RWC Diversified Return

May 2020

Q1 2020 Review and Outlook

Before jumping into a discussion of portfolio management and financial markets, we want to acknowledge the suffering due to the coronavirus and shutdowns, extending our sympathy to all those affected.

> I don't need another mortgage. The one I have is enough.[1] ”

MARIAGRAZIA FERRANDINO, a restaurateur in the southern Italian town of Apricena, wrote in an open letter to prime minister Giuseppe Conte.

Since Q4 2018 we have been writing about the overextended-leverage stage of the credit cycle, citing high and growing levels of debt globally, with shrinking levels of earnings able to support them, especially pronounced in the corporate sector. The exogenous shock of a pandemic and governments' mandated lockdowns in response laid bare the leverage-afflicted fragility of the economy and financial markets. The overextended-leverage phase of the credit cycle toppled into panicked deleveraging. The catalyst was a surprise, as often is the case, but cycles are patterns, meaning they provide good signals to take or reduce risks. Those espousing the "end of cycles" or a "permanent plateau" were proven wrong, joining the "this time it's different" chorus, which is always loudest at market tops.

The next few quarters will be critical to see if the credit cycle enters a state of healthy balance-sheet repair. In our opinion, it is too early to know. If higher debt loads are undertaken injudiciously, they may alleviate short-term pain but at the expense of long-term durability. Said another way, there is a difference between liquidity and solvency. Ms. Ferrandino, the Italian restaurateur quoted above, pragmatically puts this critical distinction into real-life context.

Portfolio Review

The RWC Diversified Return Fund's objective is to compound investors' capital conservatively *through the cycle*, while providing genuine diversification to their portfolios. The mandate goes beyond simply reducing the volatility of investors' asset allocations to generating a positive return when they need it most, such as at the outset of a market sell-off. The recent debacle in financial markets exemplifies such time. The RWC Diversified Return Fund performed well just as equity markets collapsed and, significantly, as government bonds failed to play their diversification role.

Positioning a fund to make money at cycle extremes from reversals in market sentiment, which is what genuine diversification entails, often requires contrarian thinking and the ability to generate returns by means other than common asset allocation. Moving away from the herd can be difficult and requires a strong philosophy and process to guide investment decisions. Differentiating a fund's performance from basic asset allocation requires alternative exposures and more sophisticated portfolio construction. This combination of contrarian positioning because of the credit-cycle framework combined with thoughtful portfolio construction and alternative return streams is necessary for our target outcome: conservatively compounding wealth with constrained drawdowns while genuinely diversifying our investors' portfolios. During the challenging first quarter of 2020 we brought all these components to bear and took gains in each very distinctive month. Going forward, with reasonable probabilities of significant deflation and then inflation on the horizon, having this full toolkit will be required.

1 **Italy's Crisis Funds May Come Too Late for Desperate Businesses**, *Bloomberg*, by Alessandra Migliaccio, Sonia Sirletti, and Alberto Brambilla, 14 April 2020

