Sunspur Global Fund

Phillip Capital Management

2020 Annual Letter

25 February 2020

Performance Overview

The 2020 return for Sunspur Global Fund was -7.7%, against the MSCI World Index ("MSCI") return of +16.3%, an underperformance of 24%.

Performance review and portfolio strategy

Our performance this year is disappointing, and we hope never to repeat the degree of underperformance we experienced this year. There were several factors leading to our underperformance this year, some are stock-specific, but most are strategy related.

Our value-oriented strategy, as well as our early pivot away from growth stocks meant we had practically zero exposure to the popular stocks of 2020. In hindsight, we should have adjusted our strategy to better respond to likely changes in consumer and business behaviour post the pandemic, but we were too cautious and never developed sufficient data points and confidence in the earnings sustainability of the highly valued stocks in the technology sector.

Investing in the current macroeconomic environment

We are currently in an unprecedented low interest rate, low inflation, and highly accommodating fiscal and monetary environment. This seems to have led to a breakdown in traditional correlations in bonds, stocks, commodities, currencies, and other asset classes.

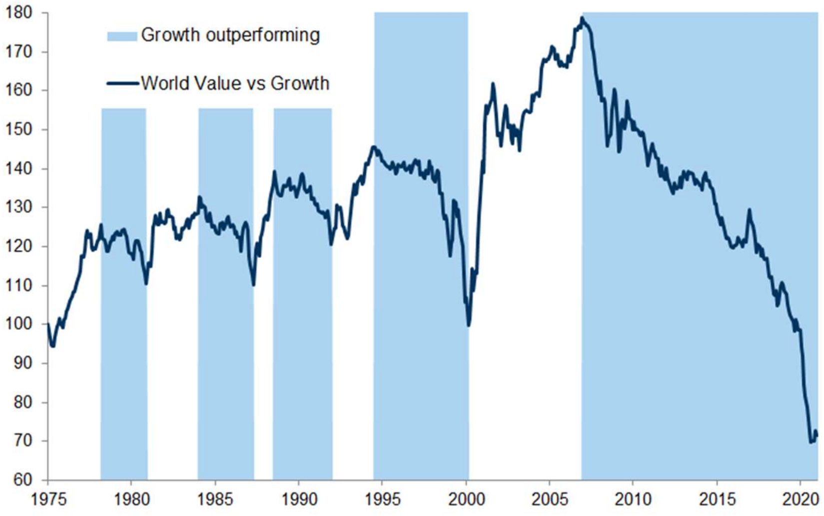
In general, investors have been more willing to look 'far ahead' into the future and have been happy to pay up for the chance at a significant future gain. This is a bit like buying a 10-year lottery ticket, except that you can keep selling your ticket for a higher and higher price as long as you can keep communicating the story of hope (and the lottery result remains unknown). We can see this in the valuations of some stocks like Tesla, and in the price movements of some no-asset and no-cashflow instruments, such as Bitcoin.

We would be extremely cautious about this approach, as there is substantial overcrowding in these purely 'thematic' names. Overcrowding has never ended well for investors, especially for those who joined when it was already overcrowded.

Is Value Investing still a valid investment philosophy?

We still believe that value investing remains the most 'business-like' and sensible investment strategy where downside risks are the primary focus. This means an obsessive focus on companies with ***sustainable*** cash flow, balance sheet strength, a strong industry position and good management, coupled with reasonable valuations.

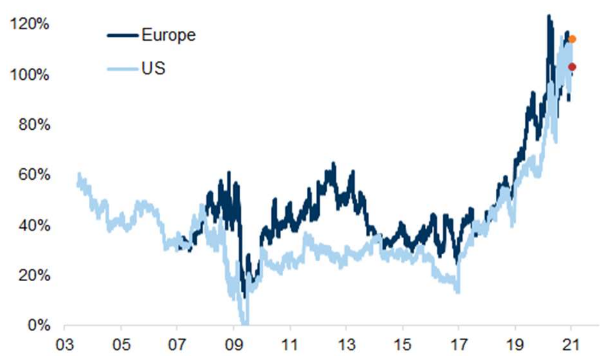
Price Performance – Growth vs Value



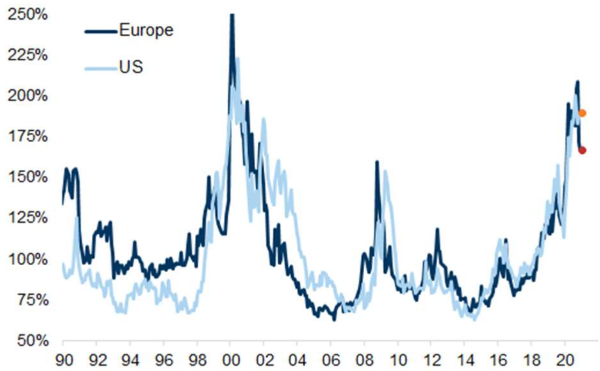
Source: Goldman Sachs, January 2021

Unfortunately, value has had a tough 10-year track record. Since the Global Financial Crisis in 2008/09, growth stocks have been large outperformers. This has correlated with the loose policy environment which has driven interest rates to record lows, and stocks to record highs.

12m fwd P/E Premium of Growth vs Value



12m fwd P/E Premium of Top vs. Bottom quintiles



Source: Goldman Sachs, January 2021

However, the gap between growth and value stocks now stands at multi-decade extremes. We are almost approaching dot-com era levels of excessive exuberance in certain stocks, and for those who remember, the dot-com era did not end well for most investors.

