Investment Update
Q2 2020

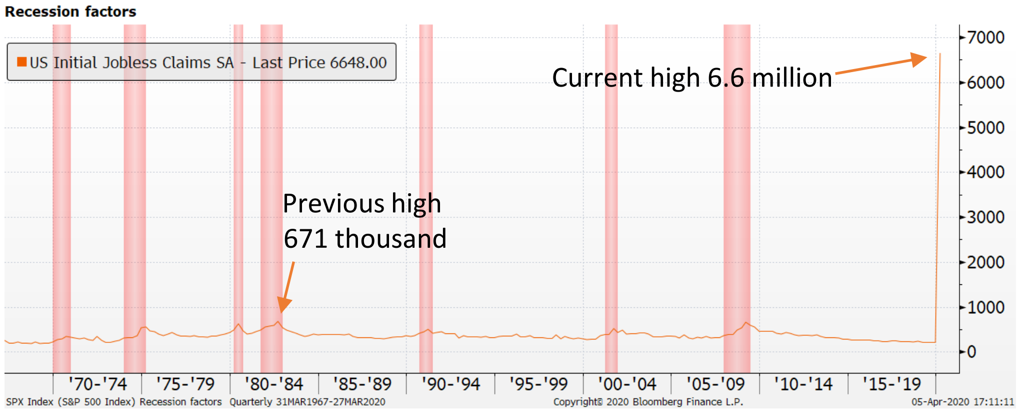
finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

March was a very long month. Not just for markets but the world in general. What the world knew at the start of March had to be quickly refreshed as the situation deteriorated rapidly.

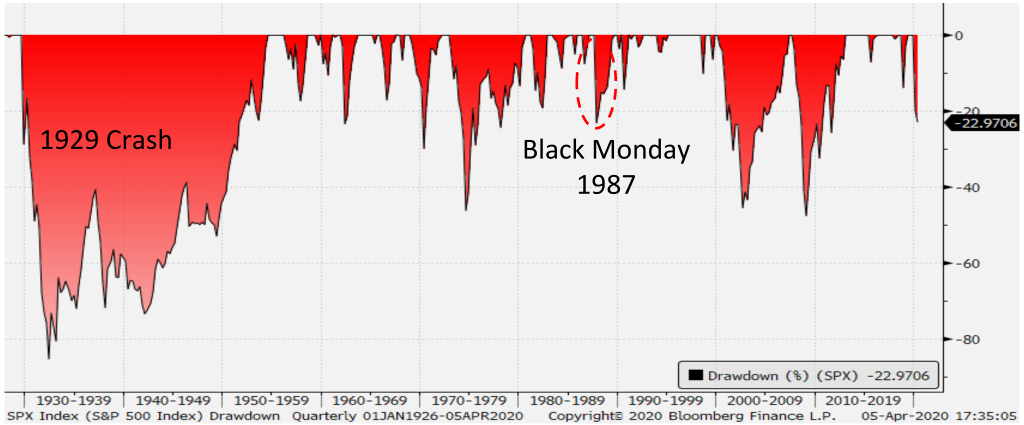
Singapore Airlines cut 96% of its capacity due to tightening border controls. On a wider scale, the world literally came to a halt as unprecedented lockdowns crippled businesses, starving them of revenue and cash.

The knock-on effect on the economy was swift, and impactful. US jobless claims (people filing for unemployment benefits) not only broke previous records, but with a magnitude none could imagine, **smashing previous highs tenfold.**



Source: Bloomberg, US jobless claims since 1967

We will not belabour how the world and economy is being affected in extreme unexpected ways. Needless to say, equity markets tanked. What was uncommon was how fast they dropped, reminiscent of Black Monday in 1987, and even the crash of 1929.



Source: Bloomberg, S&P 500 drawdown and recovery since 1927

What is less publicized is how **even investment strategies that have been doing well were also hit this time**. The impact on funds that never had losses ranged from an unprecedented knock* to literally losing their shirts (some were even supposed to benefit from volatility but were upended by it).

As of March year-to-date, global equities dropped 21%. Our portfolios had some bright spots that bucked the trend of widespread declines, but were not spared either; **with the multi-asset balanced and aggressive portfolios declining between 11 to 17%.** Indeed, some of our positions such as quality and healthcare declined less. Component such as trend-following and long volatility were even profitable. However, positions that usually do well in orderly markets such as value and emerging markets were thrown out like a baby with the bathwater in a disorderly March.

