THINK DIFFERENTLY
TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

2022 has not been pleasant. Bonds and stocks have declined in lockstep, leaving many investors scurrying for the door. Others who are uninvested remain so in order to avoid any pain or volatility. As sensible as it may seem, this leaves one at the mercy of inflation as the value of money slowly depreciates. Is there more room for the markets to fall? This appears to be the case for certain markets that are more overvalued such as the S&P 500.

Can investors earn high single-digit or even double-digit returns despite market weaknesses? Certainly, but only if they have the conviction to hold on for the long term, through good and bad times. Getting an above-average return often entails buying into markets when they appear the least attractive, i.e. markets with poor short-term (1/3/5 year) performance. In hindsight, these opportunities (such as US Small-caps) are often "tennis ball" investments that rebound strongly in contrast to "bowling ball" investments (companies with poor fundamentals or excessive valuations) that tend to crash and may never recover.

As central banks around the world continue tightening monetary policies to combat persistent inflation, the likelihood of a recession is high, if not imminent. Investors hoping for a swift 'V-shaped' recovery like the post-COVID recovery, would be disappointed to know that markets are more likely to undergo a volatile and prolonged "W" or "U" shape recovery. For the reasons explained above, it is better to invest defensively than to stay clear of the markets, and one way is to invest in healthcare, which tends to be resilient to both inflation and recession.

Opportunities frequently arise where least expected. As the Chinese put it: within crisis 危机 comes opportunity 机会. Rising interest rates may have lowered bond prices and reduced returns, but they also throw up opportunities elsewhere to invest at appealing valuations where the risk-to-reward ratio is very attractive. Asian High Yield (AHY) is one such area, which has provided better returns as compared to the popular Bloomberg Barclays Global Aggregate (Global Agg) during previous rate hikes. Investing now may be unpleasant, but what is uncomfortable is often very profitable. It is no wonder that many investors, in hindsight, wish they could go back in time to invest during such crises.

MARKET REVIEW

"In investing, what is comfortable is rarely profitable."

Many investors will feel that 2022 is very uncomfortable. Specifically, those who are invested into equities and bonds are seeing large declines. To make things worse, they are declining together, meaning the classical proposition for bonds diversifying equities is being questioned.

The only ones who might be comfortable are those who were holding cash. But **what's safe in the short-term is risky in the long-term.** While holders of cash are comfortable not experiencing volatility in their assets, inflation is an ever-present invisible thief that erodes the value of assets over time.

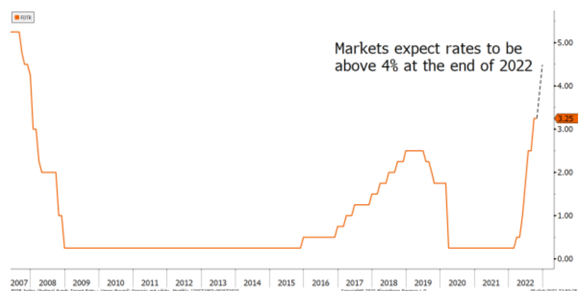
Above average growth led to above-average inflation. Consumers today are experiencing inflation rates at 8%, levels not seen since the 1970s. A few things came together to create this perfect storm: supply chains being disrupted and scaled back due to covid, post-covid rebound in demand, and geopolitics.

In geopolitics, there are worries about the Russia-Ukraine conflict, and how Europe can cope with an energy crisis going into winter. Such concerns are magnified with media reports of damage to the Nord Stream pipelines amid accusations of sabotage by governments.

Contrary to widely held fears of an impending shortage, **Europe can withstand a Russian gas cut-off**. Research by BNEF, a research provider covering global commodity markets, shows that Europe would still have enough gas to endure the coldest winter of the last 30 years without depleting its inventories.

As the world transitioned out of covid, pent up demand for goods gave way to pent up demand for services. This led to a strong and uneven surge, and above-average economic growth rates. However, for economies to get back to average long term growth rates, they have to slow down. **This is why a slowdown is a matter of when, and how hard.**

The question of when was addressed when the US Fed embarked on its series of interest rate hikes this year, designed to slow down excessive growth and stamp out persistent high inflation.



Hiking interest rates meant that bonds, even "safe" government bonds saw significant declines. The knock-on effect was equity markets also sold off, especially areas that were high growth and overvalued. The next question is how hard this slowdown will be.

