Incrementum All Seasons Fund

– *in pursuit of real returns* –

HGS own pic of LI National Day fireworks, 15.8.16, Vaduz

September 2019

Seasonal Reflections

(LI National Day fireworks (left), though I missed this heavenly display in the downpour this year, and other heavenly supplications (right)

https://app.hedgeye.com/insights/77326-cartoon-of-the-day-prayers?type=cartoons

Quote of the Month:

"Rates hit new lows this month. Symbolically, the 50-year swap rate in Europe dived into negative territory. Bonds as an asset class are in extinction, a major shift in modern finance as we know it, inadvertently turning 'balanced portfolios' into 'long-only equity portfolios'. The 'nocebo effect' of enduring negative interest rates is such that they are deflationary, hence self-defeating. Meanwhile, they have potent unintended consequences for systemic risk, which spreads around, leading the market into an historical trap. A 'Daily Liquidity Crisis' may result." ***(Source: Fasanara Capital / Outlook, August 21th, 2019)***

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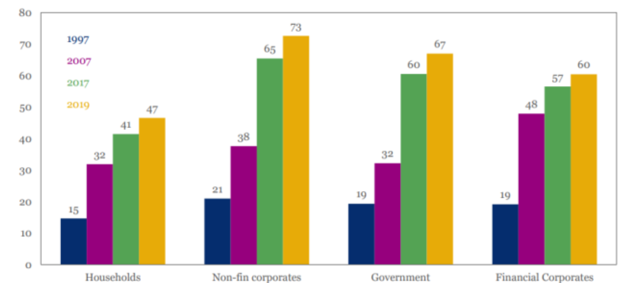
Dear Investor,

August 15 is Liechtenstein National Day, and as in most countries it is marked as a very festive occasion. 2019 was certainly no exception, given that the country celebrated its 300th anniversary. To quote https://www.300.li/en, *"In the year 1719, the diminutive Alpine monarchy was elevated to the status of an imperial principality, since when it has remained an established part of the European map. While it was still part of the Holy Roman Empire of the German Nation at the time of its foundation, in 1806 it achieved sovereignty when the Confederation of the Rhine was founded. Having abolished its own army in 1868, the Principality of Liechtenstein survived the turmoil of both World Wars and is today one of only five debt-free states around the globe."* Remarkable history, indeed.

Particularly noteworthy is the fact that Liechtenstein is "*one of only* ***five*** *debt-free states around the globe"*. One could almost get the impression that (led by the U.S. and China) there is a global race on these days of getting ever deeper into red ink, with all sectors of the economy participating. For those interested in more details, the IIF presentation on the subject, quoted as source of the chart on the right, is speaking volumes.



Source: IIF, see https://www.iif.com/Portals/0/Files/content/GDM_Aug2019_vf.pdf

6th of September 2019

incrementum
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The global debt-to-GDP level has by now exceeded 320% of GDP, and this is not counting contingent liabilities (e.g. pension and social welfare promises, mostly made in the developed world). Tiny Liechtenstein is not taking part in this race for bankruptcy; out of curiosity I looked up the other four nations which according to https://www.debtacademy.com/the-debt-free-countries/ are Macau, British Virgin Islands, Palau and Brunei. Hardly a group to bail out the rest…

I am aware that I may appear repetitive on the subject, but bear with me for a bit longer, as I intend to reflect this month on how the above described state of world affairs, combined with record low and even negative interest rates, is actually affecting management of IASF's portfolio:

How do you manage risk in a globally diversified investment portfolio? – Traditionally, as asset managers we have done this through exposure to top quality bonds and cash, which as equity markets were getting more expensive were increasingly relied upon to lower downside risk from a potential equity market correction, all the while still compensating investors with a steady, though modest and usually even real (i.e. inflation-adjusted) positive yield.

But as the graph on the left shows, interest rates are at / near record low levels around the world. Negative yielding bonds now account for a record USD 17 trillion, with more monetary easing to come, and thus potentially even lower yields ahead. Meanwhile, consumer price inflation in the EU / U.S. was recorded at 1.4% / 1.8% in July 2019, with the long-pursued intention by central bankers to increase the level to 2% and above.

Hence investors who buy 10-year German government bonds at the prevailing -0.7% yield effectively receive a guaranteed loss of approx. 7% over the coming decade on a nominal basis, while risking insult being added to injury through the effective additional reduction in the EUR's purchasing power if the ECB achieves its stated goal of an annual 2% inflation.

