Weekly Manager Views – 6 November 2013

For accredited, professional, institutional and/or qualified persons only **www.gam.com**

Global Equities

John Lambert
Investment Manager, GAM
GAM Global Diversified, GAM UK Diversified

- The year to-date has proved a tale of two halves. The first five months or so were dominated by performance in Japan, with Europe taking over for the remainder. Our general approach remains one of caution; we continue to favour larger stocks and are generally targeting high-quality names. Within the portfolio of GAM Global Diversified, financial positions continue to represent the most interesting sector and some of our largest exposures, since pockets of value still exist following the strong run.
- The portfolio is geographically segregated roughly into fifths between Japan, Europe, the US, the UK and cash. The US market continues to benefit from sustained bullishness and we believe that although long-term valuations are highly elevated, markets could rise even further in the short term. Cyclically adjusted earnings of 24x are around 50% above the 100-year average and 25% above the 50-year average. Warren Buffett's preferred measure of total market capitalisation against GDP rarely exceeds 100% – but at the moment it does, and is continuing to rise. A recent report from Citigroup highlights that the cheapest basket of stocks across various markets are as expensive now as they have ever been over the past 20 years relative to the market as a whole. All this evidence compounds the problem that we are facing, in that cheap value stocks simply are not easy to find. Indeed, they are generally looking expensive relative to both the market and their own trading histories. As such, we plan to maintain our underweight exposure to the US, relative to the MSCI World index.
- The Japanese market has essentially been in suspended animation since May, as debate continues as to when Abe's 'third arrow' will come into play. While the market is likely to oscillate over the next few months, we are identifying areas that represent good value and stocks that offer upside going into next year, and that we are interested in owning over the longer-term. Looking from a cyclically-adjusted standpoint, levels are roughly on a par with the US and the market is forecast to deliver an ROE of around 9% at 1.1x price-to-book value.
- Our UK exposure is currently materially lower than it has been over the last 15 years or so. While there is nothing wrong with UK stocks per se, we have a lingering concern over sterling. We have seen a big move in the currency since the financial crisis without the trade balance responding. To the contrary, it has deteriorated further, so we believe an adjustment needs to be made to bring the UK economy back into equilibrium. Hence we have reduced our portfolio exposure to below 20%. Moving into next year, we also see political risk becoming more of a factor for the UK.
- Europe remains the cheapest market in the portfolio despite its recent strong run, with cyclically-adjusted earnings comparable only to the emerging markets. Our position is larger than it has been for some time as a function both of us consciously moving into the market early this year and of surprisingly positive price moves. We will continue to look for opportunities in Europe, but they are unlikely to emerge at such cheap levels as we have enjoyed this year.
- Our cash holding currently represents the biggest short-term risk in the portfolio and our most contrarian position. We would like to reinvest some of the position, but we are not inclined to add to either our European or Japanese exposures at the moment, and good-value cheap stocks are proving thin on the ground, as already mentioned. While we will certainly consider select restructuring and turnaround opportunities in all parts of the world, from a top-down perspective we are not inclined to materially reduce our cash position. However, we are well placed to respond to emerging opportunities as we move into 2014.
- The key macro risks for the new year include the ongoing debate around quantitative easing, the economic scenario in Japan and central bank policy in Europe. 2014 will mark the fifth year of upswing since the crisis – albeit with many bumps along the path – which is a significant run. One must acknowledge that at some point this will come to an end and a downturn will come. Hence, our cautious positioning seems rational in such an environment.

Japanese Equities

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

- We are currently around three-quarters through the earnings season in Japan. So far, the numbers have been encouraging. Aggregate figures for those companies that have already reported show that sales are up 13.8% year-on-year, while operating profits have increased by 40%. Net profits are up 188% over the same period, suggesting that we are in a sweet spot for earnings in Japan, driven primarily by the weakness in the yen. Compared with company data elsewhere in the world, where earnings per share have barely risen and operating profits have only risen by single or low double digits, the results show that 'Abenomics' and the policy of a weaker currency are having a positive effect on the corporate sector.

Past performance is not indicative of future performance. Performance is provided net of fees.

