KTS CAPITAL MANAGEMENT

KTS Investment Horizon

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EXECUTIVE SUMMARY

- **The risk** of almost all asset classes **has evidently and uniformly risen due to the central banks' unorthodox and lengthy monetary policy**.
- **The reversing monetary policy in the western hemisphere is the elephant in the room.** The tectonic shift in policy, including President Trump's trade war and imposed sanctions could make emerging market countries with high debts most vulnerable.
- A debt crisis is inevitable with global debts severely rising ever since the housing crisis in 2009.
- Financial markets may not be driven by the improved macro-economic data, but rather by geopolitical disputes, by the overstretched asset valuation, and by the unascertained pace for higher interest rates.
- Therefore, **we believe our cautious asset allocation with an opportunistic component** to reduce risky assets drastically and vice-versa **should be beneficial during this period of time**.
- **We prefer to increase our equity position through the equity long/short strategy rather than the long-only one.**
- Furthermore, multi-asset funds play a pivotal role in our portfolio. **To reach a more sustainable result of this allocation, we will invest in a pooled vehicle of 3-5 best-in-class multi-asset managers.**

OUTLOOK

As we have argued in the past, the central banks' unorthodox and lengthy monetary policy has undeniably inflated financial assets to some extent rather than restoring the actual economy to a normalized growth rate. Accordingly, volatility in the stock markets was at a dubious low level, meaning that stocks had rallied further without experiencing a major stock market correction. **The expectation that the risk of financial markets to disappoint is high, we precociously adopted a more prudent investment strategy; we reduced our risky asset exposures in favour of cash**.

So far in 2018, **the risk** of higher volatile assets such as stocks and from lower grade bonds to emerging market debts, as well of the supposing safer assets such as government bonds **has evidently and uniformly risen**. Due to the central banks' excessive intervention in the financial markets, **stocks and bonds are unlikely to provide any diversification benefits to each other**. In February, investors' complacency to bet that markets will stay calm, as seen until early 2018, had come to an end, **see Exhibit 1**. The CBOE Volatility Index (VIX) at historical low levels of around 10, suddenly spiked to around 40 in as little as a few days just when inflation swiftly surprised on the upside. It was in 2008 when the VIX breached the 45-level and then reached around 80 as investors started the fire sale. **Compared to this year's spike, the 2008 VIX spike (from the low to 80) occurred during the period from August 2008 to October 2008, while the 2018 spike of more than +330% occurred in a few days.** This could force the Federal Reserve to raise U.S. interest rates more aggressively than anticipated. Stocks and bonds plunged strongly as a consequence, and Credit Suisse announced the liquidation of its obscure low volatility-product which bet on the inverse VIX as it lost 93% of USD 1.9 billion in assets (there were more related products in the market with similar setbacks). During the volatility overshoot period, numerous models which relied on systematic trends, lost their shirts as these strategies lagged in adapting to the changing investment environment. We, on the other hand, are constantly monitoring the financial markets to briskly adapt to any change in the surroundings.

Despite the fact that global macro-economic data remains favourable, with the exception of the U.S., the performance of stock markets including bonds in most of the countries is antagonistic, especially in Turkey and Argentina. **The reversing monetary policy in the western hemisphere is the elephant in the room. The tectonic shift in global monetary policy including President Trump's trade war and imposed sanctions could make emerging market countries with high debts most vulnerable**. The Turkish lira and Argentina's peso have been falling precipitously versus the U.S. dollar. But what is the reason behind this? During the historic low interest rate period in the U.S. and elsewhere, developing countries such as Turkey and Argentina experienced an influx of foreign money in exchange for higher investment returns. As of today, Argentina has roughly 80% of its total debt outstanding in U.S. dollars which should be refinanced. As the Argentine peso depreciated further against the U.S. dollar these debts became vastly expensive to repay. On August 30 Argentina's central bank increased its benchmark interest rate to 60%, the world's highest, in an effort to refrain its currency from falling further. Turkey is struggling under a similar trauma with outstanding debts denominating in U.S. dollars and by the majority in euro, but neglecting any market intervention. A debt crisis is inevitable with global debts severely rising ever since the housing crisis in 2009. **We would not be surprised at** the time of writing, to witness another emerging market country crisis in the foreseen future.

