Weekly Manager Views – 3 July 2013

For accredited, professional, institutional and/or qualified persons only

www.gam.com

Japanese Equities

Ben Williams
Investment Director, GAM
GAM Star Japan Equity, GAM Japan Equity, GAM Star Asia-Pacific Equity, GAM Asia-Pacific Equity

- The past six months were a remarkable period for Japanese equities. The Topix index closed the first half of 2013 up 33% in yen terms and 16% in US dollar terms, which makes it the best-performing major market in the world over this period. Volatility has been very high, however. We have seen record-breaking moves in the market, both in terms of the magnitude and speed of the rise to 22 May and the subsequent reversal. The rally was the sharpest since 1953, while the reversal was Japan's sixth-largest of all time. However, it does seem that the market has found its feet again – it has regained about 12% in the past couple of weeks.
- The past quarter was good for GAM Star Japan Equity. The yen class produced about 2.4% of alpha over this period, which we are pleased with, especially as it outperformed the benchmark both in April when the market was very strong, and again in May when the market was weaker. In the flat June market it was in line with the benchmark. That is, we are benefiting from the outperformance of our specific holdings as opposed to being reliant on market beta. Some of the strongest recent performers include the truck maker Isuzu, which was one of our largest holdings, but which we have trimmed somewhat. The stock rose on the back of the company's latest earnings report.
- 'Abenomics', the newly invented term describing the three pillars of the prime minister's economic policy, appears to be progressing. The first pillar is QE, which was undertaken in massive scale in April and triggered the major weakening of the yen. As the weakness of exports, and hence capital expenditures, has been the biggest drag on the economy since 2008, the yen's fall to 100 against the dollar from last fiscal year's average exchange rate of around 83 is very supportive of the export industry and earnings, and hopefully also future corporate capital expenditures. The second pillar is fiscal stimulus, with the prime minster implementing a 2% supplementary budget soon after his election. This stimulus has been in stark contrast to much of the rest of the world, which has continued to plough on with austerity, despite there being little evidence that it actually works. It has led to several upward revisions of Japan's GDP expectations. The final third pillar is structural reform. This is something some market participants are said to be disappointed with, however, our view is that it is much too early to say whether the necessary changes will be coming through.
- There have been concerns over the speed of the recovery in Japanese equities, but we would note that the market has only just caught up with its underperformance of the past three years in local currency terms. In US dollar terms, the market remains a slight laggard. Much of the underperformance was caused by the strong yen as well as the effect of the large earthquake. These factors have now reversed, so it makes sense for the market to have reversed the underperformance.
- We believe Japan has good medium-term prospects relative to other markets, with the sheer scale of the country's QE being one of the main levers. Japan's economic surprise indices are currently at a record high due to stronger consumer confidence, which is also visible in stronger domestic consumption data and retail sales. Company confidence levels should also be improving and should, in time, lead to improving shareholder returns through share buybacks. In the US, the combination of QE and share buybacks was strongly positive for the market, as the demand for shares was rising with the additional liquidity at the same time as supply was declining.

Pacific Equities

Michael Lai
Investment Director, GAM
GAM Asia Equity, GAM Asia Equity Hedge, GAM Star Asian Equity, GAM Star Asia-Pacific Equity, GAM Asia-Pacific Equity, GAM Star China Equity, GAM Star Emerging Asia Equity

- We have always maintained that the Chinese government is trying to effect change to rebalance the economy away from fixed asset investment and exports towards consumption. This was always going to lead to a more moderate economic growth rate of perhaps 7–8%, rather than the 9–10% pace we were used to. And this is also how it has turned out. But despite the fact that the Chinese economy has continued to advance, the market has been impacted by two significant regime shifts. First, the tapering of the Fed's QE policy and, more importantly, the spike in the Shibor (Shanghai Interbank Offered Rate), which seems to be a warning signal from the authorities to the banks of their intention to rein in excess credit growth and effect structural reform.
- Historically, Chinese equities have always been volatile during turbulent times, but we think we have been managing the volatility of GAM Star China Equity reasonably well over the past weeks through our selection of themes and diversification. The key themes of internet, technology, gaming and renewable energy account for around 35% of the portfolio and they have held their ground in a weak market. The correction means that we are once again seeing some interesting investment opportunities. There seems to be some value reemerging in the banking sector, for example, despite the likelihood that the period of supernatural profitability is now behind us.

