finexis ASSET MANAGEMENT 汇信资产管理有限公司

INVESTOR LETTER
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Dear Investors,

Feeling the wind

Imagine you are out on the sea on a boat enjoying the sea breeze. Imagine the wind turns, and now you feel it blowing cold in your face. Through the course of your journey, the wind changes direction and intensity. Sometimes it feels good, other times the chills may make you feel outright miserable. This is an undeniable truth: anyone on a boat has to accept that winds blow from all directions, almost randomly.

Markets also behave like nature. There are market winds that keep changing direction and intensity, sometimes making investors feel good, other times making them miserable. Because these market winds are felt and keep shifting, many investors get confused by the wind. Sometimes they may even get blown off course.

Yet sailors have found ways to get to their destinations, by positioning their sails to cut through the wind, and using a force that is less visible but more powerful: the ocean currents.

There are stronger forces beneath the surface

When one imagines a sail boat on the sea, the image of the boat buffeted by the wind almost always crops up. Few think of the ocean currents beneath: the continuous, directed movement of sea water that is part of the global conveyor belt that seafarers use to cross oceans.

Why do sailors use the ocean currents even though they are not so visible? Because ocean currents are patterns that are **repeated, persistent, and predictable**. Sea farers make use of the ocean currents when they happen, but cannot make them happen at will. For sea farers of before, they used a combination of knowledge that was passed down and experience to make those ocean crossings. Today, sailors make use of data and software to better identify ocean currents and plan their voyage.

Just as markets have winds, they also have ocean currents. Our interest and job are to study the market currents, and **position our portfolios to ride these massive currents**.

What currents are we taking advantage of?

What are these repeated, persistent, and predictable patterns we are looking to profit from? One example is the Valuation cycle. Figure 1 shows the valuation of the S&P 500 since 1880. This chart is often used in one form or another by market commentators, but what does it show?

It shows that at times, market participants are willing to pay more for the S&P 500; 25 even up to 45 times the annual earnings of the S&P 500, meaning it takes up to 45 years of earnings to get the same amount as one invested. There are also times when market participants are able to pay much less for the same S&P 500; 5-10 times the annual earnings. In these periods of low valuations, investors need to wait less than 10 years for earnings to cover their investments.

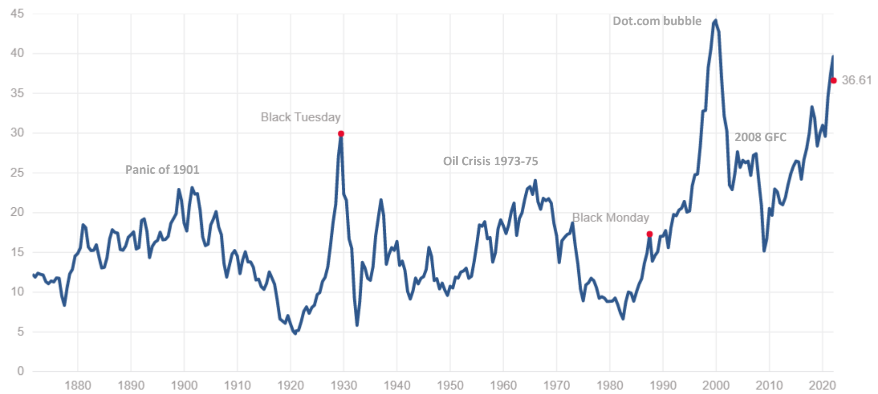

Figure 1 S&P 500 Shiller P/E valuation. Source: https://www.multpl.com/shiller-pe

Why are there times when investors are willing to shell out more for the same thing? Optimism. Optimism driven by hope that recent experience can be extrapolated indefinitely into the future. Hope emboldened by recent experience of strong returns validated from reports showing 1-3-5 year returns.

Such periods of optimism offer great memories, memories of immense wealth generation in a short span of time as portfolios rallied on and on. However, such optimism typically turns, and turns quickly when it happens.

Figure 1 marks the valuations peaks over the past 150 years with panics and crises that have led to destruction of investor capital. Investors who stayed in overvalued markets might have enjoyed some gains and enjoyed while the winds were blowing nicely for them, but were positioned against the massive ocean currents that would turn on them in due course.

