

Lucerne Alternative Investments Fund

Quarterly Report | September 2022



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Fund

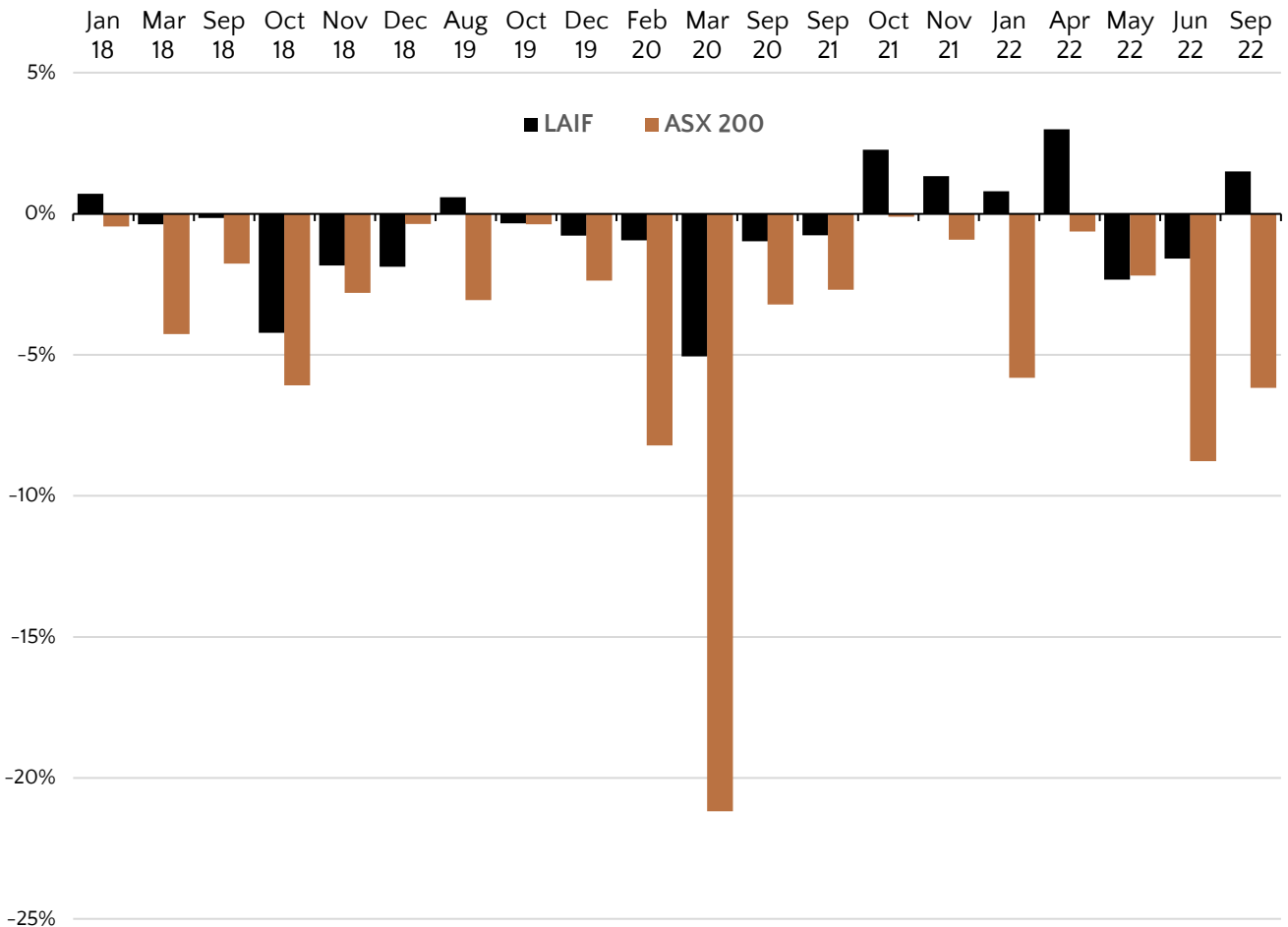


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The Lucerne Alternative Investments Fund (LAIF) returned 1.45% for the month of September bringing the quarterly performance to 2.61%. A pleasing result for our investors allocating to LAIF's diversified alternatives Fund of Funds strategy.

