Investment Update
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finexis
ASSET MANAGEMENT
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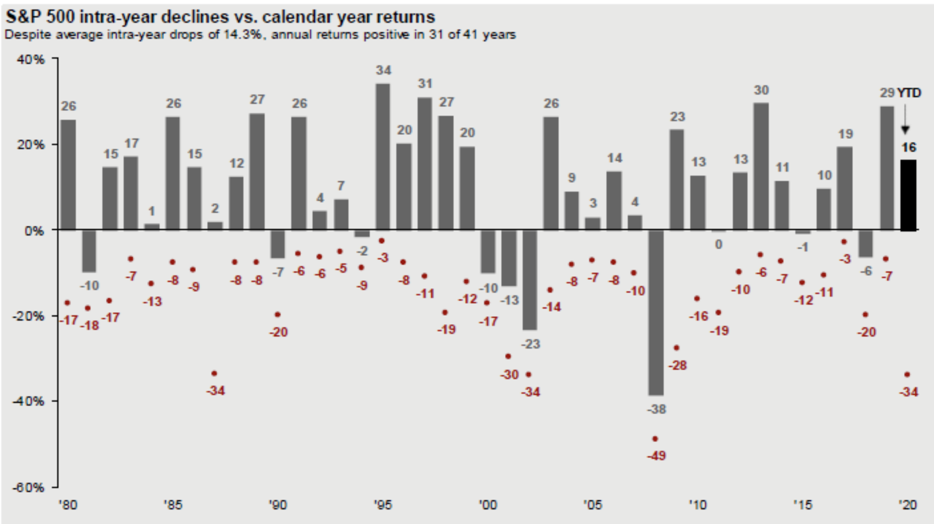
Market Review

Global equity markets rose 4.5% in December to cap off an unprecedented 2020 in terms of world and market moving events. It was a year of extremes; volatility as measured by the VIX (commonly known as the "Fear Index") hit a record high since it was first created. In simpler terms, markets were moving up and down in ways investors had rarely seen, threatening to throw them off their "boats" if they did not hold on tight. **And holding on tight was needed; while the history books will show global equities rising 16.8% in 2020, all these gains came only in the last two months.**

We refer again to the chart that shows intra-year declines and year-end returns. **Those who "abandoned ship" after seeing covid wreck havoc across economies, with markets down 34%, would also see their asset values languish as markets recovered.** If we turn back at every sign of rough sea, we will never hit our destination.



Source: JP Morgan Asset Management Guide to the Markets as of 31 Dec 2020

Unhedged global investment grade bonds were up 1.4% in December, and 9.2% for the year. Returns were contributed from currency gains as risk appetite grew, again reflecting their characteristic increasingly as a risk asset, moving in similar pattern to equities. **Here, we are reminded to invest with a forward-looking perspective**; that not all bonds are the same, and the same bond can also evolve over time.

On the credit front, high yield markets rose about 1.7% in Dec, and around 5.8% for the year. Again, **2020 was an uncommon year even for bond investors** as higher risk bonds delivered lower returns than investment grade bonds. However, this is not unique as it happens during recessions, and should not be a base-case scenario going forward.

Sing-dollar investors also need to pay attention to the appreciation of the SGD which would reduce the total return from any unhedged investments.

In a further sign of recovery, oil prices hit new highs since crashing earlier in the year, advancing towards the $50 level. Oil prices and energy equities continued to outperform in the last month as progress on covid vaccinations look to bring world economies closer to normalcy.

The chart showing that one needs one needs to take on interim losses in order to enjoy the gains they target was for the US S&P 500 index. Actually, the same concept applies to any other investment area.

