Investment Update
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finexis
ASSET MANAGEMENT
汇信资产管理有限公司

Market Review

One recent topic du jour has been about the disconnect between the stock market and the economy: How can markets be at new highs when the economy is facing 'unprecedented' challenges?

Is it too late to buy? If your investment options were confined to broad US markets which are the media's focus of this 'disconnect dilemma', the answer is likely yes. Rather than contribute to the intellectual discourse or grapple with the practical investing dilemma the disconnect presents, we see opportunities in specific segments of the US and in other markets. That is the benefit of having a wider lens and having the flexibility to allocate where others see limited options.

One consequence of investing away from areas of popular focus is that we do not always profit at the same time with broad markets. Such a lag will invariably prompt questions as to whether the choice is good, and test investors' patience, just like any supporter of the tortoise would be when they saw it trailing the hare for most of their race.

We did not invent the approach of investing differently from the rest. There are other managers that do the same, they just don't form the majority. It is also not for the sake of being different. **Warren Buffett explained in 1987 that "In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price."**

Global equity markets rose 3.24% in June, while global investment grade bonds were up 0.89%. A typical 50/50 balanced portfolio should have returned 2.07%.

Our multi-asset balanced and aggressive portfolios returned between 2.23% to 3.77%, with some effectively doing better than a 100% equity investor. This seems to be a "reversal of fortune" from our earlier lag in performance.

Did we take any special measures to outperform in June? Actually, no. Our earlier lag was contributed by emerging market exposures. The recent months have seen emerging market exposures within the portfolios' recovery theme take their turn to leapfrog global equities.

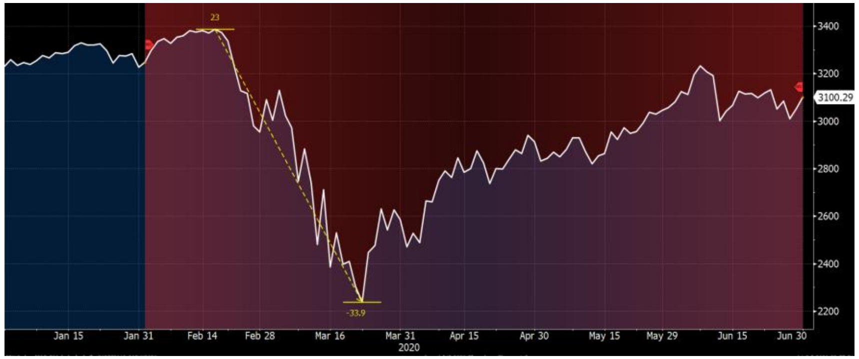
In fixed income, the shield portion comprising government bonds was generally flat. Major central banks setting low interest rates to stimulate economies has likely benefitted credit and equity markets. The flip side is expected returns for **developed market government bonds** are minimal, **primarily serving as a defensive asset during stress**. We maintain shield exposures for some defensibility but do not expect them to contribute much upside to the portfolios.

Our yield investments (Asian high yield and emerging market debt) continued to power on with gains between 2-6% in June. With expected annual yield of 9% for Asian high yield at the beginning of June, 4% returns in June came from a combination of coupon and capital gains. While returns from yield investments are driven by coupon in the long run, **our allocation process of investing more at better valuations also generates gains from capital appreciation from under valued markets.**

We take comfort that recent months' gains are coming from differentiated ideas rather than rising and falling with all eggs in one basket.

Market Review: Recession!

On 8 June 2020, we were reminded that things aren't as rosy outside of the recent strong market performance: the National Bureau of Economic Research (NBER) officially announced that the US had entered into a recession in February 2020. This fact is probably not so surprising to most of us today, having already seen the economy going into lockdown in the past few months. It would have been more useful to know in February that the economy had peaked then, as the S&P 500 went into a subsequent drawdown of 33.9% almost right on cue:



Red shaded area represent NBER-defined recessions for the US economy

Source: Bloomberg.

Recessions are usually associated with volatility and large market drawdowns, which is why investors are so concerned about them. Unfortunately, it is impossible to know precisely when this will happen, and we only know for sure after we are right smack in the middle of one. In NBER's own words: 'we tend to wait to identify a peak until many months after it [recession] actually occurs'.

In lieu of a crystal ball that can tell us when recessions will happen, we use a range of indicators to inform us on our portfolio allocations. As early as 2019, some of these indicators were showing signs that the market was heading into a more challenging environment. Imagine you were driving on the road and saw the following sign:

Any good driver would take caution and slow down, especially when it has just started to drizzle. For navigating the markets, these warning signs came in the form of **yield curve inversions**, **corporate earnings decline,** and **a general slowdown in economic activity**. In response, we started to position more defensively, avoiding areas such as small-caps with weaker balance sheets, and cyclical sectors (such as financials) that would struggle in a slowdown. On the other hand, our assessment was that large quality growth companies, and the healthcare sector would be more resilient, and which was where we found shelter. We had no way of knowing exactly where the slippery part of the road will be, but by being prepared we participated in strong gains over 2019, and avoided even larger drawdowns when recession hit this time around.

Key Themes: Resilience Amid Downturn

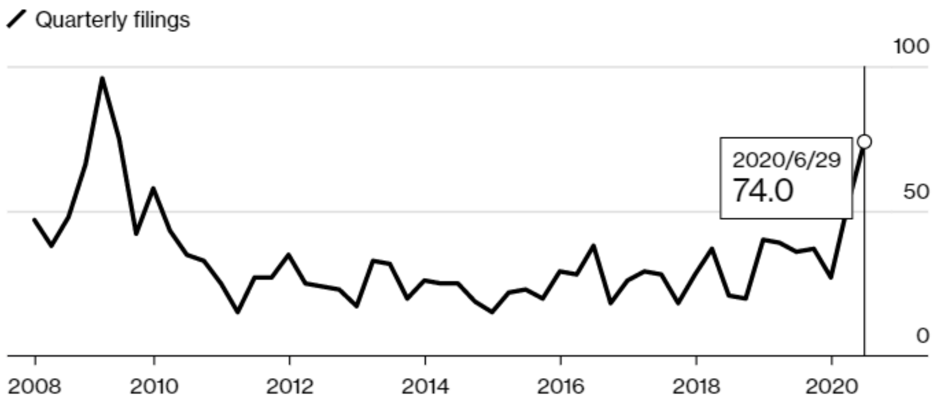
What if you drove further down the road and the next sign showed 'Danger! Cliff ahead!'? You would stop immediately. We do not have such clear signs to tell us when to 'stop' or 'go' in investing. This is especially the case today with central banks doing all they can to support the economy and markets. Covid-19 has not made this any easier, with the fate of economies somewhat tied to how soon they can fully re-open, and how well businesses are able to navigate a post-covid world. Will it be a V, W or U-shaped recovery? These uncertainties continue to linger even as markets have rallied strongly from the March lows.

Preparing for a tough environment does not mean always hide in a bomb shelter. During periods of economic fragility such as today, we want to place a stronger emphasis on investments with higher earnings predictability and healthy balance sheets that would hold up better in a less favourable economic environment. **Large US Quality Growth**, and **Healthcare** investments certainly meet these criteria. While they are not immune to economic slowdowns, they tend to grow faster than the broader economy, and earnings expected to be less volatile compared to other areas of the market – we showed last month that Healthcare earnings have held up well in Q1 2020, and are expected to continue to be more resilient than the broader markets for the rest of the year. As before, we retain a preference for businesses with **lower debt**, **stronger earnings**, and **overall healthier balance sheets**; which make them more resilient in a prolonged downturn.

Indeed, bankruptcies have been rising quickly over the past few weeks with many more expected ahead. **The pandemic is more a catalyst rather than the root cause for bankruptcies.** Companies that went bankrupt already had weaker fundamentals or poor financial discipline; the pandemic just brought these issues to the fore. Even well-known companies are not immune if they were struggling to do well in normal times and do not have robust balance sheets. Hertz, the 102 year-old car rental company, has the ignominy of being this year's largest bankruptcy so far as it buckled under a mountain of debt.

Rough Quarter

U.S. bankruptcies stack up at fastest pace since 2009



Note: Reflects Ch. 11 and 7s for public and private companies, liabilities $50m+

Source: Bloomberg.

Key Themes: Positioning For Recovery

One of the legendary investors Stan Druckenmiller, who once ran a hedge fund generating annualized returns of 30%, recently said that he was "far too cautious" and had made "all of 3% in the 40% rally."* Time and time again, we have seen how hard it is to time the markets, even for the most seasoned investors. This is why staying invested is the better strategy, so long as you can manage the risks in the portfolio, and remain disciplined in sticking to a well thought out investment strategy.

As much as we want to protect our portfolio in down markets, we also do not want to be overly cautious that we miss out on opportunities. Which is why we combine the more resilient parts of our portfolio with allocations to **China 'A' equities** and the **Energy sector** to maintain a high level of recovery potential.

Hazards of Ill-Timing

Investors sitting out S&P 500's best five days would have suffered a 30% loss

Source: Bloomberg

*https://www.bloomberg.com/news/articles/2020-07-03/the-cost-of-bad-market-timing-decisions-in-2020-was-annihilation

One question we always ask when assessing investments is **"Is it priced in?".** It essentially means, will one **get rewarded for the risk they take**. Our FVT process helps us to avoid getting into risks that do not have commensurate reward. For example, we were enthused by energy equities only when valuations declined to historic lows, beyond what their longer-term fundamentals suggest. Markets tend to overshoot or undershoot, and in this case a lot of the bad news is being priced in such that there is a good asymmetric opportunity i.e. more potential upside than downside. Indeed, oil markets continued with its rebalancing process over the past month, with the OPEC oil cartel cutting output to the lowest since 1991; increasing the odds of much higher prices when the economy improves. While we do not rule out further volatility if we get into a prolonged downturn, we can count on some valuation support as we had invested cheaply before.

We continue to maintain our long-time overweight to China 'A' equities, which led performance in June. The table of market index performance on the last page shows that China 'A' is one of the only market that is positive year-to-date. Few would have guessed this outcome at the start of the year, especially when China was the epicentre of Covid-19. Nevertheless, we stuck to our investment process and remained invested as it offered us access to a high growth market without overpaying. The situation is more positive today, with the country being one of the first to gradually re-open their economies – latest data for June showed that China's economy continued to recover in the past month. **The resumption of activity, coupled with attractive valuations and accommodative policies put the odds in our favour for China 'A' equities to continue to do well.**

Key Themes: Search for Yield

Yield of major credit markets

	30 Jun 2020
Asia HY	8.1%
US HY short dur. bonds	7.7%
US HY bonds	6.7%
EM short dur. bonds	4.5%
EM bonds	4.7%
Global investment grade corporate	1.9%

As bank deposit rates continue to drop

	30 Jun 2020	31 Dec 2019
SGD 1Y deposit	0.30%	1.35%
USD 1Y deposit	0.48%	2.01%

Source: Bloomberg

Over the past few days, more banks in Singapore have cut the rates they offer for deposits. Before we cry foul, it is important to note that this is part of a broader trend of low developed market interest rates. A crucial aspect of finance is P&L (profit and loss). If one can reduce outflows from liabilities, they will be able to enjoy the fruits of their investments more. One implication of any low rate regime is to refinance liabilities. Companies have been doing it by issuing more bonds so that their interest burden is reduced. At an individual level, one can refinance their mortgages to reduce interest payments.

The table above indicates that since any form of credit investment will beat deposits, one can just gun for the highest yielding opportunity. How we respond to low interest rates is more crucial: Do we invest in anything and everything because leaving it in the bank will yield next to nothing, or **invest to get a certain return without taking too much risk that can result in permanent capital loss**?

Companies are finding it harder to sustain bond payments, much less dividend payouts. Despite this tough environment, we should not avoid credit markets as this is exactly when attractive opportunities surface. The key is finding that balance of risk and return: are markets pricing in enough bad news to make an investment worthwhile? Certain companies will default but **the benefits of investing in diversified portfolios at attractive valuations outweighs the risks**.

Despite going through the Asian Crisis and Great Financial Crisis, emerging market bonds have returned 9% p.a. from 1993. An investor buying at the top of the Asian crisis and selling at the bottom of the GFC would have returned 7% p.a. How can this be when companies and entire governments were defaulting during the crises? The key is diversification. While we do not expect the same returns going forward due to lower rates, the principle of being rewarded for taking appropriate risk continues to apply today.

Key Themes: How Are We Positioned?

Resilience Amid Downturn	Positioning for Recovery	Search for Yield
US Quality Growth equities	China 'A' equities	Asian High-yield bonds
Health Care equities	Energy equities	Emerging Market Short Duration bonds
Currency-hedged Government securities	Emerging Market equities	

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Asset Allocation Strategy

Equity: Regions	--	-	=	+	++	Allocation strategy
United States						**Large-cap Quality Growth** have stronger balance sheets and are more resilient in an economic slowdown. **Healthcare** as earnings are less dependent on broader economic cycle. **Energy** where valuations are compelling and providing a margin of safety for investors. *Overweight in US as a result of allocations to Global Healthcare and Energy, which are US-heavy.*
Europe	0%					Maintaining no exposure as economic activity declines, and as valuations are less attractive compared to other opportunities.
Japan	0%					
Asia Pacific ex Japan						**China 'A'** overweight as valuations continue to be attractive and earnings expected to be more resilient.
Emerging Markets						Neutral as valuations attractive relative to developed markets, but where earnings have declined.

Fixed Income	--	-	=	+	++	Allocation strategy
Government						Focus on currency-hedged global government fixed income to buffer portfolio volatility during periods of stress.
Investment Grade Corporate	0%					Maintaining no exposure as low incremental yield and long duration credit exposure are less attractive than other segments.
US High Yield	0%					Maintaining no exposure due to relative poorer fundamentals.
Asia						Attractive yield across major fixed income markets with room for capital appreciation and better fundamentals.
Emerging Market Debt						Hard currency short duration focus as a more defensive credit investment for a recessionary environment.

Notes: - - Underweight - Slight Underweight = Neutral + Slight Overweight + + Overweight

Current Previous

Market Index Returns

Equity Regional	MTD	QTD	YTD
Global	3.24%	19.41%	-5.98%
United States	1.99%	20.54%	-3.09%
Europe	3.11%	13.91%	-11.75%
Japan	-0.20%	11.24%	-8.19%
Asia Pacific ex Japan	8.20%	18.47%	-5.97%
Emerging Markets	7.36%	18.14%	-9.70%

Fixed Income	MTD	QTD	YTD
Global Aggregate (Unhedged)	0.89%	3.32%	2.98%
Global Aggregate (Hedged)	0.50%	2.42%	3.90%
High Yield	0.02%	9.00%	-4.43%
Asia	1.68%	5.41%	2.36%
Emerging Market Debt	2.49%	10.00%	-0.43%

Currencies	MTD	QTD	YTD
USD/SGD	-1.41%	-2.00%	3.54%
EUR/SGD	-0.21%	-0.21%	3.74%
JPY/SGD	0.09%	0.36%	-0.63%

Commodity	MTD	QTD	YTD
Gold	2.93%	12.92%	17.38%
Oil (WTI Crude)	10.65%	91.75%	-35.69%

Equity Markets	MTD	QTD	YTD
Australia	2.61%	16.53%	-10.04%
Brazil	8.76%	30.18%	-17.80%
China "A"	8.48%	14.16%	2.72%
China "H"	3.44%	3.74%	-10.87%
Hong Kong	7.38%	5.07%	-11.87%
India	7.75%	18.67%	-14.97%
Indonesia	4.16%	9.61%	-20.44%
Korea	3.89%	20.21%	-3.82%
Malaysia	2.10%	12.21%	-3.65%
Russia	0.75%	10.59%	-8.63%
Singapore	3.84%	6.25%	-17.74%
Taiwan	6.78%	20.39%	-2.32%
Thailand	-0.26%	20.51%	-13.18%

Equity Sectors	MTD	QTD	YTD
Gold	6.38%	55.78%	24.61%
Energy	-1.42%	28.68%	-37.02%
Technology	7.19%	30.85%	13.39%
Healthcare	-1.41%	14.16%	0.52%
Financials	-0.52%	11.41%	-24.62%

Total return in index currency terms as of 30 June 2020. Source: Bloomberg

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