The Fund continues to meet its return objective of 6% or more above the RBA cash rate after fees per annum (over a cycle), with much lower volatility than equity markets. LAIF's performance during market drawdowns (chart below) highlights the importance of the Fund's differentiated return profile with low correlation to equity markets in a portfolio.

LAIF Performance in ASX200 down months (Source: LAIF)



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A look back at Q3:

- The US Federal Reserve continued its relentless pursuit of controlling inflation. For the quarter, the Fed Funds cash rate increased by 225 basis points.
- Reserve Bank of Australia followed the US Federal Reserve hiking its cash rate by 150 basis points for the quarter.
- Inflation persistence is at its peak in the US, although some relief was seen in lower core goods prices.
- Russia - Ukraine war continues to impact the global economies at varying rates with Europe affected the most.
- Global recession risk increasing. Odds for recession are now at 60-80%.
- Household wealth declines around the world increasing, particularly Australia and NZ given large mortgage indebtedness of population.

Our cautious macro view remains as several of these themes continues to impact asset prices.

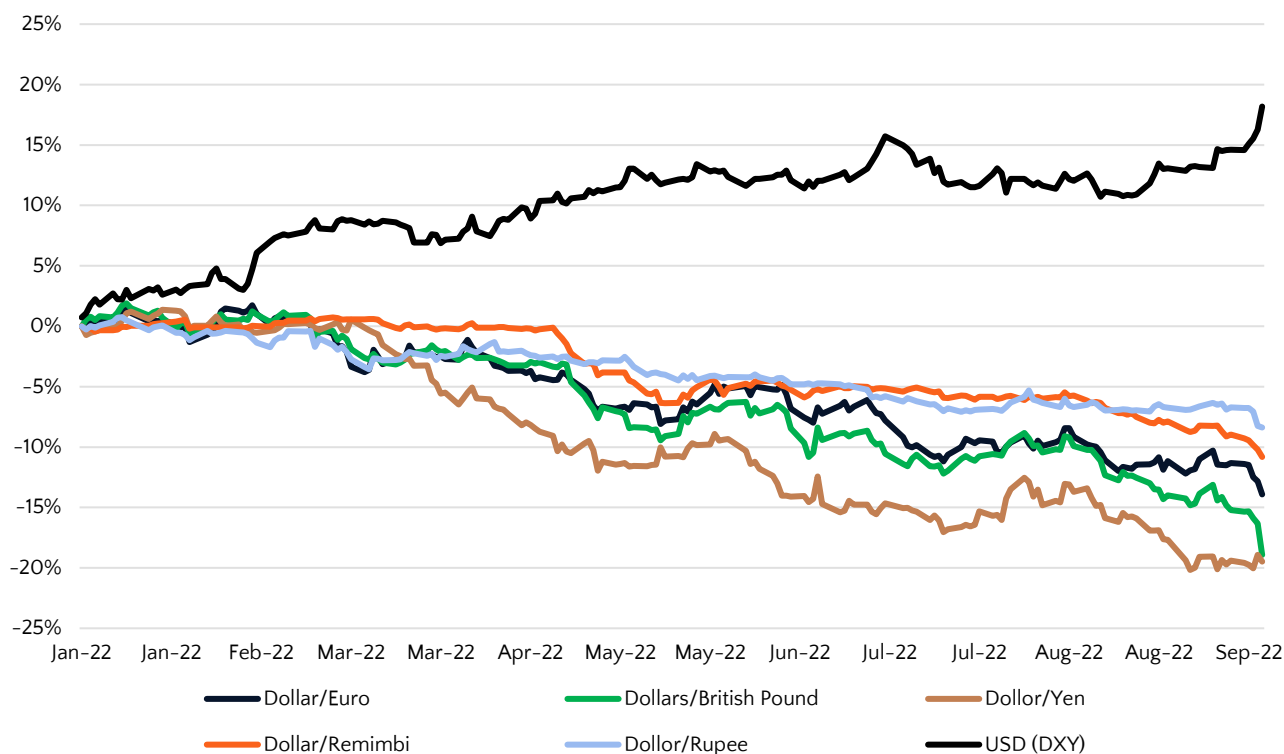
Our Macro Lens on Inflation and its Effects on Asset Prices

