Fortem Capital Alternative Growth Fund

FORTEM CAPITAL

Annual Commentary – 29th December 2023

UK & EU – For professional and institutional investors only
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2023 saw major shifts in rhetoric, policy & sentiment.

As the year began, softening inflation, foreign USD investment, a lack of treasury issuance, and the birth of AI in the public consciousness led a significant rally in duration and risk assets, particularly technology stocks. By the end of the first quarter, a re-acceleration in core inflation, higher coupon issuance, and a hawkish Federal Reserve led to bonds and equities selling off together once more and culminated in a banking crisis that prompted significant policy action.

That significant policy action, including BTFP (which was not another form of QE, but a short-term stabilising measure that still remains in place) and the underwriting of deposit accounts led to loose financial conditions and another large rally. The Treasury's August QRA then surprised the market with high coupon issuance and bonds and equities sold off once more.

The end of October saw another QRA surprise, but this time through huge bill issuance followed by the two most important policymakers in global markets declaring the war against inflation over, having not inflicted the employment and growth casualties one would usually associate with such a victory. The market, which priced in more of a consensus that any landing at all had been avoided through the year, went all in on soft/no landing.

Total Return	2023	Q4
UK 100	7.9%	2.3%
US 500	25.7%	11.6%
Europe 50	22.2%	8.6%
Japan 225	30.4%	5.2%
Hong Kong 50	-10.6%	-3.9%
US 2000	16.9%	14.0%
Swiss 30	7.1%	1.6%
Global Equity	23.8%	11.4%
Global Bond	5.7%	8.1%
Commodities	-12.6%	-5.9%
PGF	**12.4%**	**4.6%**
AGF	**0.1%**	**0.9%**
DGF	**5.8%**	**3.7%**
US Equity Income	**25.0%**	**12.0%**
ARF	**2.1%***	**-0.1%**

* Launch date July 2023

There were three possible scenarios, and those remain true:

1. Soft/no landing
2. Hard Landing
3. Higher for longer

As the year progressed, the probability priced in of either a 'hard landing' or 'higher for longer' was discounted heavily, culminating in it moving to zero as policymakers explicitly stated that both scenarios had been avoided.

It is not for us to state with objective certainty where the global economy is headed, nor is it possible for anyone else, which is why complete consensus and the associated extended positioning is of itself a risk.

Nike co-founder Phil Knight once said 'everybody has been looking for the next Michael Jordan, and they were looking on the basketball court, he was walking down the fairway the whole time.'

The same is true of market participants predicting the next crisis; it is often something that is brewing alongside the 'known unknowns' that are focussed and opined upon.

However, when looking at those 'known unknowns', it is clear that there is a significant mispricing of the probability of anything other than a soft or even no landing occurring.

Inflation, growth, unemployment, and the associated policy response and effect on liquidity will be key to the coming year.

The market is already well ahead of the Fed, having priced 160bps of cuts against the Fed's own 75bps in their dot plot, which was at 100bps in June incidentally. And the plumbing in the fiscal and monetary system needs careful consideration. The US budget deficit has topped $2trn, which is far outpacing GDP growth (even robust growth) and the cost of servicing that debt is nearing 20% of tax proceeds. The Fed's pivot in rhetoric and the Treasury fundamentally moving away from their typical issuance term structure have avoided the issue, but with RRP draining fast they could be heading for a liquidity event. This is why the Fed is talking about tapering QT at a time when supply chain risks are firmly rising and wage growth is not abating.

They declared victory too early. Whether they declared victory wrongly remains to be seen, but it is a risk that simply cannot be discounted completely.

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Quarterly Commentary – 29th December 2023

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2023

The Fund returned 0.9% in Q4, and 0.1% during 2023. It had correlations to global equity and bonds of -0.6 & -0.3.

Income

The Fund is fully backed by short-dated high-grade debt. As rates have risen, so has the return available from the Fund's collateral, which returned 3.0% over the year.

Beta

The Fund makes no allocation to the Beta portfolio. This is one reason that it has provided investors positive convexity at all points of market turbulence, irrespective of the cause.

