STENHAM ASSET MANAGEMENT

Q3 2020 Report

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Market Commentary

Q3 Market Data[1]

Equities	Q3	YTD
MSCI World (USD)	7.52%	0.37%
MSCI EM (USD)	8.73%	-2.93%
S&P500	8.47%	4.09%
Eurostoxx 600 (USD)	4.48%	-9.35%

Fixed Income	Q3	YTD
FTSE Global Bonds	2.94%	7.14%
Investment Grade	1.33%	7.53%
High Yield	4.26%	-1.14%
Barclays Global Agg	2.66%	5.72%

Currencies	Q3	YTD
USD (DXY)	-3.60%	-2.60%
EUR (vs USD)	4.26%	4.38%
JPY (vs USD)	2.19%	2.90%
GBP (vs USD)	4.30%	-2.66%

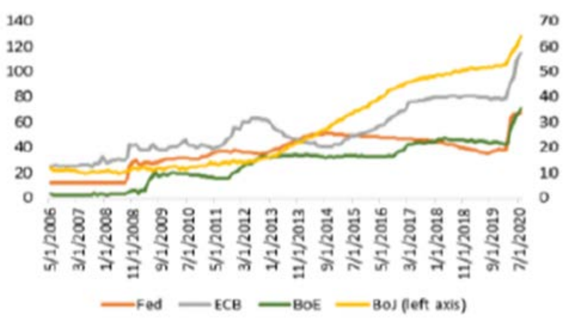
Commodities	Q3	YTD
Gold	6.42%	24.62%
Oil (WTI)	2.42%	-34.13%
Natural Gas	44.32%	15.44%
Bloomberg Commodity Index	9.04%	-12.41%

Markets continued their recovery during Q3 as economic data generally responded well to continued monetary and fiscal stimulus, as well as optimism that a vaccine for COVID-19 will soon be available. Equity markets rose significantly, with the MSCI World up 7.5%, bringing it into positive territory for the year, whilst emerging markets outperformed (+8.7%). Credit spreads, both investment grade and high yield, continued to tighten. Yields on government bonds were fairly stable after the strong moves in Q1 and Q2 with the yield on the US 10 year rising 2bps. Notably, the US dollar saw weakening (-3.6%) whilst gold rose 6.4%.

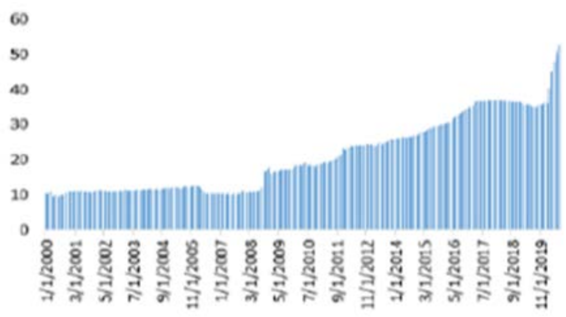
By the end of Q3, many markets had staged a remarkable recovery from the depths of March. Equity markets overall are now approaching flat for the year with the S&P500 exiting the shortest bear market in history. High yield credit's strong return during Q3 also brought the index close to flat. September saw markets trade off somewhat following the failure to pass a renewed fiscal package in the US and a pick-up in COVID-19 cases across Europe, but this was relatively constrained. Investors are looking through the rise in COVID-19 cases with an expectation that a vaccine will be approved for use certainly before year-end and then widespread distribution in Q1/Q2 2021, along with the belief of continued monetary and fiscal stimulus.

There indeed seems to be no let-up in the commitment of expansive monetary policy. Having already announced massive expansion of QE programs and taken rates to (or close to) zero, central bank announcements were concentrated on the longevity of a zero interest rate policy or the potential of even more extreme measures. This included the US Federal Reserve chair Jay Powell at his Jackson Hole speech outlining that they would be prepared to see inflation rise above its 2% target for a sustained period before raising rates. In the UK, the concept of adopting negative interest rates has been suggested. Irrespective of this, central banks' balance sheets continued to grow and at a rate not seen before.