Interest Rates and Exchange Rates

The most critical factor, and the one that best explains large rate moves, over time, is expected inflation. For the last decade, it was not quantitative easing (QE) or central bank's experimentation that kept interest rates low, but low inflation, in conjunction with weak real growth. QE was a tool to stimulate growth but as with all government backed intervention outcomes tend to overshoot. As investor expectations of inflation have risen in 2022, cash rates have soared unsurprisingly.

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US Dollar vs Other major currencies: 2022 (Source: LAIF)



The US dollar has surged against almost every currency, with the Euro and the British pound trading at, or close to, historic lows. Our initial view on this is that interest rate parity is at play defined as the relationship between the exchange rate and interest rates of two countries. Accordingly, a breakdown of this relationship gives rise to arbitrage opportunities as the interest rate differentials adjust to the exchange rates. Our view on the strength of the USD is associated with US interest rate expectations rising faster than rates in other countries.

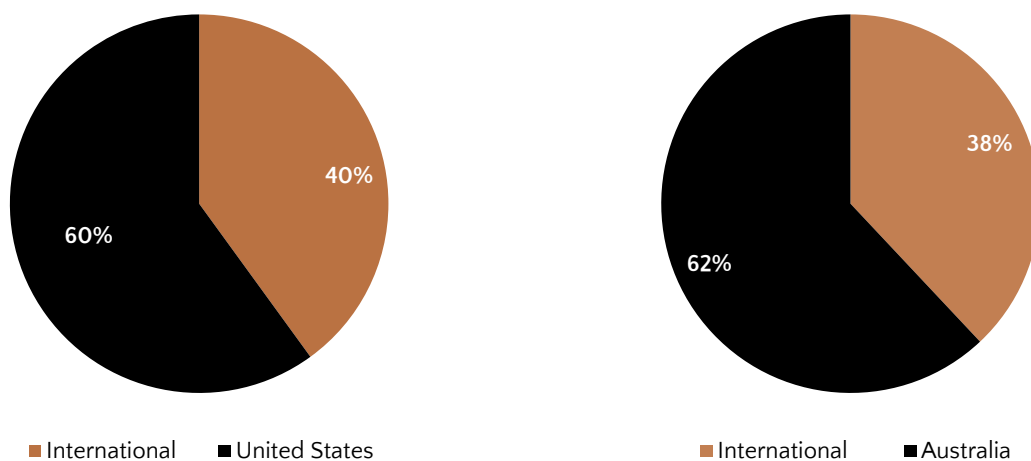
Our second view is the flight to safety, as worries about the global economy and markets take hold. At every level, though, exchange rate movements that are this fierce create chaos and disruption in the economies of both the strengthening and weakening currencies.

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As noted in our August factsheet, we believe the earnings downgrade cycle has begun. Financial year 2023 earnings for the S&P 500 and ASX 200 have been adjusted down by roughly 7%, albeit small, we expect more downgrades to materialise as more of the weaker data rolls into the forecasts.

Recent analysis from FactSet show roughly 40% of the S&P 500 companies are vulnerable to earnings compression or adjustments due to a strengthening dollar. The ASX 200 has a similar revenue exposure, but the USD strength stands to benefit the commodity exporting nation.

