ALIUM MARKET NEUTRAL FUND

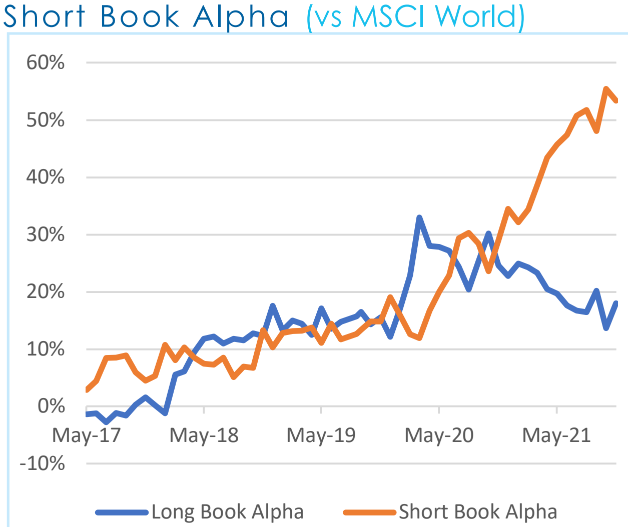
November 2021

Performance (%)	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2017					0.9	1.4	1.7	1.2	-0.3	-1.4	-0.2	-0.8	2.5%
2018	3.6	3.1	2.2	1.2	0.7	0.0	-0.3	-2.3	1.2	0.8	4.3	1.6	17.1%
2019	-1.9	1.8	1.8	-1.4	1.7	-0.5	-1.6	1.8	1.1	-1.0	0.9	0.7	1.0%
2020	1.3	1.8	7.1	-0.6	2.4	1.4	2.1	-3.1	2.8	0.4	-0.5	2.9	19.3%
2021	-0.4	1.1	2.4	1.4	0.9	-0.5	1.9	0.4	-0.2	0.4	1.8		9.7%
Inception													58.2%

Dear Investor,

Two main issues have led to a brief period of volatility in equity markets: A more hawkish Federal Reserve and the emergence of Omicron, a new strain of COVID. In the case of the former, Fed Chairman Powell's admission that current inflation is not transitory, and that policy should reflect this, is a significant change in rhetoric. It comes at a time when price rises are starting to become a political issue in the United States. The upshot of the Fed's change of view has been a flattening of the yield curve; interest rates will move higher sooner, but ultimately push down growth and inflation in the long-term. In the case of the Omicron variant, the implications of its rise are less clear. On the one hand, the inclination of governments, especially those in the Eastern Hemisphere, to shut down their economies and borders at the first signs of a new strain is negative for growth. The positive view is that this appears to be a relatively mild variant and combined with higher vaccination rates in the developed world, is unlikely to lead to pro-longed shutdowns.

Alium Market Neutral Fund Long vs Short Book Alpha (vs MSCI World)



Some funds, traders and retail investors have now de-risked into year end. This can be seen in strong moves lower in some growth and unprofitable tech stocks as holdings were liquidated. An index of US listed unprofitable technology stocks fell 30% from mid-November to Dec 3 before recovering nearly half this move. These types of companies are long duration in nature as investors are discounting cash flows and dividends that may occur a long way into the future. Assumptions of higher rates sooner impact the discounting of these cashflows and hence valuations. Despite markets themselves actually being very orderly this year (the ASX200 has traded in a 6% range since May, for example), this kind of dispersion generally helps the Alium Market Neutral Fund. The chart bottom left shows short positions have been strong alpha generators this year for the Fund and shorts account for more than half of the strategy's relative returns.

Returns in November were well-distributed thematically. In the Health theme, we have taken the view that testing for Covid and other illnesses and vaccinations/boosters will become more regular in nature than the one-off many expect. Pfizer was up 23% in November and Sonic Healthcare rose another 7% and has returned 38% this year. We continue to like the semiconductor space and Nvidia, which is included in both our Pricing Power thematic and Metaverse theme, rallied 28% in November on strong Q3 earnings and large investment plans from the likes of Meta (formerly Facebook). We are very focused on the financial and fintech space into 2022 which we discuss in more detail in this month's thematic. Part of this theme has been our belief that the extreme valuation gap between cheap Japanese banks and expensive Australian ones will converge. This started to play out in November: Sumitomo Bank rose 6% and CBA, a short, fell 11% as NIMs (Net Interest Margins) start to fall rapidly.

