Equities – Hitting New Heights

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Attractive outlook for equities: The trend reversal in interest rates and other factors suggest new highs will be reached in the coming years.

Editorial

Dear Reader

Many equity markets reached new highs until recently. Yet, the Fed’s announcement that an end to quantitative easing is in sight has caused considerable uncertainty. In this issue of Trends we explain why we expect stock prices should be able to hit new levels in the coming years. We also investigate what drives the above average earnings momentum of small and medium-sized firms.

In addition, we take a closer look at Japan. Late last year hopes started to emerge that the economic crisis, which has been going on for over two decades, could now be overcome. We consider whether the land of the rising sun is at an economic turning point or will remain clouded in gloom. And, as usual, we also report on other markets and trends.

We hope this edition makes for enjoyable and thought-provoking reading, and provides you with some investment ideas.

Best regards

Robert Parker
Head Strategic Advisory Group,
Member of the Global Investment Committee
Equity markets have continued to soar, reaching new record levels in many places. After anxiety over “ta- pering” acted as a drag in May, sentiment has undergone an interesting shift of late. Now it is a case of “good is good, and bad is better”: good economic news is greeted with cheers, whereas disappointing data is celebrated with something approaching jubilation, on the basis that it increases the chances of QE3 continuing. This raises the question of whether the markets might not be too euphoric.

After many market participants were taken aback when the Fed announced that it would start to wind down its ultra-loose monetary policy, there has recently been a change in the Fed’s communica- tion strategy. Ben Bernanke has even been making extremely moderate pro-nouncements. These have been grate- fully received by equity markets, with the setbacks of early summer quickly driven out of people’s minds. However, we take the view that the Fed has shot wide of the mark and faked in its mandate of providing the market with clear and timely statements on its monetary policy en- deavors. The current rhetoric is creating confusion rather than guiding the market toward the right conclusion, resulting in over-analysis of Bernanke’s every word. Ultimately, the key issue is not when and how the Fed begins the process of normalizing its monetary policy. What mat- ters is that the Fed will tread with extreme caution to avoid bringing about the opposite of what it actually wants: namely, an orderly exit from the ultra- low-interest-rate environment.

The route that the Fed has chosen also sends out a strong signal that it is suf- ficiently confident about the robustness of the economic recovery to scale down the money printing in the near future. It therefore seems likely that we are slowly drifting into a new world – one that re- minds us strongly of the old pre-financial-crisis world, with tighter liquidity and a self-supporting economy. This will en- able us to once again focus on investing, rather than on speculating about what the Fed will have to conjure up next in order to prop up the economy.

This new world is, in our view, positive for equities. However, until the Fed actually does turn off the liquidity faucet we think the risk of a correction is greater than the chance of unbridled market gains.

There is a particular danger looming in the shape of the US bond market. The rotation out of government bonds which the Fed has initiated has already caused long-term yields to rocket, and we see a danger of further over-shooting. The excessively fast rise represents a tempo- rary risk for equities. In addition, the geopolitical situation in Syria poses tem- porary risks. We have therefore adopted a tactical underweight and taken some profits from our overweight position in the shape of the US bond market. The rotation out of government bonds which the Fed has initiated has already caused long-term yields to rocket, and we see a danger of further over-shooting. The excessively fast rise represents a tempo- rary risk for equities. In addition, the geopolitical situation in Syria poses tem- porary risks. We have therefore adopted a tactical underweight and taken some profits from our overweight position in the region where the best of both worlds – economic recovery and surplus liquid- ity – has been priced in, namely the US. However, the rule applies: "Buy the dip."

Within the bond allocation we still favor short maturities. Even if yields temporar- ily over-shoot, we see no real technical pricing opportunities resulting. The bull market in fixed income is over, and the rotation away from expensive bonds into temporary risks. We have therefore adopted

1. the winners of the new world – equities, real estate, cyclical sectors, etc. – is only in its infancy. Therefore, the rule should read here: "Sell the rally, but don’t buy the dip."

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Late last year hopes started to emerge in Japan that the economic spiral of weakness and deflation that has been ongoing for over two decades could now be fixed. This new confidence was rooted in the magic word “Abenomics”. This term is applied to the economic policy overseen by Prime Minister Shinzo Abe, which aims to breathe new life into Japan’s economy with a very expansive monetary approach in conjunction with fiscal and structural measures. The risks underlying this economic program are now being hotly debated. Is the Land of the Rising Sun at the threshold of a new economic trend or will dark clouds continue to hang over its economy?

After the 1980s real estate boom turned to bust, economic developments in Japan during the 1990s and into the past decade were characterized by substantial and lengthy adjustments in the financial sector, weak growth and deflation. However, the weakness was also due to demographics as ageing, paired with insufficient immigration and a comparatively low female participation rate in the labor market, had a more pronounced impact on economic growth than elsewhere (see also graph).