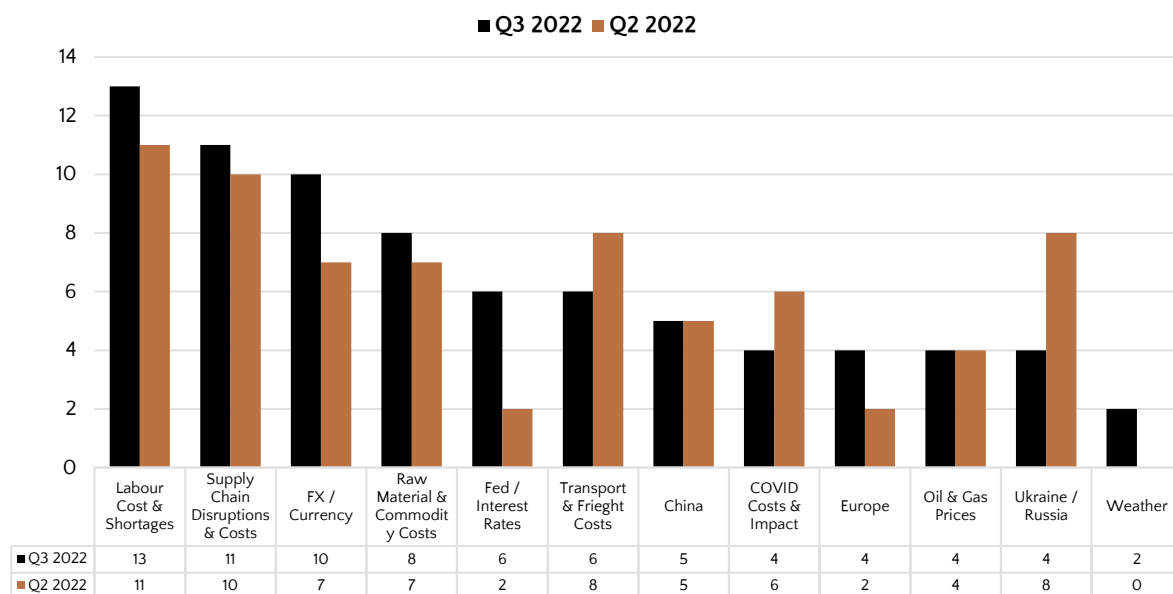
S&P 500: Aggregate Geographic Revenue Exposure VS ASX 200: Aggregate Geographic Revenue Exposure (Source: FactSet)



Concerns around unfavourable FX rates are being cited as the third-highest issue in the Q3 earnings release for S&P 500 so far. This has seen a steady increase and stands to be a large factor contributing towards the earnings compression cycle discussed earlier.

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S&P 500 Co's citing negative impacts on Q3 2022 Earnings (Source: FactSet)



Capital and Risk Premiums

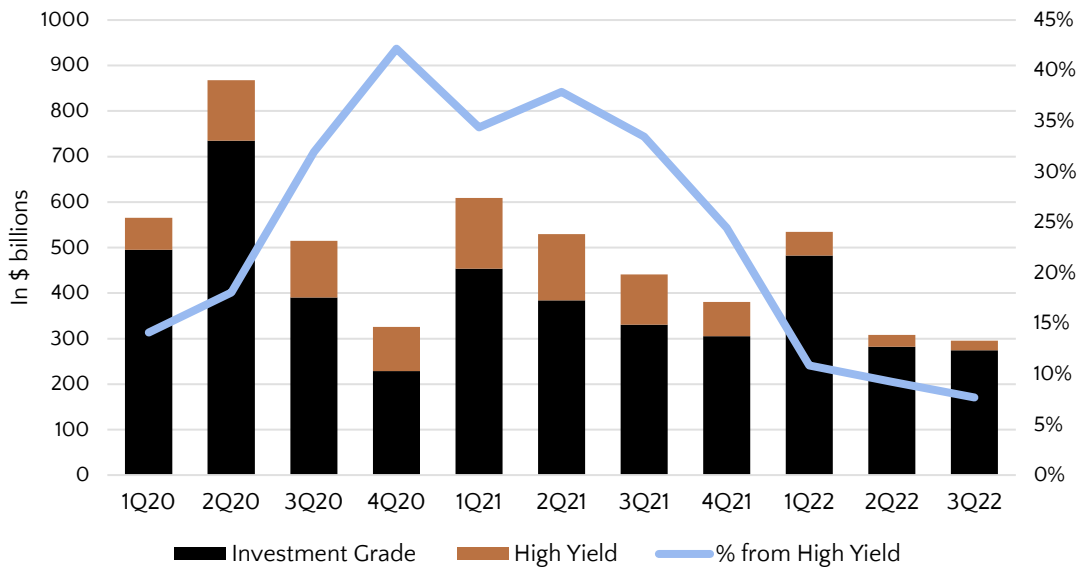
The expected ability of companies to pass on higher costs should counteract the negative impacts by earnings and cashflows growing at higher rates, aided by inflation. However, higher inflation always seems to be accompanied with greater ambiguity over inflation, and we believe this impact does real damage to capital allocation.

