Lucerne Alternative Investments Fund

Quarterly Report | December 2022

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December 2022 Quarterly Report

The Lucerne Alternative Investments Fund (LAIF) is estimated to have a positive 0.75% return for December, resulting in a quarterly performance of -0.84%. LAIF's performance for the calendar year 2022 is estimated to be positive 2.88% compared to -19.44% for the S&P 500 and -5.45% for ASX 200. A lot changed over the year, most notably in inflation expectations and cash rates while the crypto asset class had a meltdown. This marks the conclusion of a challenging year and we take away valuable insights and look forward to new opportunities for growth and progress in the coming year.

Since inception five years ago the fund has achieved a return of 9.45% pa. Having outperformed its return objective of 6% or higher per annum (over a cycle) above the RBA cash rate, with less volatility than equity markets and diversifying and mitigating risk. We believe the Fund is well positioned to deliver improved returns in 2023 as markets return to normalcy, while continuing to prioritise risk management.

In this quarterly report, we discuss the events of the quarter and review our macroeconomic thesis for the future.

A look back at Q4 2022:

- The US Federal Reserve (Fed) continued its pursuit of controlling inflation. For the quarter, the Fed Funds cash rate increased by 200 basis points.

- Reserve Bank of Australia (RBA) slowed down its cash rate hikes to 25 basis points each month thereby increasing the cash rate by 75 basis points for the quarter.

- RBA's December meeting minutes surprised the market as they considered the option of no change in the cash rate for the first time since early 2022.

- Global inflation persistence remained high, however the decline in oil prices, easing supply chains pressures appear to have helped in bringing it down.

- 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, it was unlikely to decrease immediately.

- The crypto industry had another meltdown, this time with the collapse of FTX/Alameda Research. The ongoing fallout and knock-on effects will likely continue to plague the industry.

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The Macro Thesis Dilemma:

Positive Case Scenario (Soft Landing) that everyone wants:

The recent decrease in inflation, as seen in the December US CPI report, is a positive indication that the inflation crisis may come to an end without causing the economy to enter a recession.

While it may be too soon to confirm this outcome, it is becoming increasingly clear that controlling prices does not require a recession to occur.

Some may suggest that the Fed desires an increase in unemployment as a prerequisite to declare success in controlling inflation. We believe this to be a misconception. The ultimate objective of the Fed is to curb inflation and not to harm the economy. To achieve this goal, they may use policy measures that temporarily slow down economic growth.

A desirable outcome for the Fed would be for inflation to reach its long-term target of 2% while economic growth remains steady. This "Goldilocks" scenario would allow the central bank to relax its aggressive monetary policy stance before it causes excessive reduction in demand.

If the above scenario occurs, it would be beneficial for all parties involved. Consumers and businesses would have access to more favourable financial conditions, leading to a positive impact on the economy. Additionally, with the Fed no longer needing to implement strict monetary policies, investors would no longer have to navigate the volatile cash rates which have been the catalyst for market uncertainty.

LAIF’s conviction for a soft landing:

We believe that the markets have been caught off guard by the strength of the consumer, as Q4 2022 retail sales numbers have consistently exceeded expectations. Although consumer spending and savings remain elevated, we remain cautious, as the full impact of the central bank rate hikes in 2022 is expected to be felt in 2023. We have observed an increase in credit card applications, a decrease in job listings, and an uptick in announcements of large-scale layoffs, which we believe could signify a potential end to the spending surge.

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Worst Case Scenario (Hard Landing) that nobody wants:

The outlook for inflation is mixed. On one hand, we anticipate that overall inflation (headline inflation) in the economy will decline quickly over the next 3-6 months as the cost of goods, particularly fuel, decrease. On the other hand, core inflation, which does not take into account the volatile prices of food and fuel, is likely to remain high even after the peak of the headline inflation cycle. It is important to note that core inflation has a greater impact on policy decisions and tends to be more persistent.

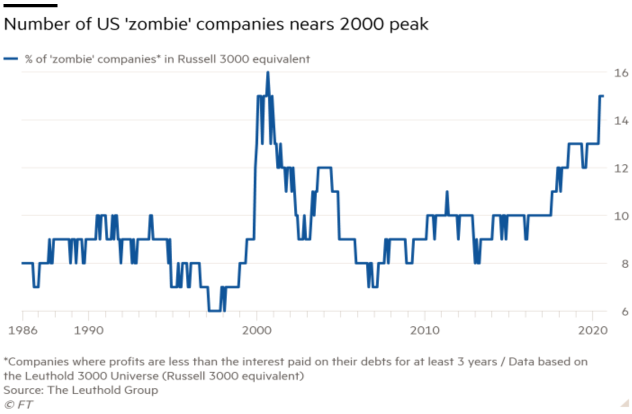
We observe that weaker preliminary data is finally affecting both the current and lagging data, indicating that the US and Eurozone economies are slowing down. In our view, this will likely have a cascading effect on the global economy.

