Incrementum All Seasons Fund

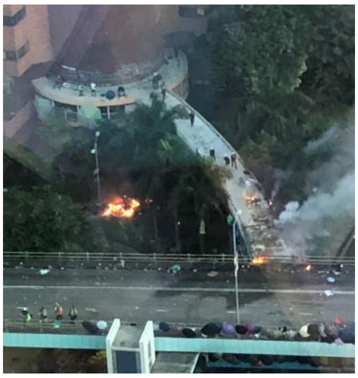
– in pursuit of real returns –

Storm clouds in autumn (www.pexels.com)

December 2019

Seasonal Reflections

Autumn is here –
Winter is coming …



Stormy autumn in Hong Kong (HGS own pic, 18.11.19)

Quote(s) of the Month:

"The US financial system is now faced with a USD liquidity issue for which the Fed has found no lasting solution yet. This puts a myriad of small highly-leveraged US financial players at risk. Incidentally, it also prevents the USD from weakening from its overvalued level. The USD 60bn monthly liquidity injection decided last month by the Fed is visibly not enough to fix the problem. More will need to be done, and rapidly, in order to avoid a liquidity accident." (Source: Didier Saint-Georges, managing director at Carmignac, FT Market Forces, November 18, 2019)

"You want the market to respect you because you run monetary policy and have a huge professional research staff. The problem is, aside from all that power and institutional knowledge, you keep babbling about the immeasurable neutral rate, and haven't been able to hit your own inflation target. The primary reason the economy has grown is because the administration has run a huge stimulative budget deficit. You criticize federal government spending and yet abet their profligacy. You cite the lack of capex, but through QE you incentivize share buybacks at the expense of productive investment. In a way, you're your own problem." (Source: Alex Manzara at R.J. O'Brien in Chicago, for TIS Group, November 26, 2019)

"The biggest event of recent weeks is the Fed moving from QT to QE. And with the Fed moving from QT to QE we now have the BoJ, the ECB, and the Fed all doing QE at the same time. This has never happened before. We have the Fed injecting liquidity at a time when median inflation in the US, and core CPI are at a 10-year high. This has never happened before. But perhaps most importantly, you have the Fed injecting liquidity at a time when budget deficits are going through the roof. So, you have very stimulative fiscal policy and very stimulative monetary policy at the same time.

You know, going back to this idea of spending money you don't have, this is the only response that governments have at this point to the popular anger: Spending money they don't have, and they are doing it in spades. And they are now doing it almost everywhere around the world. To me that is quite inflationary, with the obvious consequences." (Source: Excerpt from MacroVoices (www.macrovoices.com) Interview with Louis-Vincent Gave, 20. November 2019)

"Some stock pickers are now feeling like an endangered species. Just one-tenth of the US equity market's trading volumes now comes from fundamental stock investors, with most of the rest coming from index derivatives and passive funds, according to data from JPMorgan and hedge fund Lucerne Capital." (Source: https://www.ft.com/content/489345c6-0c6b-11ea-bb52-34c8d9dc6d84?mc_cid=b2707d3a79)

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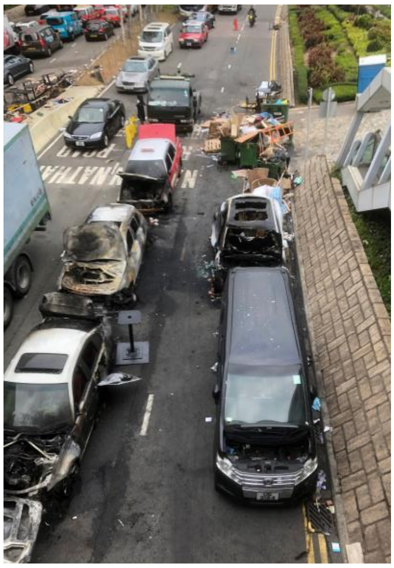
Dear Reader,

