

MANAGER REPORT

ZZ – Entrepreneurial Group

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COHORT 17

Portfolio Management Program

2019 – 2021 • ZZ-ENTREPRENEURIAL GROUP

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MAY 31ST, 2021

I. STRATEGY AND APPROACH OF THE GROUP

I.1. STRATEGY

We understand investing à la ZZ as an extensive, discretionary global macro style approach towards financial markets that generally aims for outperformance and high returns whilst deliberately taking the associated risks.

Historically, key return drivers have been emerging- and frontier markets' fixed income assets as well as the respective local currencies complemented by equities. In particular, the ZZ strategy, which therefore focusing on EMs and FMs, intends to exploit inefficient valuations in

high-yield countries and thereby puts its focus on the academically characterized ‘carry trade’, that ensures continuous liquidity and capacity to act when opportunities arise. In line with that, the cash position is usually kept at an elevated level. Moreover, tactical deviations from core regions, as well as the target asset allocation facilitate ad-hoc reactions in extraordinary market environments that may boost returns.

1.2. APPROACH

Back in October 2019, when we started as new ZZ analysts, our highly motivated managers introduced us to a professionally structured and well-performing portfolio and integrated us into the ZZ’s business from the very first second to prepare us for the eventual takeover.

In terms of resources, participation, and organization we joined a highly sophisticated environment with decent meth-

ods for qualitative and quantitative research, as well as a broad range of instruments to develop strategies, being readily available. Nevertheless, thanks to extensive quantitative expertise in our team, we focused on contributing to the ZZ toolbox by designing an automated instrument for short-term NDF investments which follows purely systematic measures. The tool, therefore, offers a great deal of diversification concerning the discretionary NDF strategy, that is built on our preferred metrics i.e., value, momentum and carry.

With respect to the extraordinary circumstances that have accompanied us throughout the program, the ZZ’s entrepreneurial approach was particularly advantageous for us as it increased our investment universe tremendously when price distortions could be observed across all markets and asset classes. That is, we benefitted from some rather untypical ZZ positions such as US equity and REITs

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and generally established a tactical shift towards a more balanced asset allocation. Hence, we conducted a restructuring of the portfolio in favour of equity, anticipating reflation and adapting to ongoing fundamental macroeconomic movements. To realize those alterations, we primarily reduced holdings that showed weak performance in the past, combined with a poor prospective outlook.

