December 2020 half-year review by the Portfolio Manager

Financial markets always seem to make much more sense when looked at in hindsight. Today, it is easy to take a cool assessment of the December half-year period and arrive at a simple conclusion; financial markets shot ahead on a giddy mix of colossal government stimulus, a strong rebound in global economic growth, and the arrival of a working Covid-19 vaccine. While that makes for simple reasoning today, the six-month period was, in fact, a pressure cooker of market angst. Sentiment whipsawed between hope that a vaccine was just around the corner, and a worry that new waves of the virus might first completely shut the global economy down again. Added to this, markets had to contend with the chaotic final months of the Trump presidency and, incredibly, price in the possibility there might not be a peaceful transfer of power following the presidential election – a notion unheard of in rich world countries since the second world war. It was not until November, when both issues were essentially resolved, that financial markets shed the last of their anxieties. That is when the widespread optimism that we see today really began to build. While the price of nearly every risk asset moved substantial higher over the December half year period, most of these gains came in the final two months of the year.

In US$ terms, global share markets[1] rose by 24%[2] over the half year, with emerging markets and 'FAANG'[3] stocks leading the way, rising by 31.1% and 53.5% respectively. The large exposure the US share market has to 'FAANG' drove its relative outperformance over most other developed world countries, with the US market increasing by 22.2% over the period. In contrast European share markets rose 13.7%, while the local Australian index was 13.2% higher.

With markets awash with cheap government money and the economy beginning to rebound, the cost of borrowing - particularly in the more leveraged parts of the markets - fell considerably. High-yield credit spreads nearly halved over the period, falling to just 3.3% by the end of December. The return of voracious investor appetite for anything with a perceptible yield, and the large fall in borrowing costs, combined to push the price of corporate bonds and loans substantially higher across the borrowing spectrum. In US$ terms, investment grade bonds were 4.8% higher over the half, while the leveraged loan markets in the US and Europe rose 8.1% and 6.5% respectively, in local currency terms.

Parts of the strong rebound we have seen in financial markets recently seem to reflect the typical 'early cycle' playbook that is expected as economies recover from a deep recession. Cyclical and small cap stocks greatly outperformed the broader market during the December half, as did emerging markets and commodity prices. In China, which demonstrated a remarkable economic resilience to the pandemic, imports of iron ore hit a new all-time high, as its historically important heavy industry sector begun to fire again. Chinese appetite drove the price for iron ore up by 58.6% over the period. As Australia's largest export industry, price moves of this size have a prodigious effect on Australia's balance of payments (and its government tax receipts). For Australian offshore investors, the downside of this iron ore windful was the strength of the Australian dollar, which increased in value against virtually all other currencies, including by 11.5% against the US$.

Thus, while the local currency price increases of many asset classes look incredible over the December half-year period, in Australian dollar terms they were far more muted. In Australian dollar terms, global equity markets rose by 11.3% over the December half, while global credit markets actually fell by 3.8%.

[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] Refers to NYSE FANG+ Index. A share market index comprising the highly traded growth stocks of technology companies like Facebook, Amazon and Google.

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Performance of the portfolio

For the half-year ended 31 December 2020, the Company's adjusted pre-tax NTA increased by 16.7%. The Company's discount capture strategy was, by far, the largest driver of this performance, generating gross returns of 16.3% over the period. The returns we quote from our discount capture strategy essentially measure the amount of value we have unlocked from the underlying investments the Company has made around the world. As such, we believe it is the most relevant measure of any outperformance or underperformance from our approach. In addition to these returns, the Company also receives a second source of performance which comes from the underlying assets it has bought at a discount. During the December half these market exposures also delivered modest positive gains; however, these returns were essentially offset by the substantial rally in the A$ discussed above, and the Company's operating costs.

The very strong performance from our discount capture strategy during the period brings with it a measured degree of satisfaction. Throughout 2020, we set out that the substantial market turmoil caused by Covid-19 had created significant dislocations across the areas of the market that we specialise in. As a result, we argued that both the underlying value embedded within our portfolio - and the investing environment for our strategy more generally - was highly compelling. It is therefore pleasing to now be reporting the best six-month period for our strategy since the Company's launch. The large amount of value we unlocked across the portfolio allowed us to comfortably outperform equity markets during the half, despite running with an average see-through equity market exposure of just 43%.

