HAMILTON
wealth management

# Investor Insight 64 – August 2018

We live in interesting times. As we have repeatedly mentioned for the last 2 years the largest threat to markets is rising interest rates.

The US equity bull market is now at a post-Second World War record, US 10-year Treasuries have struggled to settle above 3 per cent despite expectations from all the bears at the beginning of this calendar year and the VIX index of volatility has averaged year to date just over 15 per cent, again a lot lower than expectations at the beginning of this calendar year.

Apart from domestic Australian equities, what stood out at June 30 was that nearly all major asset classes are in negative territory at index levels since the start of 2018. Those who called 2018 the year of the hedge fund have also been disappointed with the HFRX global index slightly negative since the beginning of the calendar year.

As we communicated directly with clients in mid-June, the S&P 500 had appreciated 60.1% from the 1st January 2014 to the 31st March 2018. The top 7 companies in this index are (in order) Amazon, NVIDIA, Apple, Microsoft, Facebook, Alphabet and Netflix. Together these comprise 35.7% of the index and more than half of the 60.1% appreciation.

Whilst value exists in the S&P 500 in Consumer Staples, Financials, Health Care and selectively in Consumer Discretionary, the appreciation of the S&P 500 has been driven by those seven tech companies. Whilst the above sectors will provide some protection on the downside, the “big seven” are priced to perfection and bad news like what we saw in the last week with Facebook can see these companies sold down heavily.

Another area of concern is that there is an element of herd investing at the moment. In other words, investors are being attracted to the same asset classes. We strongly believe that in an environment of increasing interest rates one clear departure from what we have seen for the last 10 years will be an environment where passive investing will lose and active investing and differentiated investment strategies will prosper.

A retired fund manager recently pointed out to us that he believes the environment for differentiated or active investing has returned, describing the environment as a “stock pickers paradise”.

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To highlight this, it was mentioned how in the 2017/2018 financial year, the best ten performing stocks in the ASX100 have an average return of +78 per cent against the worst ten performing stocks in the ASX100 having an average return of -25 per cent. In other words, the relative performance within the index is going to highlight the opportunities for the better active managers. When you go to the ASX200 this relative performance differential becomes even more pronounced with the top ten providing an average return of +190 per cent against the worst ten providing an average return of -33 per cent an amazing 223 per cent differential.

Therefore, opportunity does and will exist in equity markets.

Quantitative easing is being replaced by quantitative tightening. The biggest question with this is whether investors, after years of loose monetary policy, have become complacent to risk and whether they are mispricing risk? Asset allocation could not be more important in this environment.

Fixed Income has us worried. It has failed to deliver returns. You don't want to be fixed (duration) and it doesn't produce much income. The flattening of the yield curve reflects a tightening in monetary policy. As we have also said several times, quoting our partner John Green, this asset class must "turn a lot of tricks for very little return", or to put it another way, the returns do not compensate adequately for the risks involved. Traditional Government bonds, investment grade credit and high yield have underperformed against expectations.

The investment grade corporate bond market in the US has just experienced two consecutive negative quarters, the first time this has occurred since the GFC. The flagship bond fund run by "bond guru" Bill Gross, formerly of PIMCO and now of Janus Henderson, has returned minus 3.84% so far this calendar year and the S&P500 Investment Grade Corporate Bond Index has returned minus 2.53% so far this calendar year. The Bloomberg AusBond Government 0+Yr Index is up 1.89% this year. While bonds are an important part of all diversified portfolios, they are not risk free and many investors misunderstand this. Our current fixed income allocations are weighted towards short duration funds with a high proportion of floating rate issues. Returns are positive but the risk/return payoff versus cash/term deposits in the current market environment is questionable. A larger weighting towards cash may be appropriate or, for clients with an appropriate risk profile, consideration of an allocation towards illiquid investments.

This increasing interest rate environment has been re-emphasised by the US Federal Reserve (Fed) stating that investors should expect four interest rate increases in 2018, the European Central Bank (ECB) indicating a shift in policy in that their bond buying program will come to an end in late 2018 and that there will be implicit tightening and the Bank of England could tighten as early as next month.

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Equities on a relative basis do stand out. Jerome Powell, the Chairman of the US Fed, described the US economy as being in “great shape”, Mario Draghi the Chair of the ECB believes the Eurozone economies are “strong enough” to withstand increased interest rates, the Q1 reporting season was the strongest in recent history and Q2 looks very similar. Hence active equity managers are performing, as opposed to index managers.

We cannot ignore Emerging equity Markets (EM). Again, as we communicated directly with clients at the start of July, EM are universally seen as the area of superior growth opportunities in the medium to long term. Whilst EM are attracting negative headlines, Brazil, Argentina, South Africa and Turkey are the only EM countries of real concern. We have seen less concerns over China. China is a leader in advanced technology and the sell down in their market will become a buying opportunity. Interestingly, MSCI China A shares are down 20 per cent YTD but MSCI China H shares (Hong Kong listed, and US listed) are down just 2 per cent YTD. In other words, be careful of the headlines.

Index or BETA has delivered since the GFC, but we are entering a new game now with rising interest rates.

Thoughtless or passive portfolio construction has done well in the low interest rate environment, hence the market in many cases has switched off to thoughtful portfolio construction.

This is dangerous, and many will sleep walk into an increasing interest rate scenario without knowing the implications. A good active manager should outperform in this environment and active management in equities investing is back.

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**Hamilton Wealth Management** is a Fee for Service, independently owned Wealth Management business and as such our advice is built around the conviction to our process and philosophy and our strong belief in diversification.

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We would be happy to discuss this further with you, please don’t hesitate to contact us.

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