Fixed Income

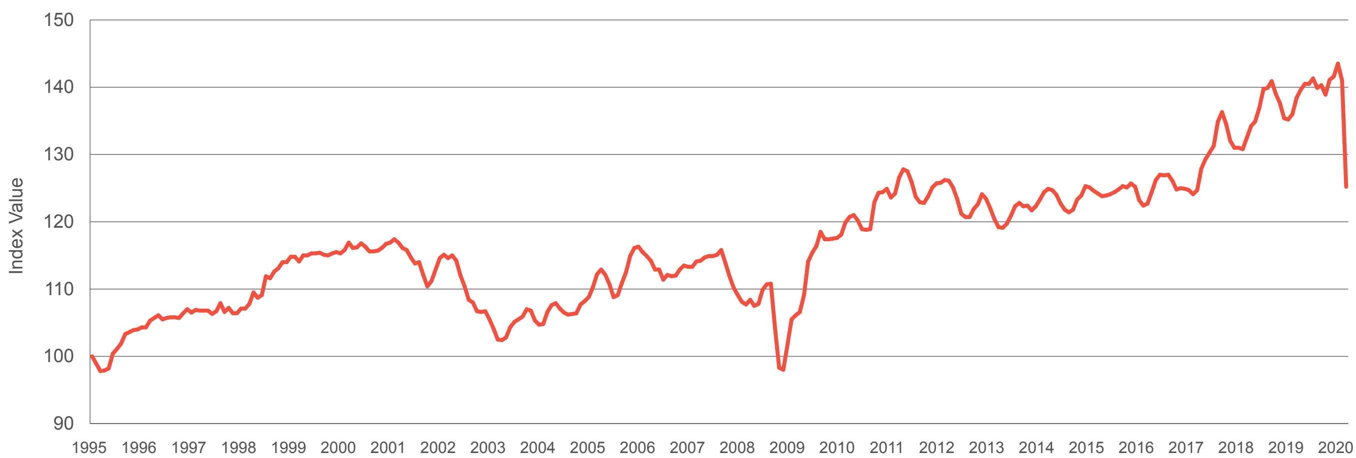
The fund's long and short fixed-income positions contributed the most to the quarter's performance. Deleveraging in February and especially March caused a panic out of credit into US Treasuries, benefitting both sides of the balance sheet. For the first time in several quarters, we added duration to the portfolio in the form of US 30-year Treasury bonds. In addition, we used a long 10-year Treasury note position to offset duration risk in short European sovereign bonds, the latter contributing meaningfully to performance. We think the ECB is outgunned by the Federal Reserve. First, having never managed to raise interest rates and only briefly reversing QE, the ECB's actions lack the torque of a meaningful policy rotation. Second, as we have discussed before, the ECB is massively hamstrung by its status as a supranational central bank in a currency area with no central fiscal authority. Third, the Fed enjoys a massive advantage, which is true over all other central banks, in the form of the US dollar's status as a reserve currency. Furthermore, fiscal discord means that money may not find its way to where it is needed most within the EU or only with the strings of austerity and further debt burdens attached. In other words, credit risk is once again manifest in certain European countries' government bonds as debt deflation lingers.

Credit protection on US investment-grade debt was the single largest contributor to performance. Our view that corporate credit represented the soft underbelly of this credit cycle's debt binge was validated by the Fed, which has attempted to come to its rescue with a forceful, if legally questionable, response. Just as subprime mortgages were the villain of the last crisis so are corporate bonds and loans this time. Fortunately, we had taken significant profits before the Fed announced its liquidity measures to bolster investment-grade bonds. The extreme liquidity chapter of this deleveraging phase may be over but the solvency one lies ahead. Consequently, we retain a smaller position to protect against a potential wave of defaults.

In much the same way we view the Fed as more powerful than other central banks in the government bond market, we also think its ability to manipulate corporate risk premia is superior. As such we did not reduce the fund's non-US credit protection, which targets areas of specific stress more than corporate credit as an asset class. These themes all contributed positively to the quarter's performance.

The auto sector exemplifies such an area. In past letters we have discussed the credit risks building in the auto sector. In summary, these risks include the very high proportion of cars purchased via financing, the high number of auto leases with negative equity, the number of subprime borrowers, extended financing periods, and OEM profitability coming from financing rather than producing cars. For auto makers with captive finance arms (finance companies(FINCOs)) the risks are more acute. There is a chain of debt linking car makers, FINCOs, the asset-backed-securities market, dealers, and consumers. The critical and weakened link in this chain is the price of used cars, which has recently collapsed.

FIGURE 1:
Manheim North America Used Vehicle Index



Source: Bloomberg, 31 March 2020

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Used cars play the important role of collateral. Price declines greatly diminish collateral value, which hurts the FINCOs, ABS holders, and consumers. Morgan Stanley estimates that for every 1% decline in the price of used cars, a FINCO's equity falls by 5-10%, reflecting the geared effect of the weak link in the auto-finance chain. While credit spreads in the space have moved, we think there are pockets where the risk is yet to be fully exposed.

The fund's fixed-income strategies best exemplify how our multi-strategy approach provides a superior means of diversification to basic asset allocation. During the most acute deleveraging in March, when our credit-protection exposure was performing best, traditional fixed income suffered as the correlation between bonds and equities became unstable. We think this instability in correlations will be a more regular feature going forward, making alternative means of diversification more necessary for investors.