References

Global equities: MSCI All Country World Index, Global investment grade bonds: Bloomberg Barclays Global Aggregate Index, High yield: Bloomberg Barclays High Yield Total Return Index, Bloomberg Barclays Asia USD High Yield Index, Oil: WTI Crude oil

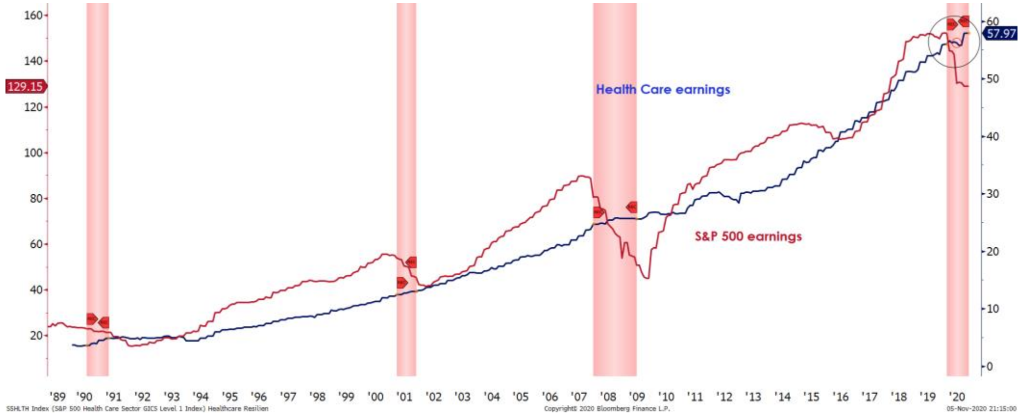
Key Themes: Stability Amid *VUCA*

Volatility
Uncertainty
Complexity
Ambiguity

Another takeaway from the intra-year return and drawdown chart shown in the previous section: we can be sure that markets *will* experience some sort of a decline in 2021, which is what normal functioning markets are expected to do – in fact, **the average intra-year decline since 1980 has been -14.3%; which would certainly rattle most investors.** We emphasize once again that this is what investors need to stomach to enjoy gains at the end of most years.

We know that intra-year drawdowns are common, but are there further insights we can glean in today's VUCA world? First coined in 1987, VUCA is used to describe environments with Volatility, Uncertainty, Complexity, and Ambiguity – an apt label as market hover around their historical highs even as the world continues to battle with the uncertainties introduced by covid-19. **One key implication of high market valuation is that they tend to precede abnormally large drawdowns. Referring back to the intra-year drawdown chart, we note that the periods prior to large intra-year drawdowns of 30% or more – 1987, 2001-2, 2008, 2020 –, all had above-average market valuations.**

This is why we balance our recovery positions with investments that are expected to provide more stability to our portfolios. For a long time, our portfolios allocated to Quality Growth and Healthcare for this role. **That said, even good investments become less attractive when there are better opportunities elsewhere, which is why we are taking profit from our US Quality Growth exposures and re-allocating to areas with better FVT. i.e. initiate new US small-cap exposures, and bolstering existing healthcare positions.**



Source Bloomberg

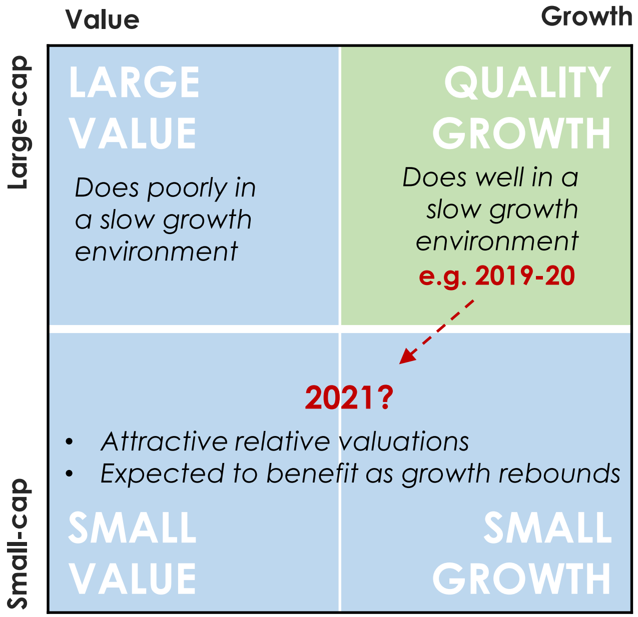
We continue to like Healthcare in our portfolios to help balance out other more volatile exposures. The chart above shows **Healthcare earnings holding up in 2020** despite a recession and pandemic, continuing with their long-term trend of being more stable than the broader markets. **Valuations are also more attractive** than other areas of the market – Healthcare valuation **is currently 86% of global equities** (discount). On the other hand, US Quality Growth (as proxied by the Russell Growth Index) has a valuation premium of 126% and is also above its long-term average.