ALIUM CAPITAL MANAGEMENT

ALIUM MARKET NEUTRAL FUND

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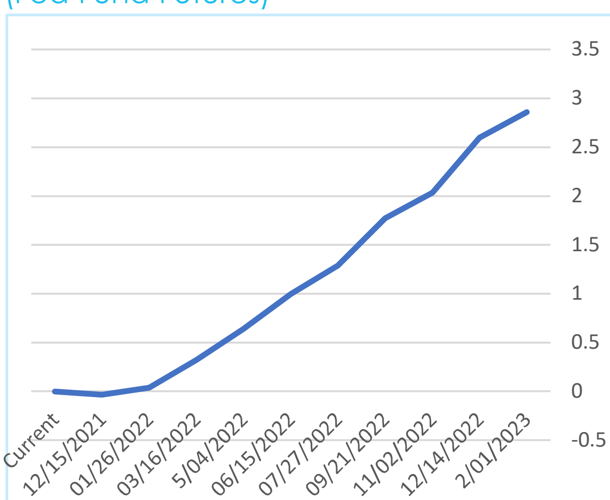
Theme: The Golden Age of Banking

Banks globally have emerged from the pandemic in far better shape than the Global Financial Crisis. Loan deferral programs have accrued significant goodwill with governments, and in turn government fiscal programs have meant asset quality has been better than feared. While, rising interest rates bode well for bank stock outperformance, they create funding challenges for many financial technology (fintech) firms. The Buy Now, Pay Later (BNPL) sector in particular is seeing headwinds from competition as a number of well-funded companies battle for market share in the US. This is manifesting itself in rising marketing costs and lower merchant fees. In our February 2021 newsletter, we laid out our bullish view on Australian, US and Japanese banks as well as a less than favourable view on BNPL as part of our "Golden Age of Banking" thematic. Below, we revisit this theme noting where our views have changed.

Still bullish US and Japanese banks… We see the Federal Reserve's pivot toward an earlier taper of their Quantitative Easing program and potential rate hikes as significant for the US Banks. Banks are the most correlated sector to interest rates and historically US financials have outperformed the S&P500 more than any other sector during periods of rising rates.

Number of US Interest Rate Hikes Priced (Fed Fund Futures)



The continued growth in cash on bank balance sheets (which now stands at >USD1tr) has only served to increase this sensitivity to higher rates. We estimate that the banks could see a 9% uplift to their net interest income from a 1% move in the Fed Funds Rate. With some of the highest rates sensitivity amongst the large-cap banks, we see **Bank of America (BAC US)** as a key beneficiary.

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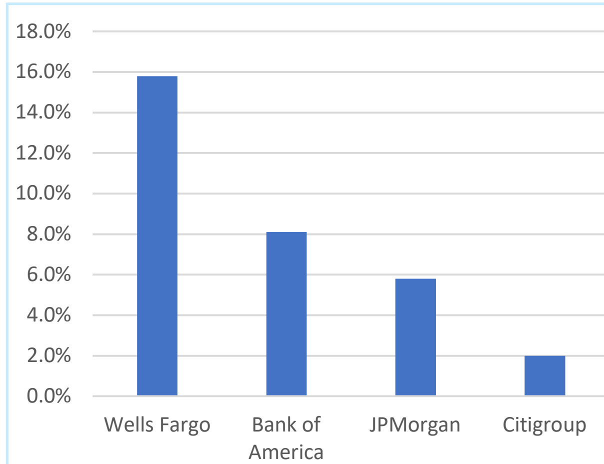
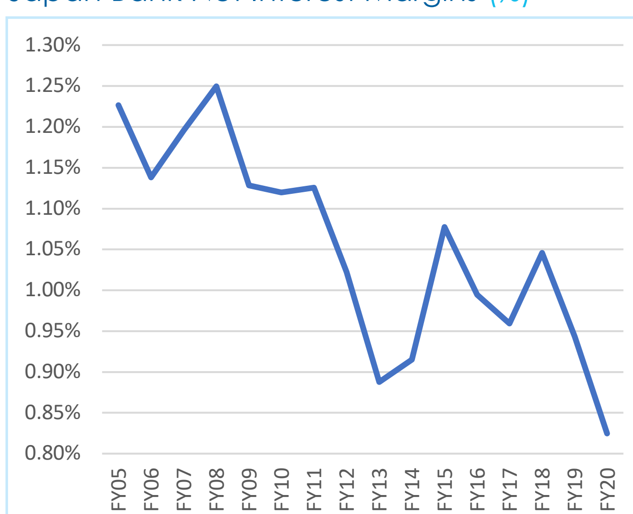
Impact to 2022 Earnings if Fed Funds Increase by 50bps



