January 2019

JOHCM Funds

Global Value and Income Dispatch

Strategies for the next market and on being greedy when others are fearful

Highlights

Markets are different these days, and **investors must adapt to the "next market,"** where liquidity can be illusory and fleeting.

Our flexible investment strategy across credit and equities can capitalize on market dislocations.

In Q4 2018 we took advantage of market stress and **deployed a significant amount of capital into equities**.

Our equity exposure ended the year above 50%.

Q4 market summary

The MSCI World Index declined 13.3% during Q4 2018 in dollar terms, while the Bloomberg Barclays US Agg Total Return Index increased 1.6% and the ICE BofAML BB-B Global High Yield Constrained Index declined 3.2%.

The US dollar's performance was mixed, with the euro, the yen and gold returning -1.2%, 3.7% and 7.7%, respectively. Oil prices cratered, with Brent crude tumbling 35.9%, while US 10-year Treasury yields fell from 3.06% to 2.68% in this risk-off environment.

Warren Buffet's best advice?

Warren Buffet's 2004 annual letter advises investors to "be fearful when others are greedy and greedy ***only*** when others are fearful." With our integrated cross-asset class approach, we believe our strategy is well positioned to do just that.

For us, there are two key elements to this:

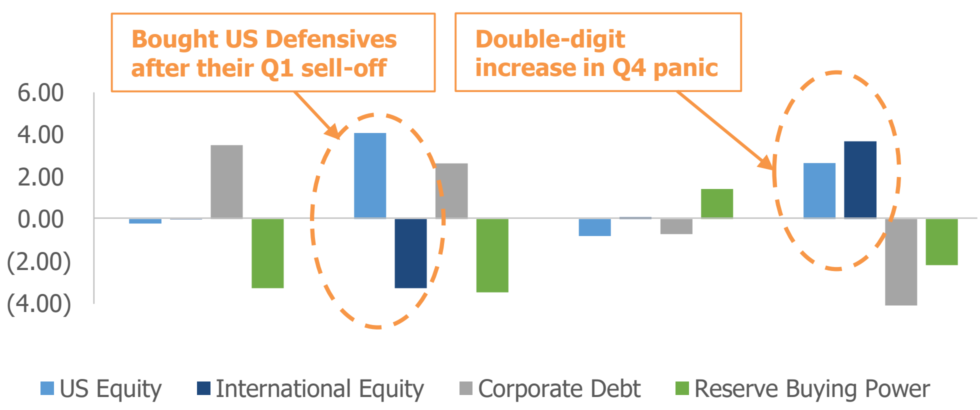
First, we are able to shift capital from one asset class to another to take advantage of air pockets and fear in certain areas of the market.

Second, our activity in different asset classes allows us to cross-reference market signals to improve our sense of how risk is being priced. For instance, sharp movements in credit spreads can often indicate that a shortage of liquidity could be impacting a range of asset classes.

A brief lookback at our first full year

Flexibility proved very useful and additive during a volatile 2018, as various portfolio actions helped improve resilience and returns. Below we review some key decision points:

2018 Capital Deployment by Quarter



Source: JOHCM, Bloomberg. Represents estimated capital shifts net of asset class performance.

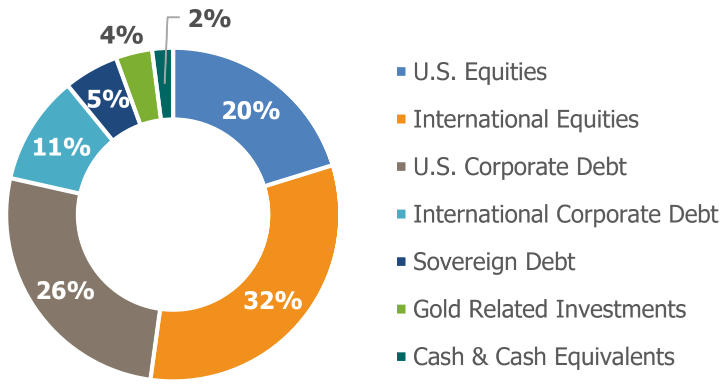
For much of the year our equity exposure was significantly lower than 50% of assets due to valuations . The dislocation in 4Q18, presented an attractive buying opportunity to increase equity exposure above 50% for the first time since we launched our strategy for JOHCM funds in 2017.

The chart below above highlights (i) a portfolio **shift into US defensives in Q2** (funded by sales of more cyclical international equities), as well as (ii) **broad scale buying in Q4** of US and global equities. This was funded by our reserve buying power, fixed income and some of the defensive equities purchased in Q2.

Our ability to deploy capital into pockets of stress was aided by our more **conservative positioning coming in to 2018**. With the strong market performance of 2017, there were fewer equities that offered a margin of safety. For much of the year our **equity exposure was significantly lower than 50%** of assets.

Due to Q4 buying, our <u>equity exposure ended the year above 50% for the first time</u> since we launched our strategy for JOHCM funds in 2017.

GIB strategy by asset class and region



Source: JOHCM, as of December 31, 2018.

We found value in market areas supposedly impacted by the trade war. In various cases, we felt the sharp price moves were excessive even under more adverse scenarios.