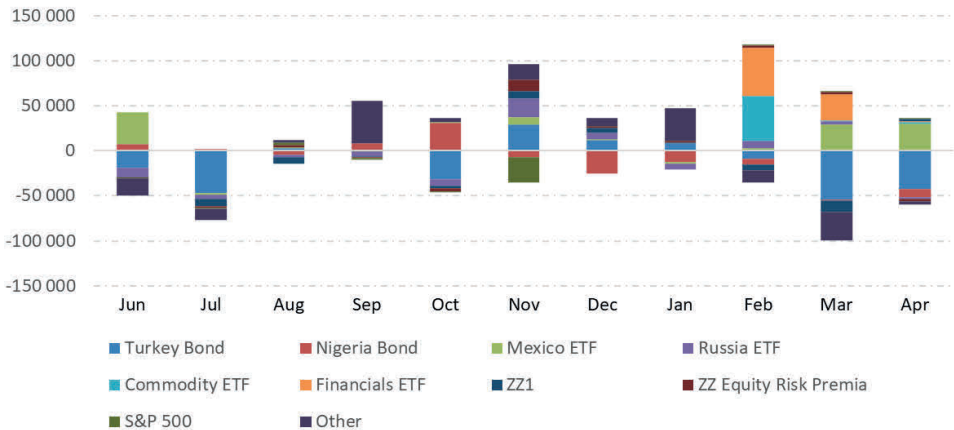
2. PORTFOLIO PERFORMANCE

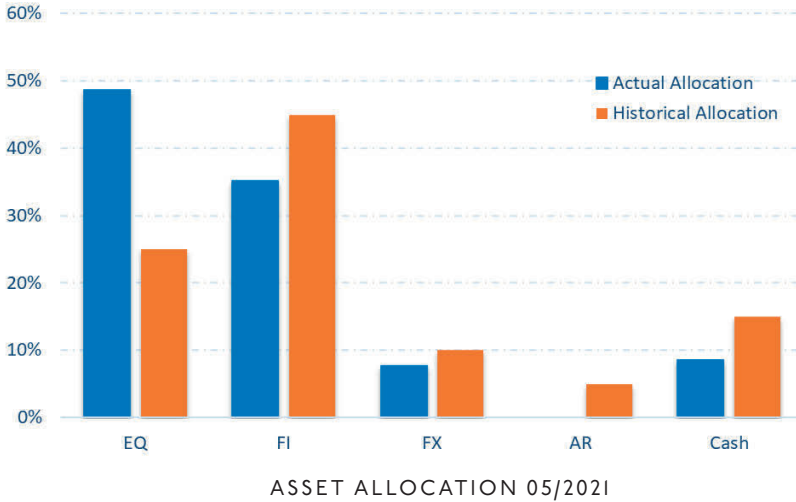
2.1. OVERALL PERFORMANCE

After taking over the portfolio in May 2020, we initially benefited from the sharp rebound that followed the COVID-19 crash in March. However, not long after the takeover, we experienced a sharp downturn up until the beginning of August, which can mainly be ascribed to our significant Turkey exposure at the time. Thus, an increasing inflation rate, loose monetary policy and the consequent

deterioration in the currency greatly suppressed our performance. After assessing the situation, we decided not to book our losses, and instead remained patient in expectation of a better exit point.

At the end of August, after a weak with little movement, the portfolio was finally able to generate some profit in September. While stock markets were volatile due to the increasing COVID-19 cases and the upcoming US elections, our portfolio remained solid due to the large, fixed income allocation at that time. After a short drop, our strategy and allocation seemed to align, when we experienced a sharp rebound in our performance in October and November. That is, the positive vaccination news combined with rising commodity prices had quite positive effects on emerging markets and thus on our performance. Furthermore, with the change of Turkey's central bank governor and the largest interest rate increase in nearly two years in November, the Lira





appreciated, and holding the position finally seemed to pay off. The position then went on and provided a solid return over the two upcoming months.

2.2. 10 LARGEST POSITIONS

While we were well positioned for December and January, our overall performance was negatively impacted by the Nigerian bond. Boxed into this position due to capital controls, we were limited in our possibilities to act, therefore, we focused on further diversifying our portfolio and generating return with other positions. The graph on the left clearly reveals when our portfolio was struck once again by Turkey in March due to the already mentioned governor change. That left us with almost no return over the whole year.

2.3. ASSET ALLOCATION

Finally, in April, we started to decrease the Turkey exposure as we assessed the

position to be too risky and unpredictable to stay invested any longer. At the same time, we doubled down on some of our most promising equity holdings and screened the market for other potential sovereign bond positions to adhere to our strategic asset allocation. That was in line with our portfolio reassessment earlier in January. As we expected larger inflation and less upside potential in the fixed income markets, we agreed to increase our equity exposure while decreasing our less attractive fixed income positions in the context of a tactical shift. By focusing on short duration equities and commodities, we managed to avoid further losses. To guarantee a certain level of carry, we additionally built a dividend basket that provides us with frequent cash flows.

