ALVIA

ASSET PARTNERS

What's the hurry Rick?

Alvia Asset Partners Investment Team Insights

March 2021 Quarter

A brief message from the CIO,

Another eventful quarter has come to an end, full of fierce speculation and get rich schemes – not quite *peak exuberance* but we feel we are on the way. One way to view the current environment is through the lens of hypothetical investor stereotypes – let's call it the uncle/aunty investor challenge. So, who do you want to invest with?

Most of us know one or all of these three investor stereotypes below (perhaps all three exist in your family). Let's call them Uncle Jim, Aunty Mary and Uncle Charles.

Uncle Jim has always been on the hunt to get rich quick – he is inherently lazy with the nice watch but little to his name, although his outgoing charisma has enabled him a reasonable income. The issue is that he has never converted his income to wealth. His latest opportunity revolves around a block of land he owns, whereby a local political connection has given him the inside word on some *'wink wink'* non-public information.

Aunty Mary is an accountant by trade and is inherently conservative. She lives within her means and focuses on passive income to reduce her reliance on her day-to-day profession. Her latest investment opportunity revolves around her own successful accounting firm and the retirement of one of the partners – she has an opportunity to purchase the firm at a discount due to her ongoing relationship with the partner.

Then there is Uncle Charles - he is the wealthiest of the three and nobody really knows exactly how, as he plays his cards close to his chest. His latest opportunity has come via his networks of existing steady growth business interests. It is a disgruntled cousin shareholder of a growing private business. The cousin doesn't appreciate the long-term future value of the business and wants out today and will take a fair offer from outside of a competitive process.

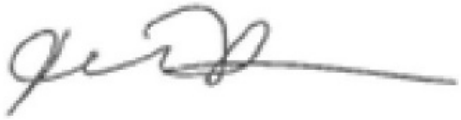
- With Uncle Jim – it could be something but who knows – its speculation and best left for the casino, not compounding wealth over the long term;
- Everyone needs an Aunty Mary in their life and portfolio – consistency of income is important but it's not without risk – we all need growth to offset business maturity. What happens if she loses multiple clients and the income dissolves – yields are not set in stone; and
- Uncle Charles is on to something, he has a fundamental long-term appreciation of the opportunity set that the seller does not, and this means he has a tactical/behavioural advantage. He also has future growth to offset immediate price risk. **This is the ideal growth/value combination, where there is a value you can fall back on if the upside does not manifest.**

I personally want to invest with Uncle Charles and Aunty Mary and enjoy the family parties with Jim 😊.

- **In today's market, Uncle Jim is Cathie Wood's ARK Innovation ETF (which we would never own);**
- **Aunty Mary is a high yield investment like Magellan Midstream Partners (NYS:MMP) (which we do own); and**
- **Uncle Charles is like Novo Nordisk (NYS:NVO) (which we also do own).**

Now we appreciate that the stereotypes don't end there; we can design various other scenarios, and many of us have larger families to name them. But the point is this; it's better to do the work and invest in areas of competence like Aunty Mary and Uncle Charles, with a risk adjusted mindset.

Yours sincerely,



Joshua Derrington
Chief Investment Officer
Alvia Asset Partners

Parallels to the Roaring 20's

We think it's a pretty well held view that post the recent splurge of global liquidity, the economy is set for a good period – perhaps as good as we have ever seen.

What perhaps isn't as well held a view is that the market has already played this out and is now waiting to predict the next 12 months once the liquidity edge has softened.

Perhaps the correct parallel is the grumbling late 20's

"History doesn't repeat itself, but it often rhymes."

- Mark Twain

At Alvia, we aren't in the business of making predictions but it's important to take a view and review.

- Without a doubt its similar to the 1920's. There was a flu and a war and the people of the time craved 'human interaction' (outside of immediate family 😉) – much like we all do today (more so ex-Australia)
- In the 20's – people wanted to club together after being starved of interaction, the music scene flourished, parties were elaborate and mankind embraced speculation on an unheralded scale. **The herd gathered strength!**
- Without doubt, the herd and exuberance is growing globally:
    - For many, risk is not a concern (not a good thing) – the economy and discretionary spend (powered by a wealth effect) is on turbocharge;
    - Supply can't keep up with demand;
    - Job postings are up 20%, boat/jet ski sales are at record highs, manufacturing is hotter than tech;
    - Personal savings are up more than ever with excess savings of $1.6 trillion in the US alone; and
    - The world is aligned psychologically and economically for a big boom – just know this should be separated from the market as this has been largely pulled forward already.

We don't want to crash the party – we just want to put the consideration of risk at the forefront. The reward has been partially consumed. Now it's time to think risk first.

Special of the Day – Get Rich Quick!

The flavour of the quarter, albeit it has felt longer than that, is that balanced portfolios and building slow and steadily are boring…

Saving and compounding appropriately **is** more important than your weighting to cryptocurrencies. Now is the time that your established investment philosophy is tested around the edges and your temperament is truly tested.

- Do you really need to be invested in the latest VC idea that your second cousin mentioned over Easter?
- Do you really need an exposure to a basket of cryptocurrencies?
- Do you find your investment strategy has become stretched at the edges?

History suggests that this is very common in late cycle behaviour. A behvaiour that materialises as the concept of risk becomes marginalised by the competitive threats of our egos.

Temperament wins over IQ every single cycle.

Bigger is not best – so play your own game.

The missing Rick

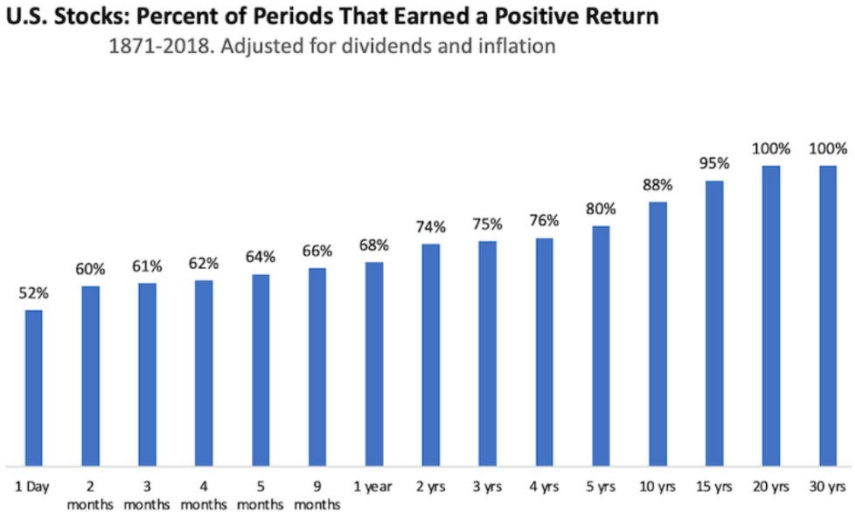
Little known fact, but Charlie Munger and Warren Buffet were once a part of a "big 3"; no not the Miami Heat. Their 3rd team member was Rick Guerin. Rick somewhat faded into the background during the 1970 bear market – why?

Well Rick was actually levered with margin loans during the 1973/74 downturn. He was subsequently margin called and as a result sold his Berkshire stock to Warren. Warren said he was able to buy Rick's Berkshire stock for under $40 a share.