Perhaps more relevantly, GVF delivered this result with essentially no 'FAANG' exposure in the portfolio. As outlined above, in A$ terms, global share markets increased by 11.3% during the December half. However, excluding the small handful of 'FAANG' stocks which continue to dominate overall market performance, global share markets rose by a more modest 8.6% during the period.

Away from the equity markets, GVF held an average see-through allocation to global credit markets of 21% during the half. Despite this asset class falling by 3.8% in A$ terms over the period, the value we unlocked across our credit holdings still meant that our credit portfolio generated meaningful positive returns for the portfolio over the period.

As a general comment, periods of market volatility typically suit our investment strategy very well. The next best six-month period we have recorded for our strategy was the December half of 2016, a time when financial markets were shocked by the surprise result of the UK Brexit referendum. During this period, we were able to capitalise on the resulting market turmoil and produced an 8.7% return from our discount capture strategy over the half.

While periods of market stress are typically very advantageous for us, it is important to say that the success of our strategy does not turn solely on market volatility. In more normal conditions, we still find the investment space that we focus on very exciting. We invest into a universe that is characterised by a host of market inefficiencies — inefficiencies that we have a long history of successfully exploiting. As an investment proposition for our shareholders, however, our hope is that our differentiated approach acts as an important portfolio diversifier through times of market stress. Often these are the periods when alternative sources of return can be at their most valuable in a portfolio.

Outlook

As we write, market enthusiasm seems to abound everywhere. The story of the day is how a ragtag group of amateur day-traders successfully routed professional investors, banding together on the social media forum reddit.com. Elsewhere, the prices investors are willing to pay for the high-growth technology stocks that may (or may not) be the disruptive innovators of the future, continues to set new highs.

Tied to this has been a frenzy of Special Purpose Acquisition Company (SPAC) initial public offerings (IPOs) in the US. These 'blank cheque' companies raised US$83Bn in 2020, six times what was raised in 2019. Their primary purpose seems to be to find the next great technology story - and then to take it public. Rounding out the craze for all things new and 'tech', the price of Bitcoin has nearly trebled over the past year.

While these sorts of market anecdotes leave grizzled investors like us feeling queasy, solid support for much of the exuberance can still be found in fundamental arguments. Real interest rates have been pushed firmly into negative territory - so if you need to earn a meaningful return on your savings, you must invest a long way up the risk curve today. Vast amounts of government stimulus are going to be rolled out over the year ahead – the new US administration has floated a further US$2Trn dollar package, while in Europe, the €750Bn EU recovery fund has barely started disbursing its money. Finally, having endured the worst peace-time recession on record, the global economy is now poised to rebound strongly in 2021.

Negative real interest rates, vast government stimulus and strong economic growth all provide a potent backdrop for financial markets and investor's animal spirits. Furthermore, in radically disrupting old business models, companies like Amazon and Google have created vast amounts of value for their investors and, as importantly, demonstrated what is possible when technology, vision and execution come together. Even though it makes value investors wince, there are solid reasons why investors today are willing to pay the high premiums we see in their hunt for the next Facebook.

It thus seems that there are good reasons for the market enthusiasm that appears pervasive today. Whether this is already properly reflected in asset prices however, remains, as ever, the unknowable risk. For GVF therefore, we continue to spread our investments across a range of different asset classes, focusing on situations where we believe we can unlock substantial amounts of value, regardless of the strength or direction of the prevailing wind.

In terms of our investment universe, while many of the extreme discounts that we saw on offer during 2020 have unwound, there continues to be significant pockets of deep value in the market which we have been actively rotating into. At the same time, the strong rally in share markets in recent months has created new opportunities for us across related asset classes, such as private equity. Thus, while the underlying value within our portfolio is perhaps not as extreme today as it was nine months ago, it remains highly compelling, hopefully setting the company up for a strong finish to the financial year.

Miles Staude
Director and Portfolio Manager
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