

Investment Strategy 2013 Recap and 2014 Outlook

Time stamping...

2013:

We began 2013 with a continuation of a long US and Europe equity stance, convinced that innovation and brands would trump cost savings. We were of the view also that main street would survive the follies of Capital Hill and Brussels et al. We were long, albeit a bit late, the Japan trade as a momentum trade. What we initially expected to be a medium term trade evolved as we saw domestic sentiment turn decidedly positive. We were of the view that China was headed for a very bumpy landing and that the Shadow Banking system posed a significant risk. The only major about turn we did intra year was to call a buy on China in late July on the back of China instructing a system wide audit of the Shadow Banking system which in our view removed a considerable tail risk which was holding back an acutely cheap equity market.

In credit, we were long high yield in US and Europe, as part of a risk on trade, comfortable that economic growth, while recovering would not be sufficiently strong to warrant rising rates. We were negative investment grade and hard duration in USD. We were long of senior, secured, floating rate bank debt as a means to obtain credit exposure without duration risk. With the announcement of QE taper, our high yield positions suffered but our significant overweight in floating rate debt dampened volatility significantly. The delay of the taper provided us an exit from US high yield. In EUR high yield we remain resolutely overweight as Europe, while recovering, does not appear to be self sustaining.

We were long US housing specifically through non Agency RMBS.

In emerging markets, we were largely underweight (through the CDS), but were long of Russia, Venezuela and Mexico while being short of Indonesia, Philippines, Brazil, Turkey, South Africa and Ukraine. We got Venezuela quite wrong with a 600 basis

point widening, but got **Russia** and **Mexico** right. The shorts all performed.

We were long USD and GBP and short JPY. We had no high conviction positions in other currencies.

2014:

Among our broad themes is bank regulation. We expect that the trend in increased regulation will not be slowed or reversed for the foreseeable future. The fragmentation of legislation will make it difficult to defeat whereas a single act such as Glass-Steagall was relatively easily repealed. Solvency 2, **Basel 3**, the Volcker Rule, the legion that is Dodd Frank, will entrench increased financial sector regulation. This will present opportunities for investors who are comfortable with illiquidity, to earn the illiquidity premium, and who are able to manage complexity.

Private credit strategies: Banks are being put in the difficult position of being expected to make more loans and take less risk. They are being asked to be more conservative with their capital. It appears that the fractional reserve banking system is being limited by a focus on depositor insurance which creates opportunities for private capital willing and able to circumvent the banks to match the duration of assets through direct funding and to pick up a liquidity premium. Mezzanine lending to corporates or to real estate and infrastructure will continue to see attractive returns. Fortunately, or unfortunately, depending on your point of view, capital will remain scarce as search costs are high. Private credit strategies are institutional strategies which private clients and retail will have limited access to for reasons of investor sophistication and liquidity preference.

Capital structure arbitrage: Efforts to reduce principal trading strategies at banks has already led to an exodus of talent into the Shadow Banking system, that is, to hedge funds and private equity and credit. **Basel 3**, the Volcker Rule, Dodd Frank are making proprietary trading extremely expensive and capital intensive for banks to maintain. As a result, banks are generally winding down or spinning out these activities. Mutual funds may invest across asset classes but they do so in segmented fashion with separate silos for equities, bonds and loans. Very few mutual funds invest across the capital stack within a single management team or a single fund. Thus, while markets may be efficient within asset classes, inefficiencies can persist across asset classes. Proprietary trading within banks used to police

relative value and arbitrage across the capital stack but with the retrenchment of risk capital, arbitrage and relative value opportunities can now persist. Hedge funds which invest across the entire capital structure of companies are very interesting in this environment.

Emergency capital structures of banks: The financial crisis of 2008 led to the infusion of morphine or emergency capital structures across large swathes of the banking industry. With time the banks have been stabilized and economies are recovering. **Basel 3** also treats certain parts of the capital stack differently and will result in some cheap equity becoming reclassified as expensive debt. Opportunities exist in providing bridge finance to balance sheet restructurings. The recapitalization of European banks post the Asset Quality Review and pre ECB regulation is an example of an opportunity to buy expensive capital (for the issuer) in expectation of the capital being retired. Other opportunities lie where emergency funding securities are on public balance sheets which politically may not be able to maintain these positions.