Big 4 Central Banks Balance Sheets (% of GDP)[2]



G4 Central Banks Balance Sheet (% of Combined GDP)[2]



Economic data has generally responded well to the vast fiscal and monetary policy introduced across the world. PMIs have risen globally and there is a bounceback in economic activity following the huge drops in Q2. China suffered before other countries but has rebounded not just quicker but stronger, posting both positive growth of +0.2% for Q2 and +4.9% for Q3. There was some weakening in Eurozone PMIs in September (Eurozone Services 48.0, indicating contraction) probably a result of COVID restrictive policies, indicating the near-term challenges to the economy from a sustained second wave of the virus.

[1] Source: Bloomberg as of 30 Sep 2020
[2] Source: Bloomberg as of 31 Aug 2020

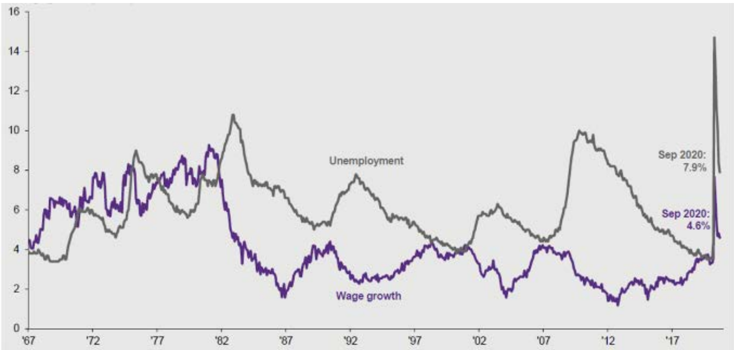
Composite PMIs[1]

2019	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Global	52.1	52.6	52.8	52.2	51.2	51.2	51.6	51.3	51.2	50.8	51.4	51.5
DM	52.3	52.9	52.7	52.0	51.1	51.3	51.7	51.0	50.7	50.3	50.8	51.2
EM	51.6	51.7	52.9	52.4	51.3	50.9	51.5	51.8	51.8	51.8	52.6	52.1
US	54.4	55.5	54.6	53.0	50.9	51.5	52.6	50.7	51.0	50.9	52.0	52.7
Japan	50.9	50.7	50.4	50.8	50.7	50.8	50.6	51.9	51.5	49.1	49.8	48.6
UK	50.3	51.5	50.0	50.9	50.9	49.7	50.7	50.2	49.3	50.0	49.3	49.3
Eurozone	51.0	51.9	51.6	51.5	51.8	52.2	51.5	51.9	50.1	50.6	50.6	50.9
China	50.9	50.7	52.9	52.7	51.5	50.6	50.9	51.6	51.9	52.0	53.2	52.6

2020	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global	52.1	46.1	39.2	26.2	36.3	47.9	51.1	52.4	52.3
DM	52.1	49.5	36.4	22.2	33.2	46.9	51.1	52.2	51.9
EM	52.2	38.9	44.9	34.6	42.7	49.8	50.9	53.0	53.2
US	53.3	49.6	40.9	27.0	37.0	47.9	50.3	54.6	54.3
Japan	50.1	47.0	36.2	25.8	27.8	40.8	44.9	45.2	46.6
UK	53.3	53.0	36.0	13.8	30.0	47.7	57.0	59.1	56.5
Eurozone	51.3	51.6	29.7	13.6	31.9	48.5	54.9	51.9	50.4
China	51.9	27.5	46.7	47.6	54.5	55.7	54.5	55.1	54.5

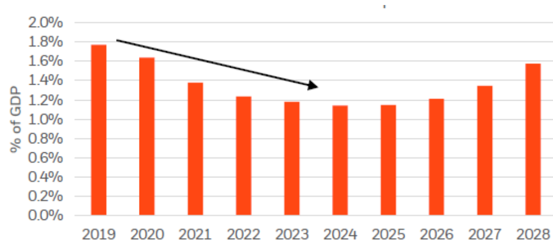
Other data, such as unemployment levels, have also continued to improve. They remain at very high levels, but now commensurate with a more normalised, though severe, recession rather than the unprecedented levels seen in the immediate aftermath of the pandemic.

