Lucerne Alternative Investments Fund

QUARTERLY REPORT | SEPTEMBER 2020

Lucerne
Alternative
Investments
Fund

Lucerne Alternative Investments Fund Quarterly Update

It was a great quarter for LAIF with a return of +9.07% achieved while Australian equities (S&P ASX 200 Accumulation index) achieved -0.44%, for an outperformance of 9.51%.

Investors who attended last year's introduction to the new portfolio management team in July 2019 heard us state our five-point mission statement for the fund:

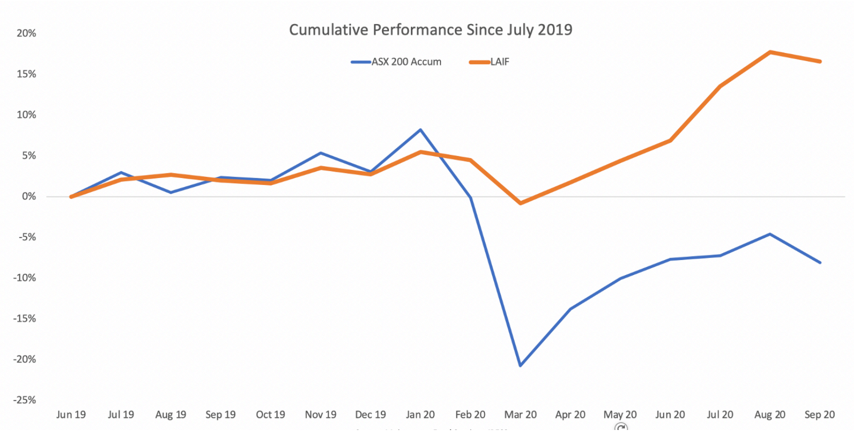
> (1) We are less risky (volatile) than an equity investment
>
> (2) We will protect substantively from market falls
>
> (3) We can make attractive absolute returns regardless of whether markets make money or not and are more likely to surprise to the upside
>
> (4) We will probably outperform traditional portfolios and equities over time despite lower risk levels
>
> (5) We are a core portfolio holding and are also valuable as a portfolio diversifier and defensive asset

Many professional investors might consider such a collection of lofty goals unrealistic from a diversified risk managed portfolio. Nonetheless, the first 15 months of the new portfolio management team saw us achieve those goals, and, importantly, we are on track to continue to do so.

These goals are not something we have made up, but in our view reflect what most investors want their fund manager to achieve for them and what we know is achievable by us. We believe we are very unusual in striving to achieve clients' needs and wants, rather than managing to an irrelevant benchmark.

In this quarterly report, we will expand on how we are tracking against the above objectives since we started managing the portfolio.

We will look to repeat this exercise in future to continue to check we are on track with our goals and to give our investors the confidence that factually, as shown in the numbers, we are offering you something truly exceptional.



Totals Since 1 July 2019	
Performance	
LAIF cumulative performance	16.56%
ASX 200 Accum. cumulative performance	-8.09%
LAIF outperformance of ASX 200 Accum.	*24.65%*
Volatility	
LAIF annualised volatility	8.88%
ASX 200 Accum. annualised volatility	23.09%
Improved risk over ASX 200 Accum.	*14.21%*
Share & Sortino Ratio	
LAIF Sharpe ratio	1.38
LAIF Sortino ratio	2.43
ASX 200 Accum. Sharpe ratio	-0.31
ASX 200 Accum. Sortino ratio	-0.34

Source: Mainstream Fund Services, IRESS

Total returns shown for the Lucerne Alternative Investments Fund have been calculated using exit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.. Denotes new investment team commencing (June 2019). Cumulative Return since June 2019 is 16.56%.Source: Mainstream Fund Services

(1) "We are less risky (volatile) than an equity investment"

We can see from our standard deviation measure, on the previous page, that we have been approximately just one third as volatile as equities have been, or nearly two thirds less risky! Our volatility measure captures our favourable upside volatility. In contrast the equity volatility has largely been driven by unfavourable and large downside volatility.

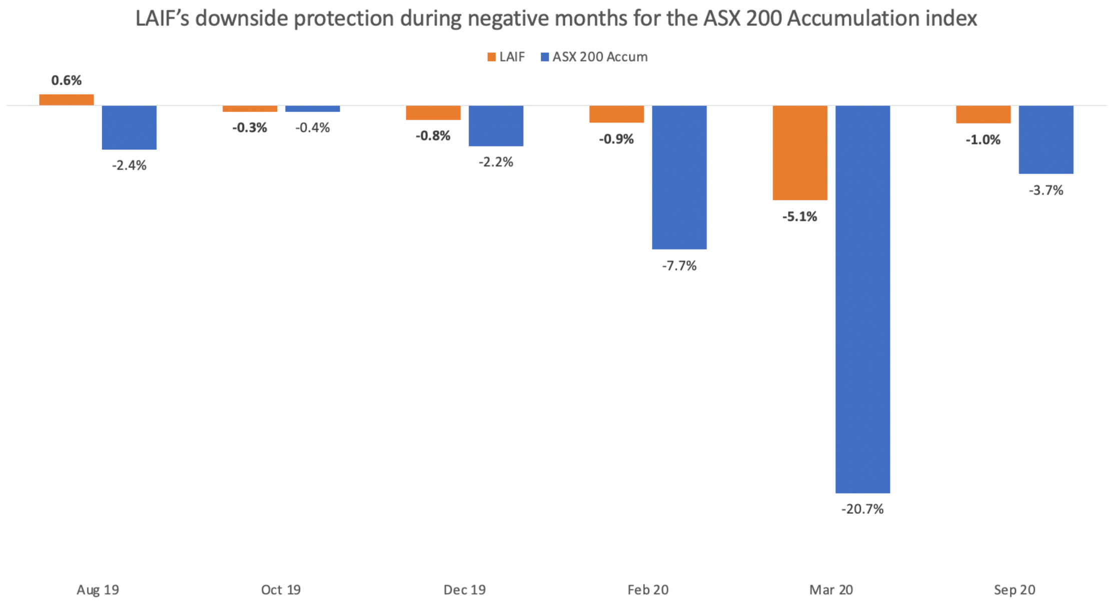
This is important because most investors want to sleep at night and know that they won't wake up tomorrow to find that their portfolio has fallen by 40%. Given equities volatility of 23.09%, large losses are a real risk from a long-only equity investment and not something that should come as a complete surprise in current circumstances.

(2) "We will protect substantively from market falls"

We believe we are living through one of the riskiest times for investors ever, as we have expanded upon in prior quarterlies. February and March provided some illustration of the heightened sensitivity of markets to shocks given their elevated (and arguably unsustainable) valuations built on unsustainable economies and debt bubbles.

During this real live stress test, we experienced only moderate losses - unlike equities which capitulated in value. Furthermore, many alternatives performed dismally over this period, suggesting we were indeed doing something different given we run a diversified portfolio of strategies and alternatives.

This makes luck an unlikely driver of our results. Our returns are much more meaningful than any single strategy manager over the same period given they come from a diversified portfolio. We can also see below that in other weak periods for markets we have also tended to protect capital.



Source: Mainstream Fund Services, IRESS

The protection against large market losses is very important for the simple reason that if you never lose a lot, compounding over the long term becomes very achievable. In contrast, large drawdowns are very difficult to recover from, in a mathematical sense.

Large losses also provide an intolerably unpleasant journey for investors and create a loss of confidence in their investment managers and markets, which in our view can and should be avoided.

(3) "We can make attractive absolute returns regardless of whether markets make money or not and are more likely to surprise to the upside".

Last financial year's numbers have demonstrated this, as does this most recent quarter's numbers. While most diversified funds we know of produced negative returns last financial year, we were up 6.9%. In the most recent quarter, equities were down 0.44% whereas we produced our best quarterly return ever of 9.07%, surprising to the upside.

Being able to achieve highly attractive returns even when markets don't is a very valuable and unusual performance result for investors from any fund, and even more so from a diversified risk managed fund.

(4) "We will probably outperform traditional portfolios and equities over time despite low risk levels"

This is probably the most contentious goal we could set ourselves and certainly not the official objective of LAIF. How could we possibly expect to outperform the power of risk assets such as equities with so much less risk?

This view depends in part on our assessment that equities are likely to continue to disappoint high investor expectations, as has been the case in fact over the last couple of years. In contrast, we can achieve high absolute returns regardless from diversified return sources and skilled investment management.

The fact that most investors miss when it comes to achieving returns over time is often the result of large downside in market selloffs; large falls simply destroy long term compounding. While we don't expect to always outperform equities in short periods of rampant enthusiasm for equities, we know this is relatively unimportant if you are truly aiming to serve investors' long-term interests.

Instead, we typically expect to massively outperform in weaker periods, more than making up for any modest underperformance in up-markets.

Furthermore, our strategy enables us to choose when to have some long equity exposure, and what specific exposure to have. We are hence able to buy and sell long-only equities when it is least risky to do so. We expect this to be a substantial source of added value over time and again something that most diversified funds simply can't do.

(5) "We are a core portfolio holding and also valuable as a portfolio diversifier and defensive asset given our diversified actively managed portfolio with low market risk".

It is very important to recognise that we offer a portfolio which is in some ways similar to what many financial planners and investors would like to have for themselves; a diversified portfolio of different managers which offer complementary strategies. We typically invest in about 15 underlying funds, each in themselves typically diversified to some extent and different to each other.

One important difference from others, however, is our heavy emphasis on risk management and true diversification. We have a much stronger preference for diversifying assets compared with the traditional equity and property dependent portfolio because we are focussed on an absolute return objective, not being the same as everyone else.

The typical "diversified" portfolio is far more dependent on the economy and markets hanging together, a risk with which we feel very uncomfortable and that sits poorly with an absolute return objective.

Another important difference from other diversifying assets is the liquidity our investors have, a factor which markedly reduces their risk. We offer investors' liquidity and their investment is not fully locked up in some illiquid investment for the next 5-10 years!

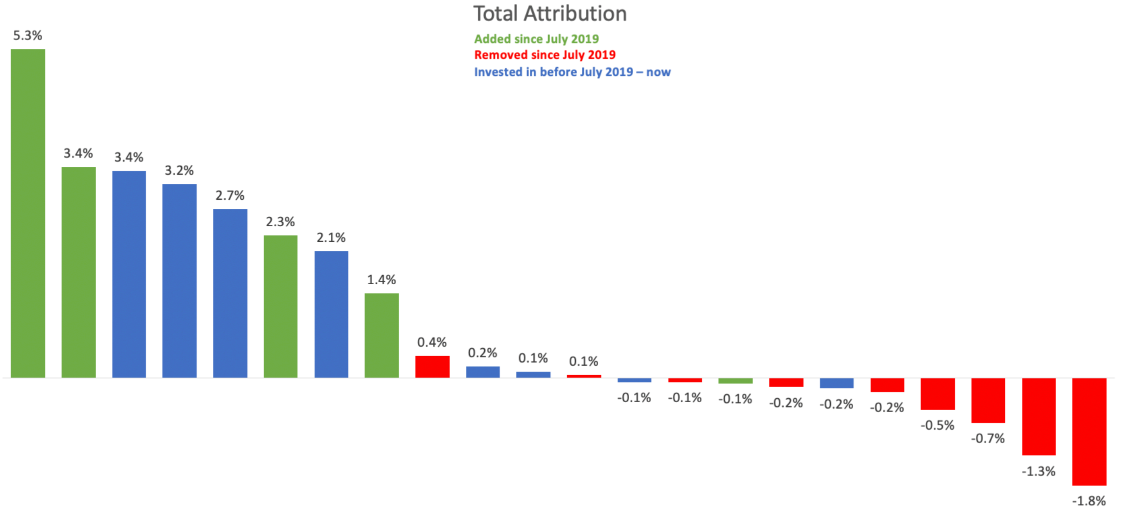
If you don't like what you see and experience over time with us, you can actually redeem. We don't expect many investors will need to avail themselves of that once they experience the results and the smoother journey with us, but it is a great benefit to know they have that option and also enables us to be flexible and active with our underlying allocations in a rapidly changing world.

Given our genuine diversification and large number of underlying funds and strategies, LAIF can be used to manage a large portion of one's portfolio. This includes managing one's entire liquid alternatives portfolio for financial planners and small institutions who have experienced the difficulty of doing this well themselves.

We believe we are ideally suited to retirees, pre-retirees and all conservative investors, as well as those looking for higher returning alternatives to cash and bonds. It is concerning to see investors chasing returns by buying more and more equities because cash no longer offers a reasonable return, forgetting about the risks they are taking from doing so. We offer a very valuable alternative to taking this large risk of being overexposed to equities and markets.

Performance Attribution

Below we can see the attribution of our results over the last 15 months by underlying manager contribution to our overall return. While we don't disclose specific names, you can see that our results have not been driven by a single 'lucky bet', but that we have made numerous beneficial investments since we joined, and no bad ones.



Source: Mainstream Fund Services

This partly reflects our selection and investments in better than average fund managers. But it is important to understand an additional, crucial important driver of these results.

Much of our favourable manager contribution to returns actually highlights the benefit of superior **asset allocation** or knowing when to be in a particular asset class and manager and when not to be – and how much exposure to have.

This is something we believe most investors aren't knowledgeable about and hence can't do well. It is the 'art and science' of portfolio management. In other words, you have to know when it is safer to invest in a specific asset class and when to get out; we offer our investors that benefit on a constant basis. To achieve what we have, one has to understand both the manager and the market environment, not just the manager in isolation.

Equally, and just as importantly, we have intensely risk managed our portfolio, removing underperforming managers and strategies quickly before they have had any chance to disappoint us further. You can hence see that no underlying strategy has lost us more than a modest amount (2% of the portfolio). When the facts change and we change our minds, we don't hope - we act.

We have many replacement managers and strategies we can use if necessary and are regularly reviewing, so there is no need to put up with mediocrity or substantive concerns of any kind.

The combination of this portfolio management and asset allocation, if working ideally, creates a relatively smooth, upwardly biased return stream.

As we have demonstrated in this quarterly update, we are working hard to provide a truly unique and beneficial investment for our clients, and are succeeding in our mission.

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.

Thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

The Lucerne Alternative Investments Fund

July 2020

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