Lucerne Alternative Investments Fund

ANNUAL LETTER | 2023

Lucerne
Alternative
Investments
Fund

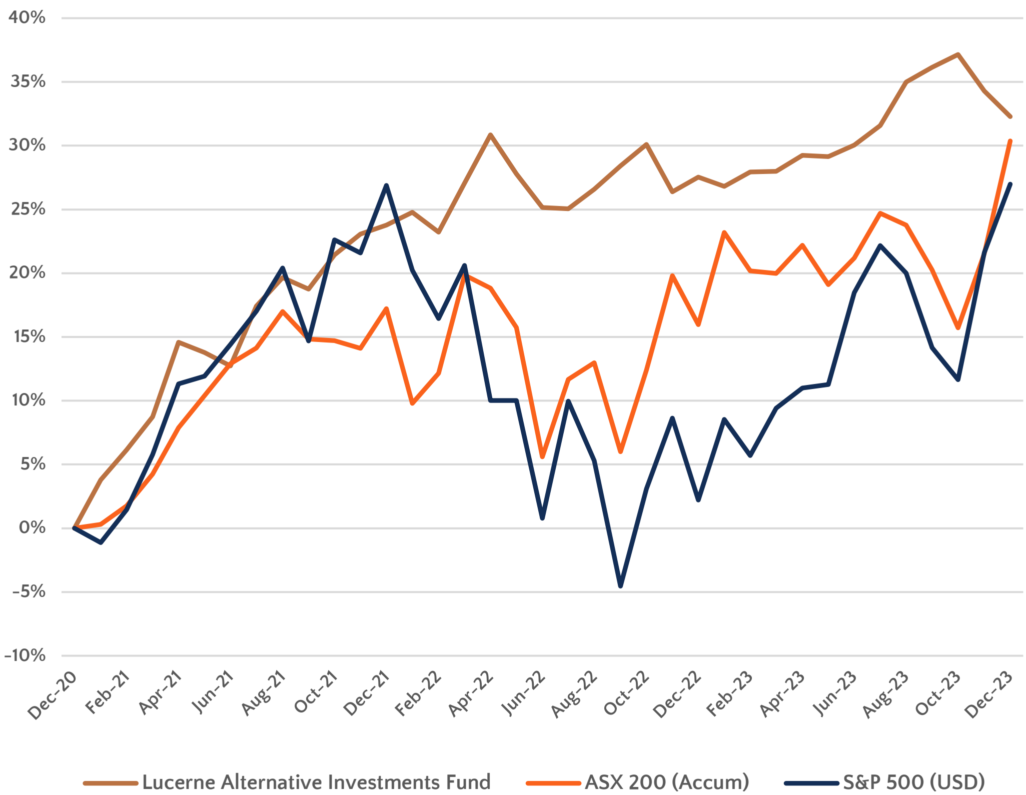
laif.com.au

Lucerne Alternative Investments Fund

The year 2023 was a year marked by significant volatility and uncertainty, both economically and geo politically. The Lucerne Alternative Investments Fund navigated this period with capital preservation in mind.

The year in review:

Cumulative Performance – LAIF vs ASX 200 Accum vs S&P 500 (Jan 2021 to Dec 2023)



(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.

Lucerne Alternative Investments Fund

March 2023 quarter

In the first quarter, LAIF experienced a modest positive return of 0.37%, despite extremely challenging market conditions. This period was marked by unprecedented bond market volatility due to the steepest rate hikes in the history of capital markets. For the first time in 20 years, we observed a shift in the stock-bond correlation to positive, adversely impacting portfolios traditionally structured on a 60/40 basis. Multiple bank collapses further complicated the quarter, raising concerns about potential contagion effects, which surprisingly did not materialise.

Additionally, the commercial real estate sector faced significant challenges, with properties being written down by 30% to 40% from their peak and a noticeable tightening in credit availability. This confluence of factors led to considerable equity market volatility, driven by expectations of rate cuts later in the year. However, the US's prompt measures to safeguard the financial system instilled confidence among market participants during this crisis.

In response to the evolving market landscape, a cautious and adaptive approach to portfolio management became essential, especially as traditional investment strategies encountered unprecedented challenges and uncertainties. The Investment Committee (IC) proactively lowered the portfolio's beta in light of weakening macroeconomic fundamentals. Consequently, the Fund increased its investments in strategies designed to offer protection during market stress. This strategic shift aimed to continue delivering uncorrelated and differentiated returns from the typical equity and bond markets. To this end, the IC notably increased allocations to volatility and long/short strategies, allowing the portfolio to navigate the turbulent market conditions effectively.

