Occasional Commentary from the Chief Investment Officer, Thursday, October 16, 2014

Are we having fun yet?

We would start with a short reflection on the events of the recent few days. Some events have been surprising whilst other risks were obvious and therefore avoidable.

Firstly, Volatility….

The timing of the spike in volatility and the associated fall in equity indices may not have been predictable in the exact sense, however our investors and regular readers of our notes and commentaries would know that we have frequently pointed out that the VIX, and therefore portfolio insurance, had been cheap for a very long time. We had advocated their use, or at least the use of some kind of portfolio protection whilst it was so cheap, repeatedly. Hence, portfolio protection was both easy to come by and also represented a very minimal drag on overall performance. We have used these and other hedging tools for our portfolios (where usage of such tools was permitted) for a considerable time and we guess that a good part of the industry will also have been hedged. It seems that the spike and liquidations may have been initiated by the activities of more specialised areas of the industry, such as event-driven, special situations and risk arbitrage players, where the collapse in deals tipped nervous markets over the edge, triggering redemptions and liquidation programs

Holding such insurance when the VIX was c.11 represented a very simple, cheap and attractive asymmetric trade. Now that the VIX is over c.26, protection is now fairly valued rather than at give-away prices. At these prices, it becomes more of a risk management and/or speculative exercise depending on your risk profile rather than a no-brainer. By historical standards, the VIX is now modestly priced, neither cheap nor highly priced.

Secondly, Bond Yields….

In April, we made the observation that the ratio of the S&P 500 Index compared with the US 30 Year Bond Future was at its highest level since prior peaks in 1999 and 2007. Both of those peak zones are remembered for subsequent sharp falls in equity markets and some flight to sovereign bonds. It's not therefore so surprising that from April to date, Sovereign Bonds have outperformed just about everything else, with US Bond Yields falling from c.2.72% in April to below 2% now. Of course the threat of deflation has played a part in the bond resurgence, although we think that the almost universal dislike for bonds was in any case reaching a nadir. These factors, coupled with a sense that the main Equity Indices were exposed to diminished returns for increased risk are the reasons, in our view, for the reversal of some flows from equities back into bonds.

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Dash to Trash and back again (aka Gravity)

In the current market turmoil, some asset classes have fallen for a reason whilst others have simply been caught in the crossfire of liquidation programs. High Momentum and ultra-High P/E investments will naturally fall sharply on any disappointment or weakening in future outlook, Netflix is only one example. Peripheral debt was always shaky and it shouldn't be a surprise to see those yields rising to more sensible levels at the expense of core debt, it was only the timing that could not be predicted. The over-valued items above are things we continue to avoid.

The skill is now in finding specific investments that (a) have fallen undeservedly and may recover and (b) in identifying sectors and asset classes that may perform in a range of expected economic scenarios and most importantly (c) preserving capital.

To these ends, we remain confident in our un-leveraged property portfolio, although we no longer acquire actively in Central London, instead concentrating on Greater London as well as special situations across the UK and globally. In the equity space, we are using the broad-based fall to study names that we like which might fit our long term criteria, select Telecoms and Energy as well as some of the really beaten-down sectors such as UK Supermarkets, Offshore Drillers, Chips, Old Tech and select Industrials. We continue to have no real desire to own Banks but may look again at other Financials such as Insurers and Asset Managers at some point. On FX, following on from our last note in June where we were bullish on the USD vs the Brazil Real and the South African Rand, we are still optimistic for the continuance of a strong Dollar trend vs these currencies but have recently become tactically flat as the USD appreciation was quite steep and fast, hence we may see a pause. That also applies to our view on USD vs the majors, principally the CHF where we also recently flattened our positions. The CHF may act as safe haven in the event of more turmoil so we are waiting for a new entry point to buy the USD. Also tactically, we have taken long positions in Wheat and Corn, based on proprietary modelling.

Lastly, Irony

Now that Governments, Central Banks, Agencies and Policy-Makers have effectively cornered investors into spending their cash and savings and to seek out risk in order to eke out any kind of return – they may now have to watch and accept some moral culpability for the next wave of value destruction. It could transpire that these investors would have been better protected from the threats of deflation and turmoil had they not been ushered out of cash and bonds. Policies that give the risk-averse no choice but to take risk can't end well.

Footnote…those that are looking for a 'capitulation' event to signal the end should study 1973-74, more attrition than capitulation…

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