US Unemployment Rate & Wage Growth (% Wage Growth is YoY)[2]



Fiscal support has been extensive and essential for firstly avoiding the worst in Q2 and now economic recovery. Many of the emergency programs announced during the first wave of COVID-19 had finite lives and are now subject to renewal. Generally, there seems to be limited appetite by governments to reduce stimulus; most debate has been centred in the US where there was a failure to pass a new stimulus package but there is the belief this will pass after the presidential election. In the developed world, at least, there is little practical immediate need to reduce government spending; despite the huge stimulus package and increase in national debt, the cost of servicing the US federal debt actually falls in the near-term as a result of the drop in interest rates. This will only encourage further spending.

Federal Net Interest Expense[3]



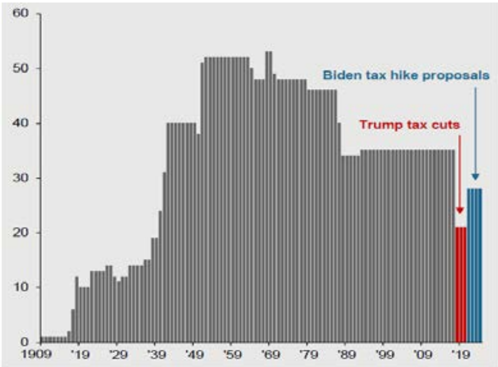
The US presidential election is imminent, taking place in early November, with polls suggesting that Joe Biden will win the presidency. On a national basis, Biden is leading Trump by an average poll level of 7.9%. In the battleground states, this is tighter at 4.3%. At the same point in the last election, Hillary Clinton was leading Trump by 3.9% in the battleground states. Hillary then suffered a loss in votes following the disclosure of her emails; the question is whether Joe Biden will suffer a similar fate, potentially from his son Hunter Biden's business activities. So far it seems not. Biden remains the favourite, but the result is not clear-cut, especially with the level of postal voting (which can be disqualified if certain conditions are not met) and variations in turn-out having the potential to alter the outcome considerably.

[1] Source: Bloomberg as of 30 Sep 2020
[2] Source: JP Morgan as of 30 Sep 2020
[3] Source: Blackrock

Just as significant is the result from the congressional elections. The Democratic party controls the House of Representatives, which is likely to continue. In the Senate, the Republicans currently have a majority but polls are very tight as to the future balance. Often it is felt that a split in control between the Presidency and Congress is beneficial in that it inhibits how extreme a party can be in implementing policies. In the current environment, the reverse may be the case. Given how markets have responded it is easy to forget that the developed world is in the worst recession since the 1930s, and much of economic activity, be it by individuals or companies, has been supported by fiscal transfers. The ability to continue, or even increase, that fiscal stimulus will be key for the short-term economic performance.

The focus has been on a renewed stimulus package following the presidential election. However, if Biden wins there will be further changes. Taxes will rise, both on more wealthy individuals as well as corporates. Regulation may well also rise, though the exact policies for the pharmaceutical, energy, financial and technology sectors are unclear. Anything overly contentious will likely not be rapidly implemented given the extent of lobbying within the US political system, but there could be significant changes especially if the Democrats control the Senate. A rise in corporate taxation does seem a certainty under a Biden presidency, though to what extent will also need to be kept in perspective with the anticipated level still lower than it was before the Trump tax cuts.

US Corporate Tax Rates (% max. corporate tax rate)[1]



Q3 was in some ways a holding quarter. There was important information gained on the leading questions driving the economic and political environment; the timing of a vaccine for COVID-19, the infection and mortality rate of a second wave of the virus and the path of the US presidential elections. However, none of these questions were fully answered and we await Q4 when many, if not all, should be. It is similar for the full impact of behavioural changes caused by, or at least accelerated, by the pandemic. There has been huge dispersion in the performance of assets, with those facilitating the “work from home” trend vastly outperforming those impacted most by the disruption from COVID-19. However, many of the changes to economic structures and business models have most likely been delayed by some of the rescue measures put in place. We believe that many changes are only beginning and will have a profound effect on business models and asset prices.