> *"Charlie and I always knew that we would become incredibly wealthy. We were not in a hurry to get wealthy; we knew it would happen. Rick was just as smart as us, but he was in a hurry."*
>
> *- Warren Buffet*

In a hurry?

- If you plan to hold for greater than 15 years, you are almost guaranteed a positive return from stocks.
- The problem for most portfolios is that most people are in a hurry and concerned by daily, monthly, yearly market gyrations.
- There is only one rational solution; slow down, enjoy the journey and acknowledge that the single largest potential erosion of wealth is caused by human interaction with one's portfolio at the wrong time…
- Your portfolio isn't mortal and doesn't require regular activity, in fact lethargy is best 😊



Source: The Collaborative Fund: Too Much, Too Soon, Too Fast by Morgan Housel

Robert Waldow "The Giant of Illinois" and Investment Performance

Growing up, Alvia Chief Investment Officer Josh Derrington was obsessed with the Guinness Book of Records, usually flicking to find the world's tallest person, which is no surprise given Josh is under 6 foot himself. Externally, Robert appeared incredible (fuelled by excess growth hormone). He reached almost 9 feet, he wore size 37 shoes and his hands were a foot wide.

With this gift, you would assume Robert to be an amazing athlete, capable of super-human feats on the basketball court. However, The Giant of Illinois could barely stand up straight, requiring braces for support. His heart could barely deal with the strain of pumping to all parts of his body – his death coming from his own body's inability to deal with infection.

We reflect on this when one makes presumptions based on superficial circumstances – in an investing sense this is very important when making judgements based on narrative…**always ask why** and **focus on the process**!

In most cases, life will pay you a fortune over the long-term with a sound process but will seek damages over the short-term if you try to rush it.

Virtually all investing mistakes are made when the investor mindset migrates from a long-term horizon to a short term one – in other words when we rush something that shouldn't be rushed.

Even companies get greedy and rush…but the piper always gets paid

- The best example of this is Starbucks (a great business)
- In 1994, Starbucks had 425 stores and by 2007 it had 3,500 and was opening a new store every 90 minutes…
- In essence they rushed and cannibalised themselves, lost their identity in the pursuit of egotistical growth and like Robert Waldow, grew to a size they couldn't manage…
- **Stock price surged until it fell almost 80%…**

We know it has now significantly compounded since this, however, we think there is still validation in the point.

So…am I actually meant to get Rich…slowly??

We can't recall a time in markets where so many people have lost their patience in a vain attempt to get rich quick. A new age term for it is FOMO (Fear Of Missing Out).

A smart young guy we know recently sold his solid global equity portfolio to get 100% exposed to Bitcoin, with this decision being so he could rapidly increase his capacity to build a house deposit…. This is truly terrifying if this behaviour is reflective of the boarder mindset of the market.

Compounding happens slowly and is almost indistinguishable at first. However, if patience prevails, it snowballs, and you soon realise it doesn't require a T20 batting mindset of hitting boundaries and sixes… it just requires a good front foot defence and consistent singles (and a boundary off the bad balls… i.e. when there is less risk 😊),

While everyone wants it all today, the world's best recognise the beauty is in getting rich slowly.

"Ninety-nine percent of investors shouldn't try to get rich too quickly; it's too risky. Try to get rich slowly."

- Sir John Templeton

Archegos Capital and Greensill (same problem, different name)

Both Archegos Capital and Greensill succumbed to the allure of leverage and ego with a dash of conflict of interest. Which when mixed are a weapon for your own mass destruction.

Using 5x leverage works extremely well right up until the point it doesn't. It causes the inevitable fire sales where the vendor loses control of the process (price diverts from real value), which can only be good for the acquirer. **Bragging rights don't last long**

An investor can look clever for a period when borrowing to invest, but creditors ultimately take control at the worst time and the investor's opinion of value becomes irrelevant. This is a bad situation. In both Archegos and Greensill's scenarios, conflicts of interest were allowed to flourish as investment banks enshrined short term profiteering over long term value.

Short term behaviours absolutely destroy corporate culture and any entity that runs to the beat of short-term measures should be avoided like the plague.

Three lessons from a distance:

1. A quick scan of Greensill highlighted plenty of red flags, therefore what were Softbank doing paying $3.5bn? Our view is they were possibly in too deep, in a very similar vein to their "good money after bad" strategy with WeWork...**Perhaps they were lucky with Alibaba?**

2. Be wary of any of your underlying investments that utilise accounts receivable factoring or financing – **if they need it, ask why (do they have cash flow issues)?**

3. Should swaps and Contracts for Difference (CFD) positions require disclosure in the same vein as equity positions? It astounds us that Archegos Capital was able to hide the size of its positions from underlying brokers...**its very likely Credit Suisse will write down circa US$4.7bn as a result.**

SPACs (Special Purpose Acquisition Companies)

- We are frequently asked to comment on these but will let Howard Marks do it for us:

"SPACs are a form of financial innovation and financial innovation can only take place when markets are optimistic. "

- Howard Marks

Price is important

Quality is only a single part of the equation

- Risk manifests in the deterioration of quality (capitalism is brutal)
- Why paying for enduring quality is a dangerous practice…very few moats are sustained over the very long term

That is exactly how the *New York Times* described Sears in 1983.

"In the markets we enter, we'll be dominant," said its head of retail. Few doubted it.

- After dominating American retail over the previous century, Sears in 1983 was pushing into banking. Few doubted it would win there, too. "On a scale of 10, not to be flip about it, I've got us at about 10.5," its chairman told the Times. **Overconfidence!**
- Its catalogue was the Amazon of its day
- Then everything fell apart. Sears made more profit in 1954 than its market cap is worth today
- Capitalism is a tough game, maintaining one's competitive edge is the singular most difficult thing to do in business
- The more you are right, the more competition gets interested
- **This is why just buying current 'quality' at any price is historically a mediocre investment strategy**

"Being right is the enemy of staying right because it leads you to forget the way the world works."

– Jason Zweig

When capital is easy, take your wallet away

- **Treat your banker like a partner**
- In the words of Warren Buffet, when the banks are excited about lending and money is easy, take your wallet away….
- **Even though debt is cheap, it doesn't mean it's essential**. Always review any gearing on the basis of the below quote by Robert Frost:

He defines a banker as "a fellow who lends you his umbrella when the sun is shining but wants it back the minute it begins to rain."

Retail investors over their skis?

"I don't know what the f– I'm doing," a young man said in a TikTok video in January. "I just know I'm making money." He added that he'd been trading stocks for only three days, but "just like that, made $300 for the day." In the next few weeks that young man, Danny Tran, racked up roughly 500,000 followers on TikTok.

Historically we have had conversations around quality and growth but at present we continue to field questions about digital coins, TAMs, NFTs or as we know them, Not For Touching Stupid.

Why do VCs run a portfolio of 500 start-ups? Because they understand the risk.

- Historically, investors haven't placed this level of confidence in their ability to pick the big winner – what does this say?

Why are profits seen as a bad thing?

Is this similar to the dot-com bubble? **In short, we think yes – it's greed.**

- The world is changing, yes and cloud computing and space tourism are legitimate things. They just aren't easy to measure as investments based on their risk/return dynamics… **however, they are very easy to 'buy' on Robinhood though**.

