Lucerne Alternative Investments Fund

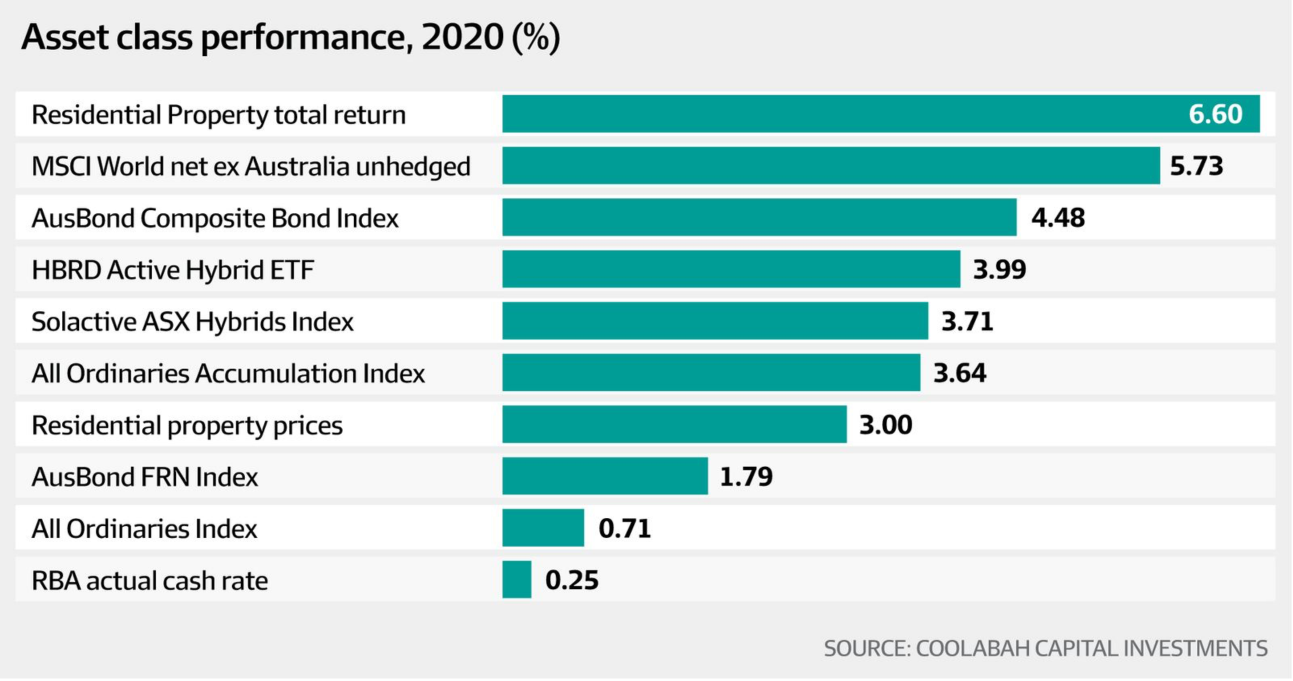
QUARTERLY REPORT | JANUARY 2021

Lucerne
Alternative
Investments
Fund

Lucerne Alternative Investments Fund Quarterly Update

The fund had another good and consistent quarter, finishing with an approximate return of …% and a historic 2020 year with an estimated return of approximately 20% (net to investors). This return is obviously far ahead of our objectives for the fund and was achieved with relatively little equity market risk taken.

We can consider our strong return in the context of major asset class returns below. All mainstream assets returned in the low single digits for the year. Australian shares barely registered a positive return, while residential property did modestly better as the Australian official interest rate was placed at 0.1% by the RBA (it will certainly be difficult for interest rates to provide the same boost from here!).



While investors should never consider past returns a predictor of future returns, achieving strong returns from a diversified fund is less likely to be misleading than doing so with a single strategy fund. The latter is much more susceptible to luck and a favourable style being the reason for its strong or weak returns. In contrast, a diversified fund investing in around 15 different underlying strategies – all with different return streams – simply doesn't have the same exposure to luck or concentration on a single style to influence its results over time.