Valuation Premium/Discount vs Global Equities

	Current	Average
US Growth	126%	119%
Healthcare	86%	109%

Source: Bloomberg. Valuation: P/E ratio of RLG Index (US Growth), MXWO0HC Index (Healthcare), MXWO Index (Global Equities). Average since 1996.

Key Themes: Positioning For Recovery



Source: FAM

One thing that we can count on when it comes to markets and investing are the cycles. Economic expansionary and recessionary cycles happen because businesses expand (typically to over-capacity) in good times, and cut back excessively in bad times. Associated with the economic cycles are market up cycles where investors, emboldened with stock price appreciation, pay exceedingly high prices by extrapolating the potential for companies' profitability and growth. These are invariably followed by market down cycles where a reversal from optimism to pessimism triggers sharp sell-offs well below fair value.

These cycles happen time and again because of human tendency to extrapolate optimism and pessimism. Such cycles create recurring opportunities for us to capture.

Though 2020 was one for the record books in terms of economic shock and recession, we had started to position for cyclical recovery with a position in the energy sector when oil prices were pricing in a lot of bad news. As we begin a new year, we continue to add to our recovery positions as the path to normalization becomes clearer.

An area that is poised to benefit from the recovery are small cap stocks. Long-term readers would remember that we introduced the above 'style-box' in our December 2019 market update; which is a page out of our cycle-investing playbook. In 2019, we positioned our portfolios into high quality large-cap stocks which were expected to be more resilient as economic growth slowed – as covered in the previous section we are now taking off these positions as valuations become less attractive, and as there are more attractive opportunities elsewhere. Fast forward two years to today, we are also cautiously optimistic that economic indicators are pointing towards early stages of a recovery cycle: declining jobless claims, improving manufacturing activity, accommodative policies, and growth normalization supported by the rollout of vaccines; just to name a few. **These are conditions that are highly favourable for small-caps, as they tend to outperform during periods of accelerating growth. We also like that relative valuations to large-caps and broader markets are reasonable and below long-term averages. Consequently, we initiate a new position in US small-caps alongside our other recovery plays that are expected to do well when economic growth rebounds.**

To be sure, we expect volatility to increase especially after the strong rally observed over the past few months, but these are shorter-term risks that are hard to predict or manage. Instead, we are better off focusing on the more sanguine growth outlook for 2021 that we have better clarity on.

Key Themes: Search for Yield

Yield investing can seem boring, especially when the news is always some stock rising xxx%. Yield investing can even be unattractive, with any media coverage typically about some bond defaulting. What then is the purpose of an asset class that has limited upside, and plenty of downside in the event of default?

Sports media tends to fawns on goal scorers and give less attention to the midfielders; we know intuitively that a team full of star strikers is not going to win a game, much less any championship. That intuition is less apparent when it comes to investing.

Yield investing is important for when the equity parts of the portfolio behave as expected, yet not to the expectation of the investor. Investors are aware that more risk means higher return but might not realise it also means more possibilities, including potentially lower returns. Table 1 shows that equities can return more than 5% about 2/3 of the time. The best year of 34% often blinds investors to the reality that they can lose an average of 16% 2 out of 10 times. Not to mention the worst case loss of 38% which might create a deep scar and make some investors shun equities and miss out on the gains 2/3 of the time. This is where **adding yield investments can reduce the experienced volatility and help them remain invested**.