I escaped the usual November gloom in this part of the world on a visit to Asia in November, spending 2 weeks in Bangkok, Perth and Hong Kong. While the first two destinations had me catch up with many old friends and acquaintances, they proved relatively uneventful compared to the second week spent in HK. In my former hometown, I got up close and personal with the protests that have rocked the city in recent weeks and caused havoc on its usually very efficient workings. On November 18 I woke around 5.30am to the sound of tear gas grenades, as the police had been battling protesters / students at HK Polytechnic University adjacent to my hotel throughout the night and was trying to enter campus. During the day there were mass protests in nearby Tsim Sha Tsui and Jordan, with thousands of people on the streets in late afternoon, tearing up pavements and using the bricks to erect barriers to block traffic, while I spent an hour trying to find a way back to my hotel.



Salisbury Road, TST, HK, ca. 8am, Nov19, 2019, HGS own pic

Despite of these impressions, which having witnessed real-time were disturbing enough (the picture above was shot on my way to Star Ferry Pier on the morning of Nov19), Hong Kong was still working, and though logistics proved unusually challenging, I spent the rest of the week travelling between Kowloon and around Hong Kong Island without encountering any other major incident. The customary efficiency of Hong Kong was also on display as roads were unblocked and sidewalks widely repaired within a day or two.

Most people I met during my trip were rather shocked about what has been happening in HK, and the majority had little understanding for the protesters and the violence displayed. For those interested in a description from someone on the ground who represents those views, I recommend listening to Louis Vincent Gave, in a MacroVoices interview from which I have extracted the third opening quote.

Having said that I also realized from talking to ex-colleagues and friends that the pro-democracy camp likely represents the views of the majority of HK people, and thus I was not surprised to learn that the District Council elections on Nov24 did not only register a doubling of voters heading for the polls, but also a truly resounding victory for the pro-democracy parties. This suggests that most Hong Kong people share a level of frustration and anger about the status quo, which has been vastly underestimated by those in power, and is another reflection of the increasing unrest experienced around the world. The apparent loss of trust in political leadership and institutions, and more importantly a better tomorrow, is rather worrying.
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My week in Hong Kong was thus a stark reminder of how vulnerable our societies have become. The world appears stable one moment, and the next the avalanche starts moving, tearing things apart, and all who watch it are at a loss at how to stop it.

Source:https://pixabay.com/photos/white-biel-avalanche-the-alps-4345133/

This actually is not so different from what periodically occurs in financial markets. Nobel laureate Hyman Minsky pointed out that the more comfortable we get with a given condition or trend, the longer it will persist. And yet ultimately stability leads to instability.

This is particularly true for macro-economic and financial market trends. The longer such trends continue, the more an inherent sentiment of stability builds. Human beings crave stability and thus everything is done to conserve the status quo, i.e. keep the economy growing and stock markets rising. But as with any enduring snowfall that sets up conditions for an avalanche, the problem with long-term macroeconomic stability is that it tends to produce unstable financial arrangements. If we believe that tomorrow and next year will be the same as last week and last year, we are more willing to add debt or postpone savings for current consumption. Thus, argued Minsky, the longer a period of stability, the more complacent all involved parties become, and the higher the potential risk for even greater instability when market participants are compelled to change their behaviour. And so, economies, financial markets and therewith the financial system always move from stability to fragility, followed by crisis. And yet each time we are led to believe that this time is different, and a crisis can be averted.

S&P500 Price-To-Sales-Ratio, Source: Bloomberg

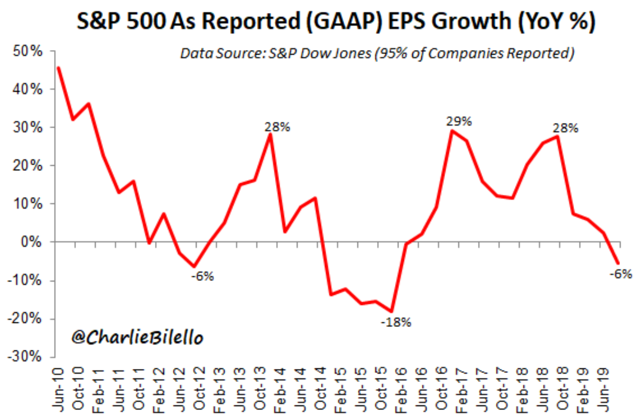
It is with this in mind, and the extreme valuations in global and particular US equity markets, that I have been applying a relatively defensive positioning for the Incrementum All Seasons Fund, where risk asset allocations are widely balanced by hedging positions. Currently, a 50% allocation to equities is hedged by a 27% futures short position and an additional 15% equity allocation hedged via put options, leaving net exposure at a mere 8% (actually, it is somewhat higher because of a lower option delta). An additional hedge is built in by the over 20% allocation to precious metals and miners.

