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INVESTMENT~INTELLIGENCE

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Annual letter to co-investors of SIH BrightGate Global Income Fund

"The tragedy of investment is that it causes crisis because it is useful. Doubtless, many people will consider this paradoxical. But it is not the theory that is paradoxical, but its subject– the capitalist economy" Michal Kalecki

Let's begin with a quick summary of the fund. The fund closed on the 31st December 2018 with an NAV of 108.1, which represents a net annual return of -6.1%. The fund was created on the 14th October 2013, and the annual profitability since then has been 1.5%. The ISIN code of the fund is LU0942882589.

The philosophy of the fund is Buy & Hold with an aim to invest in global credit with durations less than 3. The portfolio is relatively concentrated (between 50 and 55 positions) and it reflects our best ideas, that we believe offer a more attractive risk/reward profile than the medium credit that can be found in high yield (HY) markets nowadays. Although we like to maintain positions for as long as we can, our fund in this sense is not a traditional Buy & Hold fund, in which positions are bought and maintained until they expire, but rather we constantly evaluate the positions that we have according to the price that they are listed at and the evolution of the fundamentals of the business. In today´s environment, with stretched credit differentials and low interest rates, we are of the belief that the traditional Buy & Hold strategies are poor candidates to be in any investor´s portfolio, as the tight valuations make the reinvestment of coupons difficult, using the interest payments buying increasingly expensive bonds. We believe the correct reinvestment of coupons is an important, and often underappreciated, source of profitability in the long run; our investors can be sure that a large part of our attention is dedicated to this task.

With respect to the hedging policy of the fund, the portfolio is currently completely hedged. The only exceptions, which represent less than 3% of the portfolio, are two credits in Mexico and Argentina, in which we are exposed to foreign currency movement but on the other hand we keep high coupons as protection. We do not expect changes in the currency hedging policy in 2019.

Next, we will summarise 2018, how we see the markets and how we are positioned looking forward to 2019. Additionally, in this year´s letter we would like to explain in detail our vision for the Chinese economy, as we believe it is one of the current topics most poorly understood amongst financial analysts. It is not an exaggeration to say that a significant part of the allocation of capital amongst our credits for this year derives from our vision of the Chinese economy, and it is for this reason that we believe it is important that our investors know exactly what that vision is.

Summary of 2018

2018 will without doubt go down in history as one of the worst years for fixed income as a whole. The withdrawal of incentives by central banks and the rising rates of the FED putting pressure on profitability of government assets on the one side, together with higher valuations and fears at an end of the cycle triggered by commercial war pressurising credit differentials on the other side, have resulted in it being an extremely complex year. The credit index Bloomberg Barclays Global Credit IG, which is a good indicator of the investment grade universe, has ended the year which an annual yield of -6.3% (hedged in euros), while the Barclays EM Hard Currency Aggregate TR index, which represents the evolution of emerging market credits, has ended with -4.85%. Finally, the closest comparison in terms of asset type, the Bloomberg Barclays Global High Yield Total Return EUR Hedged index, has ended with a yield of -5.6%.

Growing hedging costs given the disparity of monetary policy between the ECB and the FED have led to HY bonds not being so "high" for investors whose currency of reference is the euro, and have had to put up with average annual hedging costs against the dollar in 2018 between 2.5% and 3%, depending on when the currency was covered.

On top of the widening credit differentials, the negative profitability of our portfolio during the year has been due to several idiosyncratic factors: the investment in Folli Follie and other investment in certain sectors that have particularly suffered this year. The following will add further comments regarding both of these situations.

The story of Folli Follie, since we invested at the start of the year until our total sale of our position in September, is well known amongst our investors and we will not repeat it again here. We believe that the lessons to learn are: i) the importance of qualitative factors, and not just quantitative, when taking investment decisions (e.g. the company´s headquarters and the countries in which it operates) and ii) not let the standards of profitability and risk that we expect from investments fall, even if there is nothing to buy in the market in that moment.

