# Sunspur Global Fund

**2018 Annual Letter**

21 January 2019

## Performance Overview

The 2018 return for Sunspur Global Fund was -10.2%, against the MSCI World Index ("MSCI") return of -9.4%, an underperformance of 0.7%. Since inception, our annualised return is 3.5%, against the MSCI of 3.4%, an outperformance of 0.1%.

This level of performance is unsatisfactory, but we expect this to be temporary and expect a reversion to a higher absolute rate of return.

***Performance review***

In a weak and somewhat volatile year for equity markets, the fund's performance was substantially in line with the index. This year it was partly by design. During the first half of 2018 our performance diverged from the index due to our high cash allocation. However, in the second half of 2018, we gradually deployed our cash into existing positions, as well as increased our allocation to Chinese equities, reducing our cash position at year end to ~ 10%. This led to us taking on more of the characteristics of the market[1].

Given market performance this year and the fund's returns in that environment, perhaps it would be helpful to revisit some of the statements we made over the last year, and put them in context:

- ***Our sustainable rate of return***. In our last annual letter, we commented that our 2017 performance was above our sustainable rate of return. Whilst this turned out to be true, the negative swing in 2018 now leads me to believe that the opposite now holds. From current levels, I believe our investments are likely to deliver above-average returns for investors over time – but it will be up to us to prove that to you, and we appreciate your patience as we work to have this unfold.
- ***Our cash allocation***. We highlighted our high cash position in our 2017 letter and our concern about markets in general, which turned out to be helpful to us during the first half of 2018. However, with hindsight, we were too early in deploying our cash during the second half. Pessimism towards Chinese equities had created investment opportunities which were attractive, but we did not know where markets would go in the short term. Our solution was to deploy capital, with full recognition of short-term volatility risks, and with the ability to take advantage of any significant declines to add to our positions.
- ***On technology stocks***. We also highlighted our concern on the popularity of technology stocks in 2017 – as a result of which, we held practically no technology investments during 2018. It seems that 2018 was a year for testing investor confidence in these stocks, and as their popularity has waned, valuations have become more reasonable. If there is a continued shakeout in technology stocks, you may see us re-enter the sector.

***On long-term investing***

Time has always been the friend of the investor. Yet, there is an obsessive focus by institutions and some investors on short-term performance and volatility. It is quite understandable why

[1] Despite our significantly increased allocation to Asia (especially China), we were down -10% whilst Asia ex-Japan was down ~ -15%, and the Chinese A-share market was down ~ -28%. However, this "down less than the market" argument has no meaning for us as absolute return investors – and probably why this is in a footnote.

people would prefer lower volatility. As a psychological matter, it is often comforting when something you own consistently goes up in price, because it suggests you are right and that the crowd (ever encouraging) agrees with you. The opposite happens when things go down, but the psychological impact is disproportionately worse and magnified by large swings on the way down.

What is the solution to this problem? A long-term time horizon. Above all else, I think that this is the greatest advantage any investor can have. The playing field is crowded with people obsessing over short-term price movements - there are much fewer competitors truly focused on the long-term game. Evidence suggests that the better you are at ignoring the psychological impacts of volatility and focusing on the long-term, the better your investment results.

***Misunderstanding volatility and risk***

Volatility tells you little about the risks in a fund, market or specific stock. In fact, one could argue that periods of low volatility tend to be periods when risks build, and periods of high volatility signal opportunities. For example, 2017 was one of the least volatile years in financial markets – and yet, most financial professionals would agree that we were in the "late innings" of the U.S. economic cycle. In contrast, the second half of 2018 turned out to be reasonably volatile, but as assets became 20% cheaper, the risks of owning assets must have diminished.

However, volatility does represent the opportunity cost of owning an asset – that is, we could have been able to buy it at a lower price or sell it at a higher price, despite no change in the asset. Why don't we spend more effort trying to figure out when prices are likely to bottom/peak, or attempt to reduce the 'swings' in our portfolio? The answer – we think it is unlikely anyone can do this consistently, and there is enough evidence out there to suggest that this is true.

According to a recent Financial Times article[2], the vast majority of hedge funds delivered negative returns in 2018. In fact, many of the largest hedge funds delivered substantial double-digit net losses. This group of hedge funds covers a diverse range of strategies, from macro, to long/short equities, to trend following and so on - as a whole, not only did this group deliver negative returns in a year when equity markets were negative, they have also materially underperformed equity markets over a decade-long period.

We know our limits in managing volatility, and we hope investors will sceptically evaluate any offering which claims to be able to deliver 'smooth, positive-only' returns over time.

***Our advantages***

We think the best alternative for most long-term investors remains a global equity index ETF, as equities currently remain the most sensibly priced relative to interest rates[3]. Companies are still producing goods and services and economies are growing – and this creates value which eventually gets reflected in stock prices. Investment in a global group of equities means investors are always exposed to the largest source of value creation in the world.

How do we as active managers improve upon this 'best alternative'? For us, we think we have several significant advantages over other funds attempting this:

- ***We truly invest for the long term***. Many funds claim to be long term oriented, but step inside their offices and you will find an obsession with daily share price movements. We think we are better than most of the market at containing our psychological reaction to price moves and spend far more time studying our companies of interest than we do trying to divine the reasons behind share price movements.

[2] "GAM, Schroders and BlackRock hedge funds among worst performers in 2018", Financial Times, 13 January 2019
[3] Interest rates act as 'gravity' for all asset pricing.

- ***We are focused on single stocks...*** Owning too many stocks across too many sectors guarantees market performance. Concentration has always been a key advantage – getting to know a lot about a company or sector and acting when you have an advantage over market participants is key to our outperformance.
- ***… yet are diversified across business risks.*** Despite having a small number of stocks, we diversify our business risks by ensuring our stocks do not 'cross into' each other's territories easily – for example, our top stocks are diversified into Chinese cement, US banking, baby goods, Hong Kong broadband and European cable, all unrelated sectors. This contrasts with many funds which pile into 'themes', appear diversified with many stocks but are basically driven by the same things (e.g. technology, REITs).
- ***We are willing to be contrarian at market extremes***. We are happy to flow along with the market most of the time, except on the few occasions where we identify large mispricings. During these periods we will plant our feet firmly on the ground and lean against the wind. This may lead to temporary underperformance, but if we are correct in our analysis, should be a source of long-term outperformance.

Our investment approach and time horizon are well aligned with our psychological positioning and our understanding of market realities – this combination, if executed correctly, should lead to the fund performing well over time.

## Portfolio Contributors

This year, there was a spread of both positive and negative contributors - no one particular security stood out as having significant impact on the portfolio. Hence, this year we will present and discuss the top 3 positive and negative contributors by absolute contribution to the portfolio.

***Top Contributors***

- *Seritage Growth Properties*. Our only material negative contributor in 2017 turned around this year, as some degree of optimism returned to retail REITs during the year. We took advantage of this rebound to sell out of the position, and to redeploy capital into other areas of interest.
- *Kunlun Energy, China's main natural gas pipeline operator*. We completed a trade of this stock during the year, as investors materially underestimated the earnings delivery in their portfolio of businesses[4].
- *HKBN, a Hong Kong duopoly fixed broadband provider*. The company (a top 5 holding) has continued to deliver good earnings and dividends as a result of management execution, which has been followed by good share price performance. The stock also behaves somewhat uncorrelated to the market, as investors recognise that its earnings are macro agnostic.

***Top Detractors***

- *Wells Fargo, one of the largest U.S. banks.* This is a top 5 position that has an amazing franchise and decades-long track record of conservative delivery. The bank is in the process of working through some short-term problems and in the meantime is conducting large share buybacks. Stock performance was broadly driven by the U.S. market, but we believe that with their buyback programme, the lower the stock price, the more value will eventually be created for investors.

[4] We will occasionally conduct trades of this nature on a small scale when we have enough evidence of a large gap in expectations vs. likely delivery.

- *Liberty Global plc, one of Europe's largest cable and broadband operators*. One of Europe's best managed telecom companies, it is trading substantially below values implied by the recent sale of assets due to regulatory uncertainty around completion of sale, increasing interest rates in Europe and concerns around Brexit. We believe investors will properly rate this company once these uncertainties are cleared. In the meantime, they are also conducting a large share buyback programme, delivering value to investors.
- *Sears Holdings bonds*. Our remaining holding from our Sears position last year. In hindsight, when we sold out of their equity we should also have sold out of their debt, but unfortunately, we held to our hope of them achieving cashflow breakeven, which did not happen. The company filed for Chapter 11 in late 2018 and we retain a very small position given uncertainties but expect recoveries to be greater than implied by market prices.

## Portfolio Positioning and Outlook

In general, we feel the portfolio is currently positioned for above-average returns over time.

We have previously presented commentary on our top positions and how they are designed to be macro agnostic, together with our views on *'old, industrial'* Chinese stocks, leading to our increasing allocation to them (see our October performance letter at http://sunspur.com.sg/publications/). Our views on these matters have not changed.

Our eventual returns will still be driven by earnings and cashflow performance, capital allocation decisions and market determination of valuation levels for our portfolio companies. We see decent prospects for most of these key metrics across portfolio holdings. In addition, we continue to believe that opportunities in China are attractive but will take time to mature.

Based on asset allocation data, we think we are one of the few funds which are currently well invested, as most active investors are loaded up with cash or are short the market. At this stage in the cycle, we believe that maintaining a contrarian stance is likely to lead to the best outcome for investors over time, and we hope investors will be patient with us along this journey.

## In Closing

We thank you for your support over the last year and hope to continue to grow our relationship well into the future.

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Regards,

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