- Having said that, the market has hit a lull and not made any performance progress in recent months – it is essentially pausing for breath. We think that this is because the market was initially driven by the first two 'arrows' of Abenomics, ie currency weakness via monetary policy and fiscal stimulus. These two drivers of the very strong share price performance in the first four months of this year stopped working in May. The final arrow, structural reform, has not had any impact yet and will be a long-term project for the government. Meanwhile, fiscal policy will gradually move from loose to tighter by next year as the consumption tax hike comes into effect in April 2014. However, the central bank has promised to offset any adverse effects of the tax hike. We would therefore potentially envisage further action by the central bank around the summer of next year, once a number of data points will have come out to justify any such intervention.
- We believe that the Japanese market has further potential, especially when we look towards the next year. Despite the good performance this year, valuations are still reasonable on a P/E basis and very attractive on an enterprise value basis, in our view. If we saw companies actually using the cash on their balance sheet and start investing as well as paying out money to shareholders, this would definitely provide good support to the market. On top of that, the government is encouraging Japanese retail investors to invest in shares by introducing a tax-free savings plan (equivalent to ISAs in the UK). Although the amount that can be put into the scheme only equates to around USD 10,000 per year, there seems to be very strong interest according to brokers, judging from the large number of pre-applications. In aggregate, we could see quite a substantial amount of household savings flow into the stock market.
- An increase in dividend pay-outs is likely to be the key to future performance in Japan. Our funds are positioned to benefit from this development as and when it starts to take place. Looking at the US for comparison, there are clear reasons why the S&P 500 index is doing well. First, quantitative easing effectively removes interest-bearing assets from the economy. Some of that money is of course moving into other asset classes, such as equities. Second, the S&P 500 has a share buy-back ratio of around 3% per year. So we are seeing a combination of yield-hungry investors and diminishing supply pushing the market upwards.
- Coming back to Japan, we have seen the most monumental QE programme, which equals around two to three times the size of the Fed's efforts in the US on a GDP-adjusted basis. So the potential demand, driven by QE, is certainly there. But we are not yet seeing any share buy-backs to speak of. This may be because Japanese corporates have not yet seen a full year's worth of very good results. But half-year results are pointing in the right direction. Full fiscal-year results in April are set to be very positive indeed. Combined with very stable balance sheets, this should eventually encourage companies to consider share buy-backs.
- Consequently, we continue to hold companies with very strong balance sheets that have the ability to increase shareholder returns via share buy-backs. Many of our holdings actually have an equity-to-assets ratio that is too high, which is why we are putting pressure on them to put that money to work and also to pay out more to their shareholders. We are explaining to them the adverse effect that the cash hoarding of the corporate sector has on the Japanese economy as a whole. We have also put together a research note on this subject, which we are happy to make available to anyone who is interested.
- On a sector basis, we are overweight the large trading houses, such as Mitsubishi, Sumitomo Corp, Itochu and Toyota Tsusho. These companies have been overlooked and are also being avoided for their exposure to commodities. Historically, these companies used to procure raw materials and commodities for Japanese manufacturing companies. Given the slow world economy, investors are cautious of commodities and have hence avoided trading houses. But looking more closely, Itochu only generates around one third of its earnings through commodities, while two-thirds come from other sectors. So even in the worst-case scenario where all commodity exposure was valued at zero, the stock would still be trading at a significant discount to the market. Trading houses are trading at around 6x earnings, while the market is trading at 14x, based on the Topix. However, that number of 14x is diluted by 20% cross-shareholdings and cash levels. Adjusted for these two factors, the market would be significantly cheaper. We believe that investors are far too cautious about trading houses and are overestimating the amount of commodities exposure they have. Over the summer, we have increased our position in Mitsubishi as the period of underperformance has come to an end, in our view.
- Year-to-date (to 5 November), the yen class of GAM Star Japan Equity has gained 41.3% versus 40% for the Topix index. The outperformance has materialised in the past few months as the earnings season has made a difference on the fundamental stock level. This plays to our strength and should bode well for the future. The rally early in the year was very momentum-driven and we struggled to outperform in that environment.

Past performance is not indicative of future performance. Performance is provided net of fees.

Source: GAM, unless where otherwise stated.
This material is confidential and is intended solely for the use of the person or persons to whom it is given or sent and may not be reproduced, copied or given, in whole or in part, to any other person. **It is aimed at sophisticated, professional, eligible, institutional and/or qualified investors who have the knowledge and financial sophistication to understand and bear the risks associated with the investments described herein**. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. It is not an invitation to subscribe and is by way of information only. The Star Funds are sub-funds of GAM Star Fund plc. GAM Star Fund plc is an Irish umbrella fund with segregated liability between sub-funds. GAM Star Fund plc is authorised as a UCITS pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011 (S.I. No.352 of 2011) and is a recognised scheme in the UK under the Financial Services and Markets Act 2000. The fund is managed by GAM Fund Management Limited which is regulated by the Central Bank of Ireland. Subscriptions will only be received and shares or units ('Shares') issued on the basis of the current prospectus for the fund. Copies of the fund's prospectus, Key Investor Information Documents (KIID) and financial statements can be obtained free of charge from GAM Fund Management Limited, George's Court, 54-62 Townsend Street, Dublin 2, from the centralising agent for France, BNP Paribas Securities Services, 66 rue de la Victoire, 75009 Paris, from its representative in Switzerland GAM Anlagefonds AG, Klausstrasse 10, CH - 8034 Zurich, from the information agent in Germany Bank Julius Baer Europe AG, An der Welle 1, D-60322 Frankfurt am Main ,from the information agent in Austria, UniCredit Bank Austria, Schottengasse 6 - 8, A-1010 Vienna. Paying Agent in Switzerland is State Street Bank GmbH, Zurich Branch, Beethovenstrasse 19, CH-8027 Zurich. Shares are not available for sale in any state or jurisdiction in which such sale would be prohibited. The Shares of the fund have not been registered under the US Securities Act of 1933, as amended (the "Securities Act"), and the fund is not registered under the US Investment Company Act of 1940, as amended (the "Company Act"). Accordingly, unless an exemption is available, such shares may not be offered, sold or distributed in the United States or to US persons. However, pursuant to an exemption from registration under the Securities Act and the Company Act, the shares may be sold or resold in the United States or to certain qualified US investors in transactions that do not constitute a public offering. The views expressed herein are those of the manager at the time and are subject to changes. Holdings and allocations are subject to change. There is no guarantee that forecasts will be realised. **The price of Shares may go down as well as up and the price will depend on fluctuations in financial markets outside GAM's control, as a result an investor may not get back the amount invested. Past performance is not indicative of future performance** and reference to a security is not a recommendation to buy or sell that security. Prices quoted refer to accumulation Shares unless otherwise stated. Historic data may be subject to restatement from time to time. In the United Kingdom, this material has been issued and approved by GAM London Ltd, 12 St James's Place, London SW1A 1NX, authorised and regulated by the Financial Conduct Authority.