Lessons from October & Investment Implications

"In the long history of humankind and animal kind, those who learned to collaborate most effectively have prevailed." -Charles Darwin

Collaboration is one of our core philosophies at BigSur: we look to form important relationships with our industry counterparts, always seeking to create value for our platform and clients. We prefer to cultivate our "House View" with top tier managers and "buy-side"/ independent research, more than "sell side" institutions and research. In mid-November, we travelled to New York and met with a few third party asset managers specialized in areas as diverse as distressed credit, private debt, private equity and hedge funds. It was an opportune time to hear their take on how the markets behaved in October 2014, and learn what they believe were the most important lessons. In this Thinking Man note, we recap the market behavior during October and November and highlight the investment implications for our clients' portfolios.

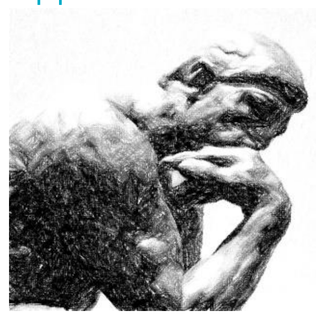
Markets Recap: Spiking Correlations & Volatility

Spiking Volatility: During the first two weeks of October, equities fell as bond yields fell and the dollar strengthened in tandem. On October 15th the yield on the benchmark 10-year US Treasury plunged 33 bps to 1.86% before rising to settle at 2.13%! This move was a 7 standard deviations away from its intraday norm. Analysts draw parallels with the "flash crash" that hit stock markets in May 2010. VIX, the index widely used as an indicator of future equities volatility and sometimes referred to as the "fear gauge", more than doubled to a 19-month high of over 30%.

Stocks and the US Dollar moved in tandem. As Treasury prices rose, the USD rose and stocks fell; but once there was a reversal the exact opposite occurred. These three diversified asset classes showed a very high correlation during this time of stress in the marketplace. Thus, there were clearly good benefits for diversification between stocks and government securities, in particular US Treasuries.

Spiking Correlations: Risk assets (equities, credit and commodities) experienced meaningful dislocations during October and their correlations spiked on one of the most volatile trading days in recent history on October 15th.

The Thinking Man's Approach



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The "Risk-on/ Risk-Off" market dynamic is here to stay, but with expected increasing frequency of spikes in volatility for 2015. But, why?

- Given the lack of clarity around the first Fed rate hike in USA and divergent monetary policies and economic forecasts;
- Due to lower bond inventory at market-makers, it now takes seven times as long to liquidate a bond portfolio as in 2008. Thus, the exits for trades are crowded. If investors suddenly sell "en masse", prices could gap down.

Based on our recent meetings in New York with top managers, our research sources and our own analysis of market behavior, we determine 5 Key Investment Implications in today's world.

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

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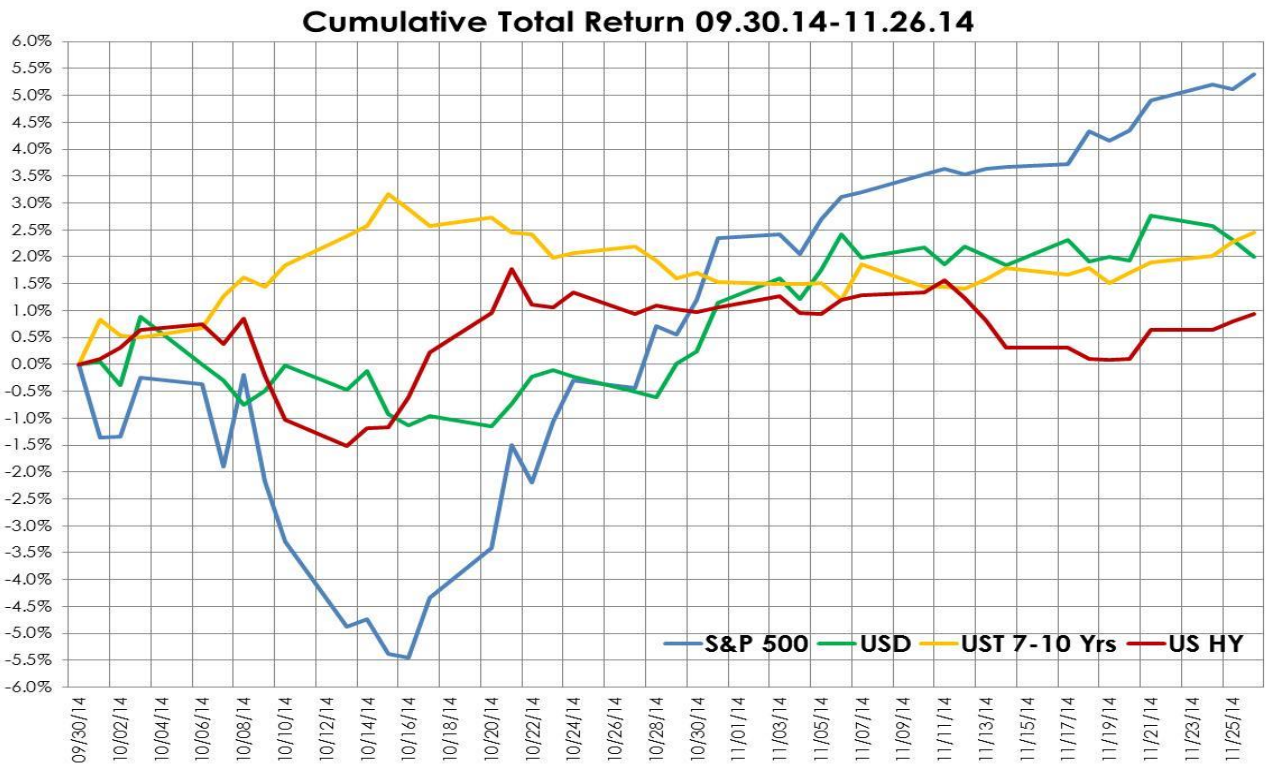
Since that spike on October 15th, volatility has been steadily decreasing consistently to low levels of around 13% as the markets have rebounded nicely. The "risk-on" trade that started on the second half of October has been supported by strong US economic and earning data, but fueled by the same "heroin" of global monetary stimulus. On November 20th, the People's Bank of China cut interest rates for the first time in two years. The Bank of Japan also expanded its asset purchases, and Mario Draghi has made strong comments signaling the continued stimulus in Europe. As seen in the below chart, the equity market staged a major recovery from October 15th until the end of November, moving into successive new record highs.

