Incrementum All Seasons Fund

– in pursuit of real returns –




2020 / 03

March 2020

Seasonal Reflections

The Return Of Volatility

Quote(s) of the Month:

"To that point, as late as last Friday, February 21st, there was not a single CV-related story on the front page of The NY Times (though there was a small window at the bottom, referencing an article on page A7). Similarly, last weekend's Barron's iconic "Up and Down Wall Street" column, long written by the late and very great Alan Abelson, was titled "It's a Bull Market No Matter Where You Look". The only article I could find related to the CV in that Barron's issue was a short article that shared half of page 12. The lead sentence was, "Most economists and strategists assume that the coronavirus will be contained in coming weeks and that China will roll out a plan to cushion the blow." (It did allow, though, that the fallout could be worse, possibly lopping off $1 trillion of the planet's GDP.)
Calming words such as the Barron's excerpt above have been the dominant mindset right up until last Monday. Remarkably the S&P 500 was actually up 3% on the year as of last Friday." (Source: The Virus Heard 'Round The World by David Hay, Evergreen GaveKal, February 28, 2020)

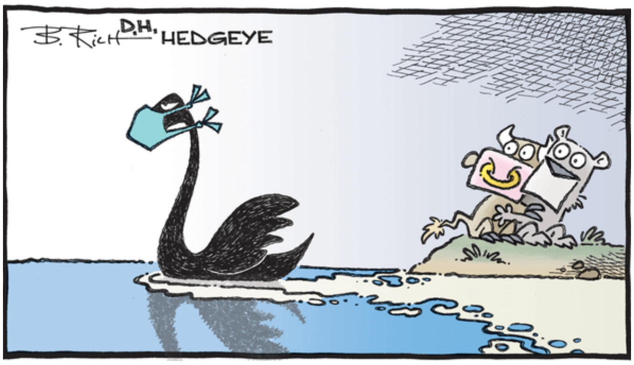
"So, what are the short-term prospects? This has been one of the swiftest stock market corrections on record. After a sudden fall, the physics of markets generally dictate that prices will enjoy what is tastefully known in trading rooms as a "dead cat bounce" (so called because even a dead cat will bounce if you drop it far enough). And there are plenty of contrarians out there who want to follow the advice attributed to Rothschild and "buy when there's blood in the street," or indeed the advice of Warren Buffett to be "greedy when others are fearful." Using more technical market jargon, there can come a moment of "revulsion," when the narrative becomes so skewed and overwhelming, that it sets the conditions for a rebound. …
Nobody thinks that a bear market bottom (and therefore a classic long-term buying opportunity) is anywhere close. The all-time high was only last month, for U.S. stocks, and we are only about 12% below that. But the virus raises real questions about the risk of a recession, and also of a bear market." (Source: Markets Are Approaching Point Of Revulsion, Bloomberg Opinion, March 2, 2020)

Must-Listen-To-Podcast: Market Nihilism: Price Discovery in a World Where Nothing Matters | Ben Hunt & Grant Williams;

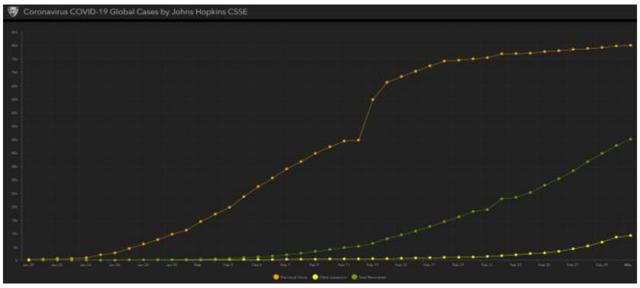
Dear Reader,

What a wild ride it was.

I suppose few saw February coming, and most certainly that includes yours truly, at least as far as the abrupt halt to the persistent "Buy the (tiniest) dip" market mentality we had witnessed for so long is concerned. – The reason? – A black swan!



