Lucerne Alternative Investments Fund

ANNUAL LETTER | 2021

Lucerne
Alternative
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Fund

Global Challenges:
Vaccines, Inflation, Bottlenecks and Climate

For most of us on the eastern seaboard 2021 began with what we all had hoped to avoid – more lockdowns. That set the scene for the year as not only Australia but many other countries either opened their economies too early or not at all. The expectation of an effective vaccine gathered pace and so did the optimism the Covid crisis would be behind us. However, this thinking was not only premature but misguided. It has taken nearly all of 2021 for the vaccine rollout to be fulfilled in developed economies with the low and slow supply of critical vaccines to underdeveloped nations allowing new variants to emerge and present continued problems around the world.

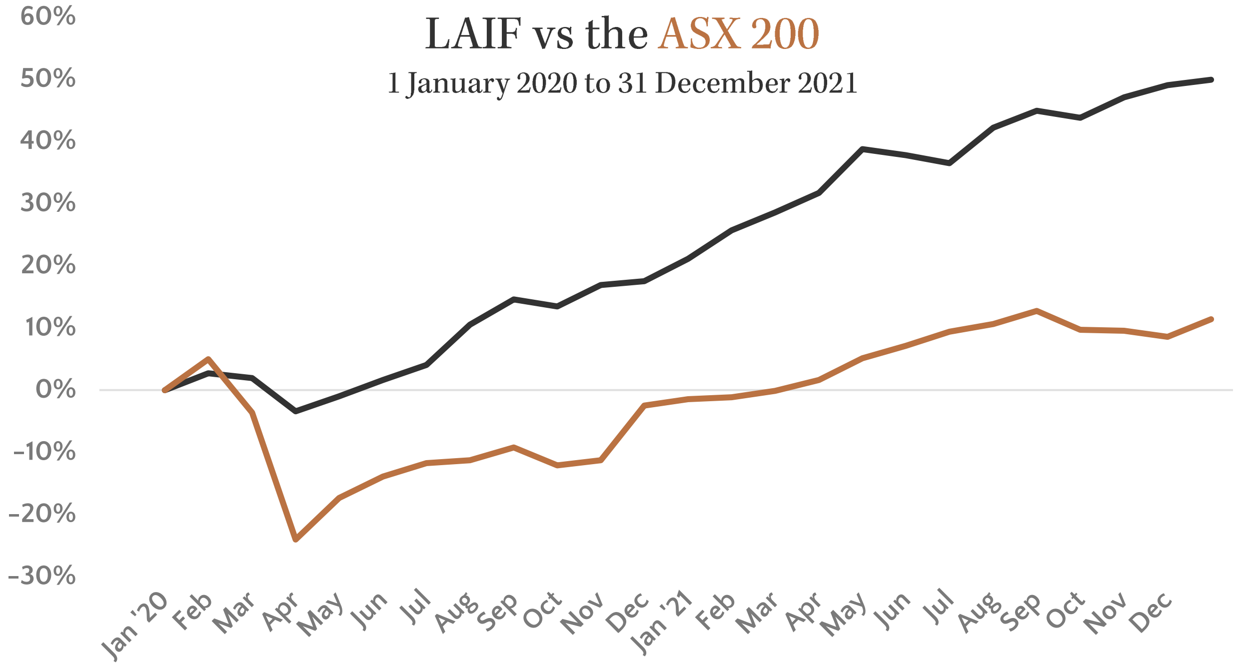
With this as the backdrop to what took place in 2021 it is important to remember supply chains ground to a halt and inflation appeared (and remained). The cause and effect say many. However, it is not to ignore the impact the rising interest rates will have on asset values and the availability of capital. The efforts of governments to act with urgency on the climate imperative or “A Code Red for humanity” as the UN Secretary General called it, culminated in the pledge laden COP26 meeting in Glasgow. This has seen many in private enterprise use whatever technology and capital is at their disposal to lead the way making a climate difference. It is once again markets, free enterprise, that is leading the way in sustainability and with the Australian Prime Minister pledging to achieve climate targets with the market led model, expect to see more of this over the coming decade.

As Investment Manager of an alternatives fund of funds, Lucerne are in the unique position to identify the opportunities change brings and position our portfolio to ensure investors are beneficiaries of those changes. We are not slaves to an index, or a stock or sector holding requirement and can invest in new and emerging market themes and opportunities, such as impact funds, digital assets and inflation driven price growth.

