July 13th, 2023

Q2 2023

Dear Investors,

Hanway Capital Fund has returned **-5,8% this quarter** dropping to a share price of **€137.7** net of fees and commissions. This brings the year-to-date return to **-7,3%**. This has been our worst quarter since we started in 2019 and represents our largest negative trend since the highs we set in October last year. You may have often heard us say that, unlike other managers, we are agnostic to the direction of the market and that our performance depends on whether or not we get our macroeconomic diagnosis and asset selection right. This has clearly not been the case in recent months, and we will devote this letter to explaining in depth what our mistakes have been and how we plan to reverse the situation in the second half of the year.

Hanway Capital's positioning

Since the end of 2021 and even more acutely with the start of the war in Ukraine, the media and market players have been predicting that an economic recession was just around the corner. The fastest interest rate hike in 40 years added fuel to the fire, convincing the market that inflation would end with a slowdown in activity. From our point of view, we dismissed that scenario outright and insisted that the focus should be on (i) a more resilient economy than expected and (ii) persistent inflation. Our monitoring of the savings generated by citizens during the pandemic and the tightest labor market in decades led us to disagree with the doomsday consensus.

Our positioning reflected this conviction: we had to have a portfolio that would allow us to successfully weather the inflationary storm. The strategy was based mainly on betting on a sharp rise in interest rates, holding a sizeable position in precious metals (gold and silver), betting on commodities, and being very selective with equities. We avoided the most expensive sectors such as technology and opted for those that benefited the most from inflation: banks, energy companies and all companies with strong cash generation.

This portfolio allowed us to successfully close a very complex 2022, generating a +2% return while the main equity indices suffered sharp declines and fixed income, the classic asset for the most conservative, suffered its biggest drop since records began.

However, everything that worked in 2022 has stopped working in 2023. The dynamics have been reversed and it has been technology companies that have led the rises. In fact, if we were to subtract the impact of this sector on the main indexes, they would hardly have risen at all in these six months. Undoubtedly, the fear of being left out of the revolution that Artificial Intelligence will bring has once again inflated the valuations of the companies most impacted by this technology.

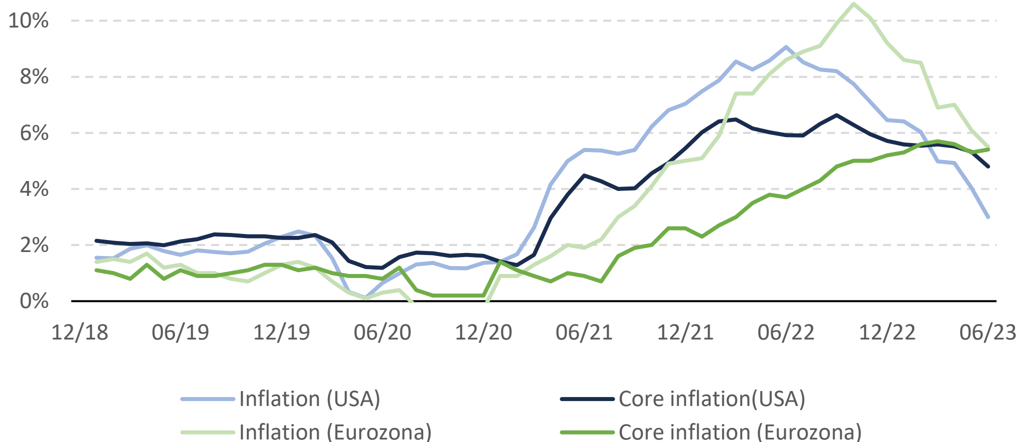
What have we gotten wrong?

The reality is that the much-heralded recession never came. The United States maintains robust growth and although the Eurozone has technically declined by -0.1% in real terms in the last two quarters, it has done so with a GDP deflator of 6.5%, which means that in nominal terms it has grown

by more than 6%. In simplified terms, we could say that businesses have seen their revenues increase by 6%. A recession is a slowdown in the demand for goods and services that generates a vicious circle of higher unemployment and lower economic activity; this is not what has happened over the last two years.