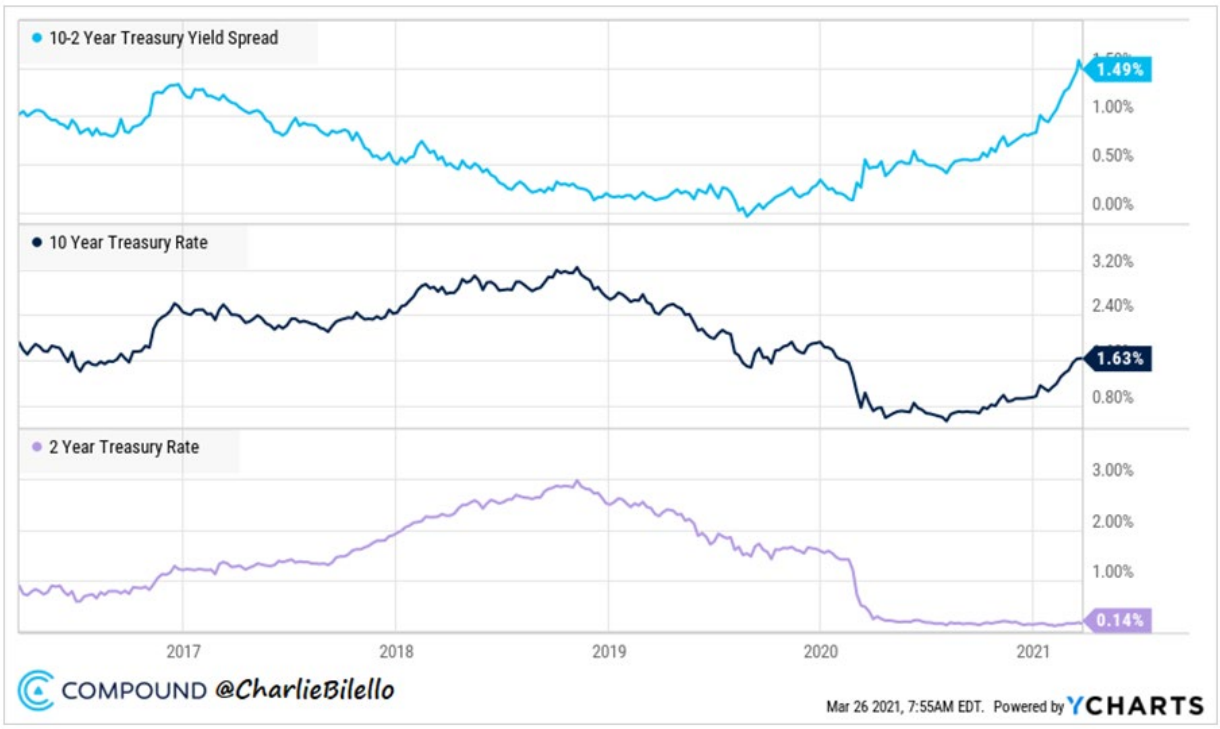
There is significant debate amongst analysts around the value of Apple, and it has produced consistent growth **and** profits for decades.

- Conversely, imagine the difficulty valuing the unprofitable. Presently, we're finding people are rather lazy, just picking any number and justifying it against a 'forecasted' total addressable market size (TAM). This is horrible analytics and stupidly risky.
- We prefer free cash flows and a traditional discounted cash flow valuation approach
- **Less vision and more earnings**

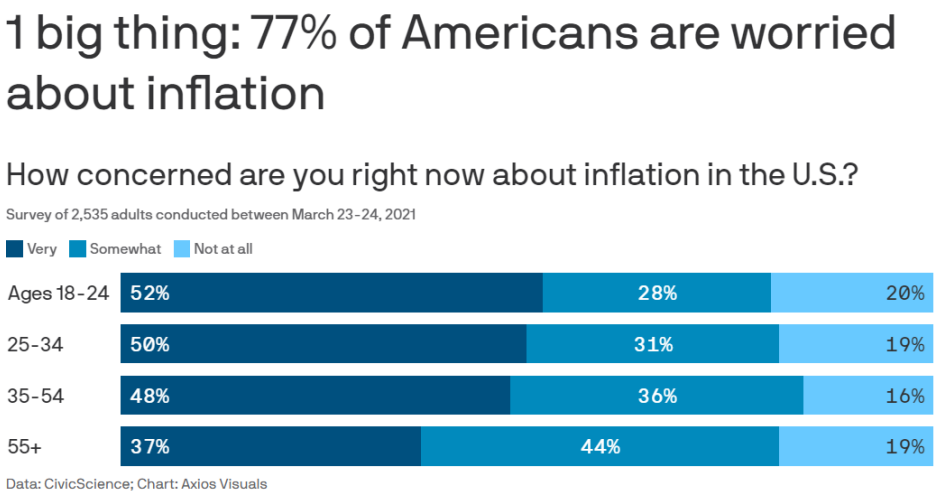
"If you're willing to sail into the land of vision stocks and pay a big price for them, you might fall off the earth,". "You might get eaten by dragons."

- Scott Opsal, Leuthold Group

The most important chart



Yields are on the move in anticipation of inflation. We have spoken quite a bit about inflation – you only have to go to our previous *Quarterly,* where we state it is **"The monster risk under everyone's bed!"**



Yields on the move are good for value factor and bad for the growth factor.

Ben Carlson @awealthofcs · 13h

Current drawdowns from highs:

TSLA -30%

CRM -26%

AAPL -15%

AMZN -14%

NFLX -13%

Yet the S&P 500 just hit its 15th new all-time high of the year

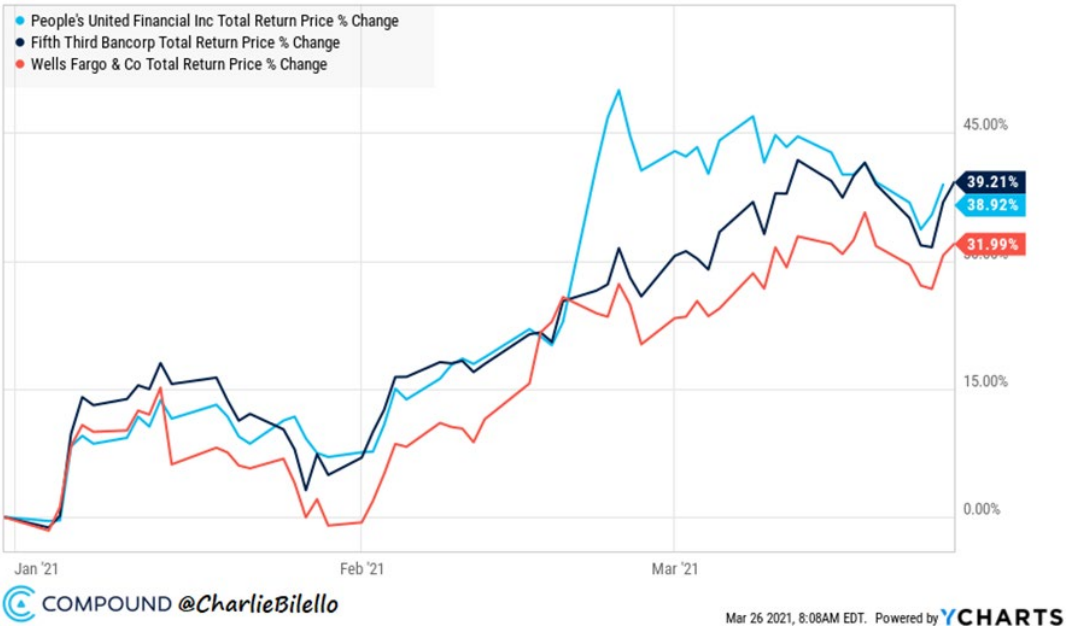
Remember when big tech was the only thing propping up the market?

