Investment Update
August 2020

finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

Apple's 6.5% weighting in the S&P 500 just surpassed the previous record of 6.4% held by IBM in 1985. Just five stocks (including Apple) now make up close to a quarter of the S&P 500. This may not be so concerning today as returns for these handful of names continue to make all-time-highs. Indeed, investors in index funds have benefited from the performance of the top five largest stocks in the S&P 500 index, and probably feel it makes perfect sense to continue to do so. Some professional managers will probably feel compelled to buy these benchmark names. After all, these names are well-known, and have done well; what could be wrong with that? At this point, "No one ever got fired for buying Apple" seems like an appropriate modern interpretation of the popular old adage. "No one ever got fired for buying IBM".

However, we can't help but wonder how long this can continue. It's not because we think that Apple, Microsoft, Amazon, Facebook and Alphabet (Google) are bad companies. In fact, we also have exposure to members of the FAANG club within our US allocations. It's just that their valuations are at multi-year highs. 'Top five' may not always be the 'best five' stocks to invest in. It's not a question of if but when the tide turns, and index investors have nowhere to hide. **As investors with a global view, we feel it is prudent (and better for long term returns) to also invest in other areas where fundamentals are also strong and where valuations are more attractive.**

Financial markets continued to gain for a fourth straight month since the bottom in March. Global equity markets rose 5.32% in July, while global investment grade bonds were up 3.15%.

Our multi-asset balanced and aggressive portfolios returned between 3.87% to 5.31%. **In general, each portfolio did better than a portfolio with similar equity and bond exposures investing in index funds.** In fact, our portfolios have been outperforming the passive equivalents over the past three months.

In fixed income, the shield portion comprising government bonds saw moderate gains. Again, these are meant to serve as a defensive asset during stress but we do not expect them to contribute much upside to the portfolios.

July was similar to June for our yield investments (Asian high yield and emerging market debt) which saw gains between 2.8-5.4%. As with June, July's returns came from a combination of coupon and capital gains. During a portfolio review, an investor remarked how good EM debt was with such strong monthly gains. We had to remind the investor that such capital gains are not frequent, and that the base return expectations are high single digits per annum as detailed in our Search for Yield section. Nevertheless, **we expect to generate gains from capital appreciation from our active allocation process of investing more at better valuations.**

We do not expect to outperform all the time. Recall that we have seen periods of underperformance stemming from our positions in emerging markets which have been lagging. **As we continue to make active allocations, we expect to outperform on the long run as the weighing machine favours our allocations, but expect occasional underperformance in the short term due to the voting machine.** For more on the voting and weighing machine, please refer to our Q3 investor letter at https://finexisam.com/letterstoinvestors.html

Key Themes: Resilience Amid Downturn

Recall that in June, it was reported the US had officially entered into recession earlier this year (interestingly, the peak of the economy also coincided with markets declining sharply in February). With the slew of Q2 GDP data coming out recently, we saw more clearly how the pandemic has ravaged economies around the world. The US economy shrank 32.9% on a quarter-on-quarter annualised basis, which is one of the worst GDP declines in modern history. Closer to home, Singapore's GDP declined an outsized 41.2% as local lockdowns and a weak external environment hurt the economy badly.

As markets continue to rally strongly from March's lows, horrible economic data does not seem to matter much at all. Maybe they do not matter as they are lagged indicators that merely tell us what had happened in the past? i.e. not so relevant for the future. Or perhaps investors expect central banks to continue to do *whatever it takes* to support economies and markets? Howard Marks, in one of his widely-read investment memos, said, **'As usual, the higher the market goes, the easier it becomes for investors to find rationalization for a further rise.'**

In any case, the past few months reminded us of the importance of staying invested…but how do we invest confidently in a pandemic? Bloomberg's 'Covid Bankruptcies' lists some 161 companies (so far) that have cited the pandemic as a factor for their bankruptcy*. As mentioned before, the pandemic is more a catalyst rather than the root cause of bankruptcies. Many of these companies had weaker fundamentals or poor financial discipline before covid-19 even came about. **As bankruptcies are accompanied by plunging share prices, this is an outcome we want to avoid.**

With this in mind, our portfolio allocations to **Large US Quality Growth**, and **Healthcare** equities fits well within the resilience theme. **These tend to be companies with higher earnings predictability and healthier balance sheets that make them more resilient in a prolonged downturn.** While they are not immune to economic slowdowns, these businesses are expected to be more resilient than the broader economy, with earnings less volatile compared to other segments of the market – indeed, we have observed earnings growth for these companies to continue to hold up better than the broader market this year.

