Sunspur Global Fund

2019 Annual Letter

6 February 2020

Performance Overview

The 2019 return for Sunspur Global Fund was 9.3%, against the MSCI World Index ("MSCI") return of 26.6%, an underperformance of 17.3%. Since inception, our annualised return is 5.5%, against the MSCI of 11.1%, an underperformance of 5.5%.

Performance review

In absolute terms this year, we believe our performance is substantially in-line with what we would expect to achieve over the long term. However, our performance relative to the market is unsatisfactory.

2019 was an exceptional year for all large asset class

2019 was a very unusual year in the history of financial markets. Asset allocators, risk parity strategies, momentum strategies all had a one of the best years on record – as bonds and equities both rallied tremendously in 2019. In fact, Goldman Sachs estimates that a 60/40 equities/bonds portfolio had the best Sharpe ratio since 1900. Basically, **every** 'large and liquid' asset class did well in 2019. Is it possible that people have gotten too complacent?

Why did the Fund underperform?

One of the Fund's core value propositions is that we are uncorrelated with markets over time, since we only focus on a small number of stocks. As such, we would expect underperformance when markets are unusually strong, and conversely, overperformance when markets are unusually weak.

We always invest with an abundance of caution, because our money is invested with yours, and we have no interest in seeing our capital decline as risks build up in financial markets. As prices (i.e. valuations) move up without any significant change to the earnings or interest rate outlook, it would be sensible to argue that risks are increasing.

Our focus on such matters as high cashflow, low debt levels, reasonable valuations and 'undiscovered' stocks was of no interest to market participants during 2019. Over time, these factors overwhelmingly determine investor returns, but there will be the occasional year when investors all charge in a different direction. We do try and 'ride' investor waves as far as we can get comfortable with them, but when large opportunities turn up elsewhere or risks build up to an irrational level, we are quite happy to stand aside while the herd charges ahead.

It is psychologically quite a challenging experience, but I would be far more uncomfortable putting our capital at risk as high markets shoot higher.

How did the fund respond to such strong markets?

We made a conscious choice 2 years ago to pivot away from the large markets and large stocks (U.S. stocks, technology stocks etc.), as we found much better investment opportunities in smaller, single stocks in Asia. We estimated back then that the S&P500 would probably return mid-single digits over the next decade and would be an unattractive investment.

In hindsight, we were too early - as Trump's trade war reduced interest rate expectations and reduced the economic outlook for Asia, and China in particular. As a result, a huge wave of liquidity sloshed into the US market in 2019, leading to the index's strong performance. It would be reasonable to ask – should we be chasing the markets? Unfortunately, this is probably a dangerous temptation known as the "Fear of Missing Out", and we try very hard to avoid this.

What should we expect over time?

Given the market performance in 2019, we feel that the chances of a "risk event" have increased. Markets move in cycles, and we have seen some interesting cycles over time as investors crowd into assets e.g. the Japan bubble, dot-com bubble, the housing bubble and (possibly) even the bubble tea bubble. Our job is to make sure that your capital is protected as risks build up in markets.

However, in the final accounting, we must be able to do better than the index over a long-term time frame – otherwise we have added no value to you as investors. There are a few ways this can happen – our performance can catch up with the index, or the index performance can decline to match ours. We suspect a combination of both will occur and time will tell if we are right.

A note on the Coronavirus

The recent outbreak of the Wuhan Coronavirus is unfortunate, but we believe China is taking appropriate measures in trying to contain the outbreak and communicating about the virus as openly as possible. There was a moderate impact to the portfolio in January as a result of the virus due to our large HK/China exposure.

Historically, these have been good times to go bargain hunting, particularly in sectors which are harder hit. We are on the lookout to add to stocks which have declined materially and will let you know if we end up with a new large position as a result of this event.

Portfolio Contributors

This year, the general theme is that our stocks did alright as more than 2/3 of our stocks posted positive returns, but we did not manage to keep up with the market.

On the downside, there were some broader losses across our Chinese small caps despite generally good earnings and underlying performance. I would attribute this to a lack of interest in less liquid names, as most investors were chasing popular stocks.

Whilst we will only discuss the Top 3 Contributors and Detractors for the year, I would like to note that the contribution from the Top 3 Contributors greatly exceeds the losses from the Detractors. For example, our top position in West China Cement contributed to almost half of our gain in 2019. On the other hand, the Detractors pulled our return down by approximately 1-2% each.

Top Contributors

- *West China Cement*. We have written about this stock multiple times (see sunspur.com.sg/publications/), and we continue to like their exceptional earnings and cashflow delivery. The stock remains exceptionally cheap, and we await greater recognition from the market as dividends and accretive acquisitions add more visible value to their profitable franchise.
- *Wells Fargo*. One of our long-term holdings, having detracted from our performance in 2018 became a material contributor in 2019 as the S&P 500 delivered a record bull run. However, compared to other large US banks Wells Fargo had the lowest return in 2019 as

historical compliance issues continue to impact their business. We expect them to do well over time as these issues are resolved and their costs normalise.

- *HKBN*. A material contributor in 2018, HKBN continued to perform well in 2019 as management delivered on their strategic plans. We no longer have a position in the stock, partly due to the HK protests likely to take a toll on their enterprise business and the emergence of other opportunities which are likely to be more profitable.

Top Detractors

- *Goodbaby International*. One of our top picks for 2019 failed to deliver on earnings as their primary Chinese business faltered when management lost focus on their durable goods division. With new management in place since late 2019 and new innovations leading to high double-digit growth in core brands, we believe improving sales momentum will lead to a re-rating of the stock and thus, we have added to our position.
- *Poly Culture*. One of our SOE reform picks unfortunately did not manage to deliver on expected shareholder reforms, which led to investors abandoning the stock. Their core business remains in excellent shape (despite a slowdown in auctions), and we retain our (now) small position in the stock.
- *Jinjiang Capital*. Another one of our SOE reform picks which was cheap and dividend yielding. Unfortunately, most of their focus was on the A-share listed subsidiary, resulting in the core company's business performance being rather lacklustre. Combined with weak liquidity and not much visibility into the H-share reform process, we have exited this stock (but we might add to the A-share subsidiary).

Portfolio Positioning and Outlook

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

We do not have many new good ideas, but the margin of safety in our current holdings is high. Once West China Cement has achieved our objectives it is quite likely that we will only add sparingly to our existing positions, and this may result in us holding above average levels of cash. In fact, we have also started putting on some protection against the S&P500, mainly to remove market risk from our position in Wells Fargo.

I would say our portfolio is more positioned for a US downturn than we have been historically, and we should be alright should there be large gyrations in the markets.

In Closing

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

If you have any queries, please do not hesitate to contact me at:
lokewenwei@phillip.com.sg or +65 6230 8162.

Regards,

Loke Wen Wei
Portfolio Manager
Sunspur Global Fund

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