*https://www.bloomberg.com/news/articles/2020-03-10/hedge-fund-lmr-that-rarely-loses-has-worst-start-to-year-ever

Market Review

Global equities experienced one of their worst monthly and quarterly declines ever. To put things in perspective, Q1 2020 posted the third largest quarterly decline since 1970. The 'VIX' volatility index (commonly known as the fear gauge), not only **spiked to a record high during the month, but did it in half the time compared to 2008** as shown on the bottom left.

In another sign of how things changed rapidly, Warren Buffett, who **added to his Delta Airlines stake in late February at $45, and on 13 March said that he would not be selling airline stocks, started selling from 16 March*** as shown on the bottom right. Even though he had gone on record that he would not sell, he sold when he felt it was the right thing to do.

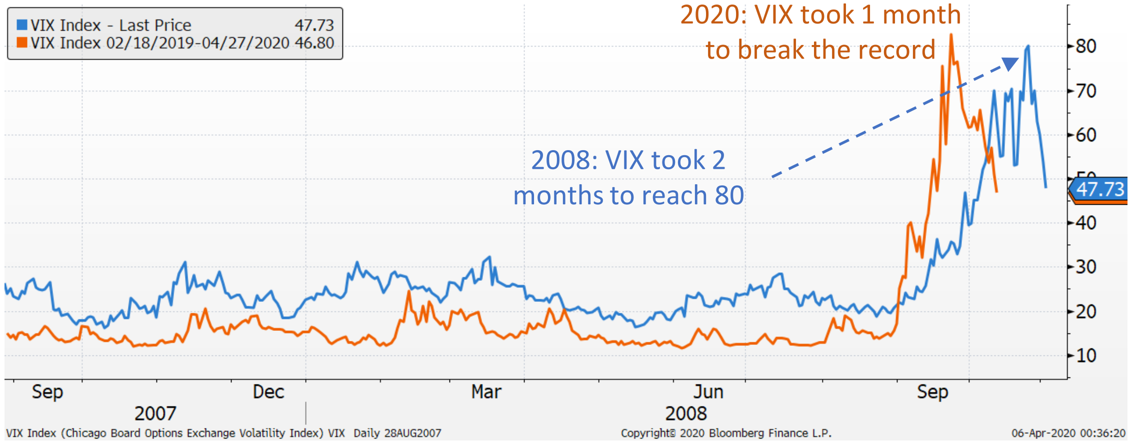
In equities, our preferred large cap quality growth, healthcare, and China 'A' held up better, consistent with our assessment of these investments in a growth slowdown.

*https://www.investors.com/news/warren-buffett-berkshire-hathaway-sells-delta-stock-southwest-stock-coronavirus/

Our preferred equity markets held up better MTD & YTD

	March Returns	Q1 Returns
World Equities	**-13.5%**	**-21.4%**
'Overweight' Our Preferred Markets		
US Growth	**-9.8%**	**-14.1%**
Healthcare	**-3.6%**	**-11.5%**
Japan Value	**-11.2%**	**-20.5%**
China 'A'	**-7.6%**	**-11.5%**
'Neutral'		
Emerging Markets	**-15.4%**	**-23.6%**
'Underweight' Areas We Avoided		
Europe	**-14.4%**	**-24.3%**

Total Return Indices measured in USD. Source: Bloomberg



Source: Bloomberg, VIX volatility index for 2008 and 2020.

Source: Bloomberg, Berkshire Hathaway transactions in Delta Airlines in 2020

Key Themes: Resilience Amid Downturn

How do we invest in such times?

Maybe the first question to ask is how can we even work in such times? The answer is: Same as before (but always little bit differently from others). As businesses fumbled with telecommuting, it was literally business-as-usual as we were fairly early adopters of workplace collaboration information systems on a day-to-day basis.

As for investing amid the monumental market volatility, we are not scrambling but investing in and divesting out of opportunities we have been monitoring.

We do the same in both the current volatile environment, and during the calm before it. **We constantly reassess risk/reward of the opportunity.** If price drops, is it due to fear or is there an unmitigated risk of permanent capital loss? If it is due to fear, then we need the confidence to ride it out. Last month, we mentioned that "we do not stubbornly hold on to existing views and positions when new significant information presents itself." If there is new downside risk that we cannot assess, we would cut the position.

As fire sales happen, we are careful not to catch falling knives or encounter permanent capital loss. This comes in two forms: poor fundamentals that became visible under stress, or those that are deprived of financing. Last month, we mentioned investors who were forced-liquidated (even from viable investments) as they were taking too much undue risk elsewhere.

With economic activity grinding to a halt, even viable business models get stressed. Expect also see bankruptcies as businesses that seemed strong in good times reveal their weaker fundamentals or poor financial discipline when the tide goes out.

The portfolios continue to be truly diversified by deploying into strategies that benefit from bullish, range-bound, and bearish markets.