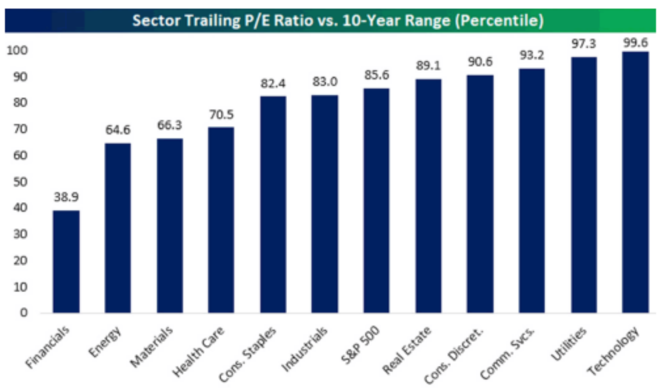
This allocation is the main reason for the languishing fund NAV over the past (couple of) month(s), which had IASF investors miss out on yet another extension of an in my view increasingly stretched risk asset rally. But the mandate of the fund is not to give investors' equity market performance (or better). Instead, it aims to provide investors with an increase in purchasing power over the course of the market cycle, and this in my experience necessitates a risk reduction during the cyclically elevated part of the market cycle, in order to preserve capital and avoid major drawdowns. And this is what the fund has delivered so far.

And it is exactly because market sentiment increasingly feels like late 1999, that both my instincts as well as my value approach, and most importantly my fiduciary obligations towards investors urge me to stay defensive, even if that means missing out on the latest gains. Chasing the current mania can in my opinion only be considered reckless.

S&P500 Index, last 20 years, Source: Reuters Eikon

The graph above shows the S&P500 over the past 20 years, which in my view is by far the most hyped up and overvalued market in the world. – If you care for some evidence, perhaps the latest fall in reported earnings (see graph below on the left) versus a blow-off top in stock prices may serve as such. Or the fact that four index sectors show trailing P/E valuations in the highest decile, with another four sitting in their highest quintile historically.





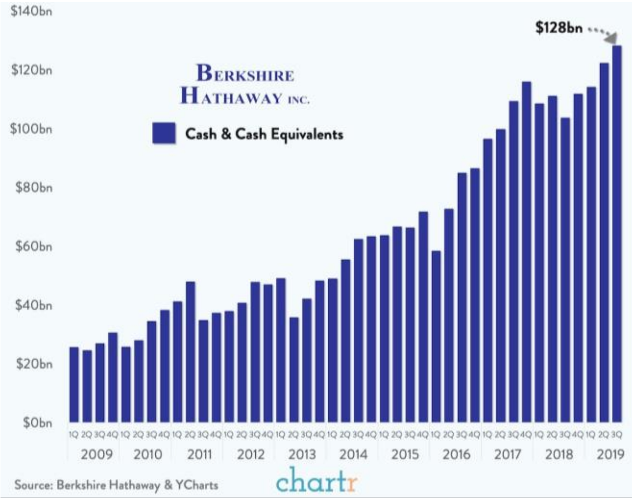
Source: Bespoke Investment Group

https://twitter.com/charliebilello/status/1198000382909263872

https://www.bespokepremium.com/interactive/research/think-big-blog

This is the typical late-cycle pattern: Economic growth is slowing, corporate price-to-earnings valuations are at elevated levels despite of the fact that they are late cycle, i.e. based on record high margins, and earnings growth starts to slow or as evidenced above even starts to turn negative. And yet investors are willing to pay ever higher prices, as the market seemingly knows only one direction.

