Lucerne Alternative Investments Fund

QUARTERLY REPORT | SEPTEMBER 2021

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Fund

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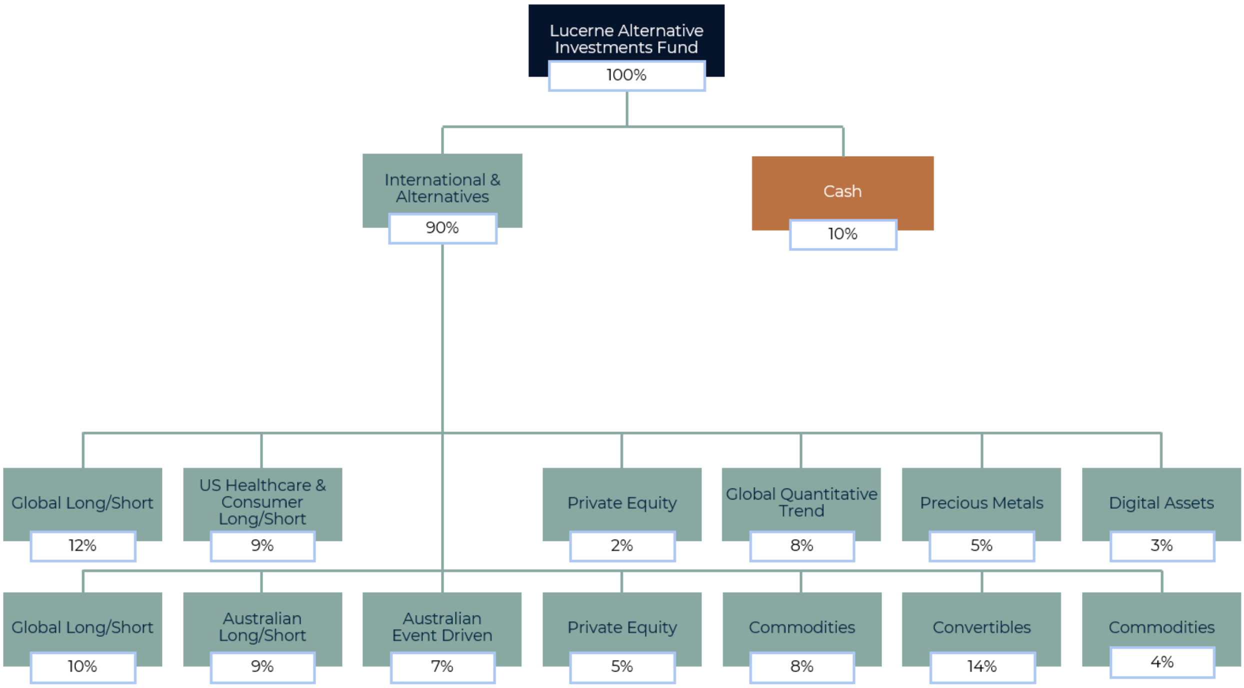
"The Fed aimed to remove the punchbowl just before the party starts. Now the party's gotten great and the Fed's not removing the punchbowl until they've seen … conclusive evidence that everyone's going to get plastered." – Larry Summers, Former United States Secretary of the Treasury, October 2021

The Lucerne Alternative Investments Fund (LAIF) enjoyed another strong quarter and its sixth consecutive positive one. While the September NAV has not been finalised, our estimate of -0.95% for the month would bring the September quarter performance to positive 5.09%.

As discussed in our August Fact Sheet the LAIF Investment Committee believes we are entering a period of increased volatility. We see recent events such as the Chinese property debt bubble, energy crisis in Europe and Asia, the Covid-19 Delta strain and Inflation as catalysts for this uncertainty in investment markets.

Our current investments continue to reflect a well diversified portfolio of strategies that aim to generate return streams that are less dependent on broader market conditions and have reduced correlation to equity markets.



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

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Chinese Debt Bubble?