Pretty strong per-capita GDP gains over the past decade but persistent deflation

In fact, Japanese growth measured on a per capita basis was a lot better than overall GDP. Of course, deflation has been bad for high and rising (public) debt, but both the public and the private sector have large assets domestically and abroad. Nevertheless, Japan has launched a set of policies to boost the economy and to exit deflation. The policy mix of “Abenomics”, named after Prime Minister Abe, who returned to office last year, consists of three “arrows”.

Anticipation of bold monetary policy has driven currency weakness

Shinzo Abe already began to discuss aggressive monetary easing, “arrow” number one of the new policy package, before he was elected late last year. Actual implementation of this policy, large-scale asset purchases and a higher inflation target, only began in April of this year, after Haruhiko Kuroda had taken over as Bank of Japan governor. But the signaling effect already caused a significant currency weakening, which now amounts to more than 20% versus Japan’s major trading partners.

... and this should continue to have positive effects

Even though the nominal yen decline came from a very strong level, currency depreciation has several positive effects. A translation effect on corporate earnings has driven earnings estimates higher, which has supported equities and the corporate sector. In principle, this should also provide room for “useful” wage inflation. On the external side, currency weakness has so far merely inflated the value of exports. Export volumes have not moved a lot but the significant yen shift should improve competitiveness and support export volumes over time. So far, import values have risen as well and this has actually led to a rise in the trade deficit. The government’s resolve and yen weakening help explain the significant improvement of corporate and consumer confidence.

Return to “useful” inflation?

Inflation has increased over the past months but probably still for the wrong reasons. If currency weakness drives imported goods inflation, this can actually be negative as it dampens purchasing power of an ageing society of savers. Rising wages are a key part of the equation to reduce income inequality and provide further support for consumer optimism and spending. Very tentative signs of strengthening wage growth suggest that this might happen. But given high inequality in the income distribution, the aggregate data might not give a clear picture. As the older income cohorts with higher wages leave the workforce, wage growth on aggregate could actually be dampened. This could mask important gains at the lower end of the income spectrum, which should have a higher propensity to consume.

Fiscal policy boost to be followed by sustainability measures

Japan’s public debt level remains one of the highest globally. The Abe government nevertheless complemented the monetary policy boldness with renewed fiscal stimulus, “arrow” number two, which has supported the growth pick-up. The problem is the high public deficit, which amounts to 10% of annual economic output, making it one of the highest in advanced economies. Credibility that stabilization can be achieved might be at risk and one measure to strengthen it is a planned consumption tax hike from 5% to 8% in April next year. To soften the impact, corporate taxes, among the highest in the OECD, are discussed to be reduced.

Structural reforms aiming at higher potential growth

While GDP per capita gains over the past decade have been strong in Japan, deflation persisted and the latest growth boost is thus positive for fiscal sustainability. However, it is too early to make an assessment whether “Abenomics” has been successful to make the growth boost sustainable. If currency weakness helps to drive wage growth for the lower parts of the income distribution, this could be the case. The reduction in corporate taxes might support investment spending but corporates are cash rich and have little leverage already so the impact would be uncertain. The challenge is that fiscal policy, the second “arrow”, will have to move towards a more credible path i.e. become more restrictive. This could threaten the recovery before it becomes sustainable and before meaningful structural reforms, the third “arrow”, are effective. If currency weakness reverses or if yields suddenly rise, the Bank of Japan would probably intervene even more but monetary policy alone will probably have difficulties to sustain growth.

Conclusion and outlook

While GDP per capita gains over the past decade have been strong in Japan, deflation persisted and the latest growth boost is thus positive for fiscal sustainability. However, it is too early to make an assessment whether “Abenomics” has been successful to make the growth boost sustainable. If currency weakness helps to drive wage growth for the lower parts of the income distribution, this could be the case. The reduction in corporate taxes might support investment spending but corporates are cash rich and have little leverage already so the impact would be uncertain. The challenge is that fiscal policy, the second “arrow”, will have to move towards a more credible path i.e. become more restrictive. This could threaten the recovery before it becomes sustainable and before meaningful structural reforms, the third “arrow”, are effective. If currency weakness reverses or if yields suddenly rise, the Bank of Japan would probably intervene even more but monetary policy alone will probably have difficulties to sustain growth.
Fixed Income Global

Time to Revisit Absolute Return

Fixed Income Strategies

Luc Mathys, Asset Management Fixed Income

With interest rates – and to a lesser extent credit spreads – still at historic lows, investors are becoming increasingly concerned about larger drawdowns for various asset classes in case of an adjusting yield environment. At the same time they continue to look for a yield pick-up relative to money market rates, which continue to hover around zero in most developed markets. Absolute return concepts cope with these investment objectives by aiming to produce consistent positive returns, independent of market direction, while trying to avoid large drawdowns in times of general market stress. Due to their low volatility, more defensive fixed income asset classes – but also combinations thereof – have shown absolute return characteristics in the past, but also longer term average returns than riskier fixed income asset classes. However, for additional return sources, the fixed income universe also offers a broad set of opportunities to run uncorrelated and risk controlled strategies that can potentially perform in many different market scenarios.