<u>(Certain) Markets have more room to decline</u>

Temasek's CIO Rohit Sipahimalani recently commented that global stock markets have more room to decline. That is true; certain markets such as the S&P 500 which are used by many as a reference for equity markets, are not sufficiently pricing in a significant economic downturn. Hence, **we are investing defensively** by

- Avoiding markets that are more overvalued such as the S&P 500
- Allocating to segments such as healthcare that can ride out a downturn better

Having said that, **we are aggressive when the risks are priced in.** There are other markets that are pricing in significant downturn. They are not expected to do much worse than the broad market in a significant downturn, yet do better during the recovery. US small caps, China and Emerging Market equities; these are markets that some would deem riskier than the S&P 500. Yes, these markets can be more volatile, but **because of the margin of safety, they are safer today**.

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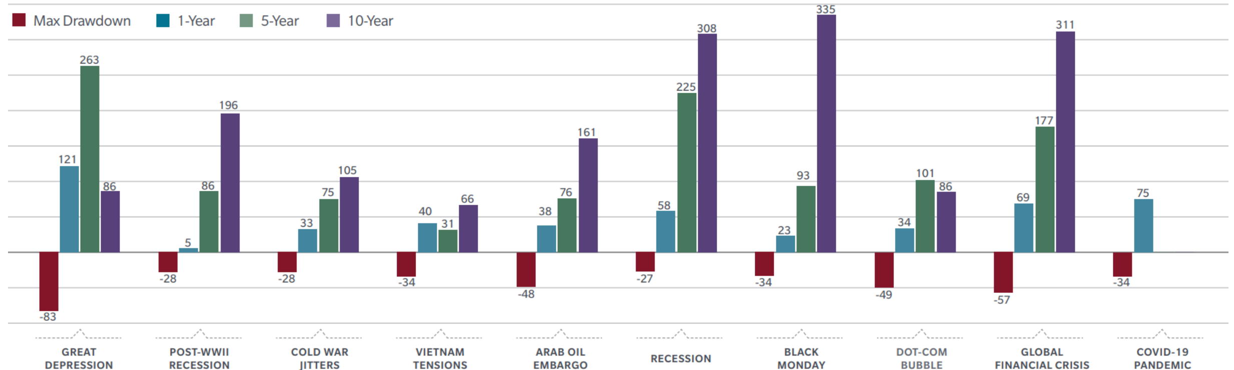
POSITIONING FOR RECOVERY

Markets have posted strong long-term returns after declines



Source: MFS Investment Management. Data: S&P 500 Index USD.

Why are we positioning for recovery? To put it simply, **we are setting our portfolios up to be able to deliver attractive long-term returns** as shown in the chart above.

Particularly, those who seek above-average returns should be excited about the recent volatility and declines – as this is where the best opportunities present themselves.

How to get above-average returns?

Looking at 20-year returns across various markets *(we update such data every month on the last page of this report; now shown in common USD currency for better comparability!)*, we see that long-term equity returns tend to range from high-single to low-double digits. Investors who stuck to broad equity markets got high single-digit annual returns. However, those who can take higher volatility can allocate to certain single markets and get double-digit returns.

One example is China equities. Over the past 20 years, China equities returned 581% vs 414% for global equities. The high return covers the ‘painful’ journey of investing in China – during the 20-year period, investors had to experience 4 separate declines of more than 30% in order to get above-average returns. As they like to say, ‘no pain, no gain’.

Like Howard Marks, we do not think that volatility equals risk if you know what you are investing into. In practice, our approach is to seek out such high return opportunities at the right time, so as to maximize reward while minimizing pain. i.e. we target the highest reward/pain.

This approach may be simple but hard to do as this often requires one to buy markets with poor 1/3/5 year performance.

One of our investment managers said that in market declines, ‘they want to **invest in tennis balls, not bowling balls’**. What they mean is some investments bounce back like tennis balls, while others crash into the ground like bowling balls. Likewise, our approach is to accumulate positions with the potential to rebound strongly in the subsequent recovery. As mentioned earlier, our preferred recovery positions - US Small-caps, Emerging Market & China, and Europe – not only benefit from lower valuations but are also expected to deliver higher earnings growth going forward.

How to avoid below-average returns?

Avoid catching bowling balls when it is high up in the air as they will come crashing down on you. These bowling balls tend to be companies with poor fundamentals and/or with excessive valuations. Remember those who had chased after pandemic high-flyers with unrealistic expectations e.g. Zoom, Peloton, would have suffered tremendously as their stock prices came crashing back down to earth.

Last but not least, **exiting after large declines and staying out of the market is an assured way of ensuring your investments don’t recover, even when markets eventually do**.

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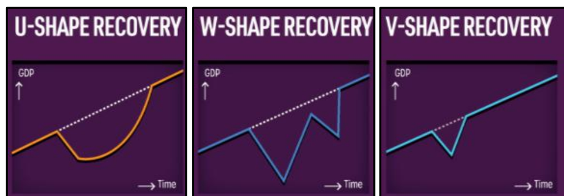
STABILITY AMID VUCA

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

With central banks continuing to tighten in most parts of the world, the odds are that a recession is imminent – it is only a matter of when and how bad. The effects are already being felt in parts of the economy. Things have become less affordable due to higher inflation and interest rates, e.g. higher housing, food, and gas prices. Alongside this, consumers are expected to dip into their savings to cover costs and to further tighten their belts going forward. Similarly, more companies have announced spending and hiring cuts, and in some cases pausing on their ambitious expansion plans.

