finexis ASSET MANAGEMENT 汇信资产管理有限公司

INVESTOR LETTER
April 2021

**Dear Investors,**

Bernie Madoff passed away this week. Do many of us remember Bernie Madoff? I'm thinking, "not much"; as I will explain later.

I recall vividly a morning in 2008 when I was woken up by a call telling me that Madoff had blown up. Madoff would turn out to be the largest Ponzi scheme in history.

Madoff stands out for being the largest Ponzi scheme, but more importantly, its unravelling in December 2008 was another in a string of financial blow-ups. Investors then were reeling from a series of blow-ups starting from a Bear Stearns fund in 2007 to the collapse of Lehman Brothers in September 2008. In between them were other blow-ups, driven by excessive risk taking or outright fraud. And just like the chain reaction of natural disasters in the move "2012", these left in their wake a trail of ruin. 13 years on, and even after his passing, those who succumbed to Madoff are still suffering[1].

One would not be thinking about a bunch of financial blow-ups from over a decade ago, except that recent reports created a sense of déjà vu. Investors in names like Coassets, Greensill, Torque, Envy discovered more than they had bargained for. Some lost their life savings, others lost money meant for buying their homes[2].

## Why blow-ups happen and will continue to happen

Recently, I did an informal poll asking which of the four borrowers one would lend to. Please take a look at the information and see which you would choose.

| | Borrower A | Borrower B | Borrower C | Borrower D |
|---|---|---|---|---|
| Profile | US government | Blue-chip businesses and banks | Asian property business | SMEs |
| Loan amount | 100 | 100 | 100 | 100 |
| Interest Return after 1 year | 28 cents | $1.30 | $6.70 | $14 |
| Default rate[3] | 0% | 0.06% | 2.5% | 0% |

Source: Bloomberg, based on yield as at 31 Dec 2020 for Borrower A: USD 1Y deposit, B: Bloomberg Barclays Global Aggregate - Corporate Index, C: Bloomberg Barclays Asia USD High Yield Bond Index
Borrower D: Coassets information from https://www.facebook.com/coassets/posts/as-chinese-new-year-is-around-the-corner-for-new-signups-only-use-promo-code-cny/1285349404968947/

[1] https://www.bloomberg.com/news/articles/2021-04-14/for-madoff-victims-tragedy-goes-on-even-after-scammer-s-death

[2] https://www.straitstimes.com/business/companies-markets/collapsed-crypto-trading-platform-torque-woman-lost-25m-including-in-laws

[3] Default rate in 2019. Source: https://www.spglobal.com/ratings/en/research/articles/200429-default-transition-and-recovery-2019-annual-global-corporate-default-and-rating-transition-study-11444862
https://www.spglobal.com/ratings/en/research/articles/201014-default-transition-and-recovery-2019-annual-asia-corporate-default-and-rating-transition-study-11669637

Majority of the respondents chose borrower D. I was not surprised because borrower D had the highest yield of 14% and best fundamentals with no defaults. This would certainly have checked the boxes even for our FVT process. Yes, borrower D would be the best choice; if one did not ask more questions. Evidently, party D ending up causing its lenders a lot of pain. (https://www.businesstimes.com.sg/banking-finance/bitter-wait-for-coassets-noteholders-as-investments-turn-sour).

As investors in Coassets try to piece together what happened, they are discovering that instead of lending direct to SMEs, their monies were directed to Coassets' unregulated subsidiaries or companies it had stakes in. Add to that poor accountability and loan repayment issues, and we have a potent mix. Investigations are ongoing amid concerns of fraud.

One might be surprised to know that many blow-ups don't start out as intentional fraud. Coassets was in the business of peer-to-peer lending, financing SMEs that generally find difficulty getting loans from banks. This itself is a proper financing activity, provided it is done properly and investors get sufficiently compensated for the risk. As the facts of the case continue to be discovered, I can only imagine that Coassets found themselves too successful in attracting investors but had difficulty in finding opportunities to deploy in the way they initially promised.

**Blow-ups happen because of greed:** Who can say no to investors shoving money in their face? I spoke of recency bias in my last letter. This time another cognitive bias crops up: that of restraint. This is where an inflated sense of self-control leads to greater exposure than one should. We can associate this bias with famous last words such as "just one more time". This bias can rear its ugly head in any unsustainable situation, be it excessive risk taking in a legitimate investment or an outright fraud.

