UPDATE – COLLETTE CAPITAL WHOLESALE IMA STRATEGY

MARCH 1

COLLETTE CAPITAL
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Environment

The response to the global pandemic has seen the amplification of many of the policy responses that were authored in response to the GFC.

This has generally seen the price of risk assets increase, as different forms of stimulus have entered the system at unprecedented rates.

Despite increasingly theoretical economic theory now seeping into real world application, most remain of the view that debts will still need to be repaid by those that incur them.

States and institutions alike remain vulnerable to rising rates of interest and funding on their obligations.

All the while increasing fragility has found its way into the financial system.

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Some observers have suggested that Western economies have now been so financialized that they simply cannot afford the equity market to print significantly lower prices, for any meaningful length of time.

Even if one is sympathetic to these views, that does not mean that the stock market is not vulnerable to significant pullbacks over shorter periods of time, especially given the levels it is achieved relative to historic norms of valuation.

There is no guarantee that a pullback will max out at 20%, as was seen in short time during the taper tantrum of late 2018.

The introduction of unprecedented levels of institutional options interest and the hedging flows that result from the provision of those contracts by market makers, is but one catalyst for a potential increase in volatility in the short term.

Another potential catalyst is the reduction in net liquidity from monetary policy and general accounts alike.

Further, the stock market does not need to pullback 20% on a headline basis, for the wrong stocks to pullback many multiples thereof in the emerging space if they are not considered to be benefited by the prevailing or anticipated macro tailwinds of the moment.

The pullback in biotech stocks in the back end of 2021 and into 2022 is an example of this.

All duration risk assets have come under pressure as longer dated yields and in particular the oft-quoted U.S. 10-year yield have rallied strongly off historic lows.

Soaring energy prices are another input that add a top-down restraint to the current global economic recovery.

Performance

The IMA has continued to perform on a headline basis, and as at the end of February 2022 that performance stood at +30.6% p.a. since inception in January of 2015.

In recent months, that performance has almost entirely been driven by a position that earlier clients hold in Animoca Brands.

At the time of writing, Animoca is reflected on client portfolios at a value of A$4.50 – which is where they raised A$500mln during January of 2022.

Animoca was delisted by the ASX in March of 2020 with a last traded price of A$0.18, after which they raised in January of 2021 at A$0.35c, with subsequent raises at A$1.10, A$2.00, and A$3.00 across 2021.

The relative gains in Animoca have led clients whom started in the IMA Strategy later in FY20 or in FY21 (and so didn't have an investment in Animoca) to have a very different experience of the Strategy's performance to date.

If considered ex-Animoca, the Strategy still made gains in FY21, but at the time of writing it has given back those gains and then some so far in FY22.

To the extent that the IMA has returned in excess of 30% p.a. net of all fees on a TWR basis since the start of 2015, it is important to note that the IMA could be down 30% (or worse) in a given year given the risks that the Strategy takes.

This has been the case so far for a client whom commenced in the IMA on the 31st of May 2021 with a $300k investment, and is down -31.34% on a TWR basis (see the final page) or -$87.9k on a cash basis, as at the end of February 2022.

The Tissue Repair and Radiopharm IPOs in November of 2021 were significant contributors to these losses, and unprecedented in my 20 years of involvement in equity markets.

These names essentially halved in a straight line from their listing, and in the case of Tissue Repair (TRP), has now gone on to trade almost two thirds down on its issue price, without any sort of reprieve from the company or those that listed it.

I write all of this to again re-state the risks the Strategy entails in a relevant and clear manner.

When the IMA returned +1.5% against a benchmark of -26.72% during the March quarter of 2020 as the pandemic hit, that was in isolation a great outcome, and in part set the stage for the gains that IMA subscribers enjoyed over the next period.

However, the recent hawkish turn from the Fed that signals a pre-occupation with counteracting current reflections of inflation, was not similarly anticipated.

Not every macro- development, pullback or factor rotation will be perfectly or even partially hedged by the Strategy.

Given that equity markets average around +9% a year, from a probabilistic standpoint it makes sense for most equity-based strategies to lean bullish or long or net long most of the time, and that is true of this Strategy also.

The concern would be if there was no plan to redress the changes to the composition of markets currently being observed.

Liquidity above all else.

> We can only ever trade in price.

Whilst any number of narratives will always be available to engage in - that seek to explain what is happening in the market – at the end of the day we can only ever trade in 'price'.

Price has no knowledge of the narratives that supposedly explain it, it just is.

How we engage with price however is influenced above all else by the depth that exists in that measure, which we know as liquidity.

As time has gone on, it has become evident that liquidity is really the only game in town.

Every transaction is already hampered by the spread, the commission, the brokerage, the fee.

Whilst the downward pressure on these costs has been relentless in recent years and decades, participants have nonetheless become habituated to them as a cost of doing business and standard.

Most recently blockchain has entered the frame – and the ability to conduct what are known as trustless transactions – transactions where the assurance or confidence of the counterparty is simply not required because blockchain technology does not require it – is the perfect riposte to human inclinations.

