THINK DIFFERENTLY
TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

July was a haven for investors, capping off a rough few months with a strong rally in global equities and bonds. One might wonder how the markets can go from anguish to ecstasy in such a short period. But such is the nature of markets, which tend to be driven by emotions (reaction) rather than logic (evaluate and respond) and underscores the importance of considering valuations to enhance investment decision-making.

Will markets continue to rise, or will they crash like previous short-lived rallies? While no one can foresee what will happen, one thing is certain: markets always reach a bottom. Long-term investors would be prudent to remain invested rather than attempt to predict bottoms and time the market, as missing out on periods of strong gains that tend to occur after the worst periods has a detrimental impact on long-term compounding.

Today's VUCA environment requires a disciplined yet adaptable approach to investing. Many zombie companies have been bolstered by the previous year's great market performance, but just as swiftly as the rising tide elevated them, tough market conditions this year sunk them. Investing in strong, profitable resilient firms is one simple and effective way for increasing portfolio resiliency. But, more importantly, to reap the benefits of long-term investing, investors must keep their calm amid volatility.

On a similar note, news of Chinese mortgage boycotts heightened investor worry, particularly for the Asian High Yield (AHY) markets in which we have invested. However, investors can take comfort in knowing that AHY is priced so that they are in a ‘heads we win, tails we lose less’ situation. Furthermore, struggling developers do not reflect the entire AHY investment, while China accounts for less than half of the exposure geographically. In fact, investors would be surprised to learn that AHY markets returned to positive territory for the month and with return expectations of approximately 13% p.a going forward.

MARKET REVIEW

Stocks slide to close worst first half in 52 years: S&P 500 plunges 20.6% YTD, 8.4% in June

Emily McCormick · Reporter
July 1, 2022 · 4 min read

The above headline was from last month, around the time of our previous commentary. Who would have imagined that the next month would have the following headline?

July Marked Best Month For Stocks Since November 2020:

Hank Tucker Forbes Staff
Follow
Jul 29, 2022, 04:40pm EDT

How can one make sense of these back to back market moves? Instead of thinking that markets are efficient, one might think that markets are schizophrenic; panic one moment, and euphoria the next.

The parable of Mr Market
Benjamin Graham, who taught Warren Buffett, used Mr. Market to describe the contradictory traits of markets which are driven by panic, euphoria, and apathy.

When there is panic, it is natural to try to find reasons to justify getting out of an uncomfortable situation. Similarly, when there is euphoria, it is natural to try to find any reason to justify getting in.

When oil prices* hit $120 in June, investors worried that inflation and geopolitics would push oil prices higher, and wondered if one should invest in energy. Currently, inflation and geopolitics still exist but oil prices have declined 25% to $90. Anyone who invested just because prices were high would have taken a loss.

That is not to say that inflation and geopolitics do not impact markets, but investors have to ask if they want to

- Be like Mr Market and approach investing as a reaction to their mood, or
- Respond to what is priced in the markets, rather than to prices themselves.

"Sell the rumour, buy on fact"
After years of maintaining low interest rates, the Fed embarked on a series of interest rate hikes from March. Since then markets have been abuzz with conversations on if and how much each hike would be.

There have been four hikes since March, with the recent two hikes the largest at 0.75% each. A closer look at bond markets would show that during the last two hikes, bond markets rose instead of dropping as expected. How could this happen? A typical response in financial circles would be it was a case of "sell the rumour, buy on fact".

What does this actually mean? It means bond markets had already sold off and priced in such hikes before the actual Fed action. In short, even if one was able to predict how much the Fed would hike at a particular meeting, such knowledge is not much help for investing. It is less important to know how much the Fed will hike at each meeting, and more important to know how much markets are pricing in. This is why we do not seek to predict, but use valuation to guide investment decisions.

Some fixed income investors are contemplating taking action after seeing declines on their bond investments. Some are dumping investing altogether, others are shifting to a different risk profile, favouring equities over bonds.