Absolute return characteristics of fixed income

Bonds with recurring income and the repayment of the notional amount at maturity – assuming low to normal default rates in a highly diversified portfolio – serve as an ideal cornerstone for absolute return investors. However, due to the different risk characteristics of fixed income asset classes, the time to achieve an absolute return result with a certain probability can vary significantly, as can be seen in the table on the previous page which shows data since September 2000. While the high grade short maturity market had a maximum drawdown of 1.98% and took only a maximum of five months to recover the loss, riskier fixed income asset classes – but also equities – had maximum drawdowns of between 20% and 50% and took up to five and a half years to recover the losses. While in the long run risk was usually compensated with higher total returns, the increased probability of losses over a 12-month rolling period for a full allocation to asset classes like emerging market bonds seems not to be in line with the requirements of absolute return investors. Additionally, it has to be taken into account that a high default rate could change the absolute return characteristics, as losses on single investments are not recovered over time. However, a broad diversification and a relatively high average rating of a portfolio should serve as an accurate protection. Due to the lower returns of more defensive fixed income asset classes, additional strategies can be used to broaden the universe for return generation. In particular, relative value strategies that are lowly correlated to general market trends or directional strategies with a defined risk limit in order to mitigate losses in a worst case scenario, seem to be well suited.

Directional risk limited strategies

Directional strategies aim to profit from the implementation of high conviction investment views on total returns of different markets, sectors, interest rates or credit spreads. In order to operate in an absolute return framework, it is important not to restrict investment managers in their opportunity set with an index benchmark orientation, but to make full use of the global investment universe. This is also true for the use of different techniques and instruments that allow, for example, the implementation of strong negative views with short positions. Of course, the resulting return of those strategies depends on the quality of the investment views and the skills of the portfolio manager to efficiently implement them. However, with a broad set of non-perfectly correlated directional strategies,
Trends

The overall volatility of the portfolio and dependence on single risk factors is not increased disproportionately, provided effective exposures to various risk factors are correctly mirrored with risk management systems and maximum allocations to the strategies are limited depending on the maximum loss in a worst case scenario. As an example, a portfolio with 95% short maturity high grade bonds and 5% high yield bonds has, over the last 20 years, shown a maximum drawdown of -3.1% and a maximum loss recovery period of five months. The worst performance over all 12-month rolling periods was -0.2%. However, an allocation of 5% high yield bonds to a high grade short maturity portfolio after the strong sell-off in 2008 would have increased the yearly return from 3.07% to 4.14%.

Relative value strategies
Relative value strategies can further broaden the universe to generate additional returns for a portfolio, without having exposure to the movement of the general trend of interest rates and credit markets. These strategies aim to profit by identifying discrepancies among markets, sectors or securities that share similar economic or financial characteristics. In addition, active relative investment views can also be implemented. In the following example, the prices of two subordinated bonds of Bayerische Landesbank, both maturing in 2016, show that anomalies – even by adjusting for currency hedging costs or small differences in coupons or maturities – between similar securities can exist, which can be exploited over time. Therefore, the undervalued security is bought and the overvalued security is sold in order to profit from a closing pricing gap between the two. The big advantage is that general movements in interest rates or credit markets have only a minor impact on these strategies – as both the long and short side of the strategy are impacted in the same way by movements in interest rates or spreads. Therefore, undervalued securities do not require hard coded limitations on exposure to all possible risk factors or maturities – between similar securities.

Price discrepancies between bonds with similar conditions

Alternative Investments

Structural Change in the European Energy Sector Opens Up Attractive Investment Opportunities in Energy Infrastructure

Damaris Reiser, Alternative Investments Advisory, and Nina Winkler, Alternative Investments Illiquids

Low interest rates and a difficult, volatile market environment dominated by the euro crisis have led some investors to seek out long-term alternatives to bonds and equities. Investments in infrastructure have come onto the radar. According to Preqin, a specialist in alternative investments, nearly 50% of the institutional investors it surveyed had a target allocation to infrastructure of more than 5% of their portfolios, although most had not actually reached that level (see Figure 1). At the same time, the structural shift in the European energy sector has opened up attractive investment opportunities in energy infrastructure. Could this be the perfect match – institutional investors in search of alternative forms of investment and European energy companies on the hunt for investors?

What is energy infrastructure?
Infrastructure consists of the durable assets that enable an economy to function. A distinction is generally drawn between social and economic infrastructure. Social infrastructure includes the education and healthcare systems, for example, encompassing assets such as schools and hospitals. Economic infrastructure includes assets such as power stations, transmission and distribution networks and energy storage.

