Issue 163 September 2014 www.risk.net

HEDGE FUNDS REVIEW

THE VOICE OF THE GLOBAL ALTERNATIVE INVESTMENT INDUSTRY

In the transitional phase of recovery, alternative thinking to identify idiosyncratic opportunities can deliver robust total return solutions in a range of potential macro scenarios, writes Matthew Addison of Platinum Capital Management.

Lack of consensus

Markets have offered investors an unusual cocktail throughout 2014. From equity momentum sectors to foreign exchange, consensus trades have significantly disappointed. Large-scale monetary policy changes appear to be underway, but the absolute change in asset prices has been muted. Continued all-time low volatility levels for rates, credit and equities have masked significant intra-month movement. The second quarter has continued the whipsawed price-action seen in the first quarter, with notable intra-month ups and downs muted in each month's ultimate outcome. The result to date, from a quick, informal survey of fund manager sentiment, is "much activity, little real action."

With positive signs in the US and mixed signals elsewhere around the globe, it is timely indeed to review and contextualise the broader market. Equity markets have roughly doubled from the lows of the 2008-09 crisis. Defensive developed market bonds have reached historically unprecedented nominal yields after a multi-decade boom, pulling forward the present value of multi-decade lending to leading governments. Gold – an earnings-free, relative-value asset – has served as one of the leading capital gains investments of the decade. From this extended positioning across investable asset classes, the natural question to ask is "what's next?" Investment themes, like the business cycle itself, are recurring, and actively managed capital allocation aligned with this rotation stands to benefit.

Consensus among leading market participants inevitably is a danger signal, but one often difficult to challenge. Only by maintaining a discipline of deliberately questioning conventional wisdom in depth and without prejudice can the successful active manager shift the balance of risk and reward to their advantage against the herd. Markets with pervasive consensus comfort are a fertile ground for investment performance, provided a long-term perspective is retained. The more pervasively held a view, the more likely it is mispriced. Both on an individual investment basis and portfolio level, this has borne out in 2014. The table contrasting year-end 2013 published strategist expectations to actual equity index performance brings the point home.

Point of transition

Self-sustaining cyclical recovery is the holy grail for policy-makers, yet the very tools employed – quantitative easing, negative real interest rates and forward guidance – are disproportionately skewing what value is being created in the economy to the owners of capital: investors – in stocks, corporate bonds, and real estate. Ironically, exporters and importers alike have seen this effect; and this is not about terms of trade. Whereas recovering job creation in the US anticipates higher aggregate income, the opportunity exists for developed economies and their high-capacity suppliers to grow again without the adrenaline shock of subsidised money. It is this point of transition that has become the focus of asset allocation.

Government intervention in markets reached unprecedented levels in the four years following September 2008 – from bailouts and rescues to experimental monetary policy. Political will, and not economic or popular voting mechanisms, determined outcomes for the majority of crises in this period. Now, governments are stepping back and, while businesses will continue to face heightened political and regulatory scrutiny, this shift is creating interesting investment opportunities. At the level of specific investments, government sales of strategic equity holdings have themselves represented among the best entry opportunities in compelling self-help stories from General Motors in the US to Lloyds Banking Group in the UK and Airbus in continental Europe. Most visibly, monetary normalisation in the US and easing liquidity in the eurozone are reshaping the return expectations of bondholders and savers. Asset reallocation landslides inevitably should follow, with early signs already evident. With financial intermediation again starting to offer returns exceeding the cost of capital, the tangible core equity of banks, insurers, and asset managers continues to be strengthened from organic operations, rather than only capital issuance. In financial markets, price signals are expected once again to reflect supply and demand for capital.

The investment cycle matters

Naturally, it is crucial to be aware of which phase the cycle has entered. Surveying the current investment landscape an inescapable conclusion emerges. The easy money has been made. Across equities, bonds and real estate, asset-value recovery has

Expectations versus performance, 2013

	US	UK	JPY
Bulls	5	4	9
Neutral	4	9	3
Bears	4	0	1
YTD (%)	6%	0%	-7%

Source: December 2013 survey of 13 major investment advisory research ratings. YTD measures: S&P, FTSE100 and Nikkei 225, as of June 30, 2014.

Read more online
For similar articles go to:
www.risk.net/tag/momentum-strategy

been shared across the traditional investment landscape. Therefore, alternative thinking is needed to deliver robust total return solutions for a wide array of potential macro scenarios.

