Aurimax Investment Club

Member Newsletter

Q2, 2022

Our Risk Management Strategies Bear Fruit

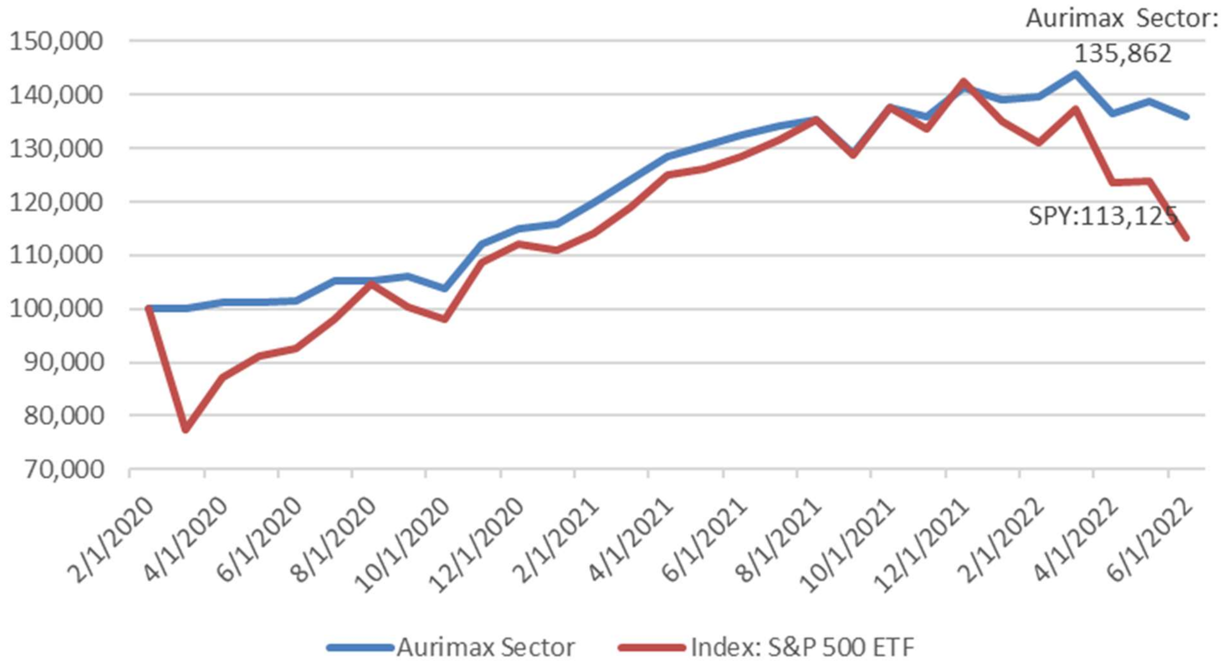
Since the beginning of this year, we have been witnessing a “perfect storm”: high inflation + hawkish Fed + high stock valuation+ recession worry. The perfect storm knocked the equity market solidly into bear territory.

As our club members are well aware that we have implemented hedging strategies on all (2020) and a half (2021~2022) of our equity exposures since the second half of 2020. The strategies cost us about 6% annually. Thanks to the effectiveness of our investment models, 2 of 3 of our portfolios still beat their relevant indexes on a net basis. Witnessing the seriousness of global inflation and the eagerness of central banks in fighting the inflation, we decided to move half of our investments that were not hedged to cash in early May, thus greatly reducing our return volatility. In addition, our change in fixed income allocation from high yield to short-term Tips ETF in November 2021 and the change in our best idea from Ark Tech Innovation ETF to VanEck Inflation Allocation ETF in April 2022 also helped reducing the volatility of our World Portfolio. As of June 2022, all of our investment portfolios beat their relevant indices on a net basis.

