OYAT ADVISORS – QUARTERLY COMMENTARY

1Q 2023

Investment landscape

Market participants and commentators may be hard-pressed to find a lot of positives to highlight in what has been an eventful first quarter of 2023. One may point to the fact that global growth has generally surprised positively, with lower energy and oil prices, as well as the reopening of China, playing an important role in improving business sentiment. But other than that and rising asset prices, there isn't a lot of good news to report.

On the other hand, the geopolitical backdrop has remained challenging, with no end in sight to the war in Ukraine, and renewed tensions between the U.S. and China. On the inflation front, headline numbers continued to ease over the quarter thanks to lower energy prices, but core inflation generally remained stickier, forcing global central banks to tighten monetary policy further.

But by far one of the most noteworthy developments this year was the collapse of Silicon Valley Bank (SVB) in March (the second largest banking failure in U.S. history), as well as the eventual failure of a 168-year old institution: Credit Suisse, which was acquired by its rival UBS under the auspices of the Swiss Federal government.

Let us briefly comment on the crisis that emerged in the financial sector, how fiscal and monetary authorities responded to it, and the implications this may have for investors going forward.

Many have been surprised that nothing in the financial system had broken as rates shot up dramatically higher, and at a very rapid pace, over the past year. Normally, in such instances (as was the case in 2008/09), a crisis may emerge as borrowers' cost of debt increases beyond their capacity to service and repay their debts. In other words, the interest rate exposure is typically on the borrowers, first and foremost.

But this time around, rising interest rates became more threatening to lenders than to borrowers. This unusual circumstance results from the fact that because central banks kept interest rates at an ultra-low level for so long, many borrowers unsurprisingly decided to take on long-duration, fixed-rate loans and mortgages. In other words, the interest rate risk is now mostly on the lenders, while borrowers may have a little more time before higher interest rates become seriously problematic for them too.

So on which balance sheets does the massive interest rate liability currently lie? The short answer: non-bank financial intermediaries, smaller/regional banks, insurance companies, and pension funds.

In the case of SVB specifically, the large influx of deposits starting in 2020 (which coincides with the restart of quantitative easing) had given the bank little time to look for loans to underwrite, so it used the funds to buy securities instead. Specifically, it bought a lot of mortgage-backed securities with long durations and fixed rates, which dropped materially in value as interest rates spiked.

When the Federal Reserve (FED) started to rapidly tighten financial conditions in 2022, the market's appetite to fund venture companies began to dwindle, which led SVB's deposits to fall. This eventually prompted the bank to have to sell some of the securities it held, and thus realize losses large enough to require raising additional equity capital. This is when market participants became aware of the sheer magnitude of the unrealized losses on SVB's books. The bank's depositors promptly withdrew their money, and in the age of mobile banking, things unravelled very quickly for SVB, which was unable to meet its obligations within a few days and thus collapsed.

In the case of Credit Suisse, its demise has less to do with the realization of losses on its bond portfolio, but rather the disastrous investments it has made in its investment banking division over recent years, among numerous other factors. Still, as is always the case when banks fail, the gradual and then sudden loss of confidence which led to large withdrawals from depositors ultimately resulted in insolvency.

In our commentary from last quarter, we stated: '*rapidly tightening financial conditions in an over-levered world also increases the risk of so-called 'credit events', in other words, when systemically important financial institutions get into financial distress, and central banks are forced to intervene or run the risk of contagion. … But importantly, where will inflation be by that point? Will another 'rescue' by central banks work this time, as it has without fail for many decades, or will it prompt another inflationary wave and turmoil in global financial markets?*'

Let us now briefly examine how fiscal and monetary authorities responded to the turbulence in the banking sector we just described.