In Japan, the banks have long suffered from a largely flat yield curve, and lately negative interest rates at the hands of the Bank of Japan (BOJ). More recently however, the new Kishida administration has made it clear it favors an expansionary fiscal policy alongside a gradual normalization of Abenomics (loose monetary policy). Just a 0.10% parallel shift in the Japanese interest rate curve would see FY22 earnings upgraded by +3% for **Sumitomo Mitsui Financial Group (8316 JP).**

Japan Bank Net Interest Margins (%)



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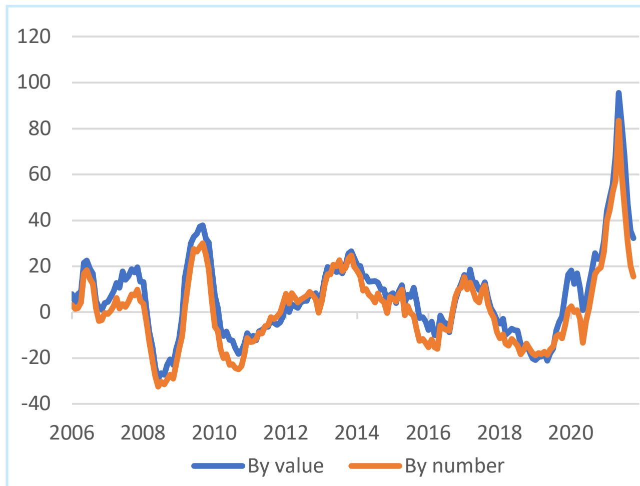
More cautious on Australian banks. As foreshadowed in October's newsletter, we have become more cautious on the Australian banks. Over the past decade, the major banks have divested a large portion of their wealth, insurance and overseas operations, instead deciding to focus largely on the Australian residential mortgage market**. Commonwealth Bank of Australia's (CBA AU)** domestic loan book is now 73% residential mortgages, up from 64% in 2007. Arguably, that has been a good call in the context of a booming housing market and a product that should be accretive to return on equity (ROE). However, there is reason to believe we have seen a near term peak in operating conditions. In response to an explosive increase in house prices, Australia's Banking regulator (APRA) has tightened serviceability measures aimed at slowing high risk lending. The direct impact of these initial steps is likely to be modest, however in the absence of a material decline in prices, we expect further tightening post Federal Election.

Australian House Price Growth (%)

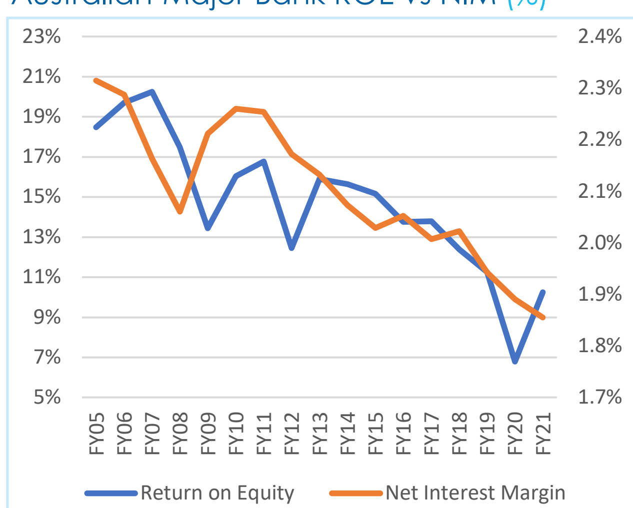
There may also be a signaling effect from the beginning of a macroprudential tightening cycle. Per the chart top right, new housing finance has peaked. Meanwhile, the Westpac-MI '*good time to buy a dwelling*' sentiment index has declined 37% from its peak in November 2020 – a sign that rising prices, deteriorating affordability and now credit availability is weighing on sentiment.