Not anymore

Source: Ben Carlson (Ritholtz)

Value personified by banks

- This is on the improve, why? Because banks borrow short and lend out long (yield curve moving up and to the right)
- Duration is good for banks on the whole
- **We own two of the most despised and unloved banks: Wells Fargo (US) and Barclays (UK)**

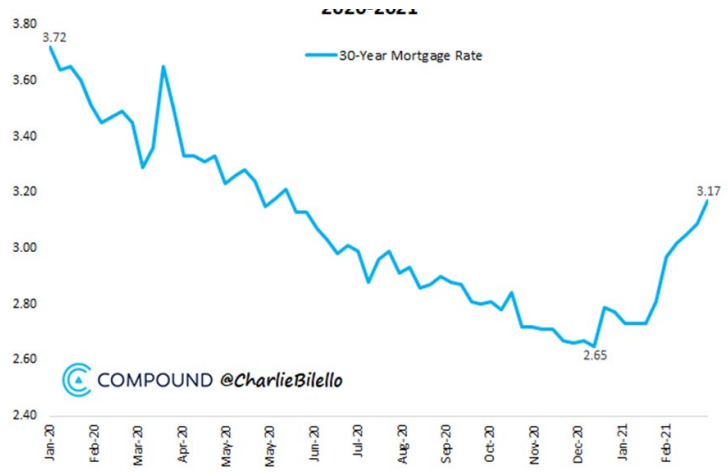


Bad for "hopefully earn one day" long duration tech…

- Long duration (earnings in the future) assets have sold off
- The question is – will this be short or long lived inflation?

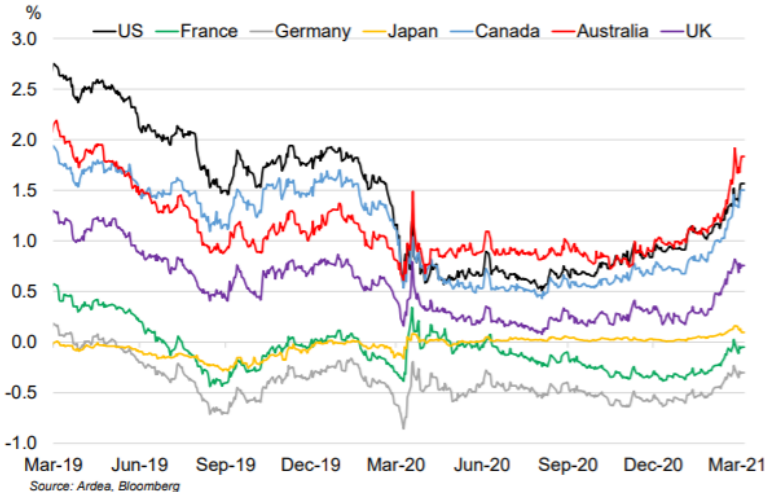
Mortgage rates are on the move

- This will be interesting to watch as borrowing costs haven't increased in a long time
- Has the average American or Australian borrowed with the view that rates are low forever? Or have they stress tested their interest bill in the event of inflation?
- **We doubt that sufficient stress testing has been undertaken.**



Cost of funding is increasing globally

- Measures of rates volatility reached the highest levels since March 2020. We expected higher bond yields in 2021, but not this quickly.
- With this follows an increase in underlying discount rates.
- Duration risk for all assets increases with every basis point increase.
- A percentage change from a low base results in large swings in volatility.
- Fair to assume volatility of all assets follows this, even within illiquid assets where day to day, mark-to-market movements are hidden from sight.



Whilst Brisbane house auctions see 80%+ clearance rates, it's not the same for the Fed… It's getting hard to sell bonds with so much excess stock around 😆.

Reversion to fundamental value is real

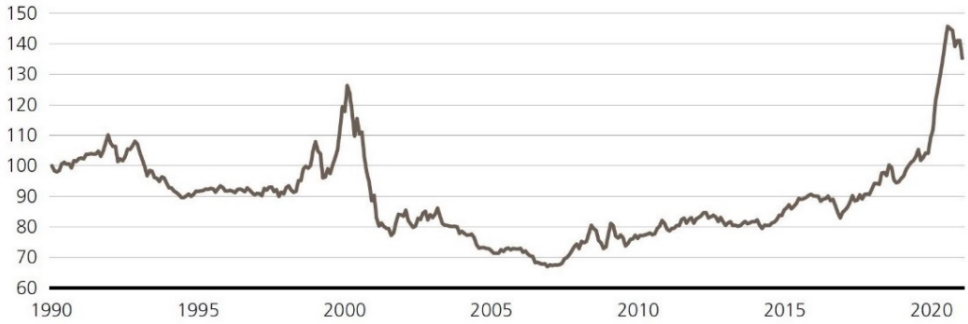
- We were early in our quest on this one, but patience tends to prevail
- The lesson is it will happen, but you will never predict the cause. This time around it was a pandemic, causing a spending bonanza, which created a concern around inflation
- Without a doubt, the economy is set for a strong rebound, however, markets are well in front of this and the two do not correlate
- Josh's 81-year-old dad is on the move looking at NZ bubble trips. There is catching up to do globally and we believe this will continue for a period… and the markets have largely brought this forward into their returns
- The laggards are leading the markets, as energy and financials companies are outperforming sexy tech for a change.
- Reversion to the mean is the current phenomenon – the question is for how long?

Our view is it still has a long way to go (the mean is far in the distance).

Figure 5

But growth's long-term outperformance is intact

MSCI World Growth vs. MSCI World Value (total return), rebased to 100



Source: Bloomberg, UBS, as of 15 March 2021

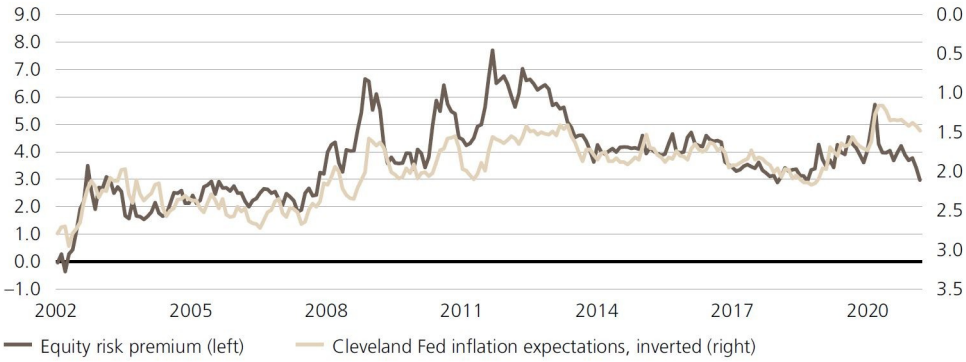
- For now, there remains few logical alternatives to an overweight equities position
- However decent hunting is required, as is a strong valuation-based methodology
- Bargains are rare but not unprecedented
- We just added **Magellan Midstream Partners (MMP)** to our Alvia High Conviction Fund portfolio at a 10% dividend yield
- The equity risk premium (ERP) still offers compensation for value equities (not so much fully valued growth names)
- However, as inflation increases the ERP decreased (below)

Using UBS 2022 earnings forecasts and current market levels, a 2.25% yield would imply an equity risk premium of around 2.95%, within the 2015–21 range of 2.85–4.7%, and above the 25-year average of 2.75% and the 35-year average of 2%.

