Investment Letter: 18th January 2013

The last quarter of the year provided a fillip to portfolios with a substantial equity component. Rotational patterns within equity markets, which had begun in the summer, were pronounced, allowing allocators a window to impress in what has been a generally tough environment for active investors during the past three years.

Value acted as a reliable guide, which it has not been for some while. So those strategies that place equity value at the engine end of the portfolio have pulled the caboose down the line very smartly. In most of our portfolios 4Q performance exceeded the aggregate of the previous three.

Mapping regions to styles, there was a marked overlap between Europe and Japan and the value style. This remains the case in early 2013. This correlation meant that it was possible for both macro-economic style, top-down equity investors and bottom-up, value- driven investors to arrive at the same place in their portfolios. Top-down stylists took heart from changes in policy in Japan, following the election of a new government and evidence that the Eurocrats (critically the Germans) were ultimately prepared to do what it took to hold the Eurozone together. Value investors have responded to the generational lows in Japanese and European valuations and the cavernous gap between the multiple accorded to a company listed in New York and one listed in Frankfurt or Tokyo. The “chicken trade” of investing in the UK, to dodge part of the euro question, also worked well; the FTSE 250 was one of the world’s top performing main indices in 2012.

Mapping styles to sectors, we find that Financial stocks account for the largest share of the value universe, followed by Materials and Energy. The available returns from investing in Financials outstripped that of all other sectors in 2012 – they led the US indices and were strong performers in the UK and Europe as well.

Here again it was possible for macro investors with a positive disposition to the US economy to relate the early outperformance of House Building stocks, spot a distinct move in the Building Materials sector and find their way into Financials. The first people they would have met through the door would have been value investors, already well into the peanuts and the twiglets. Whilst the heavy nimbus of opprobrium still hangs over the banking sector worldwide, the world slowly moves on and banks have been resoundingly good value for some time. 2011 was painful for valuedriven equity investors whose arguments brought them into banks, only to suffer one last leg down. 2012 repaid their resolution. In a bitter irony, some of the best returns were granted to those who invested in banks who lacked, at a certain stage, either a CEO or Chairman or both.

We believe that markets have entered a phase in which equity prices will grow, more driven by valuation increases than other contributory factors, and that it is appropriate to have a dominant equity weighting at this time. This belief has not been conditioned by the vibrant upward lift of the past six weeks. Our clients’ portfolios’ dedication to the equity class at current levels dates back to the autumn of last year.

Bond investors face considerable challenges in the years ahead. The avowed intent of Central Banks is reflation. Accelerating growth is the central bankers' first wish but we also surmise that they would accept a higher rate of inflation, as inflation reduces the real value of claims. Both a recovery in growth and/or an increase in inflation will result in a normalisation of the bond curve. Normalisation entails rising bond yields and therefore losses on the capital value of bonds. At the very centre of this lies the US Treasury bond market, a theoretically risk free set of investments that are anything but. From the US curve emanates "the spread", a shorthand way of describing that which you get for taking more risk than investing with Uncle Sam.

The spread, in reality a multitude of percentage point premia and curves, moves like an organism: constricting as money flows from the centre, seeking risk and expanding as money flows back, eschewing risk. The rubbery, organic nature of these moves increases the prospect of a snapping back as we have seen nothing but a constriction since early 2009. Four years of falling yields have left traditionally risky credits at astonishingly low yields. By the second half of 2012, investors were committing to high yield as if it were investment grade, the Philippines as if it were Norway, Turkey as if it were Switzerland. In the past three years, the total return on US investment grade debt has annualised at 10%. These are outsized returns and, on balance and according to our views, are likely to fade before turning negative.

We have been tracking the hoof prints of reallocation flows for several months and believe that we have only seen the vanguard pass through. Investors responsible for structured savings (pensions and the like) and insurance companies' floats have been gentlemen with a distinct preference for bonds. They face a dilemma: ageing demographics favour bonds over equities, valuations favour equities over bonds.

Currency investing has been devilled by low volatility making the recent sudden depreciation of the Yen all the more noticeable. Currency investors (pairs traders and the portion of macro investing that is dedicated to currency trading) have been experiencing a Tasmanian drought, making the good returns of managers, such as Adrian Owens' of GAM Star Global Rates, all the more creditworthy.

This low volatility is a consequence of pancake flat yield curves, abeyant inflation and the suffocating bear hug of Central Banks' oversight of, and agency within, markets. Conditions are bound to change, but perhaps not for a while. However, we should attempt to predict as to what form this change will take. To our minds, the fundamental variable that is most likely to ignite currency volatility is a change in inflation expectations of one country versus another. We have a window. It is not as wide as that of a Versailles palace, but it is wider than a Cornish cottage. For now, we should be invested.

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