New Housing Finance (ex-refinancing) (%YoY)



The other headwind that has yet to abate has been pressure on Net Interest Margins (NIMs). It is the short end of the interest rate curve that matters for the Australian banks and the Reserve Bank of Australia (RBA) has signaled its intention to stay dovish even as inflation rises toward its target band, instead relying more on the aforementioned macroprudential measures. Compounding the issue has been increased competition, a shift to lower margin fixed rate mortgages, as well as a requirement to hold more liquid assets on the balance sheet. For context, the Japanese Megabanks that have been plagued by similar issues for an extended period, and enjoy NIMs roughly half those of the Australian majors.

Australian Major Bank ROE vs NIM (%)



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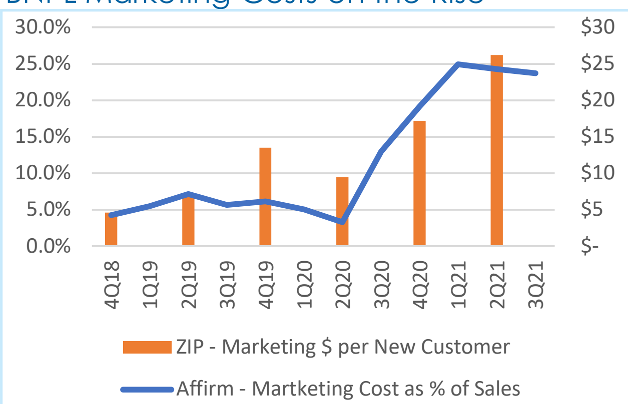
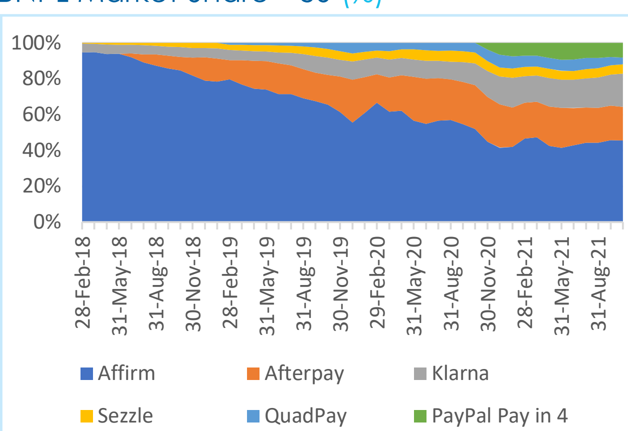
Fintech profitability pressures. In our original piece, we noted that the wave of capital being attracted to the BNPL sector was resulting in elevated competitive intensity, rising marketing costs and lower merchant fees. In short, these businesses while growing topline quickly, were struggling to scale to profitability.

BNPL Marketing Costs on the Rise



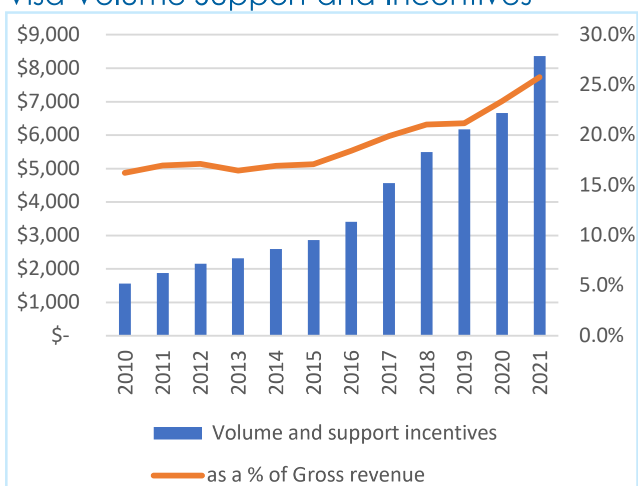
Fast forward to today, and there are 11 BNPL firms that we are aware of listed on the Australian Stock Exchange (ASX), with only 1 profitable at the NPAT (net profit after tax) line in FY21. Similarly in the US, PayPal's entry into the market had come at the expense of **QuadPay (owned by Z1P AU),** and **Affirm (AFRM US).**

BNPL Market Share - US (%)



We also believe that Amazon's recent move to stop accepting **Visa (V US)** Credit Cards in the UK due to high interchange fees is an important development. Similar disputes in the past with large retailers in the US such as Walmart and Kroger were resolved after negotiating a new pricing arrangement, the details of which were not disclosed. However, if we look at the amount of Volume and Support incentives they are paying as a % of Gross Revenue, it is clear that the balance of power is shifting away from payment companies.

Visa Volume Support and Incentives



Kind regards,

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