Where we have been wrong is with inflation. We did not believe it would remain at such high rates as we saw last year, but neither did we expect it to fall so sharply. We still maintain that this decade will be marked by high average inflation and that this will have a significant impact on financial assets, but in some years the base effect will make us believe that the problem has disappeared. As pre-invasion energy prices disappear from the calculation, headline inflation is trending downwards. However, core inflation, which does not consider the more volatile components such as energy and food, remains very high. Let us not forget that on three occasions in the 1970s, inflation returned to normal levels and then spiked again.

Headline inflation has fallen rapidly because of base effects, but core inflation remains stubbernly high

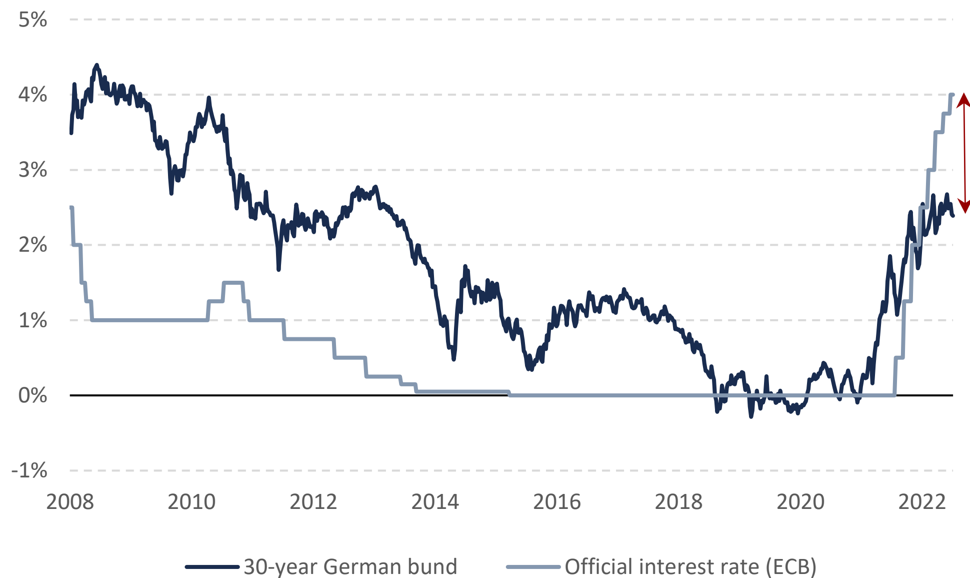


The next mistake was to assume that those assets that were performing well with inflation would also perform with high interest rates, as they are two sides of the same coin. When the Federal Reserve began raising rates in February 2022, we thought this was good news for our assets, as central banks recognized that inflation was not a transitory phenomenon. However, the opposite was true.

Although inflation remains elevated, tight monetary policies have convinced the market that inflation will not be a problem in the long term. Since early 2022, inflation expectations (the ones that actually impact investors' decisions) have fallen from 3.1% to 2.2%. Ironically, when central banks recognized that we were right, our assets stopped working. Let's look at it with some more concrete examples:

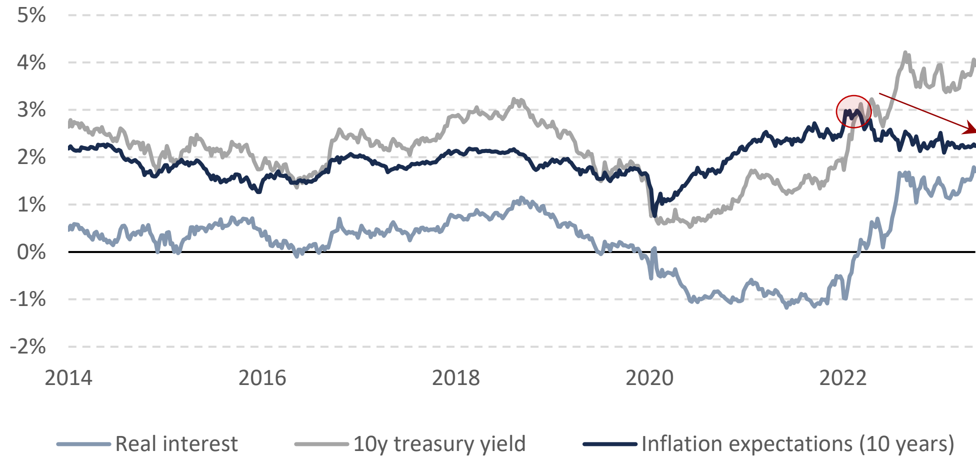
- **Betting on higher yields**: To monetize this strategy, we had to short sovereign bonds because of their inverse movement between the bond price and its interest. We expressed this view by shorting 30-year German bond. We chose a long maturity because bonds with shorter maturities are less sensitive to interest rates moves. While the official interest rate set by the European Central Bank (ECB) has risen from 0% to 4% (the official rate is the shortest maturity), the 30-year German bond was yielding only 2.4% at the end of this quarter. Financial logic dictates that the longer the maturity, the greater the interest for the investor

