RWC Diversified Return

May 2021

Q1 2021 Review and Outlook

> Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man. ”
>
> RONALD REAGAN

“The Gipper’s” colourful depiction of inflation paints a picture of its larcenous characteristics; not surprising given Reagan’s presidency followed the inflation plagued 1970s. Then Fed chair, Paul Volker, is widely credited for breaking inflation’s back in the early 1980s, even if the punishingly high interest rates his Fed set led to a recession. It turns out The Gipper disliked recessions too, especially in election years. According to Paul Volker’s memoir, he was summoned to a meeting with President Reagan and his chief of staff, James Baker, in 1984. While the president was silent, Mr. Baker said, “The president is ordering you not to raise interest rates before the election.”

Fast forward to 2021, President Biden recently said he has not spoken to current Federal Reserve Chair Jerome Powell since taking office. This seemingly quiet respect for central bank independence contrasts with the Twitter barrages to which Biden’s predecessor subjected Chair Powell—no tell-all book is required to reveal any executive overreach by number 45. However, President Biden has one ace up his sleeve in the form of former Fed chair and current secretary of the Treasury, Janet Yellen, who undoubtedly knows the characters and inner workings of the institution better than anyone. And, at least for now, the objectives of the Fed and Treasury appear totally aligned, counteracting Covid-19’s economic effects, inequality, and climate change. Effectively, these priorities translate into loose monetary policy and muscular fiscal policy. Such policies, when undertaken aggressively and concurrently, have historically led to inflation.

If inflation does manifest itself, an outcome for which we suspect few are prepared, then the impact on investors’ portfolios will be profound. Our goal is to generate real returns through cycles, protecting capital, and diversifying portfolios, and there is no exception for inflationary chapters. The RWC Diversified Return Fund consists of investment themes that not only stand on their own in terms of return expectations but also coalesce as a portfolio which we believe will thrive in an inflationary environment while still protecting against deflationary tail risk.

Portfolio Review

Q1 21 saw vicious rotations in the equity market, intense speculation by retail investors, and a sharp rise in interest rates. Against this backdrop of choppy markets, the fund was essentially flat over the first three months of the year. We used volatility to take profits in winners and to add to underperformers, but the fundamental structure of the portfolio remains similar to year-end: long commodity themes, moderate long equity exposure, short interest rates, and short credit risk.

Currency Debasement

The Currency Debasement theme was the primary detractor over the quarter. After rallying the first few days of the year, gold plummeted some 14% from its 2021 high by the end of March. Rising real interest-rates, ETF outflows, competition from crypto currencies, and a prevailing reflation rather than inflation narrative are popular explanations for its decline. We reduced our exposure somewhat to the theme as it was contributing excessively to the portfolio’s volatility, but we retain a meaningful exposure and high conviction over the long term.

Why? Looking through the short-term noise, the investment case for gold as a means to profit from currency debasement remains strong.

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.

- **Deficit Financing**

Governments are running massive deficits facilitated by their central banks' QE programmes. While economic growth may alleviate the deficits somewhat, the current political climate appears primed for more fiscal profligacy. Large deficits and loose monetary policy generally lead to rising monetary aggregates and higher monetary velocity, both of which can result in currency debasement and inflation.

