ASSET MANAGEMENT
汇信资产管理有限公司

INVESTOR LETTER
April 2019

Dear Investors,

The FAM Asia Fund closed the first three months of the year with +16.35%; a commendable achievement by any measure. Some investors asked whether we had done something different? The answer is: No, we did not. It is no surprise that we had outperformed this quarter, just like we were not surprised about the decline for FAF in the last quarter of 2018. What we had done is simply stick to our investment and risk management process. We would actually be worried if the fund did not behave like that.

We started this series of letters initially for investors in the FAM Asia Fund. Over time, we realised that the discussions were also relevant to investors in our global asset allocation strategies. Starting this quarter, the letter will cover my general thoughts about investments, which will be accompanied by specific discussions on our asset allocation and equity strategies.

HOW TO ACHIEVE INVESTMENT GOALS

Recently, I was considering options for how to manage the investable cash in my son's piggy bank. He is sufficiently insured. He gets recurring income (pocket money) that funds his expenses. He draws on the piggy bank when he needs to buy inventory (usually toys). Other than that, he generally does not have other liabilities or cash flow needs.

I was approached with an endowment plan, and it sounded pretty compelling. There were guaranteed returns of 2.5% for the next 5 years with withdrawal options.[1] A check on offerings from comparefirst.sg gave me a better feel as to the options available. I could get 105% insurance with different term to maturity and choose between:

1. **Withdrawal or non-withdrawal,**
2. **Capital guarantee or capital non-guarantee upon maturity,**
3. **Higher guaranteed return or Higher projected return.**

Then I thought about the key objective of an endowment: to generate wealth to a target value at maturity through investments. The features of the endowment plan (insurance, withdrawal, guarantee) serve to provide some peace of mind; but were the features necessary in order to achieve the objective of growing wealth? More importantly, would the features actually affect the wealth compounding?

Feature #1: Withdrawal

This was the part which was at odds for me as an investor. Market investments can be withdrawn or liquidated anytime. Was there a need for withdrawal to be a feature? A greater concern surfaced when I asked: What if we fell on bad times in future and really needed to liquidate the investment? For a direct

[1] https://singlife.com/endowment-250

investment, we could realise it at prevailing market value, while the surrender value for an endowment before maturity could be much lower than premium paid.[2] Endowments are helpful as "forced" investments for those who find it difficult to set aside capital to invest instead of spending. In times of need, the benefits of the "forced" investment will be less appreciated.

Feature #2: Capital Guarantee

How does the endowment give an explicit guarantee? Invariably, consumers have to pay a cost for that certainty as no financial institution will underwrite a guarantee without being compensated for it. If my son only needs to cash out of his investments to fund his education at the point of maturity, does he need to pay for a guarantee on the interim value of the endowment? In any case, the guarantee only applies if the endowment is held to maturity. Furthermore, it will be harder to provide capital guarantees in the current low interest rate environment, which is evident from more endowment products that are not providing capital guarantees.[3]

Feature #3: Higher guaranteed return or higher projected return

Endowment plans offer a guaranteed return from 0-2.5%, and projected return from 2-5%. Table 1 shows the annualised returns for passively-managed portfolios on a 10-year rolling basis from 1976 to 2018. Even without an explicit guarantee feature, the likelihood of being profitable investing in bonds or equities over **any** 10-year period is 100%. For the bond portfolio, the worst annualised return was 2.5%. Perhaps it is not a coincidence that a product with one of the highest guaranteed returns in town can offer 2.5% guaranteed returns. It seems that it is not necessary to protect the downside as given time, the market will bring return the capital and more.

Table 1 10-year rolling annualised return for various portfolios

	10-year rolling annualised return		
	100% bond	**Balanced 50% equity + 50% bond**	**100% equity**
% positive	100%	100%	100%
Worst	2.5%	3.6%	0.3%
Median	7.1%	7.9%	8.6%
Best	14.1%	14.4%	15.8%

Equity: MSCI World Developed markets from 31/12/1976 to 31/12/1987, and MSCI World from 31/12/1987 to 31/12/2018.

Bond: Bloomberg Barclays US Aggregate Bond Index from 31/12/1976 to 31/12/1990, and Bloomberg Barclays Global Aggregate Bond Index from 31/12/1990 to 31/12/2018.

Source: Bloomberg, Finexis Asset Management

Interesting enough, moneysense.gov.sg which is the Singapore government's website for financial education, also addresses the topic of whether one is better off investing in a diversified portfolio instead of an endowment.[4] You may ask: Is it necessary to invest into equities since bonds seem to have done very well???

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[2] http://www.comparefirst.sg/wap/homeEvent.action
[3] http://www.comparefirst.sg/wap/homeEvent.action
[4] https://www.moneysense.gov.sg/-/media/moneysense/media-article/endowment-plans-watch-the-caveats.pdf

How much difference does 1.5% make?