Aurimax Funds Net Performance Since Inception (2/24/2020)

Portfolio	Month (June, 2022)	Quarter (Q2, 2022)	YTD	One Year	Since Inception
Aurimax Sector	**-2.17%**	**-5.70%**	**-3.83%**	**2.64%**	**35.86%**
Index: S&P 500 ETF	*-8.64%*	*-17.57%*	*-20.57%*	*-11.87%*	*13.13%*
Aurimax AllCaps	**-0.55%**	**-10.43%**	**-13.78%**	**-12.22%**	**12.12%**
Index: Rusell 3000 ETF	*-8.71%*	*-17.14%*	*-21.66%*	*-15.05%*	*11.19%*
Aurimax World	**-0.61%**	**-6.99%**	**-11.80%**	**-7.20%**	**12.43%**
Index: 60% MSCI World + 40% Agg	-6.32%	-12.02%	-16.97%	-13.87%	0.10%

Note: AGG-US Aggregate Bond Index


Sector Portfolio 100,000 Invested, Since Inception
(as of June 30, 2022)
Aurimax Sector:
135,862
SPY:113,125
150,000
140,000
130,000
120,000
110,000
100,000
90,000
80,000
70,000
2/1/2020
4/1/2020
6/1/2020
8/1/2020
10/1/2020
12/1/2020
2/1/2021
4/1/2021
6/1/2021
8/1/2021
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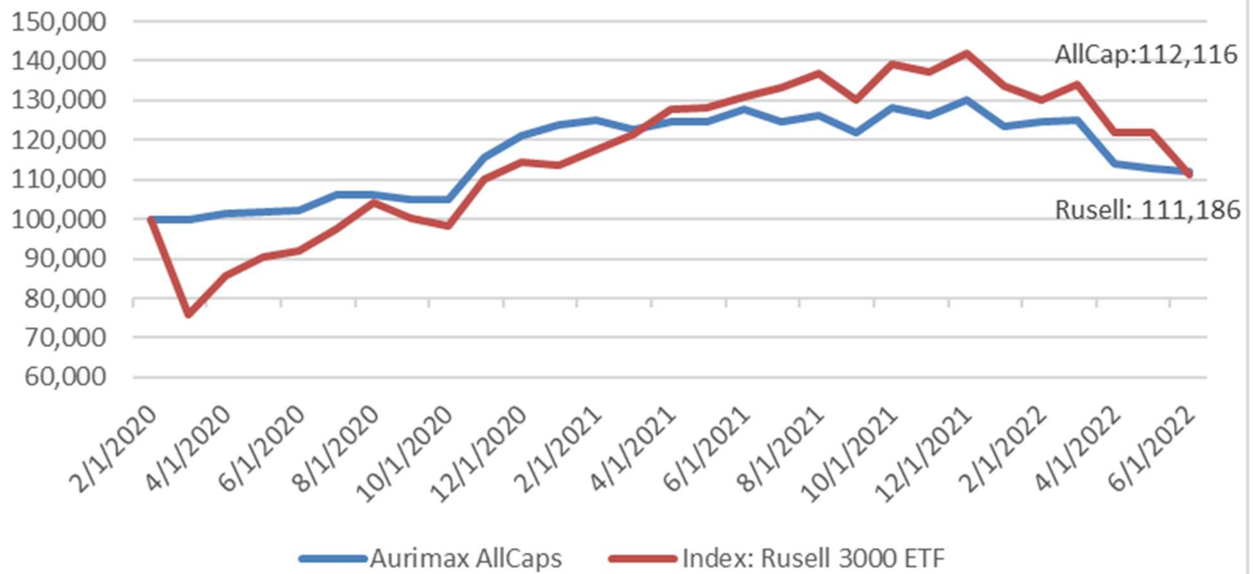
Aurimax Sector
Index: S&P 500 ETF


