December 2019 half-year review by the Portfolio Manager

Financial markets during the December half were characterised by a continuation of the ‘bad news is good news’ paradigm, which has underpinned markets since the beginning of 2019. The foundation of this playbook is that what is ‘bad’ for the economy becomes ‘good’ for asset prices, as central banks ease policy rates to support the former, pushing the latter higher in the process.

Over the period, global GDP growth continued to slow, falling to its lowest level since the financial crisis over a decade ago. The key driver behind the deteriorating economic backdrop continues to be the trade war between the US and China, which has weighed on most countries, but has especially affected export orientated economies like Germany and Japan. In response to stalling growth, central banks around the world once again responded by cutting official interest rates, or by expanding existing quantitative easing programs. In the US, the Federal Reserve cut official rates three times during the six-month period. In Australia, having already delivered a rate cut in June, the RBA cut rates twice more, in July and October, taking the official base interest rate down to just 0.75%.

In a wearily familiar playbook, financial markets rallied strongly on the back of yet more monetary stimulus, with higher-risk and growth sensitive asset classes leading the way. In US$ terms, global equity markets[1] rose by 8.9%[2], with the FANG[3] index of high-growth technology stocks rallying an eyewatering 22.4% during the period. In Australia, the local equity market rose by 3.1%, while in Australian dollar terms global share markets were 8.7% higher. Falling interest rates increase the relative value of other future income streams, like company profits. This has the effect of rebasing asset prices higher, despite deteriorating fundamentals. The re-basing process can seem somewhat perverse at times. As a case in point, over the December half-year period, reported earnings for the companies within the MSCI All Country global share market index fell by 2.2%[4], relative to the June half-year period. In Australia, they fell by 3.1% on the same basis. For the companies that make up the FANG index, which rallied 22.4% over the period, earnings fell by a remarkable 16.7%.

As a reminder for our investors, Global Value Fund Limited (“GVF”) invests across a wide variety of different assets classes, most of which have a meaningfully lower risk profile than share market investments. Over the six months to December, the fund’s see-through equity market exposure averaged just 35%[5]. The fund’s other see-through exposures span a variety of different credit markets, as well as other asset classes which have little or no correlation to general financial market moves. While we run with a low risk, highly diversified portfolio, we aim to generate equity market like returns over the long run. We set out to do this through an active hands-on program of unlocking the intrinsic value we see across the various investments that we hold. In doing so we provide our investors with a second source of return and thus market outperformance.

Given our investments into global equity markets typically make up well below half of the overall investments held by the fund, we often find ourselves discussing general equity market moves more than is perhaps warranted given the portfolio’s actual composition. In truth, this reflects the fact that the gyrations of the equity markets are generally far more animating to write about than an examination of high-yield bond convexity. That of course is not to say that the latter gets less attention from us. Thus, it is worth bearing in mind that when looking at the fund’s performance, an assessment of non-equity market movements is generally as important, if not more so, than a simple evaluation of what share markets did during a period.

[1] Global share market returns refer to the MSCI All Country World Index.
[2] All market returns quoted are total returns, including net dividends. Source: Bloomberg LLP.
[3] A share market index comprising the highly traded growth stocks of technology companies like Facebook, Amazon and Google.
[4] All earnings and market data is sourced from Bloomberg LLP.
[5] Source: Staude Capital Limited.

Performance of the portfolio

For the half-year ended 31 December 2019, the Company's investment portfolio generated net investment returns of 5.9%. The fund's see-through market exposures generated gross positive returns of 3.0%[5]. This figure comprises the underlying returns received from the portfolio's diversified holdings across global equity and credit markets, and the fund's holdings in alternative and real assets. On top of these underlying market returns, the fund's discount capture strategy generated a gross additional 4.9%[5] return over the period. Positive returns from this strategy represent outperformance over the underlying market and currency exposures of the investment portfolio, and the 4.9% return generated over the December half represents substantial market outperformance over a six-month period. The remaining attribution of returns are accounted for by currency movements, which detracted from performance as the Australian dollar strengthened during the period, and the Company's operating costs.

The success we enjoyed in unlocking value from our portfolio holdings was reasonably well-spread during the period, with several names all making meaningful individual contributions to the outperformance. Two holdings in particular however are worth highlighting: Blue Sky Alternatives Access Fund ("BAF"), and VPC Specialty Lending Investments ("VSL").