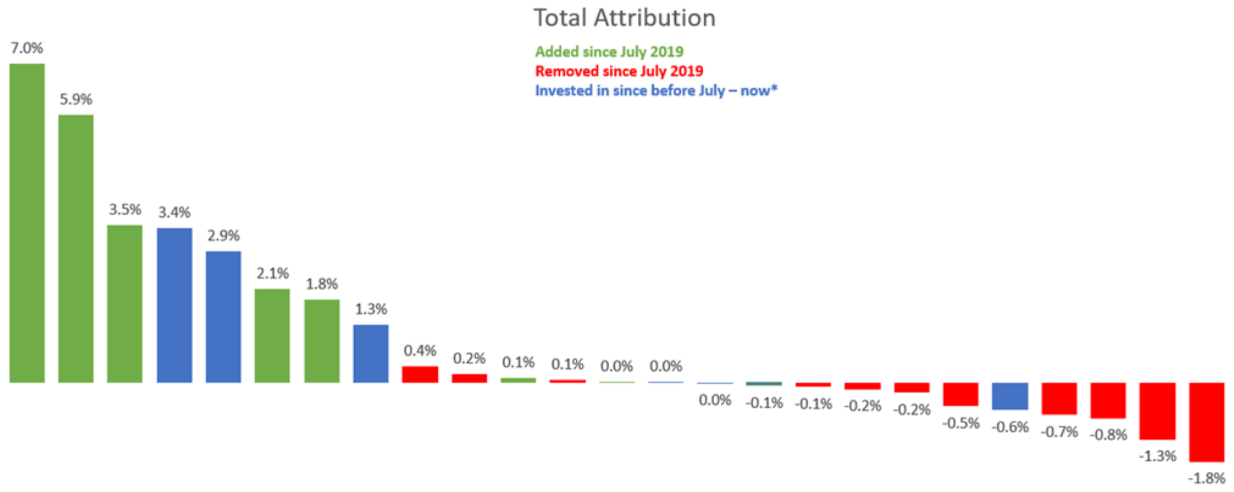
If you examine the results of other diversified portfolios and managers such as large superannuation funds during the 2020 year, you will (quite predictably) find a similar result to that of mainstream asset class returns i.e.: returns in the low single digits. This should be an unsurprising or expected result when you have limited strategy selection and dynamic asset allocation - and if you basically manage assets with a relatively static or strategic portfolio with mainstream exposures.

What then explains our substantively better results for the year while still maintaining the risk benefits of being diversified? Multiple factors explain our results:

1. The first is that we **dynamically allocate** to underlying asset classes and strategies depending upon their assessed outlook. In the early part of the year, we were expecting economic weakness and thought markets weren't reflecting the risks. The portfolio was hence positioned to provide reasonable defence in the event of market weakness, which it successfully provided. Even though we took time to confirm subsequently that all the US Federal Reserve stimulus would boost the markets - notwithstanding a continuation of massive economic problems and no historical precedent for such a rapid recovery – we still acted on this recognition and tilted the fund to be more positioned in "risk-on" strategies for the second half of the year. At the margins, this meant that we were able to participate in more of the (unexpectedly rapid and strong) recovery in risky assets. We note, however, that more recently we are moving back towards being more defensive - which we will discuss below.

2. We have had great success in **making timely allocations to value adding and skilled strategies** to populate our portfolio based on our research. Additions to the fund over the last eighteen months have been tremendously value adding from the time we added them, and the fund has demonstrated a diversified range of return sources. Furthermore, these added value and returns above and beyond the risk that we were taking by being invested with them (true "alpha"). The ability to select not only good underlying strategies – but also know when to invest with them and how much to weight them in a portfolio – is crucial to good active investing in a diversified portfolio. It means you are not entirely dependent on upon asset allocation - and our strategy enables this key attribute to make this contribution.

Fund attribution of underlying strategies demonstrates diversified sources of return and timely additions to the fund (data from 1 July 1999 to 30 November 2020)



Source: Mainstream Fund Services
**As at 30 November 2020*

3. Lastly, we have shown great aptitude in **managing the overall risk of the portfolio** at a portfolio level and retaining the benefits of diversification, creating greater consistency in return while running the fund with a low volatility of just 5% - or about one third of that of an Australian equity portfolio. This aligned the portfolio well with what we feel are the general preferences of most investors and the fund's relatively risk averse nature – low downside risks, good returns and greater consistency of returns, while enabling the potential for strong long term compounding.