Of course, as experienced spin doctors Wall Street is always justifying prevailing market levels. But have investors ever wondered why “the greatest investor of all times”, the Sage of Omaha, Warren Buffet himself, has been building up the largest cash pile ever? – Barron’s reported recently that Berkshire Hathaway is trailing the S&P500 by nearly 20 percentage points this year: *“ Berkshire is sitting on too much cash, has bought back only a modest amount of stock this year despite an attractive valuation of its own shares, has been subdued buyer of equities and can’t find suitable acquisition targets because of Buffett’s price sensitivity and unwillingness to participate in corporate auctions.”* (https://www.barrons.com/articles/warren-buffetts-berkshire-hathaway-flaws-exposed-by-failed-buyout-for-tech-data-51575305940?mod=djem_b_reviewpreview_20191202



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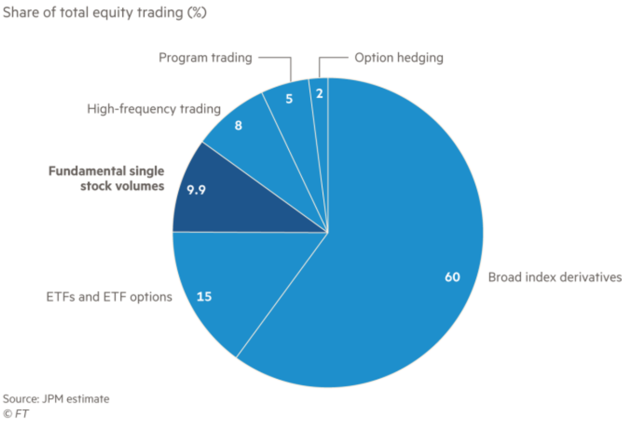
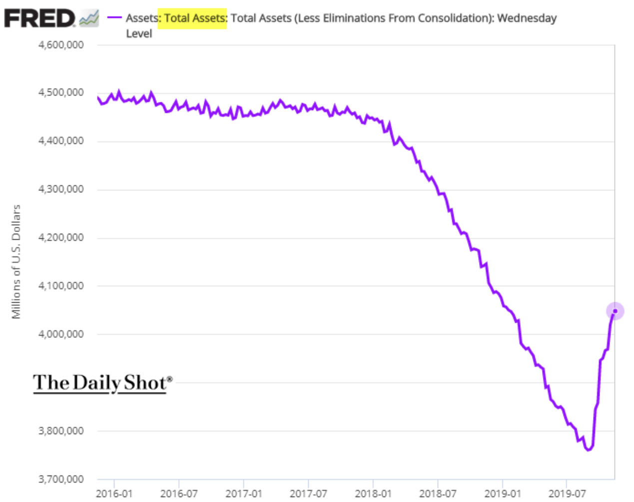


(https://www.ft.com/content/489345c6-0c6b-11ea-bb52-34c8d9dc6d84?mc_cid=b2707d3a79)

Of course, in this environment it is hardly surprising to hear further calls for interest rate cuts, as well as increased monetary intervention via direct asset purchase programs (aka QE), as the first quote of the month shows. All of this has already been reinstated, though personally I am convinced that central bankers’ ability to bail-out markets has been greatly diminished, as their policy tools have become less and less effective. And I have provided the second quote of the month as yet another reminder of how fallible their whole approach has become. – If any private sector institution had missed its own targets so consistently, it would have long been cut off from funding!

Perhaps Warren Buffet would share my sentiment concerning the last quote of the month, which I found in the Nov22 issues of the Financial Times: It highlights the plight stock pickers have been under in this day and age of passive and quantitative, respectively derivatives-based investing, which triggers buying decisions on news of more monetary policy stimulus or a possible agreement in the trade war rather than positive underlying corporate fundamentals. This is quite a change from the days when I started my investing career, and I doubt it will last.



