

Volatility, a Macro Lesson and Taking Stock of our Strategy

Newsletter for April 2018

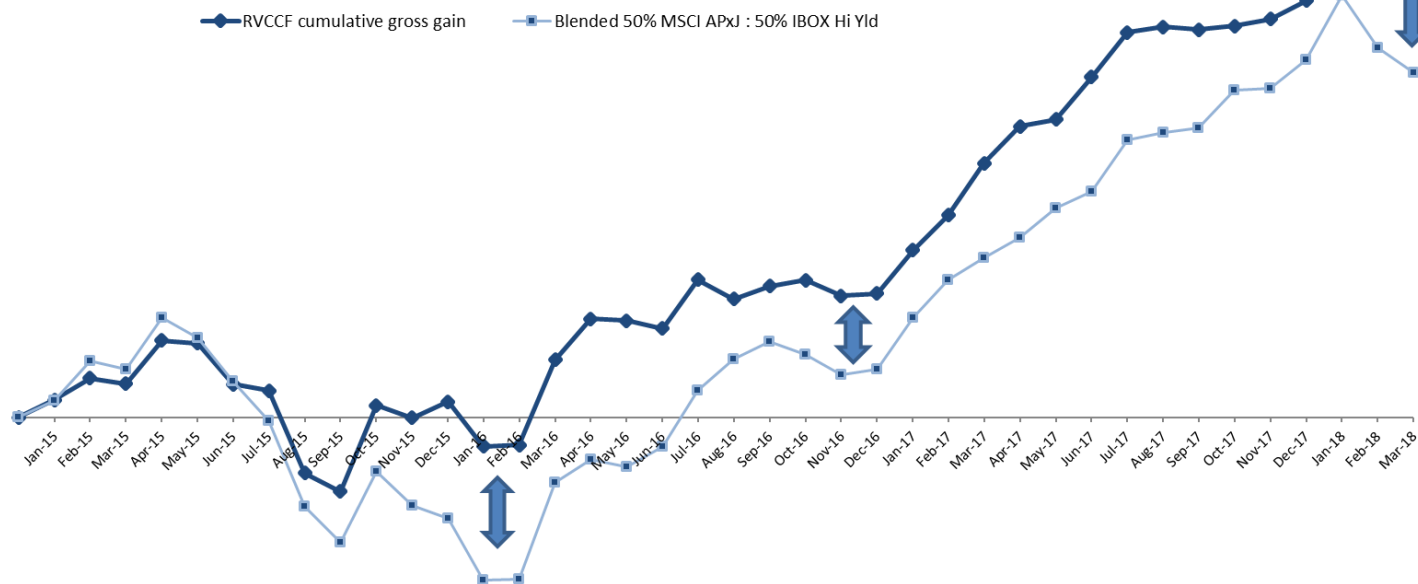
In the first newsletter of this year, crystal gazing about the landscape for 2018, we highlighted the dichotomy between bottom up opportunities which continued to excite us versus risk from optimism and excessive valuations in narrow segments of the market. Our view was that the ride will not be smooth and volatility is likely to rear its head and as investment managers our focus would be on how to manage the downside risk. We did not imagine that the first three months of the year would throw up all kinds of new challenges as markets battled with policy uncertainty.

Volatility and Our Portfolio Performance

Global markets have seen a sharp increase in volatility during the first quarter of 2018. Volatility is another word for uncertainty in how to price assets. As market participants question the underlying long-term assumptions, the uncertainty anchoring asset prices has increased. A few of these assumptions are very basic and form the bedrock of how we price assets. They include views on interest rate trends, GDP growth trends, inflation trends, globalisation, faith in capitalism itself, etc. Some of these - like interest rates - have had a secular (downward) trend for the past 30 years, and their reversal puts the market in totally uncharted territory. To us this broadly explains the increased uncertainty and volatility. Consequently, we believe it is very important to have a relook at our view on the longer-term macro trends, the drivers of economic growth and anchors of asset pricing. Unlike market gyrations, thankfully these trends are not volatile and, in our view, have been consistent over the past five years. We are still in a “lower-for-longer regime” in terms of both global GDP growth and interest rates. We will elaborate on this shortly.