- **Real Rates of Interest**

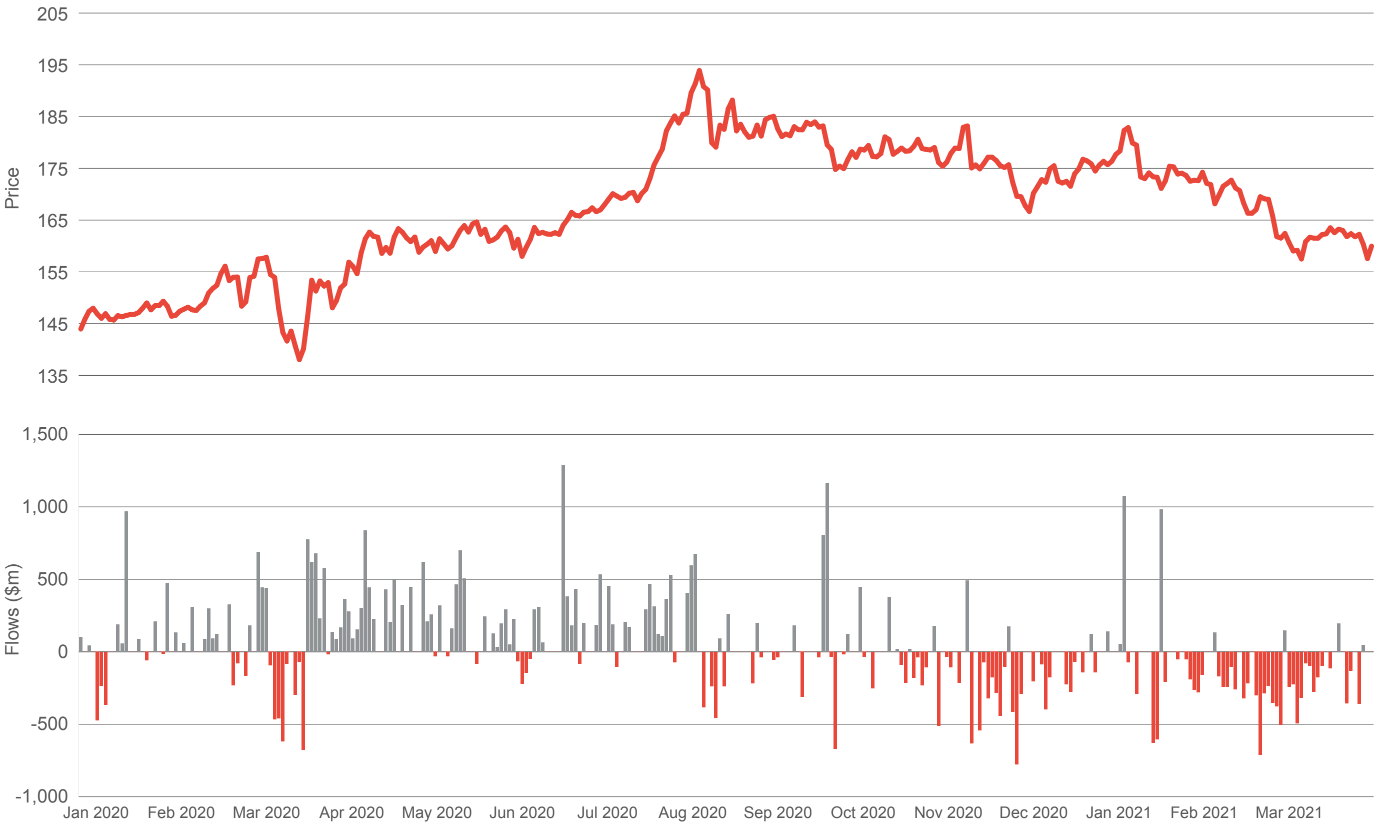
While real interest rates have risen, they remain deeply negative for much of the world. Furthermore, given the aforementioned deficits, governments simply cannot afford for real rates to rise significantly.

- **China**

The People's Bank of China (PBOC) is reducing its holdings of US dollars and treasuries, while adding to gold. This likely ties with China's desire to distance itself from the dollar-dominated international trading system, with the Yuan playing a more prominent global role, perhaps facilitated by its digital currency ambitions. After somewhat of a hiatus from the gold market in 2020, China has increased its imports substantially, expected to import some 8.5m tonnes in April-May. The government also increased the quota for banks to import more gold into the country.

Gold ETF flows have been negative most of the year, tracking negative sentiment. Other than during the deleveraging of March 2020, gold saw strong flows by financial buyers, as seen in the following graph. Since peaking last August, the flows have turned negative. However, other central banks have been buying and the jewellery market is coming back to life, providing more fundamental support. Gold demand in the key Indian market has returned in 2021. For the reasons laid out above, we suspect it is just a matter of time before the financial flows return too.

CHART 1: Price and flows of Gold ETF (GLD US)



Source: Bloomberg

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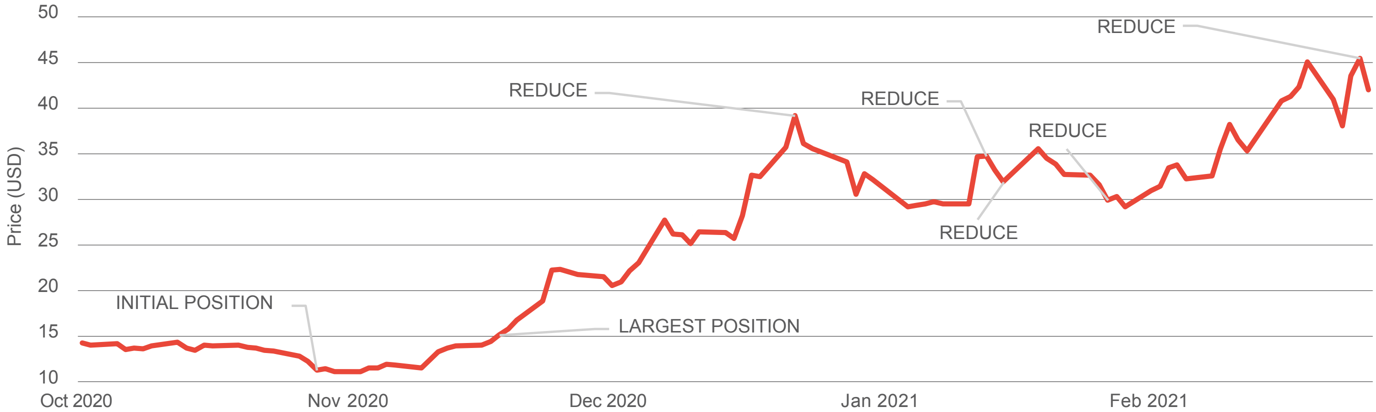
No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. The information shown above are for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