due to the greater uncertainty. But this logic has been shattered by the fact that investors are convinced that as soon as the expected recession hits, central banks will lower rates back to 0%. In that scenario, receiving 2.4% for 30 years will certainly seem like a great deal. However, we were expecting this bond to reach 4-5%, this positioning has hurt us.



- **Precious metals (gold and silver):** The quintessential asset for dealing with inflation has not worked as we expected either. Economic theory tells us that gold is capable of maintaining its purchasing power over the centuries, but when interest rate hikes began, it stopped working. Gold competes with other investment options and has the disadvantage that it does not earn any income (neither dividend nor coupon). When money market funds started to offer interesting risk-free returns, gold lost its luster. Gold has a high correlation with the real interest rate, which results from discounting inflation expectations to the official interest rate. If it stood at -1.1% at the beginning of 2022, by the end of the quarter it had shot up to +1.8%. It has been proven that seeking protection in gold only works if the market loses confidence that central banks will be able to keep inflation in check, and that has not happened. Gold has been flat for the past three years and has not risen since the inflation crisis began in 2021.

Expected forward inflation peaked in April 2022 and inflation correlated assets stopped performing



- **Companies with strong cash generation**: In simplified terms, the value of a company is nothing more than the sum of its future cash flows discounted at the present value of money. If our theory regarding inflation holds true and interest rates rise, companies whose earnings are closer in time would be preferred by investors. On the other hand, they would shy away from the more speculative stocks whose distant earnings would be worth much less. Again, this worked during 2022, but in 2023 the stocks we chose have been the worst performers. In our analysis, we overlooked the fact that companies that generate the most cash are usually also those most closely linked to the economic cycle, and the market, obsessed as it is with a recession that hasn't materialized, has penalized them.

Our last big mistake of the quarter was to buy volatility to protect the fund. With equities having had a good start to the year and the volatility index below 20, we thought it was a good time to position ourselves for a correction. It is very common during bear markets to experience strong rallies followed by falls to lower levels: volatility offered us an opportunity if we were right.

The Nasdaq went through strong rallies on it way down 83% in three years

The problem with using this asset as a hedge is that *ex ante* it is impossible to know how it will behave in the event of a market decline. In 2020, for example, a 34% decline in the S&P 500 caused the VIX to rise by 580%. In 2022, on the other hand, a 25% drop only caused the VIX to rise 105%.

It is therefore impossible to know for certain whether a volatility position corresponds in size to the portfolio it is supposed to protect: the only way to check is to see how it performs on a daily basis in relation to the rest of the fund. In this regard, we received mixed signals: on days when the market was falling, we lost more with the portfolio than we gained with volatility, which indicated that we were not sufficiently protected. But on days when the market was going up, we were not gaining enough from the portfolio to offset what we were losing from volatility, which told us that we were too protected.

So, from the end of May, the craze unleashed by the AI boom created the perfect cocktail for us: our cyclical positions were not generating any returns, but the technology companies with the highest weighting in the indices were pushing the market slowly but surely higher, causing volatility to hit its lowest level since COVID.

How we approach the second half of the year

First, we share your frustration. As you know, our interests are fully aligned with yours and there is no one more interested than us in seeing the fund generate a positive return. However, investing requires taking risks and making decisions that are sometimes incorrect. It is just as important to change our minds when we are wrong as it is to maintain our conviction when we continue to believe in our thesis.

