STENHAM ASSET MANAGEMENT

Q1 2022 Investment Letter

with Kevin Arenson & Tim Beck

Market Commentary

Equities	Q1 2022	2021
MSCI World (USD)	-5.5%	20.1%
MSCI EM (USD)	-7.3%	-4.6%
S&P 500	-4.9%	26.9%
Eurostoxx 600 (USD)	-9.0%	13.9%

Fixed Income	Q1 2022	2021
FTSE Global Bonds	-6.5%	-7.0%
Investment Grade	-8.3%	-1.5%
High Yield	-4.4%	4.5%
Barclays Global Agg Bond	-6.2%	-4.7%

Currencies	Q1 2022	2021
USD (DXY)	2.8%	6.4%
EUR (vs USD)	-2.7%	-6.9%
JPY (vs USD)	-5.4%	-10.2%
GBP (vs USD)	-2.9%	-0.9%

Commodities	Q1 2022	2021
Gold	6.5%	-3.6%
Oil (WTI)	33.3%	55.0%
Natural Gas	51.3%	46.9%
Bloomberg Commodity	25.5%	27.1%

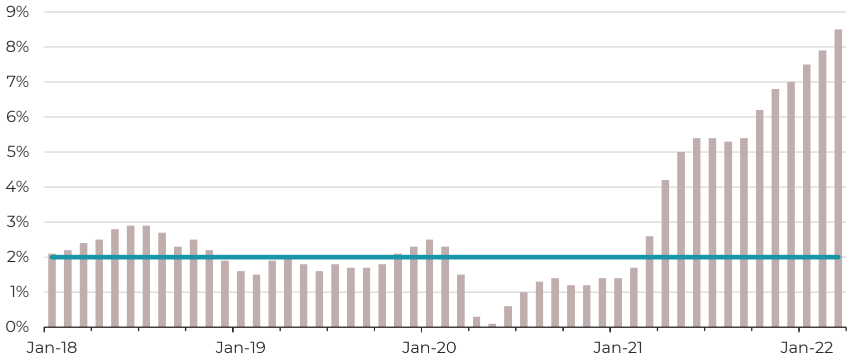
Source: Bloomberg as of 31 Mar 2022

Risk assets came under significant pressure in the first quarter of 2022. Concerns over inflation and the indication from central banks that they will aggressively increase interest rates initially drove markets lower, followed by the invasion of Ukraine by Russia. After the initial shock of the invasion subsided, investors refocused on inflation. The invasion and subsequent sanctions by the Western World against Russia only increased inflationary pressures, most obviously in natural resources but also across broader supply chains. In response to accelerating inflation, the US Fed raised short-term interest rates for the first time since 2018 and guided (increasingly so since) towards future rate hikes for the rest of the year. The yield on 10 Year treasuries hit 2.4%, the highest level since the Covid pandemic and has continued to rise, approaching 3%.

Both equity and, perhaps more importantly, fixed income indices saw significant losses, with only commodities as a broad asset class positive. The S&P 500 and MSCI World fell 5.0% and 5.5% respectively, high yield dropped 4.4% and investment grade fell 8.8%, whilst US treasuries experienced their worst quarter since 1973. These falls are all the greater given the poor yield on offer at the start of the year. Many observers' favourite leading indicator of a recession, the slope of the yield curve between 2 and 10 Year treasuries, inverted during March.

Inflation continues to vastly exceed targeted levels and central banks seem to have found religion and realise they must act to bring it down. Narratives over inflation being transitory, a result of corporates profiteering and overall being a benefit as it was leading to wage increases for the poorest, have all subsided to the need to do what is necessary to bring inflation down. Central banks around the world are behind the curve and the question is how high interest rates need to rise.

US CPI[1]



To bring down inflation, central banks must bring down demand. Supply can only adapt over the longer term and the belief/hope it could occur quickly this time has failed. Demand can decline most obviously through an economic slowdown (or recession), though, potentially, from a significant drop in financial markets. It is unclear which will come first or if they can in fact be divorced. Clearly, central banks want to avoid a recession.

Historical precedence is against this occurring. Research from Alex Domash and Larry Summers[2] shows that unemployment and inflation at these levels has historically led to a recession. In fact, since 1955, there has never been a quarter with average inflation above 4% and unemployment below 5% that was not followed by a recession within the next two years.