US All Cap Portfolio 100,000 Invested, Since Inception
(as of June 30, 2022)
AllCap:112,116
Rusell: 111,186
150,000
140,000
130,000
120,000
110,000
100,000
90,000
80,000
70,000
60,000
2/1/2020
4/1/2020
6/1/2020
8/1/2020
10/1/2020
12/1/2020
2/1/2021
4/1/2021
6/1/2021
8/1/2021
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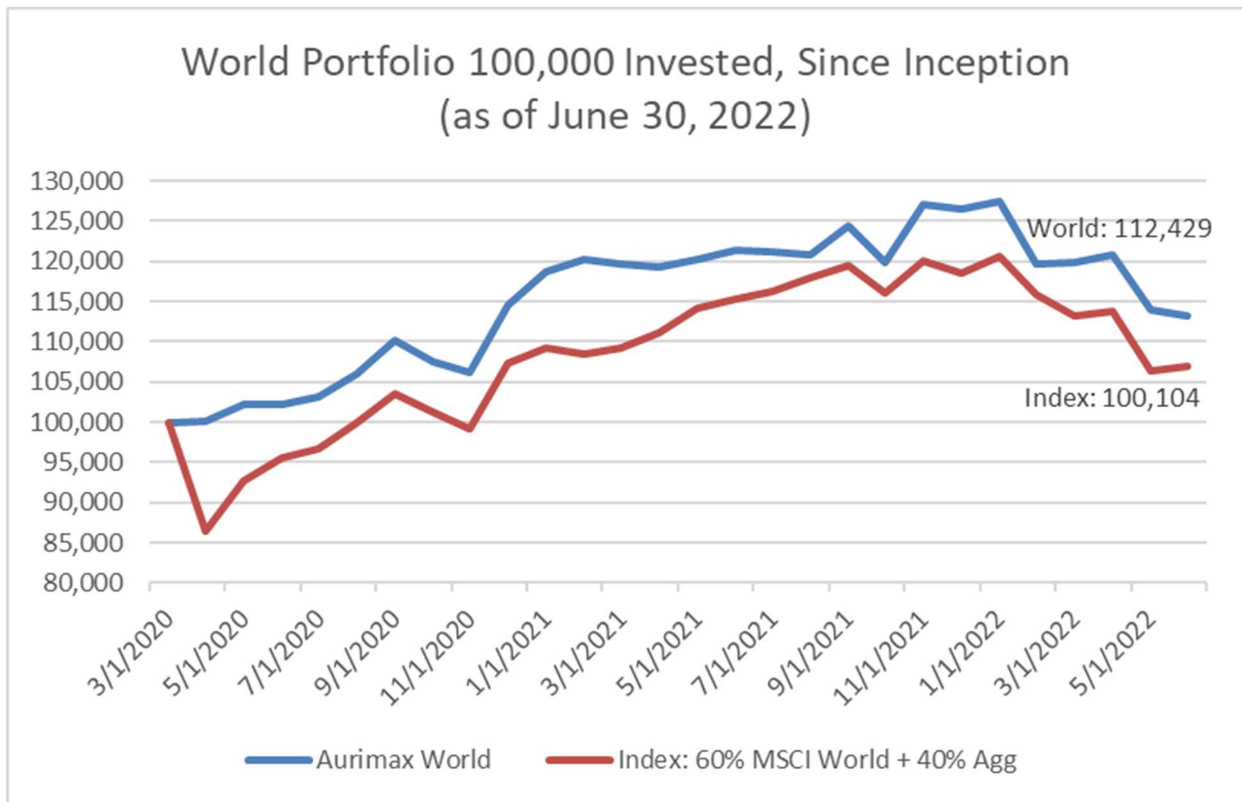
Aurimax AllCaps
Index: Rusell 3000 ETF

