thesis
asset management

Thesis Market Commentary

September 2017

"You want to be greedy when others are fearful. You want to be fearful when others are greedy."
Warren Buffett

Investments in stocks and bonds are always exposed to the ebb and flow of the markets. When the market goes up you make money, and when the market goes down you lose money. We can dampen down the swings by holding a mixture of assets that tend to move in opposite directions, for example government bonds often rise in periods when equities fall, and vice versa. However this is tricky in times such as the present, when both equities and bonds are trading at expensive levels.

We can control risk by keeping a portion of our portfolio in cash, but this means accepting somewhat lower returns. Alternative assets can be useful to diversify a portfolio, but there is still a risk that when the chips are down, such as during the 2008 crisis, investors become so spooked that all asset classes fall at the same time.

Is there an investment that can make us money when markets rise, but also protect us when they fall? To achieve this we need to look to the options market. Options are similar to insurance. Investors pay a premium to a bank in return for the right to profit if the market moves in the direction they expect. If they are wrong then the most that can be lost is the premium. Options are often expensive and complicated, and can be difficult for individual investors to hold in their portfolios from an administrative perspective.

Rather than buying options directly, we can still benefit from them by having the bank package options together into what is termed a structured product. This is essentially a bond whose payoff is linked to the performance of an underlying asset, for example a stockmarket index. The product pays a return if the asset does well, but usually protects investors from all but the most extreme falls in the asset.

An example

One such product that has been held in some Thesis portfolios has recently matured, and this seemed an ideal opportunity to highlight the benefits that such a holding can have for our clients. We bought this product near the end of August 2015, during a period of market stress which originated in China.

Despite China's slower economic growth, its equity market had surged during the previous year, boosted by demand from domestic first time investors looking to diversify their savings. Momentum ran out however, and a significant reversal followed. Initially the Chinese authorities saw this as a welcome correction, but as the falls continued they became more worried about the destabilisation that could be caused to their economy and implemented a variety of restrictions in an attempt to restore confidence.

The surprise announcement that the yuan exchange rate would be lowered caused concern among investors that China's growth may be even weaker than feared. When this was followed by poor manufacturing figures Chinese equities had a further sizeable descent which was echoed in other global markets, especially in the emerging world. The FTSE 100 index of leading UK companies fell by 10% in a week.

We felt that with economic data still looking strong, further significant market falls were unlikely and so we wanted to use this opportunity to put to work some of the cash which we had built up in portfolios when markets had been at higher levels. On the other hand with the Greek debt crisis still a significant risk and US interest rate rises imminent it was unclear how much markets would subsequently rise if we bought into equities directly. The level of volatility in the market at the time meant that we could commission a structured product with a very attractive fixed return of 21% per annum, while protecting against market falls of up to 30%.

The product was linked to the FTSE 100 index, the US Russell 2000 index and the Euro Stoxx 50 index. Each year on the anniversary of its issuance the product would mature if the worst performing of the three indices had gone up since August 2015. Investors would then receive their capital and a profit of 21% for every year elapsed since the product's launch. If after five years the worst performing index remained below its starting point then as long as it had fallen by less than 30% investors would still get back 100% of their initial investment. Only if the fall was more than 30% would capital be lost.

The second anniversary has recently taken place, and with each index now above its starting point the product has matured, paying investors a 42% profit.

As it has turned out, equity markets have been strong over the last two years and sterling has weakened considerably, so investors could have received a similar return by investing

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equal amounts in the three indices directly. This direct investment would not have had any protection if markets had been weaker however. In addition, the structured product would have paid the same 21% return even if each underling index had only risen by 1%. Therefore on a balance of risk and return the structured product was still a more compelling investment.

How is this possible?

Why was the bank (in this case Société Générale) willing to issue a product that seemed to offer such attractive terms? The answer boils down to one of the fundamentals of investing: taking a long-term rather than a short-term view.

When the bank evaluates pricing of a structured product it takes into account the current market conditions, in other words a short-term view. Investors were nervous at the time we bought the product, making the product returns high because the bank's valuation models interpreted it as being high risk.

As long-term investors we could take a different view. A 30% drop in markets, on top of the falls that had already taken place and no recovery within five years, seemed unlikely. The product certainly involved risk, but a potential 21% annual return seemed adequate compensation for taking that risk. We knew that the value may rise or fall during the term of the product, but were confident that it was unlikely to lose money over its full life. On a long term view it therefore merited a place in the blend of investments in some moderate and higher risk clients' portfolios.

The current situation is very different. The VIX or "fear index" which measures investors' expectations of future volatility is close to historically low levels. A similar structured product bought today would probably pay somewhere in the region of 12% per annum. Markets are also at much higher levels than they were in 2015, making larger falls at some point in the five year life of the product much more probable and therefore the chance of losing money higher. We would therefore not be keen to buy a similar product today. If we experience a period of elevated volatility in the future however, then we would certainly consider something similar. In structured products as in so much of investing it is wise to remember the advice of veteran investor Warren Buffett to be greedy while others are fearful and fearful when others are greedy.

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News and views

August is a notoriously difficult month for markets as trading volumes dip, leaving share prices vulnerable to large fluctuations. Much of this precariousness is due to the movers and shakers living it up on holiday, leaving trading rooms quiet and decision makers scarce. As we come out of the seasonally quiet summer months, the balance of power between bull and bear will become clearer as activity levels pick up. We think investor attention will focus on monetary policy normalisation through the remainder of the year with central bank policy meetings providing signposts towards those next steps. Patience and caution are understandable priorities given the subdued level of core inflation but with markets pricing in a shallower interest rate path for the European Central Bank (ECB) and US Federal Reserve (Fed), having now fully unwound premature expectations, the potential for being wrong footed once again has increased. With the Fed's next move likely to focus on gradual reduction in its balance sheet, and expectations that the ECB will soon announce a 2018 tapering of its balance sheet, the liquidity tide may just be turning and could lead to an increase in market volatility.