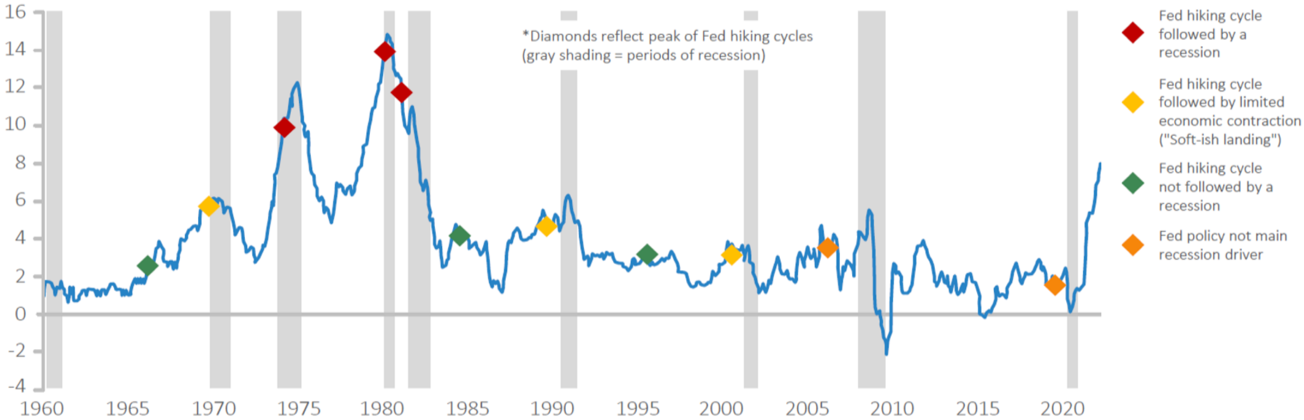
Historical probability of a recession conditional on different levels of CPI inflation and unemployment[3]

	Avg quarterly inflation above:	Avg quarterly UR below:	Probability of recession over next 4-quarters	Probability of recession over next 8-quarters	Number of quarters	When did US economy most recently cross threshold?
Inflation only	3%	#N/A	27%	48%	95	Q2 2021
	4%	#N/A	37%	59%	51	Q2 2021
	5%	#N/A	45%	62%	29	Q3 2021
UR only	#N/A	6%	25%	47%	142	Q2 2021
	#N/A	5%	31%	57%	83	Q4 2021
	#N/A	4%	42%	69%	26	Q1 2022
Inflation and UR	3%	6%	43%	75%	53	Q2 2021
	3%	5%	54%	85%	26	Q4 2021
	3%	4%	54%	85%	13	Q1 2022
	4%	6%	59%	89%	27	Q2 2021
	4%	5%	73%	100%	11	Q4 2021
	4%	4%	57%	100%	7	Q1 2022
	5%	6%	83%	100%	12	Q3 2021
	5%	5%	100%	100%	5	Q4 2021
	5%	4%	100%	100%	3	Q1 2022

Looking at prior periods of interest rate tightening, there have indeed been occasions of a “soft landing”, but this becomes more rare at high inflation levels. A recession has not been avoided when inflation has been at these levels.

[1] *Source: Bloomberg as of 31 Mar 2022.*
[2] *Alex Domash is a Research Associate and recent graduate of a Masters in Public Administration in International Development at the Mossavar-Rahmani Center for Business & Government at the Harvard Kennedy School. Lawrence Summers is the Charles W. Eliot University Professor and President Emeritus at Harvard University (MPA/ID) program at the Harvard Kennedy School.*
[3] *As of 31 Mar 2022 using data from 1955 – 2019. Sources: Bureau of Labour Statistics via FRED, authors' calculations.*

Headline CPI Inflation, % YoY[1]



Inflation has been rising, and whilst there may be some decline from base effects and supply chains, though the current lockdowns in China suggest further disruption in supply chains, it does seem to be more embedded. Wage rises are occurring across the board. Companies were already looking to shore up supply chains following the Covid crisis and this process has only become more urgent. This is not without cost and will result in higher prices. The Russian invasion of Ukraine has exacerbated pre-existing pressures. Already stretched supply chains and commodities are those most acutely impacted. Longer term, the reorientation away from reliance on Russian energy, particularly in Europe, adds to these pressures. Analysis from the Atlanta Fed (with a similar paper from the NY Fed) shows "sticky" inflation rising well above the long-term target.

Economic growth has been strong coming out of 2020, though already moderating to some extent remained healthy.