2.4. CURRENCY EXPOSURE

Throughout our managerial year, our currency exposure has naturally evolved as

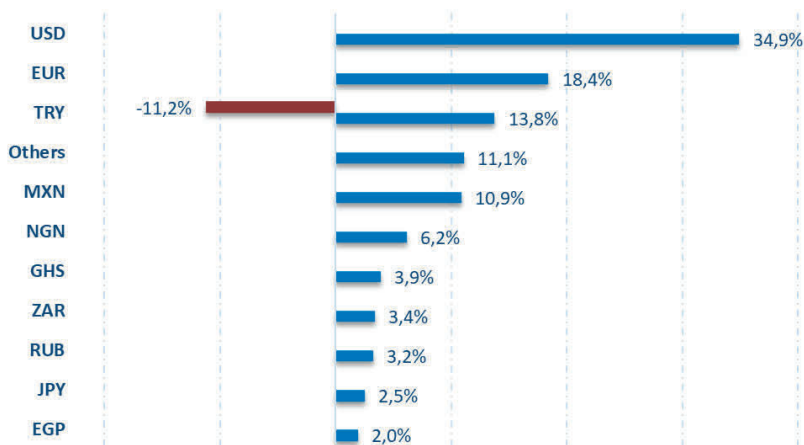
we have altered the composition of the ZZ portfolio. The most significant changes happened in our USD exposure, which has increased from -4.96% to 34.91%. At the same time, the Turkey exposure has noticeably declined from 33.54% to 24.93%. That is in line with our divesting and shifting towards a higher share of equity, which is strongly linked to the US. When we took over the portfolio, we had a 4.58% exposure in the US market which we quadrupled by taking up additional equity positions such as the S&P 500, Global Financials or US REITs among others. Furthermore, we complemented our bond exposure in Mexico by a significant equity stake as the current outlook is promising for both asset classes.

3. MARKET CONDITIONS THROUGHOUT THE YEAR

When we took over the portfolio at the beginning of May 2020, basically all asset classes were just coming from their multiple year's lows in March, comprising of equities, fixed income, and commodities. Due to central bank interventions and fiscal support for companies and individuals, all asset classes started to rebound from that point on going forward. Particularly Tech stocks began to outperform as they profited from the higher demand for digital services and e-commerce due to stay-at-home orders and lockdowns that were aimed to reduce the spread of the coronavirus. Jerome Powell, Chairman of the FED, vowed to keep interest rates near zero for an extensive period of time and to purchase public and private debt to create favourable long-term (re-)financing conditions for

companies and the government to ensure a stable financial system during the crisis. As the money printing press gained steam in the US, bonds, stocks, and commodities continued to rise through late spring and summer of 2020. In contrast, investors doubted the strength of the US Dollar and feared the risk of inflation. As a result, the US dollar began to fall, while other currencies like the euro and safe-haven assets like Gold and Silver appreciated substantially in July. Gold hit a new all-time high in the first week of August, breaking through \$2000/oz. By the end of August, Tech stocks almost gained 100% from the lows in March, with the NASDAQ rising from around 6,600 points to almost 12,500 in just under six months.

From the beginning of September, the stock market rally started to cool down as risks and uncertainties around the upcoming US presidential elections came into focus, while spreads of developed markets' bonds continued to tighten with monetary policy support. The markets did not give away which candidate they deemed more likely to win, though the surge in renewable energy stocks (also called the "Biden-Trade") was an indicator that many investors were betting on a change at the top of the US government. As the uncertainties continued to linger, all assets retreated including both growth and value stocks in the US and Europe and also commodities and EM assets. The showdown of the US presidential elections took place on the 3rd of November when Donald Trump felt confident to continue for a second term after the first count of votes despite his bad



