Investment Update

August 2021

finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

It was a sea of red in July. Emerging markets took centre stage as the Chinese government clampdown on certain industries and companies reverberated across markets. China 'A' markets were down 7.3%, and broader emerging markets dropped 6.7% in sympathy.

Yet we must remember that **this is the necessary volatility one must take on to make investment gains**. Bear in mind that global equity markets were down 0.45% in January and then went on to rally 12.82% for the next 5 months. Just like Olympic athletes, markets also need to take a breather.

Amid the sea of red, **some parts of our portfolio stayed resilient**. Global credit and trend following were positive which mitigated the overall volatility. It is in volatile times when diversification benefits are evident. (When things are going well, people invariably ask "why can't I have more of xxx that did well recently?")

<u>The EM (emerging market) story and reality:</u> If anyone can recall walking into a bank in the 90s, they would have seen a brochure with a Dragon emblazoned on it promoting China equity funds. Clearly, the investment proposition for emerging markets is not new; yet investors seem to have a love-hate relationship with it.

For decades, EM economies have grown more than DM (developed markets). And investors have benefitted: **$100 invested into EM equity will be worth $2447 vs $1388 for DM equity** (31/12/87-31/7/21). This outcome looks pretty obvious when we link it to the EM story.

Why then are investors not all in on EM investments? Instead of clamouring for EM opportunities, investors are shying away if not shunning EM. It is fair to say that one reason is because DM has outperformed EM in the past decade. And when one encounters periods of underperformance, doubts start to seed and dictate their investment decisions.

When investing, this greed-fear response needs to be managed.

<u>Why does the Bifurcation exist:</u> If emerging markets have so much going for them, and have enriched investors over the years, why are there such painful stretches of underperformance? Because there are economic cycles, and market cycles which create these cycles of out and underperformance. This is also where human psychology and herd mentality combine to extrapolate good and bad news, leading to irrational exuberance. Furthermore, governments try to rein in such exuberance through financial and regulatory policy, creating more volatility.

This round of policy controls may look surprising, but such "clampdowns" have happened time and again in China. It is also not confined to China; time and again the US government has imposed measures to moderate industries or companies that threaten to become too big for their own good (recall the breakup of AT&T).

<u>Bifurcation as opportunity:</u> What happened after the visit to the bank with the China fund brochure in the 90s? The Asian Financial Crisis happened. This is a helpful lesson that teaches us not to be the last money in. It also means that there are ongoing opportunities due to these cycles and the volatility they create.

That sets the scene for active allocation. The EM vs DM underperformance has been a challenge for us in recent years as we have had meaningful exposures to EM in our portfolios. This meant we would have underperformed compared to other portfolios that are structurally-biased to DM. It may look like our EM exposure puts us at a disadvantage, but would you rather be upset at this interim bifurcation, or enthralled by the substantial long-term advantage? With this perspective, an active EM exposure actually puts us ahead.

References: Global equity: MSCI ACWI Index, EM equity: MSCI Emerging Markets Index, DM equity: MSCI World.

Key Themes: Positioning For Recovery

While the latest set of COVID-related news contains both good and bad, there seems to be more of the former. Starting with the bad news: The now-infamous and highly contagious Delta variant continues to work its way around global communities, bringing with it deleterious economic consequences. In certain regions within China, millions are back on lockdown conditions, wearing out the last legs of many of its businesses.