Equities

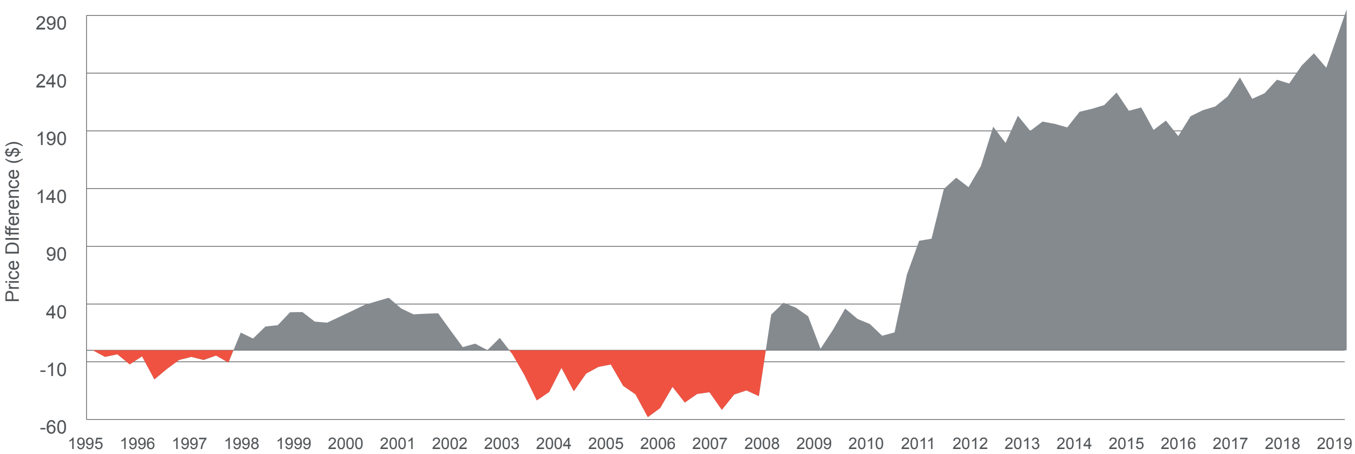
Equities experienced massive price gaps in the quarter as deleveraging met illiquidity, tripping circuit breakers on futures markets regularly. The bounce in the latter half of March was also ferocious. Over the quarter, the fund unsurprisingly made losses in its long-equity positions. Holdings designed to balance the fund's convexity, discussed in the Q4 2019 letter, such as long S&P 500 futures and a value basket benefiting from inflation, were quickly risk-managed and hence caused limited damage. Meanwhile, put positions in auto, European banks, and technology related themes contributed meaningfully.

The main detractor to the fund's performance was its core holding in gold-mining equities. Precipitous falls in share prices tested conviction, but we added to the holdings, with the positive fundamental outlook intact. We also observed that there were "technical" aspects in play such as highly leveraged hedge funds liquidating geared gold-mining ETFs. While the gold miners have recently rallied, we think they remain very attractive, especially relative to the price of gold.

The fund's overall equity exposure is moderately net long. We believe the solvency risks are too large and the uncertainty around economic recovery too great to justify most equities' valuations, especially for indices like the S&P 500. Profit margins have been declining since Q4 2018, when we changed our credit-cycle view.They are likely to be under severe pressure in the near term, especially as company management will be focused more on repairing balance sheets than maximising shareholder returns, and therefore we would require more margin of safety before increasing equity exposure.

FIGURE 2:

Price difference between Gold and Gold BUGS Index



Source: Bloomberg, 31 December 2019

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.

The names shown above are for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

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Commodities

Commodities produced a small positive return over the quarter, mostly due to gold. Over the period we added significantly to the gold holding, especially when it fell victim to indiscriminate deleveraging. We believe that the combination of central banks' balance-sheet expansion, suppression of real rates of interest, and countries' attempts to depreciate their currencies all play into gold's prospects as a source of wealth preservation. These forces were in place prior to the coronavirus and are expected to strengthen from here.