Alas this was not an isolated case. Greensill Capital, a supply chain finance firm, imploded in March. This had a larger impact than Coassets' missing U$30 million, affecting $10 billion in supply chain finance funds linked to Credit Suisse. Supply chain finance is a legitimate, yet relatively boring activity with modest expected return as it is a form of secured financing where lenders have collateral. This was what Greensill was doing; at least that was what investors thought. It turns out that this supply-chain financier started lending on non-existent supply chains. Instead of lending based on confirmed trade invoices, Greensill started lending based on prospective buyers, effectively non-existent orders[4]. Again, greed likely was a factor when investors kept piling on, and managers found that there weren't that many trades to finance, and had to "innovate".

Ponzi schemes were named after Charles Ponzi. Charles Ponzi and Bernie Madoff purportedly started out with legitimate investment strategies. It was only after being pressured to deliver unrealistic returns that they embarked on building their house of cards; which leads us to the other greedy party.

March also saw a case that is not related to financing businesses, but more in the cryptocurrency realm. (https://www.straitstimes.com/business/companies-markets/at-least-70-police-reports-filed-against-singaporean-run-crypto-trading) As I was reading the article, it looked similar to the case of Mt. Gox in 2014, a bitcoin exchange which liquidated after bitcoins held by it were stolen. It was only a comment from a Torque investor near the end of the article, that the classic signs of a Ponzi scheme stood out as red flags. "One investor, who has 350 accounts with Torque said he was attracted to Torque's reward scheme which could reward an investor between 0.15 and 0.45 per cent of the amount traded in a day." A simple back of the envelope calculation indicates that one could return 30-90% per annum, not by betting on the direction of a

[4] https://www.bloomberg.com/news/articles/2021-03-15/credit-suisse-s-greensill-funds-strayed-from-tame-invoice-loans

security but simply trading it. I can also imagine this particular investor trading across his 350 accounts with the intent of benefitting from the reward scheme.

Here, the restraint bias applies to the investor: How does one say no to a good thing? Investors were convinced enough to plough their life savings to get those returns: "Another investor, who also spoke on condition of anonymity, said he had put all his savings of $13,000 into Torque and the value of his cryptocurrency had appreciated to more than $50,000 in six months."[5]

It takes two to tango, so we cannot just pin the blame on greedy managers. Investors are culpable as well.

**One cannot talk about greed without addressing fear.** Fear is a necessary survival mechanism for humans. It heightens our senses to danger, so that we can prepare ourselves against potential pain or loss. When channelled properly, this fear leads to fruitful outcomes; from an uneventful drive while wearing a safety belt to a thrilling ski run without crashing into a tree.

When it comes to investing, fear of loss is ever present in all of us. It is how we respond to it that matters. Ironically, it might be the excessive fear of loss that attracts certain investors to those "too good to be true" schemes that promise returns without risk. There is also FOMO (fear of missing out) where "investors begged these scam artists to take their money."[6]

The table below illustrates different types of responses when greed and fear come together. At this point, ask yourself: which type are you?

| **Greed vs fear mix** | **Response** | **Example** |
|---|---|---|
| Greed much more than fear | Invest with excessive risk taking. | Archegos |
| Fear much more than greed | No investing, no return. | Anyone perpetually in cash |
| Fear + Greed | Invest in unrealistic schemes that promise returns without risk | Madoff, Torque |

Where there are humans, there will be greed and fear. Consider these steps so that we can learn from history and the mistakes of others: 1. Have a reasonable expectation of risk and return. When you only look for high returns without risk, the higher chance you will get into a potential fraud. 2. Have a sound investment philosophy and stick to it. 3. Have a process to implement the philosophy for opportunities you can access.

Going back to why I think not many remember Madoff. That investors are still losing fortunes to fraudsters indicates that lessons from Madoff were forgotten. Torque, Envy: Will anyone remember these names? Or will they join Madoff, largely forgotten until things repeat? As an industry veteran remarked on Envy Asset Management, yet another blow-up in March, "This won't be the last case and that's the sad reality,"[7].

Best regards,

Alvin Goh

Alvin Goh
Chief Investment Officer

[5] https://www.straitstimes.com/business/companies-markets/collapsed-crypto-trading-platform-torque-woman-lost-25m-including-in-laws
[6] https://time.com/5877434/first-ponzi-scheme/
[7] https://www.bloomberg.com/news/articles/2021-04-14/trading-wunderkind-s-alleged-740-million-fraud-jolts-singapore

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