But first we would like to highlight the characteristics of our portfolio performance through this period of uncertainty. We have always emphasised that ours is a lower volatility strategy than typical market benchmarks but over the longer term will deliver returns which are superior, as returns from the underlying cashflow profile of our investee companies starts flowing into numbers as performance. The proof is in the pudding and this becomes apparent as we go through performance delivered by our strategy in the next couple of charts.

RVCC Fund Cumulative USD gross gain v/s Blended Index (50% MSCI Asia Pacific ex Japan : 50% IBOX Hi Yield) %



The chart above shows cumulative returns since Jan 2015 against a blended bond and equity index which broadly represents our investment universe. The dark blue line is the trend of the RVCC Fund portfolio while the light blue line highlights how a market proxy benchmark of our typical universe performed. What really excites us is the fact that the strategy has delivered exactly as we expected over multiple cycles now, delivering cumulative returns which are not only better than the market but with significantly less volatility. The portfolio clearly protected value during bad times (like CY 2015 or the February-March 2018 period); more importantly, during periods of very strong market returns, it kept pace with market returns (as seen over the period December 2016 to January 2018) thereby delivering strong cumulative performance in the long run.

	RVCC Fund*	Blended equity and bond index	MSCI Asia Pac x-Jap	IBOX High Yield bond
Annualized Volatility	7.6%	9.2%	14.5%	5.2%
Annualized Returns	8.7%	6.8%	8.8%	4.5%
Sharpe Ratio	1.15	0.74	0.61	0.85

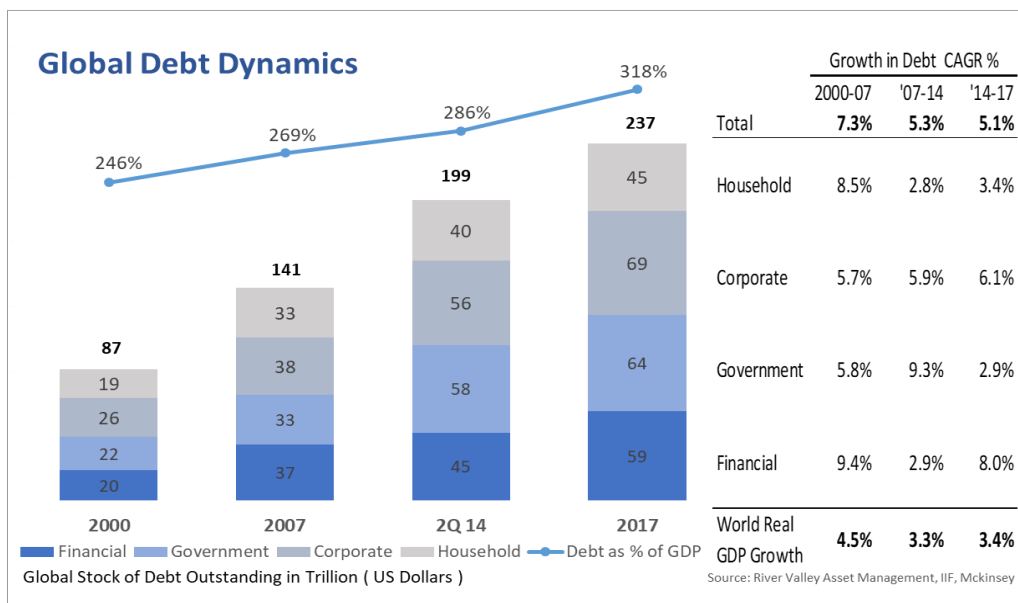
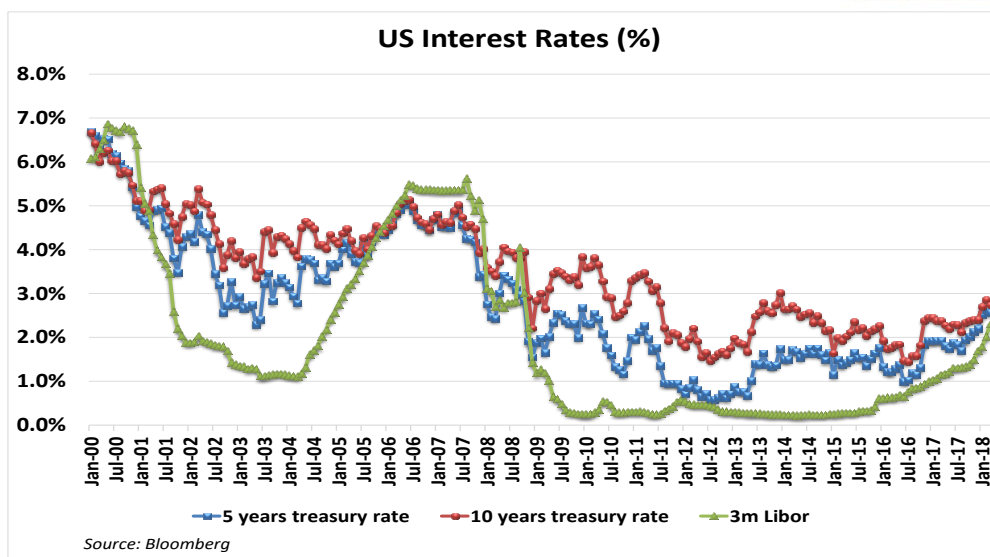
* from Jan 1st 2015 to Mar 31st, 2018 in US\$