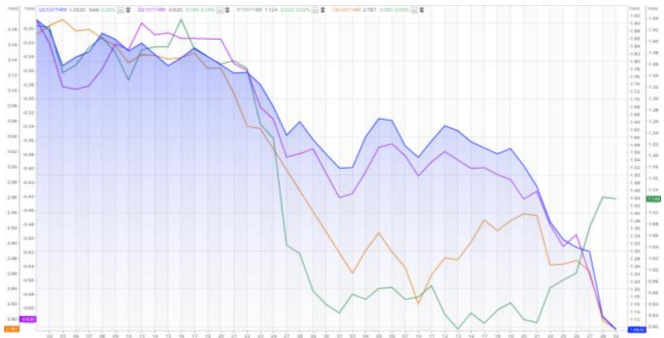
Source: Hedgeye



Coronavirus COVID-19 Global Cases by Johns Hopkins CSSE
(Screenshot from March 3, 2020)

As the opening quote shows, global and especially US investors (and narrative shaping media) had widely discounted the Coronavirus breakout as a non-event. It was only when the virus began spreading outside of China (see yellow line in the graph on the left), that equity markets went into a tailspin, causing a record correction, while bond yields plummeted.

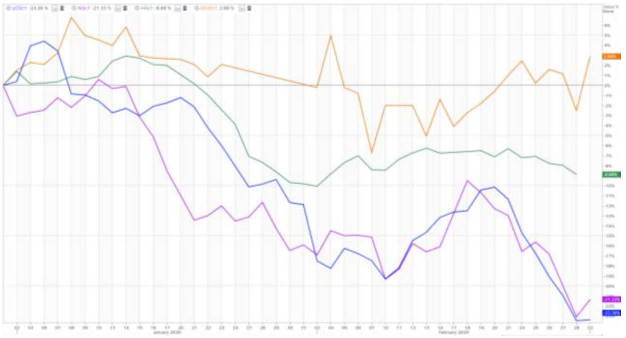
S&P500, EuroStoxx50, CSI300 and Topix, ytd; Source: Reuters



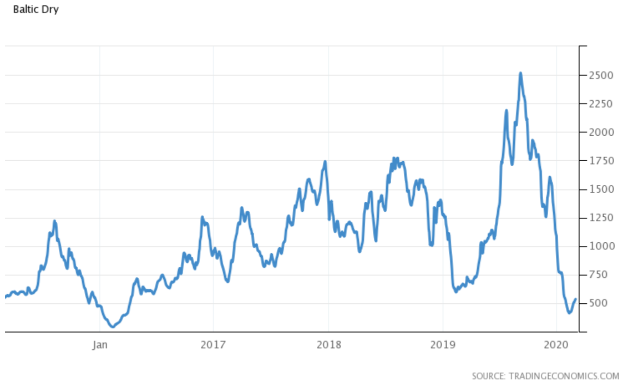
US, Germany, Italy, China 10y gov. bonds, ytd; Source: Reuters

The Financial Times commented this as follows: "The tone and extent of the selling pressure seen over the past week across equities and credit is not hard to understand given the high valuations and how crowded some parts of the markets were."

If anyone was looking for evidence of a speculative retail-investor enhanced market blow-off top, they might have found the evidence here. But all this changed latest from February 19, when US and European equity markets peaked for the year, and finally seemed to realize that bond yields had been declining for well over a month already, suggesting that COVID-19 may ultimately affect the global growth outlook. This thesis had already been supported by sharply falling commodity and especially energy prices, or the implosion of major shipping indices like the Baltic Dry Index (for both see graphs on top of the following page), even if the earlier part of these declines were well within the seasonal patterns generally observed around the Chinese New Year holidays.



Brent Oil, Natural Gas, Copper and Iron Ore, ytd; Source: Reuters



Baltic Dry Index, Source: Trading Economics

For the Baltic Dry Index I have used a 5-year graph to highlight how bulk shipping rates had been in recovery mode until the end of last year, only to crash to near all-time-lows again, with the unexpected and most painful leg down so far in 2020, as the seasonal impact has been greatly exaggerated by the wrench thrown into global logistics and supply chains by the Coronavirus breakout.