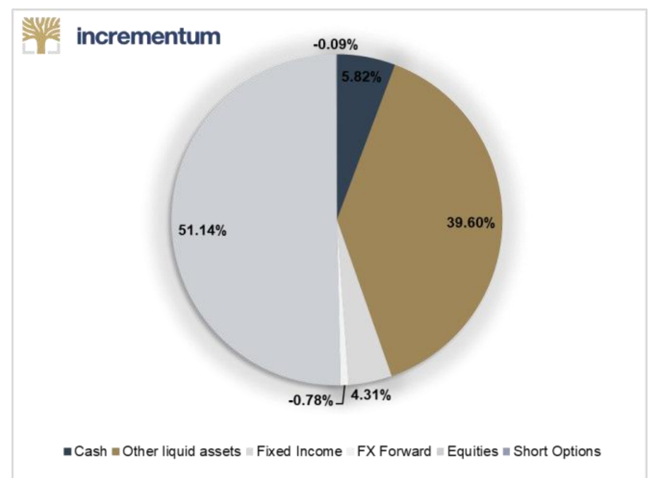
That's almost a 30% loss in purchasing power, guaranteed, without any upside whatsoever! The only "consolation" is that investors can rest comfortably in the fact that Germany with its AAA-rating will be able to make good on repaying the bonds. In fact, only today I read that Germany earns over EUR 6bn in negative interest rates annually, which approximates to 2% of its annual fiscal expenditure. Effectively this is a tax on savers…

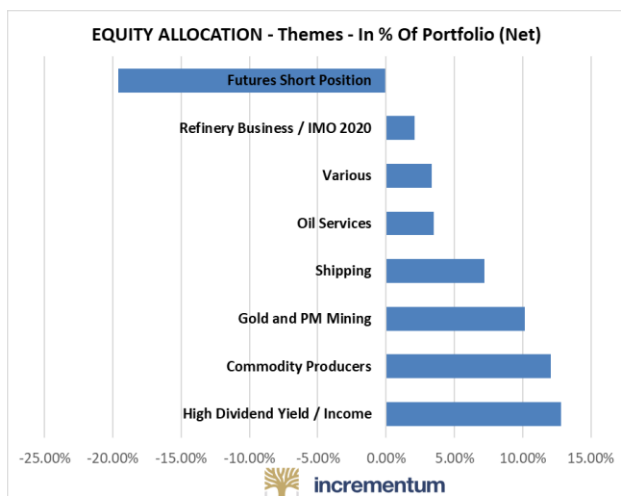
https://app.hedgeye.com/insights/77579-cartoon-of-the-day-fishing-for-ranges?type=cartoons

Perhaps you will see the resulting challenge. Not only is a substantial part of traditional asset allocation no longer usable for investors looking to achieve a positive return (especially adjusted for inflation), but this is also a problem for the theoretical foundation of the investment management industry:

"Much of the literacy and the modelling in finance, over history, assumes rates to be floored at zero. None of the founding fathers of economics and finance had to deal with this shape and form of 'market economy'. It follows that we cannot reach out easily and comfortably to the work of Keynes, Smith, Cantillon, Galbraith, Friedman, nor to the pricing tools of Cox, Ingersoll, Ross, Black, Scholes, Hull, etc. for guidance. What's the value in modelling the term structure of interest rates today? Similarly, portfolio management tools like Capital Asset Pricing Model (CAPM), Modern Portfolio Theory (MPT), Value At Risk (VaR), Risk Parity are all ill-equipped to handle a world of lasting negative interest rates. That leaves us, nowadays, in the middle of the ocean during a storm with no compass to help navigation." (Source: Fasanara Capital / Outlook, August 21th, 2019)

Indeed! So, how do we invest the fund's assets under these circumstances? – After what I have described above it should be no surprise that IASF has little bond exposure (4%) right now, except in the oil services space where the fund holds two high yield / junk bonds, which at least offer a meaningful return potential to compensate for the risk they carry. In addition, the fund holds 1% in short-term government bonds issued by Poland and Russia. The main risk asset allocation is in equities, which now account for 51% of the fund's assets. In this area we have pursued a thematic approach.



