MATHIASEN
& CHENG

Dear clients and friends,

So we come to the close of a tumultuous year. Looking back this year of so much death, so many conflicts, and uncertainties, it surely taught us a few meaningful lessons: a little more empathy to a stranger next to us, more expressive love to the ones we care, and a bit more modesty and patience in face of the unpredictability of life.

And the last bit of the above – modesty and patience – had inspired some of the transitions we made in Q2 and Q3, in how we invest and manage risk. The early result had been encouraging: we made a return of 13.14% in the past quarter (vs 7.62% from a classic 60/40 strategy), all the while we manifested an extremely low – almost bond-like – volatility.

Such risk-reward ratio is motivating! Yet we remind ourselves this was only our first quarter with the fully adjusted strategy. As a nascent venture with a not-exactly-average strategy, we know how imperfect many of our set-ups and executions are. This performance would serve as a guidance for our future research, and a fortification of our rediscovered purpose – to provide stability.

PORTFOLIO REVIEW

The return and contributions of component asset classes are as follows:

- **Equities (+13.78%), Commodities (+18.44%), Emerging Market Credits (+5.64%)** – Emboldened by Federal Reserve stimulus, vaccines and the optimistic sentiment of no bad patch lasts, virtually everyone was rushing to cash in on the market rally. This had been helpful in the past quarter for risky assets. Altogether the above contributed a 6.38% return.

- **US Treasuries (-1.89%), Developed Market Inflation-linked Bonds (+4.47%), Gold (+0.7%)** – A low risk-free rate environment brought down demanded returns all along the capital market line, compelling money managers to move from one asset class to the next in search for a better bargain. Together with a lowered volatility across assets that prompted passive strategies to further increase their positions in stocks, safe assets had had an uninspiring quarter, with a 0.77% return.

- **Bitcoin (+168.84%)** – The fortunes of the world's richest people soared even as the pandemic caused economic devastation, a stark trend that was reviving calls to tax wealth. Proposals were being floated in governments globally, which we believe had been a catalyst for billionaires taking a foray into bitcoin. Despite a conservative allocation into the asset, the spectacular rally contributed 5.97% return to our portfolio.

Yet, as much as we were elevated by the performance of risky assets, we remained disciplined in our risk-management process – we sought to capture a significant portion of market growth, while reduce the impact of severe and prolonged market declines.

- While our portfolio made an equity-like return for the quarter (13.14%, akin to MSCI World's 13.78%), it exhibited a bond-like volatility (Exhibit 1).

- The geographical diversification had proven its worth. We weathered through with stability a series of unexpected market movements, including the surge in COVID-19 hospitalizations in late October that sent S&P 500 tumbling for ~6%, and the 7% drop in MSCI China, of which Alibaba and Tencent represented a significant portion, in mid-November when the Chinese government published a guideline on scrutinizing the country's internet behemoths.

- The disciplined approach also demonstrated a good hedge across asset classes. While our allocation in bitcoin contributed a meaningful part of our return this quarter, its contribution of volatility to our portfolio as a whole had been minimal (Exhibit 2).

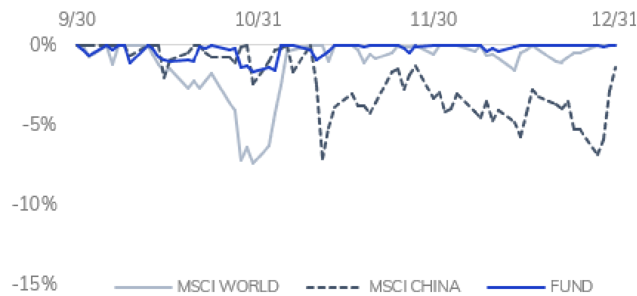
All-in-all, we find the risk-reward ratio of the past quarter rather motivating.

Exhibit 1

With a return akin to an equity index, our fund exhibited much lower volatility...

...that is comparable to a bond index

Drawdown % of our fund, vs other equity indices



Drawdown % of our fund, vs other bond indices

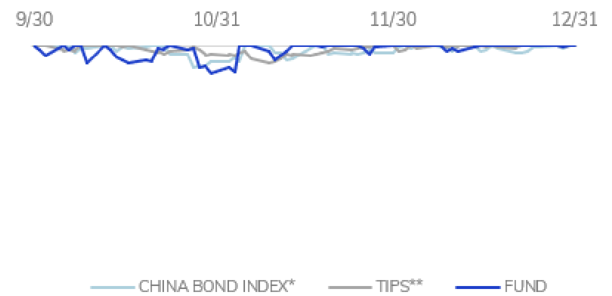
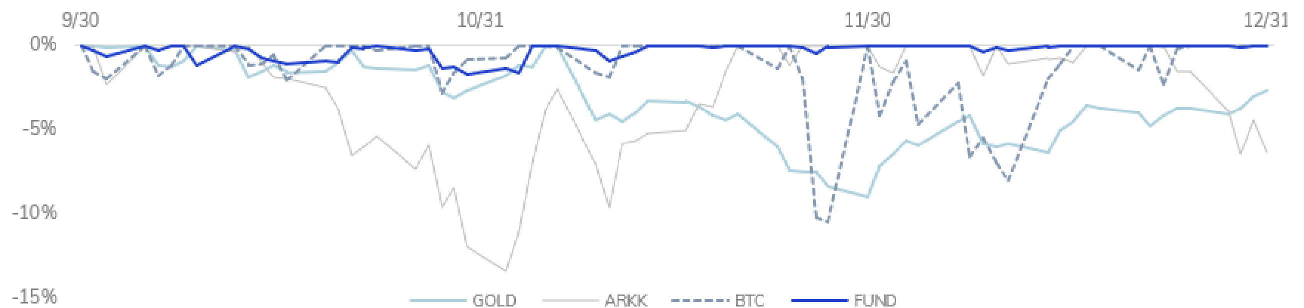


Exhibit 2

While bitcoin contributed a meaningful part of our return this quarter, its impact on our total volatility had been minimal

Drawdown % of our fund, vs other alternative assets



* Bloomberg Barclays China Treasury + Policy Bank Bond Index
** US Treasury Inflation-Protected Securities
Note: Data of MSCI World, MSCI China, China Bond Index, TIPS and Gold are proxied by their respective investable index funds, URTH, 2801.HK, 2813.HK, TIP and GLD.
Source: M&C, Blackrock, Vanguard, ChinaAMC, State Street, ARK Investment, Coinmarketcap

A LOOK FORWARD

We learnt to be very cautious about giving forecasts these days, for various reasons we noted in our previous Investor Letters. Inspired by a few readings we came across lately, we would like to add on:

- **Most forecasts are already priced in, and thus not profitable** – Back then when, say, Warren Buffett first started, a) the level of competition was much lower – there were few people in the investment field, b) information was hard to come by – investors had to request by mail

for a copy of company annual report, and c) certainly did not have computers or spreadsheets to aid their analysis. It was in such environment that opportunities could really be hiding in plain sight for anyone willing and capable to grab.

But today, with a) so many people searching, b) information readily available, and c) so many technologies to turn data into actionable insights, "*it seems foolish to think that such [opportunities] could be found with any level of frequency*"[1].

- **The profitable ones are surprises, which are hard to predict, and even harder to sustain** – Aside from eventuality itself, there is also this path-dependent reflexivity that is hard to predict – even if we could go back to December last year and accurately predicted there would be a global pandemic, we suspect if anyone would chain together the second and third order effect, which led to the market melt-down in March, the central banks' unprecedented stimulus, and sequentially the rush to market melt-up today, with a conviction high enough that warrant a trade with meaningful size.

  Now think about the probability of getting the first order effect right, then multiply it with the probability of getting the second order effect right, and the third and so on…it is extremely hard, if not impossible, to make such macro forecast.

Acknowledging there are more uncertainties and randomness than we would prefer, these are the topics we will be watching closely:

- **Divided Democrats** – *"History shows us that after the fight for power in which the common enemy is defeated, those who united against the common enemy typically fight among themselves for power*"[2]. With the Democrats having won the White House and both chambers of the Congress, the deep generational and ideological differences between the progressive and moderate Democrats may now start to present. This is a trend we shall be watching closely, on how it impacts the new administration's policy agenda.

- **Wealth Tax and Bitcoin** – our working hypothesis is that the imposition of wealth tax globally is just a matter of how and when. And we expect bitcoin to be continue benefiting from this due to its censorship-resistant nature. It also stands to us that the asset will be considered illegal in a number of jurisdictions with wealth tax imposed. We maintain the position that the impact of its legality on price would be short-term, and its biggest risk remains the advancement of quantum computing.

- **US System vs China System** – regardless of the Biden administrations' attitude towards China, China already expedited on multiple fronts to lower its reliance on the US system. A refocus on domestic consumptions, attractions of foreign capital and internationalization of RMB will be some of the most imminent tasks for the Chinese government, and, in our opinion be structurally beneficial to its assets and currency over the long-run.

- **Stimulus and Inflation Surprises** – There is likely little that will change the current plan for more stimulus and "lower for longer" interest rate environment. To us, inflation remains the biggest

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[1] By Howard Marks in his recent memo, *Something of Value*, which I found very inspiring.

[2] From my another favorite source of inspiration, Ray Dalio, in his Changing World Order.

macro uncertainty for it being the only real limitation to all the easing plans. Currently arguments could be made for a surprise both ways – positive and negative.

The ambiguity of an inflation forecast is precisely an example of the above – how eventuality AND its path-dependent reflexivity are difficult to predict. This is the reason why our positions are now volatility-balanced to reduce any environmental biases. Admittedly, it is much more exciting for one to make a case for a definite forecast, invest accordingly and boast about it when they got it right (or stay quiet when they don't). Yet, especially after such a turbulent year, we came to appreciate more what perhaps is the exact opposite of "excitement".

PROVIDING STABILITY

To draw a close to this letter and a year full of ups and downs, I would like to share with you a simple diagram (Appendix), which was first introduced to me a long while ago by my high school teacher in economics.

