Investment Update
April 2021

ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

Global equity markets continued to rally with gains of 2.72% in March. Beneath the surface, this masked some blow-ups that wiped out entire fortunes.

Closer to home, investors in Torque Trading and Envy Asset Management found that over a billion dollars of their assets were missing...

...Archegos and Greensill Capital, seemingly unparalleled before, unravelled in a matter of days. As reports come in, each event seems to try to outdo the other in terms of losses. Apart from the amount in dollars, the wipeout in terms of percentage permanent capital loss is staggering.

What was Archegos investing in? Baidu, Tencent Music Entertainment, Discovery Inc. These are well-known and profitable businesses; how can they destroy investors' fortunes? **Excessive Debt.** While **permanent capital loss** is typically associated with investing in esoteric or idiosyncratic opportunities, it **can also happen with well-known companies if one levers too much.**

Why do we look at blow ups? Blow ups are what we can see on the surface. Is a blow up isolated, or is it a canary in a coal mine, setting off a chain reaction of unwinding that affects broader markets?

A series of blow ups might be a sign of a bigger catastrophe to come; just like tremors before an earthquake. This earthquake can happen tomorrow or many years down the road. If you hide in the bomb shelter, you will miss out on life while waiting for the earthquake to happen.

This is the same for investing.

https://www.nytimes.com/2021/03/28/business/greensill-capital-collapse.html
https://www.bloomberg.com/news/articles/2021-04-01/leveraged-blowout-how-hwang-s-archegos-blindsided-global-banks

Investing is not riskless. However, investing also offers amazing odds of making money, provided one focuses on opportunities which are likely to pay off. As mentioned in our investor letter from Q2 2018, more risk does not necessarily mean more return but not taking risk will definetly not bring you return.

In the current environment of elevated valuations, with cheap money that facilitates if not emboldens leverage, it is more pertinent than ever to **focus on judicious investing that is commensurate with ones' risk tolerance**.

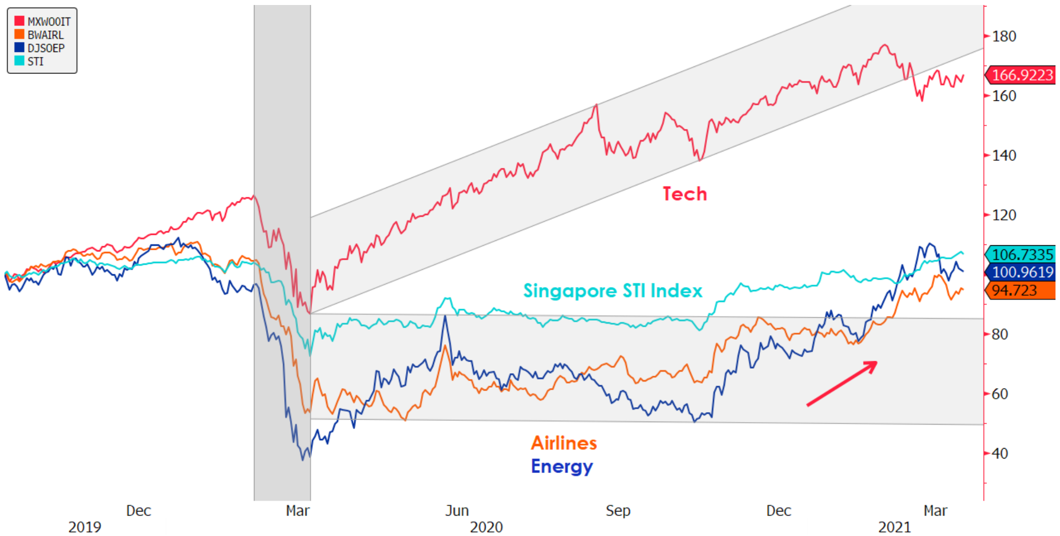
Last month we showed how the rally was dispersed across sectors. This time, the dispersion was more pronounced on a regional basis, which impacted our exposures, in particular emerging markets. Our recovery basket saw divergence; with energy and US small caps holding up while China 'A' and EM detracted. While this gap may seem alarming, it is important to take things into perspective: China 'A' and EM have risen and fallen significantly in just the first 3 months of the year. **It is not a surprise that there is a retracement after a strong run.**

The picture was harsher for bond investments. **Global investment grade bonds** have been on a downhill slide from the start of the year, **ending the quarter at -4%, mainly driven by the ongoing sell-off in government bonds.** High yield markets, which we are exposed to, are largely flat ±1% YTD as they have benefitted from having higher coupons and lower sensitivity to interest rate rises.

References: Global equities: MSCI All Country World Index, Global investment grade bonds: Bloomberg Barclays Global Aggregate Index, Energy equity: MSCI ACWI Energy Sector Index, Energy Exploration equity: Dow Jones U.S. Select Oil Exploration & Productions Index, High yield: Bloomberg Barclays US High Yield 350mn Cash Pay 0-5 Yr 2% Capped Bond Index, Bloomberg Barclays Asia USD High Yield Bond Index.
https://finexisam.com/publication/investor%20letter/FAM_Investor%20Letter_201804.pdf

Key Themes: Positioning For Recovery

We had previously introduced our readers to the 'K-shaped' recovery that was taking place after the 2020 covid-crash. Recall that economies and markets were going through a bifurcated recovery; with segments like technology rebounding quickly, while others lagged behind e.g. Airlines, Energy. **Our investment process is based on 'FVT' rather than 'FOMO', so we did not invest heavily into previous winners just for fear of missing out** – we know this is a losing strategy over longer periods. Instead, we took the chance to position ourselves more heavily within recovery plays which were expected to perform strongly when we get a broad-based economic recovery; energy being one that was particularly attractive. Let's see how this has played out since then:

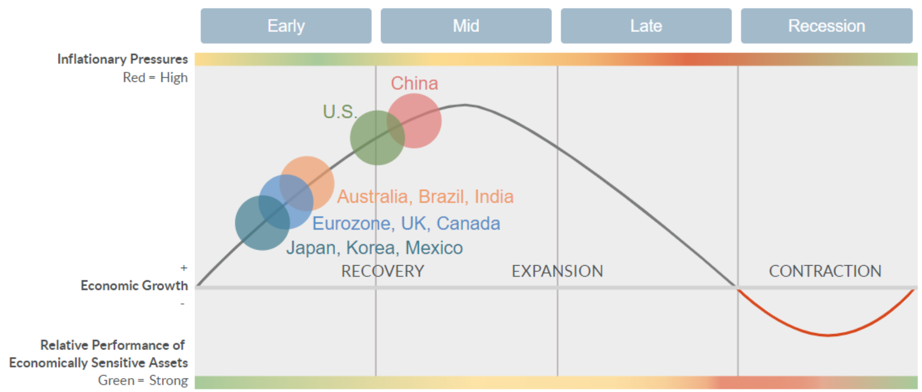


Source: FAM & Bloomberg. Reference indices: MSCI World Information Technology Index, Straits Times Index, Bloomberg World Airlines Index, DJ US Select Oil Exploration & Production Index. All returns shown in local currency terms.

As you can see, the lower-k segments have started to catch up in a sign of broadening economic recovery. Over the past few months our energy overweight has done particularly well as oil prices recovered to pre-recession levels. With such strong performance, valuations are not as compelling as before, and the risk/reward has declined. We do not want to overstay our welcome, especially as conventional energy is also facing longer-term headwinds from structural change in demand due to the transition to renewables.

With this in mind we are taking profit on our energy positions, and re-allocating to undervalued Europe equities as a catch-up recovery play. Valuations for Europe remain attractive relative to other developed markets like the US, and is expected to benefit strongly when global economic activity improves.