There is no hiding the fact that IASF was also hit over the past couple of weeks – and this following an already dismal January performance. As the first Baron Rothschild is believed to have said "it's time to buy when there's blood on the streets." Sometimes another phrase is added: "even if the blood is yours." – That would appear rather fitting from a first week of March perspective.

The chart on the right shows how various markets have performed from their recent peaks and until the end of February. It shows double-digit drawdowns across major equity sectors, but particularly crude oil / energy and other commodities.

Source: Financial Times

The notable exception has been gold, which has cushioned the blow to the bulk of IASF's real asset investments. But even the fund's equity index short and still mostly out-of-the-money put option positions could only partially soften the blow that many portfolio holdings have suffered, and here notably IASF's exposure to energy and shipping names, the industry background I already laid out in last month's Seasonal Reflections, as well as overall value stocks.

The most frustrating feature of the recent market environment was the persistent "all news is good news" attitude of investors which completely relied on central bank sponsored liquidity to maintain momentum.

Source: Hedgeye

"If momentum doesn't exist in politics, though, it certainly exists in markets. The momentum style of investing — betting on winners to keep winning and losers to keep losing — has seldom done better. And for all the apparent volatility and change of the last few weeks, that has remained constant. There has been no great reshuffling of the market.

The losers, for the most part, are value stocks — bought because they are cheap compared to their fundamentals. Value has been cheap ever since the financial crisis, and continues to grow cheaper relative to other stocks — and, yes, still the momentum stocks are able to leave them all behind. This is true in the U.S. and the world as a whole." (Source: It's Biden's Bounce But Newton's Stock Market, Bloomberg, by J Authers, March 5, 2020)

This has been a rather painful experience for any fund manager who has had exposure to what can be considered real asset backed investments and what is generally classified as value stocks. The casualties in IASF have been many and valuations have reached in some cases ridiculous levels. <u>But before I continue please note:</u>

Any investment views, analysis, assumptions and recommendations included in this letter are based upon current market conditions, reflect the opinion of the author, and do not necessarily correspond with the views of Incrementum AG as a whole. Seasonal Reflections are issued for information purposes only and must not be regarded as attempt to solicit an investment in individual securities or the Incrementum All Seasons Fund. Past performance is no guarantee of future results. All investments involve risk including the loss of principal.

A suitable example is the recent decline in BT Group, Great Britain's incumbent telecom operator, in which IASF has been building a small position within its High Dividend Yield bucket. Even after a 5 year decline, the company's share price has been dropping sharply in recent weeks, losing about a third of its already diminished value at the turn of the year, and looks extremely oversold right now.

BT Group share price, last 5 years, Source: Reuters

And yet, there seems little buying interest among investors for a utility type of business, which trades at 6 times earnings, 4.3 times EV/EBITDA, 1.25 times book value, and offers a net dividend yield of 11.5%. As usual in cases like this, analysts have been cutting their price targets in line with the falling share price, though still maintain an average GBP 2.05 expected price level.

Source: [Hedgeye]

At the same time, a company like Tesla (I don't mean to pick on this one, but given that I mentioned it before in these pages it seems an example worth citing again) with zero earnings trades at still elevated USD 724 per share (March 5 closing), which represents 5.4 times sales (!), about 60 times EV/EBITDA, 20 times book value, while lacking any medium-term prospect for any dividend distributions whatsoever.

And yet Tesla shares are up 73% year-to-date, still trading 45% above analysts' consensus price targets, and in my humble opinion floating on the momentum of speculation rather than any sober analysis of its future prospects.

This is in a nutshell the extremely difficult investment environment IASF has encountered in February, which has delivered a second consecutive negative performance month, a tendency which keeps surprising me in its complete disregard of intrinsic / underlying asset values.

IASF Month-over-month NAV change
February 2020 (30.1.-27.2.)

EUR-D	96.49	-3,13%
USD-D	97.68	-2,87%
CHF-D	94.94	-3,14%
EUR-P	95.07	-3,16%

For Charts, See Page 12

From a look at individual portfolio holdings it would seem that energy producers, oil services companies or shipping companies with their mostly modern and long-life assets are increasingly priced for bankruptcy, a prospect I do not share at all. After all, this would in turn mean that the world will be able to work with far less energy input (or discover major new / different energy sources) than it actually does and is expected to do for many years to come. Or that there will be no more need to transport major bulk or liquid transports between continents, even though these are found in places where they are not usually needed / consumed.