Investors are increasing investment allocations to gold. According to the World Gold Council:

> Global gold-backed ETFs (gold ETFs) and similar products added 298 tonnes(t), or net asset growth of US$23bn, across all regions in the first quarter of 2020 – the highest quarterly amount ever in absolute US dollar terms and the largest tonnage additions since 2016. During the past year, gold ETFs added 659t, the highest on a rolling annual basis since the financial crisis, with assets under management (AUM) growing 57% over the same period. ”
>
> WORLD GOLD COUNCIL

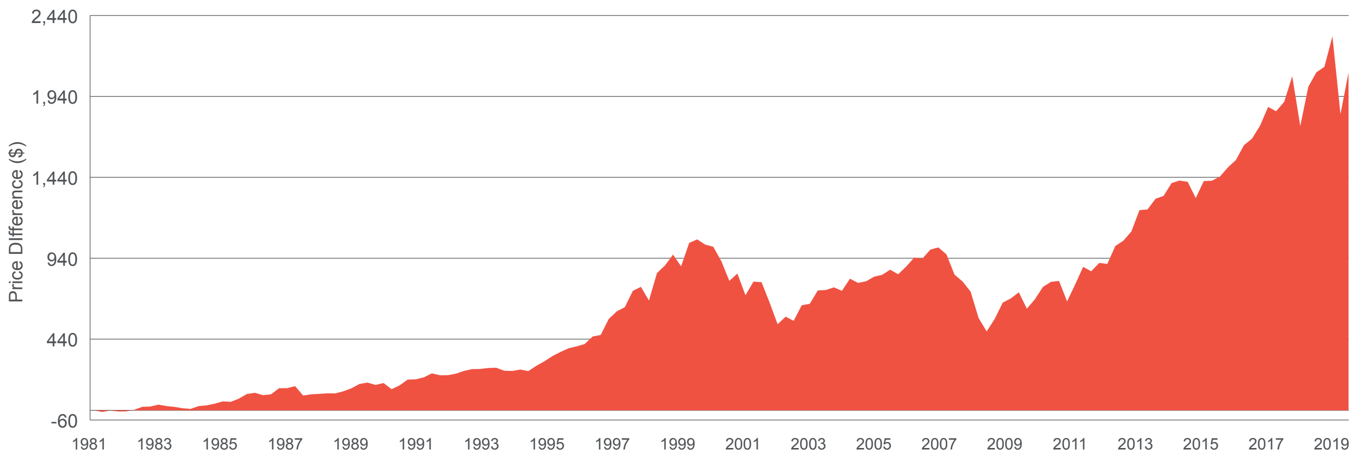
We expect our allocation to commodities to expand not only in size but also in scope. With the broad commodity index at an extreme low level relative to financial assets, there is a valuation argument for the asset class.

If central banks can stoke any inflation, commodities should be one of the primary beneficiaries, especially as a demand recovery could collide with post-lockdown constraints from the supply side, notably in energy and industrial metals. For example, much of the futures curve for WTI crude trades below the levels covering expenses for existing wells. If such a situation continues, meaningful supply will be shut in just in time for demand to increase.

Volatility

The volatility strategy turned 180 degrees during the quarter, moving from a long to a short position, as the VIX shot up from a mid-teens level to the low 80s. The strategy contributed positively in February. As the index continued to climb, we shifted to a stance whereby profits would come from declines in volatility. This small position complements our solvency trades in credit protection.

FIGURE 3:
Price difference between S&P 500 and CRB BLS/US Spot Price



Source: Bloomberg, 31 December 2019

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Outlook

Let us begin by saying we will not hazard guesses on either the ultimate path of the coronavirus or the pace and nature of lockdown removals. Both are critical yet shrouded in uncertainty, and it would be unwise to position the fund aggressively for potentially dichotomous outcomes when we have no edge in prognosticating either. Instead, we are focused on the following:

1. Running a more balanced portfolio reflecting the progression in the credit cycle and the aforementioned uncertainty.
2. Investing the most capital in themes more likely to perform under a variety of scenarios or those which still have asymmetric risk-to-reward.
3. Having playbooks at the ready for different scenarios to implement quickly as uncertainty lifts.