Almost comically, on the morning of Sunday, March 12th, 2023, Treasury Secretary Janet Yellen told CBS News: '*During the financial crisis [of 2008/09], there were investors and owners of systemic large banks that were bailed out … and the reforms that have been put in place means we are not going to do that again.*'

But then they did do it again. A few hours later, right after Asian markets opened, the U.S. Treasury announced that all SVB depositors would be made whole and have immediate access to their funds. The 'bailout' of other banks was arranged by the FED's new facility, the Bank Term Funding Program (BTFP), which enables banks to borrow 100% of the face value of certain securities for up to a year at no cost. As of the latest available data, the usage of this facility stood at nearly USD 80 billion, while other forms of liquidity assistance such as discount window and other credit extensions stood at USD 70 billion and USD 175 billion respectively, for a total of USD 325 billion[1].

Across the Atlantic and a few weekends later in Switzerland, a private transaction was being engineered for UBS to acquire Credit Suisse, thus bailing out its depositors. All it took was nearly CHF 260 billion in liquidity assistance from the Swiss National Bank (SNB) and a loss guarantee from the Swiss government (CHF 9 billion), representing about 1/3rd of Switzerland's gross domestic product (GDP)[2].

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[1] https://www.zerohedge.com/markets/fed-balance-sheet-shrank-most-34-months-bank-bailout-facility-usage-rises

[2] https://www.reuters.com/business/finance/switzerland-puts-up-260-billion-francs-credit-suisse-rescue-documents-2023-03-20/

Beyond the sheer size of the potential bailout by Swiss authorities, a number of elements from this forced marriage clearly stood out. The first was the application of an emergency decree by the Swiss Federal Council, which dispensed with the typical requirement for shareholders to approve a merger. And second, many were surprized to see some of Credit Suisse's bondholders get completely wiped out, while shareholders received a measly CHF 0.76 per share, down 59% from the last closing price. Specifically, holders of subordinated bonds (Additional Tier 1 capital notes) have to completely write off around CHF 16 billion, seemingly turning the normal creditor hierarchy enshrined in law on its head. While the write down ordered by the Swiss Financial Market Supervisory Authority (FINMA) is compliant with the terms of these debt securities, it is sure to prompt a re-evaluation of the risks associated with such contingent convertible (CoCo) bonds by market participants, which could lead to higher financing costs for European banks in the future.

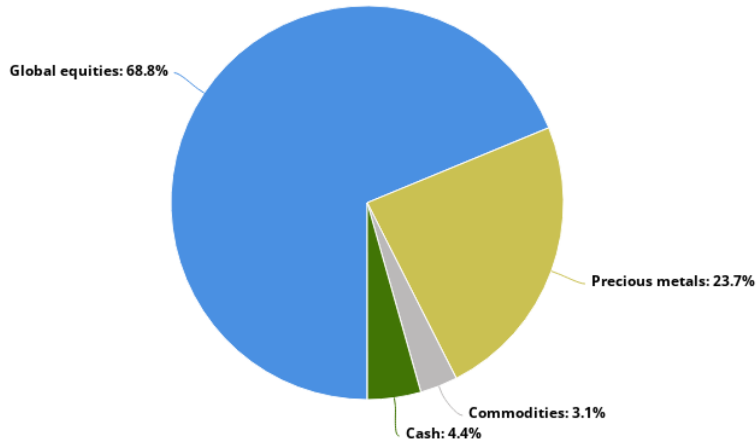
In sum, the risk of systemically important financial institutions getting into financial distress did materialize this past quarter, and central banks were predictably forced to intervene or run the risk of contagion. That risk is indeed very real, as there are plenty of other banks that would face big losses if they were forced to sell securities to raise cash, should they suddenly experience funding pressures. Nor should it be lost on market participants that most central banks also purchased trillions of dollars of fixed-rate securities at ridiculously low interest rates and are now carrying enormous unrealized losses. This might appear less consequential for the time being, but further down the line, it may erode the credibility of central banks and lead them to revalue a certain asset (i.e., gold) to offset losses and repair their balance sheets.