Is it possible to ride the crest of valuation and get out before the tide of optimism crashes? In a way, markets are like real life. If you wait until the turn at the road to brake, it's usually too late. Today, the S&P 500 is trading at valuation levels not seen since the dot.com bubble, and well above that of prior crises. Does it make more sense to look elsewhere where less optimism is being priced in?

Why are there times when investors can buy the same thing at a fraction of its peak? Pessimism. Pessimism driven by a gloomy view of the economic future. Gloom reinforced with recent experience of sub-par returns validated from 1-3-5 year reports.

Such periods of pessimism offer great opportunities. These opportunities are available for anyone in the market, but only few take them up. In my years of investing, I've seen plenty of charts labelling the valuation peak panics and crises. Strangely enough, I do not see many that label the valuation trough opportunities. I guess fear sells better. But it suits us fine when massive opportunities are underappreciated.

Why the currents are useful to us

By now, some of our regular readers will realise that the valuation cycle is part of our FVT framework for investing. Just like modern-day sailors, studying and making use of the valuation cycle helps us to ride out the markets winds and navigate the markets successfully in the long haul with confidence.

Valuations are a good indicator of future return

Figure 2 is similar to a chart we showed in our last investor letter where the study started in 1996. It showed there was a relationship between valuations and the subsequent return one would get: **The lower the valuation, the higher the subsequent returns**. Conversely, **the higher the valuation, the**

lower the subsequent return. Sceptics might feel that less than 30 years of data was not indicative, so this time we went back as far as 1927, going back as far as there is data for the S&P 500. From the 1940s, the world has gone through the Digital revolution, a shift from analog to digital, a “this time is different” moment. Yet, the relationship between valuations and subsequent return was unchanged. While some things change, some remain the same.

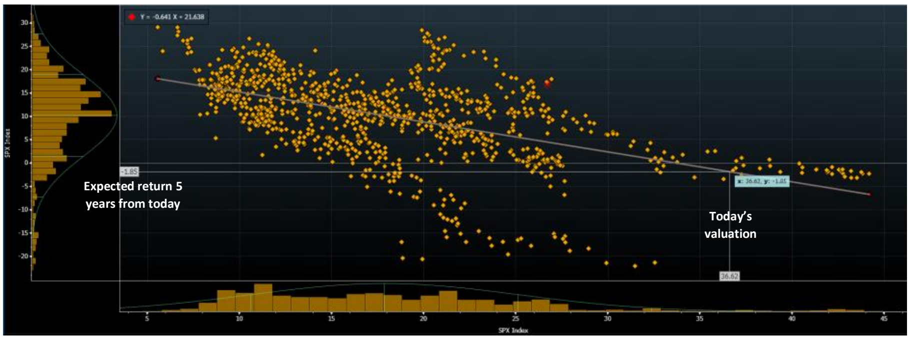

Figure 2 S&P 500 Starting valuation and Subsequent 5 Year Return from 31 Dec 1927. Source: Bloomberg.

With the S&P 500 valuation is at cyclical highs today, history is saying that subsequent returns are going to be low if not negative. What should investors do? Before doing anything, it is important to highlight that even with bear markets, equities grow wealth the most among major asset classes for those who sit through the cycles.

Do I need to wait 10 years for a valuation trough?

There may be some readers who feel that more can be done by reallocating out of overvalued markets. But they might see from Figure 1 that the S&P 500 offers compelling opportunities i.e. valuation troughs every 10 years or so. Can one, or should one wait so long? My response is no, and no.

The good news is that when the opportunity set is broadened to other markets, one does not have to wait so long. For example, when the S&P 500 is overvalued, segments such as US small caps and emerging markets are at the opposite end of their valuation cycles. Where investment grade bonds offer little value and prospective return, credit valuation cycles also offer opportunities in high yield markets which we take advantage of. It also applies to sectors, where we have benefitted from allocation to the energy sector during its own valuation trough.

Valuation cycles exist just about for every market that we study, which means ongoing opportunities for us to diversify into, and not have to put all our eggs in one basket.

We make use of the valuation peaks to reduce exposures in areas that are less attractive, and troughs to increase exposures to areas that provide better risk-reward going forward. Invariably, this means we are reducing exposures to areas that have done well on a 1-3-5 year basis, and adding to areas that are doing badly on a 1-3-5 year basis. In doing so, we are positioning our portfolios to cut through the market winds, and positioning for the nascent ocean currents rather than the ones that are about to die off.

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer

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