FRONTIER ADVISORS

Observations on Global Equity Markets

Europe & US Research December 2013

Frontier Advisors Pty Ltd

International Research Issue 05

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture.

Our research team

Fraser Murray, Sarkis Tepeli and Nathan Bode of our Equities Research team travelled to the United Kingdom, the Netherlands, Denmark and the US in December 2013, meeting with a range of equity managers. More than 30 fund managers and other organisations operating in these markets were visited onsite as part of this research.

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Quantitative easing & equity markets

As part of this global equities research exercise we sought to observe how equities managers were viewing the likely (now confirmed) tapering of the US Federal Reserve's $85 billion/month quantitative easing program, and to seek insights into how equities markets across emerging and developed markets could react to a taper. This paper is an observational piece based on our discussions with the managers we visited rather than the specific views of Frontier's Capital Markets Team[1].

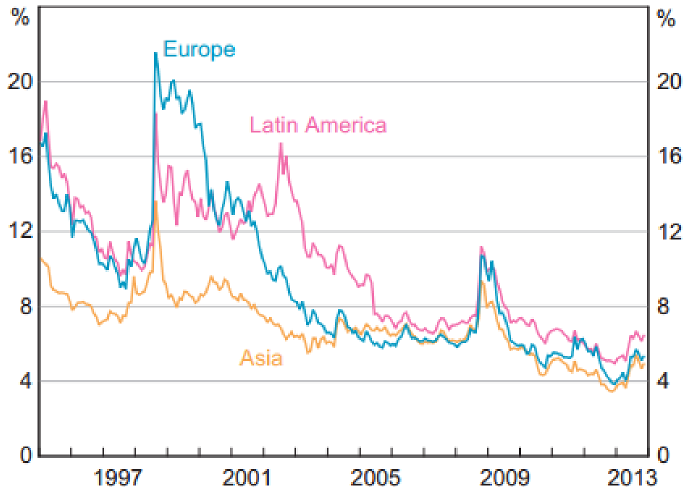
In general, we found managers were most focused on the impacts tapering would have on emerging markets with far fewer comments on developed markets, including the US.

In fact, there were relatively few concerns tapering would result in a major slowing of economic growth in the US or other developed markets. Predictably, however, there was an expectation the developed markets interest rates would be most likely to rise.

Across the managers we met with there was broad consensus the US Federal Reserve's tapering program had resulted in yield seeking and risk chasing capital.

Also, a meaningful proportion of this capital had found its way to emerging markets, both equities and, in particular, debt where the yields on offer were higher than in developed markets. This is reflected in Figure 1.

Figure 1: Emerging market bond yields reach historic lows in 2013



Source: RBA, Bloomberg, Thomson Reuters

However, not all emerging countries are the same and the effects of tapering were expected to vary across countries.

A common thread was to segment emerging markets into those with high current account deficits and those with current account surpluses/low current account deficits.

Under this grouping the BIITS countries (Brazil, India, Indonesia, Turkey and South Africa) were singled out as high current account deficit countries, although managers were careful to stress that even within this group there were meaningful differences in administration, level of reform, risks and political approach to underlying markets.

1: See "The Frontier Line – The US Federal Reserve's QA Policy: A Tapering Update" published Dec 2013; "The Frontier Line – The US Federal Reserve Tapering Update: Tapering Begins" published Dec 2013