Financial markets are bouncing between liquidity and solvency. By liquidity we mean central banks, most notably the Federal Reserve, using every tool at their disposal and making up new ones along the way in order to prevent the financial markets from seizing up to the point of certain collapse. This means defaults will likely only be mitigated, not avoided. Nevertheless, as long as market participants continue to believe that one must not "fight the Fed" then the prices of risky assets will diverge from fundamental data, and witness the massive multiple expansion of the S&P 500 since the index bottomed in mid-March.

The Fed telegraphed its intentions. Ironic in its timing nearly to the day of the S&P 500's top in February, Fed Governor Lael Brainard gave a speech about lessons learned from 2008's financial crisis, in which she outlined the extraordinary lengths her institution would go to in order to combat the next recession.[2] Plainly said, the Fed would go big and fast. It has not disappointed.

Unsatisfied with size, they also expanded the scope of assets they will purchase, notably, corporate bonds, investment grade and even top-tier junk bonds. Debate will rage over whether this is right or even legal. Our duty is to generate outcomes for our investors, not to moralise.

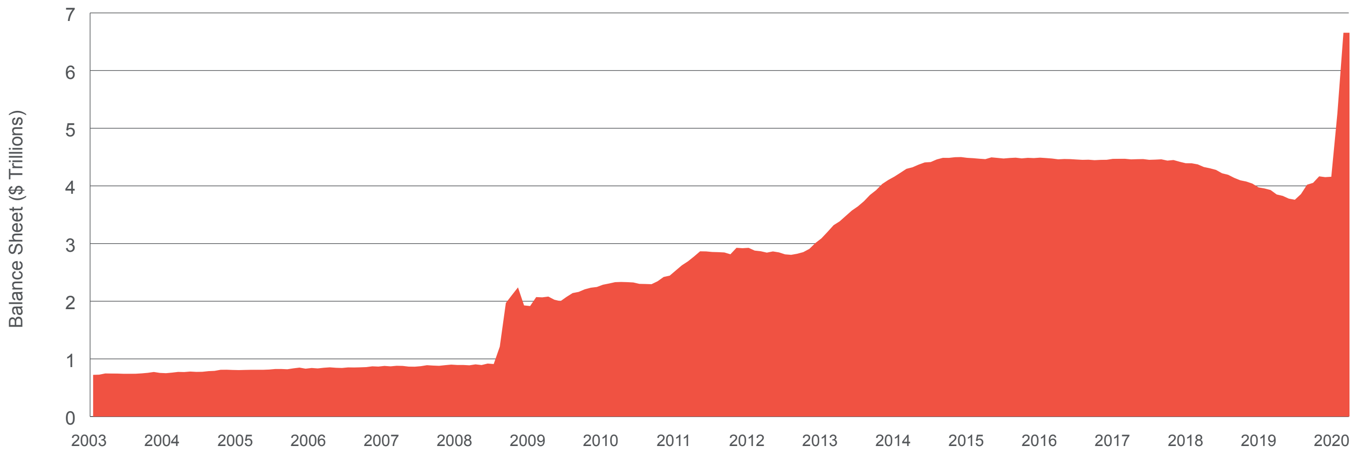
If one assumes the liquidity side of the equation is largely addressed for now, the next question is solvency. History provides little guidance related to the current situation. When was a highly integrated, indebted, and financialised global economy last hit by a global pandemic combined with government-mandated lockdowns? How do you quantify the effects of simultaneous supply and demand shocks? What is the extent of the chain reaction of those not paying rent, suppliers, debts, etc? What will be the efficacy of governments' differing policy responses?

What is known is the supposedly temporary, emergency measures undertaken to fight the last crisis endured for twelve years, making the efficacy of more of the same questionable. Asset price inflation, financial engineering, malinvestment, economic inequality, and populism followed the last crisis. Will hyperactive central banks and investors getting bailed out do better this time around?