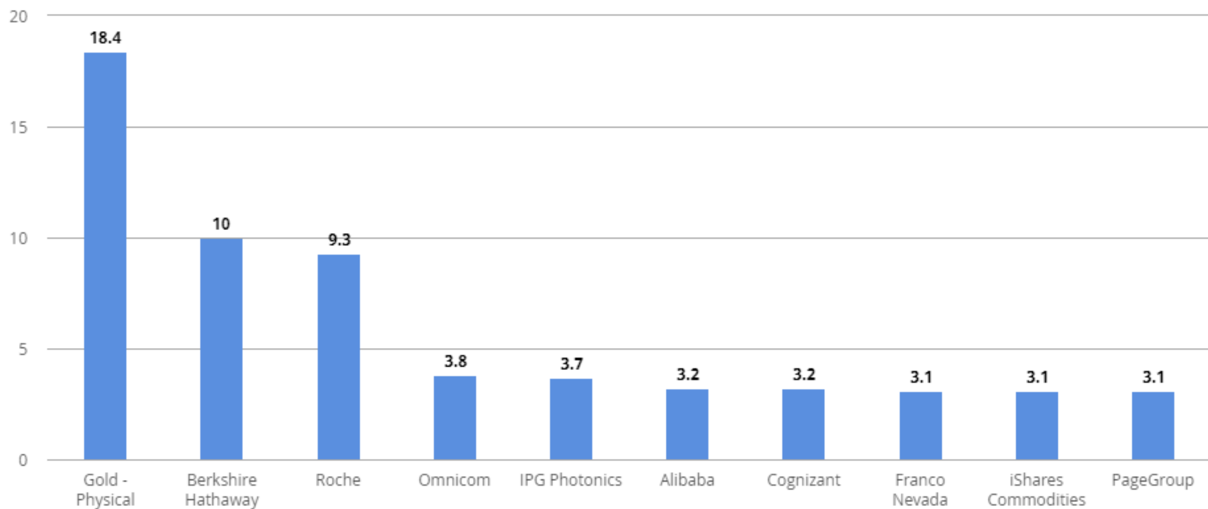
In this context, markets started the year with a strong rally for equities in January. Fixed income markets also reacted positively to the decline in inflation and the prospect of less restrictive monetary policy. In February, equity and fixed income markets were weighed down by relatively strong economic data, which together with sticky core inflation forced investors to reassess their interest rate expectations, and price in 'higher-for-longer' interest rates. In March, the collapse of SVB and Credit Suisse, as well as broader concerns around the financial sector, hit bank shares hard, while gold and government bonds rallied. The fall in bond yields also led to an upturn in growth stocks, which rallied by more than 15% over the quarter. Conversely, the hit to bank shares weighed on the performance of value stocks, which only delivered around 1% over the quarter.

Where does that leave investors? Clearly, monetary policy has long played a role in financial matters, but gradually over the last 30 years or so, it has become the dominant factor that investors have had to contend with. This is regrettable. Unfortunately, we believe that in the short-term, the investment landscape will continue to be largely driven by central bank actions. Despite this, we are convinced that active managers can still find attractive idiosyncratic investment opportunities, as well as benefit from overall market volatility. Our investment process enables us to deploy capital in what we believe to be the best possible way to navigate the current investment environment - by focusing on owning scarce and productive assets, often in the form of high-quality companies, as well as maintaining a significant level of optionality by holding liquid reserves such as physical gold.

Asset allocation

The graphs below display the Oyat Investment Fund's allocation of capital across asset classes, as well as the Fund's top-10 positions:





Performance

Quarterly returns as of March 31, 2023, in CHF

	1Q23	YTD	1 Year	3 Year	5 Year	Since Inception*
Oyat Investment Fund	3.48%	3.48%				0.98%
MSCI World	6.75%	6.75%				1.37%

Total returns presented for periods greater than one year are annualized.