INVESTMENT STRATEGIES

Taking the above outlook into consideration and looking ahead to see a rather tumultuous stock market on a time horizon of 1-2 years, **we have adopted a cautious investment strategy and continue to hold our equity allocation to neutral weighting**. Financial markets may not be driven by the improved macro-economic data, but rather by geopolitical disputes (with President Trump dealing out wild cards and accusing China of trade manipulation), by the overstretched asset valuation, and last but not least, by the unascertained pace for higher interest rates. On the other hand, investors' sentiment about stocks, according to our dialogue with many multi-asset managers, has perennially been comparatively positive. Therefore, **we believe in our asset allocation with an opportunistic component to reduce risky assets** drastically and vice-versa, and this **should be beneficial during this period of time**.

We have already been implementing a strict rule in our risk management for many years in order to preserve capital in a disastrous event. **Our unique fixed income allocation bears little duration risk and is uncorrelated to the general interest rate market, as well to the stock market**. While this part of the portfolio reduces the overall portfolio risk, our equity allocation is neutrally weighted. However, the underlying investment vehicles are dynamically managed and equity exposures could be rapidly increased when opportunities arise.

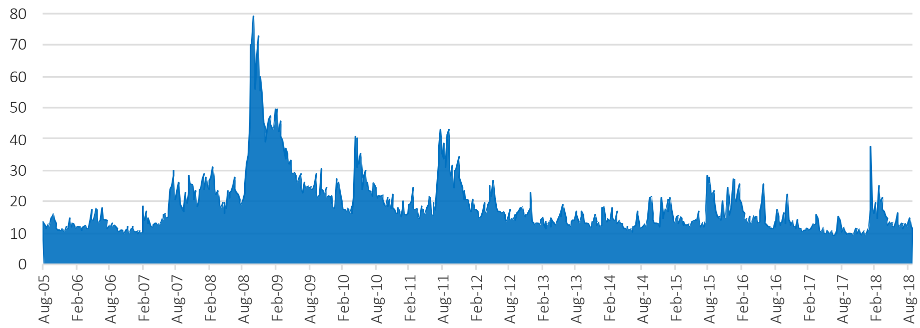
Equity long/short strategy to benefit from the difficult market conditions

Moreover, **we prefer to increase our equity position through a relative equity strategy rather than the long-only one**. We believe that investment in stocks has changed in the following ways. First of all, passive mutual funds, the so-called ETFs, are still gaining massive momentum which compels the ETFs to only buy index-member stocks. This is also the reason why the U.S.'s heavily weighted 5 major stocks (FAANG) continue to surge to an unprecedented market capitalization not seen before. Secondly, the world is constantly changing. General Electric Company (GE) was once considered as the "leading indicator" of the U.S. economy. Today, compared to most of the technology stocks, GE's stock price performed less-than-fashionable and is at an all-time low. Another case would be the juxtaposition of Tesla Inc. to General Motors Company. Last year, Tesla market capitalization exceeded the one of General Motors without making any profits since incorporation. This demonstrates that technology stocks are clearly on the rise to shape a new era and companies with innovative business plans should perform well in a highly competitive and changing environment.

As a result of this, we have taken a position in a global equity long/short strategy basket of well diversified long/short managers to achieve the highest risk/return trade-off along with the long/short efficient frontier when comparing its investment universe. We also examined all managers for their successful discipline and long track record to generate alpha, the active return, by taking long positions in promising stocks and shorting the less favourable stocks. On average, this strategy seeks to minimize equity exposure (either market neutral or net long/short bias up to a maximum of 30%) compared to the long only strategy. Existing long/short managers may be replaced by potentially better managers by continually screening the long/short strategy universe based on four main investment criteria: 1. The maximum drawdowns should be minimal if a crisis like the housing crisis in 2008 bedevil, 2. A high Sharpe ratio should prove that the manager is efficient in achieving maximum returns with the lowest risk, 3. The fund should provide a weekly liquidity and assets under management should not be less than 100 Mio., and 4. The investment process of managers should be a mix of fully systematic and pure human interaction. In doing so, we believe that the equity long/short strategy as a whole should better be able to generate alpha through sound stock selection and protect the downside risk in a challenging and expected difficult investment environment should it arise.

