THINK DIFFERENTLY
TO GET DIFFERENTIATED RESULTS

Monthly Investment Update

Executive Summary

Recent market performance has mirrored a roller coaster, with large fluctuations over the past few months. The late-cycle volatility is largely a response to the shifting economic landscape, oscillating between optimism during signs of a potential soft landing and pessimism during concerns on Fed rate hikes that can cause a more severe slowdown.

We are currently in the midst of a transition driven by the potential end of late-stage economic growth phase and the repercussions of higher interest rates. Despite the current uncertainties, it is better to invest in recovery themes now to capture potential upside before the market recognizes them.

Our barbell strategy, blending stability and recovery themes, aims to guide investors through this volatility while targeting long-term gains. The healthcare sector, in particular, has demonstrated resilience, holding steady during August's downturn.

Recent headlines, such as one about global managers dumping their stocks, have sown doubt among investors. However, a closer look reveals that the global managers retained the bulk of their holdings, indicating that the term "dumping" is exaggerated. Investors should maintain a long-term perspective, not swayed by alarmist headlines.

As we move forward, continued market volatility is expected, even as recovery themes gain traction. As Howard Marks emphasized, the pursuit of higher returns is often accompanied with higher volatility. Embracing, rather than avoiding this volatility, is essential for achieving potential outperformance.

If one desires higher yields, it is a pre-requisite to take higher ‘risk’, and then be able to hold on to the volatile position. Yield investors can get higher returns by being selective on credit rating or geography, or both. The current market environment presents higher yields and potential return compared to the era of cheap money. Nevertheless, careful evaluation of whether the incremental rewards justify the associated risks is necessary: whether the slight increase in reward from investment grade bonds outweigh the additional volatility and possible drawdowns, or whether high-yield investments offer a sufficient margin-of-safety to cushion against market fluctuations. Today, we retain a preference for high-yield investments with better risk/reward and higher return potential over the coming years.

Finexis Asset Management

MARKET REVIEW

Markets have behaved like a roller coaster in recent months. The S&P 500 was up 6%, 3%, then -2% in June, July and August (small-caps saw 8%, 6%, then -5%). It seems to be getting less volatile month by month, but they mask the fact that even within July and August, the swings were about 8% each way. Along with that, they have subjected investors to an emotional roller coaster ride.

<u>Why such big up and down swings?</u> It's because markets are responding to positive and negative events amid the current market transition. Markets rallied strongly in July when economies looked to be headed for a soft landing, and that central banks were able to rein in inflation without breaking the economy. In August, concerns that further Fed rate hikes would derail the recovery caused small caps to pull back more.

The current market transition is driven by the shift out of late-stage economic growth phase, and economies digesting the effects of higher interest rates. As these phase transitions evolve, and there is more clarity, fundamentals are expected to assert themselves and benefit the recovery themes.

<u>Why not invest in recovery themes after there is more clarity?</u> It's because by the time that is apparent, markets would already have recognized it, leaving much less upside for investors waiting on the sidelines.

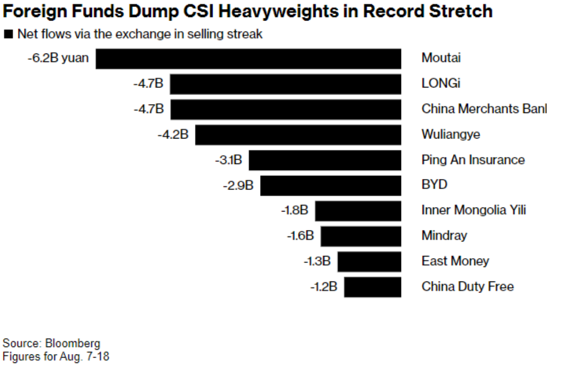
Our barbell approach combines stability and recovery themes. The stability theme helps investors ride out the volatility while the recovery theme provides the long-term return. During the recovery theme's pull back in August, the healthcare sector was flat, demonstrating its stability proposition.

There was an article published in major newspapers including Singapore's Business Times, Hong Kong's SCMP, and the Times of India. The headline alone was enough to create serious doubt in any investor in China.

Global funds abandon China blue chips in US$9.3 billion sell-off

[China Blue Chips See $9.3 Billion Selloff as Global Investors Flee – Bloomberg]

What does the article mean by "abandon"? Let us look at the provided a breakdown of the stocks being sold:



Let's look at investor activity in Kweichow Moutai, China's national liquor. Looking at filings of global managers including Blackrock and JP Morgan, the amount they sold made up less than 5% of their holdings in the stock. Whatever the reason for the selling, "dumping" seems too strong a term when one still retains more than 95% of their holdings*.