Composite PMIs[2]

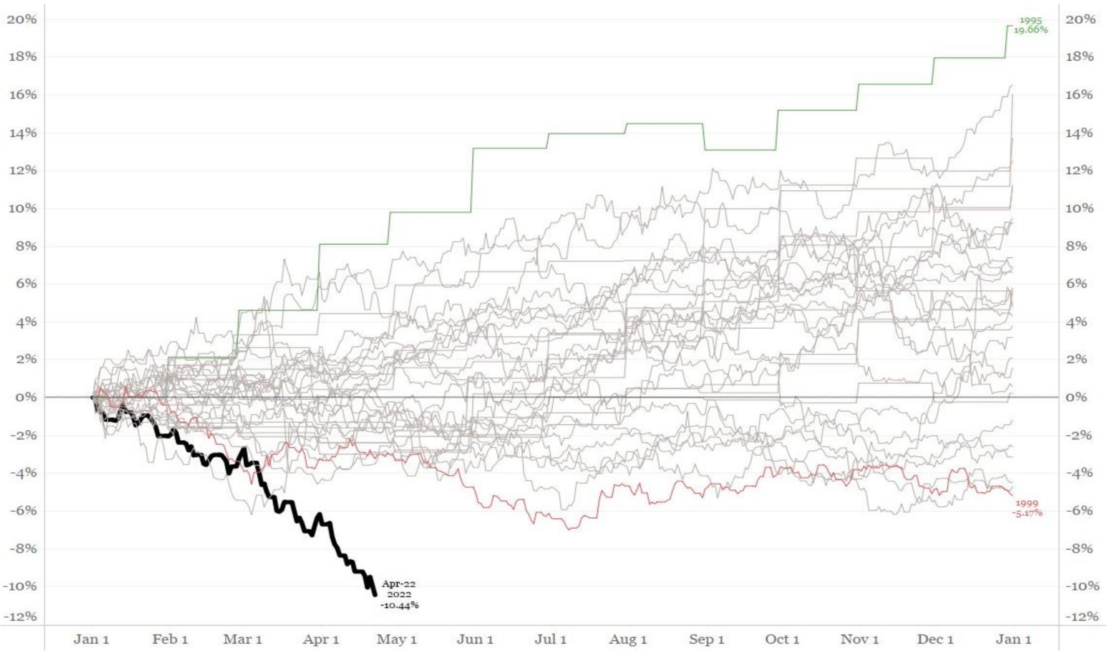
	2020			2021												2022		
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Global	53.3	53.1	52.7	52.3	53.2	54.8	56.7	58.5	56.6	55.8	52.5	53.3	54.5	54.8	54.3	51.1	53.5	52.7
Developed	52.7	52.2	52.0	52.4	53.9	55.9	58.2	61.1	59.3	57.5	54.1	53.8	55.2	55.8	54.8	51.2	54.7	56.0
Emerging	54.5	54.9	54.1	52.1	52.0	52.6	53.5	52.8	50.8	52.0	49.3	52.3	52.8	52.5	53.3	50.8	51.3	46.8
US	56.3	58.6	55.3	58.7	59.5	59.7	63.5	68.7	63.7	59.9	55.4	55.0	57.6	57.2	57.0	51.1	55.9	57.7
Japan	48.0	48.1	48.5	47.1	48.2	49.9	51.0	48.8	48.9	48.8	45.5	47.9	50.7	53.3	52.5	49.9	45.8	50.3
China	55.7	57.5	55.8	52.2	51.7	53.1	54.7	53.8	50.6	53.1	47.2	51.4	51.5	51.2	53.0	54.2	59.9	60.9
Eurozone	50.0	45.3	49.1	47.8	48.8	53.2	53.8	57.1	59.5	60.2	59.0	56.2	54.2	55.4	53.3	52.3	55.5	54.9

The Russian invasion of Ukraine is most acutely felt in supply chains and commodities, which were already stretched. The whole world is impacted, though Europe is worse hit due to its reliance on Russian energy. Europe is also more industrially focused than the US. Economic activity is going to be impacted more broadly though by inflation and price rises for food and energy, which will impact the poorest most. Both good demand and wages are 20% above 2019 levels. This is not sustainable and economic growth will be hit as prices escalate to levels which dent demand.