Outlook

Going into Q4, there are countervailing forces at play. On one hand, interest rates have collapsed, whether for personal mortgages, corporate or sovereign debt. Credit is widely available and the ability to service that debt has been reduced, even from what were ultra-low levels. Government spending across the globe has been extensive and shows no sign of letting up. This is tempered by the dependency of the economy on continued monetary and fiscal stimulus, as well as the rise in COVID-19 cases and the resulting government actions to temper its spread. Lockdowns, even if more targeted and regional than in March/April, are becoming ever more common and are imposing constraints on economic activity. In the short-term it seems likely to us that governments will take whatever action they need to maintain some balance and growth within the economy. Longer-term, the consequences of ever higher debt levels (across governments, corporates and potentially individuals), support the continued existence of so-called zombie companies, as well as disruption across supply chains will inhibit the potential of economic growth.

[1] Source: Deutsche Bank

Strategy Allocations

We remain generally happy with performance so far in 2020. Portfolios protected capital in Q1 and as at the end of Q3 are generally positive between mid to high single digits for the year. We seek to continue to upgrade portfolios where high quality managers are looking to raise, or more often replace, capital.

We are firmly in an environment of zero or negative interest rate policy across the developed world. Any rise in rates would have a devastating impact on the sustainability of corporate and sovereign debt, as well as asset prices as this would raise the discount rate, which is the foundation for what would otherwise appear extreme valuations. Whilst inflation remains low, there seems no limit to the levels of monetary and fiscal policy adopted. Monetary authorities actively want to generate inflation and have negative real interest rates. As a result, we continue to hold gold as a store of value within appropriate portfolios.

Discretionary and Systematic Global Macro

In aggregate, relative value, discretionary macro and quantitative strategies were all profitable in Q3 with discretionary macro leading gains.

Macro managers posted strong performance across July and August as they were able to capture the move higher in precious metals and the move lower in the US dollar. Initially short positions in the US dollar were expressed against the euro and other DM currencies but, during the course of the quarter, the managers shifted positions to be short the US dollar versus Asian currencies, most notably the Chinese renminbi. Increasing growth and rate differentials between China and the US, and the potential continued addition of Chinese fixed income markets to global indices over the next few quarters, supported this thesis. Within interest rates, managers retained a steepening bias with a view that central banks will keep front-end rates low to support the economic recovery, but back-end rates remain vulnerable as a result of increased issuance to pay for the fiscal spending in many countries. September saw a reversal of some of the moves that occurred in July and August but our managers were able to limit losses. Their continued use of option structures in expressing directional views helped them generate asymmetric returns.

Relative value managers had a positive quarter overall as various spreads have continued to normalise from the extreme volatility in Q1. Returns were more muted compared to Q2, which saw the bulk of the normalisation in spreads across fixed income and equity derivatives. Fixed income focused relative value managers outperformed our volatility arbitrage manager. Leverage levels came down as managers believe it is important to keep powder dry as we head into Q4 and potential further volatility given various event risks on the horizon.

Within quantitative strategies, our managers focused on trading equities and futures with a shorter time horizon, and outperformed our manager who trades predominantly equities with a longer time horizon. This has been a pattern we have noticed throughout the year in what has been a challenging environment for many quantitative managers.

Equity Long/Short

Our equity long/short managers performed relatively well for the quarter in what was a good period for both equity markets and for equity long/short strategies in general. Stenham Growth, our equity long/short fund of hedge funds, was up 6.3% in Q3 compared to the HFRI Equity Hedge Index, which was up 5.9%, and the MSCI World Index, which returned +7.5%.

We were pleased with the upside performance capture shown by our equity long/short managers, given the defensiveness that they demonstrated in Q1 and an average net exposure of just under 50%. Performance attribution was reasonably well spread across managers for the quarter. In general, our funds benefitted from long exposure to innovation-led growth in areas such as cloud computing, payments, ecommerce, software and biotech. Valuations in these areas have gone up YTD but our managers continue to find them attractive given the structural growth trends behind these businesses (which in most cases have been accelerated by COVID-19), the relative scarcity of growth globally and the fact that valuations still look reasonable or, arguably even, attractive when compared to the level of interest rates.

Given our enthusiastic view on healthcare, which has been discussed in prior letters, it is worth noting that our best performing equity long/short manager for the quarter was a biotech specialist fund in which we have a sizeable investment. Despite biotech indices being flat in Q3, this manager generated exceptionally strong performance, mainly due to the acquisition of their largest position (Immunomedics). The structural trend of greater innovation and increased M&A activity in biotech is one of the key underpinnings of why we find this space attractive.

