finexis
ASSET MANAGEMENT
汇信资产管理有限公司

FAM ASIA FUND
INVESTOR LETTER

January 2019

Dear Investors,

The Fund closed the quarter -9.76%, and the year -15.40%. If there was a four-letter word to describe 2018 (no, not that four-letter word), it would be VUCA. First coined in 1987, VUCA is used to describe environments with Volatility, Uncertainty, Complexity, and Ambiguity. Whether it's a good year like 2017 or a bad year like 2018, markets are volatile, uncertain, complex, and even ambiguous. However, it is not surprising that one feels more pain from losses compared with the pleasure from gains; we are human after all.

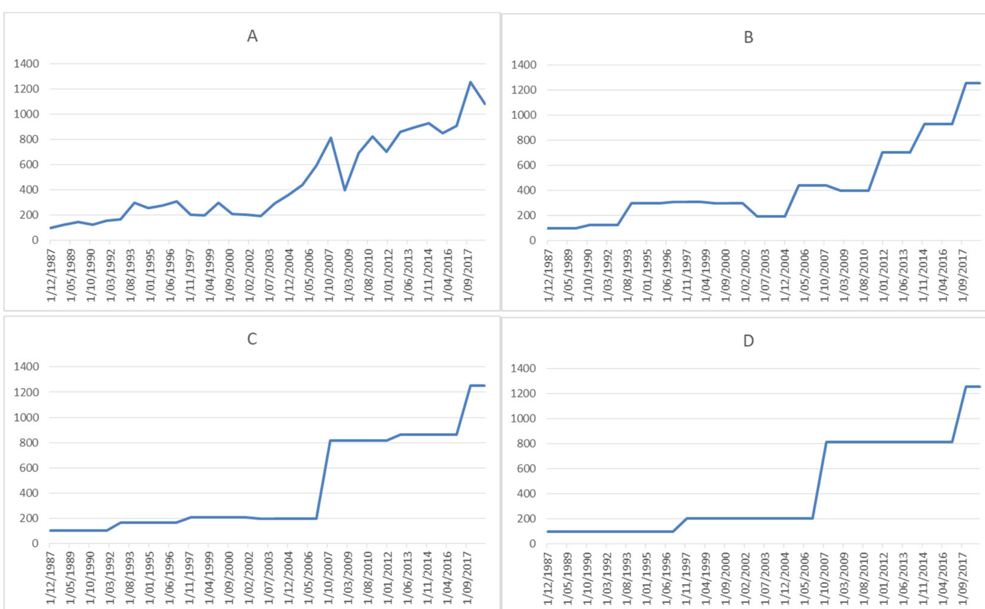
Recently, at the start of the school year, my child's school teacher explained that parents and teachers had to work together to prepare the children for a VUCA world. The question is, are we ourselves prepared for a VUCA world?

THOUGHTS ON INVESTMENT

How to "guarantee" returns.

We've been asked "Can you guarantee I'll make money?" For the longest time, I've struggled to articulate a response as guarantees mean no risk, and no risk means little or no return. Nevertheless, it is actually possible to "guarantee" a return from investing without resorting to explicit guarantees (which eat away at returns) or Ponzi schemes. In fact, the nature of investing is such that one is pretty much assured of a gain, provided they have the right perspective.

Which of the following would you invest in?



To help you with the decision, here are some statistics.

Investment	Largest periodic loss	Largest periodic gain	Volatility
A	-51%	80%	30%
B	-34%	144%	37%
C	-4%	316%	58%
D	0%	297%	56%

Source: Bloomberg, Finexis Asset Management

Actually, an investor in any of the above would end up with the same dollar wealth. All the above investments are actually the same; they reflect an investment into Asia Pacific ex Japan equities from 31/12/1987 to 31/12/2018. The only difference is that A, B, C, and D are based on 1, 3, 5, and 10-year valuation intervals respectively. With an investment horizon of 10 years, it is actually possible to compound $100 to over $1000 without experiencing losses at all. Warren Buffett said "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." Perhaps this is what he meant.

It's probably not realistic to expect investors to see their investment P&L only once every 10 years in order not to feel any losses. However, even "pretending" that your investment is valued every 5 years can reduce the pain of the market to market loss considerably from -51% to -4%.