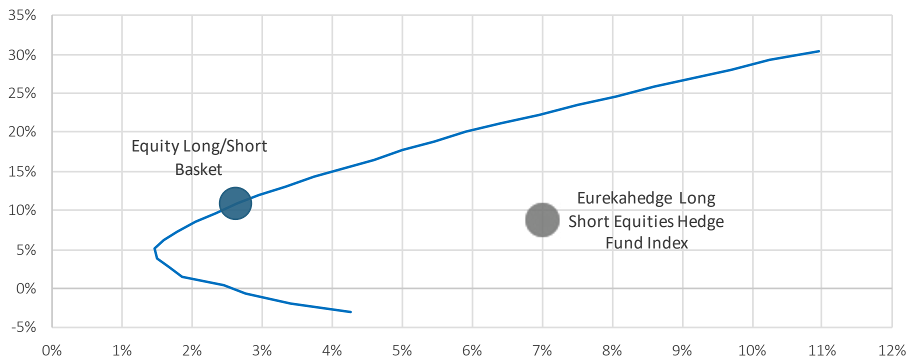
Other than that, investors should not underestimate a fraudulence like Madoff, although in today's overly-regulated world could be deceitful. To avoid this hidden risk, as a matter of course, we pursue a periodic dialogue with the managers to become aware of their strategy and their mismanagement.

Exhibit 1: CBOE SPX Volatility Index (VIX) 2005-2018



Source: Bloomberg

Exhibit 2: Equity Long/Short Efficient Frontier

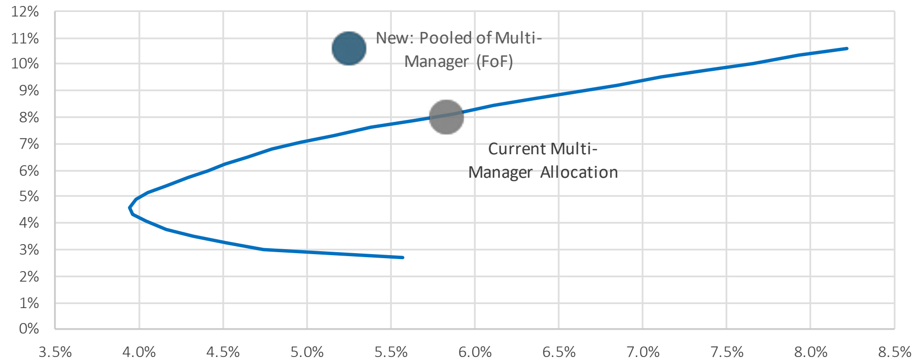


Note: Equity Long/Short Efficient Frontier created with top 20 Best-in-Class Long/Short Managers

Pooled dynamic multi-asset managers is the driver of success

Multi-asset managed funds play a pivotal role in our portfolio construction as they represent up to 20% of the total portfolio. We have a systematic model in place to screen for the best-in-class multi-asset manager whose dynamic strategy can adapt immediately to the new strategy when the rotation of asset classes materializes. Since 2011, we have allocated our capital to Flossbach Multiple Opportunities Fund by choice as one of the best-in-class and consistent good performing multi-asset manager. However, we have also acquired of the belief that one manager could do well this year, but the same manager could likely drag behind its peers in the following year. In addition, every manager has its hidden risks, like the management risk (changing the lead portfolio manager) or the fund has grown tremendously in assets which could be difficult to implement the inceptive strategy, or the management considers disposing its fund business. All these factors could lead to a mismanagement of the initial fund strategy which could negatively affect the fund's performance. For this reason, **to circumvent the hidden risks and not only optimize the overall cost, but also maximize the risk/return concept more efficiently (see Exhibit 3), we will launch a pooled vehicle of best-in-class dynamic managed multi-asset funds**. The pooled investment in the top 3-5 managers with different investment philosophies and investment approaches, from being fully systematic to a purely human driven decision, should be the main driver of success and lower our aggregate portfolio risk accordingly.

Exhibit 3: Multi-Asset Manager Efficient Frontier



Note: Efficient Frontier created with top 20 Best-in-Class Multi-Asset Managers

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