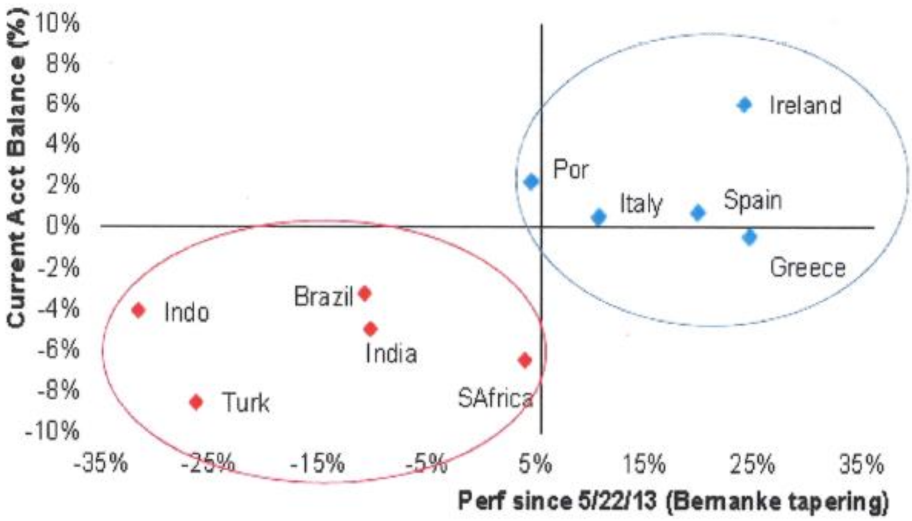
QE & equity markets continued

Most managers saw the events of May 2013, when the Chairman of the Federal Reserve, Ben Bernanke, first spoke of tapering the pace of the Federal Reserve's quantitative easing purchases, as a practice run of how equity, debt and currency markets could be impacted when tapering actually occurred.

As humans, we are anchored to past events and most fund manager expectations around tapering were linked to what they saw occur in May and June 2013.

Figure 2 displays the performance of the BIITS equity markets since Bernanke's comments in May 2013.

Figure 2: Performance of BIITS



Source: BofA Merrill Lynch, Bloomberg

There was broad agreement the Federal Reserve's quantitative easing program had been a net negative for emerging market economies. More specifically, it had fuelled inflation in some markets and increased the risk of another crisis by increasing levels of debt within the private, public and government sectors.

That said, there was little concern about a possible debt crisis. Should the risk of a debt crisis be realised, the managers we spoke to felt this would be likely contained to a limited number of countries.

Furthermore, there would be limited risk of contagion, as most emerging markets are now more resilient to external shocks than they were in the 1980s and 1990s.

On the positive, there was broad agreement Bernanke's May speech had given market participants some notice of the impending taper, and allowed policy makers, corporates and investment managers' time to put in place measures to mitigate these risks.

Given certain economies had made progress towards this aim, the consensus view was that a gradual, and sooner rather than later approach to tapering would be in the best interests of financial stability.

Key risks

The key risks associated with an eventual taper varied across managers. Some saw minimal risks with one manager going as far as to compare the taper talk and scaremongering across the financial media with the millennium bug that threatened to take down global computer systems at the turn of the century. Others painted a less benign outcome, outlining a number of risks that could eventuate should quantitative easing be wound back.

Not surprisingly the risks discussed varied between managers in terms of levels of expectation and linkages. However, in aggregate we identified six key risks.

Reversal of capital flows away from emerging markets and impact on currency markets. The yield seeking and risk chasing capital created by the Federal Reserve's quantitative easing program is expected to flow back to the US and potentially other developed markets. These flows are likely to impact currency markets, especially emerging markets currencies. This was a bigger concern for those countries with existing current account deficits.

Rising bond yields across developed and emerging markets. Tapering of the Federal Reserve's quantitative easing program should imply rising interest rates as the downward pressure from quantitative easing abates. This is anticipated to lead to rising bond yields, which has total return ramifications for bond investors in developed and emerging markets. This risk is accentuated in emerging countries' debt markets where the proportion of debt owned by global asset managers has increased dramatically over recent years. Some global investors can be fickle and momentum-driven and this capital can flow out rapidly leading to rapidly rising bond yields in these economies.

Corporate deposits in emerging markets banking systems at risk. Related to the previous point, the level of corporate deposits in domestic emerging markets banking systems has increased and these could become vulnerable. Large scale withdrawals from these systems could lead to a destabilisation of local financial sectors. Stressed banking sectors can propagate and add to a general slowing of local economies.

Slowing GDP growth in certain emerging markets economies. The flow of capital out of emerging markets economies and higher cost of debt could lead to a dampening of the underlying markets as a result of softer local demand for goods and services.

Export-oriented economies could fare better than others given local currencies will likely depreciate. This could result in an asset quality and liquidity cycle for emerging markets banks as non-performing loans would likely increase impacted by a soft local economy and rising cost of debt.

Related to the previous point, corporates under financing stress could also wind back their capital expenditure projects adding a further element of stress to the local economy.

The Federal Reserve could lose credibility in its efficacy. This is seen as an outside risk although one that is likely to have significant ramifications. Global markets could lose confidence in the Federal Reserve if the outcomes of tapering are more adverse than expected. This is a dramatic scenario with a range of potential outcomes.

Limited impact in developed markets. There was a broad view that only a small portion of the liquidity from the quantitative easing program had been used to stimulate the US local economy. As such, a taper was not expected to have a significant impact on the US economic recovery. The housing recovery in the US would be expected to bear some risk associated with rising yields causing downward pressure on consumer credit creation.