Before doing so, we would ask them to consider this. Declines are ways for overvalued markets to self-correct. After the recent declines, bonds actually have better value than before. If investors continued to hold overvalued bonds before, and are planning to cut more attractively valued bonds now, they are doing more harm than good. **Two wrongs do not make a right.**

https://finance.yahoo.com/news/stock-market-news-live-updates-june-30-22-115133813.html

https://www.forbes.com/sites/hanktucker/2022/07/29/july-marked-best-month-for-stocks-since-november-2020-here-are-the-markets-biggest-winners-and-losers/?sh=55163b467aad

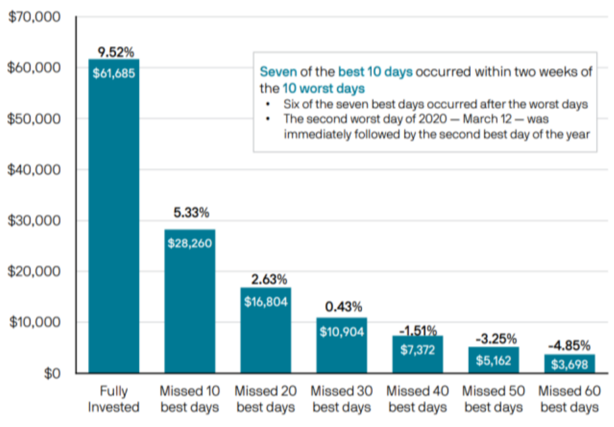
**Source: Bloomberg. Crude oil futures.*

POSITIONING FOR RECOVERY

Many investors are probably wondering if the strong gains in July will continue from here on, or falter like the other short-lived rallies experienced over the past few months. **Unfortunately, we do not know precisely when markets will bottom, only that they will do so eventually.**

For the same reason, we kept our recovery positions intact amid ongoing concerns about inflation, interest rates, and a seemingly imminent recession. Why not stay on the sidelines and revisit when things 'feel' better? The data shows that such actions can turn out to be very costly, as investors are prone to miss out on periods of swift and strong gains that negatively impact long-term compounding as shown in the following study:

Performance of a $10,000 investment [1]



The right answer points to 'doing nothing' – *provided* the investor has in place a prudent and disciplined investment strategy.

Along the same lines, Howard Marks, co-founder of Oaktree Capital Management, recently said 'the possibility – or even the fact – that a negative event lies ahead isn't in itself a reason to reduce risk; **investors should only do so if the event lies ahead and it isn't appropriately reflected in asset prices**.' Herein lies the reason for our FVT (Fundamental, Valuation, Technical) process to guide our asset allocation.

Our current portfolio is the result of such considerations. We had avoided areas which were priced excessively and managed to escape losses that were hard (or impossible) to recover from e.g. speculative tech stocks which declined more than 90% in some cases. On the other hand, we maintained a preference for markets that were pricing in the risk of recession; such as US small-cap equities:

Valuation: Price-to-Earnings[2]

	2001 Sep 21	2009 Dec 3	2020 Mar 23	Today
Large Caps	18.0	9.3	14.3	19.8
Small Caps	12.2	9.3	10.8	12.7
Small-Cap Premium/ Discount	-32.2%	0%	-24.4%	-36.0%

Depths of **recession**

While they were not spared from the year-to-date declines, the margin-of-safety ensured that small-caps were not worse off despite their reputation for being 'riskier'. On the other hand, we have certainty that they can rebound more strongly when markets do eventually recover.

Our undervalued European equity allocation had a strong start to the year before the Russia-Ukraine invasion brought about fresh bouts of volatility. We maintain a neutral exposure to European assets for now, as prices are already reflecting a lot of bad news. We will continue to monitor the situation and adjust as necessary, but like before, you do not want to be in a hurry to cut a position just because it has declined as it may now be presenting better value.

Jumping from one investment to another is never a good idea, especially if it is to chase another investment that had already done well. Echoing Howard Marks once more: '**If you wait at a bus stop long enough, you're guaranteed to catch a bus, but if you run from bus stop to bus stop, you may never catch a bus**.'.

