INVESTOR LETTER
October 2021

Dear Investors,

Investing can be paradoxical for many. How can one be confident of a favourable outcome in the face of ongoing events that create volatility and trigger uncertainty?

Over the years, I have attempted to illustrate how we are confident that superior returns are not just achievable, but highly probable. Last quarter, I wrote about "what goes down must come up". To which an investor might ask "Even with the tools and processes, how can I be sure of the outcome?" In January 2019, I wrote about how viewing markets with a 5- or 10-year horizon would effectively take away losses for an investment. To which the counter might be "This time is different."

Indeed, both arguments above were more centred on comprehending and managing volatility i.e. "take the pain and you will be rewarded". As greed and fear are the major motivators of human behaviour, these arguments on managing pain did not address the greed factor for those who might ask "so what if I take the pain?" What if we had a way to figure out what our future return might be?

How can I be sure about equity returns?

It might seem like a surprise for those who have been following us that we have a way to figure out our future returns, for we have always maintained that we do not predict. To be clear, we are not able to predict things such as "will the markets drop in the next n months?" but we are able to estimate our expected return.

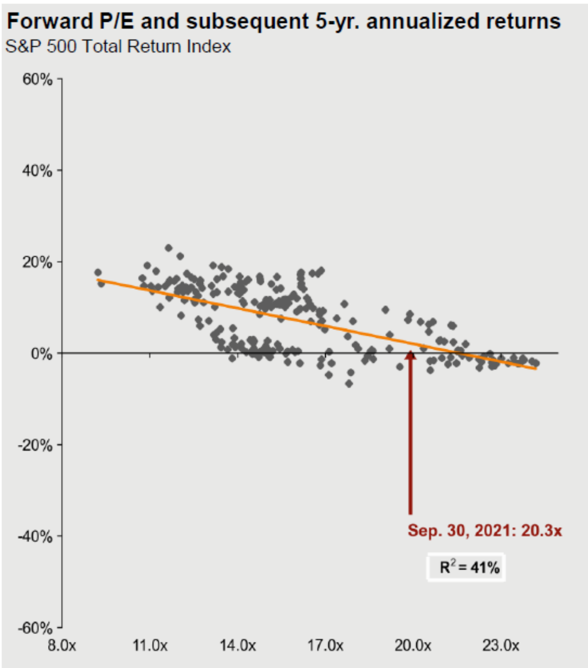

Figure 1 Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Data from 8/31/96.

Figure 1 shows the relationship between valuation (in this case the forward P/E) and subsequent 5-year annualised returns for the S&P 500 index. Each dot represents a point in the history of the S&P

with its valuation at that point in time, and the annual return an investor would have received 5 years after. The zone of lower valuation starts on the left side and shifts to zone of higher valuation on the right. Negative returns are indicated on the bottom half and positive returns on the top half. Cumulatively, what the dots are telling us is that in general, investing at times of lower valuations leads to higher annualised returns 5 years later, and investing at higher valuations leads to lower 5-year annualised returns.

This is a very powerful relationship, one that is time-tested across bull and bear markets. At the same time, we find ourselves in a situation today where **S&P 500 valuations are on the higher end of the valuation spectrum**, and if history is to repeat itself, **the expected returns going forward are in the low single digits**; not a great proposition especially if one is taking on equity risk. And while the S&P 500 may have rewarded investors handsomely in the recent years, further appreciation may bring it into the zone of expected negative returns if the valuation rises even higher.

But we are not beholden only to the S&P 500 market of large cap US stocks. There are plenty of opportunities in the US and outside of it for investors who are willing to look. Within the US, small cap stocks are trading at multi-year low valuations relative to large cap stocks at this moment, presenting us a better opportunity to get a higher expected return.

This is why valuation forms an important tenet of our FVT investing process.

Can it work for near term returns?

Now if we are confident about our prospective return 5 years out, can we push the envelope and make it work out in a year? Regrettably, **the answer is no.**

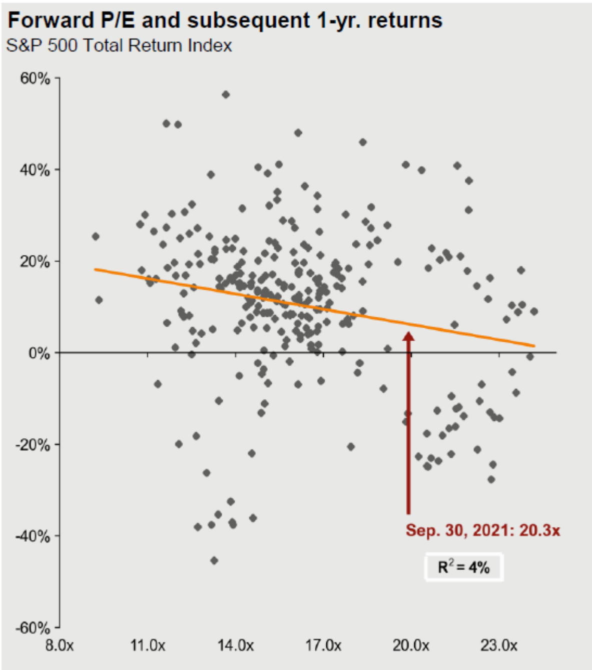

Figure 2 Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Data from 8/31/96.

Figure 2 shows the same analysis done on the S&P 500, this time with subsequent 1-year return instead of for 5-years. We find that for an investment horizon of 1 year, the returns can swing between extremely positive and negative as shown in the widely dispersed dots. **There is no chance of forming a more predictable relationship.**

How can this happen? In our July 2020 letter, we referred to what Benjamin Graham observed in 1940; that “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” The dots actually are the votes by the market. It is clear on a 1-year horizon, market participants’ votes do not matter in terms of predicting the final winner. However, these emotional responses and **the accompanying extreme pessimism and optimism generate large swings,** creating opportunities for those move differently from the herd.

How can I be sure about fixed income returns?

Can we also have similar confidence in predicting our future fixed income return? The answer is yes.

The dark blue line in Figure 3 shows the historical yield of the Bloomberg Barclays Global Aggregate index, a widely used barometer of global investment grade bonds. The light blue line shows the subsequent 5-year annualised return for an investor who invested at the respective point in time at the prevailing yield. The chart tells me two things.

1. **The yield at any point in time is a good predictor of future returns 5 years on.**
2. Today’s low yields mean that **the return for an investor in global investment grade bonds in 5 years is near 0%**, and one should not extrapolate past performance as those were from years where yields were higher.

Figure 3 Bloomberg Barclays Global Aggregate Starting Yield and Subsequent 5 Year Return

Is the outlook for bonds so bleak? Yes, if one was focused on the opportunities that many investors default to. But look beyond the typical fare of investment grade bonds; by considering opportunities across different geography, credit quality, and duration, we are able to identify investments that we expect to provide subsequent higher return.

This letter shows that attractive valuations indeed set one up for better outcomes. But I would warn against using valuation in isolation as nobody wants to catch a falling knife. That is why we have our multi-prong FVT process which provides complementary insights to allow time to do its work.

Best regards,

AlvinGoh

Alvin Goh
Chief Investment Officer

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