Europe has lagged other regions in the recovery



Source: Fidelity

Key Themes: Stability Amid *VUCA*

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

Bubble, or Not

By some measures, S&P 500 valuations already top dot-com era

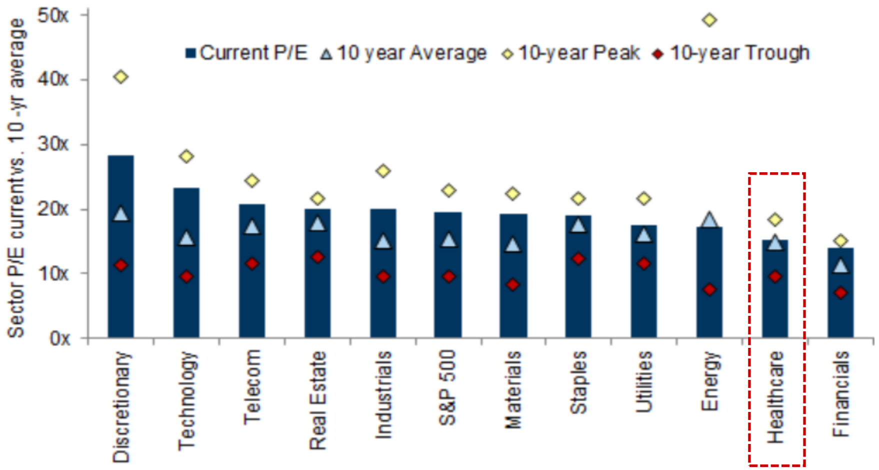
Source: Bloomberg

Does the above chart warrant caution from investors? The short answer is 'not so much', if businesses can match or exceed the strong earnings expected in the coming quarters as they rebound strongly out of the covid-recession. Of course, 'betting on huge upside earnings surprises is risky too[1]', and not a sure thing - a few earnings misses can quickly cast doubt on whether such high valuations are justified.

This is where healthcare continues to play a useful role in our portfolios as part of the 'Stability' theme. As shown before, their stable earnings profile regardless of economic growth makes Healthcare a defensive sector and a useful portfolio diversifier. **This is increasingly important as assets like safe-haven government bonds** - historically an effective diversifier - **are becoming not much of a haven**[2] with interest rates more likely to go up than down.

Healthcare's combination of steady, above average earnings growth at attractive valuations (refer to below chart) makes for a compelling investment in a VUCA environment. Additionally, Healthcare provides useful diversification for our recovery positions given that it is more defensive and less dependent on a strong economic recovery to do well.

S&P Sector Valuations: Healthcare attractive



Source: Goldman Sachs Healthcare Pulse 26 Mar 2021

References:

[1] https://www.bloomberg.com/news/articles/2021-03-27/bubble-deniers-abound-to-dismiss-valuation-metrics-one-by-one?sref=EnJawTd3

[2] https://www.bloomberg.com/opinion/articles/2020-10-15/markets-without-havens-are-becoming-all-too-real?sref=EnJawTd3

Key Themes: Search for Yield

We have been writing about the search for yield for a long time as it is a prevailing theme amid years of low interest rates.

Why this search for yield? It is because **expected returns** for the traditional bedrock **of bond investments** as represented by the Global Aggregate Index, **are at multi-year lows**. At the beginning of the year, the expected return the traditional core was 0.83% as shown in the table on the right. This led us to prefer high yield bonds as we expect to be compensated for the risk, rather than take risk with practically flat return expectations.

Three months on, **low yields have risen and bond prices have fallen.** For example, global aggregate yields rose 0.33% while prices declined -4.46%. The table on the right shows how different bond segments have performed in an environment of rising yields.

