Weekly Manager Views – 19 September 2012

Global Equities

Andrew Green
Investment Adviser, GAM
GAM Global Diversified, GAM UK Diversified

- Our stock-picking approach in the UK market has continued to help our funds' performance. However, GAM UK Diversified holds about 15% in cash and, for now, we cannot see any obvious opportunities in which to invest that cash. In terms of GAM Global Diversified, we maintain our overweight position in Japan and are encouraged by recent developments from the Bank of Japan to extend asset purchases. We believe this may lead to general outperformance.
- With the action from Japan, there is worldwide co-ordinated action from central banks for growth over the perceived threat of deflation. So, we may be in one of those short time periods when the news of inflation is perceived as a positive. In the medium term, however, it could be a problem. Much hinges on the oil price, which is to some extent politically driven.
- While wage costs in the developed world remain depressed, there are signs of considerable wage rises in developing countries, such as China, other countries in Asia and recently South Africa as well. We feel this will lead to the emerging markets' continued underperformance versus developed markets, also exacerbated by the Fed's action that pushes the problems in the US onto smaller developing nations.
- There are a number of uncertainties ahead in the coming two months or so. These include not only economic and political uncertainties, but perhaps also some geopolitical ones.

Global Macro/Managed Futures

Dr Sushil Wadhwani
CEO, Wadhwani Asset Management LLP
GAM Star Keynes Quantitative Strategies

- So far, 2012 has been a challenging year for macro/CTA investors. However, the presence of non-price factors in our models has been helping us and means that GAM Star Keynes Quantitative Strategies is up about 6.4% year-to-date (GBP class to 18 September), outperforming the CTA indices.
- We are currently at an interesting juncture. Central bankers have taken aggressive action and the ball is now firmly in the court of politicians – both in Europe and the US. We appear to have seen stage one of the 'end game' of making the euro seem secure, but the gains could quickly unravel if politicians do not deliver appropriate policies. In our view, the market needs to see credible steps towards an eventual fiscal and banking union, with proper deposit insurance. Politicians may not be able to meet the expectations, but either way markets appear set for some major trending moves in the months to come. Such moves should benefit the strategy.
- In the US, there are three obvious scenarios. The first scenario is that the stimulus has succeeded and becomes visible in improved macroeconomic data. This would lead to a rise in bond yields at the long end of the curve, while any major moves in bonds would be followed by major trending moves in other asset classes. The second scenario is that the Fed does not manage to stimulate growth but inflation expectations begin to rise. This would also lead to a rise in longer-term yields. Finally, politicians could make the wrong calls and the US could see neither growth nor a rise in inflation expectations. Investors might then decide that the US is like Japan, triggering a large drop in bond yields. We believe the odds are in favour of a more positive scenario, although we cannot rule out a more pessimistic outcome.
- Europe faces similar scenarios, the most positive of which is that politicians take appropriate action to save the euro and the macro environment begins to improve. This would lead to a rally in peripheral bonds, while 'safe-haven' bonds would sell-off. Alternatively, if the ECB decides to buy sovereign bonds and one of the peripheral countries reneges, the continent will arrive at a critical point. A stop to the ECB's bond purchases would provoke a crisis, leading to a sharp fall in safe-haven bond yields. The reverse could unsettle inflation expectations and trigger a sharp move the other way. Therefore, the fund needs to be prepared for big moves in bond yields, one way or another.
- There is currently discussion within the industry about the capping of CTA funds' bond allocations, but our view is that we should not cap, in order to preserve our flexibility to react to major market moves. Unlike funds that focus almost exclusively on momentum, a major point of differentiation of our models is that they include indicators based on underlying economic fundamentals, including valuation considerations.
- The argument for capping is perhaps driven by the fact that many CTA funds have become more correlated with bond markets – the average CTA fund has a correlation of 0.27 with bonds. This contrasts with our fund's correlation of 0.09. Medium-term CTAs have also become more long term in their approach during this bond market bubble, with their optimal point in terms of moving averages moving out from 200 days in the period 1992–2004 to the current 400 days. Such funds recalibrate their models every six months or so, which is fine while the bubble persists but dangerous once it bursts if they have not capped their bond allocations.
- We believe that the advantage of our approach is that while we have not capped exposures, we have included the above mentioned non-price variables in our models, which helps us to

exit positions faster. To illustrate this, since the inception of GAM Star Keynes Quantitative Strategies, on the 15 days when bond yields rose the most, the fund lost, on average, 0.2% versus the average loss of 0.6% for the CTA fund universe. So the data indicates that we tend to be quicker to spot big moves in bond markets and are able to react accordingly.

- Most CTA funds have been long bonds in the past six weeks, while our fund has been neutral for several weeks. The non-price factors behind our move to neutral positioning included our sovereign risk model, which pointed to lower peripheral European yield spreads, as well as a model that attempts to forecast monetary policy and predicted more quantitative easing in the US. Besides a neutral positioning in bonds, the fund is long equities, although to a lesser extent than two weeks ago. It is also short the US dollar, although again to a lesser degree than two weeks ago. It remains short the yen.

