MEMO FROM:

John Morgan

DATE: 6 May 2020

SUBJECT: "What just happened?" and "Where to from here?"

I trust that this memo finds you and your family well and managing with the lockdowns.

It has been some time since my last memo. However, given recent events, I felt it important to provide you with some thoughts around the portfolios, our performance and our views on the short and the long term.

First, a quick update on our Funds' performance for the March quarter:

Credit Opportunities Trust (COT)

This is the old High Yield Trust. We changed the name to reflect the strategy of the Fund more accurately, being to find asymmetric risk/ return opportunities in the credit space not simply invest in high yielding credit. While final returns for COT have not been concluded, the March quarter return will be in the order of -0.75%.

COT portfolio includes listed liquid debt. We hold these assets for the joint purpose of achieving diversification and creating liquidity for our investors. The desperate search for cash at any price during March meant that all asset prices including liquid debt were decimated. We are aware of listed debt funds that fell almost 50% in a combined value and liquidity squeeze. Even listed debt assets that have maintained their underlying asset value have in some instances traded as low as 65% of Net Asset Value (NAV). Our view is that this is attributable to liquidity pressures, not the underlying values of the assets as expressed by their NAV. The return of liquidity to the debt markets as fear subsides and the impact of global central bank assistance takes effect will see these discounts to NAV diminish and a return to asset price normality.

It is important to stress that all our debt investments have a buffer, both in terms of our conservative Loan-to-Value ratios and where we are positioned in the capital stack. As a result, we are not aware that any of our debt investments are subject to any principal risk and while discussions have been held with respect to the deferment of a small portion of interest payments, these sums are expected to be collected in full.

Growth Trust #1 (G1)

Those of you who have followed us for a while will be aware that we have had an underweight allocation to equities for some time. While I would love to claim that this is because we saw this crisis coming, nothing could be further from the truth. Yet, it is this underweight position, our allocation to a number of long-term illiquid investments and our use of foreign exchange exposure to protect downside risk that all factored in an approximate 0.5% positive preliminary result for the quarter.

In the almost four years that G1 has been investing, there have been four quarterly drawdowns on the Australian Stock Exchange. In all but one of these drawdowns, G1 realised a positive return. As an investor in G1, I take comfort that our strategy of capturing the majority of the upside while protecting the downside is holding up.

Ok, so to the broader macro.

Why is it different this time?

The COVID-19 impact is unprecedented in living memory. There have been similar and in fact worse health events: The 2009 swine flu (500,000 possible deaths) and the 1919 Spanish flu (50-100M deaths). And while there are key similarities, there are also key differences between these two past pandemics and COVID-19 that are driving the fear and uncertainty that we are experiencing today. Interestingly, one of the greatest risks today that did not exist in 1919 is globalisation, which has brought so much economic growth in the past.

While there is much conjecture on the appropriate method to manage this pandemic and the economic cost of lockdowns, most major developed nations have adopted some form of lockdown model, from which the economic fallout is expected to be the worst since the Great Depression. Certainly, worse that the GFC of 2008.

One of the major differences between this crisis and others has been the pervasive impact on all asset classes. Not only have equities been crushed, but other asset classes that usually provide protection in a storm have suffered as well. These include bonds, credit, infrastructure and Real Estate. The primary reason for this is that in other economic downturns, organisations see their revenue fall by 10-20%, which affects equity prices, but as revenue is still sufficient to cover debt and most labour obligations, these asset prices survive. Similarly, while unemployment may increase by 2-3%, most people still have jobs and use infrastructure assets like roads and airports. This time revenue in many instances has fallen by more than 50%, which has impacted debt serviceability and the ability to pay rent for both businesses and individuals, hence a flow on to real estate. The lockdown means that people are not using airports, nor toll roads. So all asset classes have been affected. The other primary difference today is the fear of the unknown. We still today have very little insight into how long the lockdowns will last. An article I read over the weekend said it may last two years. If this is the case the economic impact will be devastating.

What about the illiquid asset markets? While both liquid and illiquid assets are priced using similar methodologies, illiquid assets (e.g. unlisted property) do not experience the same impact of liquidity squeezes. However, by not being valued on a real-time basis they can suffer from price lag as new information is only priced in periodically.

There is a chance that as reality and data flows into illiquid asset prices, we may see illiquid prices fall in the June quarter.

