finexis ASSET MANAGEMENT 汇信资产管理有限公司

INVESTOR LETTER
January 2020

Dear Investors,

Markets capped off a euphoric 2019 with strong quarter. If 2018 was a year where investors had nowhere to hide, 2019 was quite the opposite. Most investors were able to get above-expected returns regardless of whether they were invested in bonds or equities. Our global multi-asset FGO and FGO+ funds had net returns of 10.11% and 14.53%[1] year to date, with contribution from bonds and equities. Our all-equity FAM Asia Fund (FAF) closed the year 12.99%. That the FAF year to date performance was 3.33% just a quarter ago reflects the volatility that investors have to sit through in order to get higher returns.

Last quarter, we discussed how investors react to market volatility and attempt to time their investments, often ending up with much lower returns than if they just stayed invested throughout. With the market declines of 2018, and a softening economy, it was tempting to cut exposures at the start of 2019 in anticipation of worse to come. Such is the fickleness of markets that anyone who reduced risk in any part of their portfolio would have lost out on the upside in 2019. Going forward, should investors throw caution to the wind, and bet the farm on their investments, buying on every dip? I would caution investors not to view equities as a high return proposition with limited downside based on the past decade's behaviour.

The Three Little Pigs

The fable of the three little pigs who were sent out by their mum to seek their fortunes needs no introduction. Here we adapt from the Disney version, best known for the infective tune "who's afraid of the big bad wolf?"

Fifer, the first little pig, built a simple low-cost home so that he could spend time playing his flute, and enjoy life to suit his jolly nature. Furthermore, his broker told him that straw house prices had been going up over the years and it made sense to build quickly and avoid paying more in future, and even have the chance to sell at a handsome profit. Thus, it made perfect sense to build a straw house cheaply to be able to move in quickly, and get on with other pursuits.

Fiddler, the second little pig, built a house of sticks as he tended to fall sick during bad weather, and wanted some protection from the annual rainy season. Stick house prices had also gone up over the years, but not as much as straw houses. Fiddler was fine with that as it was important to him that the house was made of the same material as his favourite fiddle.

Practical Pig was the one sibling who was more deliberative and perhaps viewed as the family party pooper. He spent time and money to build a house of bricks. He believed that straw house prices would not rise indefinitely without dropping, and that sturdy brick houses suited his temperament better.

Nevertheless, Practical was concerned about his siblings. "What if there is a storm?", he asked Fifer. "No worries, Fifer can stay with me as my stick house is waterproofed!" said Fiddler, to which Fifer threw him a grin.

[1] Net returns for USD performance fee share classes

"What if the big bad wolf comes?" Practical Pig asked his brothers. Practical was a student of history and read about legends of how the big bad wolf came when least expected, and caused mass carnage to homes. (Incidentally, Practical Pig's building contractor Black Swan told him that the big bad wolf was indeed real.) "You and your big bad wolf again!" replied Fifer and Fiddler, rolling their eyes. Bear in mind, pig-kind had enjoyed years of peace and not encountered any wolves, to the extent that it was believed wolves were extinct. Fifer and Fiddler laughed off Practical's concerns and went on playing their flute and fiddle, even teasing Practical as brick home prices were lagging straw and stick homes.

I guess we know how the story went.

One day, when it was least expected, the big bad wolf came. He blew away all the straw houses that he could see with ease. Straw house owners across pig-dom were shell-shocked as they never expected a wolf to damage their choice assets and cause prices to plummet. They had built their straw houses in the most popular areas where prices had gone up the most. And if they had money for more than one house, they built them all in the same area. Invariably, these were the places the big bad wolf targeted.

Brick home owners finally had their day in the sun. Ironically, if there was no big bad wolf, a brick house actually looked like a bad choice; clunky with no benefit. Amid the carnage, brick house owners enjoyed the shelter afforded by their homes, and prices were more resilient. Indeed, brick house prices lagged during the "good times", but such long-term resilience was what owners like Practical signed up for.

What do three little pigs have to do with investments?

Investors have two major pain points to deal with: The maximum loss they can take, and the time it takes to recover these losses. The appetite to stomach these two pain points determines each investor's risk profile. Figure 1 shows the total peak to trough losses, and number of months it takes to recover for three types of portfolios during the 2008 financial crisis.

