Weekly Manager Views – 9 April 2014

Global Macro/Managed Futures

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- The first quarter of 2014 proved challenging for both GAM Star Keynes Quantitative Strategies as well as the managed futures sector more generally. While our performance has been disappointing in absolute terms, within our peer group we are one of only two names to remain in positive territory for the 26-month period January 2012 to March 2014. Also, we are one of only two names with a Sortino ratio above 1 over the 2008–14 period (looking at the long-term track record of the fund's underlying offshore strategy).
- Looking back 40 years at the managed futures universe, we have done some analysis comparing a 60/40 US equities/bond portfolio to an index of managed futures. Essentially, the performance of these two comparables has been in line over the period. However, the relative performance has been mean reverting. As such, we believe a managed futures allocation to be preferable to a 'tail risk' fund as a long-term investment as it provides diversification without costing money in terms of relative performance. Investors must be aware though that the performance trajectory of the managed futures index is not always smooth. Our analysis highlighted two episodes of significant underperformance: 1994 to 2000 and the current period, which has been weak since 2009.
- So while the current environment is very testing for investors, we can take comfort in the fact that it is not out of the ordinary based on historic norms.
- On the topic of Europe and quantitative easing, we are mindful that any decisions may be slow to come to fruition, and there seems to be significant disagreement regarding the appropriate timing of any action. Our understanding is that even if a decision is made to what action is appropriate, it will not necessarily be deployed immediately. It seems that ECB President Draghi is readying his tools should something bad happen, rather than preparing to take immediate action. We suspect the ECB will employ a negative deposit rate should inflation not bounce back by as much as expected in April and May, before reaching for more unconventional monetary measures.

Developed Market Credit

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

- Credit spreads have continued to narrow for financial securities. We feel this is justified because there is still strong regulatory pressure for banks to build their capital bases. A theme we have therefore focused on for a long time is that of regulators forcing banks to become safer and sounder. This has been a positive development for the old-style tier 1 capital securities that we favour.
- Whenever there is a contingent convertible (coco) bond issue we consider it, but we typically prefer the old-style bonds. They may sometimes yield slightly less, but that is more than outweighed by their favourable prospectus language, which gives investors better protection. Furthermore, they benefit from their increasing scarcity value as they are gradually withdrawn from the market, either because they mature or because they get called prematurely by their issuers. Finding these securities in the secondary market is therefore profitable for us, and we continue to put in the legwork to pick up small quantities as and when we can get hold of them.
- Current yields on financial securities are at similar levels to pre-financial crisis, when interest rates were significantly higher. This means that spreads of financials over government bonds were minuscule in 2007. And despite the narrowing that has taken place in the past two years, they are still quite a bit higher now than they were back then. New cocos are being issued at 7% to 7.5%, but one can find the old-style bonds that offer better protection at around 6.5% to 7%.
- One area we continue to like is those capital securities that are floating-rate notes, where spreads remain wide, around 280 to 350 bps depending on the type of security. These look attractive at absolute levels, irrespective of whether or not credit spreads tighten again. A significant portion of our portfolios are invested in short duration bonds or fixed-to-floater notes with high coupons, which provide a good buffer if rates go up.
- We believe short-term interest rates will stay lower for longer. We also expect policymakers to target nominal growth rates, which could bring back intermittent inflation fears. Our funds are well equipped to deal with both sets of challenges. The fact that rates have not yet risen has limited returns from floating rate notes, but we have continued to buy them selectively, including a recent Deutsche Bank issue. This, we feel, represents a case of putting in place the seeds of future capital gains in anticipation of interest rate rises. While the floating rate notes are not making us any money now, when interest rates finally do go up these will provide

good capital gains. The government bond market on the other hand, with interest rates likely to go up, will probably make low levels of income with very limited, if any, additional capital gain.

- We continue to believe that the concerns around potential losses in bond markets are related to rising interest rates rather than credit concerns. We are seeing fewer concerns on the corporate debt side. The companies we invest in have strong cash flows, profits and balance sheets, while the further regulation we have highlighted in the financial sector is forcing banks to become ever more resilient.
- The three currency classes of GAM Star Credit Opportunities have had a good start to the year. Returns are always due to a combination of coupon, accrued income, and the trading strategy working as planned. As such, we are confident that this positive performance will continue.
- We have also benefited from corporate events, such as Phoenix Life's sale of Ignis Fund Management for GBP 400 million. The sale reduced the debt on the company's balance sheet, and its bonds have risen 4% this year. Similarly, F&C Asset Management was bought by Bank of Montreal and saw a big jump in its bonds.
- There is still capacity in the market for both traditional and coco bonds. With regard to liquidity, we deliberately have a good portion of the funds in names which are highly liquid, such as bonds currently callable at par, and which are relatively easy to sell in large quantities when necessary. This balances the large number of smaller, but highly profitable, individual holdings we own.

Source: GAM