

VIEWS FROM THE DESK (VFTD)

September 2012

Dare to be different?

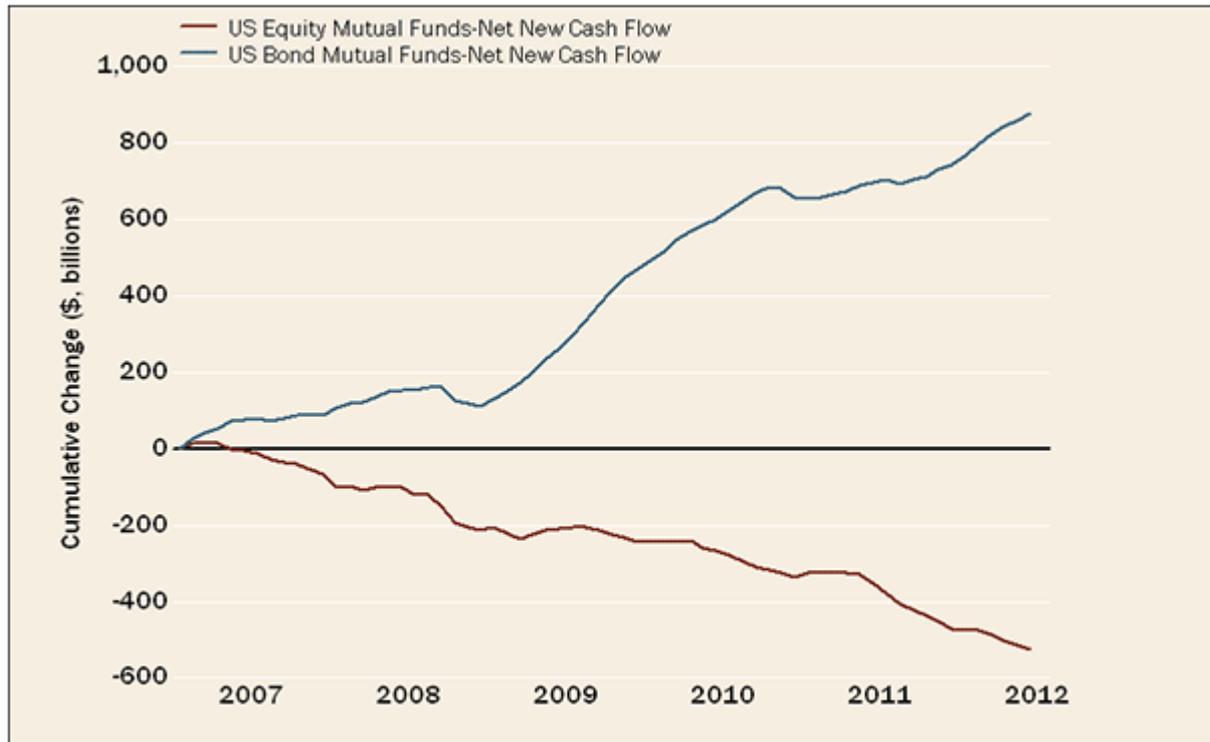
If you were fortunate enough to spend your summer holidays somewhere out of reach of media and communications, you would be returning to find most equity markets higher than when you left, credit spreads tighter and the price of oil, grains and gold on the rise. More specifically - for US retail investors – a review of their stock portfolios might reveal some very divergent performances, even within sectors. Specifically, Facebook shares are down circa 50% since their May launch, in contrast Apple is up around 27% over the same period. Analysis of this difference is revealing and offers insight into investors’ current thinking. In addition, Facebook’s losses have been cited as yet another nail in the coffin for the on-going demise of stock investing by individuals.

Why does this matter? In short: **sentiment, fund flows and contrarianism.**

The S&P is presently at levels equivalent to where it traded in 1999, a pretty dismal 13 year performance by anyone’s standards, although we acknowledge this does not include dividends.



Stock market sentiment, unsurprisingly, is principally driven by past performance, as opposed to a fundamentally based analysis of where it might be going. Currently, long-term sentiment measures reveal a level of despair about stocks not seen in the post WWII era. This is also reflected in mutual fund flows. As the chart that follows reveals, outflows from stock funds relative to inflows into bond funds have totalled \$1.4 trillion since 2007.



Source: FactSet, Investment Company Institute, as of June 30, 2012.