Let's look at how a 100% bond investor would have fared against a 100% equity investor. After all, it looks like just an insignificant median improvement of 1.5% annual returns by investing in equities vs bonds. Figure 1 shows the total return of bonds and equities from 1976 to 2018. For a starting value of $100,000, an equity investor compounding at just 1.5% more can achieve a total value of $2,882,000 vs $1,612,000 for a bond investor. **Imagine being able to make a million dollars more with the same capital just by making a choice?** With a sufficient investment horizon (and proper investment and risk management), it does not seem worthwhile passing up such wealth gains.

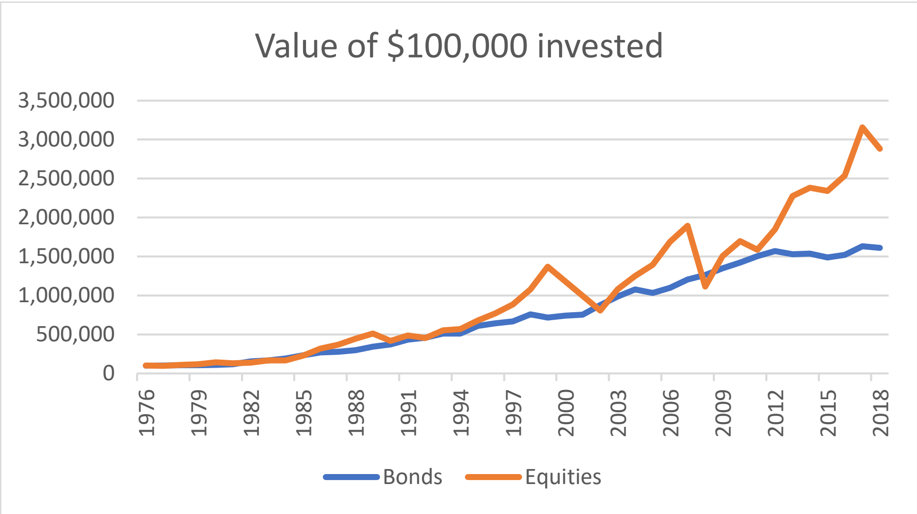

Figure 1 Total value of $100,000 invested into equities and bonds

Equity: MSCI World Developed markets from 31/12/1976 to 31/12/1987, and MSCI World from 31/12/1987 to 31/12/2018.

Bond: Bloomberg Barclays US Aggregate Bond Index from 31/12/1976 to 31/12/1990, and Bloomberg Barclays Global Aggregate Bond Index from 31/12/1990 to 31/12/2018.

Source: Bloomberg, Finexis Asset Management

Furthermore, we have not factored in the future investment environment which is very challenging for bonds to deliver similar returns as before (Figure 2). Since 1981, bonds gains have been anchored by a multi-decade decline in interest rates. Interest rates may stay low instead of going up like the period from 1962 to 1981, but rates are not likely to go lower. There are a few generations of investors have not experienced **"losses while investing in bonds"**, but if history tends to repeat itself, shouldn't we learn from history to be better prepared?

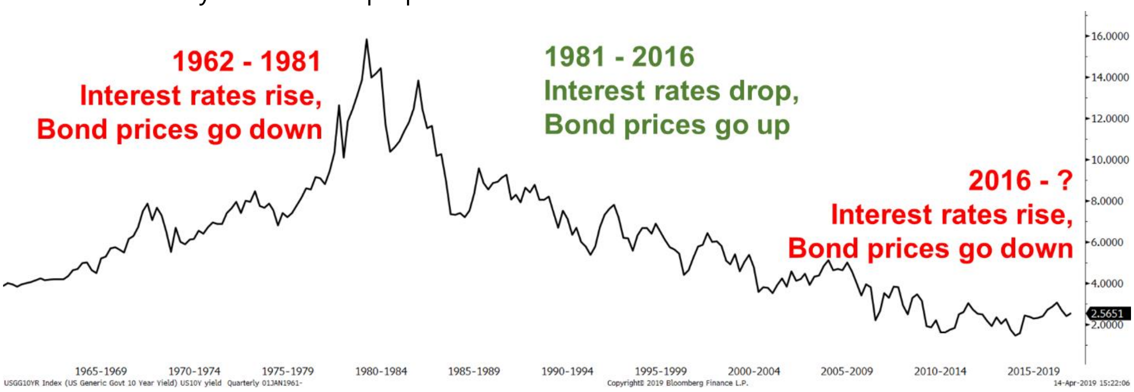

Figure 2 US 10-year bond rates

Source: Bloomberg

Why investing in equities can give you higher returns?

If I rephrase the question, the answer should be more intuitive: Who tends to earn more, a successful business owner or a creditor of the business?