The ability to identify idiosyncratic market opportunities and manage drawdown risk is vitally important at this transitional phase of recovery. Examples include dislocation opportunities, catalyst-driven self-help and relative value driven by mismatched investor capital flows. Consistently low realised volatility is translating into affordable single-stock and index options. As a tool for skewing expected value in catalyst-driven opportunities, reasonably priced options are a further source of total return enhancement. The potential, in aggregate, is to achieve real outperformance through agile, high-conviction, favourable risk/reward strategies – 2014 is a time for dynamic and disciplined investment managers.

As always, opportunities will be cycle-driven, and as such will result in generally different outcomes for debt and equity investors. While timing and experience is crucial in exploiting the kind of opportunities that this environment presents, it is clear we are emerging from a multi-decade debt boom. With normalisation comes the potential return of behaviour associated with every crisis: leverage, exuberant valuations and asymmetric complacency. Early signs of this extreme positioning are already surfacing across a range of fixed income investments, especially where unsustainable debt has been easy to obtain. Conversely, the current opportunity set for equity investing appears considerably more balanced.

M&A is back

One specific application of this alignment is to examine and understand equity-related corporate activity themes. While the build-up of corporate cash balances has been repeatedly observed, the shift in the use of this cash – and the magnitude to which it is deployed is worthy of comment. Responding to a five-year annualised growth rate of investment at the lowest level in the post-WWII period, the sources of future outperformance are companies investing in themselves and their future, for the continued benefit of shareholders.

Recent high-profile merger and acquisition activity – especially those deals that had been long mooted and that resolve unfinished strategic realignment – indicates that the economic cycle appears to have entered the M&A stage. Examples of this include Abbvie/Shire, Arbitron/Nielsen, Beam/Suntory, Biomet/Zimmer, NBC Universal/Comcast, Nokia/Microsoft and Vodafone/Verizon. Even mergers of near equals, though often unconsummated, have retaken the headlines: Holcim/Lafarge, Pfizer/AstraZeneca, Publicis/Omnicom and even Dixons/Carphone Warehouse come to mind. This should not only be seen as a major catalyst in recent share prices, but also as preparation for subsequent phases in the natural rhythm of equity and debt markets, a leading indicator of opportunities for market conditions to come.

Dispersion illustrated

Active management is rewarded in markets characterised by dispersion. This refers equally to dispersion of returns across the capital structure, between regions or among asset classes. As dispersion increases, diversification adds further value in portfolios. Hedging, generally thought of as a cost, can in fact serve to augment total return. The return of dispersion and the magnitude of this critical trend will be key in driving the capacity for outperformance from active investment management in 2014.

The chart below maps corporate industry returns among various key geographies versus market valuation, in terms of equity free cash flow multiples. The initial, and reasonable conclusion, is that equity markets are fully valued versus the long-term historical range – roughly 20-24x, or 4.5% nominal free cash flow yields. However, the critical feature from an active investment manager's perspective is the dispersion revealed. This is an opportunity-rich landscape.

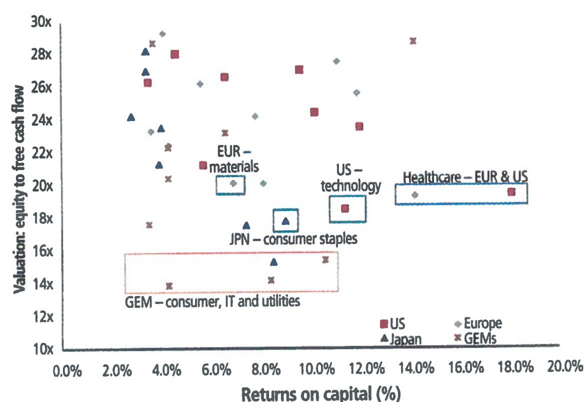
Shared across all three developed markets is the compelling valuation, and peer-leading investor returns, of the healthcare sector, highlighted in the blue box – a logical observation underpinned by strong intellectual property protection, product margins and capital discipline. Similarly, the year-to-date wobbles in emerging markets have shifted several independent sectors into attractive territory, marked by the yellow box. Most interesting for the investor focused on outperformance are the opportunities in each of three sectors/geographies, illustrated in the green boxes: European materials, Japanese consumer staples and US technology.

Conclusion

Crossing the mid-year point, it makes sense for investors to step back from the week-to-week gyrations of individual markets and securities and take stock of where we are. At a transitional point in the investment cycle, performance will follow from the dynamic appraisal of the risk/reward balance across investment alternatives. Once identified, the successful investment manager will allocate decisively to those opportunities. ■

Matthew Addison is managing director at Platinum Capital Management.

Corporate industry returns versus market valuation



Source: Platinum Capital Management Analysis and Deutsche Bank Strategy Data at April 2014.