Wouldn't it be ironic if investors reacted to the dumping headline and liquidated their holdings, while the global funds continued to benefit from their remaining holdings in Moutai, which despite its immense volatility, has compounded at over 30% per annum for those who held through the ups and downs?

<u>Will the ride be smoother even when the recovery themes work out?</u> Regrettably but realistically, the answer is no. Howard Marks' memo from 2006 is as valid today where he said "riskier investments offer the prospect of higher returns". This means taking more risk does not guarantee higher return, but not taking higher volatility guarantees there is no higher return.

When small caps outperformed the S&P by more than 5% per annum from 1999-2013, they continued to be volatile. There were up months of 15%, but also down months of -11%, even -21%*. Riding out such volatility is a pre-requisite to attain outperformance.

Markets continue to be volatile as investors try to size up the potential, waiting for the right reasons to reward the recovery themes. The question is: do we want to be invested and ready to participate, or be left trying to catch the plane after it has taken off?

Source: Bloomberg. Security ownership of Moutai. Small caps: Russell 2000 from 31/3/1999-30/9/2013.

POSITIONING FOR RECOVERY

While professional investors can wax lyrical about all the complicated and fancy methods they use, if there was ever a rule that worked, it is this:

"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."

Even though this quote is attributed to Sir John Templeton, who is known for seeking out substantially undervalued stocks, other gurus have also capitalized on this extreme optimism and pessimism inherent in markets with great success.

How is this related to our investments? Small-caps and China, which are our recovery positions, fall squarely into the pessimism bucket. Investors are clearly pessimistic because Small-caps and China are oversold and at cheap valuations today. But it is precisely these conditions which make them well positioned to benefit from an improvement in risk sentiment.

As much as we said that the above quote works well as a rule, how can one know when a market is in pessimism or euphoria? By using valuations! Looking at the valuation chart for China 'A' equities below, it is not a coincidence that periods of pessimism coincided with attractive 'buy-zones' for long-term investors.

We see that sentiment towards China has deteriorated meaningfully – do refer to our recent **flash update on China's Challenges, Pessimism, and Potential** for further details. One can think of China as a stalled engine that is restarting; multiple efforts are needed, with some false starts, until it really takes off.

Despite recent pessimism, there is still hope. In fact, here are some potential catalysts as policy makers try to restart the China engine:

Economic fundamentals: While investor sentiment is still poor, the consumer seems to be in a better mood. Consumer-sensitive names such as Yum and Ali Baba delivered Q2 earnings that beat expectations, indicating that the economy might have turned the corner.

Policy to shore up confidence: Recognizing that getting the property sector out of its doldrums is key to shoring up confidence, policy makers continued to implement measures. The latest one to make home ownership easier by reducing down payments and loosening the criteria for "first time buyers" (something that would resonate with those interested in Singapore property) seems to be getting traction. Not only has interest in new homes rebounded, but sales have also increased.

China's Mortgage Relaxation Spurs Weekend Sales in Mega Cities – Bloomberg

Even with the above catalyst for China and our broader EM positions, we monitor closely to make sure this is not just rhetoric – watching closely to see how it will translate to actual improvements in data and corporate earnings. Our cautious optimism aside, we are still disciplined to our FVT process: expect adjustments if current challenges lead to weaker fundamentals.

In the meantime, we are actively looking to capitalize on volatile markets by looking out for opportunities to further diversify our risks while maintaining a strong upside for our investors.

Source: Bloomberg. Price-to-sales for CSI 300 Index. Data as of 5/9/2023

LATE CYCLE STABILITY

Positive sentiment around the US economy continued over the past month despite market declines, as better inflationary data and resilience in the labour market led to expectations that the world's largest economy can avoid a severe recession.

Indeed, softening inflation since the peak in June 2022 has fuelled bets that the Fed will be able to pause one of their fastest interest rate hikes in history.

> ***"While it would be fair to describe prices as still relatively high in places such as shelter and used cars, we are witnessing a rate of change that is encouraging to consumers, as well as to Federal Reserve policymakers."***
>
> *Rick Reider, BlackRock's CIO of Global Fixed Income.*

Recently, we've been asked if the road ahead is 'all clear' and if so, we would be inclined to allocate more heavily into recovery positions to take advantage of a more sustained rebound (as opposed to the choppy recovery we have seen in the past year).

In short: major developed markets remain in late-cycle, with the full impact of the Fed's tightening likely not yet been fully transmitted across the economy.