Capital invested in the riskiest segments of asset classes (i.e. Fixed Income: High Yield Debt, PE/VC: Pre-Seed and Seed financing/Pre-Revenue Businesses Public Equity: High Growth/cash burners, , Real Estate: Speculative Real Estate with high leverage) in the last decade has seen an explosion in valuation, supported by the central banks. Our opinion remains that a healthy market ecosystem is a balance between risk aversion and risk taking, while the excess of risk taking leads to creating bubbles within certain pockets in the market.

Consequently, corporate bond markets, composed of investment grade and high yield debt saw large increases in issuances in the US during 2020-2022. Bond buyers were willing to accept additional risk and flocked into high yield debt. However, as risk free rates continue to increase around the world this appetite has reversed resulting in bond prices falling causing widespread losses in portfolios.

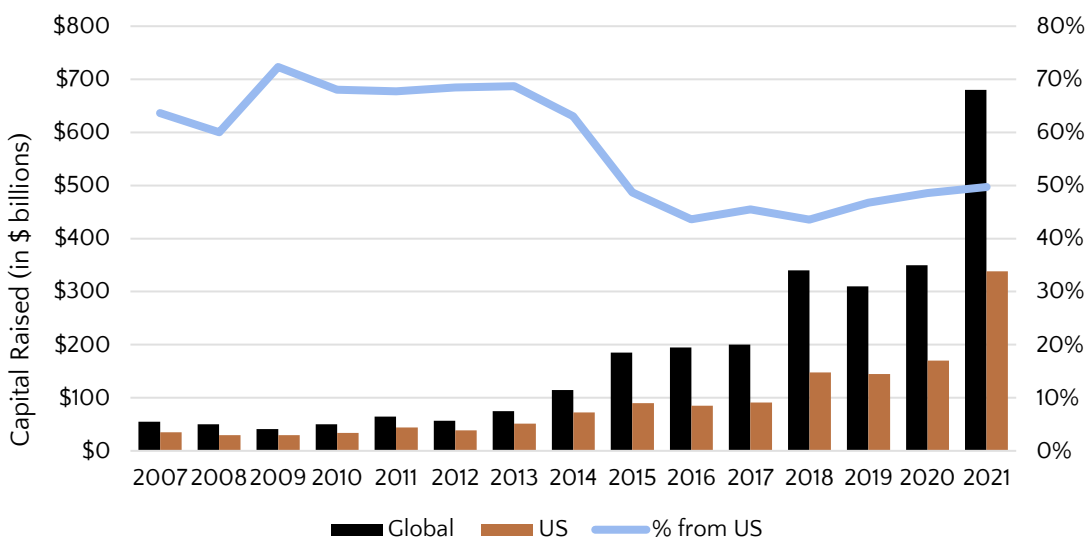
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US Corporate Bond Issuances: 2020 Q1 – 2022 Q1 (Source: SIFMA)