Chart 1: Cumulative Total Return of US Equity, Treasury, US High Yield and USD Markets



Source: Bloomberg

Fixed Income: "Entering a Phase of Credit Risk Differentiation"

One theme that came up repeatedly in our discussions with top independent managers is a potential turning point in the credit markets. The underlying cause is related to the structural illiquidity that has developed in the bond markets since the financial crisis. We highlighted this unintended consequence of the Dodd Frank legislation passed in 2010 in the Thinking Man #24. There has been a sharp reduction in the bond inventories held by market makers as proprietary trading has been substantially reduced. In risk off environments, like we saw in early October, many investors sell their lower rated bonds in a "flight to quality" trade. The traditional buyers in a risk off environment, bank proprietary desks, can no longer be buyers due to the Volcker rule. The result is a lack of liquidity and increased mark to market volatility. High yield markets are starting to perform distinctly based on quality. As demonstrated by Table 1 below, higher quality high yield (BB) were able to rebound in October and had positive performance. Lower quality high yield (CCC) did not recover, and continue to perform poorly.

Credits with low fundamentals are being punished by the market. As one manager told us, the market may have "finally entered a phase of credit risk differentiation." The price breakdown in lower quality high yield signifies a shift in the fixed income markets, and many managers believe that if there is another fall in fixed income markets, these lower quality credits can continue to gap down.

Table 1: Total Return of High Yield Indices

Total Returns (%)		Aug	Sep	Oct	2014
High Yield		1.52	-2.10	1.14	4.79
BB		1.86	-1.93	1.96	6.60
B		1.39	-1.94	0.95	4.03
CCC		0.87	-2.93	-0.67	1.61

Source: BofA/ML Indices (H0A0, H0A1, H0A2, H0A3), CreditSights
*2009-2013

Global Macro Views: US remains Best Neighborhood

In the US, deal activity remains strong, corporate cash balances are high, and credit markets are showing signs of caution but are generally intact. Earnings per share in the S&P 500 are up a healthy 7% year over year on average during the first 3 quarters of 2014. These conditions are conducive to M&A, buybacks and dividends. The US economy is better insulated from a downturn in global growth as it is less reliant on overseas export demand (which only represent 14% of US GDP vs 51% for Germany and 26% for China). At the same time, American businesses and consumers benefit from falling oil prices in a larger extent than the rest of the world.

Meanwhile, Europe is the poster child of the "New Mediocre". Poor industrial production and orders data from Germany have raised the fears of a "triple dip" recession. Japan is losing momentum as Abe has failed to deliver on fiscal reform, as VAT hikes were not matched by corporate tax cuts. China is seeking to manage an exit from a credit binge that doubled its Debt/GDP ratio from 2006 until today, global demand for commodities (oil, steel, iron ore, etc.) have weakened.

Investment Implications and Conclusions (based on our sources and market behavior)

The "Risk-on/ Risk-Off" market dynamics are here to stay, but with increasing frequency of spikes in volatility for 2015. But, why?