(https://twitter.com/soberlook/status/1195227459265945600?s=11)

As the graph above shows the Fed's balance sheet normalization (quantitative tightening) lasted about 21 months, and almost half of that has been reversed in just over two months. All other major central banks have also resumed QE. In other words, THERE IS NO ALTERNATIVE to government funding via the printing press.

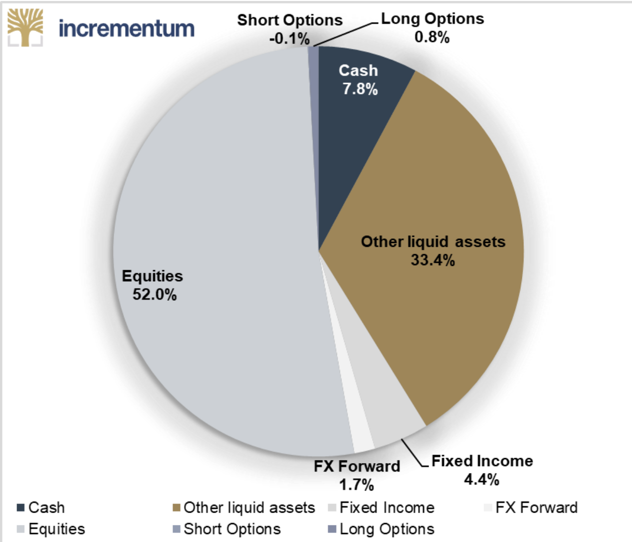
Well, so much for my monthly sermon on what is wrong with financial markets, the financial system, politics that define it, and occasionally society itself. – This would also seem like an appropriate time to remind readers that everything you come across in these "Seasonal Reflections" represents only my personal and subjective views, and that none of what I have said above or are about to say below is meant as recommendation to buy individual securities or make an investment in the Incrementum All Seasons Fund. For any of that stuff you should rely on the advice of a licensed investment professional.

IASF – November Review and Comments

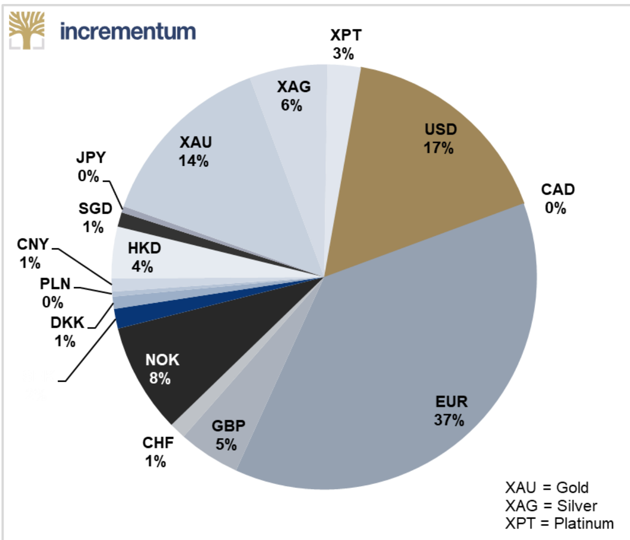
Global financial markets remained in risk-on mode in November, boosted by another Fed rate cut at the end of October and hopes for more fiscal stimulus in Europe. Investors were also cheered by a relatively resilient US economy and better than expected (though still declining) corporate earnings, while hopes for a China-US trade deal "light" were frequently cited as arguments for rising equity markets. Underneath of all this talk, however, lies the inescapable truth that risk asset markets have been boosted again by the resumption of concerted asset purchases by major global central banks. And so, monetary policy still trumps fundamentals, which have been gradually weakening during 2H 2019, as investors reflexively follow the mantra that central banks will have their backs and keep pumping risk asset prices.