Figure 2

As inflation expectations rise, the equity risk premium tends to decline

Equity risk premium, Cleveland Fed inflation expectations, inverted (rhs), in %



Source: Bloomberg, Cleveland Fed, FactSet, UBS, as of March 2021

Is cash still a thing? Does it deserve an allocation?

- It provides immediate liquidity where required, although on most occasions it is easy to raise liquidity by selling existing listed investments… the key word being **most**
- However, large cash positions in this environment are hurtful in the long term (negative real return) and should be addressed by decent forward portfolio planning
- Cash offers portfolio stability and limits capital loss across a portfolio – lowest return but also guaranteed portfolio retention in a crisis (nominal). $1 in $1 out 😊
- Despite your view of asset value – markets sometimes can conspire against you and you can misprice them significantly – your cash value will always hold in nominal terms
- Whilst "cash is trash" on a real basis in the current market where asset prices are elevated, it comes down to a risk first mindset as opposed to a return proposition
- **If interest rates rise – all asset valuations fall except for cash**
- We, however, never condone an all cash (risk on risk off) crocodile investing timing mindset. Nobody has ever been able to sustain this over the long term. Might get it right once but not consistently
- The answer, therefore, is to have a range for your portfolio's cash weighting, migrating closer to overweight during periods of exuberance and closer to nil when markets are pessimistic
- **We have done a write up on our Alternatives portfolio to demonstrate the benefit of having an allocation to this. If you would like to see our findings please reach out.**

Let us talk about "the coin"

- Is a bull market fuelled by ultra-low interest rates and Covid lockdowns causing a short term brain malfunction?
- We have tried to remain open-minded but we clearly struggle with Bitcoin (BTC). We appreciate the concerns around fiat currencies given the unprecedented levels of money printing, etc, with these concerns making us **continue to hold gold**. However, we just cannot see a world whereby policy makers allow a decentralised system underpinned by Bitcoin or another cryptocurrency
- BTC doesn't work as a form of currency when either the purchaser or the vendor cannot accurately know what value they are actually receiving due to its own volatility
- Its only value today is on the basis of it being considered a safe haven or a modern form of gold and only time will tell if this holds
- Our view of Bitcoin would likely be different if we were sitting in Venezuela with very little faith in our own currency or we were a large-scale drug dealer; but as an investor it just doesn't pass the sniff test for our conviction
- In our mind currency must serve as a means of exchange or a store of value. It doesn't hold true for either
- Decentralisation works historically until there is a shock to the system and the ledger is questioned whereby centralisation garners favour
- It will be interesting to see how Bitcoin holds in an environment where interest rates increase or risks are scrutinised rationally... **is it a safe haven or is it a speculative haven trading on momentum.... we think the latter**

Does diversification matter? Why not just hold the Nasdaq?

Diversification tends to work for you just as you are reviewing your underperformers and contemplating an addition to your winners. We have been beating the table on the benefit of commodities in the context of a portfolio for a little while now and its now starting to bear fruit.

Below is a table that outlines asset class correlations since January 1988.

- This portfolio idea is based on the historical correlation below – commodities decrease risk without clamping your upside potential.
- Commodities and gold have the highest beta to inflation by some margin and thus provided the best hedge.
- Nasdaq just happens to be a big drag this year and here in lies the tactical component. In the event of a widespread technology sell off – we would definitely start to consider it as an opportunity but not yet.
- However, humans tend to do the complete opposite and are now selling their technology stocks to buy commodities post a near 100% rally in commodities.

Exhibit 7: Asset Class Correlations

	Asset Class	a	b	c	d	e
a	U.S. Equities					
b	Foreign Developed Equities	0.67				
c	Emerging Market Equities	0.66	0.72			
d	Treasury Bonds	0.08	0.02	-0.15		
e	U.S. Corporate Bonds	0.30	0.24	0.22	0.86	
f	Commodities	0.18	0.30	0.29	-0.09	0.02

Correlation coefficients are derived from the full sample of monthly returns from January 1976 through December 2019. Emerging Markets correlations are pair-wise and derived from the period starting in January 1988 when data became available.

	Inflation Beta	Average Annualized Real Returns		
		Total Period	Rising Inflation	Difference
Commodities	4.0	4.2%	14.6%	10.3%
Gold Spot	2.1	6.1%	15.7%	9.7%
REITs*	0.7	9.8%	1.1%	(8.8%)
1-5Y TIPS**	0.5	0.9%	0.1%	(0.8%)
High-Yield Bonds	(0.4)	5.0%	(0.9%)	(5.9%)
10Y+ TIPS***	(0.5)	6.3%	2.1%	(4.2%)
Swiss Franc	(0.6)	(4.4%)	(8.0%)	(3.7%)
S&P 500	(0.7)	7.9%	(0.4%)	(8.2%)
Corporate Bonds (Baa)	(0.8)	4.5%	(1.2%)	(5.7%)
10Y US Treasuries	(1.1)	3.3%	(3.7%)	(7.0%)

*Source: Bloomberg, FRED, Verdad. * REIT data available since 1990 (Dow Jones REIT Total Return Index); ** Short duration TIPS data available since 2005 (Barclays 1-5Y TIPS Total Return Index); *** Long duration TIPS data available since 2000 (Barclays 10Y+ TIPS Total Return Index).*

Source: State Street and Verdad

Alvia's 2021 Top Performer Tracker

Back in Q4 2020, we displayed an infographic of asset class returns since 2011. We selected commodities to be the top performer for 2021.

2021 Selection off to a solid start

To give some insight, we positioned the portfolio to capture this through a little known company called Texas Pacific Corporation (NYSE:TPL).

Below is an exert from our 2021 February Monthly:

"Established in 1888 as Texas Pacific Land Trust and listed on the New York Stock Exchange since 1927, TPL corporatised in early 2021 and is one of the largest landowners in the Permian Oil Basin in the US State of Texas, operating under two business segments, namely land and resource management and water services and operations. TPL generates revenue from an oil company's utilisation of its land bank, through the full life cycle of an oil well, from the initial development phase through fixed fee payments for the use of TPL's land to build infrastructure, all the way through to a royalty interest on the oil and gas produced on that land. TPL is a company that the investment team knows well and has been a holding in the Alvia High Conviction Fund since its inception last year."

