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LATENT VALUE BUILDS WHEN MARKETS ARE LOWER AND IS RELEASED WHEN MARKETS RECOVER

INTRODUCTION

Perhaps because memories of the 4th quarter of 2018 are still fresh in the memory of some investors we get asked how the Levendi Thornbridge Defined Return Fund would perform if there was a market correction. The answer is inevitably; "it depends" which we recognise is of little use. However, as we hope to show below, even though the value of the fund will probably fall if markets fall, the Fund is an attractive asset to hold if investors are worried about a correction in market levels and/or a period where market returns are generally lower.

The fund is designed to offer a degree of protection. However, the value of the fund will fall if there is a fall in the level of equity markets because: the fund always has positive market exposure of between 30% and 60%. And the Fund will lose value if volatility increases and volatility tends to increase when markets fall.

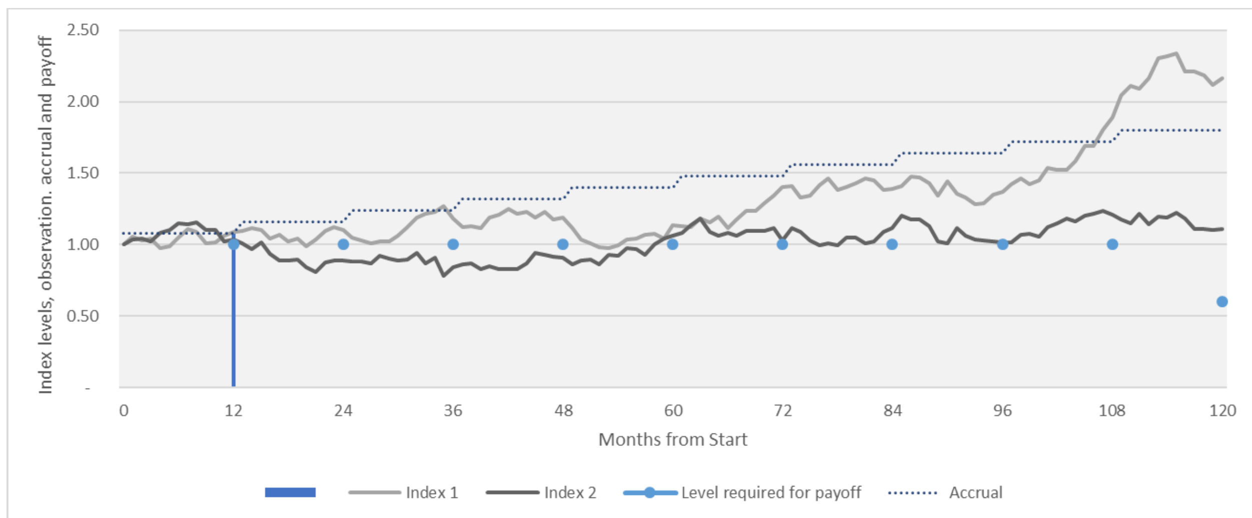
However, in our view, the Fund is an attractive asset for investors that are worried about the possibility of a fall in the level of equity markets because it accrues *latent value* within the assets held which is then released when markets recover.

It is this accrual of latent value that offers investors protection and comfort and makes the fund an attractive asset for investors that are concerned about a market correction.

If over the next year or so market conditions mean that products do not mature, the potential maturity value of assets held by the fund increases by the 7% to 9% return that is built into each investment. All that is needed to release the latent value is that the underlying indices are above the required level for the investment to pay the return. Typically, the final level required to pay a return is that markets are above 60% of the initial level at the end of the 10-year term.

The charts below illustrate how products that are like the ones that that the fund holds accrue latent value when markets are low, and how this can be released as soon as markets recover.

