STENHAM ASSET MANAGEMENT

Q4 2020 Report

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Market Commentary

Q4 Market Data

Equities	Q4	2020
MSCI World (USD)	13.6%	14.1%
MSCI EM (USD)	19.3%	15.8%
S&P 500	11.7%	16.3%
Eurostoxx 600 (USD)	15.3%	4.5%

Fixed Income	Q4	2020
FTSE Global Bonds	2.8%	10.1%
Investment Grade	3.5%	11.3%
High Yield	5.9%	4.7%
Barclays Global Agg	3.3%	9.2%

Currencies	Q4	2020
USD (DXY)	-4.2%	-6.7%
EUR (vs USD)	4.3%	8.9%
JPY (vs USD)	2.2%	5.1%
GBP (vs USD)	5.7%	2.9%

Commodities	Q4	2020
Gold	-0.2%	24.4%
Oil (WTI)	20.6%	-20.5%
Natural Gas	0.5%	16.0%
Bloomberg Commodity Index	10.2%	-3.5%

Source: Bloomberg as of 31 Dec 2020

Markets were again very strong in Q4, driving many equity markets well into positive territory for 2020, a remarkable recovery from the lows seen in March. The S&P 500 finished at an all-time high despite the sharpest slowdown in economic activity in history as a result of the COVID-19 pandemic and resulting shutdowns. The index ended the year +16.3% after dropping 34% in March from its Q1 peak in February, a 68% rebound from the trough in March. With many markets at, or close to, all-time highs, it can be easy to forget the volatility we saw during 2020, namely the S&P 500's worst quarterly performance since the Great Financial Crisis, the VIX reaching its highest level ever (83), a spike in unemployment (in the US to 14.7% from 3.6%), oil prices falling by 60% and US treasury yields reaching all-time lows (US 10yr 0.5%). Markets were ultimately supported by unprecedented levels of monetary and fiscal stimulus, though Q4 saw the result of the US presidential election and development of vaccines for COVID-19 to push markets to highs.

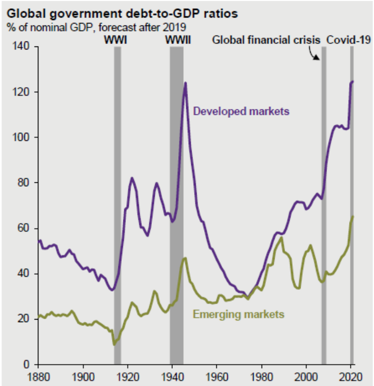
Q4 saw Joe Biden win the US Presidential election and, while events since then have not seen the most orderly of transitions of power, he was sworn into office in January. Going into the election, fears of a close, contested election with no clear winner or a resounding Democratic/Blue wave, which could have led to growth hindering policies such as higher taxes, concerned markets. Biden won a decisive but not overwhelming victory with the Democrats controlling of the House of Representatives with a split Senate, leading to optimism that there would be continued fiscal support and spending, but more extreme economic policies would be prevented from passing.

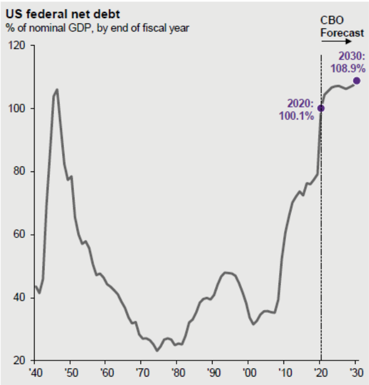
The announcement of the development of three vaccines for COVID-19 in November, with efficacy rates far in excess of those either expected or hoped for, triggered a significant rally in markets though also a sharp change in market dynamics. Value sectors, which had been hard hit by the economic shutdowns such as energy, traditional retail, hotels, airlines and financials all rallied significantly. Value equities had their best quarter since 2009 as the prospect of exiting economic lockdowns became more tangible.

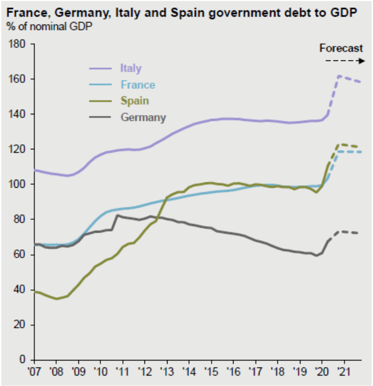
COVID-19 has taken a huge economic and financial toll on countries, with the economic downturn and subsequent recovery mixed. While the epidemic began in China, measures taken to control the outbreak were quick and effective and China emerged as the only major industrialised country to have positive GDP growth in 2020. The US has seen (and is expected to see) a strong rebound, though in Europe, there has been more lasting damage.