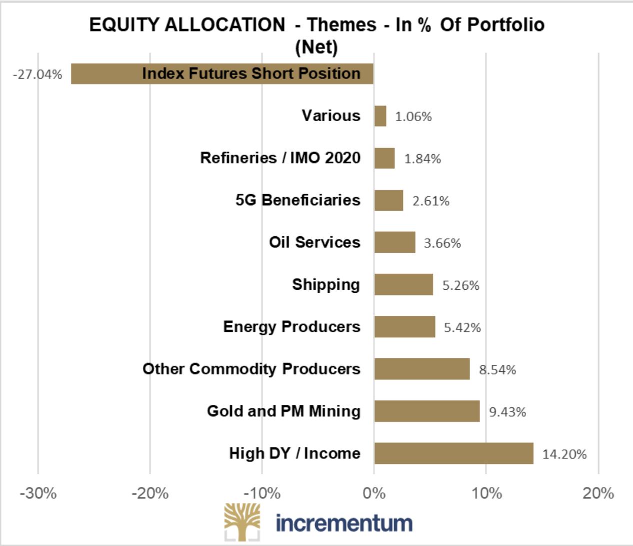
IASF ended the month of September with approx. EUR 36.3m resp. USD / CHF 40m in assets, which included net inflows of approx. EUR 2.3m resp. USD / CHF 2.5m over the course of the month. Portfolio Allocation as of end of November is shown below for your easy reference:

Asset Allocation



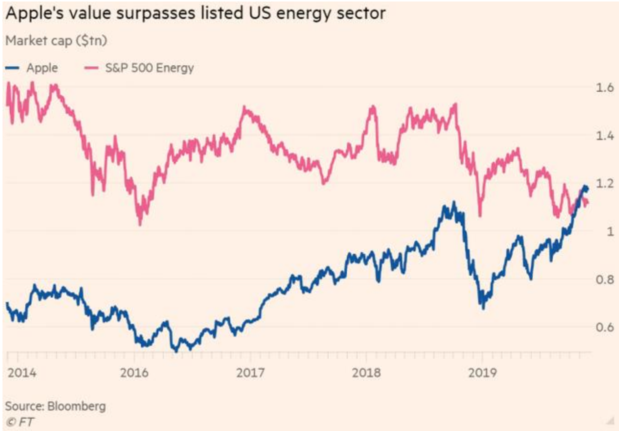
Currency Allocation





Overall IASF asset allocation was broadly unchanged last month, as was gross equity allocation. The largest exposure was to High Dividend Yield stocks, followed by Gold and PM stocks and Other Commodity Producers. The latter fell because a new category was spun off it, namely energy producers, where IASF focused most of its buying activities last month. In addition, another Dec2020 S&P500 Put was added to increase potential downside risk protection for next year, and a 1-year EUR Call-USD Put to reduce USD risk further (about 8.4% underlying). Precious metals exposure was 1% lower due to adverse price developments in metals and mining stock prices in November.

The decision to add a separate energy theme was mostly influenced by the extremely disappointing performance of energy stocks over the past two years, which has not only led to the energy sector showing the second lowest trailing 10-year P/E ratio (s. page 4 above), but also to an incredible market capitalization shrinkage, which in the US has seen only this week Apple's market capitalization eclipse the entire S&P500 energy sector's. Since this is mainly due to contracting valuations, and my expectations for energy prices remain constructive, this seems an appropriate time to initiate this theme.



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Overall, IASF paid a price for its defensive positioning and large precious metals exposure last month, resulting in a NAV decline of slightly over 1% compared to the last valuation date in October. Since due to MiFID regulations fund performance during the first 12 months following launch must not be shown in official documents the fund's German (and new English) factsheets on the Incrementum website do not include any performance table or chart. Hardly what I consider reasonable, but needless to say regulations must be adhered to. For your information, I am listing here the latest NAV valuations as of November 28 for the four separate share classes (D-shares were launched on Jun6, P-share on Sep26, all at 100.00):

- USD-D:	USD 100.73	EUR-D:	EUR 99.77
- CHF-D:	CHF 98.53	EUR-P:	EUR 98.40

As I have always seen myself in a fiduciary role towards my investors, i.e. as responsible steward and protector of my investors' assets, I cannot bring myself to chase the current mania. That does not mean that IASF will not take any risks, but as usual I am patiently accumulating what is quite obviously undervalued, even if it may take some time for this undervaluation to be recognized by the market.