Opportunities in the European energy sector
There are attractive investment opportunities on offer in the European energy sector at present. Rising demand for energy and a drive for energy efficiency are creating a need to invest in new and existing production facilities and grids. Some of the existing assets are nearing the end of their lives and need replacing. In certain countries, such as Switzerland and Germany, the need for expansion and renewal is not just politically driven but is also coming from a demand within society to remove nuclear power from the energy mix. This is boosting the investment requirement considerably, as nuclear power still accounts for a large slice of energy production in these two countries (see Figures 2 and 3 on the following page). The medium-term requirement for investment in European energy infrastructure is estimated at EUR 600-1,200 billion. The high capital requirement means that energy companies alone can no longer

Figure 1: Breakdown of infrastructure investors by current/target allocation to infrastructure

Source: Preqin Infrastructure Online.
find the necessary funds. They are increasingly looking for investors to make capital available.

From an investor perspective, the energy infrastructure sector is attractive because it is wide-ranging and offers diverse investment opportunities, enabling risks to be diversified. In addition, energy infrastructure assets have a long durability. They generate steady cash flows with a good degree of predictability, while also offering the chance of capital appreciation. What is more, income is often indexed-linked and uncorrelated to the equity markets. Returns depend on the type of investment and the risks entailed. Return on equity is expected to range from 4% to 15% p.a., depending on the sub-sector and the level of electricity price risk entered into.

**Potential investors**

Given the durability of infrastructure assets – a category that of course includes energy infrastructure assets – this is a particularly attractive area for investors that have a very long investment horizon. That makes it suitable for pension funds and life insurance companies in particular. Infrastructure offers a way for them to match investments to their long-term commitments and turn in a profit. Indeed, they are already the largest investors in the infrastructure sector, as Figure 4 shows.

However, pension funds are restricted to some extent by law. In Switzerland, for example, there are restrictions on investments not made via diversified collective investment vehicles. Nevertheless, such investments can be made as part of the allocation to alternative investments, capped at 15% of the portfolio. Insurers also face limits on direct investments in infrastructure, but the Swiss Insurance Association has already proposed a parliamentary initiative calling for greater freedom to invest more easily in infrastructure in future. As it stands, tied assets must be held in relation to domestic assets. The German Insurance Association is also calling for a separate allocation for infrastructure investments and a separate risk class that adequately reflects the risks associated with infrastructure and hence reduces the capital backing required.

**A partnership for the future**

Investments in energy infrastructure need a lot of specialist knowledge, particularly given the diverse nature of the opportunities on offer. But even institutional investors very rarely have sufficiently large allocations to energy infrastructure to justify employing their own in-house experts. Investing in a suitable fund therefore makes good sense. This brings certainty that the management and ongoing monitoring of investments, transaction management and regular reporting will be undertaken by an investment manager across the whole lifetime of the investment.

So, if the implementation is right, it really does appear that the perfect match has been found: energy firms, with their high capital requirement over the long term, and institutional investors with a long-term horizon, pension funds and life insurers in particular.
Equities – Hitting New Heights

Portfolio Rotation out of Bonds and into Equities Is Likely to Take Several Years

Adrian Zürcher, Investment Strategy

While many equity markets have recorded new highs in recent months, the environment has nevertheless remained challenging this year. This has been demonstrated by various events, including the banking debacle in Cyprus, slowing growth in China and the stalemate over fiscal policy in the US. The US Federal Reserve (the Fed) has also announced an important turning point: it is to start withdrawing its ultra-loose monetary policy. The prospect of US monetary policy normalization in particular raises the question of whether the end is nigh for the recent stock market rally.

From a strategic perspective, however, it is this new era in monetary policy that underlies our belief that equity markets will continue to rise. Why is that, one might ask? The monetary normalization process is likely to hit hardest those investments that have benefited most from the loose monetary policy and as a result are the most expensive, namely bonds. In our view, this will lead to portfolio switching in favor of equities. Equities are also likely to benefit from further factors, such as the gradual economic recovery, relatively attractive valuations and the defensive positioning currently adopted by investors.

From a flight to bonds to a flight to equities 2008-2012 is likely to go down in the history of the stock markets as a difficult era. The financial crisis triggered upheaval on the markets, with painful consequences for many investors. What is more, the years that followed were marked by unprecedented levels of macro-political uncertainty. Political stalemate – be it over the debt crisis in European peripheral states or in the form of disagreement on fiscal policy between Democrats and Republicans in the US – resulted in further painful losses. Many investors therefore sought refuge in safe havens such as top-quality government bonds, gold and similar asset classes. These asset classes also received massive backing from the central banks, which had to assume the role of economic fire fighters due to widespread political brawling and weak growth. This resulted in record-low interest rates and a flood of liquidity due to unprecedented purchases of government bonds.