Diversifier

The volatility in the Fund's diversifier bucket was doubled during the year. Previously the Fund had a realised volatility of ~2% which was deemed too low in order to achieve its target return. This is now ~4% and should increase the return profile of the Diversifier portfolio looking forward.

In 2023 the portfolio was flat.

The main detractor in performance was Commodity Value, accessed through a gold intraday strategy that was long in Asian hours, where physical buyers tend to operate, and short in European hours, where there tend to be more hedgers. The premium has closed, and the position was closed out midway through the year.

Commodity Curve, the biggest risk weight in the Fund, and FX Value, the third biggest, and Commodity Congestion were all in their bottom decile of historic performance (2007-2023 data). Carry strategies (correlated) were in their top decile.

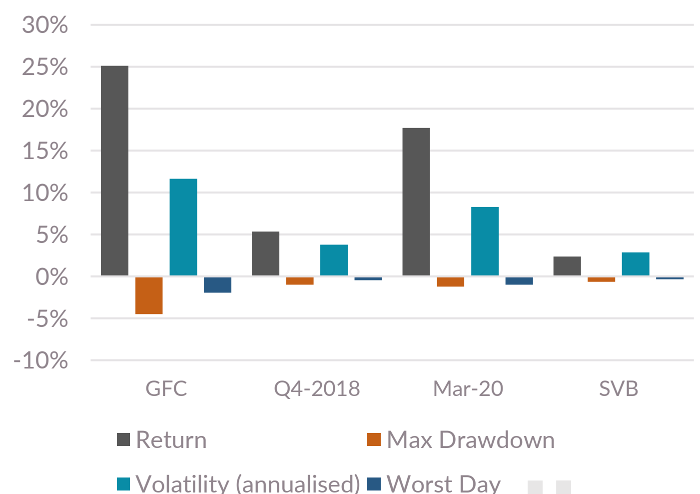
Those muted returns are unusual and have left wide disparities in FX from their fair value, particularly in the Yen (which could be this year's Tiger Woods).

The Rates Volatility strategies performed best, particularly during periods when both bonds and equities struggled together. Some profit was taken here in Q4 and redeployed into the commodity and FX strategies.

Protection

The Protection spend was at the top of its range during the year and was a drag of 2% on performance.

There was some rearrangement of protection towards year-end as equity volatility moved to historic lows, meaning that the portfolio was able to maintain its convexity, but for far less spend. The current spend in the portfolio is 0.75%, split between equity puts and credit default swaps. The current scenario analysis on the portfolio can be seen on the right-hand chart, there is more convexity in the portfolio than there has ever been.



SIMULATED PAST PERFORMANCE: Past performance data shown in this communication is derived from back-testing simulations. Factor betas and scenario analyses are simulated and represent how the current portfolio would have behaved given the current risk weighting allocation.

Outlook

The Fund is and was positioned as defensively as it is likely to ever be and affords investors genuine diversification at a time when the market as a whole is positioned for one outcome.

With regards to outlook, before postulating on what the diversifiers may or may not achieve, one can build the portfolio up by risk bucket, with some assumptions:

Income

The current yield of the income portfolio is 4.5%. Conservatively, let us assume the portfolio realises 3.5%.

Diversifier

The portfolio has returned ~1% pa through its life. It now has a higher volatility, but again conservatively let us assume it repeats at 1%.

Protection

Let us assume that all known spend on protection is lost.

Conservatively, in a scenario in which income yields reduce on what is currently locked-in, the Diversifiers are muted, and the Protection spend is lost, then gross of any fees the portfolio should return ~4%, or the low end of its target.

If the Diversifiers were to begin to work, or indeed if there were a crisis to contend with, then returns are likely to be considerably higher.

Policymakers have declared the war against inflation over, and without the usual casualties in growth and employment that one would associate with previous wars, which have tended to be messy affairs.

The market is taking policymakers at their word, and the loosening of conditions that has ensued is precisely what should promote caution. Most alternatives are steeped in carry through volatility selling and outright beta positioning; this means that they, like the rest of the multi-asset portfolio, are counting on them being right.

History tells us that the most brutal drawdowns in equity come after the pivot, not before. This time might be different, but betting the house on that being the case is a bold move indeed.

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