I'm sure a lot of us have contemplated (or flirted with the idea of) running our own business. This would be driven by a passion for the business, as well as a means to monetize the passion and resources put into the business. However, one does not need to be a business owner; as an equity investor, you can have someone run the business for you while you enjoy the fruits of their work. Contrast this against a bond investor or lender who gets limited upside even when the business does well.

This is not a pipe dream that works only for the best entrepreneurs or stock pickers. Looking at the best returns in Table 1, it seems like bond investors can also achieve similar high returns as equity investors. Here the difference is one of probability:
Figure 3 shows that a generic equity investor is likely to achieve higher returns than a bond investor. The blue line shows that **bond annualised returns are more likely in the single digits**, while the orange area shows **equity returns are more likely in the double-digit range**.

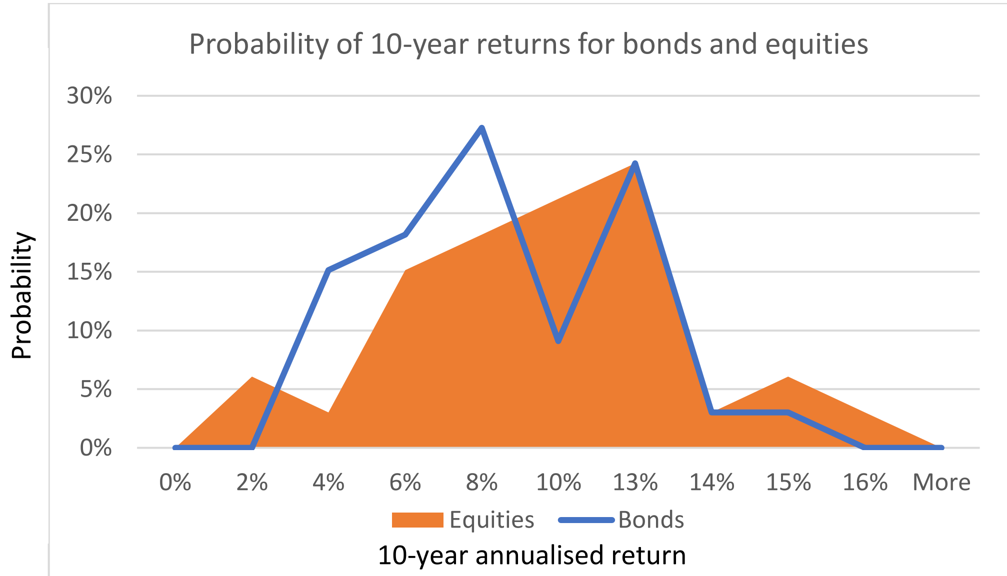

Figure 3 Probability of 10-year annualised returns for bonds and equities from 1976 to 2018

Source: Bloomberg, Finexis Asset Management

Risk management

Yes, it is true that the highest return comes from being an equity owner. At this point, I have to warn that businesses can fail, resulting in potential full capital losses. So, what can we do to mitigate such catastrophic losses? One obvious way is not to own one business but own a portfolio of businesses.

There are a few other ways to mitigate losses. None of these are rocket science, it's just that we stick to our ethos of risk management: **Knowing what we are exposed to and making sure they are behaving as expected.** Generally, more risk translates to more return. If there was no risk, there would be no reward. The key is being able to understand the inherent nature of the strategy, take on and manage the risk. In fact, we should be worried if a strategy that was inherently higher risk was not volatile. That is why we had no surprises when FAF declined 15% in 2018, and rose 16% this quarter.

Risk management also entails the element of "can" vs "will". Tail risk or large extreme losses affect the emotions, and many investors never get back into the market. We try to mitigate such tail losses not by contemplating how we "can", but by doing. Take the most recent case in March where we had some concerns and reduced equity exposure in FGO by implementing hedges (instead of selling and going to cash). Consequently, markets shook off the jitters and continued to rally, and we decided to cut our hedges and move on. However, we do not see the hedges as a waste; just like when you see potential disaster coming, you will quickly put up insurance for your property in case disaster really happened. By paying a small "insurance premium", the hedges would have reduced the portfolio downside significantly if markets crashed. Most importantly, we have also gone through an "exercise" to be more ready for the real deal which will be here one day.

For our investors, I'm sure you prefer to do other things rather than monitor portfolios and do risk management daily. But in order to get where you want to be in future and achieve your investment goals, one important point to remember: **Don't check in on the investment only when it is due**. Instead, do a status check in advance. For example, if your child is planning to enrol in college in 2019, do a check on the portfolio in 2017. With two years to go, the prior years of investments should have done the heavy lifting in terms of wealth accumulation. Plan well and plan ahead, and let time do the job. Like we always say, you cannot predict but you can prepare.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer