Lucerne Alternative Investments Fund

QUARTERLY REPORT | DECEMBER 2021

Lucerne
Alternative
Investments
Fund

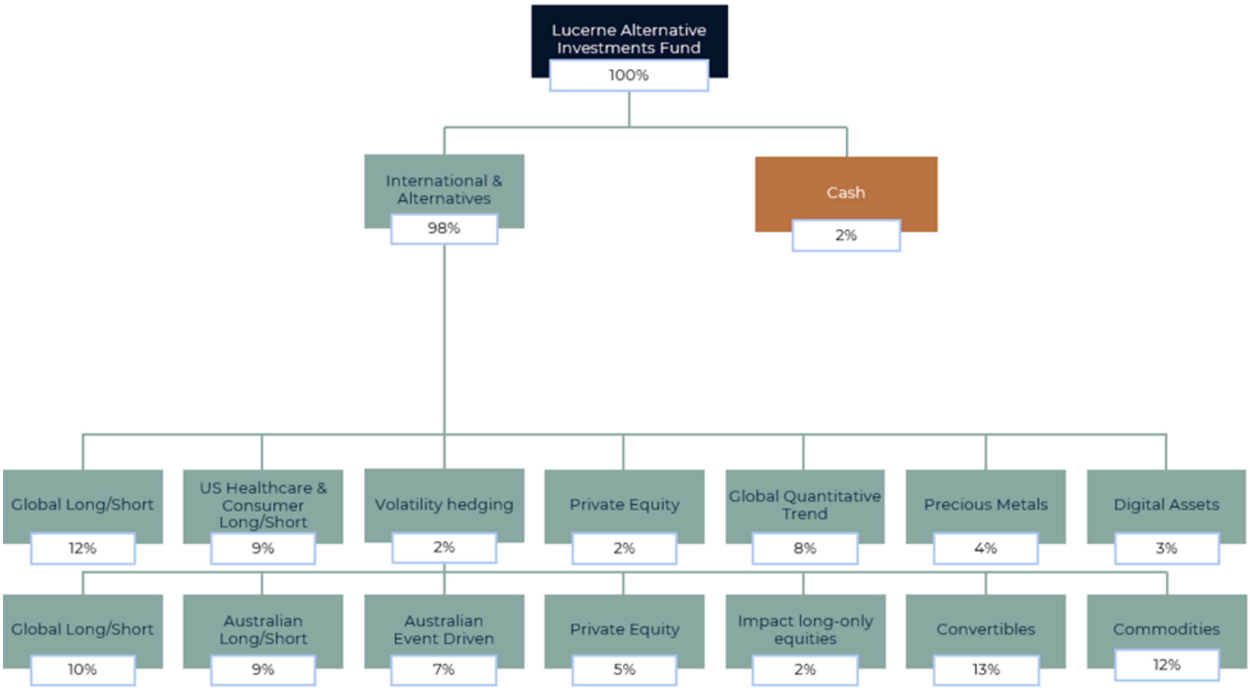
Lucerne Alternative Investments Fund December 2021 Quarterly Report

The Lucerne Alternative Investments Fund (LAIF) enjoyed another strong quarterly result posting its seventh consecutive positive quarter. While the December NAV has not been finalised, our estimate of 0.5% for the month would bring the December 2021 quarter performance to positive 4.1%.

As quoted in our September Fact Sheet "The Fed aimed to remove the punchbowl just before the party starts. Now the party's gotten great and the Fed's not removing the punchbowl until they've seen conclusive evidence that everyone's going to get plastered." – Larry Summers, Former United States Secretary of the Treasury, October 2021.

Safe to say, based on the recent meeting of the Fed, they have now seen this conclusive evidence and actions will be taken over the course of 2022 to remove the punchbowl.

While we cannot predict what markets will do the Investment Committee has ensured that the current investments reflect a well diversified portfolio of strategies that are not reliant on "Goldilocks" like market environments. Correlation has again continued to decrease over the quarter strengthening our alternative investment approach and ensuring the portfolio will perform independent of markets. The key to this is to capture as much upside as we can while limiting exposure to wild market swings and volatility.



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

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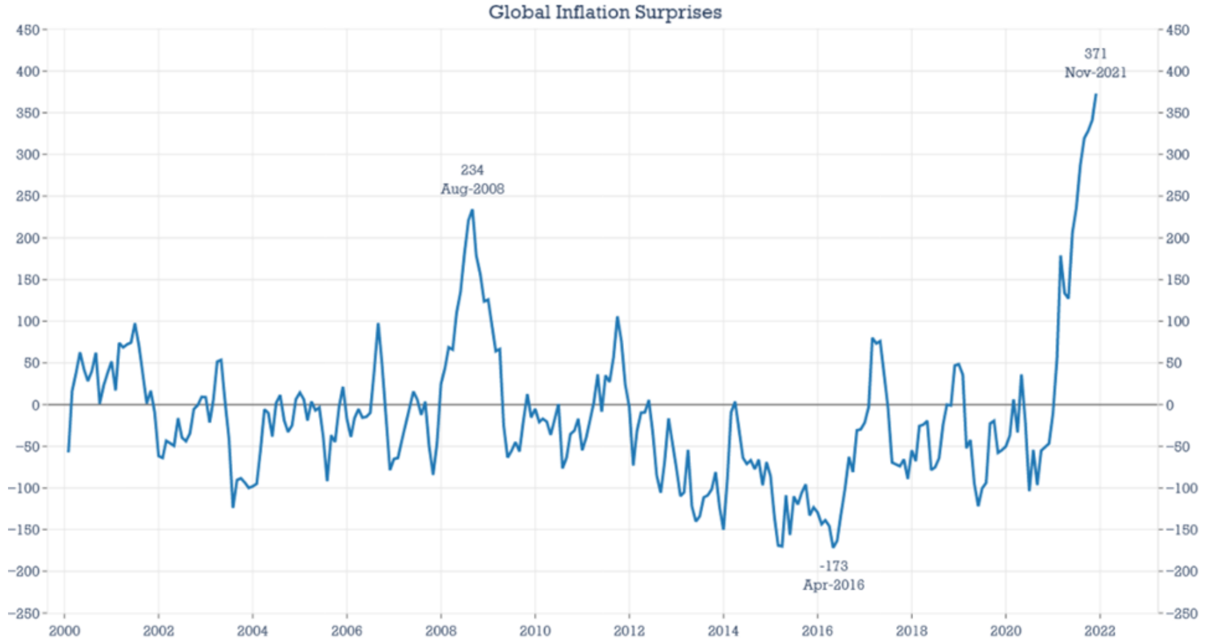
Inflation – here to stay!

One of the most spoken about topics in financial markets in calendar year 2021 was the argument of inflation and whether it is transitory or structural. The Investment Committee (IC) is of the view that inflation will increase and is here to stay. The level and persistency of inflation globally surprised most people. Refer below for the tally of inflation surprises (actual inflation relative to consensus forecasts) for a group of developed countries.



Sum of the Citigroup Inflation Surprise Indexes for the U.S., Euro Area, Japan, U.K., Canada, Australia, and New Zealand. Data: Citigroup, Bloomberg

With sustained and growing inflation comes the discussion of central banks and whether they will increase interest rates. The US Federal Reserve (the Fed) has previously tried to seek a way to ensure the market is not surprised when the rates do increase. One rules based guideline that the Fed has loosely followed in the past has been the Taylor Rule, which recommends that the Federal Reserve should raise rates when inflation is high or when employment exceeds full employment levels.

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All estimates assume a 1% real rate. NAIRU's are an average of Bloomberg and OECD estimates, except U.S. which uses 4%. Calculations based on Bloomberg collected forecasts.

As shown above the Taylor rule suggests that across the board central banks should be increasing rates at the moment. Particularly in the US where the suggested inflation range is between 7%-10%. This indicates more than anything that the Federal Reserve and other central banks have let the party continue for too long.

At the most recent Fed meeting officials stated that due to a strengthening US economy and higher inflation it could lead to earlier and faster interest rate increases than previously expected. The Federal Reserve also announced they will wind down the bond buying program at a faster pace than first outlined in the November meeting. This will now end bond purchases by March this year. As a result of Quantitative Tightening and increased interest rates we expect 2022 to be volatile. As stated in the prior quarterly LAIF initiated its first position in a Volatility Exchange Traded Note (ETN) which is designed to track and provide exposure to the VIX index. This provides a hedge against the volatility in returns during a market correction.

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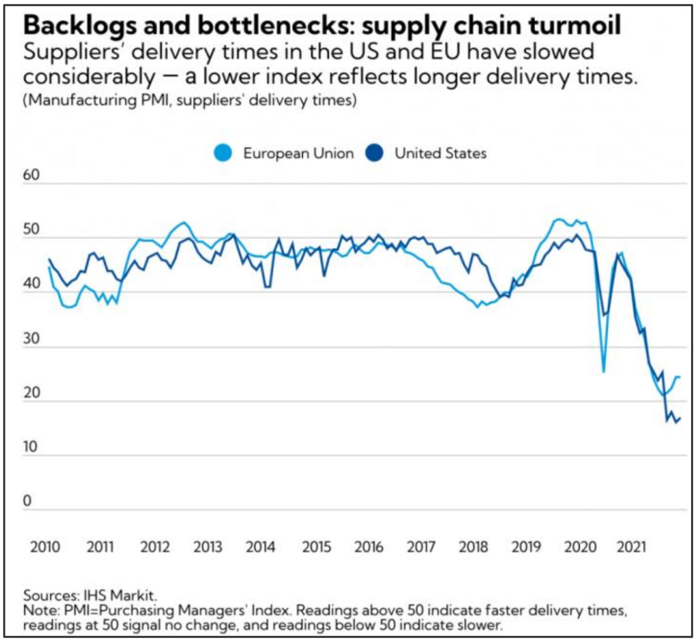
Supply chain disruption to continue

A key contributor to the sustained and increasing levels of inflation has been the supply chain bottlenecks as result of everchanging variants of the COVID-19 Virus. The rapid spread of the virus in 2020 prompted shutdowns of industries around the world and we saw consumer demand and industrial activity plummet. As lockdowns lifted demand rocketed, and supply chains struggled to bounce back. In the September 2021 quarter it looked as though supply chains were recovering but the emergence of the Omicron variant has caused many plans and forecasts to change. Due to its high rate of transmission, it has provided the catalyst for ongoing supply chain and labor issues. Recently in the AFR Arthur Tzaneros, CEO of Australian Container Freight Services (ACFS), one of the largest trucking companies for the country's major ports and whose clients include Coles, Aldi, Kmart and Bunnings, said there had been a 25-50 per cent shortage of drivers across the east coast during the past two weeks.

The below chart represents bottlenecks in the European Union and US where delivery times have slowed considerably. The lower the index the longer the deliver times.



Many industry experts have warned that the supply chain crisis could last many more months or even up to two more years.

If COVID-19 continues to wreak havoc across supply chains we would expect sustained higher levels of inflation. This may possibly cause central banks globally to rethink the pace of their monetary policies.

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Chinese Property Debt Bubble - Update

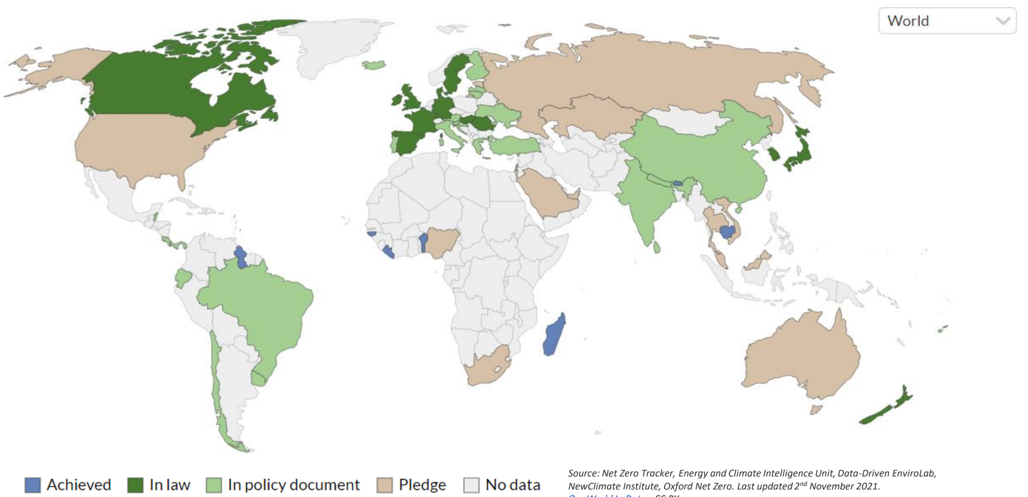
It would be remiss of us to not quickly touch on the continued drama out of China, particularly Evergrande. The troubled Chinese property giant's shares were suspended from trading on the Hong Kong stock exchange. It was later reported that Evergrande had been ordered to demolish 39 luxury apartment buildings for which the planning permit was obtained illegally and had been revoked. Evergrande will face more deadlines in January for both overseas and domestic coupon payments. The next coupon due date is January 27 for a sum of $352 million. Global markets are still unsure as to what action the Chinese government will take on this indebted sector. What impact this will have on China and global markets will most likely play out over 2022.

Decarbonisation and the focus on emissions reduction

During the quarter global leaders gathered together in Glasgow for the UN Climate Conference (COP26) to set the global agenda on climate change for the next decade. The aim is to cut emissions of carbon dioxide to keep temperature rises within 1.5C which scientists say is required to prevent a climate catastrophe.

The private sector is leading the change by creating the International Sustainability Standards Board (or ISSB). The purpose of the ISSB is to provide a consistent global standard for Environmental, Social, and Governance (ESG) reporting that will allow companies to report on relevant ESG factors. Businesses and individuals are making a concerted effort to curb their emissions footprint and shareholders have been voting against companies boards because of their engagement with fossil fuel industries. For example, HSBC had to issue an explicit policy on thermal coal after an influential group of shareholders filed a vote urging the bank to ramp up its climate commitments. The Investment Committee believes that the theme of decarbonisation will continue to grow as the world moves towards the goal of net zero.

Status of net-zero carbon emissions targets



Source: Net Zero Tracker, Energy and Climate Intelligence Unit, Data-Driven EnviroLab, NewClimate Institute, Oxford Net Zero. Last updated 2nd November 2021.
Our World In Data - CC BY

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Portfolio Changes

As part of our increased awareness to the decarbonisation theme, LAIF initiated its first position in a long only impact equities fund. The strategy aims to have more than 80% of capital invested in companies where environmental solutions (green transition or ecosystem protection) account for at least 50% of revenues or profits. One third of the fund's management fees are donated to environmental strategies.

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. Alternatively, you can 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
Investment Committee
January 2021

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