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Private and confidential

Latitude Horizon Fund - Philosophy

LATITUDE
INVESTMENT MANAGEMENT

FREDDIE LAIT
LATITUDE INVESTMENT MANAGEMENT

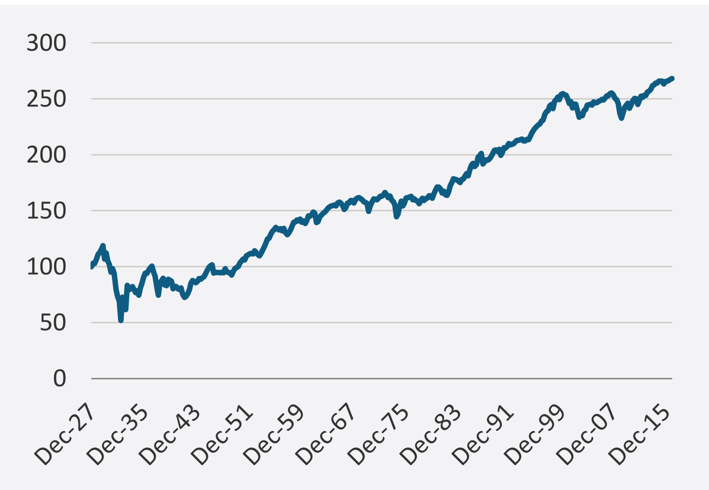
“We live in a world of low returns and high volatility, all we can do is plan accordingly.”

Equities, in the long term, earn investors returns by delivering "risk premium" above the risk free rate. When risk free rates are near zero, expected returns reduce to purely that risk premium. Moreover, since interest rates breached their zero bounds, market participants have lost their compass. The result has been an increase in volatility across asset classes, accentuated by the prevalence of trend following strategies and a rising proportion of fund managers chasing shorter term returns. So expected returns are lower and expected risk is higher. Portfolio construction and risk control are more important than ever.

Our fund is centred on a portfolio of single stock equity investments, with cash and non-equity investments alongside which are intended to produce ample returns while reducing downside risks. We embrace volatility at the individual investment level, while continuously endeavoring to reduce it at the portfolio level. This can be done without the need for short strategies or leverage by using the primary findings of diversification theory, behavioral finance, and by taking a genuinely long term approach to every investment we make.

Equities are expensive in absolute terms but they continue to offer higher prospective returns than any other asset class we can identify, despite the recent rises in yields. They also offer an inflation hedge and, as such, should continue to constitute the majority of an investor’s portfolio.

1. Long Term Equity Performance – Log Chart



Source: Bloomberg

Those who fear buying at "all time highs" need to remember that, by definition, this has been a feature of every bull market in history (c.f. chart 1). This is not to say that we are bullish *per se* and, in any event, our portfolio construction is not affected by individual views on the market.

However, given that equity volatility is set to remain high with frequent bouts of sharp drawdowns, the Horizon Fund will likely continue to invest only c.50-60% of its assets in the stock markets. With the remaining funds, we seek out investments with the following characteristics: low downside, small expected positive returns above cash, and negative correlation to equity risk or a particular factor risk which we may be exposed to in the equity portfolio. This way, our overall exposure to drawdowns in the equity markets should be less than 50% and we should have “dry powder” available to buy stocks if we see bargain prices emerging from such a drawdown.

For both the equity portfolio and the overarching asset allocation we try our best to eliminate forecasting as an input to decision making, relying instead on *ex ante* analysis. For the equity portfolio this is centered on fundamental analysis of the supply side of each industry, the current state of competition, regulation and pricing, as well as the position in the capital cycle. For the non-equity investments we look at *current* correlations very closely, which can change very sharply in the present environment, as opposed to using long term relationships to predict the future. For the asset allocation we take stock of current economic conditions, without making calls on the future. In short we attempt to make a sensible, simple assessment of the current environment, and construct a portfolio which is balanced to face the risks and likelihoods that are already in evidence.