Peter Lynch's statement that if you have spent time thinking about the macro, it was basically time that you have wasted is already well-known. Although when Peter Lynch outlined that it was probably correct (and taking into account the US economy, a market in which he exclusively invested, showed stable growth during that period), for global investors and at the end of a long economic cycle it is probably one of the worst pieces of advice that could be given nowadays. Although predictions are something that we do not do given that there is an abundance of studies that underline the futility of doing so (as Yogi Berra said, it is difficult to make predictions, especially about the future), we believe that a certain level of sensitivity to certain trends is needed in order take sensible investment decisions. For example, during this year we learnt the importance of such trends through two sectors in which we lost money, and in which we do not want to be invested in again in the future.

- ***American retail companies*:** the American "retail apocalypse" is well-known, although we believe that the majority of people still do not know the real reason behind the poor results of these companies. Although it´s true that the growth of online shopping has been a significant cause of the decline in traditional retail shopping, we do not believe that it is the only reason, nor the most important according to the analysts, since they still represent less than 10% of total shopping (and Amazon, an example that immediately comes to mind, less than 2%). The enormous overcapacity of the United States of commercial space compared to other countries (where there is 2.5m2 per person, compared to 0.5 in the United Kingdom and 0.4 in France) is another factor to consider. However, we believe that the most significant reason has been the evolution of the consumption trends. As clearly explained in this article by Vitaliy Katsenelson, the increase in spending on electronic products (like smartphones) and above all on other expenses such as health services (and we could add education, which he does not mention), combined with relatively stable income for the majority of the population since 2006, has rendered traditional retail ill-equipped to cope with these macroeconomic trends. Given that we do not except that these trends will revert in the short term (for example, the US income inequality has kept rising over the last few years), the credits of American retail are basically like quicksand as an approximate valuation to the real estate cannot be given (what is the total amount generated per metre squared?). After having invested in Sears and in JC Penney and having got out in time (but with losses), we have learnt this lesson, which can be applied to the rest of the companies of that sector. For the next years, American retail is uninvestable, regardless of the entry price of investment.
- European construction companies: if in the case of American retail the main problem has been the change in consumption patterns, in the case of the group that we are now looking at the problem has been the scarcity of investment in infrastructures built in Europe in the last decade. Although our losses in OHL during the tax year represent a modest percentage of the NAV, the majority of HY credits of European construction companies haven't had the same luck. The credit of Astaldi fell by 67.5% during the year, Aldesa by 48.3%, CMC di Ravenna b 93%, OHL by 40% and Salini (considered as the one with the best credit standards) by 21.9%. Although these companies successfully avoided the Eurozone crisis by internationalizing their operations, the lack of investment in infrastructures in local markets added to the overcapacity of the sector in emerging

markets has resulted in these companies being forced into bankruptcy. Given that we do not expect a change in the "responsible" fiscal policy position of Germany (and therefore of the Eurozone) in the short term, we think that it will continue to be a sector affected by low (or negative) margins.

Lastly, the portfolio saw itself impacted during the last quarter of the year by sharp falls in the price of oil and the rising exposure of our portfolio to credits relating to that industry. Given that we explained our vision in our November letter, we will not repeat are points here. Just to mention that the temporary falls in the price of energy credits are very different cases to the two sectors commented on before, as in this case the long term trends are very positive. According to the fall in energy bonds that have continued in December combined with the coming of positive news for the industry (such as announced cuts by the OPEC or the proposed quota for the regional government of Alberta), we have continued increasing, in a marginal way, our positions. Although at the time of writing this letter we have recuperated a significant part of the losses, we are aware that the road to recovery is not a lineal one and will be full of hurdles. However, while the dynamics unravel as we hope over the next few months, we will be happy to accept more volatility to reap higher returns that we believe in the majority of cases present limited possibility of permanent loss of capital.

Current positioning and 2019

At the close of 2018, the geographic positioning of our portfolio is 46.3% in Europe, 34.4% in the USA and Canada, 13% in Asia and 6.3% in the rest of the world. Although Europe is the area which we invest in the most, we do not have any bonds in the "traditional" part of Europe (France, Germany, Italy, etc.) which we still believe a year later, and even taking into account the recent falls, are abnormally expensive and will correct themselves sooner or later, but rather in Nordic countries, in the United Kingdom (oil companies), Ukraine and Spain. With respect to emerging countries, after a rollercoaster of decreases and increases in 2018, we find again a year later expensive valuations and unfavourable perspectives. Our exposure in emerging economies is limited mainly to Indonesia. Just like in 2018, we believe that during the year very attractive investment opportunities will arise and we will not doubt, when this happens, to assign a significant percentage of the portfolio to those assets.