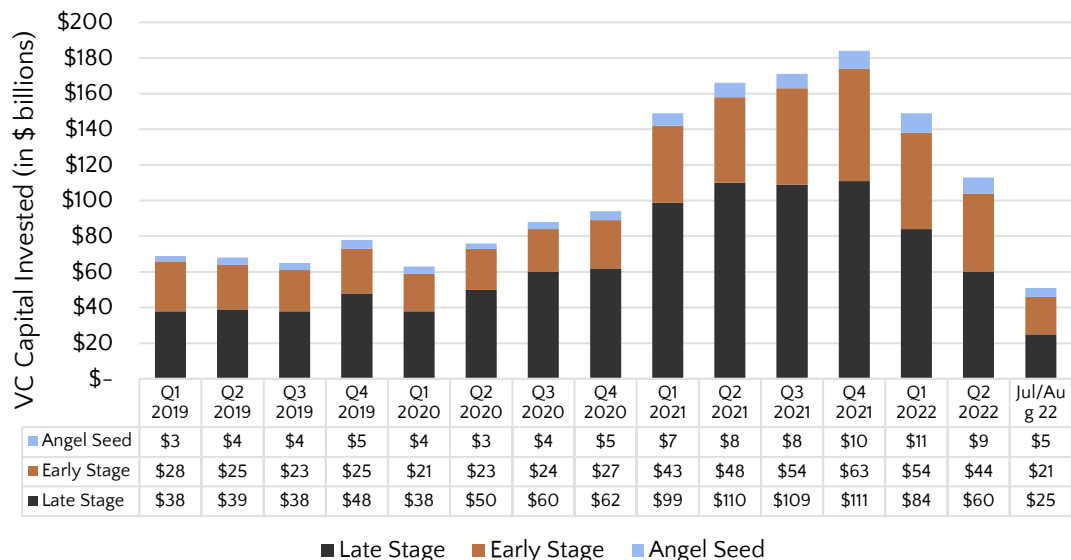
Capital allocations to early stage Venture Capital usually highlights the height of risk capital, and it has seen a steady growth both in dollar and total allocations. Historically, we observe sharp pullbacks in the aftermath of market shocks, albeit the capital allocations returned post COVID helped by artificially low borrowing costs.

Capital Raised by Venture Capital: US and Global 2007-2021 (Source: Crunchbase)



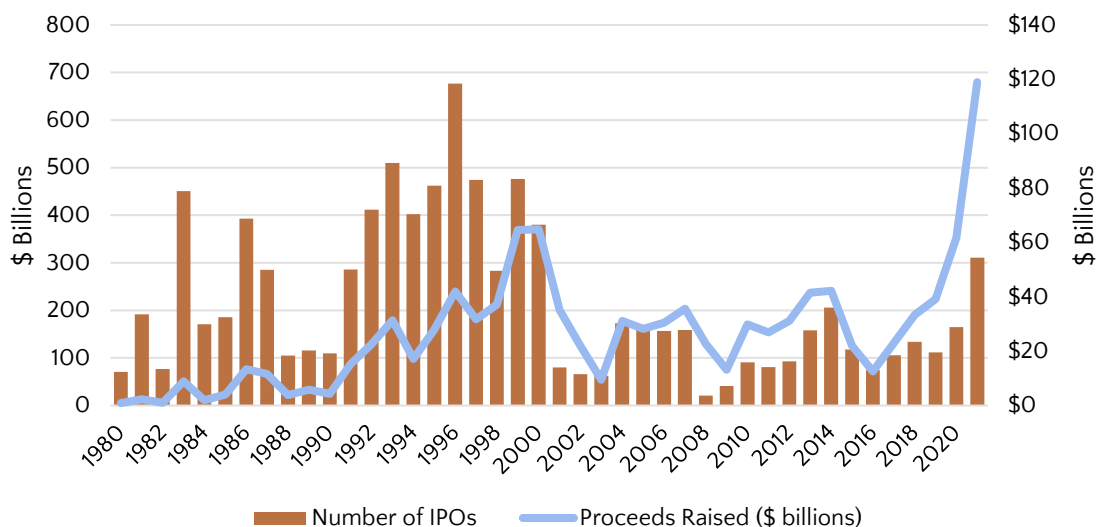
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US: VC Investing: 2019–2022 (Source: Crunchbase)