Source: JP Morgan

Government spending has been huge and, along with the economic downturn, has resulted in historic high sovereign debt levels, levels not seen since World War II. There is no prospect of this declining, but rather the reverse. In a polarised world, one of the few consensus policies is not to engage in fiscal austerity. With interest rates at record lows and there being no current signs of inflationary pressure resulting from quantitative easing, there is no factor leading politicians to decrease or moderate spending. Indeed, with the Democratic victory in the US election, it is now more ideological that the level of debt does not matter and can be monetised. Whilst there are more moderate Democrats in Congress, they may be more able/willing to block tax rises than spending increases, actually leading to greater deficits and debt levels.

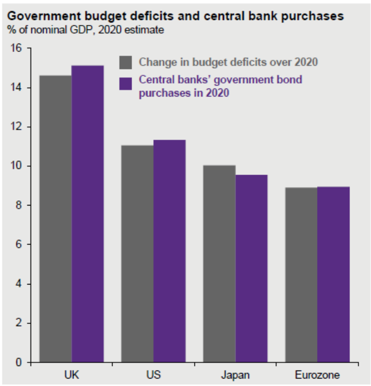


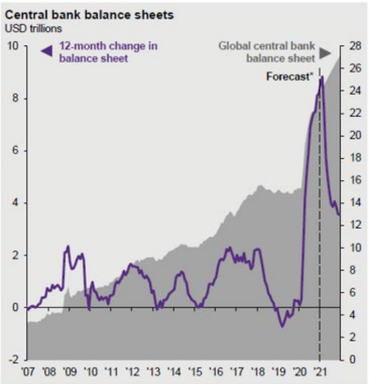




Source: JP Morgan

Alongside this has been huge monetary expansion in both size and composition of assets bought, with central banks buying investment grade, municipal and high yield (BB) debt. Of the huge government deficits in 2020, central banks have purchased as much government debt; countries have financed fiscal support through issuing debt which has been directly bought by central banks.

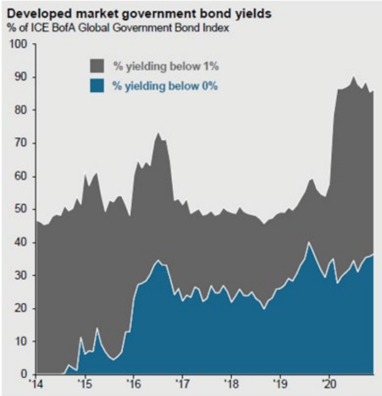




Source: JP Morgan

Asset valuations have similarly risen. Price-earnings (P/E) ratios for equity markets are at highs. For the S&P 500, the 12-month forward P/E ratio was 22.8x at end-2020, levels only exceeded in the late 1990s/early 2000s. European and emerging market valuations are also higher than average, though to not such an extent, driven at least in part by the sector composition of the index with high growth technology representing 28% of US equity markets compared with close to 10% in Europe.

Equities are not the only asset class at high levels, with fixed income potentially even more highly valued. Investment grade spreads are at 1% and high yield at 4% (depending upon index), which does not give much room for either further spread compression or, more importantly, excess return for potential defaults. Government debt yields are extremely low with close to 90% of developed market government debt yielding less than 1%.



Source: JP Morgan

There is good reason to expect a strong economic recovery in coming years. Exiting this recession, there are important differences from prior downturns. Firstly, household finances are in a very strong position, a result of the huge fiscal support and continued decline in interest rates. Supply of goods and services has fallen as much as demand and inventory levels are low. The fiscal response will also not be contractionary, government spending is likely to remain elevated with austerity not supported in any major country. As economies open up, excess savings can be spent and low inventories will be highlighted and begin to be rebuilt. Businesses will have pricing power.

Asset valuations, government spending and economic recovery are all predicated to a greater or lesser extent on low interest rates. Price-earnings multiples are more in line with historic averages if adjusted for government yields. While government spending is high, the interest cost to governments is forecast to actually fall for coming years given the significant drop in interest rates, similarly for corporates where leverage has increased significantly in 2020. The question is what can alter that interest rate environment. This is likely to be inflation. Inflation has remained muted since 2008 and consistently undershot expectations. If inflation does come through, the policy response could be significant. The easiest way to reduce national debt as a % of GDP is to allow growth of nominal GDP. Central banks, notably the US Fed, has said that it will not raise interest rates automatically in the face of inflation, but look through a cycle.