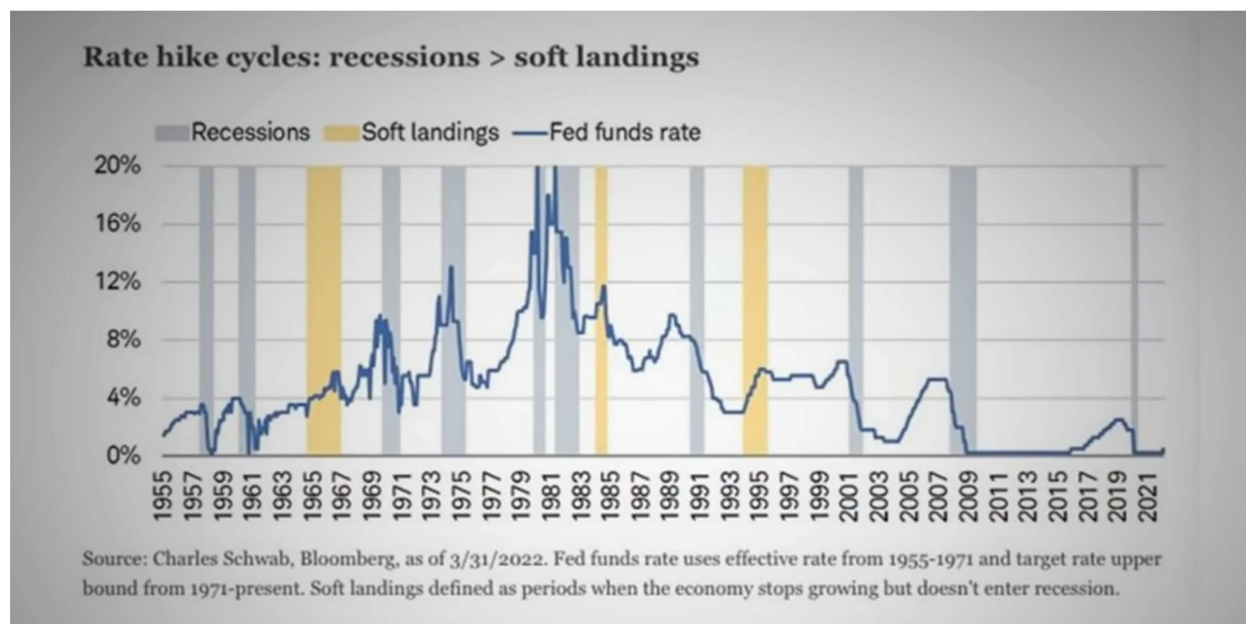


Disclaimers:

- *Aurimax Investment Club and its team has, to the best of its ability, taken into account various factors – both quantitative measures and qualitative assessments, in an unbiased manner, while conducting our strategies. However, they carry risks and uncertainties linked to broad markets, as well as model underperformance due to some potential extreme future events. They should not, therefore, be the sole basis of investment decisions.*
- *Neither our model back-testing simulation returns nor our actual incubation returns guarantee Aurimax funds or portfolios' performance, nor should they be viewed as an assessment of a fund's, or the fund's underlying securities' creditworthiness.*
- *Mutual fund or customized wealth management portfolio investments are subject to market risks and management costs. Please read the portfolio information and other related documents before investing. Past performance is not indicative of future returns. Please consider your specific investment requirements before choosing a fund, or designing a portfolio that suits your needs.*
- *The indexes we use are all ETFs for fair comparison purposes. ETF returns may differ slightly from the indexes themselves. For more portfolio information, please visit: Aurimax Investment Club (aurimaxclub.com)*

Economic Recession?

It is hard to predict a recession, especially its timing and duration. However, looking back at the history since WWII, out of 13 Fed hiking cycles, 10 led to recession.



Central banks had been slow to recognize the incoming surge in inflation or misjudged it as “transitory,” and therefore late in taking actions to fight against it. As a result, they have to take more aggressive measures now. The usually quarter-point gradual hikes are replaced with much larger steps. Quantitative tightening has also been initiated in many developed countries. We haven’t seen the tightening scale in this speed and breadth in more than 40 years!

Up to now, there is no sign that central banks blink. The Fed minutes from their June meeting showed their commitment to getting inflation down. Their priority now is inflation rather than growth. Many on the FOMC saw the risk of entrenched inflation and signaled that a 50 or a 75 basis-point hike at the July FOMC was most likely. According to the minute, “participants concurred that the economic outlook warranted moving to a restrictive stance of policy, and they recognized the possibility that an even more restrict stance could be appropriate if elevated inflation pressures were to persist.”

In such a “restrictive’ rates environment, a recession is now looking more and more likely. The situation is further complicated by the "destructive" force of an entrenched high inflation expectation (Bob Michele, JPMorgan), the uncertainty of Covid-variants and the resulted China’s zero-Covid policy, and the prolonged war in Ukraine.

We won’t know if we had a recession until afterward. Maybe we are already in a recession right now judging from the performance of the stock market, a powerful economic thermometer.