In Closing

Let me finish with another quote, this time from Gluskin Sheff's Dave Rosenberg, who opened his "Breakfast with Dave" newsletter on December 4 with the following comment: *"One day we weren't going to see a trade deal until next year, and the next day we supposedly are just inches away. Never before has Chinese purchases of U.S. soybeans managed to swing the market multiple of the S&P500 as much as it does today. Indeed, Dow futures have swung positively on one simple headline out of Bloomberg News. There is no chapter in any CFA or MBA course to teach you about how to invest in such a ridiculous backdrop where fundamentals don't matter. But what does dominate the investor mindset is that governments and central banks around the world will simply not tolerate any sustained or meaningful decline in risk asset prices, especially the equity market. … I suppose in today's investing world all that matters to the trading-types is the plus-sign – the fact that the pace of economic activity is essentially at stall-speed is of little matter. … Several official "uncertainty" measures are still at levels that exceed the peaks during the dotcom bubble burst, 9/11 and the depths of the financial crisis. And what happens when economic agents become uncertain about the future is that they spend less and save more. … You know the market peak is in when the fundamentals deteriorate, as in the current four-quarter earnings downturn, and nobody wants to believe it. Similarly, the pundits only see the recession once employment begins to contract and the stock market craters. By then, it's too late. It is critical now to worry less about being too early to take chips off the table and raise liquidity and worry more about being too late. The thing about bull markets is that they are escalators that go up over time. The thing about bear markets is that they are elevators that go straight down."*

I could not agree more with the above sentiment. Overall, 2019 has been a good year for my investors and myself, though that is hardly discernible from the flat NAV of IASF, as the gains were all made over the first 6 months of the year. At the end of yet another surprisingly bullish year, I worry more about the downside than missing further upside, and so should any investor.

With less than 3 weeks to Christmas let me close with the news that Incrementum partner Ronni Stoeferle has just had his new book "Die Nullzinsfalle" published in English ("The Zero Interest Trap") as well. For those still looking for Christmas presents, I believe this to be an excellent choice! And in this spirit, allow me to wish all my readers a wonderful festive season!

Greetings from Schaan, Liechtenstein!