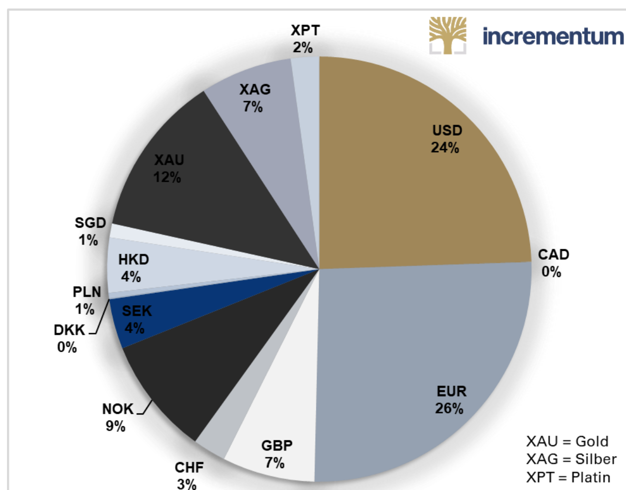


This is based on the realization that much of today's equity investment is done passively and index driven. As a result, the same group of large companies makes up the top holdings in most investors' portfolios. In fact, I read recently that concentration levels among major US institutional investors have rarely been this high, and that the largest holdings in funds mostly recruit from the usual suspects (e.g. Amazon, Alphabet / Google, Facebook, Apple, Microsoft, and the likes). Instead, IASF has opted to pursue certain sectors and bottom-up opportunities with a focus on hard asset underpinnings.

The largest allocation is to High Dividend Yield / Income stocks (12.8%), with an average weighted yield of 7.8%, which represents a highly attractive carry. The second largest allocation is to Commodity Producers (12%), which is not surprising given my hard asset focus. The sector has been hammered in August amid growing fears of an economic slowdown, but longer-term offers outstanding value. The third largest allocation is to gold and precious metals mining stocks (10.1%), which have been performing quite well last month. Short-term they may suffer a pullback, but the sector is only at the beginning of a new bull market. Together, these three themes account for nearly 70% of IASF's gross equity exposure.

Just in case you are wondering about the lack of names, as a firm we are not in the business of providing investment advice. However, if IASF investors would like to discuss individual holdings with me over the phone, I am most happy to do so.

Lastly, it is worth highlighting that net equity allocation for IASF is merely 32%, given that IASF continues to hold a short position in equity futures (80% S&P500, 20% EuroStoxx600), which is supposed to cushion overall equity market downside risk for the fund.



Another source of potential returns is the fund's currency allocation, which is shown in the graph on the left (all data as of end of Aug 2019). IASF's base currency is EUR, and both its USD and CHF share-classes are fully hedged right now. The underlying portfolio shows a high degree of diversification, with EUR (26%) and USD (24%) the largest exposures. Precious metals (PM) exposure amounts to 21% currently, led by gold (12%), followed by silver (7%) and platinum (2%). PM exposure is held via ETNs backed by physical metals, as well as gold and silver mining shares.

The remaining allocation is a mixture of currencies from underlying investments, plus small diversifications from EUR into NOK, SEK and GBP. Overall, I feel comfortable that this is a suitable allocation in these turbulent times, where most currencies are obviously competing in a race to the bottom.

So, all in all equities and currencies currently represent the main source of return / risk for the fund. Allocation to credit risk is small, as reasonable quality at a decent price is hard to find. Since the fund's aim is to achieve real yields (i.e. positive yields after deducting inflation) investment-grade bonds simply do not present a viable investment option under present circumstances.

As a closing thought, there is more and more evidence that zero / negative interest rates are no longer working. Case in point is the graph on the right, courtesy of Juliette Declerc, founder of JDI Research, posted on Twitter recently. It suggests that lower rates are increasingly "stimulating saving rather than spending", which is not the official story line.

https://twitter.com/juliettejdi/status/1168573231915294722?s=11

Meanwhile, financial markets remain in bubble territory, which is where they have been for years. With central banks buying government bonds en masse, all other investors have been forced to move ever higher up on the risk curve to achieve any semblance of real returns. With monetary policy increasingly ineffective, I expect the next round of economic crisis fighting to rely increasingly on fiscal steroids. In my personal view this will finally let the inflation genie out of the box…

