

Quarter Report EUR

Q2/2013

The Second Quarter of 2013 was heavily influenced by the announcements of Mr Ben Bernanke the US Federal Reserve (FED) Chairman. His outline of a plan that the FED was considering for the end of the current quantitative easing programme, in the event that the economy and employment strengthened from current levels, caused bond, stock and precious metal markets to sell off and produced turmoil in the currency markets. What became increasingly evident is how much short term, leveraged liquidity is flowing at high speed through the global financial markets.

The falling Bond prices are justified by the higher yields expected if the FED finds economic developments to be favourable enough to taper and finally end the current Quantitative Easing (QE) programme. However, this would mean that the economic environment would be favourable for equities and even if interest rates rise from current levels, they will remain favourable for quite some time considering the historically low rates currently in place. So why the selloff in equities? Gold was the worst hit of the three and reasons given for this downward move were the reduced risks in the economy, low levels of inflation and the reduction in QE. If the economy is expected to do better, then even if there is a reduction in additional QE all the QE already in the system plus the new QE from Japan would result in rising inflation as economies improve, and capacity utilisation increases. This would be good for gold. Therefore, all three asset classes falling at the same time as a reaction to the QE announcement seems to point to short term money responding to margin calls based on leverage.

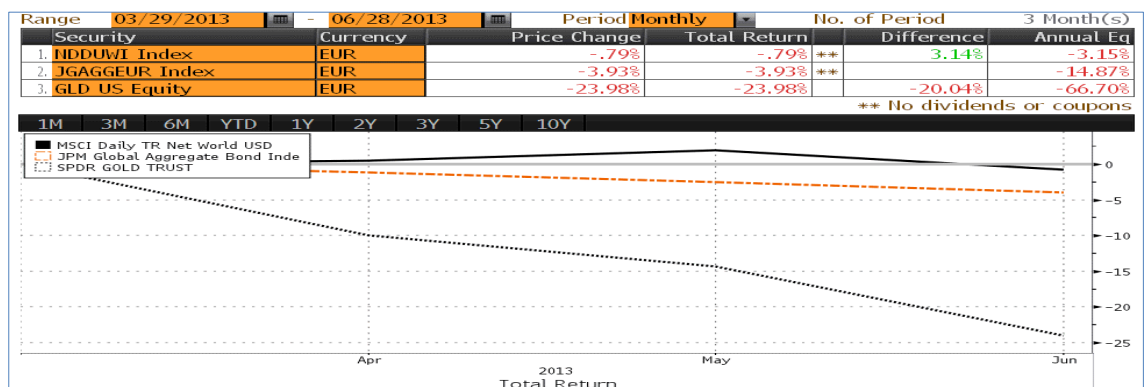


Fig.1: Global Equity, Bond and Gold indices Q2 2013

Source Bloomberg

We have therefore chosen “The dangers of fast money and short termism” as our topic for this quarter’s report. We believe that this topic is very important for investors. Short term discrepancies between the fundamental value of assets and their prices have been more pronounced in recent months and is an important influence on short term performance. What tends to rule in the short term is that whatever has done well in the recent past continues to do well irrespective of its valuation and driven to a large extent by highly leveraged, high speed trades. This situation offers advantages for those who do the analysis and have the patience to wait for the stock price of their companies to catch up with fundamentals. Our clients have experienced this several times over the years. They have noticed that we have been buyers of companies with solid balance sheets and cash flows in times when they were out of favour and though they have taken sometimes 3-6 months to rally, it has repeatedly been worth the wait. The way the markets are operating recently is that several stocks have absolutely no or even slightly negative movements in their prices for 3-6 months as the sentiment is not in their favour. Then in a space of 3 months following some slightly positive news, there is a dramatic change in sentiment as their valuations are too low and they perform better than other stocks over the whole previous year. In the past two years we have had several examples of such stocks like, Nestle, Novartis and more recently, Intel and Microsoft. Just when some clients were wondering why we had bought these shares as they had not moved at all over a period when the rest of the markets had rallied, they started to move upward and performed better

than the entire market for the year. Those clients who have been with us for several years have seen this scenario repeat itself almost every year. By going against popular sentiment and sacrificing short term performance, we have managed to consistently produce superior results for our clients over the years. We believe that chasing stocks, regions or sectors that did well last quarter, especially when they look relatively expensive, is very harmful in an environment of high speed leveraged trading. The prices of expensive stocks tend to collapse suddenly with very little warning and those that are cheap tend to rise dramatically in a very short time as well.