Capital also flowed into some of the international cyclicals we had reduced earlier in the year. In the US, we began to see more value in some technology shares as valuations declined.

While not quite a major portfolio shift, we also trimmed and reworked some of our energy holdings earlier in the year at higher oil prices. This set us up to deploy capital into some energy credits and oil service shares, that did not offer value previously but were among the hardest hit spots in Q4.

While it was a challenging year in many ways, we were pleased to finish in the top quintile of the Morningstar World Allocation category. We were also honored to be named "The Fund for the Next Market" by Mutual Fund Observer (Mutual Fund Observer, December 2018 issue).*

Managing capital in the "next market"

While it was a challenging year in many ways, we were pleased to finish in the top quintile of the Morningstar World Allocation category*. We were also honored to be named **"The Fund for the *Next* Market"** by Mutual Fund Observer (Mutual Fund Observer, December 2018 issue).

Below we share some thoughts on what the next market might look like and how we think about this challenge.

Markets have changed

We noticed this perhaps for the first time during the second week of August 2007. The event is now commonly referred to as the "Great Quant Meltdown" or the "Quant-quake." What we saw were individual security prices moving by 10-20% for absolutely no fundamental reasons.

MIT's Andrew Lo has done an exhaustive post mortem, but for us – at the time – it was perhaps the first indication that we had begun to enter this "next market."

* Morningstar ranking as of December 31, 2018. The fund rated 74 out of 453 funds in his category.

Since then we have had various similar episodes including the "Flash Crashes" of May 6, 2010 and August 24, 2015 and the "Factormageddon" of February 23, 2016. This past year has been particularly prone to bouts of volatility culminating in the market dislocations around year end.

What has become clear to us is that liquidity and volatility have become inversely correlated and that the market-making activity present in normally functioning markets is often illusory. Liquidity can evaporate quickly, making pronounced price moves necessary to balance supply and demand – particularly when selling is programmatic.

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Markets are adaptive

A complete treatment of these dynamics is beyond the scope of this update, but herd behavior and crowding are among the key drivers of these liquidity shocks. When a strategy works, capital flows into it, leading returns to erode and ultimately to sharp reversals once stops are hit.

Savvy quants try to measure crowdedness, but many use similar data to do so, which lead to false signals and … (perhaps you see where this is going) … more shocks.

Fundamental investing can work very well but it must evolve

We have never been more optimistic about the prospects of bottom up fundamental investing. Non-economic buying and selling is the fundamental investor's best friend, while illiquidity can lead to extraordinary buy and sell opportunities and the ability to rotate capital.

In order to take advantage of the next market it is critical to be flexible and resilient.

Our ability to be flexible and nimble comes from our capacity-limited approach and our integrated team structure that shares information and invests across the capital structure.

Our ability to move capital in and out of different assets classes gives us the ability to be resilient in drawdowns and deploy capital into those liquidity air pockets when superior risk-adjusted returns are potentially available.

Diversification, diversity and defense: a "3-D" approach

It is our sense that greater **portfolio diversification** will be an advantage for our approach in the next market. Our fundamental valuation process gives us conviction, but conviction can be severely tested in concentrated portfolios when positions are caught up in the wrong factor drift. A concentrated manager may have reached a full position size in a given security and may not be able take advantage of stress to earn high returns on incremental capital. In more volatile markets, this "option to deploy" can be increasingly valuable.

In managing what we view as a modern, contrarian value approach, we believe that **defense can lead to offense**. We want to be positioned such that no individual position can do undue harm to our clients' assets and – as a result of this – that there isn't a single position we hold where we cannot deploy additional capital should a liquidity air pocket or adverse factor drift provide an opportunity.

We believe that defense can lead to offense. We want to be positioned such that no individual position can do undue harm to our clients' assets and that we always have room to deploy additional capital should a liquidity air pocket or adverse factor drift provide an opportunity.

As a result, in the next market concentrated approaches may be better suited for momentum, quality and low volatility strategies, where air pockets may be less prominent.

These goals are greatly aided by a **diversity of thought** across the team and the ability to draw on different backgrounds that span: quant/programming; interest rate trading; credit underwriting, investing & restructuring across investment grade and high yield bonds and bank debt; merger arbitrage and shareholder activism; and - above all - grounded in deep fundamental industry analysis and valuation expertise.

This breadth of experience helps increase the likelihood that we will have a good sense of who (or what quant strategy) may be driving the dislocation, which can improve our conviction to act.

A market for baristas

We took note of a recent Bloomberg interview with legendary investor Stanley Druckenmiller, in which he lamented how the volatility of the next market was making it hard to find "discernable trends."

Indeed, the metaphor for the next market may be that of the barista, as we believe the path to excess risk-adjusted returns may be just to grind and grind and grind.

We found this comment both interesting and nostalgic. It is an affirmation of the trends we are seeing, but it also highlights the end of an era, during which the likes of the Drukenmiller and Soros could wager against the pound and not get stopped out 8 times by stomach churning reversals along the way.

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In any event the need to be alert and responsive (and perhaps highly caffeinated) seems as acute as ever.