

## Learnings From the Top

*Ideas & Perspectives we gained from Key Influencers & Thought Leaders at the BCA New York Investment Conference*

Benjamin Franklin once said, “By failing to prepare, you are preparing to fail.” At BigSur, we believe that continuously educating ourselves and learning from top minds is crucial to our role as advisors. We like to raise our own level of thinking by constantly feeding ourselves with information from the highest quality sources. This top level thinking helps frame how we view the global markets and ultimately how we position our client portfolios. In mid-September we attended our first BCA New York Investment Conference to learn how the world’s leading experts and key influencers viewed issues affecting the global economic and market outlook. This was an important opportunity for us to learn from top policy makers, economists and professors all known as “thought leaders” in their fields. We also gleaned information from fellow conference participants- which included elite investors from top institutions and asset management firms around the globe.

Familiar themes over the last few years were discussed- concerns about global expansive monetary policy, the debt overhang, and confusion around China’s economic and financial positions. There were a few new themes and fresh perspectives- the importance and significance of the new technology wave; a closer look at geopolitical risk; analyzing the recession and recovery in a historical perspective; and finally what asset classes top tier investors favor. We discuss each one of these themes and also how it integrates in BigSur’s house view and positioning.

### The New Technology Wave and BRAIN stocks

Andrew McAfee, the Principal Research Scientists for the Center of Digital Business at MIT gave us an eye-opening look at the new wave of technology which has allowed for the development of machines capable of performing tasks that we once thought only humans could perform. McAfee believes we are coming upon a revolution as big as the industrial revolution in the 18<sup>th</sup> century, known as the “first machine age.” Now, he believes we are starting a “second machine age,” - this time the machines aren’t generating massive amounts of electric or mechanical power like in the Industrial Revolution, but are advancing in terms of mental power. He explained that this next wave of technology has led to machines which can master both complex communication and pattern matching- two critical skills which will allow them to become an integral parts of a corporation’s supply chain by efficiently performing human tasks. Examples from this “second machine age” include Baxter, a humanoid robot, as pictured below.

## The Thinking Man’s Approach



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Ilina Dutt | Research Analyst

A BigSur philosophy is to bring our clients to a more institutional level of sophistication- and a way we do this is by applying top level thinking to our research process. Partnering with “best in class” research teams like BCA is key to enrich our house views on financial markets and the global economy. This year we attended BCA’s Annual Investment Conference in New York to listen to former policy makers, top economists, and esteemed professors discuss key issues affecting the economic and market outlook. We also enjoyed the opportunity to learn from our fellow participants- elite investors who represent the “smart money” of the world- representatives from top institutional endowments and pension funds; hedge fund managers; and directors of research from top institutions. In this month’s note, we share some of things we learned.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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*Image 1: Industrial robot Baxter who uses a vacuum gripper to pack parts in a specific order*

- To train Baxter, you grab it by the wrist and guide the arm through the motions you want it to perform. It remembers the physical actions and will repeat them over again. It can do



two completely unrelated things at once; its two arms are capable of operating independently. There are obvious advantages to using Baxter over human workers- it can work all day every day without needing any break. It also will not require benefit costs such as healthcare. Baxter currently sells for \$22,000, and McAfee imagines that it and other machines like it will become an essential part of

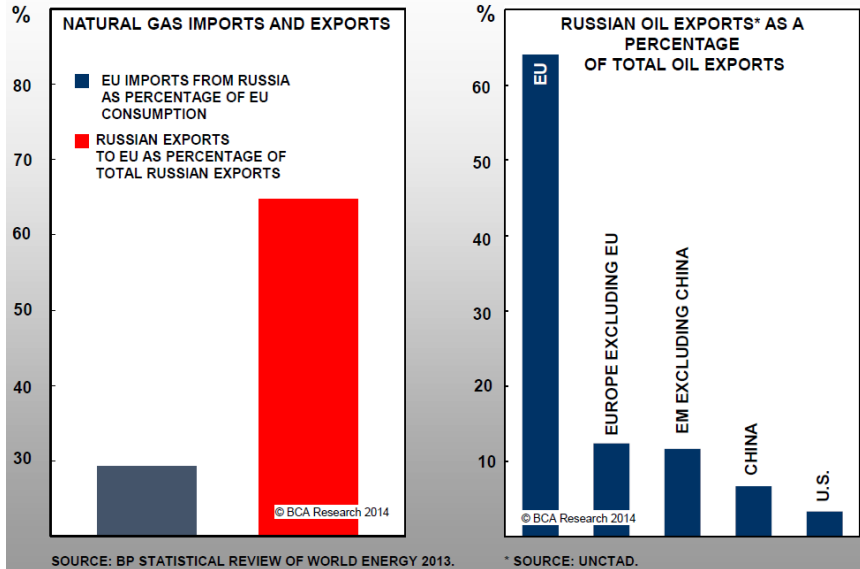
transforming industries such as manufacturing, energy and transportation, where it can easily become part of an assembly line. Integrating robots into the supply chain of these corporations will take some time, however. There are companies which are poised to benefit more immediately from this new wave of technology, known as “BRAIN” stocks: Biotechnology Robotics Artificial Intelligence and Nanotechnology. The BRAIN companies seem like an interesting theme – our Investment Committee has decided to further research the space and potential investment plays to evaluate for investment.

