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the investor's choice

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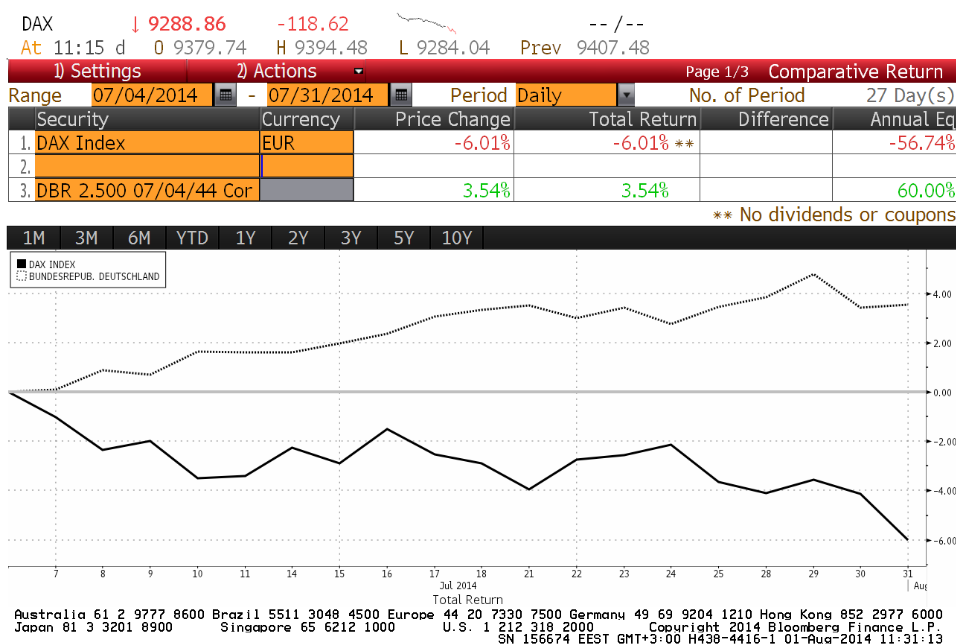
Monthly Commentary 1st August 2014

July proved to be a difficult month for equities as the developed markets fell between 2% and 6%, with Germany being hit particularly hard. Many European indices have now turned negative for the year, joining the Dow and the Nikkei. Emerging market equities were more resilient, but still have a lot of catching up to do after five years of underperformance. Commodities also took it on the chin as the USD strengthened on positive US economic data. Bonds were very strong in Euroland and the UK, but flat in the US.

The graph below says it all. It shows the German long-bond's performance versus the Dax since July 4th. The bond is up a remarkable 3.5% in less than a month, whereas the Dax fell 6%.



Should we be worried about this flight to safety? Where do we go from here?

We are not alarmed by the pullback in equities as it is both natural and to be expected. We would not be surprised if there is more downside to come, but this is unlikely the beginning of a prolonged and meaningful decline.

Why our lack of pessimism? There are many reasons to be positive, and despite alarming geopolitical events, these rarely affect world economic growth and, by extension, the markets in a lasting way. Below we quote from Jeremy Grantham of GMO, one of the most respected fund managers, whom many have branded a perma-bear. Grantham is serious value investor and is in a unique position to talk with authority about market bubbles – his firm has studied all bubbles in history. He is especially bullish on the prospect of M&A (Merger and Acquisition) activity, which should propel the markets higher:

"What is worse for us value-driven bears, a further bullish argument has struck me recently concerning the probabilities of a large increase in financial deals. Don't tell me there are already a lot of deals. I am talking about a veritable explosion, to levels never seen before. These are my

reasons. First, when compared to other deal frenzies, the real cost of debt this cycle is lower. Second, profit margins are, despite the first quarter, still at very high levels and are widely expected to stay there. Not a bad combination for a deal maker, but it is the third reason that influences my thinking most: the economy, despite its being in year six of an economic recovery, still looks in many ways like quite a young economy. There are massive reserves of labor in the official unemployment plus room for perhaps a 2% increase in labor participation rates as discouraged workers potentially get drawn into the workforce by steady growth in the economy. There is also lots of room for a pick-up in capital spending that has been uniquely low in this recovery, and I use the word "uniquely" in its old-fashioned sense, for such a slow recovery in capital spending has never, ever occurred before. The very disappointment in the rate of recovery thus becomes a virtue for deal making.