Just like we re-positioned into healthcare equities without having a crystal ball to tell us when a recession would come, we also went into steepener positions in fixed income when our process indicated the conditions were favourable. It is indeed hard to catch the perfect turning point; other investors who went in too early had to bear with the pain of taking interim losses on such positions until they started to work out.

Trend-following is another strategy that provides meaningful diversification. This was a misunderstood strategy in the past years. Investors were disinterested by lacklustre returns (not huge losses) amid an unending bull run. (Even managers in the strategy started to diversify away from core trend-following). **We do not just look at historical returns to judge whether an investment is good or bad.** Our measures for trend-following allowed us to get into the strategy under conditions where it was more likely to make gains than losses.

We try to get into investment ideas that we assess to have a large reward vs risk. Sometimes we get it wrong but we tend to be right more times than wrong. Even as we sit on initial gains on these positions (and they will encounter some pull-backs), there are even larger gains to be made that depend less on the rise of bond or equity markets.

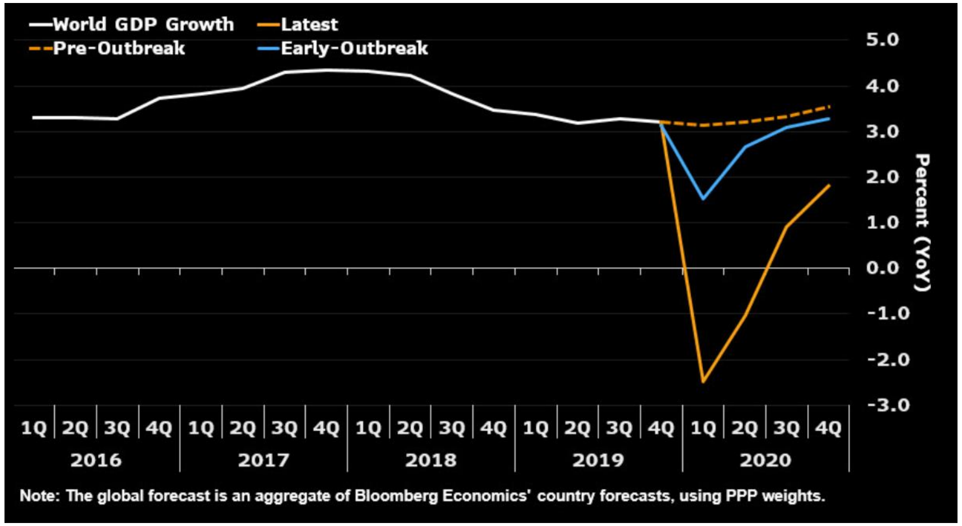
At the risk of being insensitive amid the current pandemic, we are confident our investors' portfolios will outlive them, with little risk of permanent capital loss.

Key Themes: Resilience Amid Downturn

Covid-19 has certainty thrown a spanner into the global growth engine. With globally confirmed cases exceeding 1 million people on 2nd April, countries around the world have taken increasingly drastic measures to contain the spread of the virus – at the cost of severe pain to the world economy. Central banks have reacted quickly to try and soften the economic blow, but uncertainties (and market volatility) are expected to linger for some time longer.

It is fair to say the world economy will recover eventually, but it is harder to be precise on the timing and shape of the recovery. Even as we are encouraged by a few countries that have done well to contain the initial outbreak, challenges remain before their economies can go back to normal.

Timing and shape of recovery is highly uncertain



Source: Bloomberg

As global growth slowed in 2019, our preference was for investments with higher earnings predictability that would hold up better in such a growth slowdown. Though we did not have a crystal ball to predict the latest virus outbreak, these allocations have continued to benefit us as expected when economic activity is lacklustre. Going forward, we continue to favour these investments as one way (the other being currency-hedged government bonds) to manage risks in our portfolios during these challenging times:

US Large-cap Quality Growth equities are well placed to tide through the current economic disruption. The 'Growth' in Quality Growth refers to businesses or industries that usually grow faster than the broader economy. **While not immune to economic slowdowns, growth companies tend to be not so highly sensitive to the economy as other more cyclical businesses.** More importantly for us, larger 'Quality' companies tend to have low debt, stronger earnings, and overall healthier balance sheets; which make them more resilient in a prolonged downturn.

Healthcare continues to be one of our preferred sectors for an economic slowdown. **While healthcare earnings may still decline as a result of current disruptions, these are expected to be much less severe and more temporary than the broader market.** Additionally, even as healthcare has been one of the best performing sectors YTD and have benefitted our overweight, current valuations are still reasonable relative to the broader market.