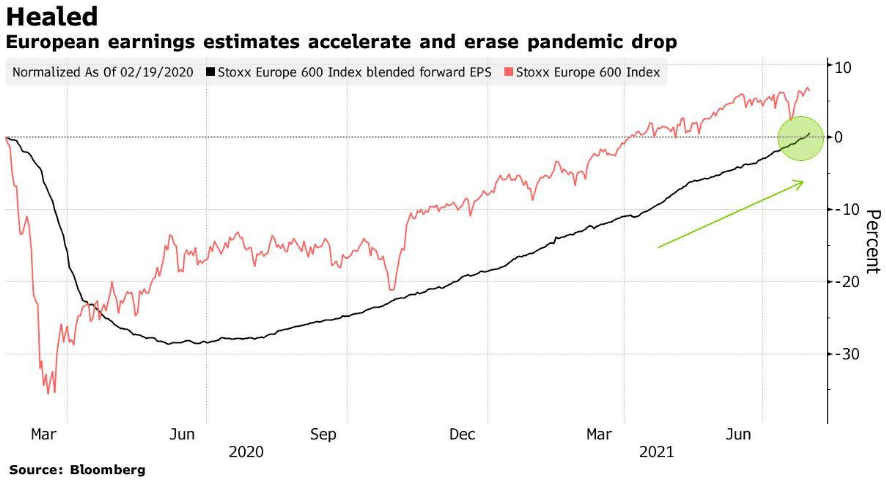
As for the good news: investors can take heart that vaccination rates are slowly increasing world-wide, reducing transmission rates and infection severity. This will **give new impetus to the global economic recovery, bringing us one step closer on a bumpy road towards normalcy.**

Efficacy after two doses	AstraZeneca	Pfizer / Moderna
Against infection	61%	82%
Against transmission	47%	47%
Against symptomatic disease	66%	86%
Against hospitalization	91%	94%
Against death	95%	96%

Source: LGT, JP Morgan based on UK vaccination data. Extracted on 27/7/2021

Amongst the countries with the largest economies, the lockdown situation in China should also be seen as an exception to the norm. Health experts in the USA and UK report that they are not expecting to return to a lockdown situation despite the rising number of cases.

Taking a step back to look at the big picture: **the overall economic situation actually seems much brighter than at the same point last year.** In fact, the following chart shows that European earnings have since recovered to the point that it is on par with pre-COVID earnings. In fact, we have observed positive earnings revisions for many of the markets we are tracking.



What is the best way to ride the post-recession bull? Our "FVT" investment process has highlighted segments that are expected to fare well in this post-COVID recovery market:

1. **Emerging Market Equities**: Despite a slower vaccination pace in EM, we maintain a neutral allocation as they are expected to benefit from both domestic and global economic recoveries – corporate earnings have continued to rise despite the interim lockdowns.
2. **US Small Cap Equities**: Continue to be trading at a wide discount to Large Caps despite expectations of growing earnings more quickly.
3. **Europe Equities**: European countries are taking steps towards resuming business as usual, Corporate earnings continued to be supported by strong business activity.
4. **Quality Value**: Value stocks set to outperform growth stocks on the back of 1. better valuations and 2. ongoing recovery benefiting the cyclical nature of the segment.
5. **China 'A' shares**: Continues to trade at more reasonable valuations. Despite a tougher policy stance, policy makers have also taken steps to calm investors more recently.

Key Themes: Stability Amid *VUCA*

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

The litany of regulations imposed by the Chinese government on Chinese companies across several sectors in July is yet another of a string of VUCA events this year that validates our diversifying into stable investments. These regulations have had a widespread impact on Chinese companies listed across China, Hongkong, and US. The private education sector in particular, has been the worst hit, facing a combination of regulations and restrictions that seek to curb its profit-seeking practices. Shares in this sector have since fallen off a cliff:

July MTD Performance (as of 7/29/2021)	
New Oriental Education & Technology Group	-73%
TAL Education Group	-77%
KraneShares CSI China Internet ETF	-26%
MSCI China Index	-12%
CSI 300 Index	-7%