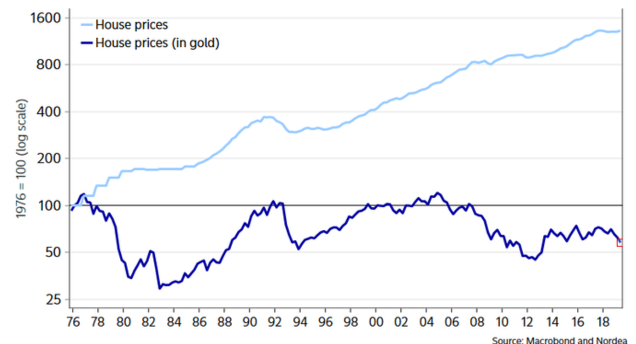
https://app.hedgeye.com/insights/77386-cartoon-of-the-day-twilight-zone?type=cartoons

Whether the bubble will be pricked by this guy (usually especially prone to produce a lot of hot air), by the evolving Brexit mess, further Emerging Market blow-ups, or other political miscalculations remains to be seen. Underlying is of course always this: *"We are in a global debt trap of immense proportions and the surreal buildup of excessive liabilities means the next recession comes with a deflationary burst of defaults."* (Source: David Rosenberg, Breakfast with Dave, GluskinSheff, September 4, 2019)

Care for more meat on the bone? – David Rosenberg continues: *"Think about it – from the bubble peak of 2001 to the bubble peak of 2007, global debt (households, businesses and governments) rose from $86 trillion to $116 trillion. That is a $30 trillion credit expansion. Global GDP, meanwhile, increased from $33 trillion to $58 trillion for a rise of $25 trillion. And we know this was the mother of all worldwide debt bubbles.*

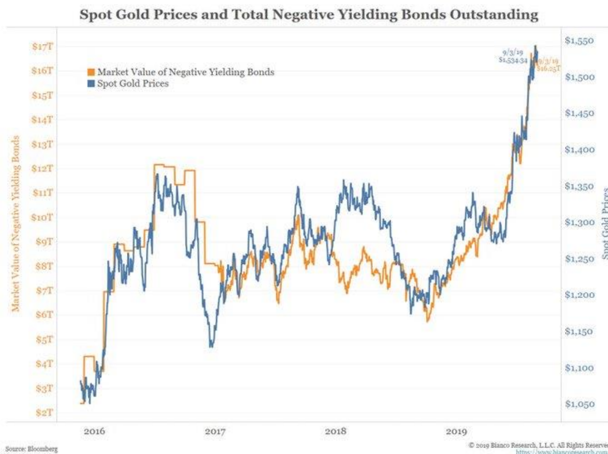
Now from the 2007 bubble peak to the current 2019 bubble peak, global debt has soared from $116 trillion to $244 trillion… in just over a decade! And global nominal GDP has risen $27 trillion. So this cycle saw debt growth outstrip income growth by $101 trillion – versus $5 trillion from 2001 to 2007." – I guess this makes it the great grandmother of all worldwide debt bubbles...

Consequently, I have no doubt that gold and precious metals will offer shelter from the coming storm as they have always done. This is neatly exemplified by the graph on the right. While it shows that Swedish house prices in nominal terms and SEK are up an impressive 1300% since 1976, the illusion of a "wealth gain" is ruined when one looks at Swedish house prices measured in gold... – I guess this lesson will have to be relearned by most investors.