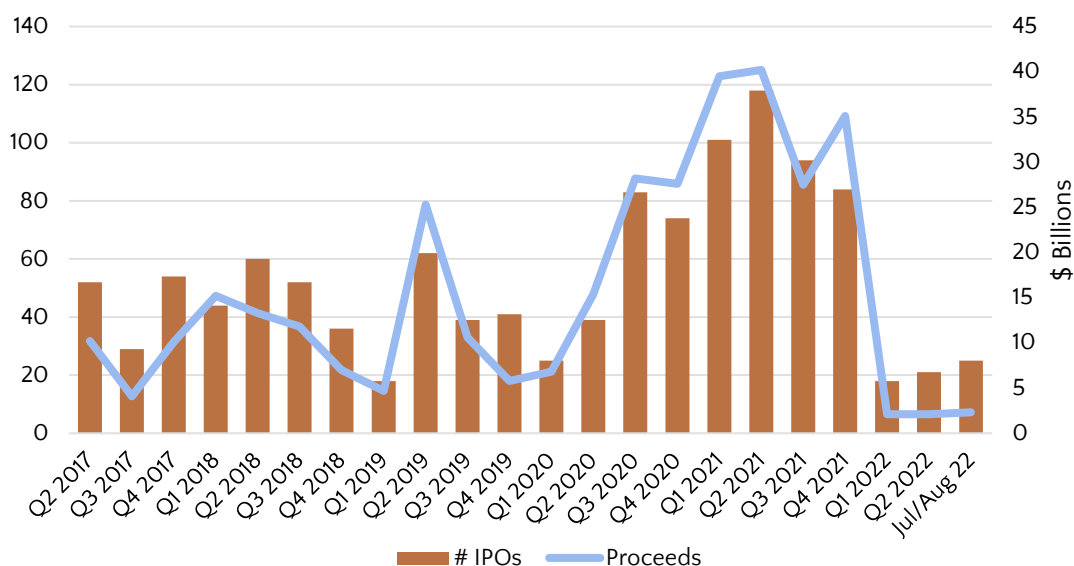
Note the drop off in venture capital in the first quarter of 2022, and the even steeper decline in the second quarter suggesting this may not be a temporary retreat. The number of IPO's and dollar values of initial public offerings historically has operated as a proxy for the availability of risk capital. We note a study from the University of Florida showing sharp pull back in the aftermath of market shocks as the flight to safety capital gathers pace.

US IPOs: Number and \$ Proceeds: 1980 – 2021 Source: (Uni. Florida, Jay R Ritter)



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US: IPOs by Quarter: 2017 - 2022 (Source: FactSet)



The market reaction to the rising rate environment has been violent and dramatic as seen in the drop off in the number of IPOs and the dollar values. Historically the recovery of this has been slow and we think may take longer as inflation and interest rates remain elevated.