Key Themes: Positioning For Recovery

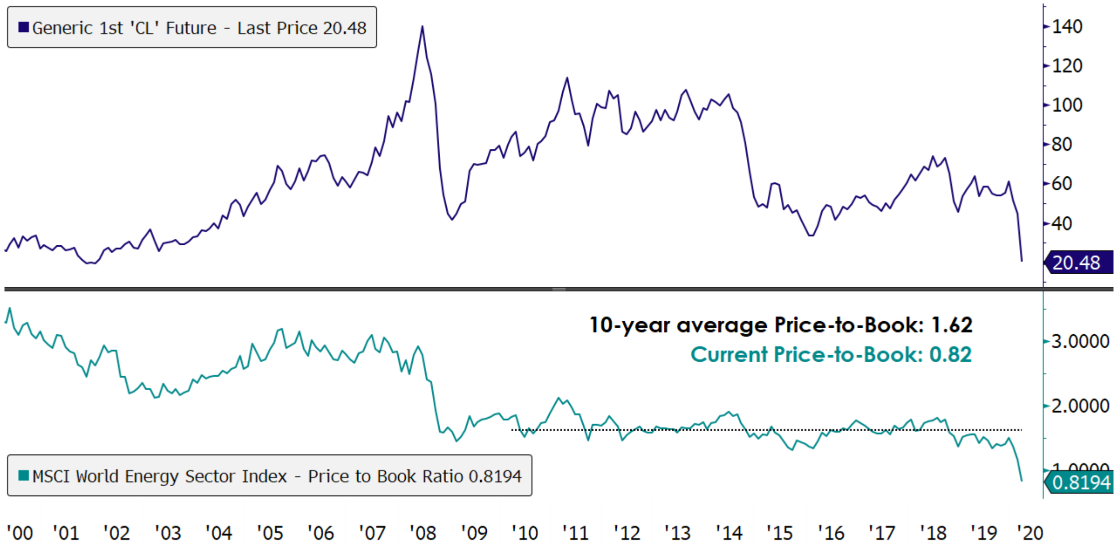
Our 'FVT' (Fundamental, Valuation, Technical) investment framework boils down to identifying areas that are priced cheaply, with good and/or improving fundamentals. Opportunities do show up routinely as part of the process, though compelling ones are less frequent, or are easy to benefit from quickly - the most undervalued areas tend to take a while to be recognised by the market.

Recall that our allocations to **China 'A' equities** did poorly in 2018 amidst the US-China trade tensions. **It was indeed uncomfortable to invest when markets are volatile in the short-term, but we took comfort in their low valuations and earnings growth profile to invest over a longer-time horizon**. Indeed, we benefited greatly as China 'A' proceeded to become one of the best performing markets in 2019, and also in Q1 2020. Going forward, we maintain our overweight as valuations continue to be below their historical averages, and as we are also encouraged by the gradual resumption of the Chinese economic activity recently.

The recent market turmoil has presented us with another new opportunity as oil prices plunged by -66%, energy equities -51%, and energy credits -39% in Q1 2020. WTI crude prices settled down to $20, which is a level not seen since 2002. Similarly, valuations of energy equities fell below their historical lows; with a price-to-book of 0.82 compared to their 10-year average of 1.62 (refer to chart).

While oil demand has dropped off sharply as countries go into lockdown-mode, prices at current levels are already pricing in a lot of the bad news. Fundamentally, most oil producers are also unprofitable at $20, and it is also in OPEC's interest to support oil prices at higher levels.

We are looking to invest across our portfolios using the most appropriate tools available to take advantage of this opportunity. Consequently, we are re-allocating out of Japan equities and into energy which is currently providing a better risk/reward. We expect oil prices to be highly volatile over the coming days and weeks. That said, volatility does not mean it is a high risk investment, and we will endeavour to provide additional updates to our investors accordingly.



Key Themes: Search for Yield

Yield of major credit markets

	31 Mar 2020	28 Feb 2020
Asia HY	**11.9%**	6.6%
US HY short dur. bonds	12.7%	6.9%
US HY bonds	8.7%	6.2%
EM short dur. bonds	**8.1%**	5.0%
EM bonds	7.2%	4.8%
Global investment grade corporate	3.0%	1.9%

Even more attractive than what bank deposits offer today

	31 Mar 2020	28 Feb 2020
SGD 1Y deposit	0.8%	1.3%
USD 1Y deposit	0.9%	1.4%

Source: Bloomberg

It is said that bulls crawl up a slope and bears fall down a cliff. **A friend also said it is not fun to be a credit investor as one is clipping coupons while running the risk of a large price drop e.g. investment grade corporate bonds dropped 7% in March. These statements indeed reflect the profile of bonds.** In the absence of stress, credit markets tend to fairly value bonds during normal times, with the main source of return being the coupon rather than capital gains. That is why credits tend to be less volatile than equities for the most part.