Energy Transition

The fund's largest theme contributed most to the quarter's performance, with copper and the rare-earth miners leading the way. We retain conviction in both investments, but as they swirled high upon winds of speculative excess, we took profits in both. In the case of copper we trimmed to a still-meaningful holding, but in the case of rare-earths producer MP Materials, it is now 1/10th of its maximum size to an exposure level which is 'option-like', suiting the risk-to-reward. As discussed in our recent note on rare earths, there is a compelling long-term growth story for companies in this space, with scarcity not only in the materials themselves but also in publicly traded companies outside of China. However, the excitement extended to retail message boards, and hype overtook reality. Additionally, sell-side analysts' valuation methodology appeared breathlessly optimistic to us. Meanwhile, we maintained our significant holding size in Lynas Rare Earths.

CHART 2: DRF's holdings in MP Materials



Source: Bloomberg, 26 Feb 2021

The fund invested in two new energy-transition ideas in Q1; both have already contributed positively to performance.

The first was a basket of four natural-gas-pipeline companies. Like most companies in the broad energy sector, they sold off precipitously in 2020. Unlike others, however, the midstream companies we selected were able to maintain comparable cash flows to the previous year, as their business models are geared more to the volume of transported gas and oil rather than to their prices. Impressively, they managed to pay down debt while maintaining their generous dividend pay-out levels, with current annual yields of 6-7%. While these are not 'growth' stories, they represent good rate-of-return investments based on a re-rating to historic multiples, high dividend yields, and stability of cash flows.

We deliberated carefully before investing in the energy sector given how we think about ESG and apply it to the investment process. A brief recap of how we integrate ESG into our decision-making:

1. We actively seek out investment themes where sustainability is essential to the thesis. The energy-transition theme is a clear example.
2. When selecting the component securities of a theme, we apply another layer of ESG scrutiny to the individual companies. We employ third-party ratings to get an outside expert view, but we also strongly believe that we must bring our own thought, judgement, and values to bear.

Back to the theme itself, we believe that natural gas plays a role in the energy *transition*. To be clear, natural gas is not the final destination, unlike renewable fuels or green hydrogen. However, the switch from coal and other dirtier fossil fuels to natural gas can achieve meaningful reduction in emissions as has been seen in the US. Furthermore, natural gas is a relatively clean fuel to substitute for renewables when the sun is not shining or wind not blowing.

The midstream companies' infrastructure is largely complete, with underground pipelines already in place. The companies have made environmental improvements to operations such as diminishing methane leakage. Looking forward, the companies are pursuing opportunities in carbon capture solutions and certifying the natural gas they transport is derived from sustainable producers. For these reasons, it is unsurprising that the companies screened well against energy-sector peers for ESG ratings.

The second new investment is in the EU Emissions Trading Scheme (ETS) and is an exciting one on multiple fronts. Not only does the investment carry high return expectations but it also integrates well with our ESG criteria. We will detail our rationale in a separate note.

Food Inflation

Food prices continue to accelerate. During the quarter we took profits in the theme in the anticipation of a supply response to rising prices, but weather and robust demand – especially from China—have been powerful tailwinds. We will look for a pullback to rebuild exposure to the theme.

The ongoing price rises of foodstuffs suggests the most difficult form of inflation—the sort which central banks can only ignore for so long—so we are paying close attention, as food inflation has broader investment implications.