We will be discussing the portfolio composition in greater length in the end of year report, so we don’t want to duplicate that work here. Instead we have chosen to jot down a few currently held views which have helped inform the portfolio construction in the past, and likely will in the future. In no particular order:

Long termism is one of the few advantages left to fundamental investors, and we hope to use it to our benefit.

Knowing the most about a company bears little correlation to making the most money out of a stock, or a portfolio of stocks.

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Knowing what to look for is more important than knowing more. We would rather be roughly right than exactly wrong and, as such, steer clear of detailed mathematical modelling believing, as we do, that good decisions are based on knowledge, not numbers.

In general non-cyclical companies are vastly preferable to cyclical companies. However, when individual industries have undergone a sharp cyclical contraction which results in reduction in aggregate capital employed, improving competition and regulation, and a change (for the better) in corporate management, then portfolios should be comfortable allocating capital to such industries.

At times of uncertainty investors seek what is certain, and price is more certain than value. Chasing price has led to the strong momentum in fewer and fewer stocks, increasing volatility and the voracity of sector rotations within the market. This is likely to continue and something we monitor continuously.

Commodities are not an asset class. They do, however clearly influence countries' economic fortunes and are an incredibly hot topic at the moment. We believe the recent price increases have been led by financial speculation as opposed to a genuine supply side recovery. In particular, the view that Donald Trump's fiscal initiatives in the US have justified such a strong increase in the price of commodities seems excessive. We know little of his policies but if Trump spends $1tn over ten years as he suggests, assuming $100bn per year, and a 30% raw material cost, this is a $30bn incremental demand for commodities, likely starting in a few years. If 20% of this demand, as an example, is spent on steel this implies a 1% increase in global demand.

Quantitative easing and other loose monetary policies have run their course, and fiscal easing across the globe will pick up the baton from here. This is broadly positive for equity markets, and broadly negative for conventional bonds.

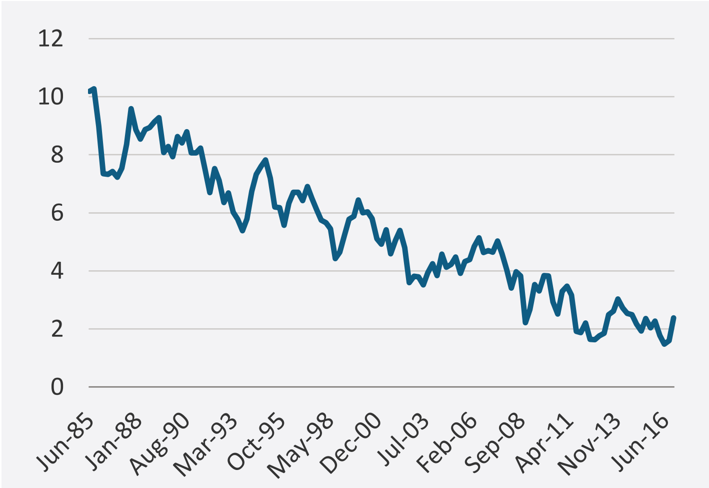
We believe the world continues to be caught in a deflation / inflation cycle as opposed to being destined one way or the other at this stage. Clearly we are on a reflation leg of that cycle at the moment. We believe this is broadly positive for equity markets, and broadly negative for conventional bonds.

We want to make two points on the political and social landscape and leave it there, because we're certain you have read views from every angle. First, liberal classes' silence in the face of populism gives consent to the movement. Expect more of the unexpected in politics until there is real change from within the system. Second, the democratic systems which we have built in the West are built to withstand abuses of power, demagogic influences included, so don't expect an end to the status quo anytime soon.

There are so many things to be worried about; you can literally take your pick: Trump, Putin, China, populism, inflation, deflation, QE, the end of QE etc. Calling turning points in financial markets is nearly impossible to do consistently, and we will not try.

We believe we have something subtly unique at Latitude, and would be delighted to share our philosophy and process with you over the coming months and years. Please get in touch if you would like to hear more about our story.

2. Long Term US Bond Yield Trend



Source: Bloomberg

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