Yield of major bond markets	31 Dec 2020	31 Mar 2021
Asia HY	6.74%	7.08%
US HY short dur. bonds	4.24%	3.83%
US HY bonds	3.99%	4.18%
EM short dur. bonds	3.01%	3.27%
EM bonds	3.50%	4.01%
Global investment grade corporate	1.34%	1.74%
Global aggregate	**0.83%**	**1.16%**
Performance of major bond markets	YTD	Change in yield
Asia HY	0.43%	0.35%
US HY short duration	2.17%	-0.41%
US HY	0.57%	0.19%
EM short duration	-0.03%	0.26%
EM bonds	-3.48%	0.51%
Global investment grade corporate	-4.25%	0.40%
Global aggregate	**-4.46%**	**0.33%**

In general, yields rose between 0.19-0.51%. If rising yields means decline in bond prices, why is there a dispersion in the returns? In fact, the high yield segments are positive YTD despite rising yields. This outcome is what has been driving our key theme for a long while: yield with short duration.

Low rates present poor risk-reward for bonds: The prospective returns are low, and the potential losses are high. It is because they have long duration (e.g. 7x for global aggregate bonds), hence high sensitivity to interest rates. This high sensitivity magnifies the impact of yield changes. From the start of the year, with yields at 0.83%, a **small 0.12% increase** in yield with a duration of 7 (0.12% x 7 = 0.84%) **would wipe out an entire year's worth of income**. Thus far, the yield increase of 0.33% in global aggregate bonds being -4.46%.

High yield bonds improve the risk-reward by improving the prospective return. Coupled with our focus on short duration, a rise in yields does not have a magnified detrimental effect on performance. **The higher coupon in high yield also serves to cushion the impact of declining prices**, which is evident here.

We have sought to emphasize that we are looking for opportunities that offer higher yields, but yield alone is not the deciding factor. It is key to understand the underlying risks that we are taking to be compensated for the additional yield. In a world where opportunities abound e.g. 0.2% per day (https://torque.asia/home/calculator/), one needs to ask "is it too good to be true?"

Key Themes: How Are We Positioned?

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

Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States			←			**Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Small-caps** as relative valuations attractive and are expected to benefit as economies recover. **Exit Energy after reaching target with strong performance. Risk/reward has declined.**
Europe	→					**Adding back to neutral as 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						**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 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 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	2.72%	4.67%	4.67%
United States	4.38%	6.17%	6.17%
Europe	6.54%	8.45%	8.45%
Japan	5.61%	9.15%	9.15%
Asia Pacific ex Japan	-2.10%	2.72%	2.72%
Emerging Markets	-1.51%	2.21%	2.21%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	-1.92%	-4.46%	-4.46%
Global Aggregate (Hedged)	-0.39%	-2.47%	-2.47%
High Yield	0.27%	0.57%	0.57%
Asia	-0.66%	-1.17%	-1.17%
Emerging Market Debt	-1.25%	-3.48%	-3.48%

Currencies	MTD	QTD	YTD
USD/SGD	0.92%	1.72%	1.72%
EUR/SGD	-1.93%	-2.30%	-2.30%
JPY/SGD	3.89%	7.23%	7.23%

Commodity	MTD	QTD	YTD
Gold	-1.52%	-10.04%	-10.04%
Oil (WTI Crude)	-3.80%	21.93%	21.93%

Equity Markets	MTD	QTD	YTD
Australia	2.70%	4.65%	4.65%
Brazil	6.00%	-2.00%	-2.00%
China "A"	-5.40%	-3.12%	-3.12%
China "H"	-2.45%	2.18%	2.18%
Hong Kong	-1.76%	4.55%	4.55%
India	0.85%	3.85%	3.85%
Indonesia	-3.93%	0.30%	0.30%
Korea	1.61%	6.54%	6.54%
Malaysia	0.87%	-2.07%	-2.07%
Russia	5.84%	7.83%	7.83%
Singapore	7.57%	11.75%	11.75%
Taiwan	3.14%	11.69%	11.69%
Thailand	6.70%	10.48%	10.48%

Equity Sectors	MTD	QTD	YTD
Gold	3.48%	-10.04%	-10.04%
Energy	2.69%	29.27%	29.27%
Technology	0.68%	1.21%	1.21%
Healthcare	2.15%	0.25%	0.25%
Financials	5.62%	15.35%	15.35%

Total return in index currency terms as of 31 March 2021.
Source: Bloomberg

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