### **East Asia and A Declining US Power are Top Geopolitical Threats**

Another interesting session from the conference was on the current geopolitical environment. We always like to hear the perspective from dedicated geopolitical analysts versus the message put forth from mainstream media. Marko Pasic, the Chief Geopolitical Strategist at BCA warned that there are geopolitical tensions which could threaten investors’ risk appetite- but contrary to most of the participants’ beliefs, Russia was not on the top of the lists of his concerns. Tensions are de-escalating, Pasic stated, and Russia’s reliance on the EU for its energy exports will curb any extreme behavior by Putin towards Ukraine. While the EU does rely on imports from Russian of natural gas (almost 30% of their imports come from Russia), the Russians rely more upon the EU as the single largest region for their exports (about 65% of Russian exports are to the EU, as demonstrated by Chart 1 on the next page). Pasic believes **Russia tensions will “simmer”** and not blow-up.



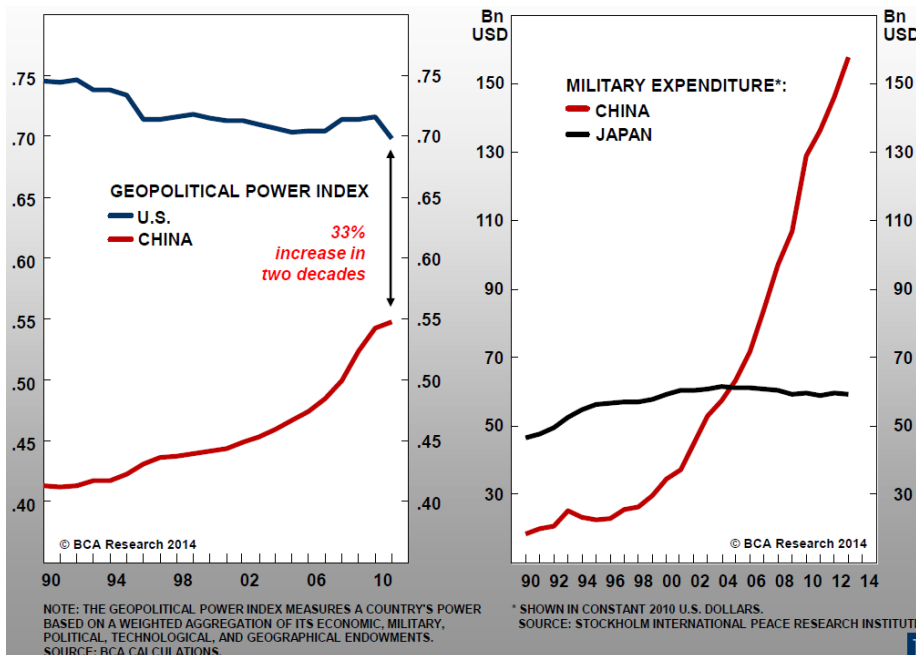
Chart 1: Russian Natural Gas and Oil Exports



What are Paptic's concerns? He believes today the largest geopolitical risk lies in East Asia. He discussed the rapid rise of China's geopolitical power in the last 20 years, and the dip in US power - as demonstrated through the Geopolitical Power Index in Chart 2. This BCA index takes several factors into account, such as a country's economic, military, political, and technological position.

China's rising power and exponential military expenditure compared to Japan (demonstrated in Chart 2) are serious cause for concern for Paptic. The combination of these two factors, makes it easier for China to increase its sphere of influence in East Asia, threatening Japanese and ultimately US security. Chinese neighbors are also requesting greater US presence in the region, and Paptic fears an "accidental skirmish" could create a "military dustup" which could spook the markets. Paptic also points out that East Asian geopolitical risk is not on investors "radar screens" yet, so any negative situation there could have a severe impact on the markets.

Chart 2: Chinese Increasing in Geopolitical Power and Military Expenditure



In the session on "Making Sense of China," veteran China expert Stephen Roach and other seasoned policy and economic experts presented both positive and negative cases for the future of the Chinese economy and markets; but no one had strong convictions given the lack of transparency of information and quality of data points provided



by Chinese authorities and Chinese companies. This lack of clarity and conviction, along with the potential geopolitical concerns, reinforced our long standing BigSur house view to avoid direct investments in Chinese markets.