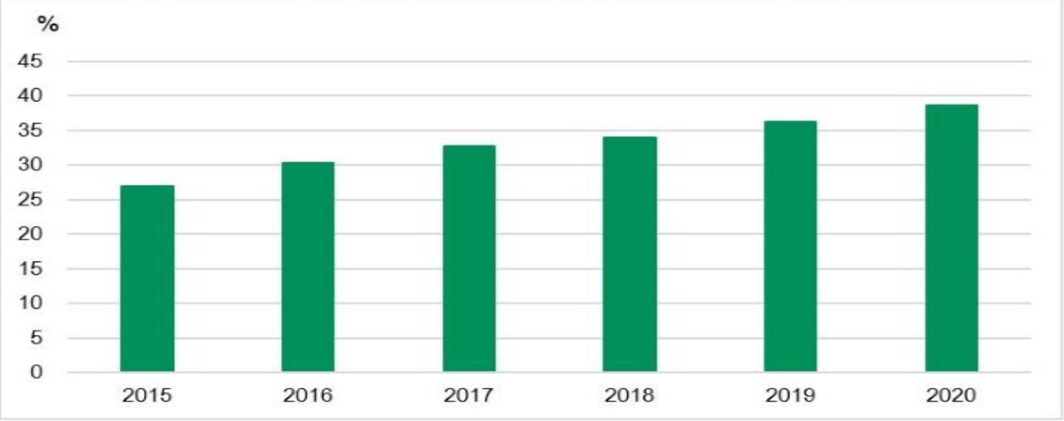
Source: Bloomberg, returns in USD

The consumer tech sector was not spared either, with the Chinese government announcing a six month clean up campaign to defuse "serious problems" relating to internet apps.

It is anybody's guess whether the Chinese Government is on the cusp of further profound and sweeping regulations, sharpening the already VUCA environment we are operating in.

Some commentators have already begun the easter-egg hunt to find the next industry to come under scrutiny. They are discounting the possibility of the consumer-tech industry facing the similar tragic ending faced by the private education sector. In 2020, the digital economy accounted for ~40% of its GDP. This means that the fates of consumer tech giants and the Chinese economy are intertwined. **While authorities are eager to regulate these giants, they must be careful (and are expected) to do so without compromising its nation's growth drivers.**

Exhibit 1: Share of the digital economy in Chinese GDP (2015-2020)



Source: Statista, April 2021

While it is a valid point that China needs to be delicate in its reining in large tech giants, we do not find it a productive endeavour to try and gaze through crystal ball to identify the next set of companies to enter the regulators' crosshairs. Instead, we continue to rely on our FVT process and go where the strongest tailwinds are for this part of the cycle.

Equally importantly, we will diversify into stability. This means identifying differentiated opportunities that do not require us to make an outsized bet on a certain outcome happening. Consequently, **we have our healthcare position that is intended to act like a loaded dice – in our favour.** The global healthcare segment is supported by secular tailwinds and a stable earnings profile; not so much at the mercy of futile policy predictions from the Chinese government. Not only so, healthcare positions also guard against the possibility of the global economic recovery being weaker or later than expected. Afterall, healthcare is a defensive sector due to its cyclically agnostic character (people need health care regardless of whether the economy recovers).

Key Themes: Search for Yield

This month, we focus our discussion on the macroeconomic environment as opposed to specifically on the search for yield.

On 19 July 2021, NBER (National Bureau of Economic Research), the authority for determining recessions announced that the 2020 recession ended in April 2020*. This makes it the shortest recession on record since 1854. Yet it took almost one and half years after the recession for the powers that be to determine it had ended. In the past two weeks, global newspapers from the Wall Street Journal to the Times of India followed up with headlines like **"U.S. Coronavirus Recession Lasted Two Months, Ended in April 2020, Official Arbiter Says".**

Imagine if one saw the news of the recession ending on 19 July, and concluded that was the time to invested in equities as it signaled that economies were out of the woods. They would have made 2.3% (S&P 500) till 3 August but that would pale in comparison if they invested from April 2020 (if it was even possible for NBER to announce then) and made 55%. Recently, we asked in a poll if clients adjusted investment decisions based on newspaper headlines. The response was about 50/50. **For those who are inclined to act on newspaper headlines, do consider if these are bringing you closer or further from your investment goal.**

