Sunspur Global Fund

Phillip Capital Management

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Commentary on Recent Market Turmoil

What a rollercoaster ride in the markets! Undoubtedly, we are all concerned about the spread of the coronavirus and the impact it has had on markets. We hope that it will be useful to you if we explain how we were positioned prior to the turmoil, the logic and rationale behind the actions taken during this turmoil, and the outlook going forward.

Our positioning prior to the turmoil

As we wrote in our annual letter in January, we were positioned for a US downturn coming into the year, with a short position of about 7-8% of the portfolio and another 5% in cash. We had no travel, hospitality or tourism exposure. We had almost no oil & gas exposure (except for a small Chinese position).

Also, we had already positioned ourselves heavily in favour of China and Asia, with our US positioning the lowest it has been in a decade. Finally, our top stock position was in Chinese cement, which has earnings generally independent of the macro environment, and is a beneficiary of needed stimulus in a downturn.

Actions we took during this period

Despite our positioning, the severity and speed of the downturn took even us by surprise. As China's virus numbers started improving, we removed our market shorts. In hindsight, we were too early – a sudden oil-price war broke out, which then combined with the spread of the virus in Europe leading markets into a freefall. As the situation evolved, we proceeded to raise some cash by selling our remaining oil and gas position and removing our smaller 'tail' Chinese positions and trading positions, choosing to focus on our existing long-term holdings and top stocks.

We thought long and hard about reducing positions across the board, but some of the top stocks we own have tremendous investment characteristics:

High Earnings, Dividend and Buyback Yields – 2019 Estimates

	Earnings Yield	Dividend Yield	Buyback Yield
West China Cement	30%	8%	-
Wells Fargo	15%	7%	20%
Liberty Global	-	-	50%

* Buybacks can be thought of, at the basic level, like dividends. But if done correctly, they are a great investment on behalf of existing shareholders. We wrote about this in our case study on Avis Budget in 2017, available at http://sunspur.com.sg/publications/.

When we look at the money we expect to receive over time through buybacks, dividends and re-investment of earnings, it is hard to justify holding cash (which yields 0%) in comparison to the cashflow and earnings these companies are generating. And that is our fundamental job as fund managers, to continuously compare investment opportunities to each other (including cash).

Some have asked - why don't we sell now if we can buy it back cheaper later? The answer is because we don't know how markets will move in the short term. We make market directional calls when there is clarity to us, but we do not do this often, and never in size. When an investment appears very attractive over the long run, we are quite happy to hold the position regardless of market movements, and to add to them as prices come down.

Market dislocations in history

We have had many such dislocations in the history of financial markets, some larger, some smaller. Since these dislocations, markets have ***always*** recovered and continued to make new highs over a long-term time horizon.

We cannot identify the exact mechanism of this market turmoil, but many market dislocations are exacerbated by leverage. The futures market is a tremendous source of liquidity, which is why hedge funds tend to participate in that market. But what also happens is that, as leveraged instruments, margin requirements tend to increase as volatility increases. And as margin requirements increase, people need to raise cash by selling futures positions, which tends to increase volatility and so on, leading to a typical spiral.

As market dislocations occur with some regularity, we have always expected 'something' to occur, but never knowing the exact nature of it. Our plan has always been:

(1) to understand if the underlying factors behind the dislocation has a permanent impact on the earnings of our investments over time;
(2) to act if they do; and
(3) to take advantage of any opportunities thrown up by the dislocation

Current positioning

As of this writing (at 5pm Singapore time), we are down approximately 24% for the year (which is about the same as the broader market). We are holding about 10% cash but are no longer short the market. Although it feels harrowing, we will be selectively deploying this cash into existing positions which were indiscriminately sold down in the market.

Looking ahead

Businesses are taking the right actions, by hunkering down and preparing for a steep downturn. However, we do not believe it will last for long. As China has demonstrated, effective preparation, containment and continued precautionary measures means that businesses are able to resume operations, and China is already well on its way to returning to capacity, and we expect this to have mostly occurred by the second quarter of 2020.

There are some who view this as another 'Global Financial Crisis', whilst the market action feels eerily similar, the financial conditions are not close to the same - banks are in amazing shape despite some stresses in markets, capital and liquidity is ample and realistically, the system is the most prepared for this than it has been in decades.

Governments (with a few exceptions) have generally had a haphazard response to the virus outbreak. We do not expect that Western developed countries will be able to contain the virus and must move responsibly to slow the spread. The biggest risk to human life is not the virus per se, but an overwhelmed healthcare system. We hope governments around the world will seek the counsel of countries such as China with more experience in these matters.

On markets, it is impossible to predict a path in the near term, but there is one thing I can guarantee – holding stocks at these levels over 10 years will earn you a better return than holding cash or treasuries.

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Regards,

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