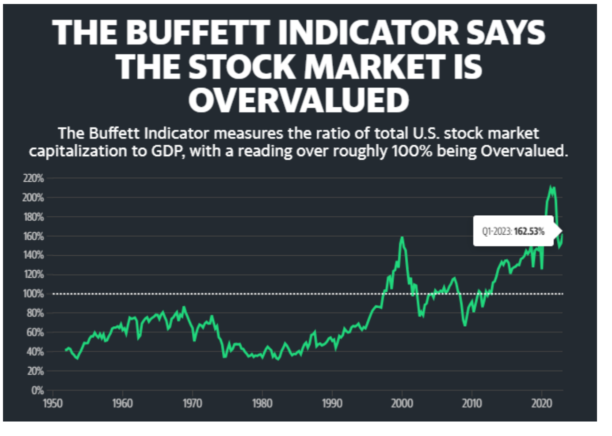
While there have been some early green shoots of economic resilience, we are closely tracking the range of leading indicators for more evidence of a sustained recovery. **Today, the indicators are still pointing towards continued deterioration at worst, and an uneven recovery at best.**

In such a backdrop, our view can be summed up as being one of cautious optimism: recognizing that there are still meaningful risks in the economy and markets, but where there are attractive opportunities that long-term investors can start positioning today to harvest good returns in the ensuing recovery (as covered on the previous page).

Today, this cautious optimism is reflected by the portfolio's barbell approach. Late-cycle markets are prone to bouts of high volatility and greater risks of financial 'shocks' as we have already experienced this year – which is why having some stability (through Healthcare equities!) can mitigate volatility, and even act as dry powder to put to work when opportunities arise.

The late-cycle is often said to be the 'most challenging stage of the business cycle', a stark contrast to the longest interrupted bull market from 2009-2020. During that period, a rising tide of low interest rates and easy money lifted all investments, akin to all boats rising with the tide.

Today, investors navigate more complex waters. While certain market segments have retreated from their peaks, preparing to catch the next upward wave, others, such as the S&P 500, continue to ride a high tide that has yet to come down. For those who prefer the technical explanation: valuations for such markets have remained at high levels, suggesting at subdued returns in the coming years. The following shows Warren Buffet's favoured valuation indicator, which presently flags the S&P 500 as being overvalued.



Source: Yahoo! Finance

Entering this new investment era, adopting a more selective approach is the key to thriving in the coming years. Alongside having stability positions in the current late-cycle environment, maintaining a strong discipline in Fundamental and Valuations can help ensure your portfolios can reach their intended destination with higher certainty at the end of the day. In essence, it's about steering your ship wisely, and adjusting the sails according to our FVT compass (Fundamental, Valuation, and Technical).

CAPTURING HIGH YIELDS

Should one invest in Investment Grade (IG) or High Yield (HY)? Developed markets (DM) or Emerging markets/Asia (EM)? Arguably, there is no wrong answer; it depends on what the investor wants. If they are looking for higher income, the answer could be High Yield instead of Investment Grade, and Emerging Market instead of Developed Market.

In the market review section, we highlighted that higher volatility offers the prospect of higher return. The table below shows that over the long run, this is not only true, but a practical certainty. Studies show that **in the long-term, one gets higher return by being able to withstand higher volatility in the form of credit risk i.e. HY instead of IG, or geographical risk i.e. EM instead of DM, or both.**

Gains on $100,000 invested	DM	EM/Asia
IG	$249,470	$341,390
HY	$335,820	$609,880

It seems then that investing into EM HY is a no-brainer for anyone with $100,000 to spare. What's the catch? Just like some prefer the teacup ride compared to Space Mountain at Disneyland, volatility is not for everyone.

For those who target higher return, not only must they be able to stomach higher volatility, but they must also be able to stomach higher interim drawdowns. The table shows the drawdown of the various fixed income segments. Combining this table with the one above shows that markets are fair; **for the same amount of capital, an investor with stronger stomach (for higher volatility) gets a larger reward.**

Drawdown	DM	EM/Asia
IG	-15.42%	-13.72%
HY	-33.31%	-38.58%

Is the path to higher return really so simple? Just pick the higher yielding market and hold on tight? If one was able to hold on for the long-term, yes. But how many can truly hold on for so long?

More practically, the yields of markets change over time. As we saw in the previous era of cheap money for the most part of the last decade, yields (and correspondingly returns) were lower than the long-term average, offering poor outcomes for income investors.