Convertible Bonds

Ben Helm
Investment Manager, GAM

GAM Convertible Bond Hedge Fund, GAM Star Global Convertible Bond

- Market conditions have changed somewhat in the past two months. In July, we were still very concerned about the macro environment and had employed much more protection than usual in our convertible strategy. Following Mario Draghi's comments at the end of July about the ECB's stance to do 'whatever it takes' to save the euro, and some positive non-farm payroll data out of the US, we became more convinced about the prospects of a 'risk-on' environment. In the second week of August, we lifted hedges and rotated out of fixed income-like convertible bonds, where spreads had tightened, and into higher-delta instruments.
- The names we added to the portfolio included Hertz in the US, as we are looking for some consumer pick-up in the third and fourth quarters of this year. We also bought into gold miners, such as Newmont, increased our holding in Glencore and added to our subsea positions. We chose a short-dated subsea issue that had an interesting gamma profile at the beginning of August and this has performed very well. In the technology sector, we had been aware for some time of the pending launch of iPhone 5 and made additions to our holding in the Hon Hai Precision Industry ASCOTs a while ago. The launch of the new iPhone has lifted Hon Hai and we are now carefully monitoring these positions, concerned that the euphoria is overdone. At the same time, we have added to our holding in Intel, which we find oversold. The market seems to be ignoring the technological and intelligence value in Intel's portfolio of chips.
- There have been some movements in the corporate bond market in the past six-to-eight weeks. The yield of the Credit Suisse High Yield index is now at an all-time low. Obviously government benchmark yields are tighter than they were, but we have had a definite crunch in spreads. We believe the high-grade corporate market is now looking a little expensive. However, the iTraxx Europe Main index – trading at around 120 – is somewhat masking this price appreciation via bank spreads, although if we do see more confidence in bank credit, we would expect that index to tighten even further.
- Overall, bond funds have done very well recently. We believe that with some more confidence in markets, it will be time to start looking at equities. Investors who are nervous about equities could find convertibles an interesting alternative.
- Countering the arguments about a lack of issuance in the convertibles market, we have seen total issuance of USD 35.2 billion so far this year, of which USD 7 billion has occurred just this month. We have found some of the recent deals difficult to get comfortable with, however. For example, while British Land seems a safe bet and has a 5% yield on equity, convertible bond holders do not receive this dividend through an amendment in the conversion ratio. As most of its earnings are passed onto shareholders through dividends, the only way for its equity price to move up is through asset growth, which is difficult to see in the near term. Thus, we bought only a small slice of the issue, at a 31% premium. The same lack of earnings pass-through applies to other issues as well, including Unibail-Rodamco and the utilities holding company, Sofina. Elsewhere, we have added to our holdings in Ford and the automotive parts supplier, Faurecia, which is 40% owned by Peugeot, which we hope will not detract from its business.
- GAM Star Global Convertible Bond is up 5.8% year-to-date (USD Accumulation class to 18 September). As a result of the portfolio changes we have made, the fund's delta has risen from around 15% of NAV in the third week of August to the current 41% of NAV. So we are cautiously bullish and predict a rise in issuance from the emerging markets, particularly Asia. The USD class of GAM Convertible Bond Hedge Fund is up 8.3% year-to-date to 11 September.

Developed Market Credit

Jeremy Smouha
CEO, ATLANTICOMNIUM (UK) Ltd

GAM Star Credit Opportunities (EUR), (GBP) and (USD), GAM Euro Special Bond, GAM Sterling Special Bond, GAM US Dollar Special Bond, GAM Interest Trend

- Our approach is to invest in bonds with an equity analyst's mindset, which means that we look at bonds on the basis of whether the issuing company is likely to survive or not. Looking at the incidence of default of investment grade bonds versus high-yield bonds over the past 30 years, we find that the latter have had an average default rate of 4% per annum, or cumulatively about 17% over a five-year investment. This contrasts with the cumulative default rate of investment grade bonds of just 1% over five years. Since default is a binary event, if an investment grade company does not default, its junior debt does not either. Thus, a focus on sound investment grade companies allows us to invest further down a company's capital structure in search of higher yields. In general, we target 7–8% yields in the portfolio.
- Hutchinson Whampoa is a good example of this as its five-year senior secured note yields just 2.3%, while its five-year perpetual bond has a yield of 5.7%. Given our view that the company will not default, we are able to take advantage of the superior yield of its perpetual note despite its lower credit rating.
- The past few months have been good in developed market credit. The current themes in the marketplace are interesting from a

credit perspective as they support the strengthening of balance sheets in Europe and will help to make the banks safer. Mario Draghi's comments about the euro and the announcement of QE3 in the US have therefore reinforced our conviction in many of the holdings in our portfolios.

- Besides safer banks, we are focusing on the theme of future interest rate rises, which leads us to look at fixed rate notes converting into floaters, as well as discounted floating rate notes. A discounted floating rate note benefits from a multiplier effect when interest rates rise, usually well ahead of the actual rise. GAM Star Credit Opportunities (USD) currently has an approximate 20% allocation to them.
- The past few weeks have seen a flurry of interesting new issues. One example is Louis Dreyfus, a family-owned soft commodity company, which has come to the market for the first time with a 8.25% coupon fixed for 10 years. The company has large borrowings from banks and the issue allows it to negotiate better rates on its loans. The bond has been favourably received and is up 3% so far. We believe this is a first step on the company's path to an IPO, which is in itself positive as it brings both transparency and publicity. We have also bought into a new fixed-to-floater type issue by Delta Lloyd, a Dutch insurance company, with a 9% coupon, as well as other names, such as Danske Bank.

Source: GAM unless otherwise stated.