Source: [1]JPM Guide to Retirement Data: S&P 500 from 1/1/2002-12/31/2021 [2]Data: Russell 2000 Index and S&P 500 as of 8/4/2022, Positive Price-to-Earnings Ratio

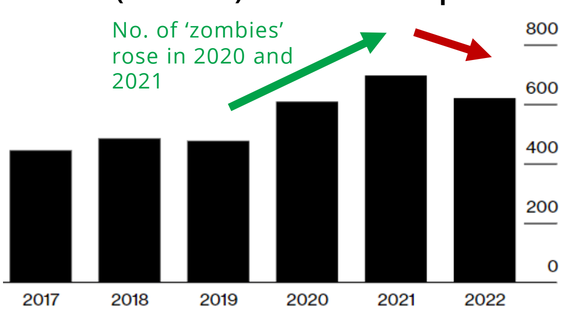
STABILITY AMID VUCA

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

'The easy money of the pandemic created bull market geniuses that were rewarded instantly, and spectacularly…but they were surfing with a hurricane behind their backs.'[1]

A rising tide lifts all boats
The hurricane of the past years came largely in the form of ultra-accommodative policies courtesy of the US Fed. Subsequently, asset prices were lifted across the board; without consideration if they were good or bad investments. In fact, we observed 'boats with holes' that would typically sink were instead kept afloat…temporarily.

The rise (and fall?) of zombie companies[2]



Back to fundamental investing?
Now that the hurricane has dissipated (and even reversed!), it is likely that good old-fashioned investing will reassert itself. Indeed, we have already observed the number of 'zombie firms' being kept afloat sinking alongside their stock prices this year. **Throughout history and across multiple market cycles, long-term investment returns are always made up of fundamental and valuation factors**. Like the famous quote coined by Benjamin Graham: 'In the short term the stock market behaves like a voting machine, but in the long term it acts as a weighing machine.' We want to be positioned for the weighing machine.

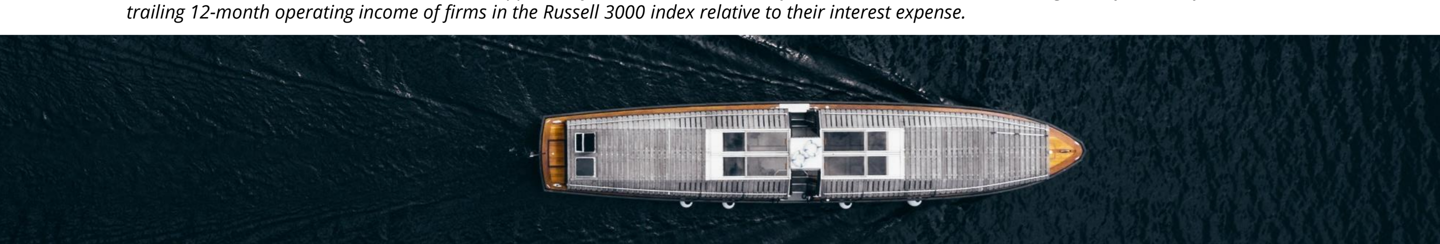
Managing VUCA
VUCA is used to describe environments with Volatility, Uncertainty, Complexity and Ambiguity – which few will dispute is the environment that we are in today. We believe that there continue to be opportunities to be found and money to be made, but investors need to be able to adopt a disciplined yet flexible approach to investing. This means investing in areas which are undervalued or fairly priced as mentioned before, and also employing True Diversification to manage the known unknowns. When will markets bottom? What do the latest US-China tensions mean for markets? We do not claim to know exactly what will happen in the coming months, but we can manage our portfolios so that they are able to withstand the unexpected.

A simple but effective way to construct resilient portfolios is by introducing stability. For us, this comes in the form of highly profitable companies which are more resilient to the ebb and flow of the economy. Profitable companies tend to have high Margins, Return on Assets, etc. – all the characteristics that you would expect of a good company and investment.