Let's look at another illustrating example: IASF has been an investor in both, Transocean (RIG), the world's largest offshore oil services company (the company and its investment case featured already prominently in SR 2020 / 01 from January), as well as over the past couple of months in Schlumberger (SLB), the world's largest oil services (mostly onshore) company. Of course, both companies work in the oil patch and thus are influenced by oil price changes, which have experienced a one-third decline between the Jan6 peak and the Mar6 lows. Allow me to quote (at length) the as ever sharp-eyed (and -tongued) crew of [Almost Daily Grants] from March 5 on the overall oil market:

"… On Tuesday, analysts at Goldman Sachs forecast an outright contraction in global (oil) demand in 2020, which would be only the fourth annual decline in the last 40 years.

Set to meet with their bankers for semi-annual financing reviews, U.S. shale producers are running out of time. "Things are so bad now," Shaia Hosseinzadeh, founder of OnyxPoint Global Management L.P., told Bloomberg yesterday. "The banks can kick the can down the road and say 'there's no point of pushing everybody into bankruptcy, we'll wait until October.' But if it's business as usual, it's going to be a horror show."

The growing ESG (environmental, social and governance) movement may act as a further constraint to industry activity. Today, Swiss banking giant UBS Group, A.G. announced that it will no longer finance environmentally-sensitive projects such as Arctic offshore and Canadian oilsands drilling, and that its overall energy and utility lending fell by 40% last year to $1.9 billion. Over the same period, so-called sustainable and "impact" investments rose 56% to $488 billion.

The major integrated oil players are likewise adjusting. Prior to its annual investor meeting on Tuesday, Chevron Corp. announced that it will upsize shareholder payouts by up to 20% over the next five years, funding the increased dividends and buybacks through cost-cutting, including pulling back on certain projects. Today, Exxon Mobile Corp. declared that it will slow down its pace of production in the Permian Basin, declaring in a slide deck that it will operate at a "reduced pace" in 2020 and 2021 relative to previous plans. Overall, XOM expects capital spending to come to "no more" than $33 billion this year, which would represent a mere $2.5 billion year-over-year uptick at the high end, compared to a $12.5 billion capex jump in 2019.

It's not just corporate America which is attempting to "right-size." Today, oil ministers from the Organization of Petroleum Exporting Countries agreed to recommend 1 million barrels per day (mbpd) in production cuts, with a further 500,000 bpd from non-OPEC member states like Russia. That agreement is contingent on support from the Russians, no sure thing as the Russian energy minister Alexander Novak was not present for the meeting and had previously expressed his opposition. According to Bloomberg, skepticism that Russia will comply with the cut factored prominently in today's roughly 2% declines in WTI and Brent Crude. (HGS: A day later, the scepticism proved appropriate, though not factored into oil prices, which declined yet another 9%.)

But while OPEC+ intrigue garners headlines, a secular shift may be quietly underway. In a report Tuesday, analysts at J.P. Morgan Cazenove concluded that the oil industry "is not well-placed to meet global energy needs in the medium term as demand recovers in 2021 [and beyond]." The analysts explain: "Cumulative underspend on oil projects, on track to reach $1 trillion by 2030, means the industry is at a point of no return with supply set to peak at 102 mbpd in 2022." The truism that low prices cure low prices will likely come into play as well: "Continued pressure on oil prices is only going to accentuate a structural supply deficit that has already taken hold."

The production retrenchment is showing up in the data: In a Jan. 9 report, analysts at Bernstein Research found that 2019 peak-rate well productivity at the oilier shale basins fell 7.6% year-over-year. More recently, Baker Hughes Corp. relayed that the U.S. oil rig count slipped to 678 last week, down 20% year-on-year.

