Occasional Commentary from the Chief Investment Officer, Monday, February 03, 2014

Where Now?

One would presume that after a 2013 which was a straight-up year, 2014 may be the year to exercise extra caution.

It certainly feels like it's going to be a more challenging year and we're just a month in. That being said, even though stocks (when considered en masse) are no longer cheap, there are other factors that mean the asset class should remain interesting, with caveats.

Our approach remains a value oriented one. We are not particularly fond of momentum stocks at astronomic multiples. We recognise that there are different ways to value businesses but are just not convinced enough by this clever bit of spin to invest in instruments with such a high inherent sensitivity to disappointment.

Even sectors with so-called defensive characteristics have seen their credentials challenged. Utilities, Food Staples, Large cap E&P – all have taken an outsized knock in recent weeks.

There will come a point where the value that does emerge will justify an entry point. Whilst the overall market may conceivably have more gyrations and quite possibly more downside, at this point and for quite a while to date, the cost of insuring a portfolio using volatility or equity futures and options has been extremely cheap. Hence, as long as that remains the case, we still feel comfortable with keeping large cap value equities as our 1st= allocation, alongside freehold property. We get paid to play and we are protected if and when the market goes a little pear-shaped. It helps to having a long term time horizon and a culture of only buying quality businesses.

Naturally, if 2014 is a repeat of 2013, then the capital spent on buying protection will only be a drag on performance. It is personal choice as to whether one does deploy capital in this way. We would add that such an approach protected portfolios completely and successfully in 2008, anything for a quiet life we say.

It may well be the case that in 2014 we give back 50% of the gains of last year. This would amount to a lot of value destruction but wouldn't dent the medium term upward trajectory of the market, only representing a bit of mean reversion. So, if this is the bear case scenario, how should one approach this? We would suggest sticking to simple investment principles, avoiding too much leverage, too much concentration risk and steering clear of high P/E multiples, especially where share price appreciation has

streaked ahead of EPS growth. We would also suggest using the cheaply available portfolio insurance for as long as it's available at such a knock-down price.

We're accumulating these bombed-out sectors, select Food Staples, Large cap E&P, Drillers and Utilities. We also continue to see pockets of value in TMT – but only where events or self-help stories can release value. Overseas, we recognise the opaque nature of Chinese GDP, where 7% really means 4%, or does it really mean 7%. Irrespective, we apply our cautious stance to all markets and still remain long of Expressway companies there, attracted by their cash flow, valuation and yield characteristics.

For us to consider taking steps along the risk curve, we would need to be more comfortable with the outlook for EPS growth and more importantly whether or not the handover of market price support, moving from the Fed's QE programme to the Boardroom's ability to drive earnings, is going to be a smooth or successful one. Put another way, when the punchbowl is taken away, will the party animals be able to walk home? Already this month, we have had some earnings disappointments by bellwether stocks lead to real drubbings by the market. Investors are on notice…

Loves, Hates and Hedges....

We are not surprised by the weakness in Japan but are surprised that the Topix weakness is just a tracking of global events rather than being caused by a policy miss-step. We are wary that the Consumption Tax may precipitate a high degree of volatility and hence we are interested in only asset-backed opportunities in Japan at the moment and perhaps some more racy stuff in Q2. The resurgence of land price inflation leads us to be looking closely at property and Reits in Japan.

Globally, we are still avoiding banks but there is a fair price for (just about) everything, so we may look again at some point given the weakness in the sector.

Commodities

We have seen the NY Coffee contract appreciate to near USD 1.40, almost 40% up from October when we mentioned our interest in it. We are paring back our position.

A final word on overall asset allocation

We remain with equities and property as our joint top allocations. We favour GBP & USD as our 2 main currencies. We continue to be short of EUR/GBP and long of GBP/CHF, primarily on tactical grounds. Currently and at times of stress (market stress, not mine), we utilise a Long Bund-ITI spread and Long 10 Year US Treasury Future. Again these are both tactical as we don't tend to see any long term value in owning Sovereign debt. We also own VIX futures and a selection of options.

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