All of the above attributes of good active management have meant that we delivered a return which was not only vastly superior to Australian equities and other asset classes for the full year – as well as many other diversified funds - but we also did so with much less risk (low volatility and low drawdowns).

Furthermore, our returns were lowly correlated and demonstrated a low relationship to equity and property returns, making our fund a great diversifier to other investments our investors typically have elsewhere. In February and March, when equity markets collapsed, we were down modestly (just 6% in aggregate) - protecting capital and enabling long-term compounding to remain intact. Despite Australian equities being flat in July, we had our best month of the year then (up 6%). In contrast, when Australian equities were up strongly in October and had one of their best ever months (up over 10%), we barely registered a positive return. In other words, we were a true diversifier during the year also.

Yet another pleasing aspect of the fund was the positive skew to the returns. Most investment managers and strategies go up by the escalator, and down by the lift shaft – giving up far too much return in weak markets. For example, equity market returns in March were much weaker than October's strong returns. In contrast, we did the opposite during the year (which is a very difficult result to achieve) - our best month was up 6% while our worst month was down just 5%.

The outlook from here

As we roll into 2021, the market conditions haven't really changed greatly from how we entered 2020. As such we expect 2021 to provide another good opportunity set for great active management to demonstrate its value.

The year is starting out (once again) with ebullient investors and great confidence in equity markets. Few investors are now focussed on market fundamentals and most strategists and outlooks are expecting a highly positive 2021 with strong equity markets, low interest rates and easy monetary conditions and strong fiscal support for markets. This is now an incredibly consensus trade. We beg to differ by reminding investors that these same strategists and yearly outlooks are almost always very positive, and that the view entering 2020 was incredibly similar (and wrong). We would not at all be surprised if the consensus once again proved to be complacent, given how stretched markets are currently and how susceptible they remain to shocks.

There are two acronyms we see everywhere – (1) TINA (There is No Alternative) and (2) FOMO (Fear of Missing Out). TINA refers to there being no alternative to equities (because bonds and cash offer such miserly returns). Our problem with the TINA view is how narrowly focussed it is. There is an Alternative – albeit this is clearly not something everyone wants to acknowledge - and that alternative is a well-run diversified alternative investments fund, as we've shown. A well-managed active alternatives fund can deliver much greater consistency of return and risk adjusted return, than a simple equity index investor can, and is in our view better much better aligned with investor preferences.