Another indicator lends credence to the bull view. In their fourth quarter 2019 commentary, Leigh Goehring and Adam Rozencwajg, co-founders and eponyms of natural resource investment firm Goehring & Rozencwajg Associates LLC, argued that so-called high-grading practices (i.e., companies drilling their best wells first when forced to cut back on activity) in the domestic shale patch throughout this cycle could lead to faster well depletion than is commonly believed:

In 2013 we estimate the top half of all shale wells were 200% more productive as the bottom half. By 2019 this spread had collapsed to only 90% more productive. As rigs are laid down, our research tells us that the narrowing in drilling productivity will have a large impact on shale oil production growth.

Reached by Grant's today, Goehring identified further differences between the current environment and prior cyclical inflections:

We believe the unexpected decline is because of the high graded effect being felt right now. The 220 oil drilling rigs that have been laid down in the last six months are twice as productive as rigs laid down in in previous drilling downtowns of 2009, 2012 and 2016. Therefore, when they are laid down, the impact on production is much greater than in the previous cycles.

If U.S. output does decline, Goehring continued, it will be difficult for the rest of the world to pick up the slack:

Regarding the international oil world, as we have chronicled, conventional oil production outside of the US and Canada has already turned negative. We calculated conventional oil production outside of the US and Canada was 47.2 mbpd in 2010 and that by 2018 that have fallen by 1.3 mbpd to 45.9 mbpd.

Stateside, there are signs of a potential sea-change. The U.S. Energy Information Agency's so-called 914 monthly production report for December (the most recently available data) showed a sequential 38,000 barrel per day onshore output decline, a surprising result as the EIA had previously projected a 15,000 b/d increase during that monthly period. …" (Source: Almost Daily Grant's, Sour Patch, March 5, 2020)

That is the backdrop of the oil market: Lower prices as a cure for low prices, which is a law in commodity investing, and the above is widely backed-up by the latest Transocean investor presentation from Feb26, which for those who want to dive in deeper can be found here. Does this justify the kind of share price performance shown below in the graphs (courtesy of www.investing.com, as I was working on this over the weekend)?


Transocean, ytd (-65%)


Schlumberger, ytd (-40%)

Transocean may have been punished more due to its high gearing and lack of dividend payment, and the shares have been diluted to a certain degree in recent years. However, they currently trade at 12.5% of book value, have ample liquidity runway until the end of 2021 and all major debt repayments have been extended beyond 2022, providing the company with sufficient time to see the nascent industry recovery delivering an improved rate and thus earnings and cashflow environment. And given the above summarized backdrop of a developing oil supply deficit, this seems a ridiculous valuation to me. After all, if oil producers do no longer reinvest into proper reserve replacement, we may well experience shortages going forward, which will lead to substantial oil price recoveries as the world will be forced to pay prices for its energy needs that do not only allow companies in the business to earn a decent return on investment, but do so on a sustainable reserve replacement basis. Hence, I am convinced that current price levels will be regarded as great bargain levels in the not too distant future.

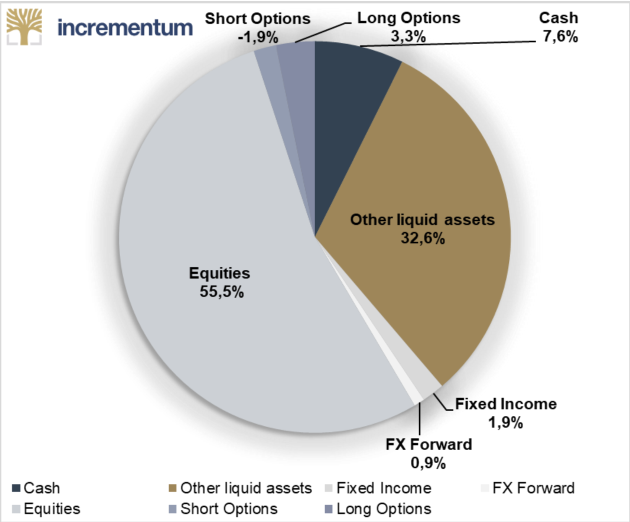
The pullback in Schlumberger's share price on the other hand was more muted, which means it "merely" declined 40% year-to-date. This is due to the company's far more solid balance sheet and a by now very healthy 7.5% dividend yield. However, at current levels SLB shares trade at a cyclically depressed 16 times earnings and 1.5 times book value, which given the company's size and global reach looks very cheap. And yet, it seems that investors are merely guided by the current level and direction of oil prices, not a reasonable assessment of their longer-term outlook, which in my view makes this a very interesting setup for a long-term value conscious investor.