Back to traditional strategies:

The **US** economy continues to perform well. US growth equities are the natural trade expression. With QE tapering, which we expect, and consider a positive for equities, corporate high yield, agency MBS, REITs and high dividend equities are likely to see more volatility and or suffer, relative to outright equity exposure. We think that short rates will be maintained at zero for the next 3 years so the taper should steepen the curve rather than signal a rise in interest rates. This should favor bank stocks. Floating rate bank debt is a natural source of credit exposure without duration, although there may be some volatility from curve steepening. The problem with floating rate debt is that if rates remain low while the curve steepens, coupons will not reset upwards while discount rates increase. This may limit the efficacy of loans as a duration hedge.

The European economy is recovering and is probably several paces behind the **US**. Corporate risk assets should continue to perform well. Given the inflation environment and the tepidity of the recovery, duration is less of a risk than in the **US**. Corporate high yield bonds provide equity exposure with a more senior claim.

We are more sanguine on **China** risk going into 2014. That said, the equity gains are

likely to be off-index in the under represented consumer sectors away from SOEs, exporters and financials. We see the Party's efforts at rebalancing as positive and effective.

The **Japan** equity trade continues. We initiated this with quite a lot of skepticism, designating it a short to medium term trade, however, upgrading it to a long term holding as we saw domestic sentiment take hold. We maintain this view going into 2014. We now regard the sentiment factor a more important one than all of Abe's three arrows.

In emerging markets we are writing protection via CDS on **Mexico**, **India** and **Brazil** and we are buying protection on **Indonesia**, **Philippines** and **Korea**. We no longer have a position on **Ukraine**. Generally we are no longer short emerging markets and are taking a neutral stance. We still don't like emerging market fundamentals but think that fundamentals are now largely in the price. Elsewhere we are short **Canada** 10 year bond futures and buying protection on **France** and writing protection on **Spain** and **Italy**.

Risks:

The most interesting strategies and trades come from our identification of risks.

One overriding risks that hangs over the global economy is the shrinkage of credit and the implications for trend growth. Less credit translates into slower growth. Human beings suffer from long memory effects and get used to and attached to comforts. There is significant risk that in a slower growth environment, people are less willing to share and cooperate. This has implications for world trade, despite recent progress in the Bali Package of the 9th WTO conference. The risk of martial conflict is also increased. The visible risks are in the East and **South China Seas**, but generally, the propensity for conflict has risen globally, if human behavior is a guide. A broader conflict could arise between **China** and the **US**, with **Japan** as a catalyst. The theater may not be spatial but financial. **China** and **Japan** own 23% and 20% respectively of outstanding **US** government debt and strategic games can be played around financial objectives.

The **EUR** continues to prevent market clearing in European labor markets. While the **ECB** has addressed bank liquidity and soon will address solvency, the real risks lie in the real economy and the impact on society. **Europe** is stable for now and the

foreseeable future, which may not be that far out. The age imbalance in the labour market is troubling and could be storing up problems for the future.

Income and wealth inequality is approaching acute levels. While inequality between nations has receded steadily, inequality within nations has increased almost everywhere from socialist to communist to capitalist economies. The triumph of the capitalist model has swept aside all competing systems leaving capitalism unchallenged and unfortunately, unchecked. Purity can only be maintained by continuing trial. Without communism, capitalism has been allowed to evolve in some rather un-capitalist ways. There are limits to inequality beyond which social issues arise.

An absence of a strong ideological compass is another risk that is apparent in the compromises that individuals and organizations are happy to make. This is especially apparent in the behavior of governments. Expediency is the new ideal which drives agent behavior. This can lead to the storing up of imbalances, inefficiencies and other problems for the future. Short term strategies in public policy are driven by electoral cycles. Short term corporate strategies are driven by myopic pandering to shareholders and analyst behavior as well as executive compensation.

The coagulation of the investment industry. Smaller investment funds are struggling to grow while larger asset managers are attracting more capital. More and more capital is being allocated by a smaller and smaller community of investment managers. This correlates the demand and supply for securities. The Gini Coefficient for each asset market has been rising post 2008. This is increasing the systemic risk in the global financial markets. The application of more universal rules, the adoption of more universal standards, the aggregation of more universal methodologies, and the concentration in more universal systems, increases the systemic risk in financial markets. It is hard to quantify this phenomenon.

The most dissatisfying thing about this entire assessment is that it is so aligned with the industry consensus. In previous years, the analysis has been different and independent. Today, independent analysis has led to an almost total alignment with the investment industry's consensus. This is dissatisfying and dangerous.