PORTFOLIO DISCUSSION

While we encourage investors not to be concerned with short term market gyrations, it does not mean that we deploy capital and take our eyes off. Think of us as similar to farmers who plant, sow and harvest crops. Farmers experience VUCA in the form of crop prices (volatility), yield (uncertainty), disease (complexity), government policy (ambiguity). Despite the risks, farmers focus on monitoring and managing crop development.

The table below gives you a sense of how a longer time horizon can lead to a more satisfying reward.

Type of Crop	Time needed for tree to start producing
Banana	1 year
Orange	3 years
Durian	5 years

What can farmers do to improve the likelihood of a successful harvest after a long period of planting and sowing? One way is to start with seeds that are good and reducing input costs. Good seeds improve the yield and reduce uncertainty, while low input costs mitigate the impact of volatile crop prices. Similarly, how can we be sure that our investments are still around in 5 years and also generate returns? Just like the farmers, we focus on getting exposure to risks with persistent returns, and tend to our FAF portfolio of cheap and good stocks regularly so that we can improve the likelihood of a successful harvest.

Is all risk the same?

VUCA nicely sums up the different kinds of risk in investing. There is a whole range of investments with varying degrees of VUCA. Investors seek to get exposure to the type of risk that they can manage and expect to get rewarded for.

This week, I attended a session with Howard Marks, one of the world's most prominent investors. I have also used his quotes in our previous letters as I find his thinking insightful. Howard said that most price change is psychological not fundamental. Due to **Uncertainty**, the inherent swing of markets on a fundamental basis goes from very good to not hot. When one factors in market psychology, the swings go from flawless to hopeless, as exemplified by **Volatility**.

Our investments focus on managing volatility and uncertainty. Market volatility creates mispricing opportunities for us to capture. Uncertainty in business metrics at different parts of the cycle allow us to rotate out of stocks with low return on capital and poor valuation into stocks with high return on capital and attractive valuation. The nice thing about focusing on volatility and uncertainty is that it is a question of when, not if, the returns will materialise.

The table below shows the likelihood of positive returns for investments in the market, cheap or good attributes, as well as when they are combined in FAF. For all opportunities, we can see that the likelihood of gains improves when assessed over a longer period. More importantly, investing in a portfolio of cheap and good significantly increases the probability of gains from 72% to 97% over a 5-year period compared to investing in the market.

Probability of positive returns	**Rolling return period**			
Investment	**Monthly**	**1-year**	**3-year**	**5-year**
Market: MXAPJ	55%	67%	67%	72%
Cheap: Value	60%	68%	81%	78%
Good: Capital Efficiency	63%	71%	80%	85%
Cheap & good: FAF multi-factor	61%	72%	91%	97%

Probability of gains for different rolling periods from 31/12/1992 to 31/12/2018
Source: Bloomberg, Finexis Asset Management

Financial markets are already complex in terms of dealing with multiple dimensions and evolving relationships among them. Furthermore, practitioners have a tendency to use different jargon for things which are essentially the same. A key way for us to reduce **Complexity** risk is "keep it simple" by distilling issues to what are significant, and identifying common elements. This is consistent with our approach of focusing on key drivers of markets.

What we are not experts at, and seek to minimise is **Ambiguity**. Generally, we do not like situations that entail asking "Will it or will it not?" which amount to a coin toss. Risks such as geopolitical events or the outcome of a drug trial for which we have no insights have binary outcomes that are hard to predict. Returns from these situations are a question of if, not when. We prefer a coin that is biased in our favour which we get from the risks we prefer.

When we select stocks with favourable attributes of cheap and good, we increase the likelihood of the durability of the portfolio and the return potential. If markets reward equity investors more for taking more risk, certainly investing in cheap and good companies will be even more rewarding. Because our cheap and good portfolio is diversified, rather than making outsized bets on a single stock, our major source of returns comes from positive attributes that markets persistently reward. Hence it is a question of when, not if, the reward is there.

If anything, the 15% decline in 2018 serves as a timely reminder after the 16% gains in 2017 that investments entail different degrees of risk that investors must be prepared to bear. In our Q2 2018 letter, we talked about how equities are inherently volatile and that it is an inevitable ingredient in achieving long term returns.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer