RWC Diversified Return

January 2020

> Whenever you find yourself on the side of the majority, it is time to pause and reflect.
>
> MARK TWAIN

Last year was difficult and disappointing, with cause for reflection, though being on the side of the majority was not our issue. In many ways 2019 was the antithesis of its predecessor. 2018 saw almost all asset classes failing to exceed inflation, rendering traditional asset allocation nearly useless. Against that backdrop, our multi-strategy approach which harnesses alternative techniques produced a positive absolute return and a very good relative one. On the other hand, in 2019, most asset classes exceeded their long-term performance averages, with US equities and investment-grade credit posting near-record results. The liquidity-driven "everything rally" severely penalized hedging, shorting, and volatility. Against this backdrop, the fund's defensive positioning struggled.

As its name suggests the RWC Diversified Return Fund is meant to diversify investors' other holdings, with the expectation of positive performance in a bear market. Therefore, by design, this will mean we will have contrarian positioning and performance expectations. As we have described in past letters, our risk-taking is grounded in a credit-cycle framework which identifies market excesses and risk. Since the fourth quarter of 2018, we have believed that these risks are significant and not reflected in asset prices. Our mandate and conviction guided us to our defensive stance which was, as it turned out, too early in the face of a liquidity-driven rally. Therefore, at best, 2019 was going to be a year of significant underperformance of risk assets. Notwithstanding these reasons, however, we have reflected upon how we can improve in the belief that we underperformed relative to what we should have achieved in absolute terms. Realistically, an excellent result would have been a small positive return. We are focusing on how to close the gap between such an outcome and the losses actually sustained. How do we intend to do this?

1. Incorporate more sector and company-specific ideas

2019 was a challenging year in terms of the market environment. We have now settled into RWC Partners where we benefit from stability, resource, infrastructure and, most importantly, the time to focus on performance generation. Our stock selection in gold miners is good evidence of our ability to add value over a simple "beta" allocation. We intend to broaden out this effort. Overall, the goal is to avoid the liquidity playground of passive and algorithmic players and to concentrate on areas where fundamentals are more likely to be reflected. Corporate credit – further discussed below – is a current area of focus.

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2. Delineate more strictly between investment and episodic strategies, with more active management of the latter

With longer-term investment strategies moving toward more granular themes, the residual asset-class and/or index positions will be generally more actively managed, i.e. traded with greater frequency in narrower ranges. The nature of passive investing and the propensity for volatility-selling mean the eventual opportunities will be tremendous; however, it also means the waiting game is potentially more costly than before. Consequently, we will adapt our long-volatility/convexity efforts accordingly.

3. A greater balance in the portfolio

We are adding more complementary investment themes to the portfolio in order to diversify it further. While their purpose is to balance the portfolio, these themes will not be inconsistent with our credit-cycle framework. Furthermore, they will be implemented in stages and not necessarily immediately. For example we have researched and constructed a basket of equities which would benefit from an increase in inflation, which normally rises during the latter stages of an economic/credit cycle. Inflation risk is under-priced in many financial markets, and we have unearthed some equities trading at depressed valuations in order to express the theme. In addition, we plan to make more use of right-tail hedges, a strategy which worked very well in 2018.

These adjustments are intended not only to address some of the issues which negatively impacted the portfolio last year but also aim to improve our investment process over the long term. Furthermore, the alterations do not supplant our credit-cycle framework. Indeed we believe they should complement the framework in terms of the expression of investments and leverage it to guide us to more specific, alpha-generating themes.

There is no hiding from the fact that last year's performance was deeply unsatisfactory. After a process of reflection, we are implementing improvements. However, we are not overreacting. By definition diversification, which is our mandate, means standing out from the crowd with contrarian views and investments. While punishing at the time, 2019's liquidity-driven rally created a better opportunity set for us in 2020. Our goal and expectation is to more than pay back last year's losses with meaningful gains when our investors need them most.

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Portfolio Review

The final quarter repeated the year's pattern: our investments which benefit from monetary accommodation performed well and those which suffer from it did poorly. The portfolio's exposures were skewed toward the latter, meaning the portfolio lost money over the quarter. The positioning was deliberate as we expected two catalysts in Q4 to cause trouble for financial markets: (1) year-end funding problems following the spike in repo rates in September and (2) equity outflows due to mandatory retirement-plan liquidations in the US. Neither were sufficient to overwhelm market liquidity and ebullience.

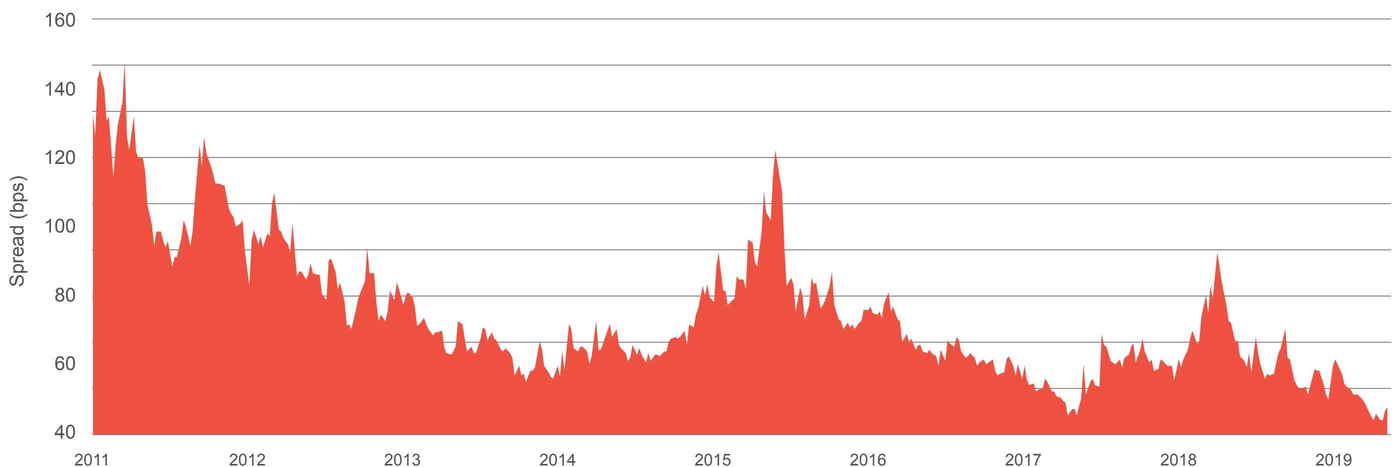
Fixed Income

Once again holdings in the front-end of the US Treasury curve made money for the fund. The investment has been a steady earner, aided by the Federal Reserve cutting its base rate three times in 2019. Given the Fed has suggested it is on-hold for the foreseeable future, the position is a low-risk source of income. With the Fed willing to "run it hot" in an attempt to stoke higher inflation coupled with a relatively flat yield curve, we think the best risk-to-reward in fixed income remains at the front end. Furthermore, our gold positions are negatively correlated to real rates of interest, so we do not need to double up on that exposure.

Short credit was the largest detractor of the quarter as investment-grade credit spreads tightened aggressively. Our significant exposure was based on two factors: first, our credit-cycle framework which shows risks building, credit quality declining, complacency in pricing and, second, our anticipation that year-end funding pressures would provide a catalyst for change. In fact, the Fed's massive balance sheet build-up assuaged the markets and pushed the CDX IG (our largest source of credit protection) to new lows.

Our conviction that credit spreads fail to reflect the many and growing risks underlying them has only grown. We will not re-hash them here in detail, but the leverage levels, credit standards, and debt-service metrics have deteriorated further. Low interest rates and/or an improving economy may delay the next default cycle, but potential amelioration has been fully anticipated in the price as seen in the graph on the following page. Furthermore, we believe the longer the delay persists there will be more mal-investment and a greater correction to follow. At these levels, the buyer of investment-grade debt is betting on a "this time is different" paradigm, where credit risk is no longer a factor and/or liquidity-driven momentum matters above all else permanently.

FIGURE 1:
CDX IG – scant risk premium here



Source: Bloomberg, December 2019

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While our basic view on the asset class remains the same, we are looking at ways of improving its implementation. Following on from the notion discussed above of shifting away from indexes toward specific alpha-generating situations, we are in the process of directing some of our negative view on corporate credit to individual ideas, which may be expressed in credit or, depending on relative value within capital structures, in equities.

2019 saw a significant convergence between investment-grade bonds, i.e. there was little discrimination between the quality levels of the issuers within the index. To take advantage of this trend, we are dissecting the index, targeting the intersection of sectors facing structural headwinds, companies with particularly onerous debt burdens, and credit ratings hovering over junk-bond status. While we still think the index is meaningfully overvalued, it has become dominated by passive and systematic flows, neither of which invest based on price momentum rather than fundamental analysis. At some point, this momentum will reverse and potentially cause an overshoot in the opposite direction. In the meantime, our goal is to find credits which are weaker and thereby more vulnerable that the average reflected in the index. In this way we are less reliant on timing the cycle's turn.

An example of where we are finding such stresses building is in the automotive sector, where loans to finance car purchases amount to some US$1.2 trillion. While US households have deleveraged relative to their 2008 highs in aggregate, mostly due to the froth taken out of the housing-mortgage market, car loans are back at peak levels. Not only is the stock of debt back to pre-financial-crisis highs but there are also a series of other worrying signs in terms of the rate of deterioration:

- Delinquencies on loans are rising to a record high
- The share of cars with negative equity is rising when trading in for new ones
- Lease terms are being extended to compensate for larger loans in an effort to reduce monthly payments
- Banks are tightening their lending standards
- With many OEMs and auto dealers making most, if not all, their profits from financing, their incentive to push borrowing onto potential customers is high. There is anecdotal evidence of income falsification by both borrowers and lenders, reminiscent of the malfeasance during the housing subprime crisis.

After an extended cycle of auto sales, the amount of financing required to pull new car buyers into the market is troublesome and leaves little room for error.

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FIGURE 2:

Equities up, economic activity down

Source: Bloomberg, December 2019

Equities

The quarter and year were characterised by multiple expansion, the equity market's version of the phenomena described above relating to corporate credit. The divergence between economic activity and stock prices was remarkable.

On a price-to-sales and enterprise value-to-EBITDA basis, the S&P 500 trades at a record level. Buyers at this level have to reconcile the purchase with either an extremely optimistic view about an earnings recovery or new rules applying. Either way, the room for error is razor thin.

One tactical modification we made during the quarter was to add a basket of equities which benefit from inflation. They contributed positively as "reflation" and "value" themes gained popularity toward the quarter's end. While we believe inflation risk is under-priced by most investors, we also think that a significant position to inflation themes is probably too early, which is why we characterise the holding as tactical, treating it as an episodic trade rather than an investment at this point. That said, having not only the selection criteria but also the names for an inflation basket identified means we can act decisively once our conviction builds that a regime shift to inflation is underway.

Commodities

Gold was a winner for the year and contributed the most in the fourth quarter. Alongside the commodity itself, we are including the gold-mining equities we own, which have rallied alongside the metal but have also been a source of significant alpha. As we have said before, we believe gold, alongside our US Treasury position, is the best way to play the theme of monetary largesse. If central banks continue the game of driving down real rates of interest in order to support asset prices, then gold will benefit greatly as a store of "real" rather than leveraged wealth. For more on our thoughts on gold, please see this blog written earlier this month.

Volatility

The losses we suffered in 2019 and the fourth quarter were of a magnitude to cause us to rethink the strategy. Much as credit spreads betray the lack of room for error in asset prices, so does the level of equity volatility. However, as discussed previously, volatility-trading will feature as an episodic trading strategy going forward. The shift in mind-set is to generate small gains from a long-bias rather than a consistent long-volatility position. We expect the pattern of returns to be less volatile as a result.

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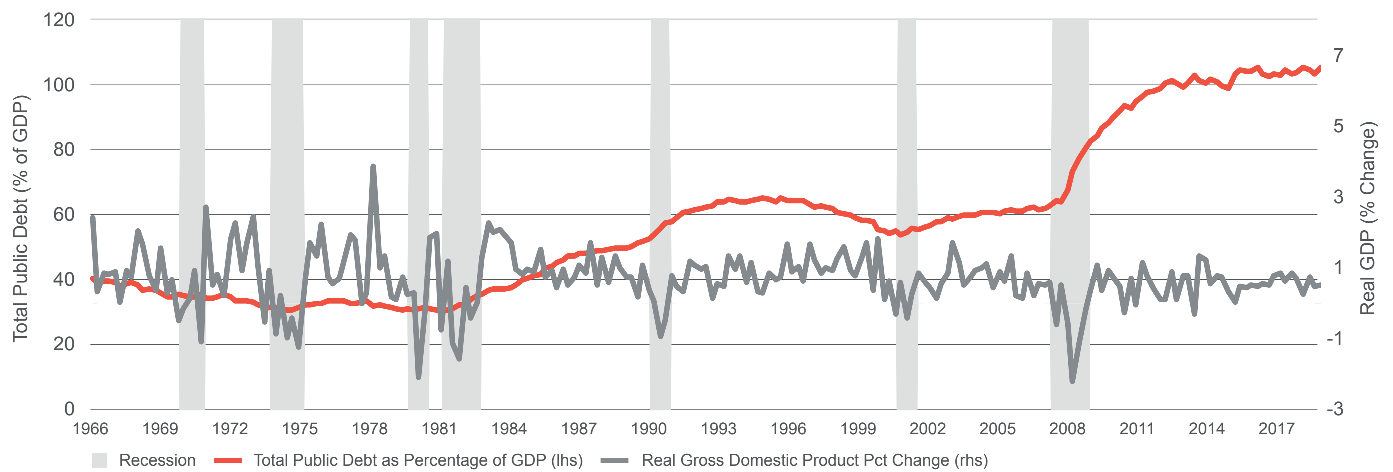
Outlook

Central to our view on markets, is what one might call a roaring bull market in "financialization". Credit cycles operate at various frequencies, and while the last deleveraging phase occurred during the financial crisis eleven years ago, that cycle was a cautionary chapter in a longer chronicle of debt increase. Since Paul Volcker broke the back of inflation some 40 years ago, interest rates have been trending toward zero. Demographics, technology, globalization, and – somewhat counter intuitively – more debt have contributed to this decline. We are now in a situation whereby the sustained build-up of debts and the inflated assets against them are critical to the global economy.

The first graph below shows US GDP trending down, while federal debt to GDP surges higher. This relationship illustrates the law of diminishing returns at work. Meanwhile, as seen in the second one, financial-asset (and property) prices also appreciate significantly relative to economic output and, consequently, their importance to consumer confidence and purchasing power also increase.

FIGURE 3:

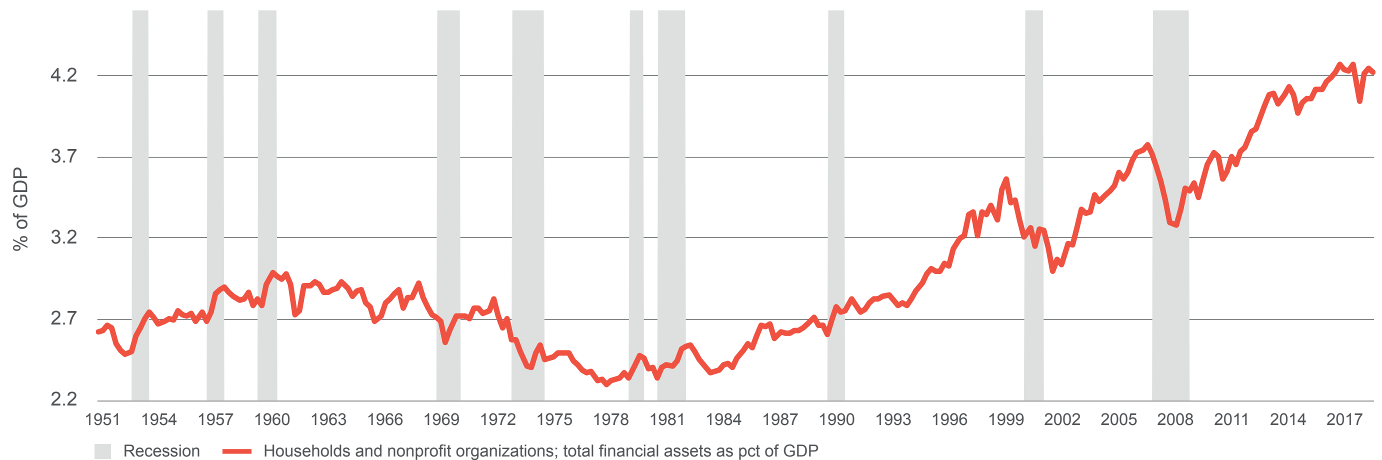
Diminishing returns of increasing debt



Source: Federal Reserve, December 2017

FIGURE 4:

Asset prices appreciation relative to GDP



Source: Federal Reserve, December 2017

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These graphs relate to the United States, but very similar circumstances afflict most other developed markets and are appearing in China too. Over-indebtedness, asset bubbles, and zero interest rates are now very real topics for what has been the world's growth engine as discussed in this interesting article published last November in China's *Global Times*:[1]

> It appears we are past the point where a central banker could even countenance addressing asset bubbles by adopting "normal" monetary policy, as the repercussions would be too severe – witness December 2018. Consequently, central bankers are ultra-vigilant and hyper-active yet, paradoxically, lacking choice. Forced to act in a way diametrically opposed to his original intention in 2018, Chairman Powell led the Federal Reserve to cut its base rate three times last year and resumed growth of its balance sheet in a massive way, undertaking repo operations which to this day go inadequately explained. The market rejoiced as asset prices (and debt) ascended.