BAF, in our view, is a great case study in how much market 'noise' can differ from underlying fundamentals during times of stress. The highly public collapse of the listed fund management group Blue Sky cast a wide shadow across the market. In the process, BAF, a LIC that Blue Sky was the manager for (and which, perhaps unfortunately, shared the Blue Sky name), sold off heavily. Our view has always been that there is a great difference between Blue Sky the asset management company (BLA), and Blue Sky Alternatives Access Fund (BAF), an investment fund which BLA acts as the manager to. The first is an operating business, the second is just a portfolio of assets. At our core, we are asset traders, looking for assets that we can buy below intrinsic value, and where we believe we can be involved in the process of unlocking this value. While the unfortunate collapse of the management company generated copious amounts of bad press, we did our own patient due diligence on the specific assets within the BAF fund and subsequently built a substantial position at a deep discount to asset backing. While there are always some risks involved when investing into private market assets, our view was, and remains, that an exciting pot of gold lies beneath the Blue Sky rubble. The key issue confronting BAF shareholders is how to go about realising this value.

I joined the board of BAF in July 2019, to add my skill set to those of the existing directors as the board set about tackling the challenge of unlocking the considerable underlying value within the company. Over the December half year period, the BAF board covered substantial ground, often in very trying conditions, working to negotiate an acceptable commercial exit from the existing Blue Sky arrangements. Pleasingly, the board was able to announce in November that is was close to finalising the process, and that it had selected Wilson Asset Management ("WAM") as the preferred new investment manager for the company. WAM arguably has the most impressive LIC franchise in the Australian market, and the board's view is that they are an ideal firm to revitalise and reboot the BAF story.

Over the December half, in tandem with the progress the BAF board was making, the company was substantially re-rated by the market. The company's discount to asset backing moved from 33% at the end of June 2019, to 22% by the end of December. Including the positive underlying performance of BAF's investment portfolio over the period, and the dividends we received, the position generated a 23% total return for GVF. While the company is no longer as cheap as it once was, we remain confident that there remains substantially more value to be realised from our holding once the transition to a new manager is finally complete.

VSL is another position worth discussing. We highlighted in our FY2019 annual report that it was an example of 'stored value' - a position that had gone against us in the short-term, but where we were confident of recouping this value and more over the medium term. VSL is a London listed investment trust that lends to middle-market financial companies, mainly in the USA, where it has a profitable niche lending model. Despite our original investment thesis playing out as hoped, the stock sold off heavily in the final few months of FY2019. The main drivers for this sell-off were technical factors that had little to do with the underlying fundamentals which we were excited about. The first of these technical drivers was the very public fall from grace of Neil Woodford, one of the highest profile fund managers in Britain. In the wake of this, Woodford Investment Management was forced to close its main investment funds. It then embarked on a large scale forced-selling program across many of his holdings, including VSL, where it owned 18% of the shares outstanding. We took advantage of the share price sell-off this generated and participated in the buying of this stock - at prices that we believed to be highly distressed. Further adding to the technical selling pressure, VSL was erroneously removed from the important FTSE All-Share Index in June 2019, resulting in a considerable amount of passive index fund selling. In July 2019, the FTSE index service announced that it had incorrectly removed VSL from the FTSE Index and re-instated the company. With the Woodford stock-overhang passed, and passive index funds needing to repurchase their previously sold stock, the VSL share price recovered strongly over the December half year period, delivering a 14% total return. Despite the re-rating, we continue to be very positive about the position. The underlying lending strategy generated a 11.3% return over calendar 2019, which supports its current running yield of circa 10%. More interestingly, the trust faces a continuation vote in June 2020, at which point shareholders can vote to put the fund into liquidation. Given the discount to asset backing remained at 16% at the end of December, we expect a substantial drive by both the manager and the board to address the discount in the run-up to this vote.

Outlook

How much longer the current iteration of the 'bad news is good news' playbook can run for is of course unknowable. Early economic indicators suggest that the actions taken by central banks over 2019 seem to have arrested the synchronised global slow down for now, with the market and most forecasters expecting a modest reacceleration throughout 2020. In the near-term, any improvement in the economic backdrop will most likely be positive for risk assets, as monetary policy remains incredibly loose and the market starts to price in better fundamentals. The longer that persists however, the greater the likelihood that interest rate expectations start to rise, and thus the risk that the 'bad news is good news' playbook moves into reverse. Ultimately, 'good' economic news must one day become 'bad' market news, given the risk that rising interest rates will re-base asset prices lower again. From where we sit today, that risk seems some way off yet, and of course there is the real possibility that economic fundamentals continue to worsen, potentially heralding yet more stimulus.

In our view, the biggest risk in the current environment is complacency. Highly supportive central banks and rallying stock markets are hiding a host of sins. Central bank stimulus is not infinite, something we discussed in this recent article, while the sorts of returns that have been generated from holding higher-risk assets classes in recent times are unsustainable over the long-run.

Thus, as ever at the Global Value Fund, we continue to keep our head down and our focus on managing risk, despite how benign the current backdrop may seem today. Our portfolio remains full of underlying value, with clear catalysts in place to release this to the benefit of our investors. Importantly, our ability to unlock this value remains independent of what broader markets may, or may not, do next.

Miles Staude
Director and Portfolio Manager
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