Overall, this is one of those occasions, where a fund manager's mettle is tested. It is when the 3 C's of successful long-term investing, which are **Capital**, **Conviction** and **Courage** are required. **Capital** is obvious, because if you don't have access to it, you cannot take advantage of such extreme situations. **Conviction** is always the foundation of any successful investment case, and without it you'll likely panic in sell-offs like the one we are currently experiencing (I am last revising this letter on the morning of March 9, when oil prices have dropped another 30% overnight, and equity markets are 5% lower on average). **Courage** is perhaps the most underestimated, because such episodes tend to seriously damage investors' sentiment, which might cause them to not follow their conviction.

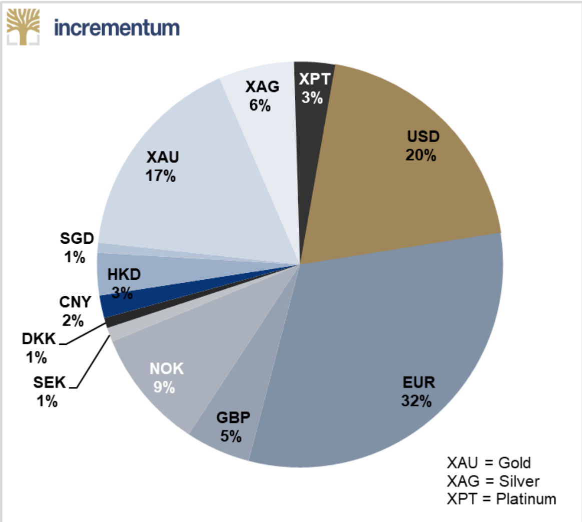
How is IASF positioned in this respect: Capital is still plentiful, even though I have been adding to a number of portfolio positions over the past month. Most of the cash came from margin payments from IASF's short futures position, the early redemption of the Transocean 2023 bond, as well as the buy-out of HN Renewables last month.

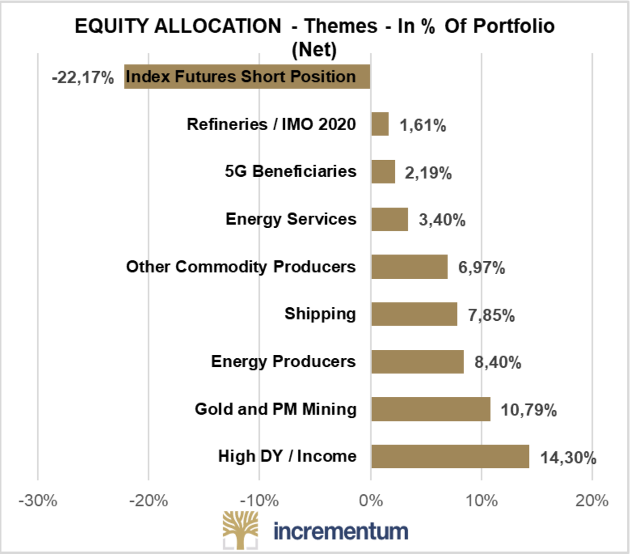
IASF ended the month of February with approx. EUR 42.2m (USD 46.3 / CHF 44.8m) in assets, incl. net inflows of approx. EUR 2.5m over the course of the month. End of February allocations are shown below. They show a slight increase in equity allocation to 55.5% (+1.5%), and a reduction in bonds to 2% (-3%), while cash and other liquid assets remained roughly unchanged at 40%. With equity prices across the board meaningfully lower this means that I have been rebalancing towards IASF equity allocation over the course of the month. At the same time, currency allocation has been little changed.