The results speak for themselves: globally, the most profitable stocks have outperformed the most unprofitable ones in the past year. It is no surprise then, that our Healthcare and Quality Value equity positions have benefitted, as they are market segments which consist of many profitable companies. Consequently, they have provided our portfolios with much-needed stability during such uncertain periods.

With our portfolios positioned to tide through short-term volatility, all that's left is for investors to remain level-headed and disciplined in sticking to their journey to reap the rewards that markets are offering over the long term.

Source: [1]Australian Financial Review: 'Gamestopped: why this could be the end of the meme stock era.' [2]Bloomberg. No. of 'zombie firms' based on trailing 12-month operating income of firms in the Russell 3000 index relative to their interest expense.



SEARCH FOR YIELD

In late 2020, there were concerns that excessive leverage in the property sector posed systemic risk to the Chinese economy. The sector has since gone through a deleveraging cycle, which has reduced the systemic risk. Such deleveraging resulted in declines in the Asian High Yield market, which created opportunities for us to add exposures.

In mid July, news of mortgage boycotts surfaced, creating concerns for investors. Subsequently, more news emerged.

China Mulls Seizing Builders' Idle Land to Fund Frozen Projects

Bloomberg News
July 29, 2022 at 7:18 PM GMT+8

China plans real estate fund of up to US$44b for distressed sector, says source

MON, JUL 25, 2022 - 4:30 PM | UPDATED MON, JUL 25, 2022 - 7:25 PM

Which article do you think received more hits?

The first article on land seizure may sound alarming but let's take a look at what it is trying to achieve. The property sector is currently in a stalemate: housing projects are not being completed as contractors do not have confidence they will be paid by the developers who are experiencing cash flow issues. In turn, developers are not able to complete projects, get paid, and move on to new projects.

Hence, the land seizure plan is to try to **get the property sector to regain momentum** by getting some financing into the system. Other measures to get the property sector moving include the real estate fund supported by the Chinese central bank.

After deleveraging to prevent a bigger blow up, the government is now employing measures for the sector to recover without the excesses of before.

How did markets respond when the mortgage boycott news broke? Asian High Yield (AHY*) markets rose 4.4% while China equity markets were down -4.1%, so it was not a case of the tide lifting all boats. This is also despite the subsequent news of the land seizure. Is this another case of sell on rumour, buy on fact, just like what we saw with US government bonds? We can never be sure.

**Source: Bloomberg. AHY: Bloomberg Asia High Yield Bond, China equity: Hang Seng China Enterprises, 20-29/7/2022.*

But what we are confident is that Asian High Yield markets are pricing so much bad news that

- More bad news is less likely to impact AHY markets meaningfully
- We don't need to rely on very optimistic developments to profit on the AHY position

This is essentially a **heads we win, tails we lose less situation**. And we are able to do this because of our focus on FVT, adding when markets are down and providing some margin of safety.

While we cannot predict markets, **we can invest for predictable outcomes**. What kind of outcome do we expect?

We expect a return of ~13% p.a. over the next few years from AHY markets. But we also expect that

- It will not be a smooth 13%; markets will continue to be volatile, and the journey ahead will be rough
- The returns will be lumpy; coming in a small window which we cannot predict, so **we prefer to be positioned for the recovery rather than try to time it**.

How are we confident the bonds will recover? This is where our **PPP process of knowing what our Positions are is essential**. News articles tend to shine the spotlight on certain troubled developers. But these troubled developers do not represent the AHY investments.

Geographically, China makes up less than half of the exposure, with diversification into other Asian growth engines such as India and South East Asia. Sector-wise, Asian real estate and financials (for those worried about Chinese Banks) also account for less than half of exposures, with the remainder in other sectors. Our AHY exposures are structured such that they are a balance between capturing the investment opportunity while being adequately diversified.

https://www.bloomberg.com/news/articles/2022-07-29/china-mulls-seizing-builders-idle-land-to-fund-frozen-projects?sref=uinoKNE3

https://www.businesstimes.com.sg/government-economy/china-plans-real-estate-fund-of-up-to-us44b-for-distressed-sector-says-source

HOW ARE WE POSITIONED?

