



Creating Value through Innovative Financial Solutions

LC CEO MEMO : JUNE 2020

The events of the last few months, brought about by the Covid-19 pandemic, could potentially be recorded as one of the pivotal points in history, leaving humanity at a crossroads. In the context of Financial markets, it seems like we went through a blip, and everything is back to normal. We have come across many commentaries from industry experts, which explained in detail every possible scenario that could transpire after the Covid-19 event. One of the most debated topics is the shape of recovery to be either a V, U, L or W backed by various assumptions.

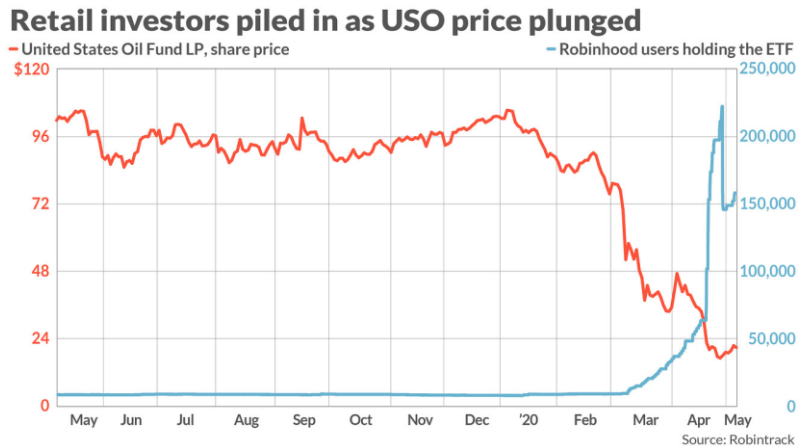
History can give us some insights into the behavior of society and markets when events like this happen. That said, specific to Covid-19, we find ourselves at some disadvantage simply because there are no strong parallels here. The two incidents that we can relate to are the Spanish Flu and the Great Depression. However, the Spanish Flu was a pandemic that had occurred in a world that was not as interconnected as we are today while the Great Depression was an economic event that was not preceded by any pandemic. So, unfortunately, this leaves us with very little to make sense of the potential outcome of what is happening right now.

Our clients have asked us about our house views of the market and the way forward. The conventional approach of forming such opinions is to rely on key economic indicators such as data on unemployment, the Purchasing Manufacturing Index ("PMI") levels, and corporate earnings reports, to name a few. The data which accompanied these key indicators all point to a gloomy and uncertain future – not supportive of the strong rally we are witnessing now. The actions by central banks and Governments have been unprecedented, and markets have responded by ignoring everything else. The adage "Never fight the Fed" seems to be taken to heart.

If one were to go with conventional wisdom, the markets could potentially be at a much lower level than what we are seeing today and should correct significantly at some point soon. However, the speed and magnitude at which the market rebounded back to its pre-Covid-19 levels is saying something else altogether. Again, there are many theories to rationalize what is happening right now: for instance, could this rally be driven by boredom resulting from the "stay at home" orders, which in turn prompted the retail investors to dabble in the stock market? The brokerage accounts saw a spike in the first quarter as reported by this [article](#) on CNBC. While this does translate into an increase in interest and volume in the stock market, keep in mind that retail investors generally take long positions, and are not skilled at shorting the market. A recent example of this is the behavior exhibited by the retail investors as shown in Chart 1 below. This investor group carelessly piled into the U.S Oil Fund LP ETF (USO ETF) as oil prices declined, without realizing that the expiry was due in less than 24 hours (no wonder oil touched -\$37 for the first time in history). Another evidence is the increase in prices of stocks of the companies such as Hertz and JC Penny which have filed for Chapter 11.



Chart 1: Retail Investors activity



There are other factors which could contribute to this rally: i) investors perceived the fall in March to be overdone and hence felt this is a good opportunity to bottom fish, ii) genuine optimism on the tech companies which have successfully adapted/built their models to benefit from "new" norm, or iii) FOMO (Fear of Missing Out) mentality among investors as they reflect on the rally they might have missed out post-GFC when the market recovered and sustained the bull rally.

Another theory is the "There Is No Alternative" or TINA factor. With interest rates at such low (and for some, even negative!) level, investors have little choice but to look at equities in their pursuit of returns. I have been actively following the publications and interviews of some of the renowned names in the industry (Howard Marks, Dr Lacy Hunt, Ray Dalio to name a few). Their wisdom does point to two things which have made them successful investors over many market cycles: i) Nobody knows what the outcome would be or could correctly predict the market, and ii) by focusing on portfolio management and understanding your skills would lead to better results than trying to predict the markets.

At Lighthouse Canton, our focus is on strategy allocation (as opposed to asset allocation) to build diversified portfolios that have a low correlation to the broader market. This approach has served us well both in good and bad market environments. The objective is to prevent severe losses - the lesser the drawdown, the quicker the recovery.

We also have been emphasizing on the understanding of portfolio leverage, which we believe to be an essential component of risk management. What many investors might not be aware (until it is too late) is that leverage tends to take the decision making away from you during times of distress. At Lighthouse Canton, we explore other ways of generating potential returns without being dependent on leverage.



Currently, the markets are priced for perfection, and as you may agree, the world is not anywhere close to perfect. The coming days or months will put all the hypotheses to the test – some will be proven right and others wrong. Our job at Lighthouse Canton is not to guess or predict the future. However, our approach focuses on portfolio construction and risk management, which has been time tested through different market behaviors as it swings from greed to fear and back to greed.

Should you be interested in discussing our views and ideas, please don't hesitate to reach out to us at ir@lighthouse-canton.com.

Kind Regards,

A handwritten signature in black ink that reads "Shilpi Chowdhary".

Shilpi Chowdhary

CEO, Lighthouse Canton

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