The table above shows annualised gross returns of the RVCC Fund portfolio compared with typical indices which reflect the underlying assets that we invest in, i.e. MSCI AsiaPac x-Japan equity, high yield bonds or a hybrid blended index. The aggregate impact of security selection through bottom up focus on cashflows combined with our portfolio hedging strategy has resulted in an overall volatility which is notably lower than benchmarks while at the same time delivering our targeted returns. Hence our Sharpe ratio (Annualised return/ Annualised volatility) is 30-90% better than any combination of these indexes.

The Global Macro Backdrop

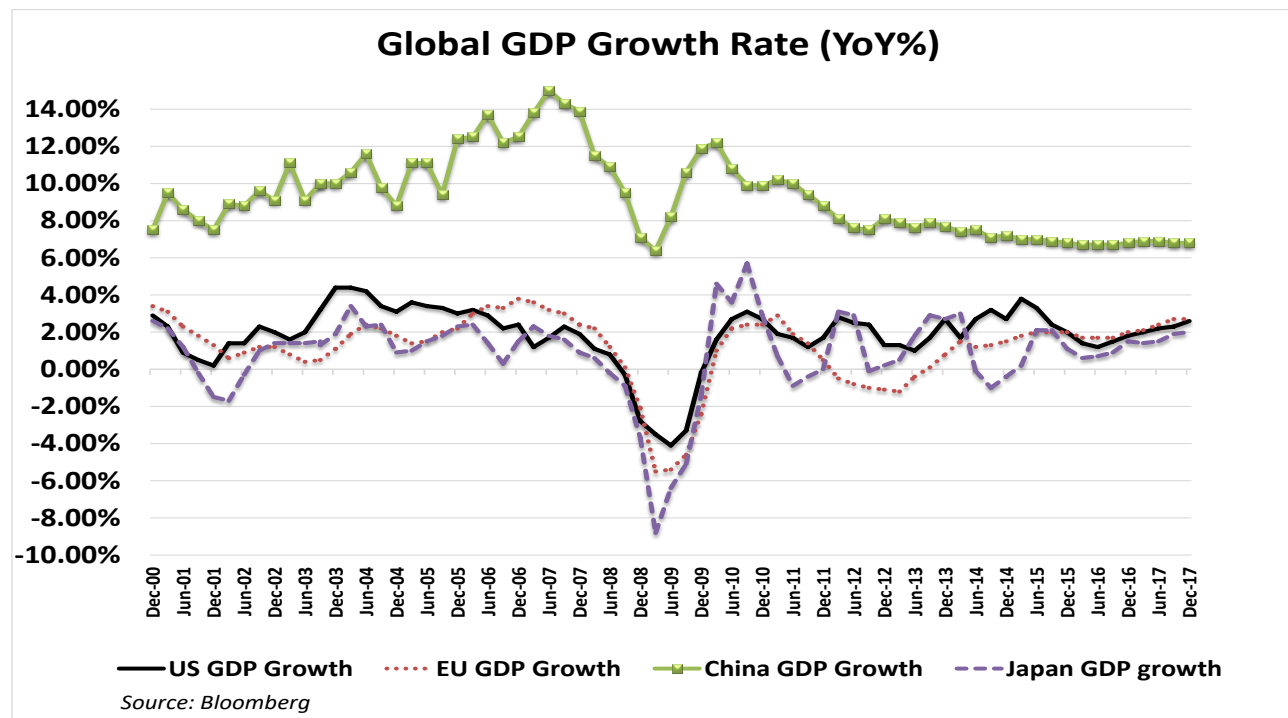
After years of undershooting growth expectations, world economies are finally seeing the sun shine with expectations being revised up consistently since the middle of last year (we wrote about this in our November newsletter). As the market evaluates whether it is a cyclical upturn or the start of a new paradigm, our analysis shows that the broad macro thesis of a lower-for-longer regime in terms of GDP growth and interest rates still holds good for the medium term. The underlying logical flow is as follows:

- The 35 year trend of dropping interest rates is ending:** We have benefited from a 35-year interest rate down cycle. This trend is ending. Though we could see some ups and downs around the current range, the secular down cycle is clearly over as global growth normalizes. Cyclically we are in a period of normalization with rates readjusting up to a more normal level, definitely higher than the recent past, which was pushed down artificially by the extraordinary burst of central bank liquidity support (QE, etc.)



- Through all this leverage has increased:** The last 30 years have seen a secular increase in leverage with short bursts of deleveraging during crises. Since the days post the Asian crisis and the US dotcom bust (over the period 2000 to 2017), global debt as a percentage of GDP has moved up from 246% to 318%. The absolute level of debt stock outstanding has increased from USD 87 trln. to USD 233 trln., growing much faster than global GDP growth.