MATURITY AFTER ONE YEAR

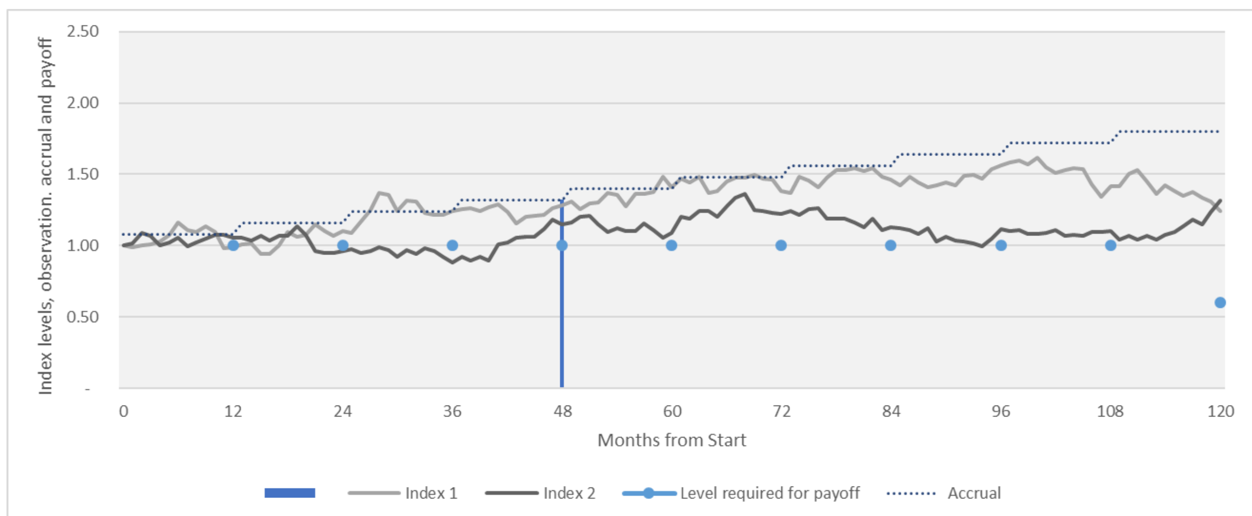


Source; Levendi Investment Management

Our analysis shows that this is the most common result based on how indices have performed and from our stress test. To mature at the end of the first year both markets must be above the initial index level at the end of the first year. If this happens the product matures early, and the maturity value is 108%.

Based on the past performance of markets there is a two thirds chance that a product matures after one year. The stress test results suggest that there is about a 50% chance of this happening.