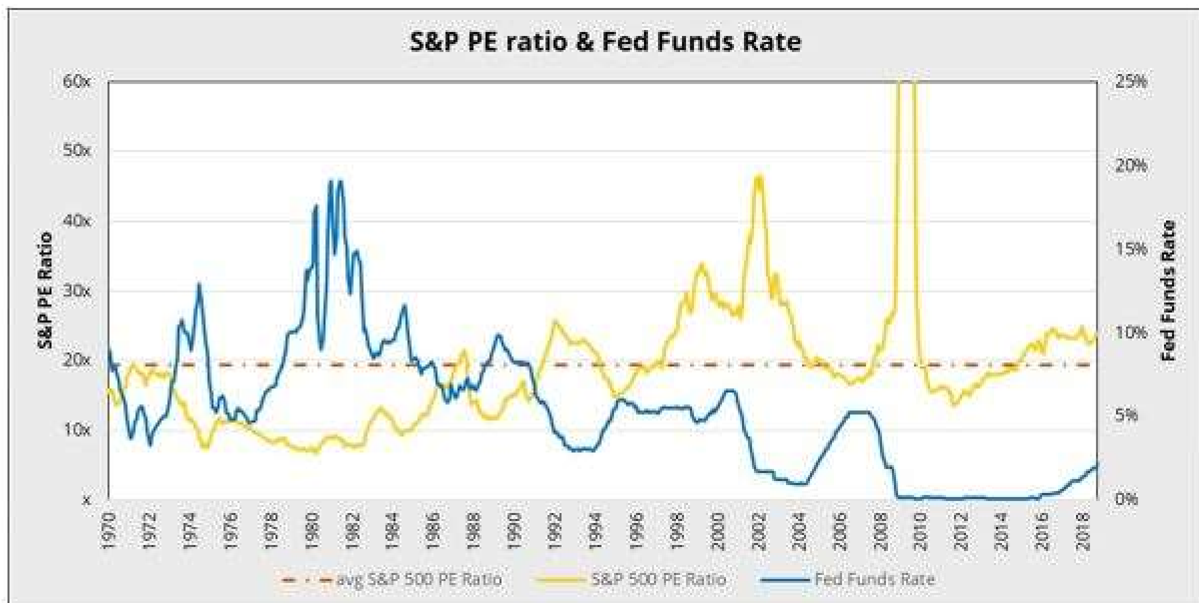
Is the Market still overvalued?

After the bloody bath in Wall Street in the first half of this year, the stock valuation was off about half from the peak made in 2020. The current PE multiple of S&P based on the 12-month reported earnings-per-share went down to 20 from 39 in December 2020. This leads some Wall Street gurus to claim that the market valuation is "fair" now. They might be right if the EPS continues to grow from here, and Fed stops raising rates and ends QT.

At this club, we have a different perspective.