Outlook

Economic recovery is underway and we believe is likely to continue. The main risks to our minds are i) issues with the efficacy of COVID-19 vaccines; and ii) too rapid inflation leading to an unexpected rise in interest rates. There have been new strains of COVID-19 originating from around the world, but for which the current vaccines being deployed will be effective. If a new strain requires modification of the vaccine, this modification may be achievable in a relatively short timescale but the subsequent manufacture and deployment will take longer. Consequences will depend upon whether renewed lockdowns, however short-term, are necessary to prevent a high number of hospitalisations and deaths if current vaccines are quite ineffective.

Given the continuing, huge fiscal and monetary stimulus, healthy corporate and household balance sheets, with inventory levels low and businesses having pricing power, this does have the potential to be inflationary. Inflation will likely be tolerated by central banks. Asset class allocation will be key with low yielding fixed income investments generating minimal if not negative returns. The risk is that inflation accelerates beyond a tolerable level and it becomes perceived that central banks are behind the curve on raising interest rates, which leads to an unexpected and sharp rise in interest rates.

Strategy Allocations

We are generally happy with performance in 2020. Portfolios protected capital in Q1 and, as at the end of 2020, were up high single digits for low volatility portfolios and well into double digits and higher for more balanced and growth portfolios. We upgraded portfolios during the course of the year, taking advantage where high-quality managers were looking to raise, or more often replace, capital.

Overall, we have not increased the directionality of portfolios. We continue to look for regions/strategies which enable alpha generation and have increased our allocation to locally based Asian equity managers. We continue to see strong alpha generation within healthcare (in particular biotechnology) and are further exploring opportunities within the climate change theme.

We are firmly in an environment of zero or negative interest rate policies across the developed world. Any rise in rates would have a devastating impact on the sustainability of corporate and sovereign debt, as well as asset prices as this would raise the discount rate which is the foundation for what would otherwise appear extreme valuations. While inflation remains low, there seems no limit to the levels of monetary and fiscal policy adopted. Monetary authorities actively want to generate inflation and have negative real interest rates. As a result, we continue to hold gold as a store of value within appropriate portfolios.

Discretionary and Systematic Global Macro

Discretionary macro managers had a strong quarter with returns led by the classic thematic macro managers. Trades that worked included steepeners in US rates and a short bias to the USD against Asian currencies in particular. Emerging markets oriented macro funds also finished the year strongly with positions in Brazil rates and sovereign and quasi-sovereign credit in LATAM and CEEMEA driving gains. There were no major detractors. The one manager who posted slight negative returns for Q4 was also our top performing macro manager during the tumult of Q1 and for the year overall. This manager saw modest losses from risk-off positions in currencies and sovereign credit.

Within relative value strategies, returns were led by our volatility arbitrage manager. This fund was well positioned for the US election outcome and sector rotation. They were able to identify kinks in the volatility curves which made no fundamental sense and which they correctly anticipated would dissipate post the US election. Our fixed income relative value managers were also positive but returns were more muted in Q4 following the outsized returns earlier in the year. We continue to monitor spread and leverage levels to determine if the opportunity set for this strategy remains as promising as it did 12 months ago.

Our quantitative managers saw mixed performance in what was a volatile year for the peer group. The manager with whom we have our largest allocated capital performed well from short to medium-term equity and futures trading, but two smaller positions were down on the quarter with losses from equities and energy respectively.

We believe the outlook for 2021 looks particularly interesting for macro managers with expertise across asset classes and those who can structure positions in a differentiated manner leading to asymmetric outcomes.

Equity Long/Short

Our equity long/short managers generated decent positive returns for the quarter, but unlike the prior three quarters of 2020, they did meaningfully underperform the market indices which were up strongly (MSCI World Index +13.6%, S&P 500 +11.7%).

Aside from an average net exposure of 55%, the main reason that our managers underperformed indices for the quarter was the strong rotation which occurred from sectors like technology and healthcare towards cyclical sectors post the positive vaccine trial news. This rotation corresponded with a move from “Growth” to “Value”, as well as from Covid winners to Covid losers and from YTD winners to YTD laggards.

In general our managers are positioned long structural growth in areas such as technology, emerging markets and healthcare, and more short cyclical areas which face structural challenges, often due to being disrupted by newer technology.

2021 should certainly be an interesting year because any increases in economic growth or in inflation should increase the relative attractiveness of cyclicals/value sectors relative to growth sectors. Having said that, many cyclical sectors face real structural challenges which are not going away post-Covid (autos, brick & mortar retail, banks and shopping malls being some examples). On the other hand, Covid has accelerated the adoption of many technologies and it is hard to see this adoption getting rolled back.