MATURITY AFTER SEVERAL YEARS



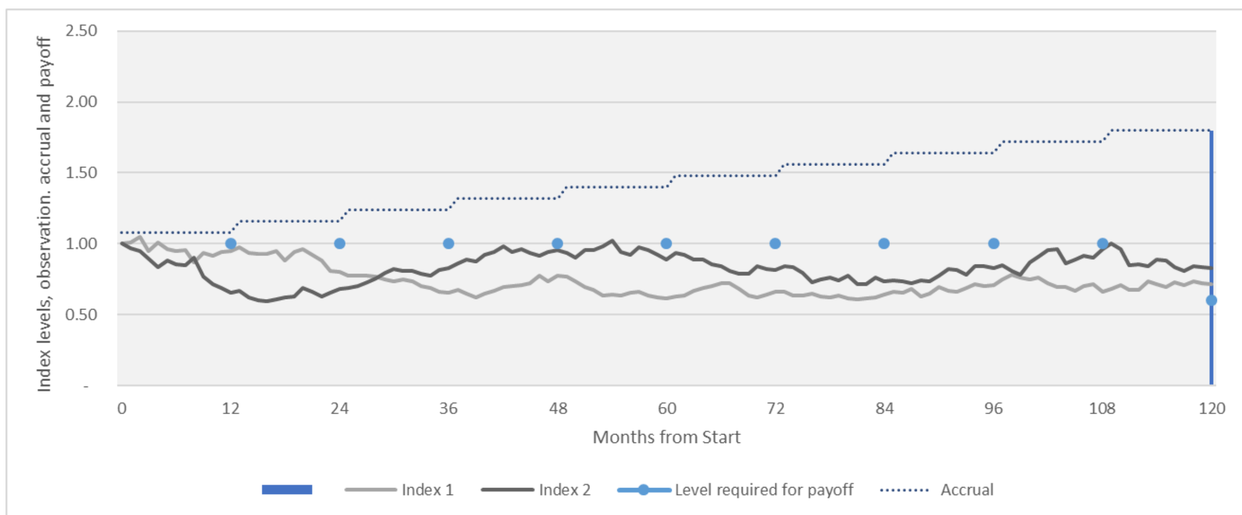
Source; Levendi Investment Management

If either or both markets are below the level required for the product to mature early, the product term extends and the latent return increases.

In this case one of the indices has been below the level required for the payoff for the first three years. During this time the accrued value has increased to 32%. At the 4th anniversary, both indices are above the initial level. The product matures then paying 132%. 32% is an annualised return of 7.2% per annum.

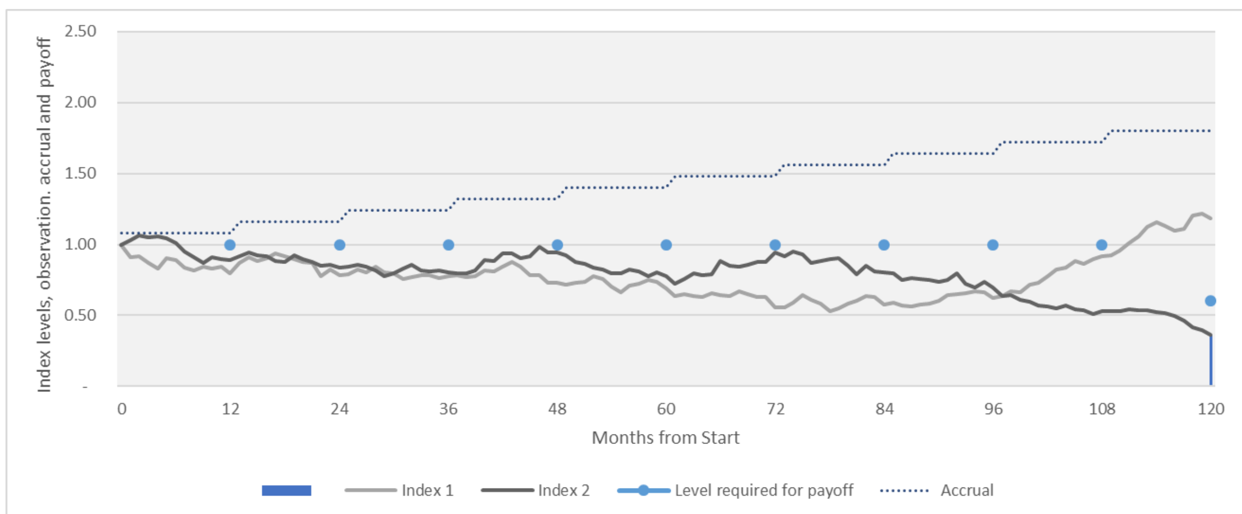
POSITIVE RETURN AT END DATE

Our analysis shows that there is about a 12% chance that a product will get to the end of the 10-year term. At this point, based on the back-test, there has been a 7% chance that both indices are above 60%, the final level required for a return. The accrued latent value by this stage is 80%. The maturity value of 180% means that the investor has earned a 6.1% annualised return over a period where market returns will probably have been dismal.



Source; Levendi Investment Management

NEGATIVE RETURN AT END DATE



Source; Levendi Investment Management

The final case to consider is the chance of no return or a loss. If the product has not matured early and if the final level of either index is less than 60% of the initial level, then there will be no return. Our analysis shows that there is a 2% instance where both indices are above 50% but below 60% of the initial levels, and a 3% chance that one or both indices is below 50%. These scenarios will result in a maturity value of 100% or less than 100% respectively. Where there is a loss the average maturity value in the past has been 56%.

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