Lucerne Alternative Investments Fund

ANNUAL LETTER | 2022

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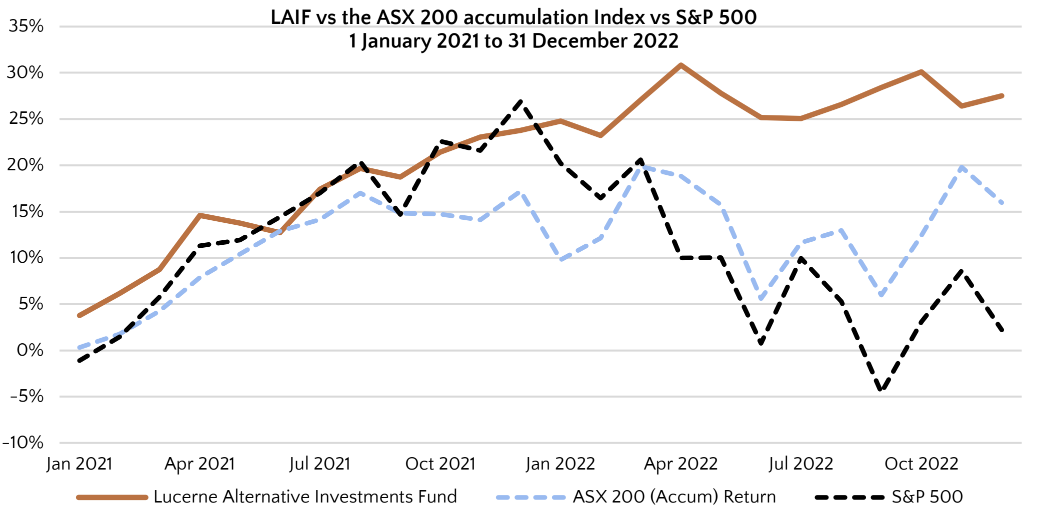
The start of 2022 was marked by the belief that inflation was temporary. The US Federal Reserve ("Fed") and other central banks portrayed it as a transitory phase, as inflation rates started to rise after being dormant for over 10 years. In Australia, it was noteworthy that commercial banks raised interest rates before the Reserve Bank of Australia ("RBA") in anticipation of an impending rate rising cycle.

The topic of inflation being a permanent fixture was widely communicated to our investors in 2021, however the rate at which it increased and the swiftness of central banks globally to raise rates was unprecedented.

COVID and lockdowns that affected much of 2020 and 2021 seem to be a distant memory as the world opened up, albeit slowly to travel and business. By the end of 2022 the market seemed to be pricing an easing in inflationary pressures and a Fed pivot. This in spite of the continued rise in interest rates and the very hawkish statements from central banks around the world.

2022 the year in review:

The Lucerne Alternative Investments Fund (LAIF) had a successful 2022, with a net return of 3.03% after fees, whilst the ASX 200 Accumulation index saw a loss of -1.08% and the S&P 500 suffered a decrease of -19.44%. This marks the third consecutive year that LAIF has outperformed the equity indices, even in contrasting and unpredictable market conditions.



*(Source: Lucerne Funds Pty Ltd) *Total returns shown for the Lucerne Alternative Investments Fund have been calculated using unit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made of taxation. Past performance is not indicative of future performance.*

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March 2022 quarter

The markets began 2022 with uncertainty and apprehension. However, LAIF performed well, returning 2.84% for the quarter despite declining major global indices. In our quarterly report, we emphasised the market's realisation that the Fed was increasing rates at a faster pace than originally anticipated. The long awaited Fed pivot came in March of 2022 with the first interest rate rise in three years. The goldilocks environment of easy money had come to a grinding halt.

Sadly, tensions between Russia and Ukraine escalated as Ukraine's efforts to join NATO faced opposition. On February 24th, Russia carried out its threat of invasion, leading to a full-scale attack on Ukraine and the largest military mobilization in Europe since 1945.

The invasion resulted in food commodity prices hitting all-time highs, as Russia and Ukraine together accounted for 30% of global wheat exports and 20% of maize exports. While the push to reduce reliance on Russian oil and gas accelerated, the Eurozone's strong dependence on Russian imports led to higher inflation, reduced growth, and a surge in demand for non-Russian fossil fuels due to western sanctions.

The Investment Committee decided to diversify its sources of alpha in response to the ongoing political and economic uncertainties. In the quarter ending March 2022, allocations were increased in gold, impact investing and trend following.