**Inception Date: November 10, 2022*

In the first quarter of 2023, the Oyat Investment Fund returned 3.48% in CHF, versus 6.75% for the MSCI World Index. Since inception, the Fund's total return stands at 0.98% vs. 1.37% for the aforementioned reference index.

The Fund's largest performance contributor this past quarter was physical gold, which increased by 7.2% in CHF. The yellow metal, which we consider as the ultimate reserve asset, given its scarcity, permanence, and the fact that it carries no counterparty risk, initially moved up in January, before losing most of its gains in February. Only throughout March, as central banks were forced to intervene to address solvency issues in the banking sector, did gold resume its long-term upward trajectory.

Shares of IPG Photonics advanced approximately 28% last quarter, also meaningfully contributing to the Fund's success. IPG's dominant position in the fiber laser industry for materials processing applications gives us confidence in the company's long-term prospects, and we stood ready to acquire a participation in this high-quality company once again at depressed levels late in 2022.

Spanish multinational clothing company Inditex also had an impressive quarter after reporting its strongest ever year of sales in 2022. Inditex continues to protect its brands such as Zara and effectively handle inflationary pressures, all the while continuing its shift to omnichannel retailing. We trimmed our position in the company late in the quarter after a rise of nearly 30% since our purchase in 2022 but continue to own a moderate position in this quality retailer.

Advertising leader Omnicom also contributed positively, with a rise in the period near 15%. Omnicom produces steady profits and cashflows despite operating in what is viewed as a cyclical industry, enabling us to take advantage of volatility to purchase the company when the shares offer solid value, all the while benefiting from attractive dividend payments.

The continued strong performance of Novo Nordisk in the quarter is also noteworthy, as its diabetes and weight-loss treatments continue to benefit from structurally growing end markets.

The overall positive performance so far in 2023 was tempered by one of our largest equity holdings, Roche, which failed to impress in the first quarter. The company proved to be a meaningful performance detractor, as shares faltered by approximately 10% in a market increasingly focused on growth stocks, including technology companies, rather than dependable pharmaceutical leaders. Roche has recently lost the market's interest as growth expectations for the near-term are increasingly subdued. The company's diagnostics business is receding from a pandemic-driven peak, while pipeline disappointments in both the Alzheimer's area and the company's TIGIT cancer immunotherapy trials have left growth expectations in the doldrums. The good news is the depressed share price offers rare value in one the world's best pharmaceutical companies. Investors with a longer-term perspective may recognize that recent short-term setbacks do not materially impair Roche's deep research and development capabilities, that few peers can match. The reliable Swiss franc dividend is adequate compensation to wait for the market to once again recognize Roche's value, while the company's defensive nature leaves the Fund well prepared for any possible market turbulence as we move through 2023. Our response to the share price weakness in Roche was to meaningfully increase our position in the company during the first quarter, largely funded through the sale of our Novartis position.

Another significant performance detractor was our position in 3M Co., which continues to struggle with weak near-term fundamentals, as well as the overhang from potential litigations related to earplug products manufactured for the U.S. military, and the production of perfluoroalkyl or polyfluoroalkyl substances (PFAS), otherwise known as 'forever chemicals'. The stock was down over 15% this past quarter.

When looking at the Fund's performance relative to the MSCI World Index, one should note that large technology companies led the charge, and our relative underweight in the area proved to be a headwind as companies such as NVIDIA (up over 80%), Meta (up over 70%) and Tesla (up over 60%) pulled global equity indices up. We welcome market optimism but remain wary of the plethora of risks facing companies and investors as of today. As such, we remain positioned across an adequately diversified selection of high-quality companies trading at attractive valuations, as well as a significant allocation to physical gold. Trading in the quarter also featured a modest increase to precious metals miners such as Franco Nevada, as gold's investment case continues to strengthen in light of recent market developments. As always, capital preservation is our first priority, and a prerequisite to our second main objective of capital appreciation in real terms. We believe the Fund is well positioned to fulfil its long-term investment objectives.

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