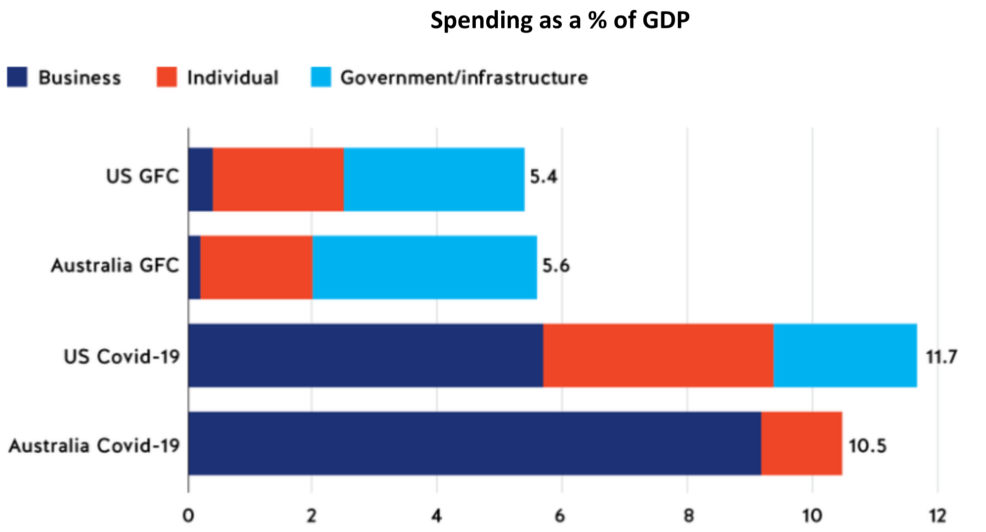
What are we doing to prepare for the future?

As investment professionals and custodians of your money, we are responsible for positioning capital to profit from future developments. The challenge is that, as encapsulated by Howard Marks, ***"These days everyone has the same data regarding the present and the same ignorance regarding the future.".*** We really have no certainty about future developments, hence the Investor's paradox. What adds to our paradox is that we also know very little about the present.

To combat this we use the past, together with current information and the "Why is it different this time" to extrapolate the future. So, what do we know?:

1. We are currently experiencing the greatest pandemic since the Spanish Flu. Our response has massively reduced the death toll from between 50 and 100M to 250,000;
2. The actions to mitigate the human loss have delivered the greatest economic contraction since the Great Depression; and
3. Concurrently, we are experiencing the largest oil price decline in the OPEC era (and, probably, ever).

To combat this, central banks and governments have commenced the largest fiscal and monetary stimulus of all time, far greater than the GFC and far quicker than in the Great Depression. To provide some level of scale, the chart below highlights the US and Australian spend on the GFC and COVID.