Let us review what has happened in the recent past with respect to asset classes, sectors, regions, currencies and even some stocks in order to get a better idea of what we are referring to.

Bonds

We have been cautious with bond purchases for our clients for about a year and have kept maturities to an average of 3-4 years in order to avoid capital losses if yields start to rise. We have said repeatedly that when interest rates are at historical lows even small absolute increases in rates will cause large losses in long maturity bond portfolios. We can see from the graph below that US and European 10 year bonds lost more than 5% and Swiss bonds more than 3% in just one month when interest rates rose just 0.3%-0.6%.

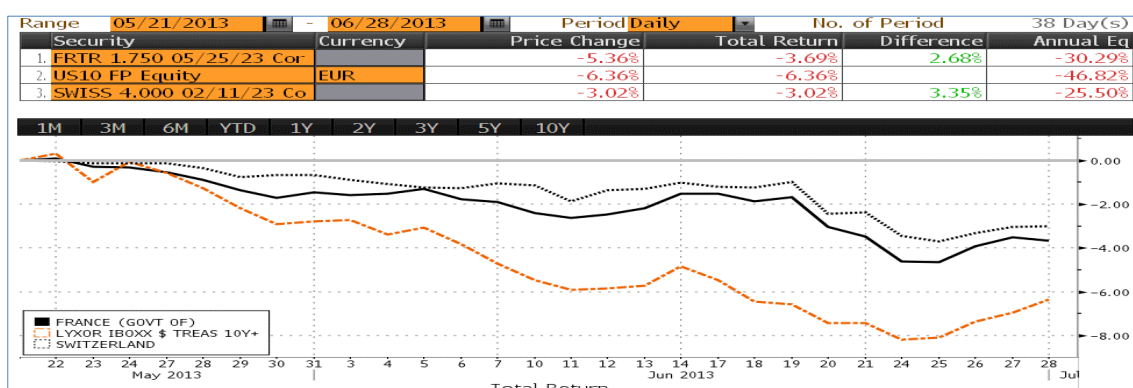


Fig.2: European & US Bond prices over the past month

Source Bloomberg

Investors who had been buying bonds with long maturities in order to maximize yield felt confident for the past 3-6 months but then suddenly suffered a substantial loss on their bond portfolios in a short time. Even if we see some retracement in yield in the short term we expect that the general tendency is for yields to move up and for every one percent increase in a 10year bond yield a 10% capital loss can be expected. Of course there are investors who say they will not make a loss as they will hold the bonds to maturity. However, then there will be a loss of purchasing power for the whole holding period as inflation would exceed the interest rate being earned. Additionally, there is an opportunity cost involved in holding bonds with lower interest for such a long period of time when other bonds and assets offer better returns.

Stocks

In the second half of 2011 and the first half of 2012 we added to positions in cash rich high dividend paying consumer staples and healthcare stocks as we believed they were cheap and were far better value than bonds. At the time we were building these positions very few people were recommending these stocks. As can be seen in Fig.3 below, for about six months there was a sideways movement in Novartis but when it started to climb, it outperformed not only bonds but global equity indices as well.

After the strong performance of such stocks, which was very favourable for our clients' portfolios last year and early this year, we felt that their valuations were not as attractive anymore and started to reduce positions gradually while building positions in Intel and Microsoft. At the time we were building these positions most analyst were very negative towards both stocks and saw very little future for them. Our research led us to another opinion as we felt these stocks offered capital gain potential based on expected technology and product announcements in addition to their very healthy dividend yields and solid balance sheets.