Many economists have highlighted the relationship between credit and speculation as an essential part of booms and crises. Some notable examples have been the Great Depression, the Asian Debt Crisis and the Global Financial Crisis. Could the debt laden property development industry in China be the next debt fueled left field event that ripples through global economies? Certainly, the market felt nervous about this in late September causing equity markets to record their first negative month in 12 months.

Since our last quarterly Evergrande by far the largest property development company in China has indicated that they are negotiating their interest obligations, causing speculation they could potentially default on their estimated $300bn in liabilities. Evergrande is currently the most indebted property company in the world. To make matters worse, Fantasia another property developer in China recently missed a $206 million repayment deadline. China has thus far taken a hard stance on the property sector trying to take control in an environment of rapidly increasing property prices. Both Evergrande and Fantasia shares have been suspended pending updates.

Evergrande Proper...	$5.12	-$3.66	↓41.69%
Fantasia Holdings ...	$0.56	-$1.01	↓64.33%
Country Garden H...	$7.61	-$2.43	↓24.20%

Source: Google Finance

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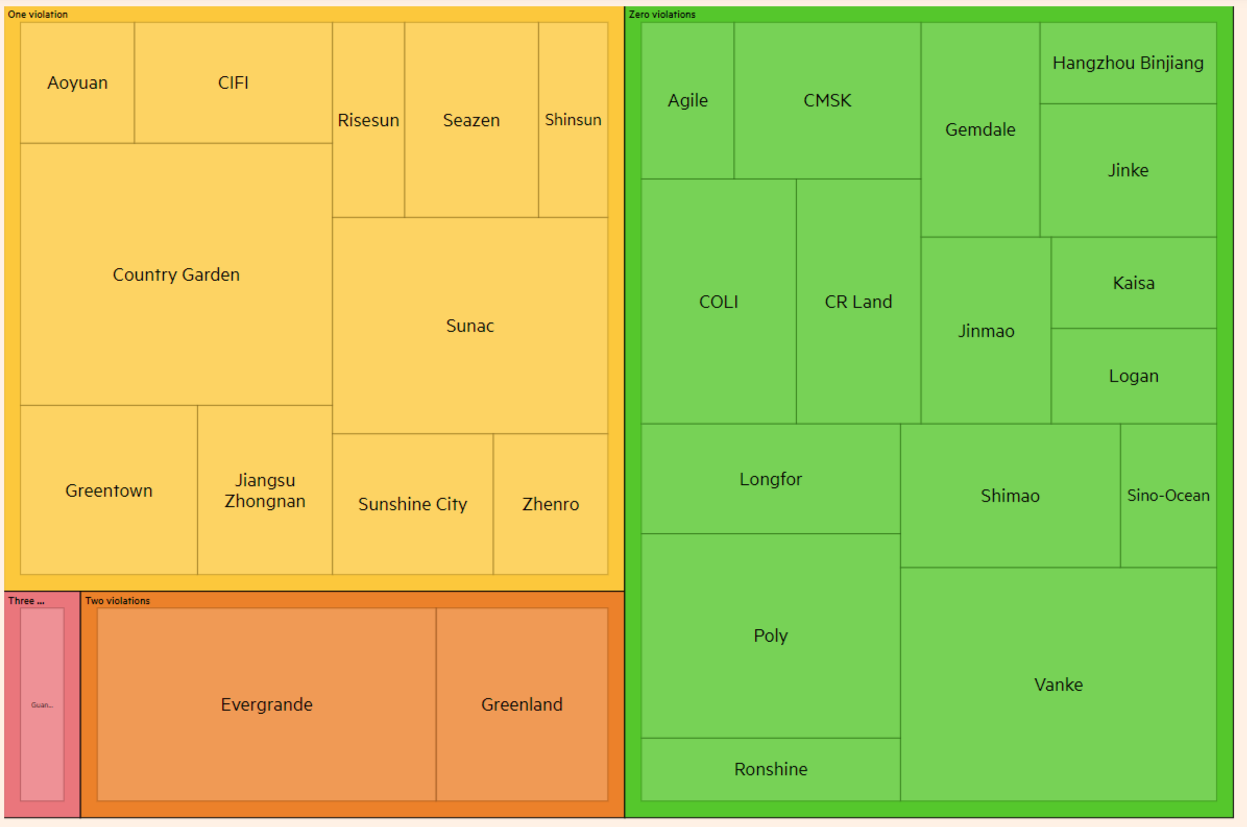
Along with Evergrande and Fantasia almost half of Chinas 30 biggest developers were in breach of at least one of Beijing's recently introduced rules on property sector leverage:

1. Liability-to-asset ratio (excluding advance receipts) of less than 70%
2. Net gearing ratio of less than 100%
3. Cash-to-short-term debt ratio of more than 1x

The below heat map represents the 30 largest property developers in China and how many violations they have committed. The companies in green have zero violations, companies in yellow have one violation, companies in orange represent two violations and companies in red represent three violations. Even though Evergrande is under the microscope the below heat map shows that there could be many more developers following suit and negotiating their interest obligations.



Source: Financial times, Beike Research Institute, China Index Academy.

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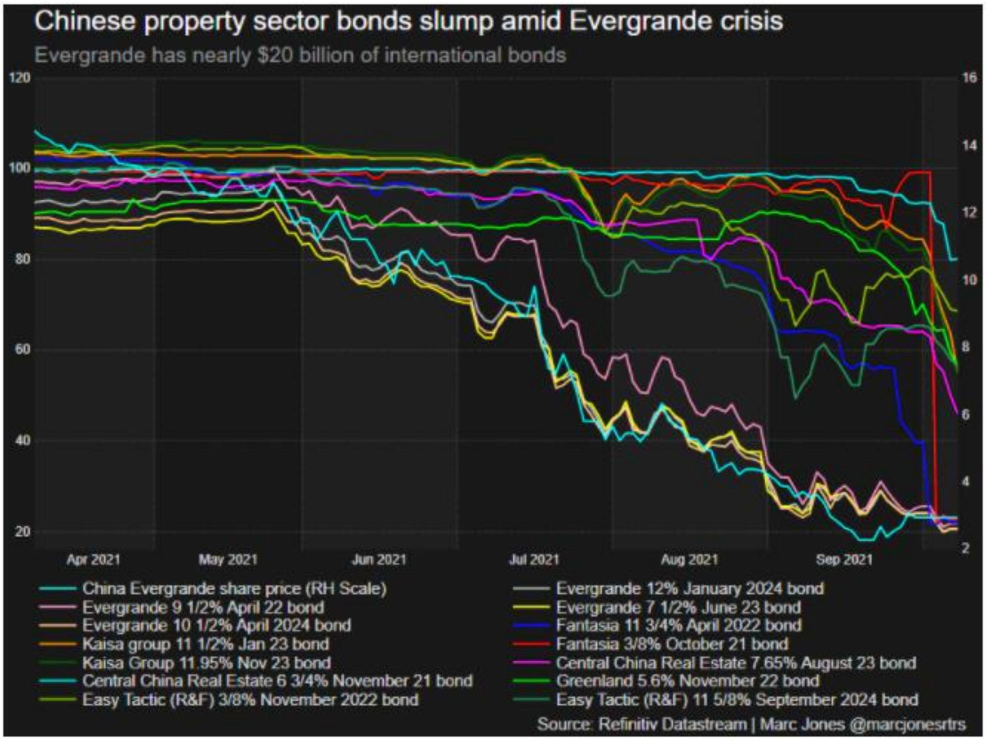
The world will be watching how Chinese regulatory bodies handle the situation. Either they launch a restructuring of the China Evergrande Group, or alternatively, allow the company to fail which most likely will cause a contagion event across the Chinese property sector. This is already being reflected in the below Chinese property sector bond market chart.



Source: Refinitiv.

This outcome would likely cause a wobble in developed economies as there is a lot of cheap money fueling price growth and debt is supporting some of these fully priced markets. Such behavior can be likened to what caused the Global Financial Crisis.