### An Expert Assesses Where We Are After the Financial Crisis

Carmen Reinhart is a Professor of the International Financial System at Harvard University and holds positions as a Research Associate at the National Bureau of Economic Research and advisory positions with the US Congress and the New York Fed. Since 2009, she has been focusing her research on studying past economic and financial crisis to better understand this latest financial crisis.

- In Reinhart's research she found that it typically takes more than two decades to unwind the levels of debt overloads the global economy current holds.
- She believes this won't move any faster in our current situation which is also affected by a combination of sluggish growth and low inflation. In her opinion, sustaining low real interest rates may be necessary to unwind the public and private debt overhangs.
- Given that much of the debt has gone into official hands, she foresees a series of debt restructurings in our future.
- In her studies she has found that the average number of years to recover to the pre-crisis peak is about 8 years (median is 6.5 years); however in more recent systemic crises the average may come closer to 10 years.
- Her assessment of the current crisis is as follow, "now in the fifth or sixth year of crisis, there are signs of stabilization and recovery in Europe but output remains well below its pre-crisis peak in 10 of the 12 crisis countries. The gap with potential output is even greater."
- Of the 12 countries experiencing a systemic crisis starting in 2007-2008 (France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Portugal, Spain, Ukraine, UK and US) only the US and Germany have reached their pre-crisis peak in per capita GDP.

Reinhart believes both US and Germany are the most fundamentally sound of the advanced economies and fears investors are too comfortable with a false idea that Europe has "recovered." She fervently dismissed fellow speaker Jean-Claude Trichet's comments that the ECB policies have already succeeded in creating a recovered and "new Europe" as extremely premature. We share this sentiment; while we do have a small exposure to Europe in our equity portfolios; the US has still remained the largest overweight, and within Europe, we have the most allocation to Germany, largely based on our fundamental views as these two countries being the best "neighborhoods" to be in. We have also been concerned about the debt overhang since the start of quantitative easing, and will be eager to see how advanced economies tackle this problem in the future. Our house view is that any type of rise in rates will be done very gradually, and Reinhart's



*Chatting with former ECB President Jean-Claude Trichet at the BCA Conference*



comments on the importance of low rates in managing the debt overhang helps to reinforce this view.

### Investors Are Still Favoring US Equities

Throughout the conference, panelists and investors discussed equity markets being close to fully valued, and even starting to approach levels in bubbly territory. We heard complaints about finding negligible value in bonds, and concerns about cash. At the end of the conference, BCA told the participants that they wanted to hear from us on what our favorite asset was for this coming year- the results are shown in Chart 3 below. Despite concerns about increasing valuations, the majority of investors still believe equities are the best asset class to be in, with 50% favoring developed market equities are 27% favoring emerging market equities. Commercial real estate was a distant third favorite, with 9%. Cash only earned 1% of participants' votes; down from 8% previously. Although this was a surveyed question, considering the quality of our fellow participants (elite asset managers and institutional investors), we believe this provides an insight into where the world's leading investors see value and potentially where we can see near term asset flows.

Our view remains in line with our fellow conference participants- in terms of traditional assets, we are the most comfortable with US equities. [While analysts forecast S&P500 profits to increase 11.5% for 2015 and this high figure looks vulnerable](#) (as global economic growth is deteriorating and the US Dollar is strong), we think there is still more room for multiple expansion from the current 15.6 times forward earnings. This is because the [US will continue to be favored versus Europe, Japan and EM stocks](#).

*Chart 3: BCA Participants Choose their Favorite Asset Class for the Coming Year*

#### What Is Your Favorite Asset For The Coming Year?

	% CHOOSING THIS ASSET SEPT 2014	% CHOOSING THIS ASSET SEPT 2013	% CHOOSING THIS ASSET SEPT 2012
Developed Market Equities	50	45	40
Emerging Market Equities	27	31	30
Corporate Bonds	1	4	N/A
Government Bonds	3	1	4
Industrial Commodities/Oil	5	3	N/A
Gold	4	2	N/A
Commodities (Including Gold)	N/A	N/A	20
Commercial Real Estate	9	7	N/A
Cash	1	8	6

### Conclusion

BCA and the panelists overall macro view is that [the debt overhang will require continued accommodative monetary policy, and that real interest rates and bond yields will have to stay relatively low in the future](#). We came away with some new investment ideas and perspectives which helped solidify conviction in some of our portfolio positioning. The conference however, was not rich with exciting investment opportunities- mostly because, as many of the panelists suggest, there simply are not too many out there. This isn't to say that there aren't investments which can bring value and generate returns, but they are much more selective: [investors must focus on generating](#)





alpha, as the “low-hanging fruit from global equity beta has been picked.” We discussed this very theme on our last Thinking Man (Note 22 written on 9/2/14): investors should be focused on high quality nontraditional opportunities for portfolio positioning given our views that there is little value in traditional asset classes.

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