Our view is that the hurdles to get into a state of healthy balance-sheet repair are high and the path to get there very uncertain. The impact on small businesses will likely

FIGURE 4:

Federal Reserve Balance Sheet



Source: Bloomberg, 31 March 2020

2 https://www.federalreserve.gov/newsevents/speech/brainard20200221a.htm

be acute and given their important role in most economies, important. Consider the following facts regarding small businesses in the US[3]:

- There are 20.7 million businesses with fewer than 500 employees
- These businesses employ 135 million people (approximately 40% of the total population)
- They account for US $8.8 trillion in annual sales

Then consider that according to an NFIB Small Business Association survey taken on 30 March, 15% of small businesses can operate for less than one month and 35% can do so for one to two months under current conditions. The potential for lasting economic damage is significant. Fiscal responses to help these businesses to maintain payroll and stay solvent are critical. In the US political differences have been overcome to an extent, providing sizable, if not on-target or efficient, support. In fiscally separated Europe, the will and ability to provide similar support has been uneven to say the least.

Balance-sheet repair requires saving, streamlining costs, eliminating wastage, paying off debts, and sometimes raising equity. Often it also requires the elimination of weaker competition often through bankruptcy. Central banks' recent liquidity splurge has stabilised credit markets and unleashed a furious rally in equities. Whether it is enough to alleviate solvency problems and encourage healthy repair of balance sheets is an open question. Issuing more debt, which seems to be the corporations' current strategy, does not necessarily create more robust balance sheets for the long term.

Meanwhile other asset markets are not signalling an economic recovery. Interest rates remain low, industrial commodities depressed, and the US dollar stubbornly high. Until they reverse, debt deflation maintains its slow-growth chokehold on the economy. When they do change, however, watch out for a complete reworking of the monetary system and therefore investment environment.

If massive fiscal stimulus coincides, which is financed by central banks, with an uptick in demand and supply constraints due to the lockdowns and re-shoring of supply chains, then inflation may present itself for the first time in decades. Inflation has been elusive since the 2008 crisis despite developed-market central banks' designs to "run it hot". In the immediate aftermath of the financial crisis, many investors thought that ultra-low interest rates and QE would spark inflation. Instead, a decade of debt deflation ensued, and the only form of inflation was in the price of financial assets and some non-discretionary domestic services such as healthcare and education. The former takes advantage of a global supply chain, which endeavours to exploit the cheapest labour possible, while the latter does not.

Will inflation finally ignite after this crisis? Some of the following pre-conditions to inflation are presenting themselves.

- Political will –politicians are very exposed by the epidemic and are likely to follow the most expedient course as they attempt to mobilise the will of the people behind them. They have every excuse to open the cheque book. The war analogies they frequently use in speeches are telling. Inflation often follows wars as government profligacy is justified for the war effort.
- Grants over loans – if governments manage to get money directly into consumers' hands, without the weight of extra debt (deflation), then fiscal stimulus takes on a new meaning, with inflationary consequences.
- Central banks financing fiscal spending – Modern Monetary Theory has been fast-tracked from a fringe economic theory into what is arguably current practice in certain countries. Money supply is surging. If the velocity of money increases as economies come back online, then inflation will surge.
- Supply chains – the era of globalisation has depressed wages, weighing on the prices of tradable goods. Globalisation was already under threat from various populist agendas. The coronavirus has exposed vulnerabilities in supply chains, which may be addressed by domestic production. All else equal, more domestic production leads to higher prices. Furthermore, there may be supply shortages following the lockdown period.
- Psychology – ultimately inflation derives from people's perception of money. If they fear prices rising while doubting the value of their fiat currencies, they will spend faster, creating a self-perpetuating cycle. A confluence of these conditions may transform the public's attitude toward money.

Inflation is far from priced into financial markets making the set up very interesting should the items above fall into place. However, our view is that deflationary forces still have the upper hand because of lingering solvency risk. While the fund is relatively balanced at present, we have scenario-planned very different types of portfolios for insolvency/deflation on one hand or liquidity/inflation on the other and are ready to execute them as the nature of the recovery becomes clearer.

Thank you for your support,
The RWC Diversified Return Team

3 Source: Dun & Bradstreet, data Q4 2018 – Q4 2019

CONTACT US

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

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