This perfect environment for bonds artificially created by the central banks enticed many investors to disregard the old saying “there is no such thing as a free lunch.” In stead, they took the view that falling interest rates meant investing in bonds would enable them to generate extremely good performance, without any need to enter into significant risks. The combination of high risk aversion, caused by the considerable uncertainty over the macro-political environment, and bond markets generalizing very good returns led to a massive shift within portfolios out of equities and into fixed income, particularly among long-term investors such as pension funds, insurers and private investors. This rotation was reflected in impressive fund flows: Between the start of 2008 and the end of 2012, global bond funds registered inflows of around USD 1.2 trillion, whereas equity funds posted outflows of USD 420 billion. Equity allocations in many portfolios fell to historically low levels.

However, when Fed Chairman Ben Bernanke announced that the Fed was to start scaling back its bond-buying program, many investors found out the hard way that their supposedly secure investments in bonds were not risk-free after all, as interest rates suddenly spiked. At the same time, the end of the 30-year contraction in yields has made it impossible for many investors to keep achieving their performance objectives due to their defensive positioning. This is forcing them to increase their risk tolerance and look to other asset classes. As such, investors who focused almost exclusively on bonds during the past five years are increasingly considering investing in equities (see Figure 1).

They include in particular pension funds, insurers and private investors mentioned above. This portfolio rotation out of bonds and into equities is only just beginning and we believe it could last several more years, providing a boost to equity markets (see Figure 2 on the following page).

Economic cycle and central banks are fundamental drivers

The flood of liquidity from central banks over recent years has been a key factor in combating economic contraction and a decisive driver of financial markets. The recent announcement by the Fed that it is to reduce its bond purchases marks the beginning of US monetary policy normalization. We do not believe that this will happen immediately; instead we think that we are set for a drawn-out, gradual adjustment process spanning several quarters. The Fed has almost no choice but to act cautiously and ensure that its exit from quantitative easing does not lead to panic selling. This would push up yields on US government bonds too quickly, having precisely the opposite effect of what the Fed is trying to achieve: to keep yields low over an extended period and subsequently return to “normal” levels in an orderly manner. Neverthe-
The main message that Bernanke is sending out by scaling back purchases is that we will be able to focus on investment decisions. We expect the Fed to adopt a similar strategy; it has made clear that the speed of the reduction will be adjusted incrementally as befits the economic situation. Given that economic recovery is sluggish, the liquidity effect will therefore also abate slowly. Although the economic upturn is modest in many countries as a result of deleveraging, global growth is on a steady road to recovery, driven by the US. For most asset classes, economic momentum over time is a far more important factor than the liquidity artificially created by central banks. The relationship between equity performance and economic growth is not immediately obvious. If one observes the correlation between the two over a longer period of time, no statistical relationship whatsoever will be found. This is due, however, to the fact that the stock market anticipates developments. If we analyze the relationship between equity returns and global economic growth in the following year, we find a markedly higher level of correlation (see Figure 3). In fact, that statistical relationship seems to have been even stronger over the last 20 years. Our study shows that in this period no year followed by a year of growth of more than 3.5% experienced a negative equity performance. Over the entire period covered by the study, there was only one exception, specifically the stock market performance in 1970. Given the forecasts by the International Monetary Fund (IMF), which is predicting real global growth of 4% and 4.3% for 2014 and 2015 respectively, the macroeconomic environment should remain supportive for equities.

Historical performance data and financial market scenarios are no guarantee of current or future performance.

**Figure 2: The end to the 30-year contraction in yields is likely to boost equity markets**

We expect the central banks to proceed very cautiously, closely monitoring the effects on markets. However, we still believe it is important to note that adjusting monetary policy measures is ultimately little more than a response to the gradually improving economic environment. Parallels can be drawn with a doctor’s actions in reducing his patient’s medication as they move along the road to recovery from a serious illness. Initially, he will proceed very cautiously, closely monitoring the effects on the patient. If there are any concerns, he may even up the patient’s dosage again.

**Figure 3: Correlation between equity returns and expected economic growth**

Many market participants are currently under the impression that stock markets are expensive, especially when one considers that central bank capital injections are being reduced prior to their eventual withdrawal. One definite effect of the surplus excess liquidity created was that while equity multiples were made strong gains, earnings growth failed to keep pace due to the difficult economic environment. This led to a significant increase in valuation multiples. Nevertheless, we do not consider equities to be overpriced. During the financial crisis, many stock markets had historically low multiples and were significantly undervalued. This has been corrected in the last few years, and many indices are now once more valued at close to their historical averages. Looked at from this angle, we believe equities are at present fairly valued on an absolute basis. Nevertheless,
we do not see an end to the trend toward higher valuations, as risk premiums continue to strongly argue in favor of equities relative to bonds (see Figure 4). In other words, we believe that risk assets are attractively valued at present, while “safe” investments remain expensive. Investment strategy should therefore focus on riskier asset classes, and equities in particular.