Some blockchain related protocols already solve issues for liquidity by creating what are known as liquidity pools – which ensure the ability of participants to enter or exit at a price governed by a mathematical formula.

Liquidity pools in isolation are far from perfect vehicles, but they give participants liquidity at a price when it is required, as the world moves away from 30 hours a week and toward 24/7.

Returning to equity markets, and a focus on liquid investments through the lens of macro conditions, give investors the best chance to be nimble and responsive to evolving markets and conditions, without overcommitting in any given direction.

Every trade implicitly involves the adoption of a host of incomplete information, as it is impossible to know every relevant piece of information that forms an input into price, price discovery, or the likely path of a price over the time that a position will be held.

As participants, we need to ensure that we are limiting the number of unknowns to the extent that is reasonably possible.

Most explicitly, that involves employing rigor around liquidity, as the more liquid the activity at a given price, the more differentiated information is being brought to bear by varied participants in that market.

That is how we give ourselves the best chance to overcome our own inherent biases, focusing rather on the only thing that we can ever actually trade in.

Strategy

The following are some broad structures that the Strategy will be adopting in the short term, to respond to the evolving market conditions that have been referred to in this document.

There will be a stricter differentiation between exposures that have been adopted on a medium term, narrative basis – that is sacrificing for liquidity – and everything else.

There will only be five designated slots for medium term, narrative plays – and if being newly entered then any one of those plays will not exceed 5% of available funds in the IMA calculated in terms of cost base at the time of entry.

The rest of the available funds will be used on liquid investments – typically with a macro-focus.

Existing exposures will be excluded from the above process.

Outside of the first five designated slots (and there may well be less than five for periods of time, but there will not be more) – this will result in more incisive market exposures with tighter stops.

It will also result in higher cash balances for periods of time when there is felt to be no edge in additional exposure.

IPOs are highly unlikely to be entertained although placements in sufficiently liquid names will be considered.

Investors coming into the IMA do not have the existing position set replicated, but rather receive the next trade that the IMA undertakes.

An entity in which I am a beneficial holder is increasing its commitment to the IMA from $1.5m to $2m AUD as at the start of March 2022.

This will not be the last change to the Strategy – in response to market conditions or otherwise – as we must trade the market we have in front of us – not make the market into what we want it to be.

If one looks closely the Strategy itself is not actually changing in any significant way, rather it is doubling down on liquidity as the vehicle by which to seek the most beneficial exposure to price.

The purpose of this missive is to explain some of the thinking that goes into the Strategy - as it necessarily evolves in pursuit of best outcomes - and to again reiterate what might reasonably be achieved.

The only guarantee is change, and as trite as that adage is in isolation, we cannot sit still given all that it implies.

Additional Disclosure with reference to TWR method of calculating return:

The Time Weighted Return (TWR) method allows the calculation of returns according to the amount invested on any given day – excluding cash.

In so doing it does not take into effect the amount of any cash that the client or account is holding on any given day.

This has the effect of amplifying stated positive or negative returns relative to dollar outcomes in any period where the client is not 100% invested and so is holding no cash.

In simple terms, this means that if the client offers an investment of $300k in the Strategy and has a stated return of 15% over a given period net of all costs but has only averaged 50% drawn down (50% cash), then the return will have been +$22,500 as opposed to +$45k for that period.

However, the opposite would also be true if the stated return were -15% under TWR, the loss will have been -$22,500 as opposed to -$45k for that period.

The TWR method is used in calculating returns for Collette Capital Wholesale IMA Strategy because the client account upon which the reporting is based has historically settled to an external bank account.

Incoming clients should know that use of the TWR method in their instances will take into account any cash on deposit at CMA, as all incoming clients are required to have excess funds on deposit at CMA.

A detailed explanation of the TWR method for calculating returns is available here:

https://au.praemium.help/home/twr-percentage-return-calculations-in-the-investment-movements-report

All trades that have contributed to the stated return are available upon request.

Additional Disclosure with reference to the Performance Figures:

The performance figures are based on an account with $1,325,000 in the Strategy as at the start of January 2022. The amount that this account has made available to the Strategy has changed over time and since inception. The minimum to participate in the Strategy is $100,000. As at the start of January 2022, accounts considered to make available or be likely to make available to the Strategy an amount between $100,000 and $500,000, will hold a smaller position set, which may not include the same composition as that held within the account and / or position set used to calculate the performance figures, and hence the returns on those accounts will vary from those included in this report.

Incoming accounts do not have the existing position set of the Strategy replicated, rather they receive the next position the Strategy acquires from their start date. This also has the effect of varying returns on new accounts from the returns included in this report. Investment performance includes dividends (but not franking credits) and is calculated net of all fees. Past performance is not a reliable indicator of future performance. Individual IMA Strategy results will differ depending on committed funds, start date, brokerage, fees and taxes. Quoted returns are based upon a client account which has historically operated with a brokerage charge of $75 or 0.5% whichever the greater, and no management fee. At times the manager will vary the brokerage down in the client's favour, but never up.