At other times, when yields (and correspondingly returns) are higher than the long-term average, they offer better opportunities for income investors. **We are currently in one such period where yields and prospective returns are higher.**

The following table shows yields for the different fixed income segments today. Should one just invest into the fixed income segment based on the yield they are targeting? Yield is only the reward side of the risk-reward equation. This is where the nuances of asset allocation come in; where to allocate capital based on assessment of risk and reward.

Yield as at 4/9/2023	DM	EM/Asia
IG	5.68%	5.86%
HY	8.40%	13.25%
Yields of HY over IG	2.72%	7.39%

DM IG bonds with expected return of 5.68% looks great. But if we compare it with a Money Market fund yielding 5.28%, **one has to decide if it's worth the extra 0.4% to subject themselves to the volatility and drawdown** potential of DM IG bonds whereas a money market fund has practically no volatility or drawdown. Similar considerations apply to EM IG that is providing just under 0.6% more than money market funds.

Is HY then an obvious choice for those seeking higher return? The yields of HY over IG is 2.72% in DM, and 7.39% in EM as shown on the table above – which is why we have a preference for EM HY for their return potential and the margin of safety.

Source: Bloomberg. DM IG: Bloomberg US Corporate Bond Index, DM HY: Bloomberg US Corporate High Yield Bond Index, EM IG: ICE BofA Asian Dollar Investment Grade Index, EM HY: ICE BofA Asian Dollar High Yield Corporate Constrained Index. Money market fund: Vanguard Federal Money Market Fund. Performance from 31/12/1998-31/12/2020.

HOW ARE WE POSITIONED?

Positioning for Recovery	Late Cycle Stability	Capturing High Yields
China 'A' Equities	Healthcare Equities	Asian High-Yield Bonds
Emerging Markets Equities	Government Bonds	Emerging Markets Short Duration Bonds
US Small-Cap 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.

Europe

Lower risk/reward after previous attractive value translated to strong performance over the past year. Potential for earnings disappointment as global growth slows.

Japan

Maintaining no exposure as they are less attractive compared to other opportunities. Valuations have also become less attractive.

Asia Pacific ex Japan

China 'A' overweight as deleveraging cycle has taken its course. Tailwinds steadily building up in the form of improving credit conditions and economic activity.

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 to focus on return from credit while limiting exposure to emerging market currencies and interest rate risk.

MARKET INDEX RETURNS

Equity Regional	MTD	YTD	10Y	20Y
Global	-2.76	15.22	9.15	8.56
United States	-1.59	18.72	12.79	9.92
Europe	-4.00	12.38	5.91	7.52
Japan	-1.90	12.60	5.93	5.21
Asia Pacific ex Japan	-6.09	2.32	4.28	7.90
Emerging Markets	-6.14	4.80	3.36	7.84

Equity Markets	MTD	YTD	10Y	20Y
Australia	-4.26	2.25	6.01	10.22
Brazil	-8.82	12.89	1.10	7.90
China "A"	-7.53	-5.48	5.45	8.62
China "H"	-8.72	-3.31	-0.85	6.63
Hong Kong	-8.76	-4.86	1.70	6.18
India	-2.85	7.78	12.32	12.85
Indonesia	-0.60	7.19	4.58	13.33
Korea	-6.48	9.40	2.98	7.59
Malaysia	-3.31	-5.81	-1.76	6.16
Russia	0.75	19.93	4.19	8.37
Singapore	-4.18	2.82	3.88	7.95
Taiwan	-3.89	17.00	10.86	9.85
Thailand	-1.52	-4.94	4.22	10.19

Equity Sectors	MTD	YTD	10Y	20Y
Gold	-6.23	2.65	1.65	1.79
Energy	1.81	3.27	4.94	9.25
Technology	-1.86	40.19	19.40	12.48
Healthcare	-0.74	1.67	10.63	9.76
Financials	-2.65	1.53	10.29	4.84

Fixed Income	MTD	YTD	10Y	20Y
Global Aggregate	-1.37	0.74	0.06	2.59
Global Aggregate (H)	-0.13	2.87	2.10	3.30
High Yield	0.29	7.24	4.03	6.53
Asia	-0.74	2.69	3.17	2.76
Emerging Markets	-1.20	3.26	2.81	5.88

Note: (H) Currency Hedged

Currencies	MTD	YTD	10Y	20Y
SGD/USD	-1.60	-0.86	-0.58	1.31
EUR/USD	-1.40	1.29	-1.96	-0.06
JPY/USD	-2.23	-9.91	-3.86	-1.09

Commodities	MTD	YTD	10Y	20Y
Gold	-1.27	6.37	3.35	8.56
Oil	2.24	4.20	-2.49	4.99

As of 31 Aug 2023. 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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