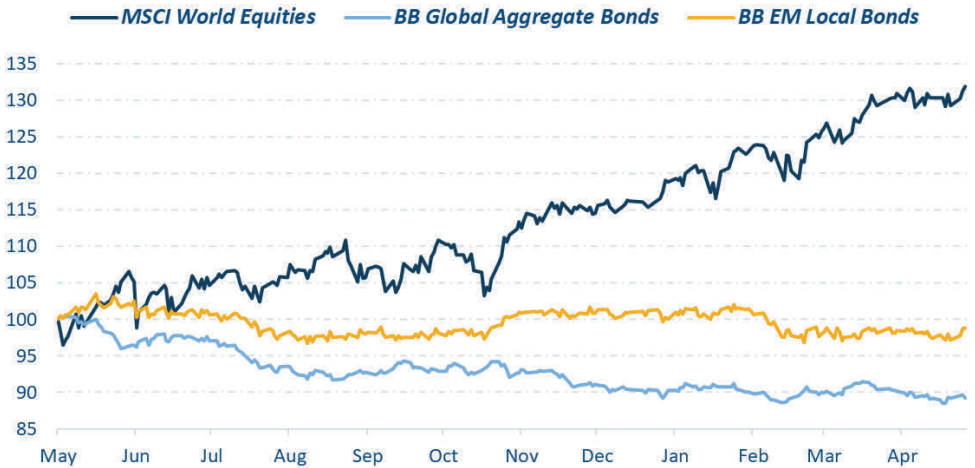
CURRENCY EXPOSURE 05/2021

reputation on handling the pandemic. Due to the lockdown and other social restrictions, a record number of Americans decided to vote by mail, therefore counting all votes and determining the winner of the election took much longer than in the past. However, after a few days, it became clear that Biden would get the majority of the electoral college votes, which made him the next US president.

Only a few days later, on the 9th of November, Pfizer and BioNTech published their vaccine results, which showed an efficacy of over 95% against COVID-19. This great news for the economy boosted investors' hope that we would get back to normality soon, so the markets went off like a firework. Risk-off assets like the US Dollar and Gold were sold off, while stocks and bonds surged higher. From this point on, the so-called "reflation trade" formed, which means that especially hard-hit and cyclical industries (like the oil and travel industry) as well as EM and

other risk-on assets began to outperform.

By the start of the new year, the first signs emerged that inflation might become more of a topic in 2021 as people might increase their spending due to a consumption backlog that already resulted in a higher savings rate in 2020. In January, a slow but steady decline in bond prices could be observed. A completely different and unexpected phenomenon occurred in the last week of January – a group of retail investors on Reddit, more specifically on a subreddit called "Wall-StreetBets," came together and discussed the stock of Gamestop and deemed it a potential target for a short squeeze as over 100% of the float was sold short by hedge funds and other institutional investors. Indeed, the short squeeze kicked in and as short-sellers retreated also from other highly shorted stocks, investors turned into a risk-off mood. A week later, the Reddit mania was over, and the market recovered from the swift shock.



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While inflation fears grew in February, fuelled by higher-than-expected inflation readings in the US and Europe, the bond market became more and more bearish. By the end of February, bonds were sold off heavily, pushing yields higher. While the market stabilized in March, the reflation trade started to outperform the rest again in April 2021, as a new fiscal stimulus was agreed on under the Biden administration. Bonds stopped their decline and stocks and industrial commodities e.g. copper and lumber rallied massively, reaching new all-time highs. Stock markets outside the US, especially in Europe and the EM, were amongst the biggest winners. With the beginning of May and the handover of the portfolio to the new managers, inflation stays the dominant topic. Bonds show again weakness as the economic recovery picks up due to widespread vaccinations and the end of the pandemic within reach. It remains to be seen, whether central banks will be able to keep yields low during the

time of elevated inflation, or if the classic monetary policy of hiking rates in times of heated inflation will see a comeback, with potentially greater impacts on the economy and financial assets.

4. INVESTMENT BEHAVIOR

The unprecedented circumstances of the pandemic world have forced us to pivot from the traditional source of carry of the ZZ group, which is based predominantly on the fixed income exposure to the frontier and emerging markets. With almost half of the portfolio allocated there, the pandemic outbreak last year caught us off guard. Hence, we faced significant difficulties with finding the optimal allocation and it took us more time than it should have, to adapt to the new paradigm of financial conditions and implement the necessary alterations.