June 2022 quarter:

The June quarter began with significant worry and ambiguity. Macro data on inflation came in surprisingly higher than market consensus or expectation. The Fed increased the intensity of rate hikes to get ahead of the curve, increasing rates by 125 basis points for the quarter and ending June 2022 at 1.75%.

The inflation data released was surprisingly higher than expected and the market's consensus. In response the Fed escalated the pace of interest rate increases by raising rates by 150 basis points during the quarter.

Markets were caught off guard with the speed and magnitude of interest rate hikes and the realisation of supply chain uncertainties due to China’s Zero Covid lockdowns. Inflation, stagflation, economic slowdown, earnings downgrades and interest rate rises were in full force and playing a crucial role in the market pull back.

The crypto market was dealt a severe blow in early May, as the stable coin "Terra" experienced a rapid drop, leading to a widespread collapse in the asset class. Before the fall, Terra held a top 10 ranking among crypto coins with a market value of over USD 18.7 billion, but it is now virtually worthless. Bitcoin, the most popular cryptocurrency suffered a massive 70% decline from its peak in 2021.

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For the quarter, the Lucerne Alternative Investments Fund was down 1.49%. While Q2 was not a positive quarter, LAIF was up 1.12% for the first half of the year, which was a strong result in highly volatile markets. For the financial year ending 30 June 2022, LAIF was up 11.04% outperforming the ASX 200 Accumulation index by 17.51%. We are pleased to note LAIF's annualised volatility in the same period was 60% lower than the ASX 200 Accumulation index.

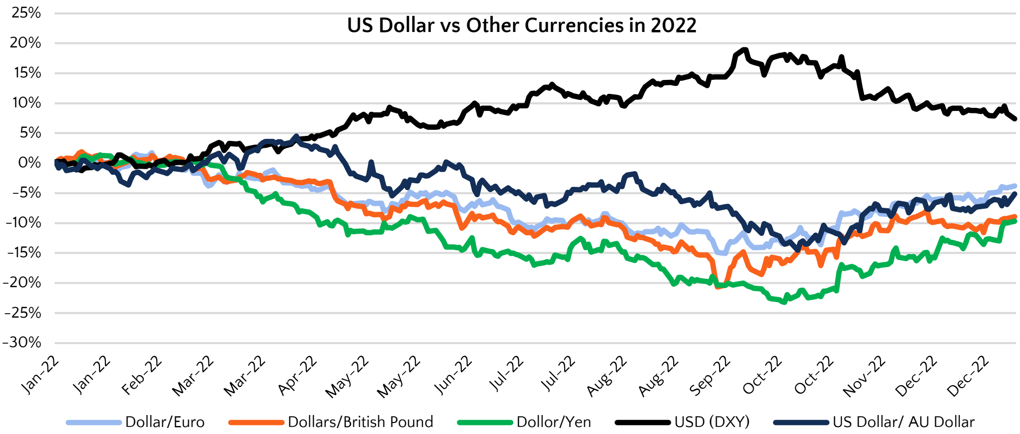
September 2022 quarter:

Q3 2022 saw the Fed's continued and relentless pursuit of controlling inflation by front loading the interest rate hikes. For the quarter, the Fed Funds cash rate increased by 150 basis points to 3.25% while the RBA followed with 150 basis points increasing the cash rate to 2.35%.

During the September quarter, the Lucerne Alternative Investments Fund returned 2.61%. The main considerations affecting performance were the appreciating value of the USD, the deceleration of headline inflation and the persistent energy crisis in Europe which heightened the risk of a worldwide recession.

The US dollar saw an extraordinary increase against most currencies, causing capital to flow towards the US as investors sought safety and interest rate parity. In our September quarterly report, we noted that such drastic exchange rate movements cause chaos and upheaval in both the strengthening and weakening currencies' economies.

While this was the case for nearly all of the year, USD gave up most of its gains towards the later part of the year as seen in the below chart. This was seen as a significant factor in reducing goods price inflation in the US during the quarter.



(Source: Lucerne Funds Pty Ltd, Investing.com)

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December 2022 quarter:

The Lucerne Alternative Investments Fund recorded a negative 0.70% return in the quarter, ending the year with a positive 3.03% performance compared to the S&P 500's -19.44% and the ASX 200's -5.45%. Over the course of the year, major shifts occurred, particularly in inflation expectations and cash rates and the crypto market experienced another crash.

In the quarter, the Federal Reserve maintained its focus on inflation control by raising the Fed Funds cash rate by 125 basis points to 4.50%. Conversely, the Reserve Bank of Australia slowed its cash rate hikes to 25 basis points per month, resulting in a total increase of 75 basis points for the quarter, bringing the cash rate to 3.10%.