The Covid Bankruptcies

Company	Industry	Bankruptcy Date	Assets ($) ▼
Hertz	Travel, Lodging and Leisure	May 22	25.8B
Latam Airlines	Travel, Lodging and Leisure	May 25	21.1B
Frontier Communications	Telecoms, Media and Technology	April 14	17.4B
Chesapeake Energy	Energy	June 28	16.2B
Ascena Retail	Retail and Restaurants	July 23	13.7B
J.C. Penney	Retail and Restaurants	May 15	8.6B
Whiting Petroleum	Energy	April 1	7.6B

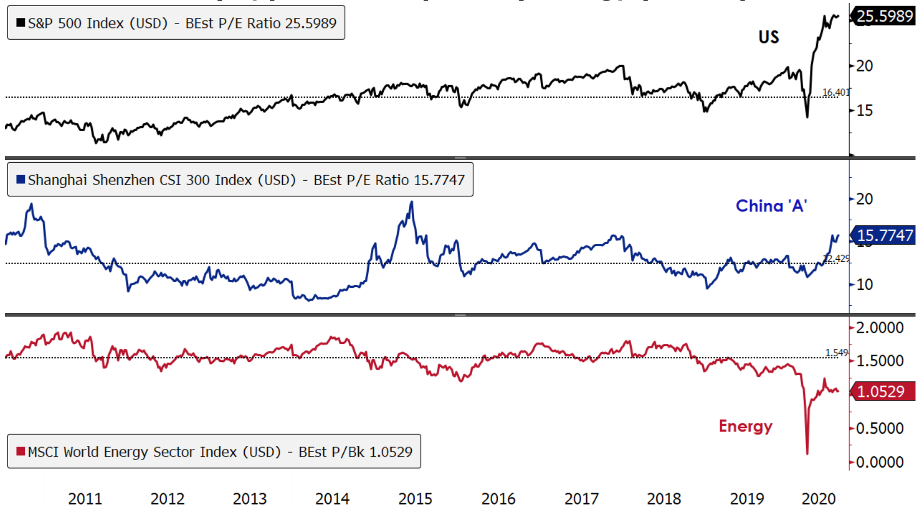
Source: *https://www.bloomberg.com/graphics/2020-us-bankruptcies-coronavirus

Key Themes: Positioning For Recovery

As much as we want to ensure our portfolios are resilient in market declines, we also do not want to be overly cautious that we miss out on opportunities. Indeed, some markets have already experienced a sharp V-shape recovery since the March lows, seemingly ahead of economic fundamentals. While it may be tempting to chase performance, it should be noted that valuations for some of these markets are at the top of their historical range, making them less desirable for long-term investors.

A passive investment into the S&P 500 Index would have done well YTD, but the high valuations today (refer to top panel of chart) may limit further upside even as economies recover. Markets at high valuations are also more prone to sharp corrections. Luckily for us, our flexible approach allows us to look beyond the major markets to identify opportunities with better risk/reward such as **China 'A'** and **Energy equities**.

Valuations: US (Top), China 'A' (Middle), Energy (Bottom)



Source: Bloomberg

Our long-time overweight to China 'A' paid off handsomely in July, extending year-to-date gains to +16.6%. Few would have guessed that China 'A' would emerge as one of the best performing markets YTD, especially when it was the first to be hit by covid-19. Nevertheless, we stuck to our investment process and remained invested as it offered access to a high growth market without overpaying. While valuations are not as attractive today, it is still reasonable compared to its own history and relative to other markets (refer to middle panel of chart). Additionally, as one of the first countries to contain the virus, economic activity has also rebounded strongly and expected to support earnings growth. For now, we maintain our overweight but look to adjust as conditions change.

We believe that **Energy equities** continue to retain high recovery potential that has yet to be unlocked. Prices were more volatile over the past month as concerns over further lockdowns and weaker demand resurfaced. That said, we continue to be encouraged by the ongoing rebalancing process that is happening in the oil market: declining inventories, number of oil rigs at multi-year lows, and oil production curtailed meaningfully. It is often said the best cure for low oil prices is low oil prices, and we are seeing this play out again today. While we do not expect smooth sailing from here on, we take comfort that we had invested at low valuations with a margin of safety. Additionally, we maintain a preference for larger energy companies with healthier balance sheets that are better able to weather a prolonged downturn.