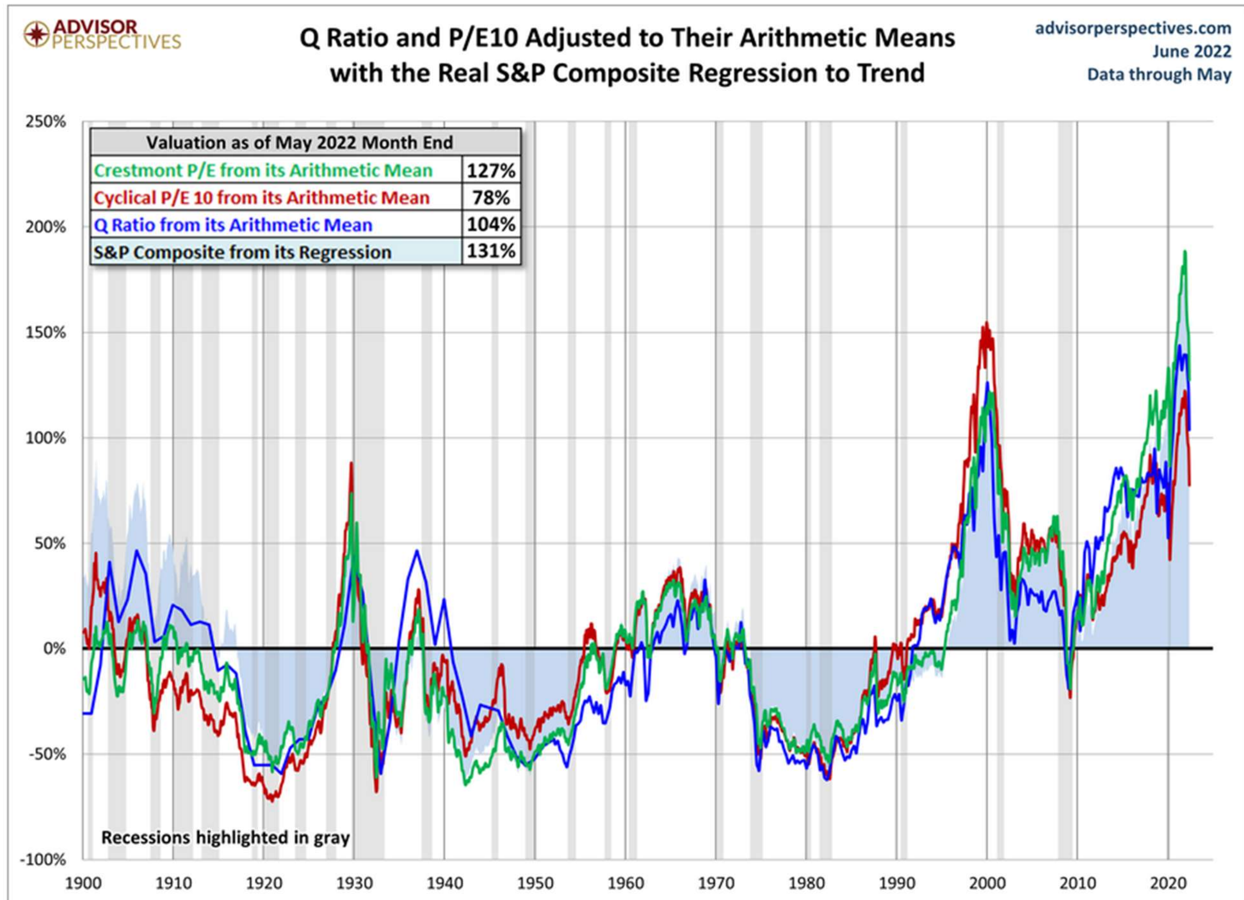
First, we believe US corporate earnings are going to peak in the first half of this year. As the rate hike effects take hold in the real economy (e.g., the rising business funding costs), corporate profit will start to deteriorate. Furthermore, high inflation will hamper consumer demand and thereby squeeze profit margin. The tight labor market and rising wage costs also add salt to the wounds. So, it is highly likely that we will see S&P earnings to start declining in the second half of 2022 and beyond. As denominator "E" gets smaller P/E gets larger.