Table 1	S&P 500	S&P 500 more than 5%	S&P 500 worse than -5%
% years	100%	62%	19%
Average return	9.5%	20%	-16.5%
Best	34.1%	**34.1%**	-6.2%
Worst	-38.5%	7.1%	**-38.5%**

Source: Bloomberg. Yearly returns from 31/12/1973 to 31/12/2020.

Table 2	S&P 500 between ±5%	Corresponding Credit return
% years	21%	-
Average return	**1.7%**	**3.8%**
Best	5.0%	16.6%

Source: Bloomberg. Yearly returns from 31/12/1973 to 31/12/2020.
Credit: Bloomberg Barclays US Corporate Bond Index

Another role for yield investments is for when equities are choppy, and investors need other sources of return. Table 2 shows that equities can be choppy between ±5% about 1/5th of the time, with low average returns. Yield investments come in to complement with higher returns than equities. This is what we mean by taking a portfolio approach. Unlike in sports, a portfolio of equities can still win games, provided the investor has the risk tolerance. For those with lower risk tolerance, there is always a suitable mix of capital appreciation and yield opportunities for them.

Key Themes: How Are We Positioned?

Positioning for Recovery	Stability Amid *VUCA*	Search for Yield
China 'A' equities	~~**US Quality Growth equities**~~	Asian High-yield bonds
Energy equities	Health Care equities	Emerging Market Short Duration bonds
Emerging Market equities		
US Small-caps		

Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States						**Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Energy** where valuations are attractive and are expected to benefit as economies recover. **Small-caps** as relative valuations attractive, and are expected to benefit as economies recover. *Overweight in US as a result of allocations to Global Healthcare and Energy, which are US-heavy.*
Europe	0%					Maintaining no exposure as they are less attractive compared to other opportunities.
Japan	0%					
Asia Pacific ex Japan						**China 'A'** overweight as valuations continue to be reasonable and supported by a stronger economy.
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	4.66%	14.77%	16.83%
United States	3.84%	12.14%	18.39%
Europe	2.60%	10.87%	-1.44%
Japan	2.96%	11.16%	7.40%
Asia Pacific ex Japan	6.55%	19.07%	22.76%
Emerging Markets	7.25%	19.61%	18.50%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	1.34%	3.28%	9.20%
Global Aggregate (Hedged)	0.31%	0.89%	5.58%
High Yield	1.69%	5.96%	5.87%
Asia	0.69%	1.95%	6.52%
Emerging Market Debt	1.52%	4.50%	6.52%

Currencies	MTD	QTD	YTD
USD/SGD	-1.45%	-3.17%	-1.77%
EUR/SGD	0.90%	0.89%	7.00%
JPY/SGD	-1.02%	-2.11%	-4.94%

Commodity	MTD	QTD	YTD
Gold	6.83%	0.66%	25.12%
Oil (WTI Crude)	7.01%	20.64%	-20.54%

Equity Markets	MTD	QTD	YTD
Australia	1.22%	13.81%	2.27%
Brazil	9.30%	25.81%	2.92%
China “A”	5.07%	13.70%	29.89%
China “H”	1.84%	14.33%	-0.03%
Hong Kong	3.39%	16.25%	-0.23%
India	8.18%	25.70%	17.16%
Indonesia	6.69%	23.01%	-2.44%
Korea	10.91%	23.46%	31.55%
Malaysia	4.57%	8.89%	5.71%
Russia	6.35%	15.70%	14.82%
Singapore	1.35%	15.88%	-8.05%
Taiwan	7.52%	17.90%	27.03%
Thailand	2.96%	17.36%	-5.26%

Equity Sectors	MTD	QTD	YTD
Gold	4.57%	-7.49%	23.69%
Energy	4.27%	25.78%	-37.31%
Technology	5.68%	12.71%	42.65%
Healthcare	3.00%	6.59%	11.92%
Financials	6.05%	22.52%	-4.10%

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

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