Pleasingly, LAIF's underlying investment managers have successfully navigated this period as they have minimal, if any, exposure to Chinese equities and bonds.

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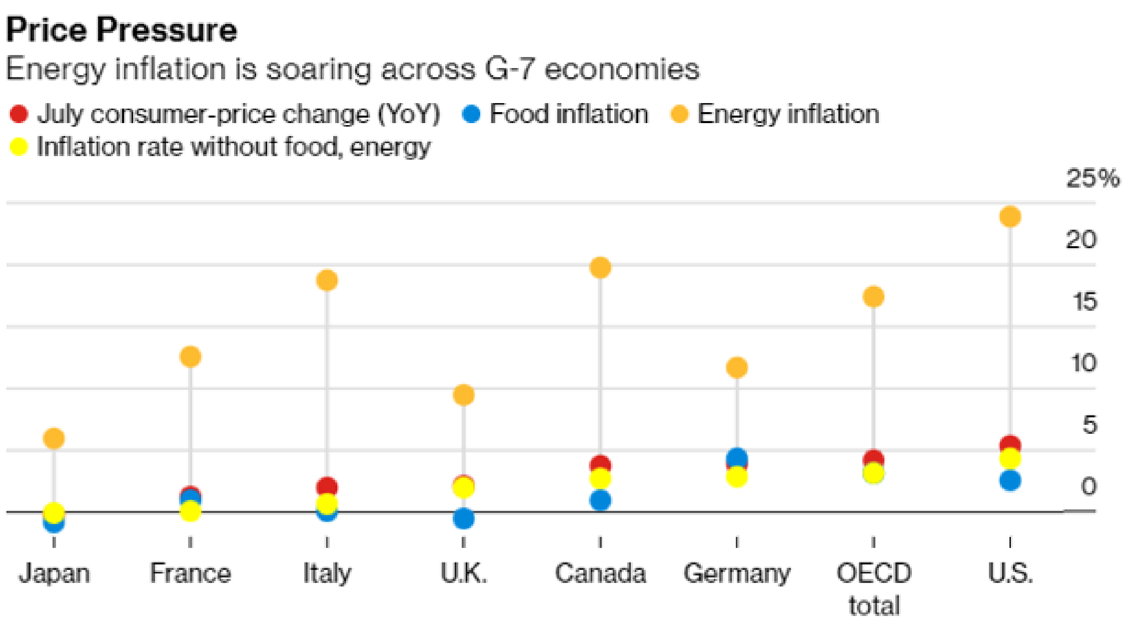
Inflation, Stagflation and the Energy Crisis

The LAIF Investment Committee has focused on the debate of whether inflation is transitory or structural for the past quarter. As inflation pressures continue to rise commentators are predicting that we may move into a stagflation (high rates of inflation, increased unemployment, with low levels of economic growth) environment. Recent data shows the smallest hiring of Americans in seven months, deterioration in Germany's IFO Index, crumbling of China's services sector and a weakening of global manufacturing. On the supply side the Delta Variant is hurting supply chains, limiting worldwide provisions of key products.

To add fuel to the inflation fire, global markets are in the grips of an energy crisis that could derail the economic recovery. Oil and natural gas prices are their highest since 2014 and energy coal prices are at record levels as the UK, Europe and China experience energy shortages and attempt to secure supplies of gas and coal as these countries move into the winter months.



Source: Organization for Economic Cooperation and Development

Inflation is climbing to levels not seen in a long time across major economies, consumer prices in Germany rose 4.1% in September from a year earlier, while US inflation is running at 5.3%, close to the 2008 highs. All the while, the International Monetary Fund is also expected to cut its global growth forecast for 2021. This leads many to believe that inflation is no longer transitory and central banks can no longer continue with inflation complacency and need to reconsider how best to manage inflation without further slowing economic growth – a very difficult mandate.