- Whilst we think the rally in commodities has room to play out, be very wary of super cycle stories – these have been told many times over and very few super cycles actually play out.
- This is recency bias and there aren't many Chinese large scale urbanisation stories left to play out.
- However, we do believe this cycle has real legs on the basis that both demand and supply prongs are aligned.
- Inflation almost always starts with commodity prices – out of favour commodity underinvestment leads to supply shortages which leads to price shocks and higher input costs.

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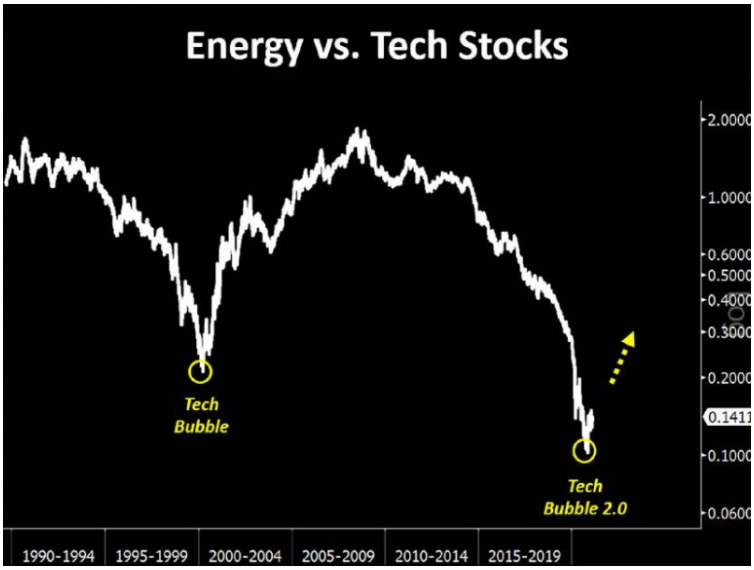
Commodities Supercycle Looks Like a Stretch

Some investors are betting prices will surge over a long period, but history suggests the conditions aren't right



Why we like Uranium and have for some time now

Irrespective of your political views, it is becoming more apparent we are trending towards a greener energy mix.

- The end goal for the US is **zero emission power sources**
- The jobs push is likely to be aimed at a high paying clean energy workforce
- This will cost a lot (below) and there needs to be a baseload coal fired capacity that must be replaced (200GW in fact)
- Nuclear is effectively the only viable baseload option, meaning the demand drivers for uranium could be significant – paired with lack of exploration and mining of uranium (supply) for a significant period of time now
- New exploration to production takes circa 10 – 15 years… this may mean higher prices

What does it Cost to Replace Coal?	
Current Operating US Coal Plant Capacity	200 GW
Replacement Cost Calculation	
Assume 60/40 split between nuclear and renewables	
Required Nuclear Capcity (GW)	120
Construction Cost per GW*	$5,979,000,000
Total Investment Required	**$717,480,000,000**
Required Wind+Solar Capcity	80
Construction Cost per GW	$1,000,000,000
Total Investment Required	**$80,000,000,000**
Total Cost to Update Generation to Zero Emissions	**$797,480,000,000**
*Source: NREL 2019 figures	

Source: Marin Katusa research

We aren't wedded to traditional value cyclicals

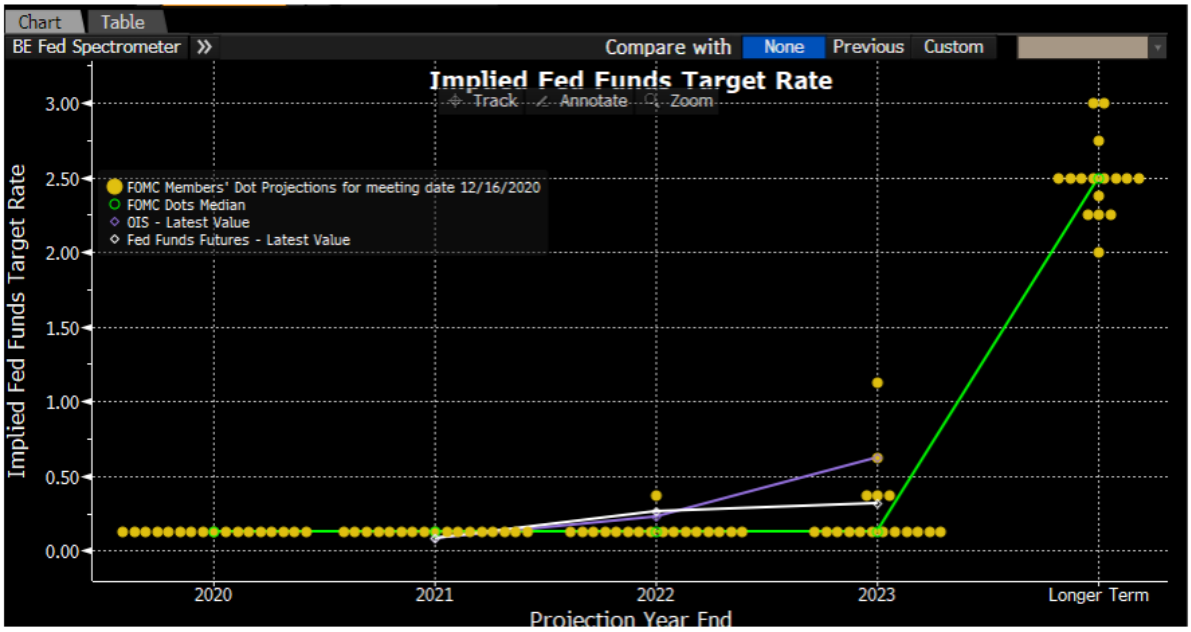
- Some less loved tech stocks sold off and allowed us to add to them - Facebook is a solid example from this past quarter.
- We aren't static value at all costs, we just want to ensure growth assumptions are realistic and can be realised.
- We added to Facebook recently at near 25x current earnings (which seems high) however this is only a slight premium to the overall market, and for an entity without peer which at its current growth rate is trading on a PE of 16x based on 2024 earnings.

How to define a bubble and is this one?

- All bubbles start with a grain of truth and a supportive narrative.
- During the tech bubble it was that the internet will change the world which it certainly has – nobody can dispute that.
- With tulips it revolved around their scarcity and status.
- The narrative however is always taken to an extreme and the momentum becomes self-fulfilling and the assumptions start to become preposterous.
- No price is too high and irrational optimism sets in.
- So today we would suggest that whilst prices are high and certain stocks irrationally so, it isn't completely irrational.
- Sadly, with rates at their current low point higher stock prices are justified… but as rates do move higher this argument becomes harder to make.
- Higher rates mean lower asset prices and better returns for those with a valuation bias and much lower returns for those saying no price is too high.