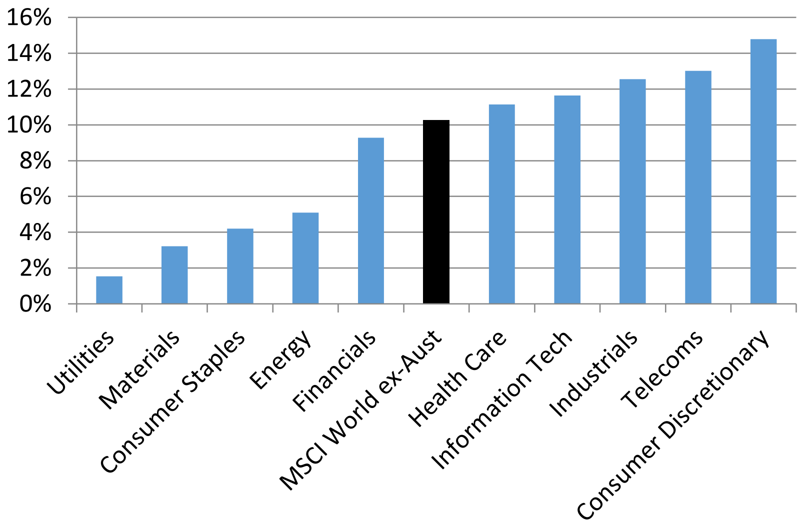
Sector performance

Historically, defensive sectors have benefitted most from a fall in rates.

Since Bernanke's May 2013 speech warning of an upcoming taper to the Federal Reserve's quantitative easing program, the defensive sectors have struggled to keep up with the broader index and have already de-rated. This is illustrated in Figure 3.

For price taking sectors like Mining, Energy, Utilities and some Industrials, a benign inflationary environment has resulted in a tough operating environment and this is expected to continue should dis-inflation expectations remain. In a rising rate environment, the expectation is for cyclical companies to perform better, although gearing ratios need to be scrutinised in greater detail.

Figure 3: Performance of MSCI World Index by GICS Level 1 sectors Jun 2013 to Nov 2013



Source: RBA, Bloomberg, Thomson Reuters

Positioning

Despite having a view on the expected market behaviour following a taper of the Federal Reserve's quantitative easing program, none of the managers we met with had taken distinct steps to position their portfolios for this event. For the most part, this is a function of the managers adopting a fundamental bottom-up approach.

However, we did observe that managers were generally wary of emerging markets (and underweight), so it was possible tapering was a partial contributor to this. In our discussions, we felt it was difficult for managers to have sufficient conviction in the likely outcomes of tapering to materially alter portfolio positioning.

This was not unexpected given market behaviour in these events is extremely difficult to predict. The main impact in portfolio positioning for the minority of managers was to tweak their allocation to individual BIITS countries with views varying as to which BIITS were more exposed. The overwhelming majority conceded they did not have any predictive power over the consequence of tapering and had been running their portfolios through various scenarios to identify any large and undiversified factor risks. Most expressed confidence in their investment philosophy, noting "the best way to insulate the portfolio from macro events is to buy good companies".

Conclusions

During the course of our meetings with global equities managers, we heard a broad spectrum of views with regards to how markets are likely to respond to a taper of the Federal Reserve's quantitative easing program.

Views ranged from the benign millennium bug comparison to the risks of a loss in confidence in the Federal Reserve if the outcomes of tapering are more adverse than expected. There was some consensus on a number of potential risks, particularly as they related to emerging markets countries with meaningful current account deficits.

Not surprisingly, the majority of managers acknowledged the broad range of potential outcomes, but few had been positioning portfolios for the event outside of small allocations away from individual BIITS (although there was no consensus on which of these were most exposed).

This trip reinforced the importance of adhering to a given investment philosophy with stringent risk control and diversification at portfolio level. Many of the managers were comfortable with an impending taper and confident in their portfolio's ability to weather the resulting ramifications.

Managers visited

Altrinsic	Ardevora	Artisan Global Equity
Artisan Global Opportunities	Aubrey Capital Management	Baillie Gifford
Carnegie	Dundas	First State Stewart
Global Thematic Partners	Harris Associates	Investec
Jennison Associates	Man GLG	Marathon
Martin Currie	Morgan Stanley	Morgan Stanley Emerging Markets
Nordea	Oaktree Emerging Markets	River & Mercantile
Robeco	RWC Global Equities	Sands Capital
Tradewinds	Trilogy Global Equities	Trinity Street
Turner Investment Partners	Walter Scott	Wasatch
Wellington Global Value	William Blair	

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