June 2023 quarter

As we progressed into the second quarter, the Fund achieved a return of 1.57% and finished the financial year with an increase of 4.01%, significantly better than many traditionally structured portfolios, underscoring the benefits of investing in a well-managed and diversified alternatives portfolio. The Fund's beta reduction exercise in Q1 was paying off. Investors benefitted from the capacity to generate positive returns and maintain lower volatility, demonstrating the Fund's effective navigation through diverse market conditions.

A series of macroeconomic events marked this quarter. Central banks persisted with their rate hikes, and the emergence of the Chat GPT and the Artificial Intelligence (AI) era captured the public's attention. The anticipation surrounding generative AI's potential to revolutionise everyday tasks drove this segment of equity markets to generate new equity price highs. Despite persistent inflation and interest rate expectations, consumer spending remained stable.

Lucerne Alternative Investments Fund

The Investment Committee (IC) observed that the effects of the aggressive tightening of monetary policy were starting to surface in the economy, albeit unevenly. Changes in monetary policy significantly impacted various interest rate sensitive sectors, including economic demand, investment, housing, and consumer spending. While influencing bank lending, the higher interest rates and a flatter yield curve reduced credit availability as net interest margins began to compress. These effects, however, were gradual in permeating the broader economy.

The IC focused on identifying and employing strategies best suited for risk mitigation, consciously avoiding popular strategies that did not align with this objective. This approach led to a significant reduction in portfolio volatility. In the twelve months leading up to June 2023, LAIF exhibited a volatility of 3.95% and a return of 4.01%. These figures highlight the portfolio's capability to manage market fluctuations and its success in preserving capital and generating positive returns for investors.

September 2023 quarter:

The Fund maintained its strong trajectory in the third quarter, achieving strong quarterly return of 4.62%.

During this period, the economic landscape remained inconsistent and uncertain. However, there were growing indications that efforts to reduce inflation were becoming increasingly effective. Input costs began to decrease, and oil prices stabilised. Additionally, the freight industry saw a significant improvement, with charges for freight movements reducing to pre-COVID levels, indicating that previous bottlenecks were no longer a pressing issue. The financial markets were confused about the future direction of interest rate hikes. While there was growing anticipation for a potential pause or reduction in rates, consistently strong economic data, including surprising global GDP figures and a robust labour market, dampened these expectations. In particular, the labour market's strength and excess savings enabled consumers to maintain their spending levels.

The IC observed a concerning uptrend in credit card delinquencies, auto loans, and bankruptcy filings, reminiscent of patterns seen in 2007. However, mortgage delinquencies remained low, likely due to homeowners benefiting from previously secured low interest rates and the tendency to prioritise home payments. The rising interest rates, however, continued to pose significant challenges, especially for small businesses and the commercial real estate sector.

Despite the ongoing concerns about persistent inflation and the looming possibility of a recession, market responses were often unpredictable. However, there was a noticeable trend of caution, particularly in the high-risk investment areas such as venture capital, private equity, and high-yield bonds. The tightening of credit conditions led to reduced capital availability, prompting investors to adopt a more prudent capital allocation approach.

Lucerne Alternative Investments Fund

December 2023 quarter:

The year's final quarter posed a significant challenge for the performance of the Fund, reporting a quarterly performance of -3.04% (this loss was from the phenomenon of the broad based rally in all major asset markets). Despite these challenges, LAIF ended the year with a positive annual return of 3.51%. A notable shift in market dynamics occurred in the last two months of the year, driven by the US Federal Reserve's commentary suggesting 3-4 rate cuts in 2024.

This announcement catalysed a surge in equity and bond markets, leading to a broad-based rally. This shift from previously concentrated market breadth to a more inclusive rally was fuelled by continued strength in the labour market and robust consumer spending, which supported strong economic growth and corporate profits, thereby driving equity prices higher.

While the market seemed to have inflation under control, the IC remained vigilant, particularly in light of increasing geopolitical risks. The ongoing conflicts in Russia-Ukraine and Israel-Palestine, along with significant disruptions in the Red Sea impacting about 15% of global trade, have led to a 150% increase in shipping costs. A significant turnaround from earlier in the year. These factors pose a risk of triggering a second wave of inflation.