Indices	Value as at 31/08/2017	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7430.62	0.80%	4.03%	9.57%
FTSE All Share	4072.98	0.66%	5.16%	10.16%
S&P 500	2471.65	0.05%	10.40%	13.85%
Dow Jones	21948.10	0.26%	11.06%	19.28%
Euro Stoxx 50 EUR	3421.36	-0.81%	3.98%	13.17%
Nikkei 225	19646.24	-1.40%	2.78%	16.34%
MSCI Emerging Markets	1087.70	2.01%	26.14%	21.71%
UK Treasury 1.25% 2026	104.82	1.52%	2.40%	-3.13%
Sterling/US$	1.29	-2.24%	4.83%	-1.88%
Sterling/Euro	1.09	-2.81%	-7.23%	-7.84%

Source: Bloomberg

UK

Backward looking economic data clearly illustrated the extent to which underlying momentum has slackened. UK GDP growth slowed to just 0.3% in the second quarter as continued weakness in sterling and Brexit uncertainty hit household spending and business investment. UK business sentiment surveys however point to a brighter outlook and continue to read more positively than the hard economic data. Equity markets closed the month marginally higher, although this hides the fact the market suffered

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some high profile profit warnings from WPP, Dixons Carphone and Provident Financial that prompted a sharp sell-off in the share prices of these companies.

US
The US equity market remained jittery as concerns around growing political risk dominated as the North Korea stand-off intensified. Aside from this we see other headwinds abroad (the uncertain nature of the future trade relationship with China) and at home (the Trump administration's ability to carry out its business-friendly policy measures) weighing on sentiment and potentially capping the upside in equity markets. Investors can take courage however from a larger-than-expected revision to GDP growth. Data showed that the US economy expanded at an annualised rate of 3% from April to June (revised from an initial estimate of 2.6%) as household spending and investment improved.

Europe
The equity markets remain beholden to exchange rate moves but it feels like the euro vs US dollar surge is fading, which should give the eurozone markets some respite after another month of underperformance. Although equity markets ticked down in local currency terms, they rose in sterling terms as the euro hit an 8-year high. On the macroeconomic front, GDP figures showed the European economy gathering pace in the second quarter. Eurozone GDP growth stood at 0.6% in quarter two, up from 0.5% in the first quarter. France and Italy lagged slightly behind German growth, with Spain delivering the strongest performance of the big four.

Emerging markets
Emerging equity markets extended their winning ways, but this month we saw a change in leadership with Latin America leading the gains, as stronger than expected economic releases, as well as positive political developments provided a supportive backdrop. In emerging Asia we have seen resurgent PMIs with broad-based improvement in manufacturing conditions and stronger export orders which reinforces the view that a cyclical recovery should continue through the remainder of the year.

Japan
Overseas risks offset tailwinds such as solid corporate earnings momentum and a strong domestic economy. The earnings results saw better than expected sales revenue for the second consecutive quarter while profit margins continued to rise. The Q2 GDP data delivered a big upside surprise with the headline annualised growth rate surging to +4% quarter-on-quarter (QoQ), driven by strong domestic demand as both household consumption (+0.9% QoQ) and capital expenditure (+2.4% QoQ) comfortably beat expectations.

Bonds
Global bond yields have reversed and headed lower again over the past month, with geopolitical concerns and increasing levels of market volatility leading to government bonds outperforming corporate bonds, and investment grade outperforming high yield.

An update on some of our favoured stocks

Morgan Advanced Materials
Morgan Advanced Materials is the most recent addition to our buy list. It designs, manufactures and distributes products, principally out of ceramics and carbon, that are fundamental components or enabling technologies used in high temperature industrial processing of metals, petrochemicals, cement, ceramics and glass, and by manufacturers of equipment for aerospace, automotive, marine and domestic applications.

We view Morgan as a turnaround story with management committed to repositioning and improving the group for longer-term profitable growth. Its broad array of businesses are still seeing varying fortunes, not everything has yet turned the corner, but the laggards appear to have at least stabilised. The key to enhancing performance is to take advantage of the opportunities the CEO's review has identified: reducing the complexity of the business, greater global co-ordination, improved operational execution and improving the sales effectiveness and management talent. We have already seen positive steps taken with the recent divestments of the Rotary Transfer Systems and the UK Electro-Ceramics businesses, an important simplification of the group, and it has materially strengthened the balance sheet.

We think the new management team is committed to the long-term, sustainable development of the business evidenced by delivering meaningful cost savings but reinvesting these into R&D and the sales force. It has a number of strategic priorities such as focusing on high-growth and high-margin markets, offering niche products to its customers, adding value to its customers and being number one or two in its chosen markets, while "operating in a culture of excellence and cost efficiency" and reducing the group's exposure to economically sensitive and commoditised end markets.

We appreciate this two to three year change and improvement programme will take time and has a large number of moving parts but we continue to believe there is an opportunity for a sustainably stronger financial performance to emerge. The challenges the business faces in executing its plan is fully reflected in its low, relative to peers price to earnings forecast of roughly 13.5x which we view as undemanding and supported by an attractive 3.75% dividend yield. If the management team can build credibility by delivering on its agenda and by producing a more consistent level of performance then the shares will enjoy a re-rating.

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