As we enter the second half of the year, we remain confident that inflation will continue to be a problem and will negatively affect the markets. However, we have completely restructured a positioning that has not been working for the past nine months.

First, we have reduced our equity exposure to a minimum. Our exposure to cyclical companies, which have not performed at the height of the expansion, worries us the day a recession finally arrives. We think it is wiser to accept that we have missed the ride on equities this year than to jump on the tech bandwagon at this stage. In fact, we see more risk of correction in the second half of the year than upside in the major indices.

Liquidating equity positions allows us to bet on a correction using unconstrained volatility. If there is no portfolio to protect, the bets will have a smaller size with which we will be more comfortable, and they will hardly harm the fund as they have done this quarter.

On the other hand, having a large part of our assets in liquidity will allow us to be much more flexible in taking advantage of the opportunities we expect to present themselves in the second half of the year. We expect to be particularly active in buying options on major assets, as the low levels of implied volatility make them very attractive. The moves required to generate returns with options are much smaller than just a few months ago.

With the current returns being far from what we expect, we can only ask for your patience. The fund is up 37% since its inception almost four years ago, and hopefully this bump in the road will soon be behind us. We continue to work with the sole objective of protecting and growing your investment over the long term.

Management report

Let us know analyze the funds' individual positions for this quarter:

1. **Equity positions**: The world stock markets have seen a repeat of what happened in the first three months of the year: the technological Nasdaq has risen by 15%, the S&P 500 by 8% while the Dow Jones Industrial, much closer to our positioning, has barely risen by 3%. With the Eurostoxx 50 closing the quarter at its all-time high and the US stock market only 4% below it, we see little upside for this asset in the second half of the year. Its demanding valuations and the prospect of further rate hikes have led us to temporarily abandon this asset altogether, which has only added **+0.1%** to performance in this period.

2. **Volatility position:** As we have explained, this position has been the one that has hurt us the most this quarter. When in April the VIX broke the 20 level for good, we thought it was a good time to position ourselves for a correction. Instead, the debt ceiling crisis was resolved on May 27th, and from then on volatility began to make low after low until it reached 12.9 points. No doubt this paradigm shift has found us on the wrong side, but ironically volatility lows often precede panic episodes. Its performance this quarter has had an exaggerated impact on the fund, reducing the result by **-5.7%.**

3. **Precious metals:** Rising real interest rates, as a result of rising rates and moderating inflation, have negatively affected the gold price. We have slightly reduced our exposure to the asset as we believe that with money market funds paying risk-free yields above 3%, the opportunity cost for gold investors has increased. Over the past few months, it has subtracted **-0.8%** to the fund's performance.

4. **Commodities:** As has been the case with cyclical companies, our exposure to commodities has not paid off during a period of economic expansion. Our position remains very small as we are concerned about their performance in a slowdown. Its impact within the fund has been limited to **+0.1%** this quarter.

5. **Short position in fixed income:** Once again, our fixed income position has done worse than expected. With two more rate hikes by the ECB this quarter, long-term rates have barely risen by 25 basis points. As long as short-term bonds continue to yield much more than long-term bonds, it will be difficult to capitalize on this position, which has helped the overall result by **+0.5%**.

"It requires strength of character to think and to act in opposite fashion from the crowd and also patience to wait for opportunities that may be spaced years apart"

- Benjamin Graham

Regards,
Hanway Capital

Appendix: Hanway Capital Fund historical returns

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2019	-	-	-	-	-	-	-	-	-	-	-0.4%	1.2%	**0.8%**
2020	-2.9%	-3.0%	18.3%	4.6%	-0.4%	3.2%	-2.3%	0.5%	-2.7%	-1.9%	9.1%	3.8%	**27.0%**
2021	-1.9%	2.8%	3.0%	1.2%	0.6%	0.9%	-0.8%	1.5%	-1.1%	2.4%	1.3%	3.1%	**13.7%**
2022	-1.7%	0.0%	2.1%	1.8%	0.8%	-6.1%	3.0%	2.6%	2.1%	1.9%	-2.2%	-1.7%	**2.0%**
2023	1.1%	0.5%	-3.1%	-1.0%	-1.2%	-3.7%							**-7.3%**

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