The high level of uncertainty and the element of surprise in market movements typically is expected to lead to heightened market volatility. However, the year presented a contrasting scenario: while equity market volatility, as indicated by the VIX index, remained relatively subdued, bond market volatility, as reflected by the MOVE index, painted a different picture.

The disparity and disagreement between market forecasts and expectations is cause for caution by the IC as the equity investor stills seem complacent in response to critical economic indicators and the ongoing tension geopolitically.

Conclusion

Throughout 2023, the Lucerne Alternative Investments Fund navigated a complex and fluctuating financial landscape marked by significant equity, bond, and currency market shifts. Central bank policies and global economic developments further intensified these fluctuations. Despite these challenges, LAIF's consistent performance throughout the year is a testament to its ability to adapt and respond effectively to changing market conditions. As we look ahead to 2024, we continue to seek emerging opportunities and navigate potential challenges, with a continued focus on delivering robust, risk-adjusted returns for its investors.

Lucerne Alternative Investments Fund

Reflecting on the year, 2023 stood out for its high macroeconomic activity and data level. Despite widespread expectations of a recession, the year unfolded differently, with the anticipated risks persisting and becoming more pronounced as the year progressed. One notable trend was the reversal in the trajectory of falling earnings in equities, with projections for 2024 and 2025 now adjusting upward. However, this optimism seems premature because of the declining strength of consumer spending. A noticeable reduction in consumer purchasing power and an overall slump in consumption are likely to have lingering effects, potentially becoming more pronounced in 2024.

Portfolio Positioning for 2024

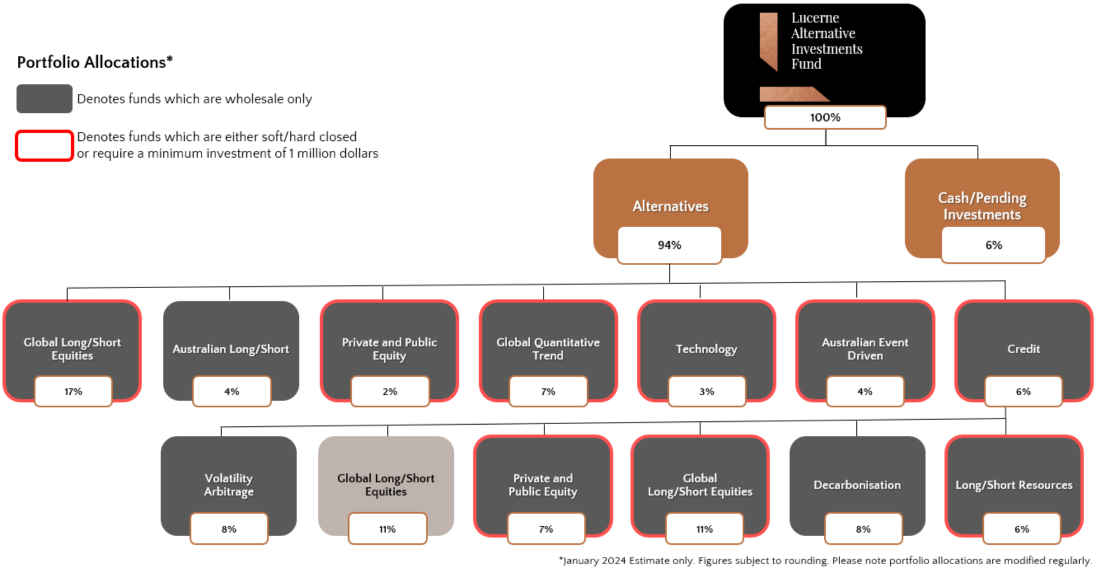
The Lucerne Alternative Investments Fund is dedicated to delivering steady absolute returns, distinct from the performances of traditional equity and bond markets. As we enter 2024, the Fund faces a highly uncertain macroeconomic environment. Despite these challenges, the Fund's Investment Committee adopts a cautiously optimistic stance. This approach is particularly pertinent given the deteriorating macro fundamentals and the troubling trends in the global credit market, especially concerning small businesses. The shrinking availability of credit and the rising cost of capital, partly due to the influx of private credit providers, are significant concerns. This situation demands caution, as small business failures' potential broader economic impact could be substantial.