The quarter showed a decline in headline inflation as energy prices had fallen, although food price inflation remained strong. Service inflation remained high, underpinned by strong demand and rapid wages growth, while services inflation appeared to have levelled out recently, in our opinion it is unlikely to decrease immediately.

LAIF Positioning for 2023

The equity and bond markets in 2022 were nothing short of chaos, while 2023 is expected to present greater challenges as the markets experience sharp fluctuations. The overall situation is further compounded by a deteriorating macro environment, with increased concerns over the onshoring claims from western nations, relocation of supply chains and heightened geopolitical tensions.

The Russia-Ukraine crisis is a major source of worry for global economic stability. History shows that while wars may subside in the first few years, they continue for much longer and have far reaching impacts to global economies than initially thought. Unfortunately, the tensions between China and the US regarding Taiwan are escalating. The likelihood of a significant geopolitical event is becoming more probable.

For the first two decades of the 21st century, we note investors were largely able to rely on their bond investments for protection when equities sold off. However these portfolio risk and return attributes fell apart in 2022 as the stock - bond correlation turned positive, meaning the usual reliance on one performing when the other didn't no longer existed. In fact we argue that this inverse relationship only came to be as central banks and governments commenced flooding economies with liquidity over the last 20 years.

We believe the sustained rise in inflation uncertainty will drive the stock-bond correlation higher in the present decade. Investors can make up the diversification deficit by raising allocations to alternative diversifiers, such as dynamic liquid alternatives and commodities.

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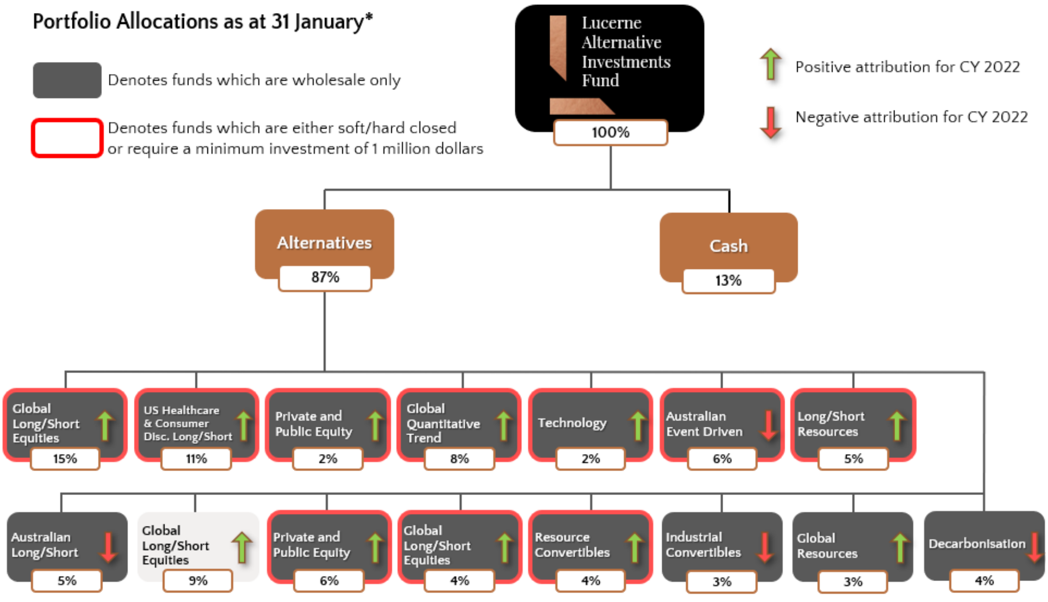
Alternative assets tend to be uncorrelated to traditional equity and bonds and could realistically make up a third or more in a portfolio allocation strategy to improve the diversification deficit. This reallocation will maintain portfolio return and is expected to reduce overall portfolio risk.

The Lucerne Alternative Investments Fund is positioned to provide uncorrelated returns in all market conditions and has demonstrated this is 2020, 2021 and 2022.

Within LAIF, the Fund is structured to hold liquid (80%) and illiquid (20%) alternative assets to provide this outcome. The liquid allocations provide strong diversification during periods of inflation uncertainty through commodities, long/short strategies and systematic trend following strategies. The performance of these strategies is largely unrelated to the macro environment and act as a strategic diversifier. While the illiquid allocations provide the cushion against short-term volatility due to the absence of minute by minute mark-to-market pricing.



*Estimate only. Figures subject to rounding. Please note portfolio allocations are modified regularly.

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 2023

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