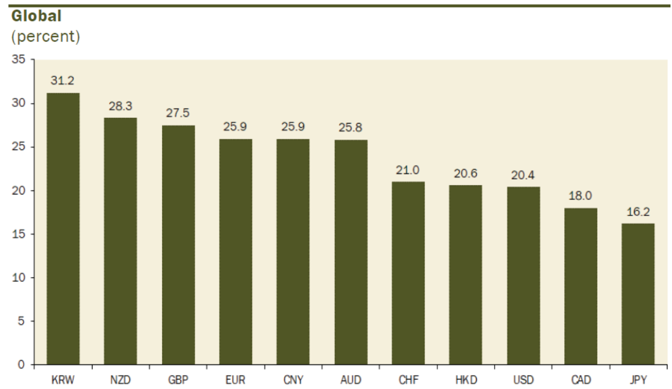


https://twitter.com/enlundm/status/1167422053017956354?s=17

Precious metals are the safe havens (some call it anti-bubble investments) everyone is looking for in this environment which has seen the proverbial can kicked down the road for far too long already. The problem is we just don't know when the road will end and have little historic evidence to draw upon in our scenario analysis. David Rosenberg in the above quoted piece points out *"the rising odds that we experience a huge deflationary default wave"*, which seems a logical course to go. But he also points out that *"Central banks will have no choice but to fight this coming recession hard, and that will include pegging rates at, or below, the zero bound."* This they will likely do, but that does not take into consideration the enormous pressure this will put on the banking system (see https://on.ft.com/2LkaU2I, courtesy of FT), and the strain these policies are already putting on developed world pension schemes as well as the massive destruction of savings involved. Hence, I expect fiscal stimulus and eventually helicopter money to ride to the rescue, because the only way to deal with this enormous debt burden is to inflate it away.



Source: https://twitter.com/biancoresearch/status/1168954541565501442?s=11



David Rosenberg, Breakfast with Dave, GluskinSheff, September 4, 2019

This is why gold has been soaring in this submerging yield environment. After all, (at least in the form of bullion) gold is a highly liquid asset with no counterparty risk, where the lack of interest paid on it increasingly turns into an advantage. At least it does not face a guaranteed loss as wide areas of global sovereign bonds promise investors these days but has instead been reliably preserving purchasing power over centuries for its holders. And as the graph above on the right shows this realization is clearly dawning on investors around the world. Personally, and given this unique state of affairs I continue to believe that prudent investors should maintain a 10% allocation to physical gold.

So much for this month's SR, which I hope you have found an interesting and stimulating read. None of this is meant to scare readers, but merely to remind them of the truly extraordinary times we live in. It is also meant to raise awareness for the challenges that lie ahead of investors. At the same time, I am seeking to convey my conviction that with proper recognition of our current economic and market dilemma the appropriate measures can be taken to ensure IASF's goal of achieving a long-term increase in the purchasing power of invested assets can be reached.

As usual, I will be more than happy to discuss any of this in more detail with investors.

Greetings from Schaan, Liechtenstein!