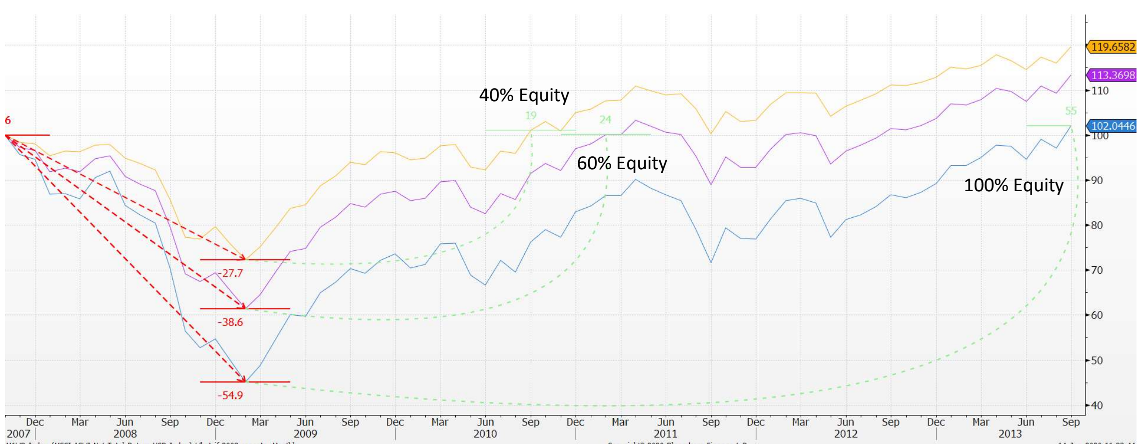

Figure 1 Drawdown and recovery period for three types of portfolios during 2008 financial crisis

These portfolios comprise of 40%, 60%, 100% equity exposure respectively, each representing a different risk and return profile. It is generally accepted that a higher risk portfolio is expected to experience a larger maximum loss and take a longer time to recover e.g. 100% equity takes about double the time to recover compared to 60% equity. A similar scenario played out during the dot.com crisis. Please refer to our Q1 2018 letter for more on negative compounding. Of course, 100% equity portfolios are expected to compound more than lower risk portfolios if we start from the bottom of the market (Figure 2). And these are the periods that attract and embolden investors to swing their preference to equities.

Figure 2 Compounding for three types of portfolios from market bottom post-2008 financial crisis to 31 Dec 2019

Which little pig do you want to be? There is no right or wrong type of house; we just have to know which type suits us better, particularly in times of stress. Just like how different types of houses withstand the big bad wolf, how a portfolio is constructed influences its response to a market crisis. Investors who have lower loss tolerance and less patience for recovery should invest in brick home portfolios. Yes, they may seem dull and rigid in good times but are more resilient in bad times.

How is it that markets had strong gains in 2019 amid the negativity, but dropped in 2018 when things did not seem so bad? While fundamentals determine long term investment outcomes, there are indeed “disconnects” in the interim between fundamentals and market performance. Arguably, market crashes, while not desired, have not derailed the long-term fundamentals of investing, and need to be seen as part and parcel in long term compounding. These disconnects will be uncertain in terms of when they happen. It is important to be able to understand how much this disconnect can be, and whether one can live with it. The extent to which one can accept such disconnects shapes their investment strategy.

Despite this, do we resign ourselves to this? Fret not, we try to improve on the cards that are dealt to our investors (which includes us) via our FVT (Fundamental, Valuation, Technical) process. We have addressed certain investment challenges in our prior letters and look to cover more going forward. Investors can also help by having a perspective that reduces the psychological pain of drawdown significantly (refer to our Q1 2019 letter).

Our process allows us to be comfortable with ourselves yet not complacent, and be able to improve. For matters beyond our control, and to stay sane in the face of seemingly irrational markets, we seek the serenity to accept the things we cannot change, courage to change the things we can, and wisdom to know the difference.

Best regards,

AlvinGoh

Alvin Goh
Chief Investment Officer