At the same time, we expect corporate earnings to gain momentum in the coming quarters on the back of improving fundamentals. This will tend to make up for the pressure on multiples produced by higher share prices. As stated above, we think that the US economic recovery is well supported. There are also clear glimmers of light on the European economic horizon. We also take the view that the fears over Chinese growth are overdone. Although we do not expect growth to pick up again in the second half of the year, we do see stabilization at the current level.

Companies could also prove to be an important driver of growth in the coming quarters. After years of cost-cutting and efficiency gains, they now have very healthy balance sheets with low levels of debt and high cash holdings. In light of the better economic outlook, many are now once again focusing on expanding their activities. They are increasingly willing to proceed with projects that were pushed back in the last few years (such as IT projects) due to the uncertainty that followed the financial crisis and to grasp new opportunities, by means of organic growth or acquisitions. Both require investment, which is currently at a very low level, as illustrated by Figure 5. This situation provides scope for sales and earnings growth. The statistical relationship between real global economic growth and earnings growth is relatively strong, meaning that mounting earnings momentum should boost share prices.

Short-term setbacks versus long-term potential
In summary, we feel equity markets have considerable upside potential over the long term. The flood of central bank liquidity has created distortions on the capital market, as a result of which riskier assets offer considerably more opportunities than risks, while “safe” investments are expensive. Around a year ago, in an environment of falling risks and extreme differences in valuations between equities and “safe” investments, a multi-year portfolio shift was initiated. Even from a risk-adjusted perspective, we see significantly more potential for equities than we do for other asset classes.

For tactical reasons, however, we would advise caution in the short term. Many equity markets have already posted considerable gains in recent months and are trading at or close to all-time highs. They appear overbought from a technical perspective, meaning that a temporary consolidation phase within a longer-term upward trend may be on the cards. This view is backed up by the fact that good news is currently perceived as good, while bad news is interpreted as being even better — an indication that the markets are somewhat overheated. We would therefore advise caution to investors wishing to gain exposure to equity markets in coming weeks, as there could be better investment opportunities in the near future.
Attractive equity segments
Our investment specialists in Asset Management believe that the following equity segments in particular will offer above-average return potential in the coming months:

- **Small and mid caps**
  Academic studies have shown that small and mid caps generate higher returns in the long term than large caps. This outperformance is, however, subject to significant cyclical fluctuations. The environment for small- and mid-cap companies should now gradually improve in line with the economic recovery.

- **Luxury goods stocks**
  The global luxury goods industry is enjoying strong growth momentum. This is being driven by increasing levels of prosperity and, in particular, the growing propensity to spend of the emergent middle class in up-and-coming economic regions. The strength of brand loyalty within the luxury goods sector also means that it is less susceptible to the effects of economic cycles.

- **Value stocks**
  In the last few years, many investors have focused on defensive growth stocks, where valuations are consequently high. Value stocks, on the other hand, have tended to be overlooked. This has led to a considerable valuation gap to form. As the economic environment improves and risk tolerance increases, value stocks are likely to increase in popularity.

- **Dividend gems**
  Since interest rates are set to remain low despite the trend reversal, a dividend-oriented equity strategy makes an interesting alternative to fixed-income investments. This involves investing in shares in sound, well-run companies that regularly pay out an attractive dividend. In addition to the chance of profiting from price gains, investors can also enjoy a high level of regular income. Due to the income component, dividend gems exhibit greater price stability than the broad equity market. They also generate significant outperformance over the long term.
Better Returns from Small and Mid Caps

Interview with Patrik Carisch and Felix Meier, Senior Portfolio Managers Small and Mid Caps Switzerland/Germany

Small and medium-sized companies are often highly specialized, innovative and very well managed. They therefore grow their earnings faster than average. Studies have shown that over the longer term they deliver significantly higher returns than blue chips. In the interview below, portfolio managers Patrik Carisch and Felix Meier provide some fascinating insights into their investment universe.

Equity markets are up sharply over the last twelve months. The Swiss Performance Index (SPI) has been one of the world’s top performers. How have small and mid caps in Switzerland been doing?

Patrik Carisch: Even though the markets have done well, investors were defensively positioned largely as a result of the euro crisis. In other words they were backing large, liquid companies with good cash flows, solid balance sheets and high dividend yields. Small and mid caps put in a positive performance, but did not quite keep up. This was partly due to the sector composition of the segment.

Felix Meier: In Germany there are many industrials in the small- and mid-cap segment. Other important sectors are IT and consumer discretionary. Germany too saw solid companies with good business models and dependable cash flows perform well. Companies with cyclical problems struggled.

What makes small and mid caps particularly attractive?

Patrik Carisch: Small- and mid-cap companies are the beating heart of the economy. They are also the engine of growth. They frequently operate in high-margin niches and are very innovative. They are also flexible, which has a lot to do with their size. Companies have very healthy cost structures at the moment. If the top line grows, this has a major impact on profits. And since capex may be more expensive, but it is also highly financed.

Can one say that sector selection has been important as well as size?