Hans

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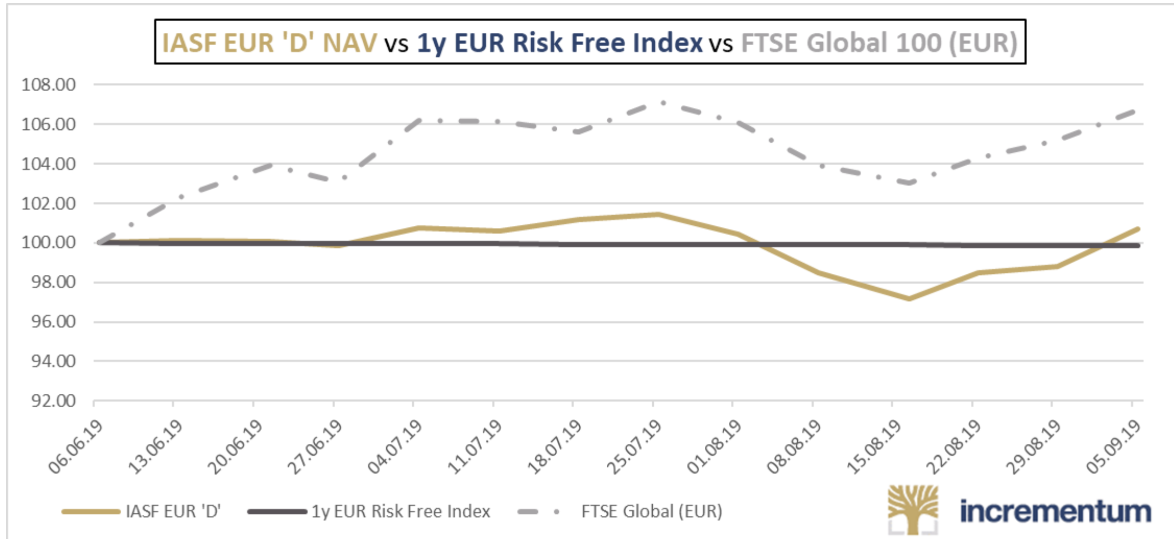
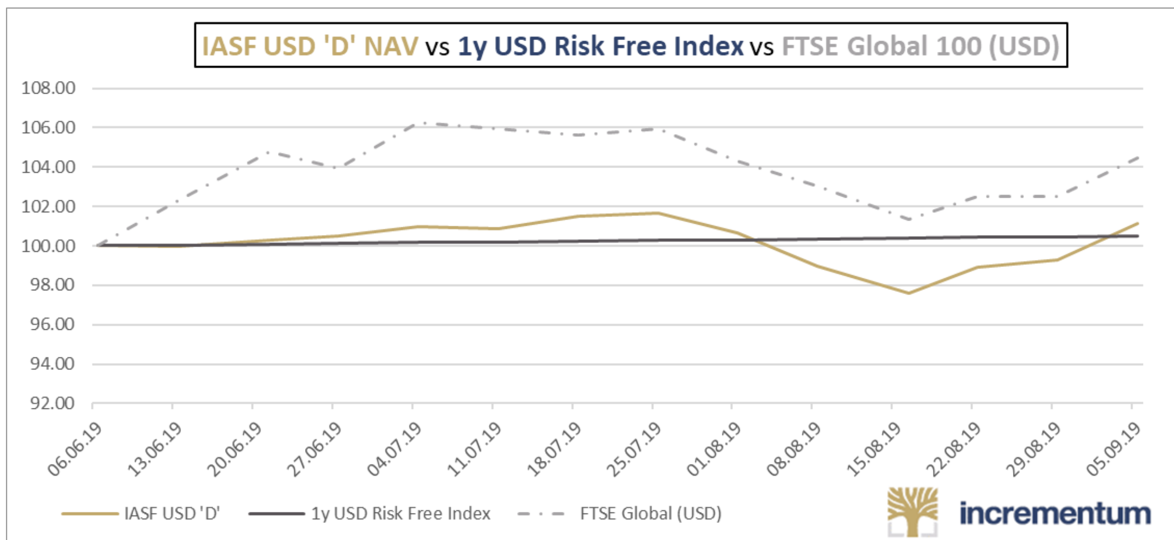
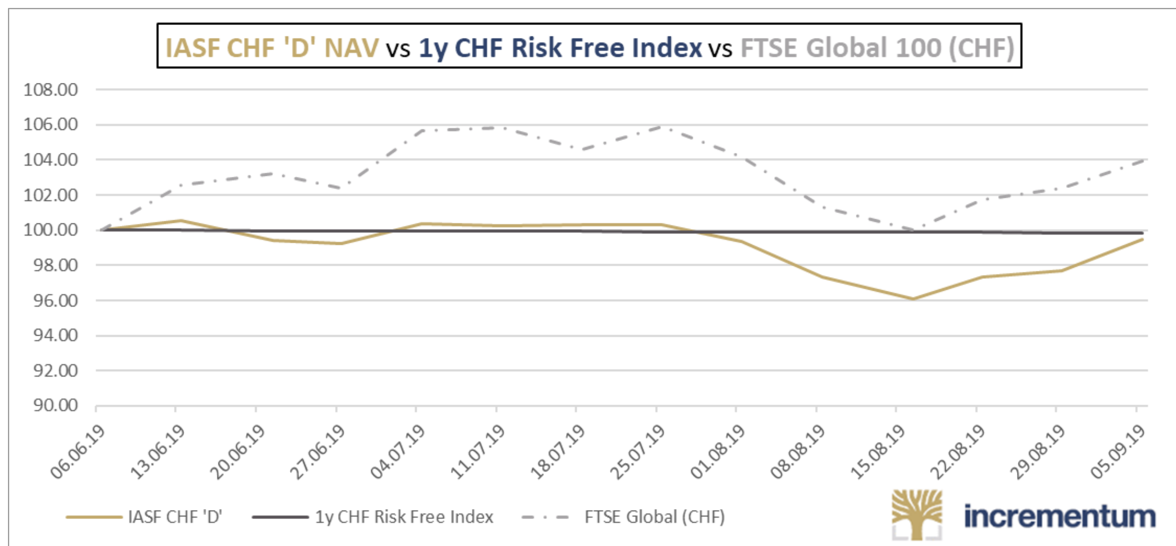
Appendix *







* Graphs display **NAV of IASF 'D'** shares as of September 5, compared to the respective **risk-free 1y-government yield** and **FTSE Global 100** development from the start of the investment period (6. June 2019) on an indexed basis.

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