Key Themes: Search for Yield

Yield of major credit markets

	30 Jul 2020
Asia HY	7.3%
US HY short dur. bonds	6.2%
US HY bonds	5.1%
EM short dur. bonds	4.1%
EM bonds	4.3%
Global investment grade corporate	1.6%

As bank deposit rates remain low

	30 Jul 2020
SGD 1Y deposit	0.21%
USD 1Y deposit	0.39%

Source: Bloomberg

Singapore banks were recently asked by the Monetary Authority of Singapore (MAS) to cap their dividend payouts at 60% of last year's amount. The announcement led to a decline of over 3% in local bank shares. The MAS said the restrictions were a pre-emptive measure so that banks could continue to support lending to businesses and individuals in the face of uncertainties ahead.

This sounds like the state interfering with capitalism; since when did governments start to dictate how much companies should pass on to their shareholders? Nevertheless, this is happening elsewhere around the world. European banks and companies that have had EU government bailouts have been banned from paying dividends. The restriction for bail-out companies makes sense, as governments (and the populace) don't fancy bailout money ending up in the hands of financial investors.

On the dividend cap, the MAS elaborated that they had "carefully calibrated the restrictions on dividends, taking into account the needs of investors who may rely on this income." **Yes, certain investors have been using or even relying on dividend stocks for income. Yet such income is being reduced especially when they are needed the most, when times are hard.** Even without government intervention, dividend yields for stocks in general have been coming down. The dividend yield for MSCI World is at lows not seen since Oct 2007.

When times were better, we were asked, "why not invest in dividend stocks since one can get yield as well as capital appreciation?" The reason is clear now; when times are bad, there is the double whammy of dividend reduction and share price declines. Hence, we do not equate dividend stocks with credit investing when it comes to the search for yield; dividends are at the discretion of the company whereas companies are obligated to make bond payments to creditors. There is higher confidence that credit investors will get their yield even when times are tough, and this is why we favour the Asian high yield and EM bond markets where we are able to get more predictable income and higher returns for our portfolios.

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 equities	Emerging Market Short Duration bonds
Currency-hedged Government securities	Emerging Market equities	

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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** 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 remains lacklustre, and as valuations are less attractive compared to other opportunities.
Japan	0%					
Asia Pacific ex Japan						**China 'A'** overweight as valuations continue to be reasonable 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

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	5.33%	5.33%	-0.96%
United States	5.64%	5.64%	2.38%
Europe	-0.91%	-0.91%	-12.55%
Japan	-4.01%	-4.01%	-11.86%
Asia Pacific ex Japan	7.95%	7.95%	1.54%
Emerging Markets	9.01%	9.01%	-1.53%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	3.19%	3.19%	6.27%
Global Aggregate (Hedged)	1.09%	1.09%	5.03%
High Yield	4.94%	4.94%	0.29%
Asia	2.16%	2.16%	4.58%
Emerging Market Debt	3.12%	3.12%	2.68%

Currencies	MTD	QTD	YTD
USD/SGD	-1.37%	-1.37%	2.13%
EUR/SGD	3.43%	3.43%	7.30%
JPY/SGD	-1.95%	-1.95%	-2.56%

Commodity	MTD	QTD	YTD
Gold	10.94%	10.94%	30.22%
Oil (WTI Crude)	2.55%	2.55%	-34.05%

Equity Markets	MTD	QTD	YTD
Australia	0.52%	0.52%	-9.58%
Brazil	8.27%	8.27%	-11.01%
China "A"	13.57%	13.57%	16.66%
China "H"	4.24%	4.24%	-7.08%
Hong Kong	1.50%	1.50%	-10.54%
India	8.14%	8.14%	-8.05%
Indonesia	5.16%	5.16%	-16.34%
Korea	6.69%	6.69%	2.80%
Malaysia	6.86%	6.86%	2.96%
Russia	8.63%	8.63%	-0.75%
Singapore	-2.02%	-2.02%	-19.40%
Taiwan	10.73%	10.73%	8.16%
Thailand	-0.75%	-0.75%	-13.82%

Equity Sectors	MTD	QTD	YTD
Gold	17.65%	17.65%	46.60%
Energy	-5.35%	-5.35%	-40.39%
Technology	5.82%	5.82%	19.99%
Healthcare	4.02%	4.02%	4.56%
Financials	3.52%	3.52%	-21.97%

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

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