- We have a new top 10 entrant in the China portfolio, a mobile internet / internet search company, which has almost doubled since we initiated the investment last year. One of its key products is internet security software, which has gained prominence given recent events, while its mobile app platform is also doing very well. It is gaining significant market share as a search engine, from nothing this time last year to 15% today. We continue to like the business, despite the stock's good performance. Additionally, our largest holding in GAM Star China Equity, a diversified internet services company, has also done well, especially its e-commerce division, and we have had to trim the position somewhat after a more than 20% rally year-to-date.
- Other areas that have done relatively well include the gaming sector, despite its recent 15% correction from its highs, as it continues to grow at an annual pace of about 30%. Despite macro concerns, gaming has good fundamentals.
- Finally, we have continued to add to the renewable energy sector, which has suffered from the weaker market trends given that the stocks generally have smaller market capitalisation. However, we believe there are sufficient growth drivers to support the sector over the long term.
- We have continued to underweight banks and telecoms. Meanwhile, some areas, such as real estate, have sold off fairly indiscriminately, despite property prices holding up quite well, and are beginning to look interesting. We have started to buy into some good-quality names in real estate. But we remain underweight cyclicals, where we think the hyper-growth days are now over.
- We expect the next reporting season, starting in late August, to be reasonably good. Based on consensus estimates, our companies should see 17% growth in earnings versus 11% growth for the MSCI China index, and show dividend growth of 10% versus an average of 0% for the index. Our portfolio is now trading on about 10.2x earnings, down from 11.5x at the end of May, while the index multiple is currently under 9x.

Convertible Bonds

Alex McKnight
Investment Manager, GAM

GAM Star Global Convertible Bond, GAM Convertible Bond Hedge Fund

- Since Ben Bernanke's speech, all asset classes have begun to adjust to a new environment – one with flat and potentially rising yields. Although this is not a rising default environment, rising basic yields do not bode well for credit in particular. A chart plotting the performance of our own asset class, global convertibles, versus high yield credit shows that convertibles have already outperformed high yield year-to-date. That makes sense, as a rising yield environment should trigger a move from credit into equities and equity-related instruments, although history shows that the first six to nine months of a changing environment tend to be fairly volatile.
- GAM Star Global Convertible Bond performed well for the year to the end of May, and despite a challenging June, it remains up for the year both in absolute terms and relative to our peers. Some of our peers are close to flat for the year, and those located in Asia tend to be either flat or down. During the second quarter, we benefited from our exposure to Japan as we were very overweight the market relative to peers. We also had a reasonable amount of downside protection, in the form of puts and credit protection across the markets, which helped to protect the fund during the recent market weakness.
- In the current situation, a short and sharp sell-off would suit our book the best. That is because we have both overlay credit and equity protection in place at the moment. If the market rises, we should perform in line with our peers. A sharp sell-off should lead to significant outperformance.
- Convertible arbitrage as an asset class gained some 8% (as measured by the Dow Jones Credit Suisse Convertible Arbitrage index) over the 12-month period to the end of May, whereas the US dollar class of GAM Convertible Bond Hedge Fund gained nearly 17% over the same period. Although the fund has given back some of the performance since the end of May, its recent performance has been in line with peers and the significant longer-term outperformance remains intact. One convertible issue that has done well for us over this period is ITV, which we began to buy at 106 in 2010 and which the company redeemed recently at 204. This illustrates the difference between convertibles and high yield bonds that are redeemed at par, which are not ideal in a high yield environment. That is, convertibles have the upside potential of the underlying equity story.
- In the immediate term, equities may well go through periods of volatility as global economies are not yet on secure footing. We are only talking about rate rises and the potential reduction of QE, but they have not yet materialised. Initially, that is likely to lead to a steep curve. Some investors may attempt to exploit that through carry trades, but that is not our style. We are focusing on exploiting the relative value in equities versus credit, as long only credit no longer looks attractive.