Positioning for Recovery	Stability Amid VUCA	Search for Yield
China 'A' Equities	Healthcare Equities	Asian High-Yield Bonds
Emerging Markets Equities	Quality Value	Emerging Markets Short Duration Bonds
US Small-Cap Equities		
Europe Equities		

The 'Positioning for Recovery' positions are expected to do well as the economy and markets gradually work through current shorter-term volatility, while the complementary Stability and Yield positions provide effective diversification to the rest of the portfolios.

ASSET ALLOCATION STRATEGY

-- Underweight | – Slight Underweight | = Neutral | + Slight Overweight | ++ Overweight

Equity: Regions

United States

US Small-caps as relative valuations are attractive and expected to benefit as economies recover. **Healthcare** as earnings are more stable and less dependent on broader economic cycle. **Quality Value** as valuations are 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

Maintaining no exposure as they are less attractive compared to other opportunities

Asia Pacific ex Japan

Maintain **China 'A'** slight overweight as deleveraging cycle has taken its course, with credit conditions expected to improve.

Emerging Markets

Neutral as valuations are attractive relative to developed markets, but where earnings tend to be less resilient

Fixed Income

Global

Focus on currency-hedged government bonds and unconstrained credit to buffer portfolio volatility during periods of stress.

Investment Grade Corporate

Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments

US High Yield

Maintaining no exposure due to relative poorer valuations.

Asia

Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.

Emerging Markets Debt

Hard currency short duration focus as a more defensive credit investment amid low rates.

MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	7.03	-14.35	9.95	8.67
United States	9.22	-12.59	13.79	10.00
Europe	7.76	-7.78	8.87	6.90
Japan	3.72	-1.26	12.61	5.52
Asia Pacific ex Japan	0.01	-15.64	4.95	8.88
Emerging Markets	-0.17	-17.68	3.20	9.20

Equity Markets	MTD	YTD	10Y	20Y
Australia	5.75	-4.09	10.95	10.10
Brazil	4.69	-1.58	6.28	12.51
China "A"	-6.33	-14.10	8.27	7.55
China "H"	-9.30	-14.04	0.30	9.81
Hong Kong	-7.32	-11.79	3.72	7.09
India	8.72	-0.26	14.33	17.69
Indonesia	0.65	7.92	7.64	17.46
Korea	5.10	-17.34	4.51	8.32
Malaysia	3.34	-2.95	2.44	7.49
Russia	1.54	-40.07	10.26	15.02
Singapore	3.56	4.98	4.14	6.47
Taiwan	3.05	-14.70	11.46	9.57
Thailand	0.53	-3.32	6.03	11.37

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-4.63	-17.90	-3.67	1.11
Energy	9.72	44.44	4.79	8.81
Technology	13.13	-20.40	18.49	12.80
Healthcare	3.29	-7.10	12.99	9.80
Financials	7.21	-12.86	13.20	5.25

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	2.13	-12.08	0.20	3.31
Global Aggregate (H)	2.55	-6.74	2.35	3.69
High Yield	6.63	-9.15	4.38	8.14
Asia	0.25	-10.42	2.75	5.31
Emerging Markets	2.11	-15.39	2.31	7.41

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
USD/SGD	-0.72	2.34	1.04	-1.22
EUR/SGD	-3.22	-8.04	-0.82	-1.00
JPY/SGD	-1.81	15.81	5.49	0.53

Commodities	MTD	YTD	10Y	20Y
Gold	-2.29	-3.46	0.90	9.20
Energy	-6.75	31.13	1.14	6.69

*As of **31 July 2022**. Source: Bloomberg. Total return in index local currency terms. 10 and 20 year returns are annualized.*

"Wealth isn't primarily determined by investment performance, but by investor behavior."

Nick Murray

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