Asset Allocation



Currency Allocation





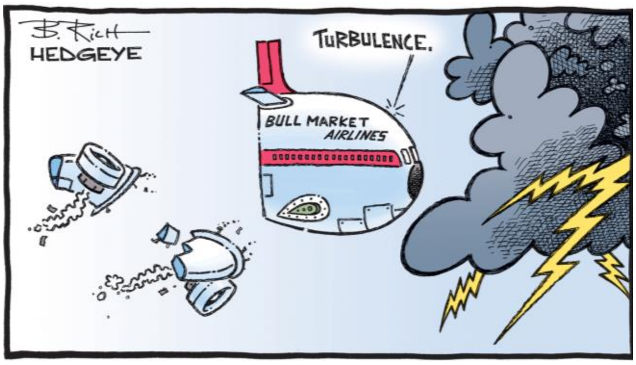
In terms of IASF's thematic equity allocation there have been small additions to the High DY bracket (+1%), as well as a 0.8% increase in the Gold / PM allocation due to higher prices. Energy producers (+0.4%), shipping stocks (+1%) and energy services (+1.4%) all saw small increases in weight, despite of significant falls in underlying share prices, as I have been gradually adding to positions. Other commodity producers were kept unchanged, yielding a 1.4% decrease in portfolio weighting. The net short futures position fell by 2.3% amid the fall in both S&P500 and Stoxx600 prices.

In summary, there has been no significant change in overall allocation, and although IASF's NAV has held up far better than the broad market in February, the portfolio has proven less robust overall than expected. This is due to the cyclical and economically sensitive nature of its real asset heavy risk exposure, which was heavily penalized by investors selling IASF's most favourite themes and sectors indiscriminately.

March has also seen a rather challenging start, as the sell-off in economically sensitive areas continues unabated. Even gold and precious metals prices have experienced what is widely regarded as liquidity-induced selling, and the advance in gold and precious metals mining shares has come to a halt at levels that are 40% lower than where they were the last time gold traded near USD 1700 in late 2012.


Source: Reuters

As the macro-picture of increasingly negative real yields does not suggest any reasons for a fall back in precious metals prices, but rather for a continuation of their recent bull market, I am optimistic that the miners will have some catching-up to do.



Source: Hedgeye

Overall, I expect further turbulences in March and possibly beyond as the full impact of the Coronavirus on the global economy, and the lack of effectiveness of the monetary policy response becomes increasingly evident. The impact on the US economy is only slowly showing, and I expect that to be countered by significant government intervention / stimulus to cushion the blow (same as China).

Meanwhile, at the time of writing these concluding lines on March 8 it seems that Saudi Arabia in response to the failure to secure an OPEC+ production cut is flooding the market with cheap oil, which obviously does not bode well for the short-term outlook of the energy sector, though it will very likely strengthen the longer-term prospects for oil markets even further. Volatility is already at very elevated levels, which adds an important ingredient for yet another disruptive week / month. (This is confirmed in the morning of March 9, which delivered an eye-watering 30% fall in oil prices, and similar declines in many energy related equities, which feels like a real wash-out at least in this sector is happening. – Meanwhile, broad equity indices are 5% lower, US 10-year bond yields at record low 0.4%, and VIX futures slightly below 50.)

At times like this it is always important to remember that investing is a long-term endeavour, which requires patience and discipline to successfully master. And so, on this quiet Sunday afternoon, I would like to ask all investors in the fund for patience while thanking them for their faith in my stewardship of the portfolio. Despite of a turbulent start into the year, I remain optimistic that IASF will get through the rest of the year in decent shape, and thus proves a suitable vehicle for anyone pursuing real returns across the investment cycle.

Greetings from Schaan, Liechtenstein!