Grantham also sees the S&P 500 reaching 2250, a level that is 17% higher than today. This level is confirmed by technical analysts at Merrill, who see the market reaching 3,300 – see below.

Why the US still has an edge

There has been concern lately that America is losing its edge on the corporate front as companies from other countries have become more competitive. There is no doubt that staying competitive is essential to companies' performance in the market. Additionally, companies that spend reasonably on R&D have positive excess returns versus the market as a whole.

The graph below dispels any such concerns. In the US, R&D spending has more than tripled since 1989 and the US now represents 75% of global venture capital, making it difficult for others to catch up. Perhaps this is a reason why US companies often command higher valuations.

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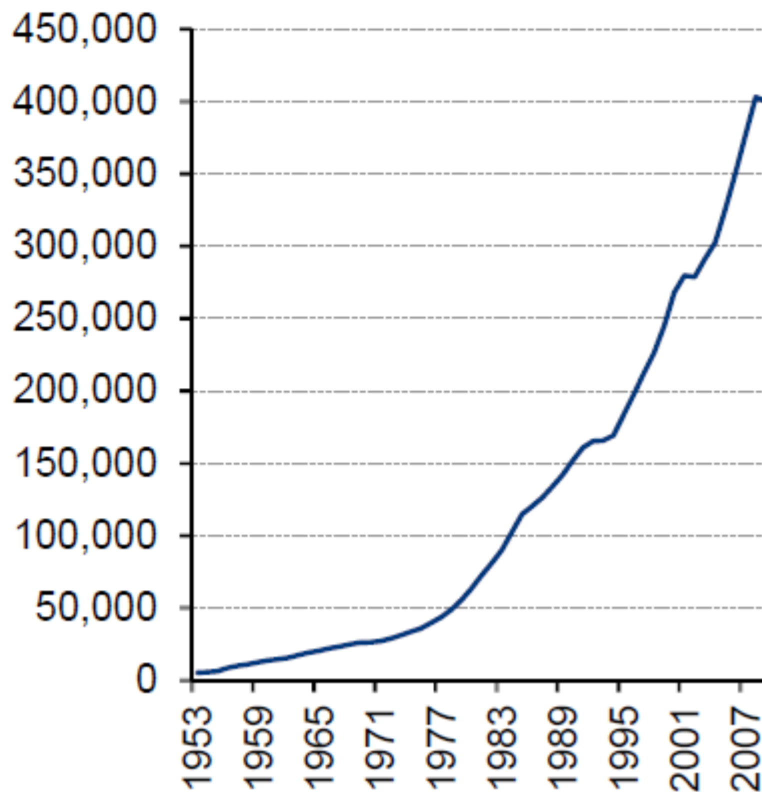

Portfolios' status and tactical moves

In our last monthly commentary on June 2nd, we highlighted our preference for two sectors, Energy and Technology. Since then, they have both handily beaten the S&P 500. Almost all our portfolios, across most strategies continue to be exposed to these two sectors, and we shall keep this exposure.

We gave decided to take profits in Global High Yield, which we have held for a long time. Many experts have been warning about high yield for over a year but we resisted selling, arguing that there was more yield compression (and thus capital gains) to come. This was a good call, but we are now concerned that the risk reward Is not as good as it used to be, and that at best, there is only the coupon to pick up. Consequently we are reducing out high yield exposure across the board by 50%. We are maintaining a position as the coupon is still reasonable, and spreads are not yet at historic lows.

We are also mulling the sale of some small company funds as valuations have become stretched in many small-cap areas.

We are also selling our exposure to midcaps in the UK, as they have struggled this year.

We are holding on to our Japanese exposure, and adding for those that do not have it. The Japanese market, which lagged most markets this year has improved lately and has been resilient during the latest selloff in developed markets.

Finally, we are considering whether to dip our toes back into emerging market equities, as valuations are indeed more attractive than developed markets. At the same time, we are aware of many problems that plague EM companies so the decision is not final. In order to buy, we want to see EM's break out of a 4-year trading range, which they are close to, but have yet to do. As for which emerging markets to invest in, we are considering both broad funds, and China-related ones, as the latter seem to be poised for a breakout.