2021:
The year that was

Looking back on 2021 we have reviewed our Investment Committee minutes and deliberations and the research undertaken by our investment team over the year to summarise what we thought and how we acted on it quarter to quarter.

The Lucerne Alternative Investments Fund ("LAIF") had another strong year in 2021, delivering a performance of 23.77% net of fees, whilst the ASX accumulation index delivered 17.23%. This is the second straight year that LAIF has outperformed the index and in contrasting market conditions. 2020 saw the fastest drawdown and bounce back in history whilst 2021 was smooth sailing for equity markets.



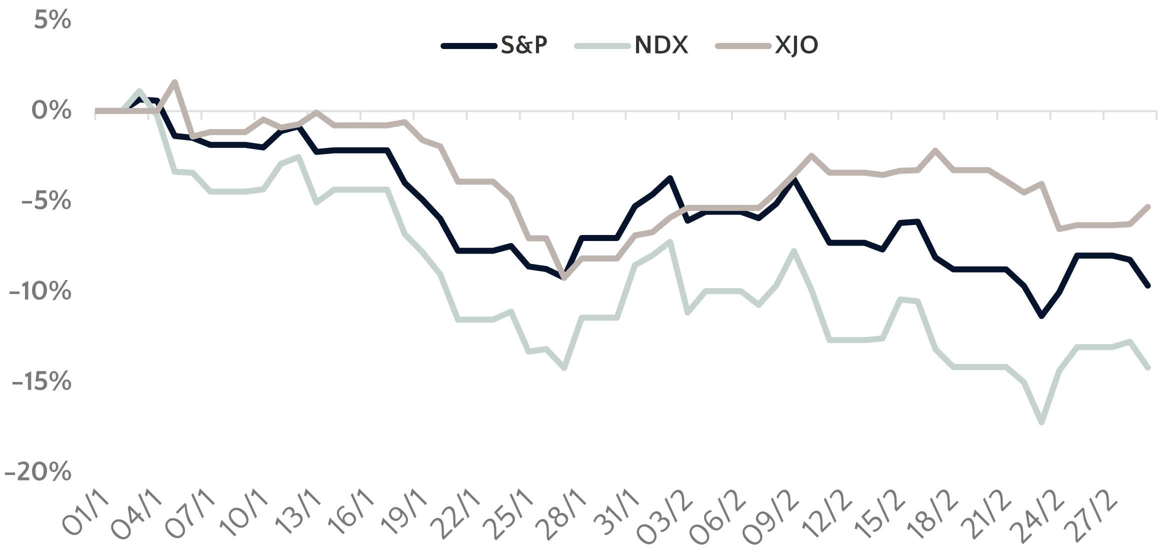
Fund	Cumulative Return	Annualised Volatility
Lucerne Alternative Investments Fund	49.90%	8.53%
ASX 200	11.38%	20.35%

2021:
The year that was (cont.)

Markets have started 2022 in a panicked state, with central banks around the world contemplating or already increasing interest rates to tackle large bouts of inflation.

The Investment Committee has been positioning the portfolio over the last year to tackle this.

1 January 2022 to 28 February 2022:
A panicked start to the year



March 2021 quarter:
Our annual return target in one quarter

LAIF returned 8.74% surpassing our annual return objective of RBA Cash Rate +6%. In our March quarterly we wrote about life after COVID, Gold and Resources being undervalued and the VIX being at all time lows.

Global economies around the world were recovering from a once in a generation pandemic.

> *"The US economy will have soon made a full recovery and tipped into the black. This remarkable milestone draws close while the Fed fund rate remains at a record low, QE continues, Biden's $1.9 trillion Economic Stimulus Plan is being deployed, and an additional $3 trillion infrastructure package is being finalised.*
>
> *Paraphrasing the late Senator Everett McKinley Dirksen, 'a trillion here and a trillion there, and pretty soon you're talking real money'. So, with the US suddenly starting to envisage 'life after COVID', while monetary settings and fiscal stimulus are at historically supportive levels, for the first time in a generation, the market is factoring in a real risk of inflation returning."*

The inflation discussion continued to be an ongoing theme for the remainder of the year. This led the Investment Committee to review potential strategies to combat the risk of inflation. One possible strategy discussed was a position in a VIX trading strategy.