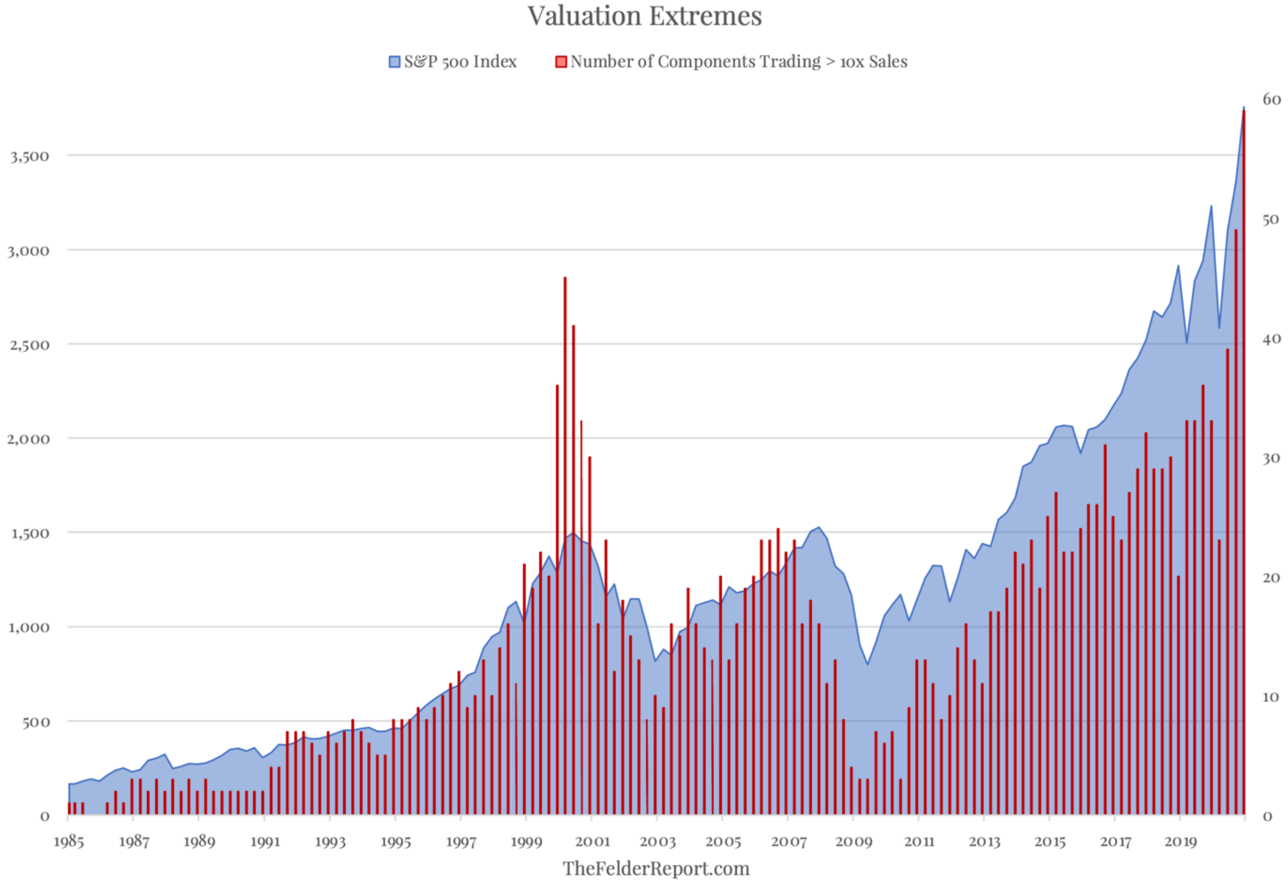
We continue to expect that equities will suffer further crises this year and beyond, providing somewhat binary returns over shorter term time periods to investors. This return profile is unlikely to be easy to live with or one that many of us would want for our money. Furthermore, the long-term return outlook for equities is for continuing low returns.

In the current environment, well-run active portfolios should include and upweight well-run actively managed alternatives portfolios, as this should provide much better risk-adjusted returns than equities will with greater downside protection in what remains a highly binary market.

FOMO refers to investors all chasing strong past returns and being afraid to miss out on the speculative mania in strongly performing risk assets. Many investors seem to have forgotten the market falls in early 2020 already, yet alone previous crises!

In our view, the fear of missing out is partly created by excessively easy monetary policy and short-covering feeding on itself and is of course an essential ingredient in any bubble. Strangely enough, however, easy monetary policy may well be close to peaking.

It will certainly be increasingly difficult from here to outdo the market's already very lofty expectations for continuing massive government support. Furthermore, market euphoria is already at or near a historic peak.



As a result of all this, we have seen risk-on strategies massively outperforming our more defensive allocations in recent months. Given the above and the numerous risks to markets in 2021, not the least of which is rising yields and the large gap down towards fundamental valuation support for markets, we are moving the portfolio to being more defensively positioned – in direct contrast to what most investors are doing.

We expect that a reality check of any kind – or any reversion or recognition of fundamental risks or the elevated valuations - will once again be unkind to the overly risk-taking investor.

Risks noted, a resilient portfolio like ours always has a mix of underlying investment strategies from which to prosper, and we enter 2021 with continuing enthusiasm. We look forward to a year that could provide another very attractive opportunity set for good active alternative investment management, in which experienced and hard-working investors should once again be able to continue to differentiate their portfolios for the benefit of their investors.

Thank you for investing with us in 2020, and we wish you safe investing for the quarter ahead.

If you, or someone you know, would like to talk with us, please do not hesitate to contact us on laif@lucernepartners.com to arrange a call. Alternatively it is now possible to invest directly by clicking here.

The Lucerne Alternative Investments Fund

January 2021

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