In terms of key areas of focus on the equity long/short side, we are currently looking to build and improve our specialist manager exposure in healthcare, TMT, China and climate change related investments.

Event Driven

It was a good quarter for our merger arbitrage managers. For one in particular, increased exposure in March/April to Special Purpose Acquisition Companies (SPACs) has continued to drive performance and has remained a fruitful source of opportunity throughout the year. The fund's SPAC strategy has historically been a cash arbitrage strategy. SPACs are companies which raise capital to be able to buy other companies. This cash is typically invested in US treasuries and when the company identifies an acquisition target, holders of SPACs can elect to convert into the acquisition company's equity or take the cash. If the company does not identify an acquisition target during a defined period (typically 12-24 months) SPAC holders receive back cash. Many SPACs traded below cash value during March/April and this manager significantly increased exposure. Since then, many SPACs have risen significantly in value on announcement, or even rumour, of an acquisition. Often these acquisitions are of private companies. Our fund's strategy is to sell these SPACs when they rise above cash value and is not seeking to hold exposure to the equity of these companies but to monetise gains. SPAC issuance has been huge in 2020, over $40bn YTD compared with $13.6bn in 2019, itself a record year, and $10.7bn in 2018 (data from dialogic). SPACs are becoming an increasingly accepted way of a company entering the public market alongside the traditional IPO process. This high level of issuance has provided ongoing opportunities for this manager.

Our other managers are more traditional, focusing on merger arbitrage and distressed debt. Merger activity picked up in Q3 from the very low levels seen in Q2 and our managers have increased exposure. Exposures are somewhat barbelled within merger arbitrage with relative safe exposures from the large healthcare deals, which have minimal (if any) anti-trust exposure, to certain deals (notably Simon Properties buying Taubman and LVMH buying Tiffany), which were agreed before March and where the buyers are looking to exit, or at least renegotiate.

Credit

The credit allocation generated good returns in Q3, with all managers positive. Performance came from a variety of sources. Some managers added to investment grade or higher quality high yield debt in March/April. This has performed well, and managers have largely sold these investments and crystallised gains as spreads have tightened, sometimes to levels lower than that seen before March. Other distressed and restructuring positions have also risen in value. Despite spreads being tight, our Credit Long/Short manager is finding a lot of opportunities on both sides, with there being strong winners and losers from the new environment as well as from companies needing to raise capital at attract risk/reward levels. The extreme policy action taken has meant that the level of companies defaulting on their debt has remained lower than we would have anticipated in March or April. However, the action of these policies has been an increase in overall corporate leverage and, as behavioural changes become apparent from COVID-19, we feel that this has delayed rather than removed the prospect of corporate defaults.

Our emerging markets focused manager saw positive performance, though gave some back in September, driven by positions in Argentina. The Argentine sovereign completed a restructuring of its debt during August, which led to an appreciation in the value of debt throughout Argentina. In September, the country announced a series of new capital control measures. The actual specifics of the regulations were not as significant as the impression it created of a country that was not being investor-friendly. This has deterred foreign investors looking at Argentine securities, which led to them trading down during the period.

Summary

In August, management completed the 100% buy-back of Stenham from Peregrine. We wish Peregrine well following their acquisition by Capitalworks, they have been a valued majority shareholder since 2008.

We are very excited to be entering the next chapter for Stenham. We are in an environment where prospective returns from traditional investments are, at the very least, lower than they have been. Yields on high quality bonds, especially sovereign, offer minimal returns and potentially losses in real-terms. Equity returns are likely to be very specific with winners and losers arising from structural changes in individual and corporate behaviour following the COVID-19 pandemic. We feel that hedge funds are a compelling investment in a variety of strategies; relative value to generate traditional bond-like returns with limited beta to markets, equity focused managers identifying the winners and losers in a rapidly changing landscape or private credit to take advantage of stress and over-leverage within corporate structures as business models are challenged. Stenham, with our experienced and stable investment team, is very well positioned to help clients take advantage of these opportunities.

Thank you for your ongoing confidence in Stenham. Please contact us if you would like to hear more about our strategies or funds. Further information can also be found on our website at www.stenhamassetmanagement.com

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