On the other hand, the weight of our portfolio by ratings is: investment grade 1.6%, BB 15%, B 32.2%, CCC 0.5% and without rating 36%.

On a sectorial level, the main weights of our portfolio are: communications 9.3%, cyclical consumption 5.8%, defensive consumption 12.5%, energy 19.9%, financials 6.8%, industrials 18% and basic materials 9.2%.

Despite recent corrections, 2019 is again a year of adjusted valuations in HY markets and with possibilities that any little correction can destroy profit generated throughout the year through coupons. In a schematic way, the portfolio can be divided into the following sections:[1]

- **Energy companies** (19.5% of the portfolio): credits commented on before, with good fundamentals in the middle-term and relatively cheaper than the indexes in general.
- **Short term bonds** (18.1%): bonds with less than 2 years maturity in which the credit risk is normally very low (Aimia, Ferrexpo), although some of them still have uncertain futures (Imperial Metals).
- **Cyclical companies but cash generators** (8.6%): companies dependent on the cycle but that in reality enjoy reasonable margins and manageable debt positions (our positions in Palm oil, in Ukraine and in Geo Coal).
- Companies **not correlated with the economic cycle** (9.3%): Finally, we keep positions in business models that we believe are interesting in moments of tension in markets and that currently yield an attractive profit. We have a position of 7% in gold mining-related companies and 2.3% in bonds completely uncorrelated to the economic cycle (our positions in Thornburg and the GSEs). Additionally, in January, with the revision of our change in prospectus that we will comment on later, we will incorporate a

[1] The portfolio metrics referenced below are all dated January 9.

higher position in the credit of a company dedicated to the business of pawn shops (a business with high profitability on capital investment and that, also, depends heavily on the price of gold and on alternative funding within reach of the consumers), in the credit of a company dedicated to making medicine (businesses with high barriers to entry, replacement costs for clients and stable cash flows) and lastly the priorities of an insurance company in liquidation that has a stack of cash on the balance sheet and whose bonds are listed with a large discount.

To summarise, the fund has an YTW, net of hedging costs, of 7.9% and we have a position of 14% in cash and a duration of 2. We believe that these measures will allow us to obtain a yield higher than the index in 2019 and at the same time provide us with sufficient flexibility for opportunities that may arise throughout the year.

Lastly, we will make a change of prospectus in the coming weeks. This change will not change our investment philosophy, but simply rectify a poor composition that prevents us investing in convertible bonds that are not listed in any stock market (but that allows us to invest in listed convertible bonds). In this way, simple convertible bonds like that of Teekay Corp. maturing in 2023, a company we have known for several years (and in which we are currently invested in a simple bond until 2020), is out of our reach due to this reason. We are finding unlisted convertible bonds at attractive prices, and this change will enable us to take advantages of such opportunities.

We would like to conclude by thanking you for the trust placed in us. We hope that the future results will continue to maintain that trust.

Appendix – The Chinese economy: is a "rebalancing" possible?[2]

Following a calm 2017, the fears caused by the current commercial war between the US and China have brought the latter back to the forefront of international economic concerns. Given the importance that this theme is gaining on the front page of all international economic newspapers, we believe that this year´s letter is a good time to present our vision on the Chinese economy, which differs in several aspects (and we believe that will prove to be more correct in the upcoming years) from the general opinion.

The best way of understanding the economic challenges that China faces is by framing them in a general outline of the rebalancing of the economy. The rebalancing, which has been (and is) the big challenge of the Chinese economy during the last decade, is to simply reduce the importance of investment to the GDP growth in favour of consumption. At the beginning of the 21st century, the participation of consumption (private plus public) in GDP represented 60% whilst investment represented 38% (with the remaining 2% the surplus in the current account), while in 2010 the participation of consumption represented roughly 50%, while that of investment shot up to 45%. The global financial crisis of 2008, joint with the enormous stimulus program in infrastructure driven by Beijing, kept increasing the importance of investment as a crucial factor of Chinese economic growth.