[1] *Source: "Landings Hard and Soft: The Fed, 1965 2020" Alan Blinder (2022), Alan Blinder (2022), Goldman Sachs GIR.*
[2] *Source: Bloomberg as of 31 Mar 2022.*

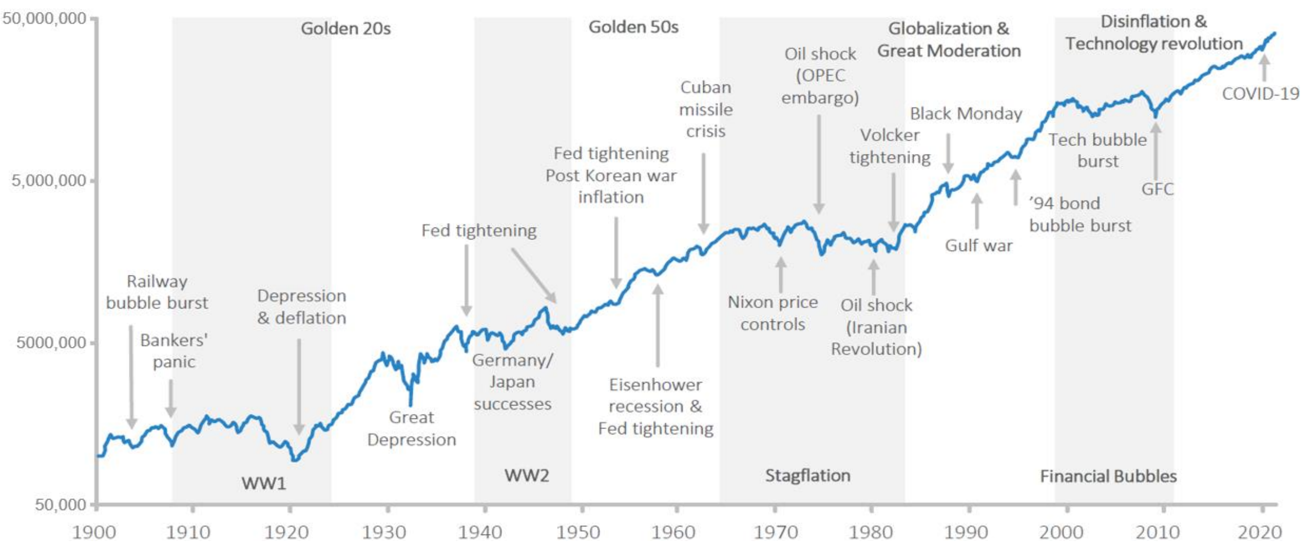
Whilst equity investors are somewhat accustomed to volatility, as unpleasant as it may be to live through, fixed income investors are less so, especially given the multi-year decade trend of declining interest rates, which drove fixed income prices up and also generally offset losses in equity allocations given the decline in interest rates at times of economic stress. In fact, this is the worst drawdown seen in the Barclays Global Aggregate Index since its inception. The scale of the losses is really unprecedented.

Bloomberg Global Aggregate Total Return Index[1]
Daily YTD total returns



There is the real potential that we are at a crossroads. The traditional investment in a portfolio of 60% equities and 40% bonds has generated strong returns over time and, as alluded above, reduced volatility as bonds have tended to outperform at times of equity weakness. However, there have been periods where this has not occurred and long periods of time when that portfolio allocation has not generated returns.

Real total performance of US 60/40 portfolio[2]



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[1] *Source: Bloomberg*
[2] *Monthly rebalancing, shading denotes 'lost decade'. Source: Goldman Sachs Global Investment Research.*

We could be entering a similar environment. Inputs into models will vary but analysis by Goldman Sachs indicates that returns from such a portfolio will be muted at best if inflation declines to the target of 2%, and if inflation averages at 3% it could prove very difficult to generate positive real returns. Disposable income for the poorest in society is going to fall after energy and food costs are taken into account.

US 60/40 real return = 5.0% - 0.25% x (S&P 500 Shiller P/E - 16.5) + 0.67 x (US 10yr yield - 4.6%) + 0.53 x (10yr DPS growth - 4.5%) - 1.33 x (10yr CPI inflation - 3%)[1]