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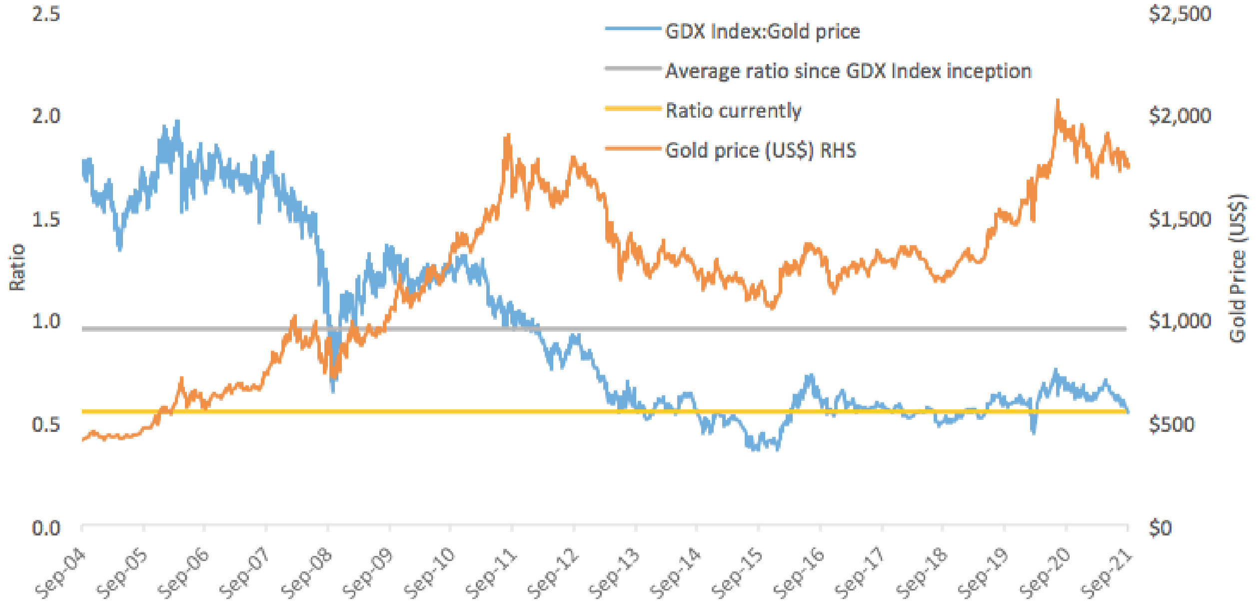
What's Next?

The LAIF Investment Committee does not know what the next destabilising event will be or how it will unfold. History tells us such events will inevitably occur and when they do, the price of most assets will correlate to 1 as markets and their participants react to uncertainty with fear and caution. We are constantly reviewing the portfolio to reduce correlation, not only to major markets but also between investments within the portfolio. Therefore, aiming to continue to provide consistent risk-adjusted returns in all markets.

Portfolio Changes

As part of our caution, 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 is a way of providing the Fund with an alternative hedge that is cost effective, liquid, does not require collateral or subject to margin calls, and should provide positive returns during a market correction.

Further, the Investment Committee has been consistent in its view that gold play's an important role in uncertain times. As an investment, gold has underperformed other assets classes thus far in 2021, weighed down by elevated US Treasury yields, and a strong US Dollar and an ongoing complacency about inflation and its potential impact. The rollout of coronavirus vaccines has provided the impetus to the global economic rebound which has also dampened gold's momentum. There are several catalysts that could help the recovery in the yellow metal's price in 2022 and one of these is inflation. Gold mining stocks are also trading well below historical averages.



Source: Bloomberg, as of 1 October 2021. All figures in US dollars

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LAIF also increased its investment in the Funds trend following strategy over the quarter. This strategy will seek to capture profits from market divergence. This particular fund has a correlation to equities of -0.10 and has produced large periods of Alpha when markets trend in one direction either upward or downward.

LAIF has further reduced correlation by allocating to Long/Short strategies with a short bias, which typically outperform equity markets in downturns.

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
October 2021

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