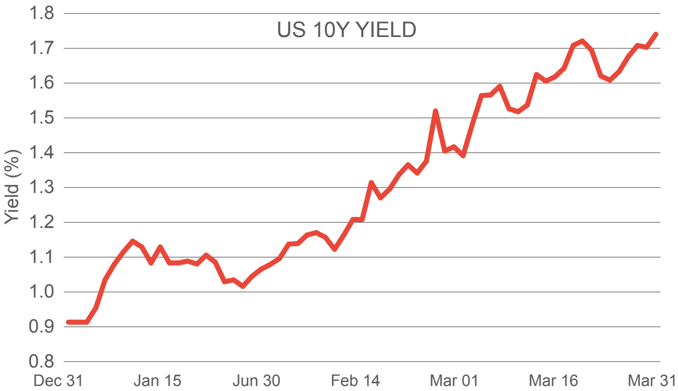
Private to Public Risk Transfer

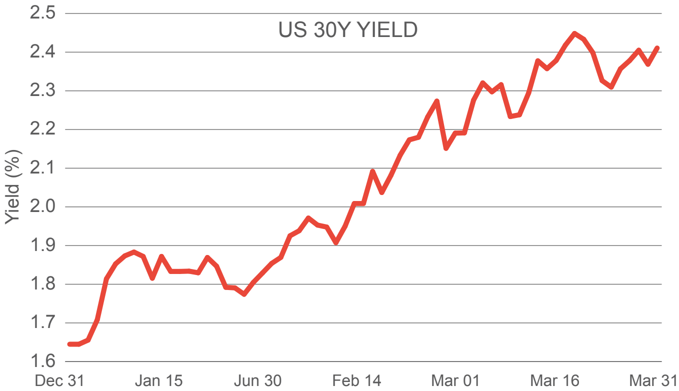
At the risk of repetition, we believe it is critical to understand debt dynamics to guide investment decisions. Furthermore, debt sustainability will be a theme for the fund until there is some clear out of the huge stock of borrowing. Presently, our investments are concentrated on shorting European sovereign debt, first Italian BTPS and, more recently, French OATS. As we discussed in the Q4 2020 letter, the investment has multiple ways to win. Anywhere on the spectrum between reflation and inflation, upward pressure on interest rates is likely; meanwhile, solvency worries precipitated by deflationary shock or political discord amongst EU states would also push rates up. We recently wrote about the topic of EU politics, the ECB, and the implications for European bond markets: **Europe – things may be changing, but not in the way you might suspect**.

Reflation

The reflation theme was the second-most profitable investment over the quarter, with the fund's short position in 10 and 30-year US treasuries leading the way.

CHART 3: Yield spikes in 10 and 30-year US treasuries





Source: Bloomberg, 31 March 2021

The bond shorts again show the fund's ability to make money in a differentiated manner. Indeed, we have constructed the portfolio to perform well in a large bond sell-off. We continue to believe that global debt in its overextended state represents the single greatest threat to asset markets. Said another way, it is the epicentre of the 'everything bubble'.

The move in treasuries caught investors off guard and reverberated through other asset markets, especially those which benefit from low discount rates, for example, growth equities. We took profits in a portion of the position, recognising that the global thirst for yield goes unquenched, so higher yielding treasuries will prove irresistible for many buyers. However, after a period of consolidation, we expect the bond markets will get tested again, with continued inflationary pressure building and eyes on the Fed for any hint of tapering its QE programme.

Unsustainable Corporate Leverage

With credit spreads near their pre-pandemic lows, the price credit protection is cheap. We calibrate the amount of protection to own based on cost and scenario analysis. Given ongoing fiscal and monetary stimuli, a deflationary shock is not our base case for the near term. Nevertheless, the time for hedges against less-likely scenarios is when the price for insurance is right and the payoff is highly asymmetric.

Outlook

Transitory. This word encapsulates the key debate for investors and policy makers. Will inflation rise then fade as predicted by central banks and the investing consensus, or will it take hold as reckoned by a group of fewer but louder market participants? The outcome is critical for investors, and those lacking a portfolio built to handle inflation if it does grip the economy like a "violent mugger" will likely suffer. The price spikes of commodities, houses, cars, the growing tightness in labour markets, not measured by unemployment but job openings and surveys showing difficulty filling jobs, and the litany of companies citing pricing pressure in their earnings reports all suggest the lagging and hedonically photoshopped Consumer Price Index (CPI) will finally start to spring to life. Here are some more thoughts on inflation:

A user's guide for distinguishing between reflation and inflation

Inflation – the first stage of grief is denial

Essentially, our outlook remains similar to the start of the year. Excessive debt levels undermine the long-term stability of financial markets. In the near term, however, we are more sanguine because of the aforementioned stimulus. We see bigger risk in the stimulus resulting in more inflation than economies can handle. Central banks and treasury departments are effectively handing the "inflation hit man" a weapon and inviting him in through the front door. We continue to pose the question: can central banks afford to raise rates meaningfully to counteract price rises? Sky-high debt and asset levels, i.e. financialisation of economies, suggest this will be very tricky.

The RWC Diversified Return Fund's investment themes such as energy transition, currency debasement, reflation, private to public risk transfer, and food inflation should thrive if reflation slides into inflation. The coming quarters should raise the stakes of the "transitory" debate as the worst effects of the pandemic fade and economic data takes on more meaning. Meanwhile, and helpfully, the cost of insuring against a surprise in the other direction has become cheap once again. It is an exciting time to be running our strategy and providing genuine diversification from the "60/40".

Thank you for your support,
The Diversified Return Team

CONTACT US

Please contact us if you have any questions or would like to discuss any of our strategies.

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