Uncorrelated does not mean "Alternative Asset"

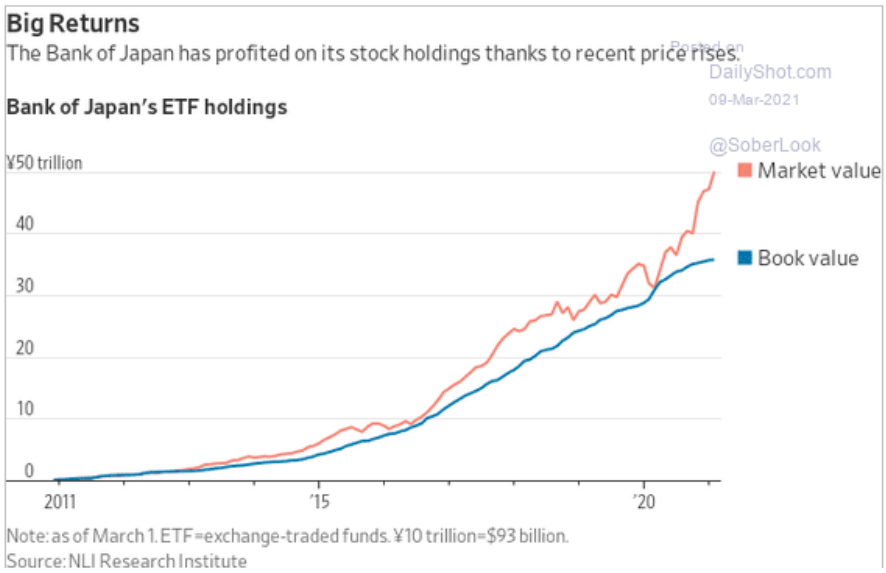
- Always ask yourself, why "am I seeing this now?". You aren't an investment genius because your old Pokémon card is now fetching a speculative dollar – you are merely lucky. Cash it in and reinvest it 😊
- Many weird and wonderful non-traditional 'items' are now getting attention in light of traditional low investment returns on offer.
- In almost all cases its nothing but pure speculation exacerbated by FOMO.
- You shouldn't care if someone's making money out of gooseberry seeds. Easy come easy go and their investment strategy is about as useful as used wrapping paper on Boxing Day.
- Anything we want to own we stress test under a significant increase in interest rates and if we still want to own it then we know we are protected.
- **We recently saw a petrol station sell at a 2.9% cap rate in Sydney… we cannot quite understand this one. Maybe future tax loss harvesting?? 😉**
- **See below, the market is assuming a longer-term 2%+ rate which whilst will be difficult to get to – its rational to suggest that it should be factored in for valuation purposes.**



Source: Bloomberg

Even the BOJ is feeling the wealth effect – lunch on Mr Kurodo…

Japan: The BoJ is making money on its ETF holdings.



Private equity…everyone wants it but why?

- We love unlisted markets and have for a long time invested across both listed and unlisted markets – however, we are concerned by the popularity of the private space of late.
- In private equity investments, you need to know what and why you get paid above market returns and whether you wear the additional risk to ensure you are compensated over the long term.
- In short, you are paid an illiquidity premium for participating. On the whole, people do not like tying their capital up and thus an incentive is required to induce capital into such investments (no T+2 in unlisted markets). **This additional return is your illiquidity premium.**
- **There is no doubt that all portfolios can and should benefit from this additional return – it is just important to know what you are buying and that your portfolio can cope on the whole with an allocation to unlisted markets.**
- **No investor needs 100% liquidity (in fact in some ways – the bottom draw assists behavioural biases). It can save people from themselves.**
- **However, no investor should be 100% illiquid either so as with most things it comes down to awareness and balance.**
- **Investor skill is also absolutely critical in these markets – alpha only exists for those that know what they are doing.**
- **Track record is absolutely essential.**

Interesting chart of the quarter

We have never seen this before

- Bond volatility substantially higher than equities
- When equities offer more stability than treasuries we live in a weird and wonderful world

Investing Complexity

- We meet lots and lots of different managers from all around the globe and there are lots of different ways to make money.
- The key for anyone should be to find a methodology that suits their personality and is sustainable – sustainability tends to correlate with understanding.
- Investing in something one does not understand is the easiest way to lose money.
- Investing **offers nil compensation for complexity** – there is no degree of difficulty multiplier for going for the triple spinning backflip over the basic pin dive.
- **Keep it simple!**

Behavioural Finance

Howard Marks tells an amazing story about one of his fund vehicles and its woes during the Global Financial Crisis (GFC). It is a great lesson in the irrationality of markets and how the smart money becomes the dumb money at the wrong time.

- At the time (2007), Howard was running a 4x leverage credit fund – investors could not get enough of it, especially the institutional investors. It was heavily oversubscribed.
- Long story short, liquidity dried up and Howard looked to reduce leverage by doing a number of equity calls on the fund.
- The last equity call came at the absolute bottom of the market (reducing the leverage from 4x to 1x)
- At this stage, the debt fund was producing a 20% yield against an historical 1-2% default rate…
- There were no bids. Only a few months earlier it was selling like hot cakes at a 5% yield
- Howard had to tip personal money into the fund, because the 'smart' money was terrified…

Lesson: Markets migrate from intense excitement to intense fear very quickly and it's wise to test your resolve at the best of times to ensure you are prepared for the worst of times…

Would you deploy capital into the above scenario when everybody on earth is telling you to capitulate and it's going to get much worse?

- This is why we love markets, because herding = opportunity

"The stock market will offer you opportunities for profit**, percentage-wise, that** you'll never see, in terms of negotiated purchase of business." **- Warren Buffett**

"Research has shown that over the last century, U.S. stock prices **have been** three times more volatile **than fundamentals."** - **Frank Martin**

"We believe that shares spend relatively little time at 'fair value'**. Rather, lengthy periods of overvaluation are followed by lengthy periods of undervaluation…** Extreme valuation spreads in the equity market **aren't necessarily rare or short-lived." - Marathon AM**

Fed Watch

Come on Fed…Do you really expect us to believe this?

Fed Projections

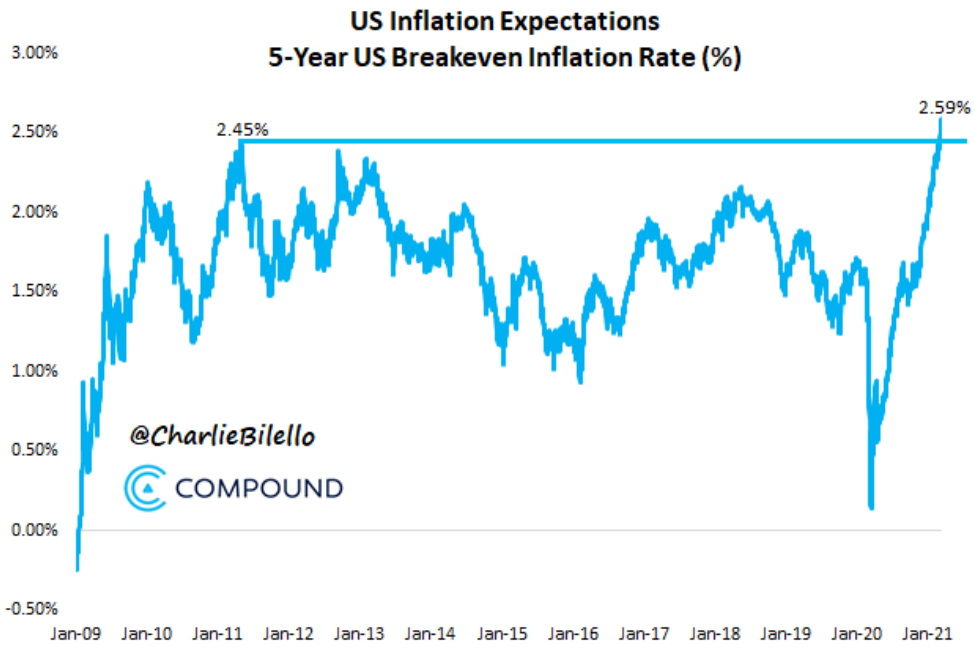
GDP Growth: 6.5% in 2021, 3.3% in 2022, 2.2% in 2023.