This is US data, however, the picture is much the same in Europe. In part this can be attributed to asset allocation changes as the baby boomers look to protect capital heading into their retirement. It also reflects other factors including: the poor returns from stocks, several periods of unprecedented market volatility, the growing dominance of high frequency trading, on-going bank scandals (JP Morgan's trading losses, LIBOR manipulation etc.) and disastrous IPOs (e.g. Facebook). As a consequence, many individual investors have understandably lost confidence in the integrity of the market.

In our view such extremism presents both risks and opportunities. To quote the investment veteran Howard Marks on the subject of contrarianism: "Investment success requires sticking with positions made uncomfortable by their variance with popular opinion." At Affinity we do not advocate doing things just because they contradict the majority, rather because we believe we can identify quality that many others don't see or appreciate and – just as importantly – is not reflected in the price. The best investments are usually "contrarian, challenging and uncomfortable".

So how does this all translate into our investment views and current positioning within investment portfolios?

- **We do not agree "the cult of equity is dying"** as per Bill Gross' (PIMCO founder) controversial August Investment Outlook (see [here](#)). Whilst we would temper expectations that annual real returns of 6.6% are achievable (the so-called Siegel constant based on the past 100 years), we feel confident and comfortable that our equity allocations will deliver. As mentioned in previous

VFTD, we are enjoying the high quality, sustainable dividend yields generated by our holdings in equity income funds. Their global mandate provides a much broader, less crowded universe from which to select from than the narrower UK centric funds. We also believe that current valuations for emerging market equities are relatively attractive and offer opportunities for growth over the longer-term. This view is reflected in our allocations to GSAM N11 fund and an emerging market equity tracker. In addition, we select funds that invest in Western companies with significant exposure to the rapidly growing demand from the emerging consumer. Finally, and closer to home, our growth orientated, UK equity funds have already produced excellent risk-adjusted performance year-to-date (Cazenove up over 20% and Heronbridge over 14%) and, whilst stock picking will be key going forward, valuations are not stretched.

- Throughout 2012 and across all our strategies, we have had significant exposure to high yield debt issued by non-investment grade companies. The investment rationale behind this allocation still holds true: namely weak but positive economic growth, robust corporate earnings and healthy balance sheets. In addition, the current yield over government bonds still reflect a significantly worse economic outcome than we expect. That said, we acknowledge this is an increasingly crowded trade and, if the significant funds flows into this sector reverse, the limited market liquidity may result in a meaningful sell-off. Having enjoyed double digit returns so far this year, we will most **likely reduce our high yield position** in the coming weeks, especially if yields continue their path towards all-time lows.
- We may look to replace a part of our high yield exposure with **emerging market (EM) corporate debt**. This is a relatively new but growing universe (outstanding bonds total \$958bn versus US high yield \$1.3tn, source: BlueBay), with a dedicated and increasingly diverse investor base. Current valuations, relative to developed market investment grade bonds and EM sovereign debt are attractive and market participants are forecasting annual returns close to 7% (UBS). Whilst defaults are low in aggregate, EM corporate debt is not without risks and it is important to differentiate between sectors and countries. However, there are plenty of opportunities in a sub asset class with an average investment grade rating, solid standalone fundamentals and offering wider spreads than similar rated corporates in developed markets.
- Developed government bonds are our least preferred fixed income sector on both valuation and credit grounds. That said, we have made specific allocations to **global index linkers**, as a longer-term defence against the impacts of QE and the need for indebted Western governments to inflate their way out their debt trap.
- We acknowledge that lower volumes, reduced liquidity and short-termism, when combined with a lack of visibility with respect to the actions of governments and central banks, will create periods of significant **volatility**. This cannot be avoided but **can be mitigated by ensuring we hold tail risk hedges** – so called “shock absorbers” - in all our portfolios. In addition to the small holdings in government bonds (linkers and conventional), and our existing gold positions, we will be

shortly making allocation to a specialist volatility fund. This is managed by the investment house Amundi and has an excellent track record for delivering uncorrelated returns.

We conclude this VFTD (thank you for reading this far – constructive feedback always welcome) with the words of Sir John Templeton:

“To buy when others are despondently selling or to sell when others are euphorically buying takes the greatest courage, but provides the greatest profit”.

Or put more simply – it pays *to dare to be different*.

Performance of strategies

Strategy	August 2012 % Performance	YTD 2012 % Performance
Income	0.55	6.63
Real Return	0.51	6.14
Growth	0.60	5.57

Composite performance numbers are currently being calculated and will be provided on request.

The performance detailed above is for illustrative purposes only and reflects the returns across Affinity Private Wealth's Income, Real Return and Growth model strategies, net of 0.95% management fees.

This does not constitute investment advice and past performance should not be viewed as an indicator of future performance.

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