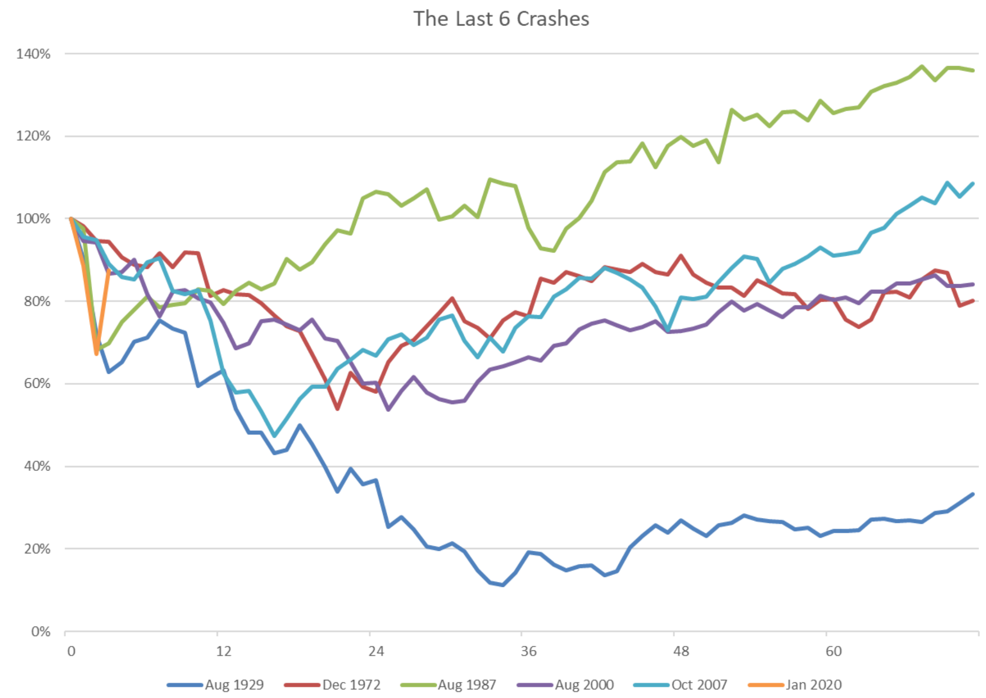


Source: United States Studies Centre

If not for this, according to Fed Chair Jerome Powell, potentially limitless set of stimuli, we may have had a reasonable chance of extrapolating the future based on 1919, 1929 and 1972.

But that is not the case, so the core question is will this global stimulus be enough to turn the tide (what is being referred to as a V shaped recovery) or will it not in which case we can expect economic periods more similar to the Great Depression or the Oil Crisis (a U or L shaped recovery).

The graph below charts the performance of US markets for the last six great shocks:



Note: Shows the performance of the S&P 500 index (except for 1929 crash which uses Dow Jones index data) from its highest point pre the crash to pint of return or six years hence.
Source: Dow Jones, Standard & Poors, CTE analysis.

From this chart we believe the following is relevant to today:

1. Clearly the most debilitating event was the 1929 crash, both in terms of market loss and time to recover. It is generally agreed that the length and depth of this crash were exacerbated by the central bank and government response at the time, during which monetary supply was in fact tightened until 1933/34. This is clearly not the case this time.
2. In all instances, other than 1987[1], there were many false recoveries, by which we mean rises in the index that ended up seeing new market lows until the final bottom was reached. This is generally the result of false hope and more recently momentum and program buying and selling.

So, the question becomes not what will happen in the future but what are the probabilities of a range of possible outcomes and how can we best position ourselves to protect capital and, if possible, profit?

We view the probability of a 1929-like depression as low. The considerable and immediate global stimulus packages should prevent the levels of economic and employment decline witnessed during the 1930's. Economic and financial markets recovery are likely to be much quicker.

Similarly, we place a low probability on a one-fall 1987 like scenario. We see few similarities between today and the events generally considered to have led to the 1987 crash[2] and many similarities between today and the events that led to other crashes (prolonged uncertainty, economic stress, rising unemployment etc).

So, against this, what are the new uncertainties?

1. For every major global market, other than China, we have no real insight into the length and nature of the lockdowns, nor how quickly communities will respond as lockdowns are lifted.
2. In spite of the stimulus, unemployment is still expected to reach levels above 10%[3] with no view as to how long before we return to normal employment.
3. Future demand conditions, even after lockdowns are lifted, are completely opaque as is in evidence in China at this time as demand lags supply.
4. While markets have responded very positively to the stimulus announcements and they have delivered a mini boom; yet to be determined is the effect of this unprecedented and unlimited government debt on future economic growth.

Despite all of this, global markets are down around 15% from their highs and are currently trading at record forward Price Earnings multiples[4]. For reference, this is roughly the same fall as realised in the December 2018 quarter.

This just does not sit well with us.

Considering all of the information to hand, the outcomes upon which we place highest probability are:

1. Global Equity Markets will re-test their lows of 23 March. The June quarter is likely to be the period when the worst news is released globally. The March quarter only saw a limited period and limited degrees of lockdown in globally developed nations[5]. The June quarter will see all three months under lockdown with at least two months at the highest level. This is particularly true for the US, which is a long way behind most nations in getting through this first wave.