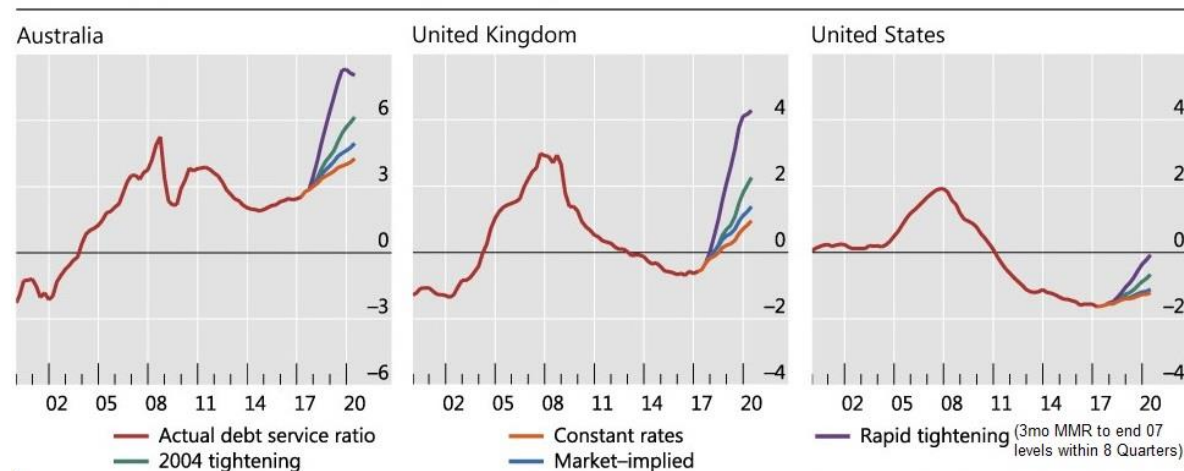
- Debt historically supported growth:** The availability and use of debt capital stock has helped amplify growth through increased leverage. In spite of this so called “boost”, global GDP growth has been stuck in the same range for the past 20 years. If the boost from rising debt stock had not been there, the growth trend lines (chart on the right) would have been lower.
- The interest burden went down through this time:** This has been sustainable for so long because, while leverage increased, the interest rate (as proxied by US rates) has come down. This has ‘miraculously’ brought down the total interest burden while leverage was going up. A rough calculation shows that between 2000 and 2017 the interest burden as a % of GDP has halved while debt as a percentage of GDP has moved up from 246% to 318% due to the lower nominal interest rates.



This party is clearly running out of stimulants. As rates normalize the rising interest burden will start to weigh on global growth. BIS in a recent research paper (chart below) highlighted how household debt service burdens are forecast to rise as we enter a period of potential rising interest rates.

Household debt servicing burdens under different interest rate scenarios¹

In percentage points, deviations from long-run average



¹ Projections for debt service ratios for the household sector given four interest rate scenarios : BIS Quarterly research publication estimates
 Source : National data, BIS Calculations, RVAM

- **Secular drivers of lower inflation are running out of steam:** We were secularly able to bring down interest rates because inflation was under check due to a variety of reasons like a large increase in the global labour pool, excess industrial capacity creation in China, increasing use of technology, etc. Some of these factors have run out of steam. Also, nominal rates are now bouncing around near a physical bottom. Hence a case can be made that rates can't go down much further from here.
- **But rates can't go up much either:** Given the high leverage today, as soon as rates go up, the interest burden will sharply start rising and will drive down growth. This would force central banks to again look at lower rates. Hence rates have a natural cap. This is basically what Japan has been going through over the past three decades and other developed markets (maybe China) will have to grapple with this in the near future.
- **The solution for a world awash in debt:** The only way out of this is a clear and consistent increase in productivity. But that is something that has not happened for quite some time and we do not have any reason to believe that this is going to change.

Macro Underpinnings Going Forward

While the market grapples with the current cyclical phase of global growth uptick with rising rates, our analysis shows that global rates can rise only so much before they start acting as a natural check on growth. Consequently, on a structural basis we continue to be in a phase of lower-for-longer GDP growth as well as interest rates, but normalization will bring with it higher cyclical volatility. We believe that this environment will create value in ways which are different from the past.

A few of the salient features of this new environment from a value creation perspective will be:

- For the same amount of risk as in the past, return expectations should be lower.
- Good companies should generate higher amounts of cash as growth requirements reduce.
- Compared to the past, cash return from companies will form a more significant component of investors' total returns.
- Pockets of growth will remain (in places like Asia, technology, etc.) and investors will bid up their valuations, whenever they find them.

When one considers our portfolio philosophy, we have been banking on this trend for the past five years. Though some of these have now become more recognised by markets, we think this is a multi-year strategy. There could be cyclical moves around this strategy, when we overshoot and undershoot, but we continue to see strong return from this strategy continuing in the near future. Also, a less recognised advantage of this strategy is its lower volatility (as shown earlier). Hence on a risk-adjusted basis, this strategy stands out in a period where "lower-for-longer" will continue to dominate as a debt-loaded global economy battles between growth, deleveraging and the increasing burden of rising rates.

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