A person of small stature, bespectacled, my teacher was a steadfast Catholic, and a loving father with two daughters (and many dad jokes). Despite his seniority in the school, he was also modest, patient, and carried no pretention – in winter, he would walk into the classroom in a sweater. "It's a gift, hand-knitted by my wife", he would say, with a sunshiny, almost ingenuous smile.

In contrast, I was a teenager back then with all the youthful pretensions. Having so many questions in my head and an urge to be "always right", I often stayed long after class, trying to clarify every ambiguity (which, unlike physics, is quite common in economics) we came across in class.

And it was in one of these after-school sessions that we briefly talked about investment.

"If you invest with a purpose," he concluded, after drawing the chart, "you probably won't seek to be 'always right'".

At the time I was young, earnest, and eager to prove myself – I did not appreciate that answer.

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This year we had a few misjudgment, and in turn led to some bad trades in Q2 as reported.

What I did not report, however, was the anxiousness I was in. For a good part of the summer, I stayed late in the office, spending hours reading up analysis and research reports, inhaling the latest memo by Howard Marks, a new chapter by Ray Dalio or that new book from Stephanie Kelton – I was eager. I was eager to clarify the ambiguity of the market environment we were in; I was eager to prove to others that I have the right answer.

In retrospect, I realize I was doing what most of us tend to do when we are uncertain or floundering: we reach for what feels familiar, what we think we are good at. I knew economics theories, and I knew how to consume and process information.

It was then I stumbled on a similar chart that my economics teacher showed me. And it took me a while to realize my problem was not a lack of understanding of the economic fundamentals, but my obstinate pursuit of being "right".

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It was after that we started to center our research on the all-weather investing approach. I talked about the merits of such approach since then – what it does with asset allocations, and how it is a superior framework in managing risk. But these are just the What and How. The more important question – the Why – was less obvious: I came to appreciate something I did not – stability.

Like most other cities, Hong Kong had its share of panic-buying on masks and groceries early in the pandemic. But this quickly died down after Li Ka-shing, an influential business leader and the owner of the largest grocer in the city, assured there would not be any food shortage, and later-on personally escorted the delivery of a plane load of medical supplies – when many governments around the world failed doing so.

The concept of stability looks most of the time as mundane as the stock price of a grocer, especially when we have their exciting tech counterparts, like Zoom, hogging the headlines these days. Nevertheless, it is precisely the stability this grocer provided that saved the elderly in my neighborhood from shouldering past other shoppers for their essentials; it was also the reason why we could afford new ventures like Zoom (Li invested in the startup back in 2013) that kept us connected over this grim year.

On reflection, it was also stability that my economics teacher was providing, to allow his daughters to go to private schools and receive top-notched education; and the same stability my own father provided, that enabled me to pursue a career that I enjoyed, despite its sporadic income at its early days.

If we invest with a purpose, we don't seek to be always right – we seek to provide the stability that enables something more than money, and larger than ourselves.

Slowly, we are forming our investment philosophy and a sense of purpose. It has not been easy so far, and in the future we certainly will encounter challenging situations like our hedging model failing to work or another cross-asset meltdown. But if I have learnt a thing or two by looking up to the three men above whom I have come to respect, there are several characters I see in common: the same lack of pretension, the same patience, and the same modesty of expectation.

Have a great year ahead!

Ryan

APPENDIX

Exhibit 3

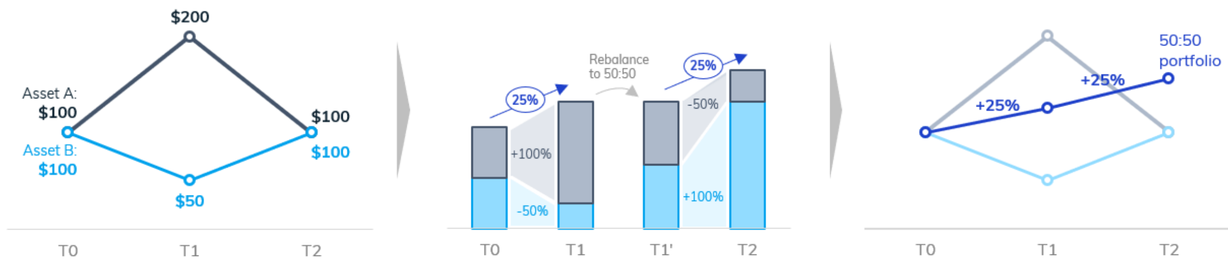
Without macro-forecasting, a portfolio could still produce stable positive return

Illustrative

Given two assets with the same return and volatility, but negative correlations...

...we could create a 50:50 portfolio. And with regular rebalancing...

...the portfolio will produce positive return with less volatility.



- Note that even if both asset A and B ended up back in $100, the portfolio could still make a positive return.
- Hence it stands that, if we could engineer this asset A and asset B to possess opposite environment biases - e.g. A appreciates when inflation goes up, while B appreciates when inflation goes down - we could make a stable return regardless of how inflation actually turns out.
- The 25% from T2 is compounding on the first 25% from T1 – stability fortifies the power of compound.

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