Best regards,

Hans

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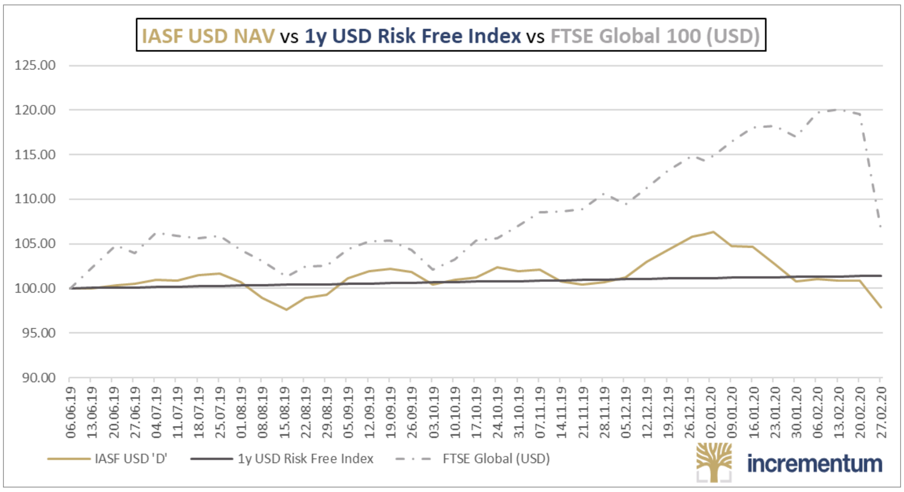
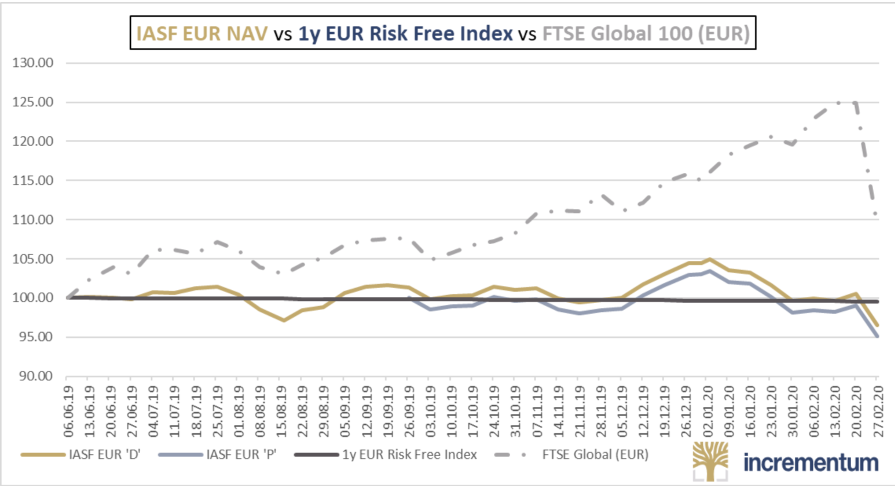
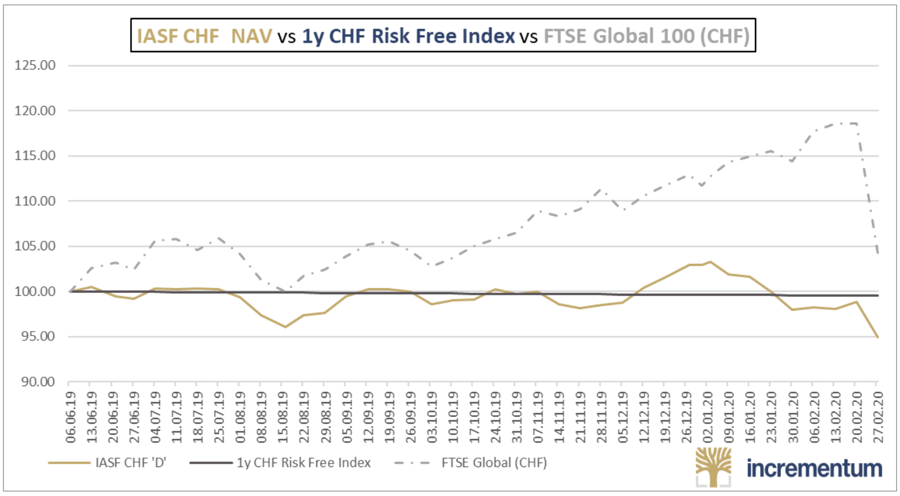
Appendix *







* Graphs display NAV of IASF 'D' shares as of last valuation date (**27Mar2020**), 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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