Our goal in positioning our equity long/short portfolios for 2021 is to maintain balance between value and growth because outcomes are unclear and both groups of investments have merit. In general, however, we maintain a predilection toward areas of long-term structural growth rather than businesses which might be short-term cyclically depressed but still long-term structurally challenged.

In terms of areas of structural growth, we did additional work during the quarter on Chinese healthcare and initiated two equity long/short investments in that space. We are excited about these investments because we think that we are very early to the China healthcare story, our interests are aligned with the Government who are targeting world-leading biotechnology science capabilities, interest in the space from sophisticated US and Asian managers is clearly building, and there is a huge remaining runway for growth.

Climate change related managers are another area of equity long/short research currently. We are looking, for example, at ways of investing behind the European Green Deal which is expected to result in €1tn of spending between now and 2030 directed at areas like power generation, clean technology, energy efficiency and infrastructure.

Event Driven

It was an extremely strong quarter for our merger arbitrage managers. For one of our managers, exposure to SPACs continued to drive performance. This manager increased exposure to SPACs during October as the universe traded down and the portfolio they built traded below cash/trust value. This then drove performance for the rest of the quarter. We see SPACs as a legitimate part of financial markets but also valuations following rumours of deals to be signs of excess. Our fund's SPAC strategy is to sell SPACs when they rise above cash value (on announcement or rumour of a deal) and is not seeking to hold exposure to the equity of these companies but to monetise gains. SPAC issuance has been huge in 2020, over $83bn, six times the 2019 level. SPACs are being an increasingly accepted way of a company entering the public market alongside the traditional IPO process and this high level of issuance has provided ongoing opportunities for this manager.

Our other managers are more traditional managers, focusing on merger arbitrage and distressed debt. Merger activity continued to pick up in Q4 and our managers profited from some of the more contentious deals including Simon Properties buying Taubman and LVMH buying Tiffany, which were agreed before March and the buyers are looking to exit, or at least renegotiate, the deals.

We anticipate a robust M&A environment in 2021. 2020 saw aggregate deal volume at the lowest level since 2009 at $1.6tn. Low interest rates and easy access to capital makes it a ripe environment for deal activity. 75% of SPACs have yet to identify an acquisition target and, given the price rewards for so many announced deals, the pressure and motivation to complete a deal is huge. Ultimately, many of these deals will more than likely prove to be poor deals, but there will be activity and being able to isolate the deal/merger arbitrage rather than taking a view on the end value of the deal should be profitable. Corporate balance sheets are flush with cash and private equity dry powder is at all-time highs. By contrast, private equity exit activity hit a 10yr low, creating a pool of motivated sellers.

Credit

The credit allocation generated good returns in Q4, with all managers positive. Performance came from a variety of sources. Distressed managers performed well, having an almost defined position to benefit from any opening up of the economy as the capital structures which have been most under stress have been those most impacted by the pandemic. There were also idiosyncratic events which benefited managers including more advanced restructurings looking for an exit. The extreme policy action taken has meant that the level of companies defaulting on their debt has remained lower than we would have anticipated in March or April. However, the action of these policies has been an increase in overall corporate leverage and, as behavioural changes become apparent from COVID-19, we feel that this has delayed rather than removed the prospect of corporate defaults. Our emerging markets focused manager saw positive performance, driven by positions in Argentina Provinces (where the manager has the bulk of its exposure) which continued to restructure. Performing credit spreads have rallied significantly and are very tight. Despite this, our credit long/short manager is finding a lot of opportunities on both sides, with there being strong winners and losers from changes in corporate and competitive behaviour.

Summary

We are very excited by the investment opportunities we see across a number of strategies. We are in an environment where prospective returns from traditional investments are at the very least lower than they have been. Yields on high quality bonds, especially sovereign, offer minimal returns and potentially losses in real-terms. Equity returns are likely to be very specific with winners and losers arising from structural changes in individual and corporate behaviour following the COVID-19 pandemic.

We feel that hedge funds are a compelling investment in a variety of strategies; relative value strategies to generate traditional bond-like returns with limited beta to markets, equity focused managers identifying the winners and losers in a rapidly changing landscape or private credit to take advantage of stress and over-leverage within corporate structures as business models are challenged. Stenham, with our experienced and stable investment team, is very well positioned to help clients take advantage of these opportunities.

One area in which we have made additional progress is in integrating ESG further into our business. We have received an ‘A’ rating from the Principles for Responsible Investment (‘PRI’) for Strategy and Governance and we are continuing to enhance our processes both as a firm and within our investment activities.

Thank you for your ongoing confidence in Stenham. Please contact us if you would like to hear more about our strategies or funds. Further information can also be found on our website at www.stenhamassetmanagement.com

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