Dividend growth (next 10 years)	US CPI inflation in the next 10 years								
	0.0%	**0.5%**	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**	**3.5%**	**4.0%**
-6%	-4.3%	-4.9%	-5.6%	-6.2%	-6.9%	-7.6%	-8.2%	-8.9%	-9.6%
-4%	-3.2%	-3.8%	-4.5%	-5.2%	-5.8%	-6.5%	-7.2%	-7.8%	-8.5%
-2%	-2.1%	-2.8%	-3.4%	-4.1%	-4.8%	-5.4%	-6.1%	-6.8%	-7.4%
0%	-1.0%	-1.7%	-2.4%	-3.0%	-3.7%	-4.4%	-5.0%	-5.7%	-6.4%
2%	0.0%	-0.6%	-1.3%	-2.0%	-2.6%	-3.3%	-4.0%	-4.6%	-5.3%
4%	1.1%	0.4%	-0.2%	-0.9%	-1.6%	-2.2%	-2.9%	-3.6%	-4.2%
6%	2.2%	1.5%	0.8%	0.2%	-0.5%	-1.2%	-1.8%	-2.5%	-3.1%
8%	3.2%	2.6%	1.9%	1.2%	0.6%	-0.1%	-0.8%	-1.4%	-2.1%
10%	4.3%	3.6%	3.0%	2.3%	1.6%	1.0%	0.3%	-0.3%	-1.0%
12%	5.4%	4.7%	4.0%	3.4%	2.7%	2.0%	1.4%	0.7%	0.1%
14%	6.4%	5.8%	5.1%	4.4%	3.8%	3.1%	2.5%	1.8%	1.1%

Outlook

We are potentially in a very different investment environment from that we have experienced in recent decades, with different themes driving markets. Most obviously, this is the reversal of ever lower interest rates driving markets. Inflation is high and central banks realise they need to act and they will do this by raising rates whilst also reducing the size of their balance sheets.

Economic growth is positive and, in many respects, strong. Corporate defaults are low (with limited near-term maturities), US unemployment is below 4% and there is lots of capital available; mutual fund cash balances are elevated and there is estimated to be over $1tn of private debt and equity capital raised, but yet to be deployed. Nonetheless, the impact of inflation, in particular in energy and food, and higher interest rates is going to impact consumer spending and overall growth. History is against central banks being able to bring down inflation from these levels without a recession ensuing.

One area which is most definitely changed is the freedom of action of central banks. It would be a vast understatement to say that we are in a significant geopolitical crisis. At a similar point in the last decade, central banks would have flooded the market with liquidity. They no longer have that freedom. Instead, we have hawkish statements from central banks on action they will take to bring down inflation.

Strategy Allocations

All strategies bar equity-related strategies were positive in Q1, with the strongest performers being those within discretionary macro. This is encouraging given the difficult market for almost all asset classes during the period. Our portfolios' performance depended upon overall exposure to equities. Portfolios with limited

[1] *The model is based on a regression of 10 year rolling US 60/40 real returns on starting valuations as well as dividend growth and inflation during the investment horizon, all relative to their LT average since 1900. The intercept is the long run average real return of a 60/40 portfolio and the regression coefficients indicate potential drags/boosts to real returns in the event explanatory variables are above/below their long run average. Source: Robert Shiller, Datastream, Goldman Sachs Global Investment Research.*

beta to equities generating positive performance. We are not making many changes to portfolios; at the margin we are further reducing equity exposure and we are looking at adding some exposure to commodity strategies. Within equity strategies, we are looking to ensure we are not overweight growth-orientated managers compared with value.

We believe the current environment, with uncertainty over the path of interest rates and strength/direction of economic growth, continues to create an attractive opportunity set for alternative strategies, both in absolute and relative terms.

Discretionary and Systematic Global Macro

Macro strategies drove gains during the quarter. Macro managers had believed for much of the last year that inflation was likely to prove stickier than the US Federal Reserve's forecast and had built sizeable short positions in the front end of the US rate curve. These positions drove returns in Q1 as markets repriced inflation expectations and Fed hiking projections. Our top performers were classic discretionary thematic macro managers who run more focused risks. These managers expressed short positions in fixed income via options and were able to generate gains both from rates moving higher and volatility repricing upwards. We also saw strong performance from a multi-strategy macro fund who benefitted from their quantitative strategies, commodity trading and discretionary macro allocations. The only laggard for the quarter was a manager who has been amongst our top performers in each of 2020 and 2021. This manager focuses on trading macro, event and volatility strategies. The manager suffered from a long bias to non-US equities versus US equities and a long bias to emerging market currencies.

Relative value strategies also performed well. Our top performer was a manager who acts as a hedge to our portfolios. This manager is always positioned long volatility and does not take significant delta risk to assets. Long volatility positions in US interest rates drove gains. The manager also made gains from currency volatility positions. This manager has shifted exposures actively in recent months and increased exposure to long volatility positions in currencies, which they believe offer compelling value. Our fixed income-oriented relative value funds were positive on the quarter but posted more muted gains. Our multi-strategy relative value manager outperformed the fixed income-oriented relative value funds.