Where do we go from here? We see three potential paths:

1. ***A continuation of the current state*** – Stuck in the realisation that they are powerless to change tack, central bankers remain accommodative and politicians engage in fits of fiscal stimulus. As a result, there may be short-lived increases in economic growth and reflation but they fade under the weight of too much debt and the financial repression of very low interest rates, which only serve to cause an ageing population to save more. Low rates embolden countries and companies to take on more debt but often are unaccompanied by structural reforms by politicians or capital expenditures by management. Consequently, quality and lasting growth proves elusive. On the other hand, in the absence of inflation, tight financial conditions or a recession, asset prices could appreciate further. This view appears to us to be the consensus from what we read and hear, not to mention what is priced into most financial markets.
2. ***Central banks get what they want*** – Most central banks are targeting higher inflation levels and are willing "to run it hot" in order to get there. If they were to succeed in a meaningful way, i.e. overshooting targets, we believe the results would be very damaging to financial markets, which have been dancing to the rhythm of low interest rates, cost of capital, raw-material and labour costs, while paying up for elusive growth. We think that significant inflation is unlikely in the near term, but is also much underappreciated and therefore under-priced in markets. Central banks should be careful what they wish for; this segues into the next possibility.
3. ***Central banks have to work harder and differently to get what they want, and only after a recession*** – Notwithstanding quantative easing (QE) back in action in Europe, Japan and the US (the Fed does not want to call it QE, but their balance sheet is growing again), there is little to suggest reflation is underway. From the recent collapse in copper and oil prices to falling real rates and flattening yield curves, market signals portend no inflation. Meanwhile, the US dollar and gold continue to appreciate in tandem, a rare combination. On one hand this suggests central banks, the Fed in particular, have not done enough. On the other, there is the possibility that they are nearing the end of the line in terms of the efficacy of the tools they have employed to date. Figure 5 puts the Fed's predicament into perspective.

1 http://www.globaltimes.cn/content/1170984.shtml

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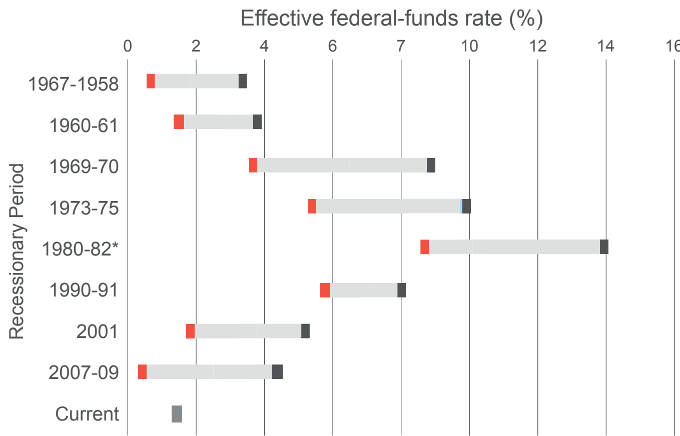
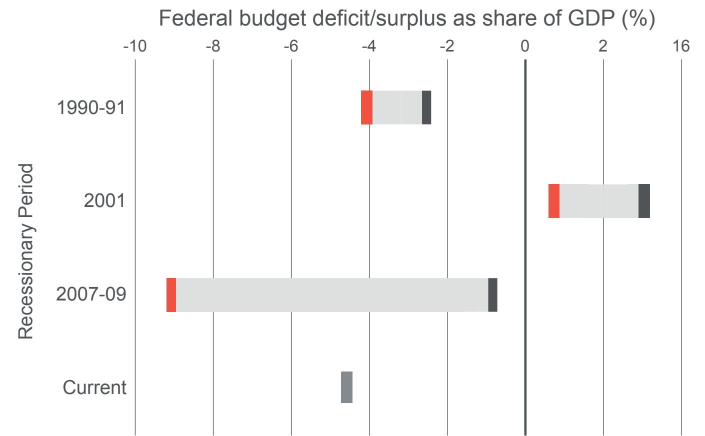
FIGURE 5:
How much monetary ammunition is left?



Source: Federal Reserve, December 2019

FIGURE 6:
And fiscal?



Source: Treasury Department, December 2019

There has been much discussion, including among central bankers, about the need for fiscal action to complement monetary stimulus. While a logical conclusion, the scope is constrained. The graph above shows a similar situation, with the budget deficit close to a post-recession level. Without much scope to enact traditional forms of stimulus, policy makers will require more potent tools to steer the global economy away from a debt-deflation trap.

We have modified our portfolio to manage a continuation of the status quo better, the path-one scenario. Our central case is that path three is not too far away and debt deflation will eventually cause a significant sell-off in risky assets and our portfolio is still designed to make money in that scenario. Finally, we have a model for a portfolio when the transition to inflation occurs. We suspect we will not need to implement it until after the extraordinary policy response occurs to fight the next recession.

Thank you for your support.
Diversified Return Team

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Please contact us if you have any questions or would like to discuss any of our strategies.

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