Unemployment: 4.2% in 2021, 3.9% in 2022, 3.5% in 2023.

Inflation: 2.4% in 2021, 2.0% in 2022, 2.1% in 2023.

Policy: No change in 2021 (0% rates), No change in 2022 (0% rates), No change in 2023 (0% rates).

Clearly the market is losing faith in this narrative



But who are the Fed?

- The Fed is 108 years old. Its mission is to smoothly control money supply – its role, therefore, becomes important during a crisis;
- They are effectively the bank of the banks;
- We have heard them described as the captain of the economic spaceship **– their job is to run with just the right amount of fuel;**
- **Too much fuel and there is the danger of an explosion;**
- **Too little and it could fall out of the sky;**

Apply Accelerator	**Apply Brake**
Purchase Bonds	Sell Bonds
Lower Rates	Hike Rates

Who is purchasing treasuries?

- Bond supply is significant – monetary regime is in full tilt and a new US$1.9 trillion fiscal policy program is in place with more infrastructure spending in the works.
- Who picks up the US treasury tab – the Fed needs to do a lot of the heavy lifting…
- In the last week of February, a $62bn US 7y auction recorded the weakest demand statistics in years (high auction clearing yield margin over pre-auction secondary levels, low indirect share and the lowest coverage ratio in at least a decade).
- This all points to an overburdened Fed or higher rates….

Currently we are seeing government (fiscal) and Fed (monetary) tied at the hip.

Fiscal Accelerator	**Fiscal Brake**
Increase Stimulus & Spending	Decrease Stimulus & Spending
Lower Taxes	Raise Taxes

Right now, all governments and central banks are hard on the accelerator (US rates nil and spending 16% of GDP).

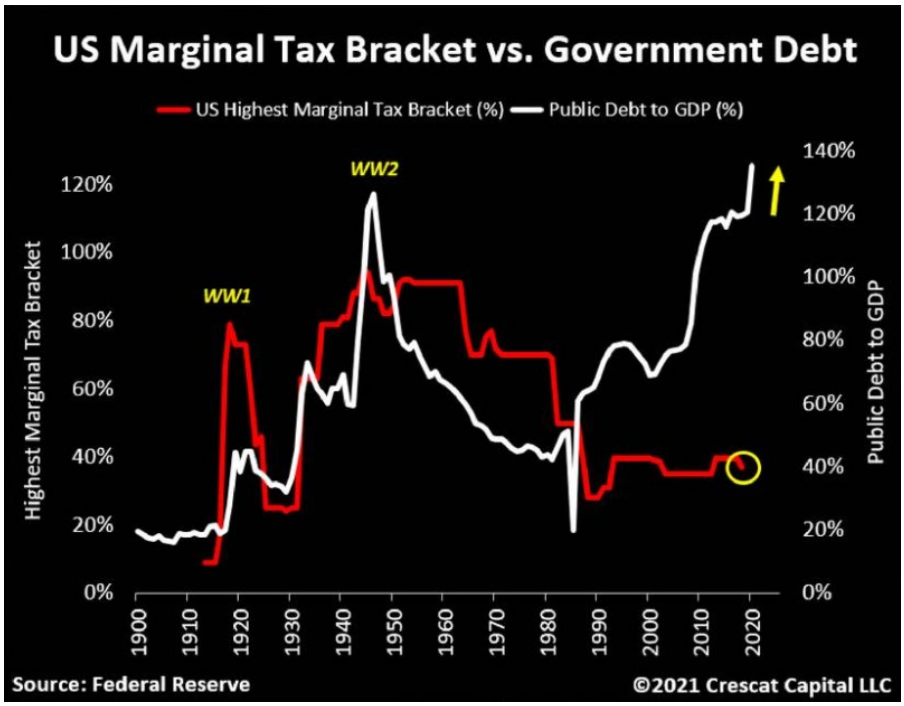
- They owe money to themselves and their citizens/agencies/funds, etc (circa 75%) and the rest mostly to Japan and China.

So, to fund these obligations at some stage, they need to apply the monetary and fiscal brakes **(very gently):**

- Thus, its steady politically agreeable tax increases (on the wealthy and corporates)
- Slow bond purchases (tough one) as they need to buy to ensure rates stay low
- Increase rates directly (another tough one) unless inflation forces their hand

Therefore, higher global taxation is an absolute inevitability

- Brace for higher taxation and get your affairs in order



The Cayman Islands could look like this in 10 years...

Source: Male Maldives Google Images

Being a passive investor

This could be the single worst time in history to be entirely index passive on a risk adjusted basis.

- This goes for bond and equity indices alike.
- In our opinion, Vanguard is not the best option in this environment.
- Low return expectation matched with higher volatility equates to a dud risk adjusted deal.

Figure 6: Estimated annualized total returns and Sharpe ratios for select equity benchmarks

	Unhedged			USD-hedged (for global indices)		
Index	5-year nominal return*	Volatility**	Sharpe ratio***	5-year nominal return*	Volatility**	Sharpe ratio***
S&P 500 Index	5.3%	14.9%	0.34			
MSCI World Index	5.5%	15.0%	0.34	5.1%	14.3%	0.33
MSCI EAFE Index	5.9%	16.0%	0.35	4.9%	13.9%	0.32
MSCI Emerging Markets Index	6.2%	20.3%	0.29	5.4%	17.6%	0.29
MSCI All Country World Index	5.6%	15.0%	0.35	5.1%	14.1%	0.34
Dow Jones US Select REIT Index	6.4%	18.8%	0.32			

Source: PIMCO calculations as of 9 Nov 2020. **Hypothetical example for illustrative purposes only.**

* For indexes and asset class models, return estimates are based on the product of risk factor exposures and projected risk factor premia which rely on historical data, valuation metrics and qualitative inputs from senior PIMCO investment professionals.

** PIMCO's estimate of volatility over the secular horizon

*** The Sharpe ratio calculation is as follows: (estimated asset return - estimated cash return)/estimated asset volatility. Estimated cash return = 0.35%

Source: Pimco

Conclusion

We believe at Alvia that now is the time to increase your financial cynicism. We always ask ourselves, **"why are we hearing this now and how are we being sold?"** In our opinion, it's time to reduce the compression on the accelerator and add a little brake in the context of your asset allocation. We similarly believe that owning Bitcoin, NFTs and leverage should come with the same health warnings as cigarettes given the potential long term health risks.

Could it be time to review what hasn't been working in your asset allocated portfolio? **What might have worked in a lower forever rate environment might not work in a rising yield environment. There is always a chance that your winners of the past might not be your winners of the future.** We also prophesise that we are nearing the peak of passive index "investing" euphoria given the market weighted concentration to technology and long duration winners of the recent lower for longer interest rate paradigm.