Indeed, the uncertainties today are likely to mean market volatility for some time. Investors hoping for a sharp 'V-shaped' recovery like the one-month Covid-19 crash in March 2020 should know that such quick rebounds only happen once in a blue moon. A recent article showed that 'common bear markets' (between 20-40% declines) lasted an average of 13 months[1]. As long as the Fed continues to hike rates, it is more likely we will get a more volatile or prolonged 'W' or 'U' shape recovery.



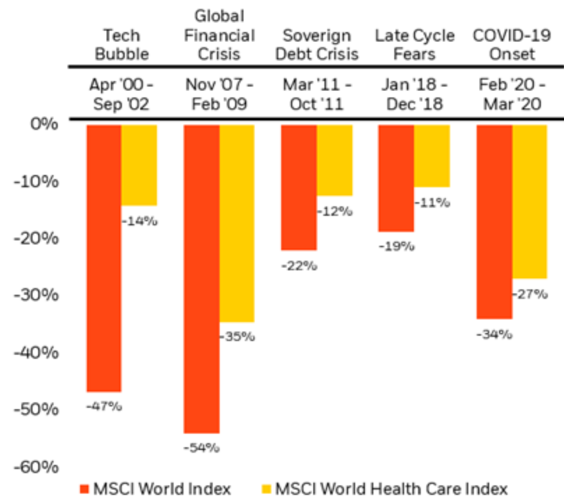
Source: [Visual Capitalist]

Investing defensively

To be clear, we have not suddenly become pessimistic about markets. Conversely, after recent declines, markets are finally offering long-term investors a better return expectation going forward. Rather than try to call the market bottom (and risk losing out on strong gains), we focus on ensuring our portfolios are resilient in the current downturn so that investors can look forward to the subsequent recovery with confidence.

With this in mind, we will be consolidating our current stability positions in both Quality Value and Healthcare equities into a larger Healthcare allocation where we have higher confidence will outperform in case of a prolonged downturn.

Healthcare Resilience



Source: Blackrock

How can one be confident that healthcare equities will prove resilient?

Firstly, healthcare has demonstrated a repeatable track record of resilience in previous crises (as shown above).

Instead of just relying on price action, there is a fundamental real-world reason that explains the resilience. We can use two potential future scenarios to explain this:

1. Inflation persists: Consumer cope with inflation by reducing spending on wants.
2. Fed beats inflation but overdoes it resulting in recession: Consumers reduce overall spending.

It is fair to say that regardless of which scenario happens, consumers have little room to compromise on their healthcare spending. This is why healthcare sector earnings are inherently resilient against both inflation and recession.

The role of the stability position in a portfolio is to keep the investor in the game, especially during crises.

[1]https://www.cnbc.com/2022/10/04/why-its-smart-to-keep-investing-during-a-garden-variety-bear-market.html

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SEARCH FOR YIELD

China is in the midst of a crisis. As crises go, few will be comfortable going through them. While we can repeat the quote *"In investing, what is comfortable is rarely profitable."* The Chinese put it in a more elegant yet practical way: within crisis 危机 comes opportunity 机会.

Crisis 危机：Policy pressures

Many point to monetary and regulatory policy pressures in the past two years that led to the current property crisis. While painful, these were required in order to prevent a leveraged property sector from turning into a bigger problem down the road. Such policies have worked. Based on how negative the sentiment currently is, some might say the policies worked too well.

Opportunity 机会：Policy easing

Where there was policy pressure on the property sector, the situation is now the opposite. Below are some **measures to stimulate the property sector and wider economy, setting the stage for recovery**.

- The State Council injected economic stimulus of 1 trillion yuan focused on infrastructure.
- Unlike other countries where homeowners are grappling with rising mortgage rates, China's mortgage rates were reduced with the lowering of the loan prime rate.
- State-owned China Bond Insurance Company to provide unconditional and irrevocable guarantees for property developers.

Crisis 危机：Hawkish Fed

Rate hikes by the US Fed this year have resulted in unprecedented declines for bond markets this year, creating pain and concern for those with bond exposures.

This is best represented by the Bloomberg Barclays Global Aggregate (Global Agg) which is one of the most popular choices as a bond investment. Many bond and multi-asset funds are benchmarked to it, and consequently have meaningful exposure to US interest rate risk. Meaning for every 1% increase in interest rates, such popular bond investments are expected to decline about 7%.