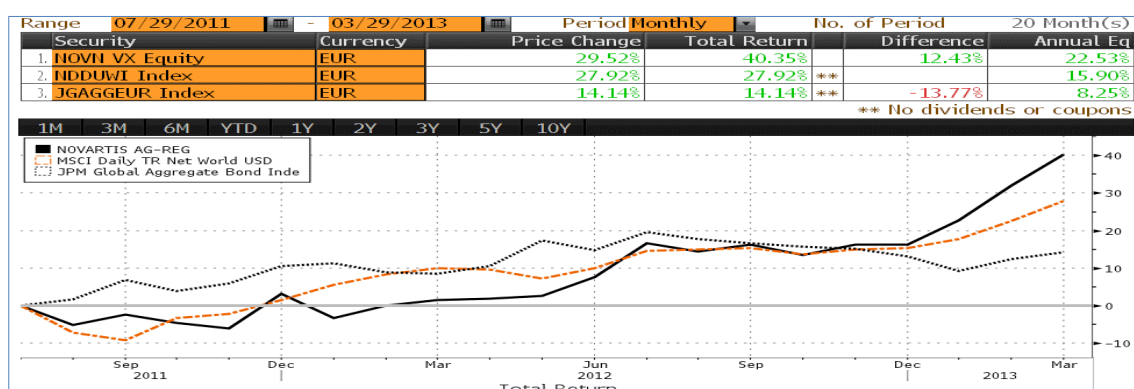


Fig.3: Novartis vs. global equity and bond indices

Source Bloomberg

However, for the first four months of this adjustment, Nestle and Novartis continued to perform better than Intel and Microsoft as those who had missed buying Novartis and Nestle kept chasing the market higher. In April this year fundamentals prevailed again and our clients benefited from the change we had made four months earlier. Intel and Microsoft outperformed most large capitalisation stocks last quarter.

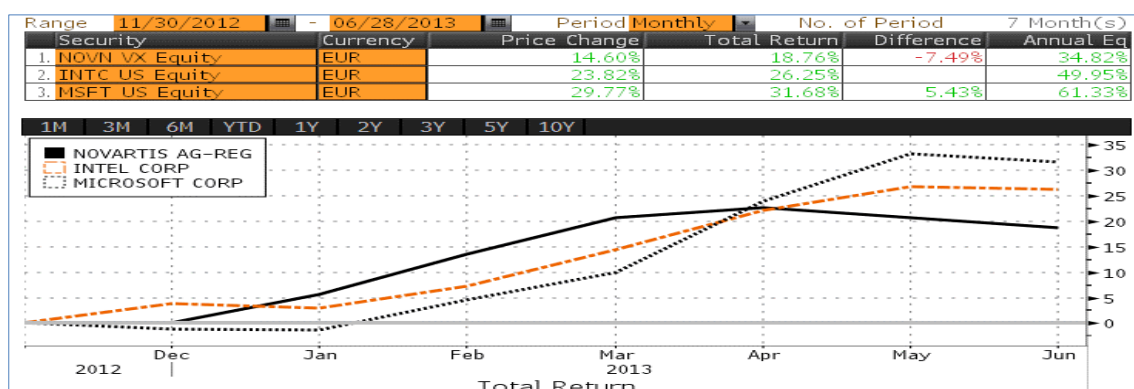


Fig.4: Performance of Novartis, Intel and Microsoft since November 2012

Source Bloomberg

During the last quarter there has been an underperformance of Emerging Markets which has reached historic extremes. Chinese shares as of 5th of June were trading at 7 times earnings and 1 time book, the cheapest since 2003 just before the multiyear rally in Chinese shares.

The same applies to commodity stocks, even though China has started stock piling metals for the first time since 2008. They started with Nickel and are now considering Copper. This has historically been a very good sign for the metals markets as Chinese stockpiling has preceded very strong rallies in the past. The Chinese consume about 40% of the global output of these two metals and therefore their stockpiling is very supportive of sentiment. China has de-stocked to a large extent over the past two years and this re-stocking move sends a very positive signal about possible future consumption. Asset Allocation to

commodities is the lowest since 2008. The last time Rio Tinto was trading at these levels, iron ore was trading at half its present price. We have been building positions in these areas and they have underperformed equity markets over the past four months. We believe that this too is a short term effect mostly caused by a kneejerk reaction to the FED comments in May and June. Those speculators who borrowed dollars to buy Emerging market assets faced margin calls and had to immediately close positions causing the extreme volatility we have seen recently. Those investors who are not leveraged and have the patience can take advantage of this situation and build some exposure to these areas at historically cheap valuations as we have done. Europe has also not done as well as the US in the last six months even though European stocks were cheaper and pricing in very subdued expectations, whereas US stocks are more expensive and pricing in a rosier picture. This is why we have decided to build more European positions since the start of this year. Recent economic figures show Germany, Spain and Italy exceeding expectations on economic indicators and the US just about in line. This is the first sign that maybe markets need to think about the relative valuation of these regions and make adjustments. We believe we are correctly positioned to take advantage of this move.

For the first half of 2013, Financial stocks have been one of the best performing sectors (+22%) in the US and make up 17% of the US Index. As our clients know, we have avoided these stocks since before the financial crisis started and still continue to do so. However, there are 3-6 month periods in which they perform better than everything else and as can be seen from the graph below, the last six months have been such a period. It is surprising to us that companies with very intransparent balance sheets, which were at the epicentre of the financial crisis and are under constant regulatory and margin pressure, have done so well recently. These companies have reported rather bland results without much hope of substantial improvement in the medium term, on the contrary we believe that they will face additional margin contraction due to increasing regulatory pressures. Despite all of this, for the first half of the year US financials performed twice as well as global equity markets and 10 times as well as the average European large capitalisation stocks as can be seen from the graph below. For us this rally looks illogical and could also be a result of people who were short this sector and leveraged having to close their short positions, thus artificially boosting the sector in the short term.