Is that the only reason why the bulk of the world's investors still invest in them? It is important to emphasize that bonds are senior to equities i.e. in the event of stress, bond holders have priority over equity owners in terms of the businesses' assets and pay-outs. This means that while equity dividend yields may be attractive now, the better risk-reward may be in credit.

The opportunities for meaningful capital gains in bonds is during large market declines where things get shaken up. During most months, readers may ignore the table above as there does not seem to be meaningful changes over time. Again, in a reflection of how March was, we show how yields have changed in a month. The interesting thing during stress is as central banks cut savings rates even lower, the yield and potential reward for credits is significantly improved.

Generally, global credit markets sold off in similar fashion but some have since priced in more optimism. Ironically, the ones that are more expensive now such as US high yield are those where we are less optimistic on the fundamentals e.g. pending default rates. **Asian high yield and emerging market short duration bonds have better fundamentals, are at valuations that have greater room for capital appreciation, and have also started to recover.** So these check the boxes on our FVT process leading us to be constructive on these credit segments.

Key Themes: How Are We Positioned?

Resilience Amid Downturn	Positioning for Recovery	Search for Yield
US Quality Growth equities	China 'A' equities	Asian High-yield bonds
Health Care equities	Energy	Emerging Market Short Duration bonds
Currency-hedged Government securities	~~Japan equities~~	

Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States		→				**Large-cap Quality Growth** have stronger balance sheets and are more resilient in an economic slowdown. **Healthcare sector** as earnings are less dependent on broader economic cycle. **Energy** where valuations are compelling, and providing a margin of safety for investors. *Overweight in US as a result of allocations to Global Healthcare and Energy, which are US-heavy.*
Europe	0%					Maintaining no exposure as economic activity declines, and as valuations are not attractive.
Japan	0%			←		Rotating out of Japan as economic activity declines, and into energy which has better risk/reward.
Asia Pacific ex Japan						**China 'A'** overweight as valuations continue to be attractive and earnings expected to be more resilient.
Emerging Markets						Neutral as valuations attractive relative to developed markets, but where earnings have declined.
Fixed Income	**--**	**-**	**=**	**+**	**++**	**Allocation strategy**
Government						Focus on currency-hedged global government fixed income 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 fundamentals.
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 for a recessionary environment.

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

Current Previous

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Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	-13.45%	-21.27%	-21.27%
United States	-12.35%	-19.60%	-19.60%
Europe	-14.44%	-22.52%	-22.52%
Japan	-6.10%	-17.55%	-17.55%
Asia Pacific ex Japan	-14.01%	-20.66%	-20.66%
Emerging Markets	-15.41%	-23.59%	-23.59%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-2.24%	-0.33%	-0.33%
High Yield	-10.51%	-12.32%	-12.32%
Asia	-5.26%	-2.89%	-2.89%
Emerging Market Debt	-10.68%	-9.48%	-9.48%

Currencies	MTD	QTD	YTD
USD/SGD	2.07%	5.65%	5.65%
EUR/SGD	2.12%	3.96%	3.96%
JPY/SGD	-0.32%	-0.99%	-0.99%

Commodity	MTD	QTD	YTD
Gold	-0.54%	3.95%	3.95%
Oil (WTI Crude)	-54.24%	-66.46%	-66.46%

Equity Markets	MTD	QTD	YTD
Australia	-20.47%	-22.79%	-22.79%
Brazil	-29.90%	-36.86%	-36.86%
China “A”	-6.44%	-10.02%	-10.02%
China “H”	-6.87%	-14.08%	-14.08%
Hong Kong	-9.53%	-16.12%	-16.12%
India	-22.85%	-28.35%	-28.35%
Indonesia	-16.68%	-27.42%	-27.42%
Korea	-11.69%	-20.16%	-20.16%
Malaysia	-8.05%	-14.13%	-14.13%
Russia	-9.90%	-17.38%	-17.38%
Singapore	-17.29%	-22.58%	-22.58%
Taiwan	-13.81%	-18.87%	-18.87%
Thailand	-15.47%	-27.95%	-27.95%

Equity Sectors	MTD	QTD	YTD
Gold	-11.66%	-20.01%	-20.01%
Energy	-34.97%	-51.06%	-51.06%
Technology	-9.35%	-13.34%	-13.34%
Healthcare	-3.93%	-11.95%	-11.95%
Financials	-21.48%	-32.34%	-32.34%

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

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