As the Chinese Prime Minister Wen Jiabao already recognized in 2007, "the major problem of the Chinese economy is growth that is unstable, unbalanced, uncoordinated and unsustainable." Since Wen Jiabao carried out this analysis without reservation, the participation of consumption to the GDP has remained approximately the same.

Seeing the success story of the Chinese economy, one may wonder why, at the end of the day, it matters whether growth comes from investment or consumption. In fact, it is of course thought that investing is a good thing (better than consuming, in some cases), as is helps us to be more productive and improve infrastructure. However, there are various reasons as to why said model is unsustainable over time:

- Investment-led growth is debt intensive, since obviously investment is not solely financed by one´s own resources, but also with debt. When countries begin with low levels of debt and capital, domestic sectors have a large capacity for new increments in its

[2] A part of the content of this section has been taken from articles that we have previously published about China.

debt levels since they start with low indebtedness and the majority of investment carried out is quickly profitable, allowing debt to be paid off. As the level of capital grows, because of pure arithmetic, increasingly large volumes of investment are needed in order to maintain steady growth, and with that come larger levels of debt.

- Given the increased GDP growth generated, models directed by investment usually run into severe external crises, since imports (for stable income elasticities for imports and exports) grow faster than exports and the resulting gap must be financed. To make matters worse, the spectacular growth of GDP (considered by investors in every moment "unique economic miracles") help to strengthen the local currency, to amplify the external imbalances and to finance the deficit with volatile capital that leaves as soon as it enters (note what happened in Turkey last summer). Historically, current account deficits have acted as one of the most powerful restrictions when it comes to limiting the duration of investment-led growth stories. In this sense, the case of China is truly exceptional, as that growth did not result in external deficits, but rather the opposite – helped, without doubt, by aggressive import substitution policies and, until recently, by a permanently undervalued currency.
- Lastly, and as the economist Michael Pettis has been repeatedly explaining, all economies that historically have followed investment intensive models have ended up rebalancing in an abrupt manner. It does not matter whether it is the USA of 1860, Nazi Germany of 1930, Russia of 1960, Brazil of 1970 or Japan of 1980, all of these countries ended up at some point of the economic cycle investing disproportionate amounts of money in their GDP and accumulating as a consequence high levels of debt; in all of those cases the rebalancing happened not thanks to a smooth planned landing, but rather due to deep (and in some cases long, like Japan) economic contractions. Although evidently the future cannot always be explained by looking at the past, the fact that such a wide range of economies, operating in such different times, and even in very different political regimes, makes you think that over accumulation of debt is likely to lead to similar results.

The above enables us to use simple numbers to understand the magnitude of the challenge of the Chinese rebalancing. Assuming that, at the close of 2018, the participation of consumption and investment are 57% and 43% respectively and (assuming for simplicity) that the balance of payment is zero, a simple projection in Excel supposing growth of consumption and investment in nominal terms of 10% and 2% shows that in the year 2025 the participation of investment would be above 30%, still far from what could be considered a rebalanced economy.[3] Even with these high increases in consumption, that would facilitate higher GDP growth and would help at the same time to reduce the enormous corporate debt of the economy (the majority of Chinese debt is in the balances of businesses, not of households or the government), the time that it would take China to rebalance in an orderly manner is long – moreover, given that the investment fluctuates more during the economic cycle, a "disorderly" version of the rebalancing would result in a rapid fall in investment and a modest increase in consumption.

From this point of view, data that could be considered anecdotal, such as the fall in car sales throughout 2018, gain special significance: not only is the consumption-led growth of China very far from being what is needed for an orderly rebalancing, but also probably during these last few months it has been barely positive.

Although the investor community does still not seem to have had the simple numbers above, the fact that the rebalancing involves shifting resources from investment to consumption is well-known: the sell-side has been selling for years the idea of being positioned in sectors favourable to consumption and being distant from sectors which rely heavily on investment.