Best regards,

Hans

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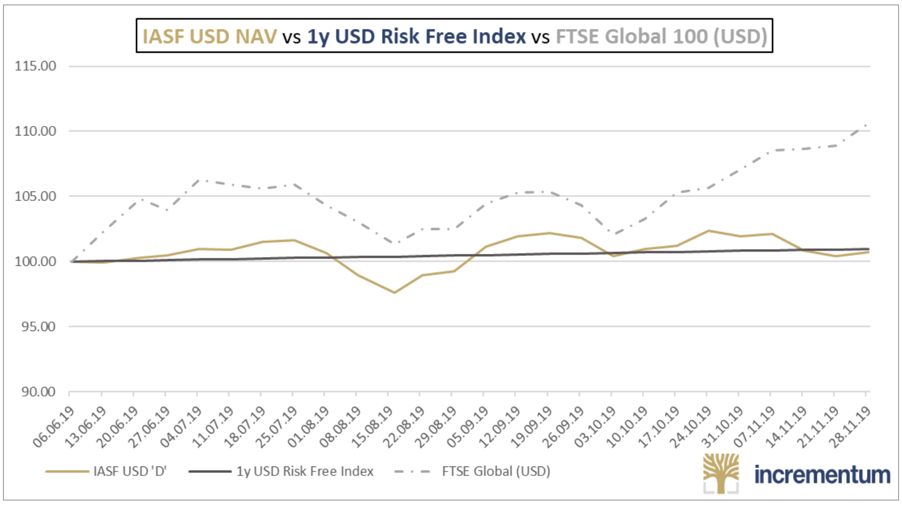
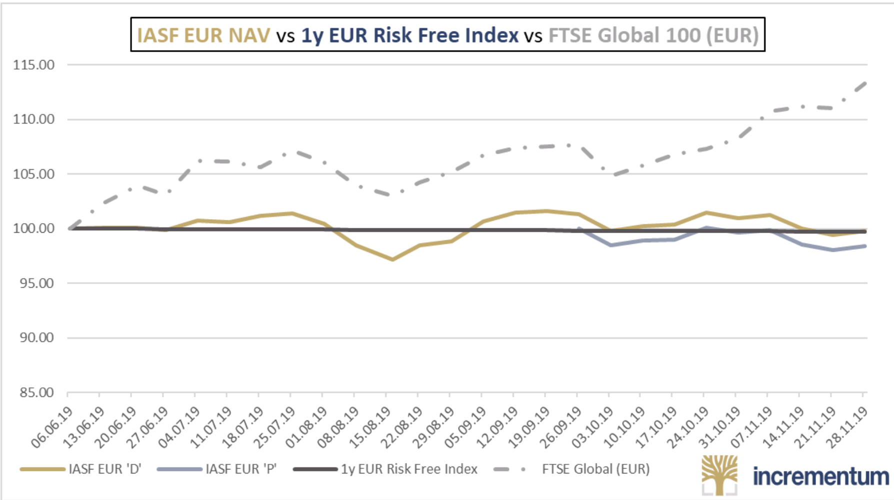
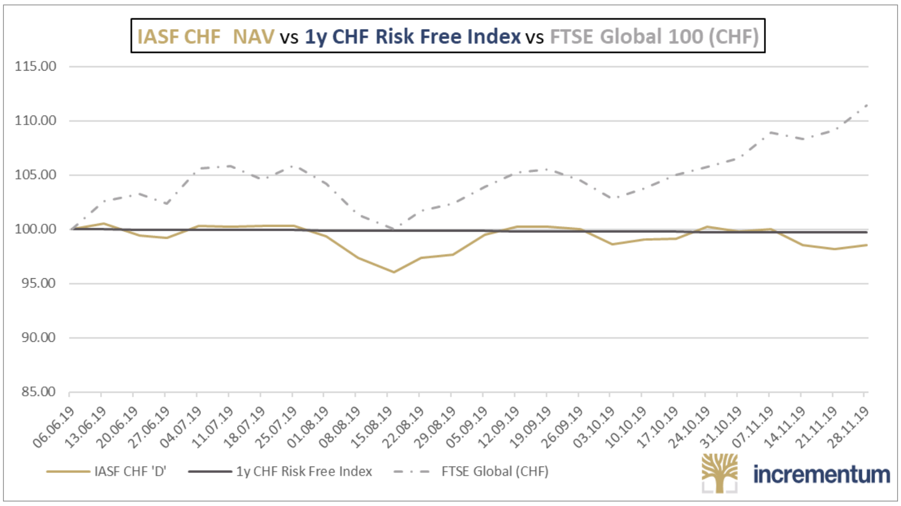
Appendix *







* Graphs display NAV of IASF 'D' shares as of last valuation date (**28Nov2019**), compared to the respective risk-free 1y-government yield as well as the FTSE Global 100 Index in respective currency as a proxy for overall equity market performance, from the start of the investment period (6Jun2019 for 'D' shares; 26Sep2019 for EUR-P shares) on an indexed basis.

IASF PM Shaped By 8 Investment Lessons

1. Capital markets, like the economy, are inherently cyclical in nature, and you must always know where you are in the cycle, while not hesitating to "Be fearful when others are greedy and greedy when others are fearful." (Quote: Warren Buffett)
2. Prices paid determine future returns, i.e. the higher valuations are, the lower future return expectations must be (and vice versa), which is the essence of value investing.
3. Capital preservation is the conditio sine qua non, and a consistent and long-term investment strategy is more important than short-term momentum chasing.
4. As a result you must always know when you trade, or when you invest.
5. The most basic and effective risk management tools are proper diversification and the ability to hold cash.
6. Hard assets are preferable to intangibles, distributions to accruals.
7. Look for the incentives: True alignment of interest works in investors' favor.
8. There is no magic formula for successful investing: Consider both macro- and micro-economic issues, be diligent, flexible, patient, keep an open mind, and realize that investing will always remain more of an art rather than a science.

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