold	4.74%	4.74%	4.74%
Oil (WTI Crude)	-15.56%	-15.56%	-15.56%

Equity Markets	MTD	QTD	YTD
Australia	4.98%	4.98%	4.98%
Brazil	-1.63%	-1.63%	-1.63%
China "A" (Market closed 24th-31st)	-2.26%	-2.26%	-2.26%
China "H"	-8.30%	-8.30%	-8.30%
Hong Kong	-6.66%	-6.66%	-6.66%
India	-1.27%	-1.27%	-1.27%
Indonesia	-5.68%	-5.68%	-5.68%
Korea	-3.58%	-3.58%	-3.58%
Malaysia	-3.60%	-3.60%	-3.60%
Russia	1.27%	1.27%	1.27%
Singapore	-2.04%	-2.04%	-2.04%
Taiwan	-4.18%	-4.18%	-4.18%
Thailand	-4.11%	-4.11%	-4.11%

Equity Sectors	MTD	QTD	YTD
Gold	-1.43%	-1.43%	-1.43%
Energy	-11.18%	-11.18%	-11.18%
Technology	3.31%	3.31%	3.31%
Healthcare	-1.50%	-1.50%	-1.50%
Financials	-2.79%	-2.79%	-2.79%

Total return in index currency terms as of 31 Jan 2020. Source: Bloomberg

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