---

1 *Many among you may recall that the ASX did not recover like the US markets after 1987. Australia took 9 years to recover, however this was primarily attributable to local events including the "recession we had to have".*

2 *Program selling, portfolio insurance and inadequate technology*

3 *Around 30 million American workers have signed up for unemployment benefits in six weeks; the previous record for a six-week stretch was just under 4 million, in 1982. In Australia, recent data shows that unemployment hit 12% in April, 1% higher than at any time in the past 40 years.*

4 *Excluding the technology bubble of 2001.*

5 *The European Union's GDP fell by 3.5% in the first quarter of the year, which included only a few weeks of lockdown.*

3. The impact on GDP, inflation and the draw on the stimulus package is likely to be highest during this quarter. The bad news combined with the realisation that we are not in a V-shaped recovery is likely to put new pressure on markets and send the optimists to the door and momentum in the other direction.
2. Economies will start to open in June. Europe, excluding the UK, and Australia will be among the first. We note that China has already commenced this process. The US will lag and the timing will be fractured as it is not one market with one approach. The three west coast states will lead the re-opening. The east coast states will be hindered by the fact that some states may have only recently seen maximum cases[6]. The UK will also lag in its relaxation of lockdown conditions.
3. Demand normality will be considerably slower to return than supply. This is currently being experienced in China where manufacturing PMIs have rebounded quickly as factories have already returned to 90% of capacity. Yet consumer spending has not increased. Early lockdown relaxations may be more beneficial to mental health than economic activity. Opening beaches and parks might be great for mental health but is unlikely to stimulate spending.
4. While domestic conditions will be managed on a nation-by-nation basis, global integrations, including business and personal international travel, exports and international education will be the last to recover. It is quite likely that stringent international travel conditions will exist for the remainder of 2020.
5. There will be continued pressure on oil prices as demand exceeds supply and growth remains negative.
6. There will be permanent change. While these are yet to fully present themselves, these will include the demand for office space and domestic and international business travel.
7. Governments will build huge amounts of debt. In 2020 and 2021, the US and Australian budget deficit is likely to exceed 10% and 7.5% of annual GDP respectively. Closing those deficits over time will be a major challenge and will come at an economic cost.

Impact on our investment strategies and portfolios

So how does this affect our investment strategy and the immediate and future composition of our portfolios.

Immediate changes

Our investors will be aware that both the Growth Trust and the Credit Opportunities Trust are predominantly made up of illiquid assets. This helped us in the last quarter as the limited impact of the liquidity squeeze assisted in the protection of capital.

There is little we can do with our illiquid portfolio even if we wanted to sell, which we do not. However, we have been monitoring each investment closely for signs of income or principal stress. There is a possibility as highlighted above that these assets may revalue downwards this quarter, however we are confident that they still represent great investments in the medium to long term.

We have avoided stepping back into equities in any meaningful sense and in fact have lightened our exposure as we feel downside risk in the short term still exists.

We have been active in picking up dislocated credit opportunities at distressed prices. This has helped us recover all of our losses realised in CP1 and COT we believe provides good growth and income opportunities for us at this time.

---

[6] *Australia experienced maximum cases on 22 March; Spain and Italy, the worst of the European countries between 21 and 26 March. The UK may have only seen maximum new cases on 10 April and the US on 24 April, yet that may be too early to tell. Also of specific interest is that for many countries, new cases drop off quite quickly after their peak. This does not appear to be the case for the US and the UK, which seem to go through a plateau phase, which has not ended for either.*

Other than that, we have not made wholesale changes to the portfolios. They have either withstood the pressure of the last quarter or with these changes recovered most of their drawdown. We feel confident that they are well positioned to perform favourably in our favoured probable outcome and if we are being overly conservative, then we should still perform to target.

Structural Changes

We have adjusted our desired investment list to remove assets where we see prolonged uncertainty. This includes such segments as global commercial office, retail real estate as well as global single dwelling residential real estate. We continue to monitor this list as the post-COVID-19 world emerges.

In closing, while we must assess the future, we cannot make predictions about how long this will last. No-one knows. Nor the extent of the impact. What we do know is that we will come out the other side. We are confident that human behaviour is consistent through time, and like many crises past, people and markets panic, leading many investors to over-react, creating enormous volatility but also significant opportunity.

Australia is in a better place than most in the first wave of COVID-19. However, while we are an island, our economy and markets are not. Our return to economic growth will be heavily dependent on the global economy. Added to this, Australia is heading into the winter months and the risk of a second wave of COVID-19 is probably higher than in countries moving into summer.

I wish you all the best and welcome the opportunity to discuss any aspect of this memo or any other matter of interest. As always, I extend my gratitude to you our investors for your ongoing support.

Stay Healthy.