Our FVT investment process uses Fundamental inputs including econometric data that we find to be more ahead of the curve. We do not rely on official recession announcements to make investment decisions because they tend to be released a long time after the fact. The recent announcement, though lagged, serves to confirm our thesis rather than be used to initiate a position for recovery. If we wait for the all-clear signal to invest, there is little money left on the table. **Being ahead means we improve the odds of making money, but are prepared for a bumpy ride.**

A couple years ago, we were asked pointedly when a recession would happen. Our answer was "we do not know"; a response that made us seem like we did not know what was going to happen. The fact is nobody knew then. So when did the world know it was in recession? It was 8 June 2020. By then, the actual recession was already over. By then, the first of our recovery positions via the energy exposure was already running for two months. Indeed, a bumpy ride ensued for energy investments but they were a meaningful contributor to performance as economies recovered.

Do you ask a captain to predict the weather or to navigate the seas? Which is a more relevant question to the objective of crossing the sea? Inevitably, there are players in finance whose day job is to confidently prognosticate about "will xxx go up/down!", "yyy will happen". Bear in mind they are paid to comment, not to manage portfolios. With this incentive structure, they are more likely than not to pander to audience needs. If you were a passenger on a ship, do you need a weatherman more than a captain?

*https://www.nber.org/research/business-cycle-dating/business-cycle-dating-committee-announcements

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
Emerging Market equities		Emerging Market Short Duration bonds
US Small-cap equities		
Europe equities		
Quality Value		

Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States						**US Small-caps** as relative valuations attractive and are expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Quality Value** as valuations attractive, and expected to benefit as economies recover. Quality bias to avoid potential 'value traps'
Europe						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						Maintain **China 'A'** slight overweight as relative valuations continue to be reasonable, and supported by a recovering 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

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Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	0.72%	0.72%	13.36%
United States	2.38%	2.38%	17.98%
Europe	2.09%	2.09%	18.20%
Japan	-2.18%	-2.18%	6.52%
Asia Pacific ex Japan	-6.61%	-6.61%	-0.22%
Emerging Markets	-6.69%	-6.69%	0.28%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	1.33%	1.33%	-1.92%
Global Aggregate (Hedged)	1.24%	1.24%	-0.29%
High Yield	0.27%	0.27%	3.30%
Asia	-0.24%	-0.24%	-0.29%
Emerging Market Debt	0.16%	0.16%	-0.44%

Currencies	MTD	QTD	YTD
USD/SGD	0.67%	0.67%	2.44%
EUR/SGD	0.78%	0.78%	-0.43%
JPY/SGD	-1.25%	-1.25%	6.27%

Commodity	MTD	QTD	YTD
Gold	2.49%	2.49%	-4.43%
Oil (WTI Crude)	0.65%	0.65%	52.41%

Equity Markets	MTD	QTD	YTD
Australia	1.10%	1.10%	14.76%
Brazil	-3.94%	-3.94%	2.34%
China "A"	-7.31%	-7.31%	-6.37%
China "H"	-12.79%	-12.79%	-12.20%
Hong Kong	-9.58%	-9.58%	-2.87%
India	0.36%	0.36%	10.99%
Indonesia	1.54%	1.54%	3.19%
Korea	-2.86%	-2.86%	11.78%
Malaysia	-2.46%	-2.46%	-6.13%
Russia	-0.11%	-0.11%	19.32%
Singapore	1.19%	1.19%	13.16%
Taiwan	-2.05%	-2.05%	18.60%
Thailand	-4.06%	-4.06%	6.93%

Equity Sectors	MTD	QTD	YTD
Gold	3.08%	3.08%	-2.69%
Energy	-8.44%	-8.44%	30.35%
Technology	3.54%	3.54%	16.68%
Healthcare	3.65%	3.65%	13.03%
Financials	-0.61%	-0.61%	23.75%

Total return in local currency terms as of **31 July 2021**
Source: Bloomberg

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