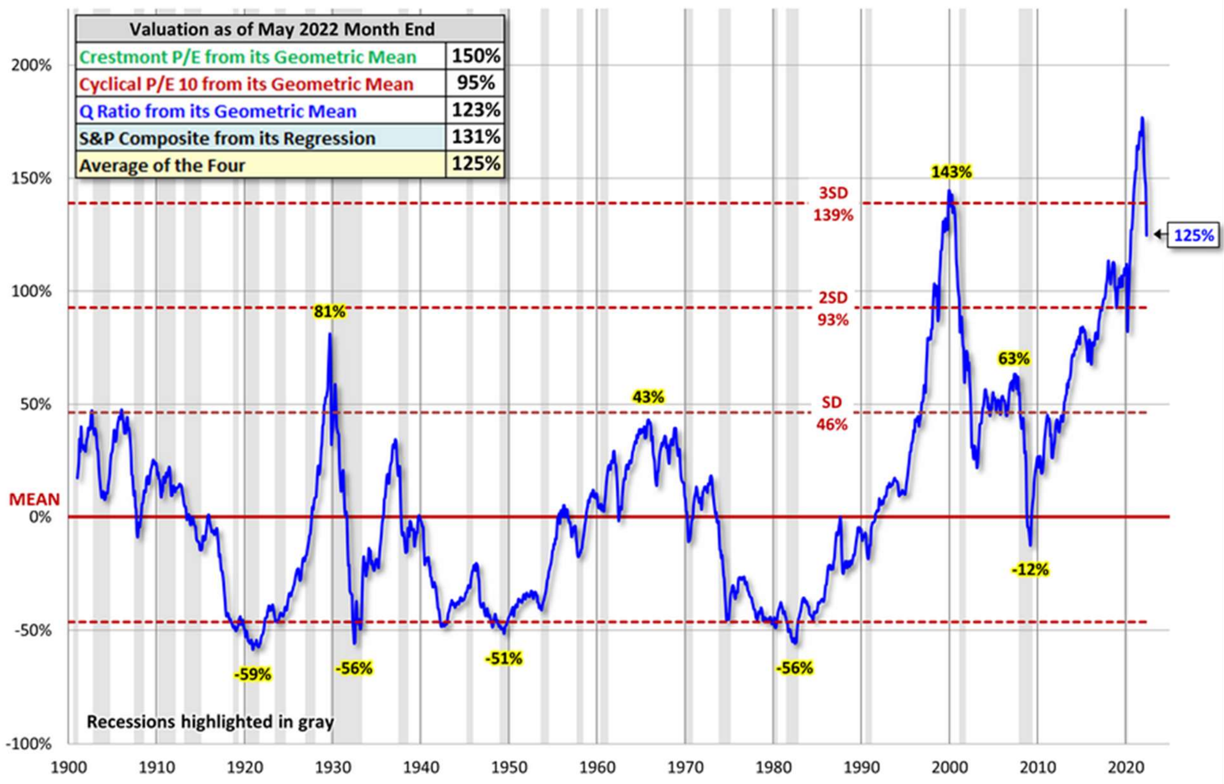
Second, as interest rates (also called "discount rate" in stock valuation models) jump due to central banks' aggressive measures, the anchor for which professionals valuing stocks will change. A P/E multiple of 20 may be deemed "fair" in a low-interest rate environment, but may be considered "expensive" in high interest rate settings. As the chart below shows, in the 70s and 80s, when the Fed Fund Rate was high, the P/E ratio was low. Since the 90s, during a long period of low Fed Fund Rate, the P/E ratio of S&P 500 remained above average most of the time.



(Source: Valuescope)

Third, although current P/E collapsed in the short term due to the market downturn, a longer-term P/E measure, Shiller P/E (or P/E 10), remained at the high end of history. So are other macro equity valuation ratios, such as the Q ratio. The data of the charts (by Jill Mislinski) below are from May 2022, but they can still give us insight from a historical perspective.





From the above two charts we can conclude that despite the “correction” of equity multiples this year, the stock valuations are still not cheap from a historic perspective. Of course, as Mislinki, the creator of these charts points out that “these indicators aren't useful as short-term signals of market direction. Periods of over- and under-valuation can last for many years. But they can play a role in framing longer-term expectations of investment returns.”

Our conclusion is: despite the more than 20% drop in the stock market this year, the market valuation still has not necessarily come down to a “fair” level. The coming corporate earnings recession and the high discount rate in valuating stocks could bring new complications to the equity market given the still elevated longer-term multiples.

Our Q3 Investment Strategy

The main world equity markets are in bear territory. We believe the "perfect storm" that rocked the markets have not pacified yet, at times may even intensify. Therefore, our general attitude is still cautious.

Nevertheless, bear market rallies are a phenomenon that can't be ignored. The rallies may be caused by various reasons. For example, the inflation in certain months shows cooling down; or China abandons zero-Covid policy due to the new variants no longer cause social health crisis; or Russia's war in Ukraine ends; or even the market hits certain major technical supports. These events alone or combined could cause market sentiment to swing. Depending on our research, we will use our cash positions to take advantage of these opportunities. However, to be a bull we need to see if the Fed has completed its rate hiking cycle, if the market multiple really come down to a reasonable level, and above all, if corporate earning prospective starts to brighten.