> *"The VIX is presently at a long-term low and so we would consider it prudent to be prepared for the next inevitable phase of uncertainty. Volatility, or risk, is elevated at these times and we are conscious that a spike is possible without even knowing the catalyst. LAIF is positioned to withstand these periods of volatility in most market events given its unique investment strategy and weighting to asset classes. The Investment Committee continues to discuss what impact an unexpected event could have on markets, inflation and naturally the Fear Index (VIX) and how these transfer into asset prices. We are positioning investments to prepare for such events, especially as momentum can deliver both positive and negative outcomes."*

The LAIF Investment Committee also reduced its exposure to digital assets as we locked in the gains made over the previous year and could only see volatility returning after such a strong rise in this asset class. This ended up being a winning call as valuations in the crypto market proceeded to contract in April.

June 2021 Quarter: *Vaccination rates, global economies, valuations and is inflation here to stay?*

The June quarter started off with information regarding the disparity between vaccination rates around the globe. This led us to write that:

> *"As long as there is a large unvaccinated population the virus has the opportunity to spread and mutate. As such we should anticipate new and potentially more aggressive, variants to continue to emerge. There is the possibility that existing vaccinations are not effective against future variants. As well as being a humanitarian goal, reaching herd immunity on a global basis is therefore critical to beat the virus while we can."*

COVID-19 did in fact mutate into the Delta strain which was twice as contagious as previous variants and more likely to cause hospitalisations. The Investment Committee was confident that the equity risk premium associated with subsequent waves has been lower for each variant, this was evidenced further by Omicron which resulted in a flat market in December.

Market commentary around inflation begun to ramp up and the debate between Transitory vs Structural begun.

> *"Viewing this dynamic through a 'risk-on / risk-off' lens, the 'risk-on' proponents would see the inflationary pulse as likely to be transitory and look through a few months of raised data caused by short-term effects and supply chain disruptions. The 'risk-off' camp, however, see central bank dovishness as misplaced and are concerned that the inflation genie could escape from the lamp. This situation would likely force the hand of the US Federal Reserve and other central banks, to tighten sooner than they have guided, triggering another 'taper tantrum' while potentially knee capping the economic recovery."*

The Investment Committee again spoke about the fact that the market has not yet priced structural inflation in. This was demonstrated by the continued low reading on the CBOE Volatility Index.

We also spoke about the exuberance the market was feeling during this period:

> *"Coupled with the prospect of lower for longer as it pertains to interest rates and the expectation of a transitory inflation spike, both the US and Australian equities markets are trading at price earnings multiples not since seen the tech bubble. This is one of the metrics supporting the IC's cautious outlook and the positioning of the portfolio."*

During the period the LAIF Investment Committee took steps to mitigate the risks at the time. Several of the underlying positions increased in value such that their weightings became disproportionate. Thus, the fund reweighted to their original weightings. The aim of the Investment Committee this quarter was to smooth returns, while retaining the gains made and position the portfolio in a risk off environment.

September 2021 Quarter:
Property Debt Bubble in China

We started the September quarterly with a quote that should be re-shared:

> *"The Fed aimed to remove the punchbowl just before the party starts. Now the party's gotten great and the Fed's not removing the punchbowl until they've seen ... conclusive evidence that everyone's going to get plastered."*
> *– Larry Summers, Former United States Secretary of the Treasury, October 2021*

LAIF returned 5.09% for the September quarter. The key themes through this quarter were the Chinese debt bubble and the energy crisis.

In the September quarter we wrote about how Evergrande, the largest property development company in China looked like defaulting on their estimated $300bn in liabilities. Along with Evergrande 30 of China's biggest developers were in breach of at least one of Beijing's recently introduced rules on property sector leverage. The saga continues with Evergrande recently stating that they aim to have a preliminary restructuring proposal in place within six months as they attempt to comfort creditors that have been spooked by defaults announced last year. We must reiterate that LAIF's underlying investment managers successfully navigated this period as they have minimal, if any, exposure to Chinese equities and bonds.

December Quarter 2021:

Removal of the punchbowl

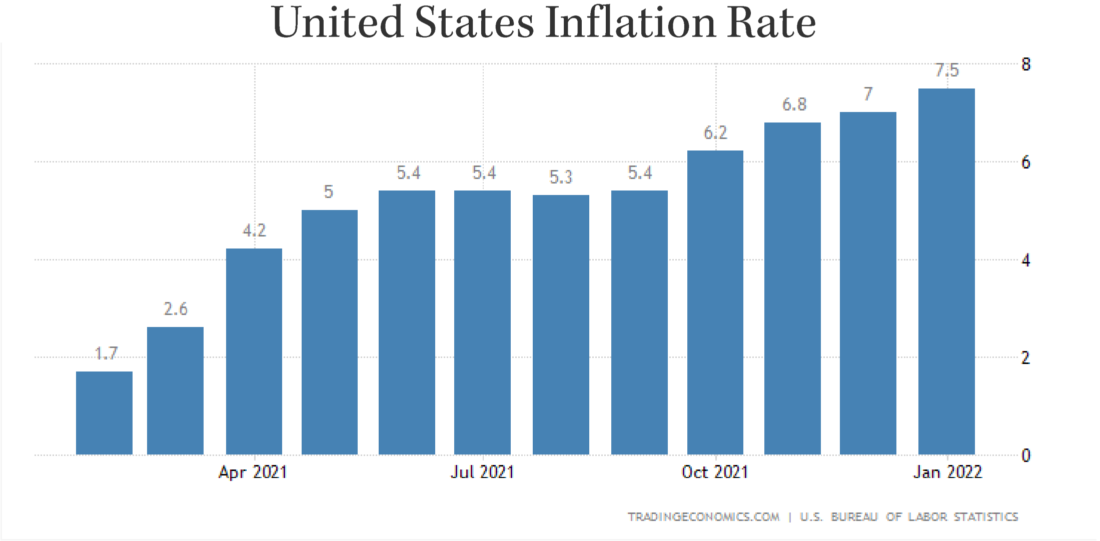
LAIF had another strong quarter posting its seventh consecutive positive quarter returning 4.24%.

The December quarterly focused on inflation, supply chain disruptions and decarbonisation. We wrote:

> *"At the most recent Fed meeting officials stated that due to a strengthening US economy and higher inflation it could lead to earlier and faster interest rate increases than previously expected. The Federal Reserve also announced they will wind down the bond buying program at a faster pace than first outlined in the November meeting. This will now end bond purchases by March this year. As a result of Quantitative Tightening and increased interest rates we expect 2022 to be volatile. As stated in the prior quarterly LAIF initiated its first position in a Volatility Exchange Traded Note (ETN) which is designed to track and provide exposure to the VIX index. This provides a hedge against the volatility in returns during a market correction."*

Often spoken about as the main driver behind the sustained increase in inflation was the supply chain bottlenecks that occurred as variants of the COVID-19 virus arose. Logistic costs are expected to remain high through 2022 and likely 2023, however, supply capacity is expected to increase and demand side pressure to subside this year. Albeit the case, now that Inflation is truly here to stay, supply chains normalising will not prevent the US Federal Reserve from tightening monetary policy and reducing balance sheets.

Decarbonisation and the focus on emissions reduction was a key theme the Investment Committee discussed throughout the 2021 calendar year. LAIF initiated its first position in a long only impact equities fund during the December quarter.



LAIF:
Positioned for 2022

The market is now rationalising and investors need to follow suit. One must think forward when considering their portfolios, but too often we look in the rear-view mirror to repeat what has previously worked. This is completely normal behavior and works in many facets of life. But the investment world is a different beast, and it's time to look through the windshield at that road ahead, which we believe will be a bumpy one.

In 2021, central banks around the world continued to label inflation as transitory – this has now changed. Inflation is here to stay and central banks will turn to their traditional play book and commence raising rates. We are already witnessing this from our commercial banks in Australia, increasing interest rates before the RBA has officially raised the cash rate – they're already looking through that windshield.

As interest rates rise, global asset prices should contract, and therefore prioritising investment strategies that can still deliver positive returns across all market conditions becomes an important consideration.

It is pleasing to review the quarterlies and research conducted by the LAIF Investment Committee and to see the fund perform through periods of market volatility in 2021. This was evidenced in the September 2021 quarterly where LAIF initiated its first position in a liquid volatility strategy providing the fund with an alternative hedge that was inexpensive. This proved to be effective in November 2021 and January 2022 as markets came off in these two months. LAIF also continued to reduce correlation by allocating to Long/Short strategies with a short bias, which would typically outperform equity markets in downturns. This was evidenced via our largest holding in the fund which returned a positive mid-single digit return in January when the Australian market was down ~6%.

So while 2020 was the year to remember and 2021 the year of multiple factors, in our opinion 2022 is the year of uncertainty. There are too many things at the moment presenting as potential problems to address in 2022 that we again see the role alternatives can play, in particular LAIF. Being able to lower your risk, achieve good returns in a highly volatile and uncertain time is the role of our Fund. We have demonstrated this in 2020 and 2021 and will work hard to ensure we can do the same this year.

On behalf of the whole team at the Lucerne Alternative Investments Fund thank you for your ongoing support and confidence.

Lucerne Alternative Investments Fund
February 2022

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