Felix Meier: For Germany, “yes, but ...” The large caps include insurers, banks, car manufacturers and utilities. These sectors are relatively under-represented in the small and mid-cap segment. That is why simple comparisons can be misleading. Companies that were able to benefit from low interest rates and cheap money and that generated stable cash flow tended to see their shares rise.

Patrik Carisch: It’s a similar picture in Switzerland. Healthcare makes up one-third of the SPI index; in small and mid caps, it’s only 11%. Med tech is dominant in this segment. Or take a look at financial services, banks and insurance companies. These have a much heavier weighting in small and mid caps than in the market overall, as represented by the SPI: 30% compared to 20%. But this 30% includes a large number of regional and cantonal banks that are only posting sluggish growth and are relatively highly priced.

Companies have very healthy cost structures at the moment. If we do indeed see a moderate economic upturn, will this have a big impact on profits?

Patrik Carisch: People are just more cautious with money, and more thrifty – because it’s their own money.

Felix Meier: Swiss and German companies make truly high-quality, high-end, highly engineered products; that’s their strong point.

Patrik Carisch: And they are very innovative. Swiss companies in particular have to be innovative, because wage costs are very high and the Swiss franc is strong. In such a position you cannot make a name for yourself with mass-market products.

How important is product quality in today’s global economy?

Patrik Carisch: Ever more important, quite clearly. Take mechanical engineering: a machine from Switzerland or Germany may be more expensive, but it is also more reliable. It needs less servicing, so even if you have less production downtime. The bottom line is that it pays to go for quality.

Felix Meier: You can grow faster from a small base. If you are market leader, it’s hard to grow faster than the market. Remember too that smaller companies are often run by a family. You have a single large shareholder who runs the business and can take decisions quickly. The interests of owners and managers are much better aligned than is the case with large companies.

Patrik Carisch: Yes, because most companies have significant economies of scale. If the top line grows, this has a major impact on profits. And since capex is staying low and companies have plenty of cash in the bank, we expect dividends to continue to rise.

Do Swiss and German small and mid caps have particular strengths?

Felix Meier: Swiss and German companies have significant economies of scale. Other important sectors are IT and consumer discretionary. Germany too saw solid companies with good business models and dependable cash flows perform well. Companies with cyclical problems struggled.

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Felix Meier: Innovation is becoming increasingly important for Swiss and German companies as other countries raise their quality. The solar industry is a good example; Chinese products are now just as good as Swiss and German ones, but much cheaper. That’s why the companies here are struggling to survive, and some have even gone bankrupt. Swiss and German companies have to stay a couple of years ahead of the game if they are to survive. But that has always been the case.

Studies have shown that over the long term smaller companies provide better returns than large ones. How do you account for this?

Patrik Carisch: Profits tend to grow faster than at large companies, since as we mentioned they generally operate in high-margin niches, are innovative and have excellent management.

Felix Meier: Over the long term, investors earn a risk premium because small and mid caps are more volatile. The smaller the company, the lower the market liquidity. Investors are rewarded for that in the long term.

Is limited market liquidity in some stocks a problem for you as investment managers?

Patrik Carisch: Switzerland has enough sufficiently liquid stocks that we find attractive. Occasionally we invest in stocks with limited liquidity. You need to take your time buying and selling in such cases. Or you can do block trades. I would say that 80% to 90% of the stocks in the Swiss small- and mid-cap market are liquid.

Felix Meier: The German small- and mid-cap market is much more liquid. The mid- and also small-cap stocks in Germany tend to have a much larger market cap than those in Switzerland.

The small and mid-cap segment is very varied in Switzerland and Germany. Assessing companies and picking stocks must be challenging even for experienced portfolio managers. How do you set about it?

Felix Meier: This brings us to one of the main arguments in favor of small and mid caps: the ability to pick stocks.

Patrik Carisch: Large caps are covered by plenty of analysts. That’s why it’s hard to generate alpha in the segment. But only a few analysts follow small and mid caps systematically – hence there are market inefficiencies to be captured. We keep in touch with companies. We see the management three or four times a year in some cases and have known people for years. That’s something we can build on. We also have our own valuation tool, HOLT, that shows us where value is to be found.

Felix Meier: Based on all these inputs and analyses we come up with a price target. A stock is attractive if it stands at a clear discount to the target.

Patrik Carisch: A meeting with management where you get the sense that analysts’ forecasts are too cautious can also be a trigger to buy. Or if we think a company is being unfairly punished for a bad quarter.

Some studies have shown that small- and mid-cap fund managers cannot actually beat the benchmark.

Felix Meier: You get these sorts of reports occasionally. You can prove things either way: that most actively-managed small- and mid-cap funds either beat the benchmark, or that they don’t. It’s all a matter of the time period studied. Exploiting inefficiencies is the key to success. The smaller the company and the fewer analysts are covering it, the more alpha you can generate. That’s why many investors index their large-cap
positions, because there is little scope to outperform, and turn to active management for small and mid caps.