However, on the flip side of the coin, what is always overlooked is that any rebalancing that substantially reduces the share of investment in GDP entails, tautologically, a reduction in the share of profits in GDP and an increase in the share of wages in GDP. Corporate earnings on a macroeconomic level are determined by the sum of investment, the government deficit plus the

[3] The previous growth results in a nominal GDP growth of 7% during the whole period, which could be conceptualized as 4% in real terms and 3% inflation.

current account surplus, plus dividends minus household savings (this equation is an accounting identity, which is therefore always met).[4] In an economy like China, where the volumes of investment in recent years has not historically had any equivalent, this amounts to saying that the business profits of the last few years have mostly been the result of the enormous quantity of investment carried out. That is to say, the reduction in the share of investment in GDP that we will see in China in the coming years will result in a reduction of the profit share.

Coming back to the numbers, if we believe that the rebalancing is real from here to 2025 lowering the levels of investment from 43% to 23% of GDP, and additionally we assume (to be able to facilitate a transition to a consumption model) a reduction of household savings of 10% of GDP, the reduction of the profit share would be 10% of GDP; given that the share is currently around 20%, the rebalancing would involve a reduction of the profit share by half. In other words, even under very optimistic GDP growth scenarios5 the best prediction of the evolution of earnings of the Chinese economy in the next decade, in absolute terms, is that they will fall or remain constant. As stated, only time will tell how the dynamics will unfold with corporate balances increasingly levered.

We would not want to conclude the analysis without a brief reflection on the balance of payments of China and its role during the rebalancing process. As we have mentioned before, a week currency and aggressive substitution of imports has allowed China higher growth rates joined with healthy positions in its external accounts. However, given that China represents in relative terms a much higher percentage of global trade than it did in 2007, it is worth asking to what extent China can continue growing at high rates (in order to facilitate an orderly rebalancing) without incurring substantial deficits. It is not a trivial question, since their balance of payments (even after taking into account methodological problems in those statistics which reduce the true surplus) is very close, for the first time in a long time, to being balanced.

In conclusion:

- China will certainly rebalance over the coming years, but the issue is knowing whether they will do so in an ordered way or not. Historically, there is no precedent of investment-led economics rebalancing in an ordered way; moreover, most of these economies had more manageable volumes of debt than China has now.
- An ordered rebalancing with reasonable shares from consumption and investment in 2025 will result in growth in consumption in nominal terms above 10% and modest (or no) growth in investment; recent data shows that neither consumption growth is high nor investment growth is low.
- The evolution of debt is easier to control with high nominal growth rates than low ones. Given that we do not expect increased growth rates in real terms, the only way of "fabricating" higher nominal growth rates is through higher levels of inflation. In effect, inflation is one of the necessary ingredients for China to be able to solve its economic puzzle. However, the recent evolution of prices in China shows the opposite dynamic.
- The rebalances also involves a redistribution of profits to wages. Given that investment generates profit, the lack of it will leave companies without an importance source of cash flow to deleverage their balance sheets.
- Lastly, the Chinese economy does not have all the time in the world to orchestrate an ordered rebalancing, given that the higher GDP growth rates needed in said scenario would massively deteriorate the Chinese external sector. Of course, Beijing could opt for a devaluation of the renminbi (an option that we believe is almost a certainty and will occur in any case in the next few years), but in the current tense environment of commercial disputes it is difficult to imagine that the rest of the world would allow China much freedom in the short term in this respect.

As the polish economist Michal Kalecki would summarise, the paradox of investment (and the Chinese growth model, as a result) is that it creates economic cycles because it is useful.

[4] James Montier presents a simple derivation of this accounting identity here.

[5] Thanks to the rule of 70, we know that in 7 years growth rates of 10% in nominal terms would be needed for GDP to double from current levels. Our readers can judge for themselves if such growth rates are realistic.

Although the Chinese elite has an arsenal at their disposal that Western economies do not have, the fact that the debt has continued to rise without any apparent side effects has led analysts to attribute supernatural powers that the Chinese bureaucracy simply does not have. Now, with an economy that has not been rebalanced (and in which as we have seen consumption is far from being where it needs to be) and that continues accumulating debt all over the place, the issue for us is not whether the economy will rebalance in an ordered way (the probability of which is close to zero), but rather what the Communist Party will do when the largest accumulation of debt in history comes to its end. The risk that the Chinese economy keeps unravelling, with its global consequences, is our most significant macroeconomic worry for 2019.

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