Credit crunch:

We are observing a large number of indicators showing the impending difficulty for businesses as profits decrease and demand drops. We remain surprised (even shocked) at the lack of investor concern about the depth of the developing global recession.

The evidence, both economic and geopolitical, that a severe recession and significant decreases in corporate earnings estimates are forthcoming in the next few months is becoming increasingly clear. An illustration of the current level of investor complacency is the market's reaction to the December meeting's predictable announcement that the Fed and RBA plan to keep increasing interest rates until inflation is under control.

The accompanying charts provide one reason for our belief that the recession will be more severe than what is currently predicted. The percentage of "zombie" companies in the Russell 3000 index is at an all-time high, surpassing the levels seen during the dot-com bubble. (A "zombie" company is one that is unable to cover the interest on its debt with its operating income).



An increase in interest rates may lead to a higher percentage of "zombie" companies and ultimately result in a wave of debt defaults, causing significant harm to the economy and markets. We believe that the negative effects of rising interest rates will not only impact "zombie" companies but will have a far-reaching impact on the highly leveraged global financial system.

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We have previously noted that estimates for 2023 U.S. earnings have dropped significantly in recent months, yet they remain optimistic despite the Federal Reserve's ongoing efforts to raise interest rates and decrease the money supply.

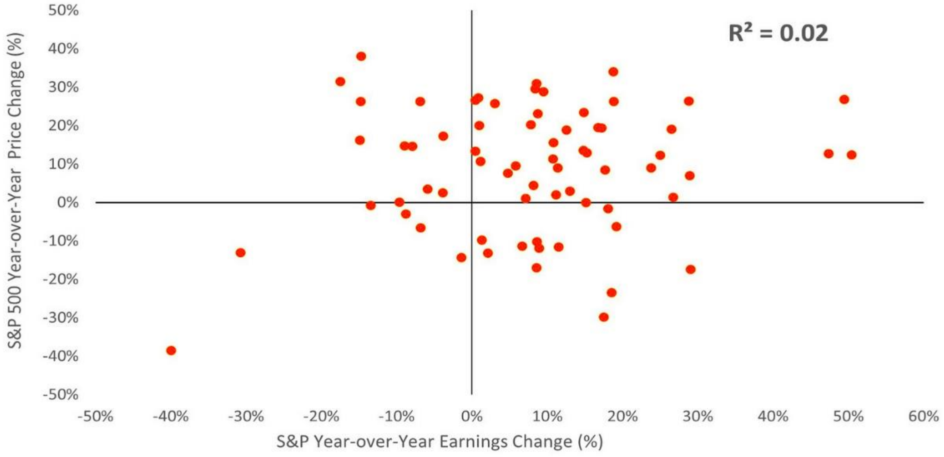
We pay close attention to any discrepancies between earnings projections and stock market performance, as they often reveal important information about future prospects. It is important to note that the effects of Federal Reserve policies tend to be delayed and often go beyond the intended outcome. Therefore, the impact of the Fed's actions in 2022 will likely not be fully visible until 2023.

Forecasting Challenge: Earnings vs Price

Equity and bond markets tend to be unstable and highly volatile in the short-term, but ultimately follow the earnings of companies in the long-term, as history has shown. We acknowledge that reductions in earnings forecasts for 2023 may play a significant role in future market declines, however, we are cognisant in conceding the lack of clarity about what stock prices will do in 2023.

Recent research by Janus Henderson showed there is no correlation between earnings and price in the short term. However, the data did show an average annual growth rate of 8% in the long term.

Exhibit 1: S&P 500 annual earnings change vs. price change (%)



(Source: Janus Henderson)

As the chart illustrates, the scatter plot is highly inconsistent. With an R-squared* value of 0.02, there is no significant linear relationship between the growth of earnings in one year and the performance of the stock market in the same year. Therefore, having knowledge of next year's earnings growth in advance provides very little insight into what next year's stock price return will be.

** The R-squared statistic quantifies the predictive accuracy of a statistical model. A value of 0 indicates that there is no linear relationship between the observed and predicted values.*

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This aligns with the idea that valuations in one year do not provide much information on what stock prices will do in the following year. And while we're talking about the perils of predicting the short-term, the past year's market returns don't tell you much about the next year's returns, either.

We have consistently advocated for managing portfolios through a structured investment process. The points mentioned above further emphasise the complexity of analysing the current investment climate. As an absolute return fund, LAIF has lived true to its objective, by outperforming the S&P 500 and ASX 200 by 22.47% and 8.48% respectively in 2022.

FTX Meltdown

The recent collapse of the crypto exchange FTX and its related trading company Alameda Research sent shockwaves through the crypto market. It is a stark reminder of the risks associated with investing in the volatile and unpredictable cryptocurrency space.