The continued uncertainty around inflation will likely lead to a higher stock-bond correlation in the current decade. To address the diversification deficit, investors must consider increasing allocations to alternative diversifiers, such as dynamic liquid alternatives and commodities. These alternative assets, typically uncorrelated to traditional equity and bonds, could constitute a third or more of a portfolio allocation strategy, enhancing diversification while maintaining portfolio returns and potentially reducing overall portfolio risk.

The Lucerne Alternative Investments Fund is strategically positioned to provide uncorrelated returns in various market conditions, a capability it has demonstrated consistently in 2020, 2021, 2022, and 2023. Within LAIF, the Fund is structured with a mix of liquid (80%) and illiquid (20%) alternative assets to achieve this outcome.

The Fund is managed with a strong thematic-driven approach, reflecting the Investment Manager's deep conviction in this philosophy, ensuring the portfolio is strategically positioned to capitalise on emerging investment opportunities and is equipped to navigate and overcome potential market challenges effectively. The performance of these themes and the strategies deployed to exploit the opportunity are largely independent of the macro environment, serving as strategic diversifiers. Meanwhile, the illiquid allocations provide a buffer against short-term volatility, benefiting from the absence of mark-to-market pricing.

Lucerne Alternative Investments Fund



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 2024

Disclaimer

Summary of information: This presentation contains general information only and should not be considered to be comprehensive or purport to comprise all the information that an investor should consider when making an investment decision. This presentation is not a prospectus, disclosure document, product disclosure statement or other offering document under Australian law or under any other law. The information in this presentation remains subject to change without notice. Lucerne Investment Partners is not responsible for providing updated information and assumes no responsibility to do so.

Not financial product advice: This financial information provided in this presentation is for information purposes only. The information contained in this presentation is not a financial product, investment advice or a recommendation to acquire securities and has been prepared without taking into account the objectives, financial situation or needs of any person or entity. Before making an investment decision prospective investors should consider the appropriateness of the information having regard to their own objectives, financial situation and needs, and seek legal, taxation and financial advice appropriate to their jurisdiction and circumstances.

No liability: The information contained in this presentation has been compiled in good faith using sources believed to be reliable. However, Lucerne Investment Partners and its affiliates and each of their respective directors, agents, officers, employees and advisors expressly disclaim, to the maximum extent permitted by the law, all liabilities (however caused, including negligence) in respect of, make no representations regarding, and take no responsibility for, any part of this presentation and make no representation or warranty as to the currency, accuracy, reliability or completeness of any information, statements, opinions, conclusions or representations contained in this presentation.

Existing relationship: Lucerne Investment Partners and its affiliates may have an investment banking or other relationship with the companies that are the subject of this presentation and may trade in any of the securities mentioned in this presentation either for their own account or the accounts of their clients. Lucerne Investment Partners and its affiliates therefore may at any time have a long or short position in any such securities, related securities or in options, futures or other derivative instruments based on those securities.

Future performance: This presentation contains certain forward-looking statements and opinions. The forward-looking statements, opinions and estimates provided in this presentation are based on assumptions and contingencies which are subject to change without notice, as are statements about market and industry trends, which are based on interpretations of current market conditions. Forward-looking statements, including projections, forecasts and estimates, are provided as a general guide only and should not be relied on as an indication or guarantee of future performance and involve known and unknown risks, uncertainties and other factors. Past performance is not necessarily a guide to future performance and no representation or warranty is made as to the likelihood of achievement or reasonableness of any forward-looking statements or other forecast.

Not an offer: This presentation is not, and should not be considered as, an offer or solicitation to buy or sell securities or any other financial products. Neither this document nor any of its contents will form the basis of any contract or commitment to act as a securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This presentation must not be disclosed to any other party and does not carry any right of publication. Neither this presentation nor any of its contents may be reproduced or used for any other purpose without the prior written consent of Lucerne Investment Partners.

Monetary values: Unless otherwise stated, all dollar values are in Australian dollars (AUD).

PDS and TMD: A person should consider the PDS and TMD in deciding whether to acquire or continue to hold units in Lucerne Alternative Investments Fund. The PDS and TMD are available for download at **laif.com.au** as well as by scanning the QR codes on the following page. **Lucerne Services Pty Ltd AFSL 481217**

Lucerne
Alternative
Investments
Fund

laif.com.au

PDS & TMD

Level 4, 45 Wangaratta Street,
Richmond 3121

+61 3 8560 1440
laif@lucernepartners.com