Fig.5: US financial sector versus global and European equity indices

Source Bloomberg

As investors it is our view that, while speculators may run from trade to trade without any regard for the fundamentals, we should stay with the strategy that has worked well for us over the years and buy cheap stocks and regions when others are rejecting them because of short term considerations. We also prefer to book profits in areas which are currently fashionable if we believe that valuations are not attractive anymore. We continue with this approach and believe it will be successful again as it has been several times in the past.

Currencies

The Australian dollar has been adversely affected by the recent reduction in interest rate and the current weaker than expected economic figures from China. However, we believe that sentiment is too extreme as bearish wagers are the highest they have ever been. The Australian dollar was probably too expensive a few quarters ago as it was being chased for better yield by short term leveraged speculators. As all these speculators have fled in a very short period of time, we believe that the Australian dollar has been disproportionately affected and the probability of it moving higher is greater than a probability of a further fall.

At least with the Australian dollar investors can make a case for part of the weakness stemming from the currently subdued demand from China for commodities. However the recent dramatic drop in the Norwegian Kroner follows no such logic. It appears to be totally driven by leveraged speculators moving out just as they moved in a few quarters ago. Norway is one of the most solidly financed economies in the world, with a budget surplus and a positive current account. The commodity they are dependent on is oil and its price has been rising. The International Energy Agency expects oil demand to rise over the summer as new refineries recently opened in the Middle East and Asia will demand more crude oil.

In fact, the Norwegian sovereign wealth fund is getting too large to manage as one entity and the government is considering dividing it into two sub funds. The government is very aware that it has a strong balance sheet and economy and that yield chasing speculators find their currency attractive. As a result, even though it was not required they reduced their interest rate recently with a comment that there may be more to come. The Norwegian Kroner fell more than 4% in just one day on this news. Such moves do not seem logical or sustainable to us and appear to be driven purely by short term orientated, highly leveraged speculators.

Gold

Those investors who have been clients since we founded LABHA had a profit of over 400% on their gold positions before the recent drop. We have booked profits regularly when we saw overshoots in 2007, 2011 etc. and bought back the gold we sold on average 20% cheaper each time. In the summer of 2006, gold corrected by more than 26%. In 2008 the metal plummeted 32% before recovering. This latest market correction for gold has already seen the metal pull back by more than 32% since October 2012. The second quarter of 2013 has been the worst quarter for gold in almost 100 years.

Financial traders have the largest short position in gold since 1999 which was just before the rally in Gold got underway. In stark contrast, Commercial market participants have the lowest shorts on gold since 2001. Physical demand in India, the US and several Asian countries has risen dramatically after the fall in Gold prices. In India, the biggest consumer of gold in the world, the government had to artificially hold back demand for gold at these levels because gold has to be imported into India and this causes current account deficits to rise. However, as a result of these actions pent up demand for physical gold is rising. The premium on Bullion for immediate delivery in China, the second biggest consumer, has almost doubled this year. Imports into Turkey more than doubled in April and this level has held in May and June.

There has been some talk of gold having been in a bubble which is now deflating. In our opinion most bubbles look quite different to the gradual progression of gold prices over the past 12 years. The chart below compares the gold price appreciation in percentage terms from 1970 to 1985 (black) with that of the current rally (orange) starting in 2001. The bubble in the 1979-1981 period is clearly visible, whereas the current rally just shows a steady rise.



Fig.6: Comparison of the 1970-1985 gold rally with the current one

Source Bloomberg

Though it is not possible to rule out further pressure on gold prices, we believe that the fundamentals are still intact and that short term volatility in this asset class is also a function of leveraged speculation in the paper market while physical demand still remains strong.

As we begin the third quarter of 2013, we believe that volatility in the short term will be a regular feature of these markets considering the mix of central bank policy, geo-political events and on-going debt issues. However, it is important to filter out the noise and take advantage of the opportunities offered by volatility. We currently hold the stocks of several companies with solid balance sheets and high dividend yields in client portfolios. Some of them are being ignored by the market due to short term considerations despite their compelling valuations. We believe this situation will also rectify itself and look forward to the benefits that it will bring to our client portfolios.

We have put forward our opinion on the recent market movements and welcome your feedback or queries.

Gillian Hollenstein

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