1. Given the lack of clarity around the first Fed rate hike in USA and divergent monetary policies and economic forecasts;

2. Due to lower market-makers bond inventory, it now takes seven times as long to liquidate a bond portfolio as in 2008 (source: Bank of England). Thus, the exits for trades are crowded. If investors suddenly sell "en masse", prices could gap down.

Investment Implication #1: *As an investor play "volatility" to your advantage*

One simple way offering good liquidity is by:

- buying S&P 500 puts to hedge when VIX < 13%
- selling S&P 500 calls to generate income when VIX > 25%

At this juncture, equity market volatility has drifted to the lower end of the range around 13% (from over 30% on Oct-15th "flash-crash") and seasonal strength may keep volatility below normal for the remainder of 2014. But divergent Monetary Policies (between the Fed and the European Central Bank, Bank of Japan and People's Bank of China) and uncertain global growth forecasts make for a more volatile 2015, with spikes in volatility similar to what we witnessed in May 2013 or October 2014.

Investment Implication #2 *Rather than diversifying by different asset classes, focus on diversifying by different risk factors*

As we saw in October, correlation between risk assets (equities, credit and commodities) overshoots in times of stress in markets. During these times of stress is when an investor wants to see the benefits of portfolio diversification, with assets showing uncorrelated behavior. This is the theme of Professor Geczy from Wharton School of Business latest paper, in which he elaborates on the importance of "Risk Factor" diversification.[1] Some examples investors should consider away from the commonly used equity, bond, commodity and currency factors are: Macro Factors (like Illiquidity, exposure to Banks), and Non-Linear Factors (like Volatility, Reversals, Momentum). Our Investment Committee (IC) has recommended several asset types with large illiquidity premiums like private debt, distressed credit, bank loans and private equity. Several of the investments we have recommended to clients over the past year have been nontraditional assets which have low correlation to financial markets assets.

Investment Implication #3: *Selectivity in fixed income*

The combination of higher volatility and poorer liquidity is pressuring investors to demand higher yields. Most of the recent price movement seems to be driven by technical rather than fundamental factors; however, prices may gap down very quickly, because everyone is on the same side of the trade and there is limited inventory. However, weak credits have had a tough time recovering from the correction in the first two weeks of October and investors are expecting more premium for the lack of liquidity in many lower quality high yield paper. Thus, as investors we should be compensated for this "illiquidity" risk (of each security). Sectors to keep an eye are High Yield Shale Energy companies as well Emerging Markets Corporate bonds. Credit markets are poised to enter into a credit risk differentiation phase which begins with weak technical that in turn shun light on vulnerable and previously ignored fundamentals. We're seeing this effect especially play out with

[1] Dr. Christopher Geczy and BlackRock, "The New Diversification: Open Your Eyes to Alternatives: A Conversation with Professor Geczy, Ph.D", April 2014

the "worst of breed" companies, sectors and countries are being re-priced. That's why we say "buyer beware"!

Investment Implication #4: *Stay long USD (vs Majors and EM currencies) and Underweight Commodities in a low-growth environment (with deflationary pressures from Europe and Japan and a decelerating China)*

The strong USD and weak commodity price cycles are secular! The USD will stay strong as the Fed has a more restrictive monetary policy relative to BOJ, ECB and even the PBOC, at the time that the US economy is relatively better and in an improving shape (employment, manufacturing, retail while housing seems stable). There are strong deflationary pressures coming from a sick Europe, a sick Japan and a decelerating China (which is changing from a producer/ exporting/ supply economic model to a one more focused on consumption and social stability). But if the Fed follows the correct monetary course, it will further restrain growth. So it will be interesting to see if the Fed takes a US-centric decision or if it takes a decision based on global economic conditions.

Oil has a unique supply side dynamic, due to the shale revolution in the US and the fact that OPEC abandoned its cartel power by deciding not to lower output and leave the weaker producers to "pay the bill". The growth in the US crude production accounts for all of the growth in non-OPEC supply. While during the last 5 years oil spot prices have averaged $92 per barrel, we expect a price range well below this average for a few years.

Investment Implication #5: *Managers think there are more opportunities for Alpha than for Beta*

Divergent monetary policies and uncertain global growth could make for a more volatile 2015; managers see more opportunities to add value through alpha than beta (meaning fewer directional bets and more relative value bets). As equity markets hit new records and government bond markets trade at the lowest yields ever, most managers don't foresee a great pay-out for directional bets in traditional assets. However, they see better opportunities for relative value trades. A clear example of this is Merger Arbitrage, where spreads widened to very attractive levels in the aftermath of the Shire/ Abbvie debacle- when many risk arbitrage hedge funds were on the same side of the trade, and then when the deal was put into question, everyone went on the same side of selling the trade. Liquidity in the trade was hammered because there were not market makers, and risk arbitrage players had some of the great losses in their history. As merger arbitrage spreads widened (well beyond the "tax inversion" related pharma deals), many investors have increased their investments into this relative value strategy.

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