Our flagship NDF strategy is the implementation of an FX carry trade op-

timized for harvesting the interest rate differential boosted by expected currency appreciation. A carry trade consists of shorting the low yielding currency (in our case EUR or USD) and buying the high yielding one. The carry premium revealed its fragility during the surge in demand for the US dollar at the beginning of the pandemic in the western world. The monetary interventions that followed have resulted in 0% interest rates across developed and even some emerging markets. This has negatively affected our NDF strategy, by constraining yields in the frontier markets since the US Federal Reserve funds rate serves as a benchmark and reference for the central banks around the globe.

With bond yields as well around historic lows, we were forced to look for alternative sources of carry across available asset classes, generalizing it to a difference between any higher-yielding asset financed with low yielding cash. Under such conditions we had to swiftly rebalance our portfolio, partially replacing bonds with higher-yielding asset classes, keeping 30% of the portfolio allocated to the fixed income, building up on equities and continued to maintain exposure to alternative asset classes such as dividend futures.

During our term, we have been progressively unwinding the overweighted Turkey exposure which has proven to be the right choice. The deterioration of quality of public institutions combined with the disruption of the hospitality industry caused by the COVID pandemic has negatively affected the Turkish Lira.

We strongly believe that the portfolio inherited by the new managers is now already well-diversified, resilient, and well prepared for the uncertain times ahead, however, the dynamism of the current situation requires it to be constantly challenged and evaluated. We believe the most crucial factor implying the composition of the portfolio for the next year is the inflation in western economies, especially in the United States. As of the writing date of this report, the latest Consumer Price Index in the US was 4.2%, the highest since April 1982. Going forward, it is crucial to evaluate both structural and cyclical inflation factors. The key question we encourage the new managers to ask themselves is whether the rise of inflation in the US is just a temporary phenomenon caused by the unfreezing of the economy and postponed realization of demand. If it is not temporary, would it lead to the hike of interest rates or rather an era of the increased inflation? We also encourage them to extend the spectrum of asset classes by the positive exposure to volatility.

5. CONCLUSION, OUTLOOK, AND TIPS FOR THE ANALYSTS

Whereas most of us have joined the PMP with a certain bias towards equity, we built on that and developed a more holistic understanding of markets and investments, particularly strengthening our abilities in macroeconomic and political analysis and using these to identify opportunities. Hosting weekly team meetings, following extensive discussions, and learning from the great exper-

tise of our tutor Richard Boulanger, who patiently taught and answered our questions no matter what, eventually enabled us to professionalize our decision-making as well as our investment behavior. Therefore, we were able to outgrow ourselves.

It says that one learns the most during times of stress in financial markets since the rules that were thought to apply may prove unreliable if panic and irrationality distort human psychology and therefore decision-making. We sincerely hope that the global pandemic will be only a once in a lifetime event, nevertheless, we were able to manage the ZZ portfolio throughout the COVID era, which at the same time, has represented a rare opportunity to learn as it forced us to adapt and collaborate in an unusual order of magnitude. Overall, the sharp decline, and the even faster V-shaped recovery in 2020 capture the market turbulence perfectly that we experienced and therefore affected our course of action. And we must admit that we have not fully anticipated this development. We now know from first-hand experience that the market will not wait until you are ready to decide about how to proceed and that establishing a view and acting accordingly represents a key part of investing since a lack of action will prove worse than being wrong sometimes.

Addressing our analysts as well as future PMP generations, we would like to highlight all the advantages of this truly unique opportunity. Growing together as a team and delivering results during demanding times are invaluable soft

skills that accompany the fundamental knowledge and business acumen in asset management that we got to enjoy. Hence, however turbulent markets might be, history teaches us that good value for money is always true but often hides in between the lines. Therefore, we encourage all PMP students to be open-minded, always discuss ideas proactively and just do it if their intuition, the facts, and the circumstances are in favor of an investment.

Lastly, we are extraordinarily grateful and proud of participating in the Portfolio Management Program and gladly preserve the spirit, the skills, and the knowledge gathered throughout this truly unique journey approaching our diverse future career paths.