Patrik Carisch: I should add that for many investors, small and mid caps only appear on the radar when they have reached a certain size. In other words, it’s not just analysts that ignore the minnows, investors do too. This creates opportunities for active portfolio managers.

Can we look to the future? How do you see the medium-term prospects for small and mid caps in Switzerland and Germany?

Patrik Carisch: You can definitely say that we are running out of steam a bit after the recovery of the last twelve months. We expect a consolidation in the short term. But we remain bullish about the medium term. The leading indicators for Switzerland and Germany are improving. The economy is likely to pick up speed, so we can expect earnings upgrades. And valuations are modest.

So maybe we can say in summary that small and mid caps cannot buck the market trend or the economy, but there are certainly reasons to back them.

Felix Meier: Correct. If the economy splutters, small and mid caps feel it too – more strongly than the market as a whole, in some cases. When a sector has a problem, the smaller companies feel it as well. But the opposite also applies. If a sector is doing well because the economy is healthy or prospects are good, smaller companies get pulled along.

Patrik Carisch: There are two main things that are typical of small and mid caps and that make the segment attractive for us. The combination of innovation, lean structures, clear ownership and a risk premium for the higher volatility.

Felix Meier: The second is the ability we as portfolio managers have to identify and exploit market inefficiencies. They still exist in this segment, and digging them out by visiting management teams and doing in-depth research pays off.

Defining small and mid caps

Small and mid caps are small and medium-sized companies listed on a specific stock exchange. They have a smaller market capitalization than the blue chips on the market in question. That is why small and mid caps in Switzerland have a smaller market capitalization than those in Germany.

To put it another way, small and mid caps are the stocks that are not included in the main index. In Switzerland this includes those not in the SMI (which interestingly rules out Swatch bearer shares but not Swatch registered shares, for example). In Germany it includes all stocks not in the DAX. People also talk about second-liners, in contrast to (big) blue chips.
Hospitality is the business of accommodating guests and has its roots in the hotel trade. Today it refers to several different types of accommodation for guests, who may be tourists, students or even patients. Hospitality properties are a special segment within real estate, but offer investors the opportunity for broad-based diversification.

It all started with the traditional hotel. Hotels are changing fast as they adapt to the increasingly varied demands made by guests. The spectrum ranges from traditional hotels through more recent formats such as wellness and sport hotels to residential apartments with hotel-style services. The hospitality industry also encompasses conference centers, student residences and real estate for the healthcare sector such as doctors’ practices and medical centers.

Rising demand
Demand for hotels in Switzerland is set to grow in the coming years:

- The baby-boomer generation is gradually retiring. This relatively wealthy cohort of people will likely spend some of their newly acquired free time traveling – including in Switzerland. The number of overnight stays by Swiss guests in Swiss hotels has been going up in recent years. The first half of 2013 was no exception: 6.5% more overnight stays were made by Swiss guests than in the same period in 2008.

- The materialization of a large middle class in populous emerging markets like China and India is resulting in strong demand for tourism services and top-flight education opportunities, not least in Switzerland. Once again, the Swiss Federal Statistical Office has solid evidence in the shape of the number of overnight stays: These have more than quadrupled for guests from China since 2008, and doubled for visitors from the Gulf states. Overnight stays by guests from Russia, India and Brazil have also been growing at rates of 40% to 70%. All in all, this shift in demand towards emerging markets has been sufficient to make up for the decline in stays by visitors from countries like Germany, the UK, Italy, the Netherlands and Belgium.

Swiss hospitality properties are an attractive segment to invest in

Hospitality is a special segment within real estate, and there are good reasons to consider such investments. Demand for hotel rooms in Switzerland is set to rise in the coming years, so utilization can be expected to be high. Operators tend to take out long-term leases, and rents are in some cases indexed to inflation. There are also plenty of opportunities for diversification: by type of accommodation, location or operator.

Hospitality properties are especially attractive for investors with a medium to long-term horizon and a focus on regular income. Our assumption is that a carefully selected and well diversified portfolio of hospitality properties can generate an average net yield of 4.5% to 5.0% p.a.

Real estate funds as an investment solution

To professionally select investments in hospitality properties requires special expertise. That is why many investors prefer to invest in fund solutions. The first real estate fund in Switzerland investing in a broad range of hospitality properties was launched in November 2010. It considers both completed sites and development projects. The portfolio currently contains some 40 properties. The operators’ leases are long-term (running for at least 15 years) and indexed to national consumer prices. The fund owns its properties directly. This brings significant tax advantages for investors who are Swiss taxpayers, since the portion of income (and assets) derived from the direct ownership of land is not subject to income or wealth tax. The fund is, as yet, only open to qualified investors.

Hospitality is an Attractive Segment to Invest in

Ulrich Braun, Head of Real Estate Strategy and Advice, and Lucas Meier, Fund Manager
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