

The Trade Press

The monthly magazine exclusively for FEIFA members



Turning Japanese

Active management balances seismic demographic shifts. The thoughts of **Matthew Addison**, Managing Director, Platinum Capital Management Limited.

These past few months have welcomed investors with a return of day-to-day market volatility. This increase was most evident in currency markets, but also echoed in short-end interest rates and equity markets. September included six days where the dollar (versus a basket of global currencies) moved by more than 40 basis-points, in contrast to only one such day in the preceding three months. Dollar-

sensitive investments slumped throughout the month, illustrated by the MSCI Emerging Markets equity index dropping nearly 8%. As for monetary policy, QE liquidity provision expectations are highest for the ECB, replacing the stimulus-pumping Fed. Asian fiscal and monetary stimulus continues, mainly offsetting lukewarm private-sector activity.

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Turning Japanese

Rate sensitivity and yield appetite are structural – not tactical. Demography dictates changing saving and investing patterns. Global population continues to grow, albeit at a slower pace and in specific pockets. Based on UN figures, where Africa represents the greatest 40-year forecast in population explosion, the top-table of global GDP contributors (US, China, and Western Europe) are turning Japanese. The UN's reported Dependency Ratio – comparing retired population to working-age – captures this convergence.

This affects three broad areas of investment: volatility, relative returns, and return expectations.

affects allocation of internal capital at firms, as well as in individual portfolios and benchmark market valuations. The rise in corporate activity – investment, M&A, etc. – is a direct, rational market-influenced response to a low-for-longer world. Equity market investors' willingness today to pay a higher market CAPE (cyclically adjusted price-earnings) ratio is linked to the comparative excess return of a 5 – 6% earnings yield available in global, world-class equities.

The chart showing US data illustrates this relationship over the past 60 years and suggests a mismatch opportunity in the market prices of bonds versus US equities. Note, this is NOT a US-only dynamic.

Finally, returns in a world of aging savers are depressed by the substitution of long-term capital gains for income to replace wages. The benefits of cash flow to the end investor in many ways trump the total

Region	1970	2010	2050
Japan	10.2%	36.0%	71.8%
Western Europe	20.7%	28.1%	50.1%
USA	15.8	19.5	35.5
China	7.1	11.4	39.0
Africa	5.5	5.8	8.0

Source: UN Department of Economic and Social Affairs.

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The lesson of Japan's equity market over the past 20 years has been that as interest rates anchor to nominal zero and debt balances reach new all-time highs, equity markets become more volatile. Steadily – some would say relentlessly – long-run realised Nikkei volatility has risen over 25%, based on trailing historical quarterly data. For investors, this prefigures a market of sharp rallies and corrections. For navigating a Japan-like structural equity market, diligence and flexibility from active management are critical for preserving long-run returns.

The population-ageing re-balancing of portfolios structurally shifts asset pricing. It comes as little surprise to see Western European bond yields following the path of Japanese JGB's, albeit 20 years later. Similarly, low "risk-free" rates do have consequences for positive value creation (ROIC – WACC, or NPV). This



return potential of the investment – similar to paying over par value for a high-coupon bond: current yield is prized despite capital loss at maturity. Hence, there is greater need than ever for alternative sources of income, especially income that replenishes itself from

excess returns.

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(1994-2013 calendar)	Japan	Europe	US
No. of +15% Years	6	8	8
No. of -15% Years	6	3	2
CAGR	(33) bps	+80 bps	+713 bps

Source: Bloomberg; Platinum Capital Management analysis; Nikkei / Stoxx600 / S&P500.