Finally, quantitative and commodity strategies also performed well. One of our quantitative funds generated outsized returns in January from the stock market rotation. Our exposure to commodity strategies via both discretionary and systematic funds was very profitable during the quarter. Gains came from a general long bias to energies, metals and agricultural commodities. Our managers navigated the unprecedented volatility in various commodity markets including nickel and European gas very well.

We remain constructive on trading strategies in this environment. There has been increasing volatility in all asset markets, which is creating more opportunities. Risk management is vital in this environment and we are continuing to favour those managers with a proven history of protecting from left-tail risks and who can navigate periods of market dislocations.

Equity Long/Short

There was a high level of performance dispersion among our equity long/short managers in Q1. Given it was a weak quarter for equities, the managers that outperformed were generally those running low net exposure and/or a more defensive portfolio tilt. We are reasonably pleased with how our more defensive managers have performed in this difficult environment. These managers typically have an acute understanding of how their portfolios are exposed to various risks, including factor, size, and crowding, allowing them to largely mitigate these risks through the quarter. As such, their performance has been somewhat independent of broader equity indices. The funds that struggled the most were those exposed to high valuation growth stocks or biotech as a sector.

Within equity markets, there was a clear underperformance of growth stocks relative to their value and more cyclical counterparts. The Russell 1000 Growth Index was -9.2% while the Russell 1000 Value Index was -1.3%. A large part of the value/cyclical outperformance was due to the staggering rally in energy stocks; the S&P Energy sector was +37.7% through the quarter. This made it a difficult environment for our long-biased secular growth equity long/short allocations, which typically have no exposure to energy as a sector, resulting in them falling in line with broad growth indices.

We continue to like healthcare as a sector. Broad healthcare proved to be a relatively defensive sector in Q1, although biotechnology as a sub-sector struggled, falling 20%. Several of our healthcare managers performed relatively well, especially those aiming to achieve non-directional returns. Our more long-biased biotech managers struggled, although the opportunity set and valuations within this sector remain compelling.

Chinese equity markets were particularly weak; the MSCI China All Shares Index fell 14.3%. Foreigners dumped Chinese stocks at a record pace, with net outflows of $6bn via Hong Kong's stock connect scheme. This was largely on the back of new Covid lockdowns, as well as the SEC clamping down on Chinese ADRs listed in the US. Our China-orientated managers have been proactive in reducing risk into what has been a tough quarter, with many of them successfully limiting losses relative to broad indices.

Event Driven

Our event driven allocation was positive in Q1. Merger activity continues at a decent pace; $1.3tn of deals were announced following $1.8tn in Q4 2021, the highest quarterly figure since Q4 2015[1]. The best performer was our higher risk manager, who benefited from some merger positions closing during the period. The manager entered 2022 with a relatively high amount of risk in the portfolio, reflective of the high level of merger activity during 2021, and saw gains across merger arbitrage, as well as a soft-catalyst position in the natural resources sector. Our other managers saw more subdued performance. One manager continues to have a high proportion of their portfolio in SPACs. SPACs within the portfolio trade at a discount to Trust value and offer a positive return with optionality if a SPAC announces a deal which is well received by the market.

Credit

The credit allocation continued to generate good returns, following on from a strong performance in 2021. Whilst headline credit indices are negative in Q1, and significantly so, this was due to the impact of interest rates, as well as spread widening and in fact the latter has been somewhat more orderly. Despite that, it is encouraging that even more directional managers (such as distressed debt) were positive as events occurred to drive performance. Our funds were also able to take advantage of volatility in the market as events such as

[1] *Source: Bloomberg.*

the invasion of Ukraine created at times indiscriminate selling of, for example, bonds in Eastern Europe infrastructure companies.

We continued to be active in allocating to drawdown private credit funds. This encompasses distressed debt, as well as niche areas of direct lending and specialty finance across the risk spectrum, though we target a net IRR of >10% for our investments. The difference in returns and yield available from private credit compared with publicly-traded credit is at wide levels and offers attractive yields in today's low interest rate environment.

Summary

We are overall pleased with performance in Q1, a period when almost all traditional asset classes experienced large drawdowns. Uncertainty continues and the themes which have dominated investing for previous decades, most clearly the continuous decline in interest rates, may well be changing. There is the real chance that returns from traditional investing disappoint and do not meet the return objectives of investors. We feel that alternative investments offer a valuable role in portfolios to address these concerns.

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.

Kevin Arenson
Chief Investment Officer

Tim Beck
Senior Investment Executive

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