There is a silver lining – post the dot-com bust, value had a tremendously strong, multi-year rally. We believe this scenario could repeat itself once the economy settles down and business fundamentals reassert themselves, making value-oriented stocks the best positioned in the current market environment.

Minor adjustments to our investing strategy

We have made minor adjustments to our strategy to add more balance to the portfolio with a barbell approach. This is where we have a portion of the portfolio invested in the most widely diversified index, covering most of the popular sectors, whilst maintaining most of the portfolio focused on bottom-up, off-index, value-oriented stock picking. In addition, we have reserved space for a large portfolio position which may be classified as 'growth at a reasonable price'. We have yet to fill this space, but we hope to find something suitable when the market corrects.

This should have the effect of levelling out the portfolio over market cycles.

Portfolio Contributors

As usual, we will discuss the Top 3 Contributors and Detractors for the year. Our Top Detractors recorded (in aggregate) approximately 2% greater underperformance than our Top Contributors, which added to our net negative outcome this year.

Top Contributors

- *Baidu*. Our only significant contributor this year was also our only 'old technology' stock. We invested in Baidu as we felt its businesses were undervalued, misunderstood by the market and that underlying trends were turning in their favour. This turned out to be true and led to an almost 100% rally in the stock from our cost in 2020. We started trimming along the way and sold out for an average 50-60% gain. It has since continued to rally on speculation of them manufacturing self-driving cars, a sign that it has entered pure thematic territory, and this is not an area we are keen on participating in.
- *West China Cement*. This has been one of our long-term holdings. Its share price fluctuated quite a fair bit during the year, and we reduced our position slightly as the price moved up. This trading combined with dividends resulted in a moderate gain for the fund despite the share price ending slightly down for the year. We still think West China is quite undervalued, and we hope to see greater recognition of its value in the market over time especially as they continue to deliver on earnings and dividends.
- *Berkshire Hathaway*. We returned to one of our long-time favourites during the pandemic, as we felt that the defensive nature of its businesses would allow the company to continue generating strong cashflows despite the economic environment (plus, it seemed reasonably priced). As the market recovered, Berkshire generated moderate gains for the portfolio.

Top Detractors

- *Wells Fargo*. This was our primary negative contributor, as we held almost 15% of it in our portfolio, and it declined over 40% in 2020. During the pandemic, US banks stocks were hit with expectations of an extended low interest rate environment and significant loan loss provisions impacting earnings combined with a dividend and buyback cap. In hindsight, we should have traded out of the stock as we did foresee the issues above, but I felt that the stock's cheap valuation, dividends and buybacks would provide some support. I was wrong on that count. We still retain a large portion of Wells Fargo but have now diversified our financials holding to include Bank of America.
- *Goodbaby*. Another underperformer over the years, we trimmed a fair amount of it during the pandemic as we felt that the pandemic would lead to another material decline in birth rates (as every challenging period in history has done). This, combined with their post-merger leverage, made us feel uncomfortable with the stock. We still maintain a small holding in it, as we see potential for comeback as the economy recovers.
- *Astra International*. We had a small negative drag from our main Indonesian holding, as we sold out during the pandemic at a loss. We felt that the pandemic would impact Indonesia disproportionately, and the impact on consumer spending (in Astra's case primarily cars and motorcycles) would be long lasting. We no longer hold a position in Astra.

We did make a few stock specific mistakes this year, as discussed above. However, it is worth noting that even by removing the stock-specific mistakes from the portfolio, we would still only have registered a mildly positive performance for the year. The overall strategy is still the primary determinant of performance, and we believe we are well positioned for outperformance going forward.

Portfolio Positioning and Outlook

In general, we feel that our portfolio has a good probability of outperforming the market in the medium term. As discussed above, we do think value investing as a strategy has great potential for a bounce back, as the gap between growth and value has reached near historic proportions. We have begun to see some of the gap narrowing starting in late 2020, and this trend seems to have continued hesitantly into early 2021. We do not know if it is sustainable, but we are certainly positioned for it.

Most of our stocks remain highly cash generative despite the pandemic, have commanding industry positions and utilize little leverage, and are also sensibly valued relative to other stocks in the market. As businesses we expect the earnings of our stocks to grow moderately over time, and to continue delivering cash returns in the form of dividends or buybacks.

As you may have noticed, we have, for the first time, invested a significant portion of the fund in our main benchmark index, as part of our shift to a more barbell-oriented strategy. We will be cautious in allocating to this indexed portion of the portfolio depending on the opportunities or risks we can anticipate in the market.

We still maintain an unusually high level of cash and have recently put on some market hedges in the US. We believe that the US market remains somewhat lofty – we can see this in the degree of retail participation, with pure thematic stories driving stocks and stock performance untethered from earnings performance and valuation. An unexpected rise in inflation and correspondingly, interest rates, may well lead to a general market downdraft and force investors to shift to more cashflow generating stocks.

As such, we are well positioned to take advantage of any such 'shift' and are also well positioned to take advantage of large drawdowns in markets, when we may be able to pick up some good, long term holdings.

In Closing

We thank you for your support and patience over the last year and hope to deliver better performance in the future.

If you have any queries, please do not hesitate to contact me at:
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Regards,

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