Many investors found it hard to believe that this basic rule of bond markets would apply: when interest rates rise, bond prices usually fall. Because for many years, they only saw bond prices go up. The problem was that during those years, interest rates did not rise.

We have been concerned about rate hikes for a long while. With yields practically at zero, and central banks wanting to hike rates to get out of years of QE (Quantitative Easing), investing in the Global Agg was essentially return-free risk.

Hence, we avoided exposure to the Global Agg as it was poor risk-reward. Actually, **knowing what to avoid is one of the important components in investing.**

Opportunity 机会：Don't fight the Fed; find opportunities in non-US, short duration credit

By investing in the Global Agg, one would be fighting against the Fed. Which is why we focused on areas less sensitive to a hawkish Fed: Short duration credit away from the US.

This helped us avoid a lot of the pain faced by classical bond investors this year when such bonds that were long duration i.e. more sensitive to rising interest rates faced unprecedented volatility.

While the Fed has already made a few hikes, it is likely they will continue hiking until they stamp out persistent high inflation. Nevertheless, the current environment is more conducive for bond investing today.

Despite the general discomfort towards **Asian High Yield (AHY), it presents meaningful upside while being less sensitive to Fed rate hikes**. We can always learn from history. Let's see how AHY and Global Agg have performed in previous rate hikes.

Fed hikes	1999-2000	2004-2006	2015-2018
Asian High Yield return	4.55%	16.83%	17.91%
Global Agg return	2.99%	8.49%	8.35%

"For professional investors, what is uncomfortable can be very profitable."

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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 Equities~~	Emerging Markets Short Duration Bonds
US Small-Cap Equities	Government Bonds	
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.

Including 'Government Bonds' under Stability Amid VUCA' for better clarity of portfolio positioning. Quality Value positions have been consolidated into 'Healthcare Equities'.

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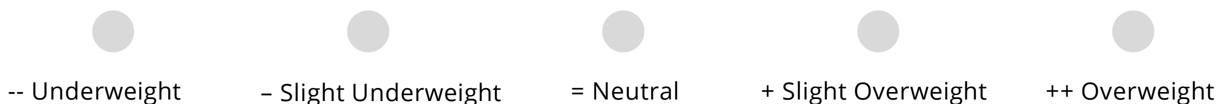
ASSET ALLOCATION STRATEGY



-- 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.

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 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.

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MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	-9.53	-25.34	7.87	8.54
United States	-9.22	-23.88	11.69	9.83
Europe	-8.89	-29.54	4.36	7.03
Japan	-9.54	-24.93	5.25	4.60
Asia Pacific ex Japan	-12.57	-26.38	2.98	8.67
Emerging Markets	-11.71	-26.99	1.40	9.09

Equity Markets	MTD	YTD	10Y	20Y
Australia	-5.71	-18.99	4.77	10.92
Brazil	0.47	7.88	-3.55	11.62
China "A"	-6.67	-29.79	6.14	8.18
China "H"	-13.29	-26.13	-1.47	9.35
Hong Kong	-13.15	-24.49	1.46	6.87
India	-3.54	-8.78	8.54	14.62
Indonesia	-1.89	2.45	2.62	15.05
Korea	-12.81	-39.72	-0.02	7.32
Malaysia	-6.34	-17.38	-2.36	6.79
Russia	-18.24	-34.06	1.63	10.57
Singapore	-2.82	-2.58	2.21	8.25
Taiwan	-10.84	-32.94	8.68	10.41
Thailand	-2.62	-13.31	3.12	12.90

Equity Sectors	MTD	YTD	10Y	20Y
Gold	0.43	-24.78	-6.65	0.67
Energy	-9.45	34.49	3.47	8.90
Technology	-11.90	-34.01	15.64	12.90
Healthcare	-3.90	-16.08	11.30	9.54
Financials	-7.76	-21.25	11.33	5.27

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-5.14	-19.89	-0.93	2.69
Global Aggregate (H)	-3.21	-12.09	1.69	3.25
High Yield	-4.20	-15.54	3.39	7.59
Asia	-3.67	-14.10	2.11	4.83
Emerging Markets	-5.53	-20.50	1.39	6.87

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-2.67	-6.04	-1.55	1.08
EUR/USD	-2.51	-13.79	-2.68	-0.03
JPY/USD	-3.99	-20.47	-6.00	-0.86

Commodities	MTD	YTD	10Y	20Y
Gold	-2.95	-9.22	-0.65	8.52
Energy	-11.23	5.69	-1.47	4.91

As of 30 Sep 2022. Source: Bloomberg. ***Total return in USD****.*
10 and 20 year returns are annualized.

"In investing, what is comfortable is rarely profitable."

Rob Arnott

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