The cryptocurrency asset class has seen a significant decline in its ability to provide diversification benefits in a portfolio. While there may be potential for asymmetric returns, it is crucial to be aware of the risks involved in investing in these markets. Furthermore, we emphasise the importance of investors being mindful of potential conflicts of interest between trading platforms and their affiliated trading companies. The events of 2022 have reminded us of the importance to thoroughly evaluate investments through our comprehensive due diligence practices, particularly with regards to operational aspects, before making any investments.

We would like to highlight that LAIF's initial allocation to crypto was successfully divested in May 2021 and the Fund was fully out of the asset class by June 2022.

Conclusion

This should not be interpreted as an assertion that the possibility of markets performing poorly in 2023 can be disregarded. Rather, it is a warning against becoming too certain about the likelihood of markets declining further, particularly when prices have already decreased.

It is uncertain which perspective will prove accurate. Our perspective is that a recession will result in a steep decrease in earnings, while the market's perspective is that a recession will be avoided. Until new information comes to light, we maintain our expectation of a recession that will have a significant impact on earnings, making markets susceptible to further substantial declines.

Portfolio Movements

Lucerne Alternative Investments Fund continues to achieve uncorrelated and differentiated returns to equity and bond markets. To adapt to the current market, the Investment Committee has decreased investments in strategies that are predicted to have a challenging macroeconomic outlook and increased the allocation to long-short strategies that are likely to perform well.

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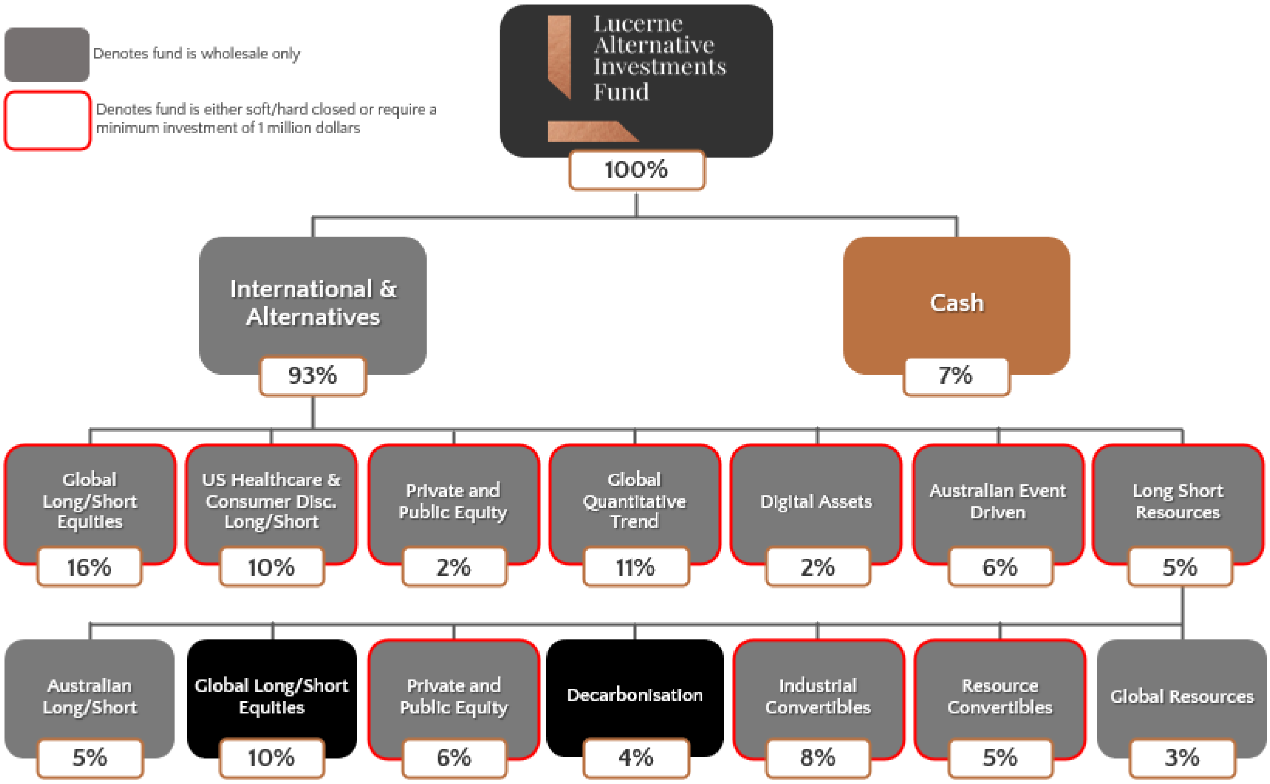

If you, or someone you know, would like to talk with us, please do not hesitate to contact us at laif@lucernepartners.com to arrange a call. Thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

The Lucerne Alternative Investments Fund
Investment Committee
January 2023

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