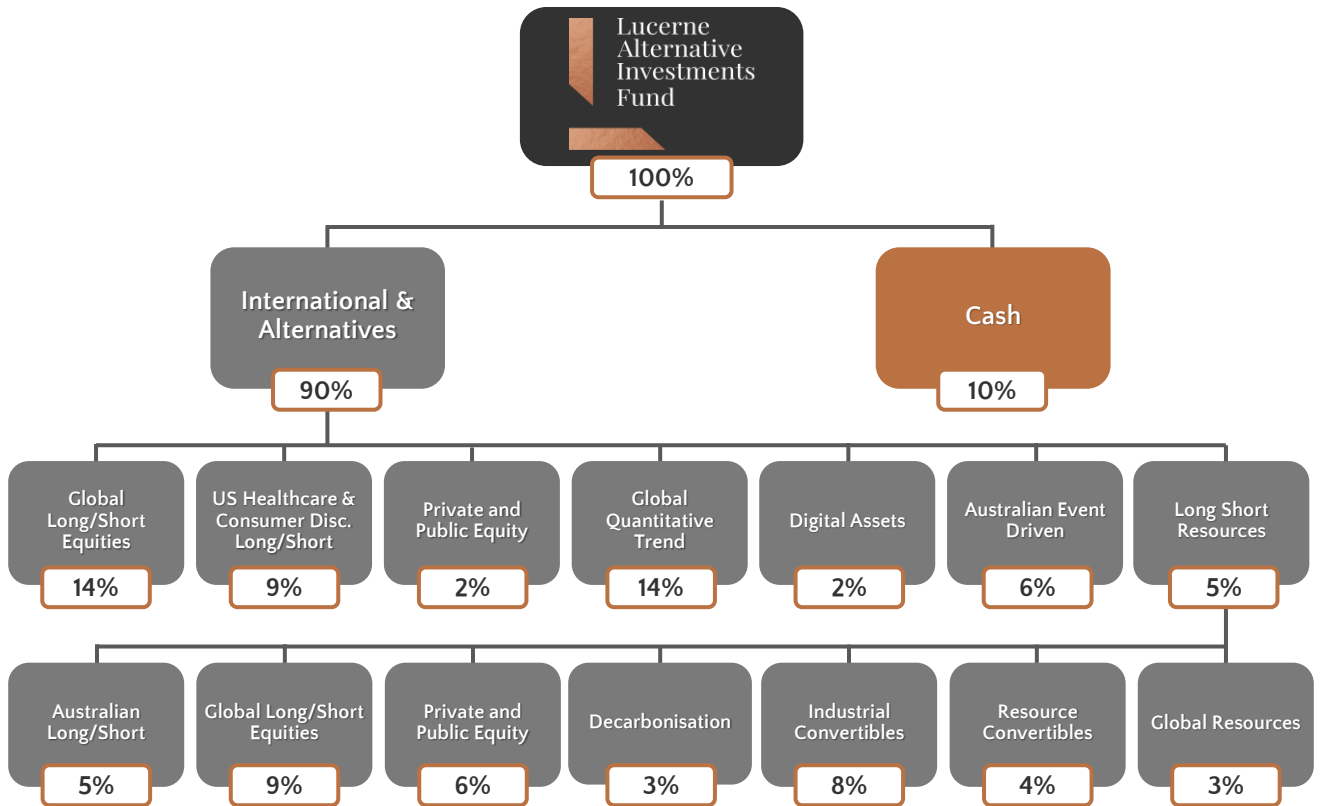
Volatility

The Investment Committee notes the effects of interest rates, exchange rates and capital movements have been significant and damaging as a consequence of inflation's return to the center stage. But the question remains of what the long term impacts on the economy and more importantly on the investor and consumer mindset would be. Data releases linked to the consumer have worsened as we have gone through 2022 even at historical lows in unemployment. Much has been debated on the central banks policy mistakes as the detrimental factor for the crisis. However, we believe it is inflation that is in the drivers seat, not the Central Banks. As noted earlier, interest rates have risen this year because of inflation expectations rising, and it is these higher rates (and expected inflation) that are leading the Central Banks to act. We expect high volatility to be a regular part of equity and bond markets as noted in our last report.

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Portfolio Movements

Lucerne Alternative Investments Fund continues to achieve uncorrelated and differentiated returns to equity and bond markets. The Investment Committee reduced exposures to strategies with high market beta on the back of our macro outlook and initiated a position in the De-Carbonisation theme.



If you, or someone you know, would like to talk with us, please do not hesitate to contact us at laif@lucernepartners.com to arrange a call. Thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

**The Lucerne Alternative Investments Fund
Investment Committee
November 2022**

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