

26 August, 2015

ARRIA Newsflash - Current markets and volatility. Short and sharp correction or more malaise to come? Threat or opportunity?

As the peak body for the real return investment industry, ARRIA has collated a number of our Industry Associates and Asset consultants' views and comments on recent market volatility in order to assist our Practitioner Members in gaining access to high quality information and knowledge.

The recent volatility in global equity markets in recent weeks is a clear reminder that investment strategies need to be built with sufficient diversification and some key features that reduce the impact of share market volatility on investor returns such as allocations to real assets, alternative strategies and portfolio construction that builds in downside protection.

Thinking carefully about how to build investment strategies that can deal with challenging periods of market volatility that are part and parcel of equity market investing, should ensure that during these times your clients' portfolios are better positioned to deal with these market conditions.

ARRIA's recent roundtable on Risk provided some insightful strategies and insights into this complex area. Please refer to the website for further White Papers on this.

This Newsflash is broken into 2 parts. The first part looks at Market and Economic commentary and the second part looks specifically at how some funds have fared during this volatile period.

[**What's been happening and what are the views going forward?**](#)

Simon Kitson – Economist Blue Sky Investments

There's two major questions on every-one's lips; 1) is the recent global equity rout the start of a prolonged and sizable bear market or a correction that will present a superb buying opportunity & 2), what was the key catalyst for the sell off? China, data, commodities, the dollar, etc.?

So let's not beat around the bush; yes we believe this is the start of a major bear phase, that will be punctuated with violent counter bull moves & secondly, there doesn't need to be an obvious catalyst. I'll use the ubiquitous US equity market as a proxy for global markets. It's

over-valued (Mkt Cap/GDP, margin adj. CAPE), over stretched (margin debt / GDP, mutual fund cash levels), over-positive (AAII) and over-due (avg. length of a bull market, mutual fund equity exposure). But then it has been for a while, as risk appetites continued to expand, fed by global QE & ZIRP. But now they're in reverse as advance-decline ratio's fall, DOW theory fails, credit spreads expand (see ETF's: EMB, HYG, JNK), 52-wk lows outnumber 52-wk highs at peaks etc.

There's a smorgasbord of technical failure, i.e. it's fallen under its own weight. The fact that we see the US slowing, China heading for major recession & Japan all over the place, just adds to a bear case. It wouldn't matter if the bull was young and feisty, but alas it's old & tired.

Jerome Lander – Pro Capital

I think more volatility is still ahead of us. There are so many momentum strategies that will be forced sellers here that despite deep pessimism and short term oversold conditions I am not ready to step up and think about being an aggressive buyer just yet. Markets like the US still remain overvalued and could even be at risk of an unexpected slowdown. I think we are a hold currently assuming you can stomach further losses while potentially looking to be a buyer of risk at some unknown time down the track. That said I'm worried central bankers may have lost their perceived omnipotence and this could be really nasty if their eventual efforts e.g. further QE doesn't work. A lot of people are saying this sell off is unwarranted by the fundamentals as these are fine. I'm not at all convinced the fundamentals are fine.

Angela Ashton – Independent Asset Consultant

I think this is the beginning of a very rocky road. China is clearly quite weak and the knock-on effects, particularly for Australia, will be profound. The world generally is in quite a weak position, fledgling growth in the US and the UK notwithstanding.

The drivers of the coming volatility are not based just on China though. China is just another symptom in a fairly complex global tapestry. We're moving from a unipolar to multipolar world, we are seeing the beginnings of digital disruption, demographics is working against growth in global consumption and inflation is extremely weak at best.

Given monetary policy is already at near-to-maximum speed and easy fiscal policy looks very unlikely, it's hard to see exactly what will kick-start the world into a normal, or even near-normal growth trajectory.

Markets have been priced for perfection, based on low interest rates. Unfortunately, markets have been disappointed and we will have to go through a painful period of adjustment to more reasonable price levels.

Neuberger Berman - Michael Dyer

Long-term investing is similar to eating healthy – we all know what we should do but it's hard to not to be tempted by junk food or the latest fad diet. In investing, we know we

should invest for the long-term, buy on the dips, diversify our portfolio but it's easy to be drawn into chasing short term returns. Over the past few years, global market risk has been suppressed by unprecedented monetary policy and it easy to have been seduced by juicy equity returns. However, history tells us that volatility clusters in that periods of low volatility persist, then periods of higher volatility persist. The recent spike in market volatility suggests that we are now moving to a higher volatility regime with potentially lower expected returns from market indices. The good news is that volatility and market dispersion can create some great alpha opportunities for active management across hedge fund strategies. However, just like we should eat a varied diet, investors should diversify risk by seek multiple sources of alpha when investing in active strategies. Investing in multiple lowly correlated strategies and constraining market exposure should provide the opportunity to generate returns while protecting the downside.

Standard Life Investments

Events in China have undoubtedly startled many investors over recent days. In [the attached](#) Rapid Response Note, we give our views on the current market turmoil, including analysis on underlying factors, future outlook and triggers investors should look out for."

Specific Fund commentary:

Spire Capital

The SPIRE ROC Private Equity Fund Series continues to provide investors with the benefits of high annual yield and total returns that are uncorrelated to equity markets and largely immune from macro events.

Investing in US denominated "real assets" has provided SPIRE investors with a low volatility, 65% total return over the last 2 years smoothing the impact of equity market volatility. We expect ongoing value appreciation and growing yields for the ROC FUND SERIES.

The strategies are driven by a MEGA TREND, a shift to rental over ownership driven by societal, demographic and vocational shifts underwriting demand for "essential and affordable rental accommodation" in urban apartment communities and seniors housing.

The market has significantly underestimated the impact of the GFC, functional obsolescence of aged stock and societal shifts on the demand/supply dynamics for rental accommodation thus driving rental appreciation (>5%pa) and occupancy levels (@96%).

The PWC US Urban Land Institute report estimates that in the next 15 years 59% of all new home formation will be rental providing significant tailwinds for the ROC Strategies.

[Please see the attached Media Release.](#)

Blue Sky Investments

The Blue Sky Real Return Fund has been maintaining a defensive equity exposure for some months now and reduced it further early last week through shorting of S&P500 futures. Its Beta exposure in advance of the recent market sell was approximately 35% well down from its long term target of 55%.

Pengana

Since the start of July, Pengana's funds have all performed better than the markets in which they invest. While our funds do not develop strategies to profit from macro-economic views or forecasts, they are aware of the current environment and adjust the risk taken to reflect this. The signals used to assess the environment are more driven by bottom up research (company contact, event driven activity etc) than "macro" variables.

When we do believe the environment is abnormally risky there are a number of techniques our funds are able to employ, which are not available to benchmark constrained funds:

- Being benchmark unaware allows the funds to focus more on economically insensitive companies with sustainable business models, strong balance sheets and predictable earnings.
- Active management of cash weightings in some of the funds means we do not have to be fully invested if we cannot identify attractive investment opportunities.
- Hedging is also employed by some of the funds, either to reduce market exposure or to mitigate particular risks that the fund may be exposed to.
- Some of the fund's will also make use of derivatives to reduce risk, for example buying out of the money put options.

Our funds tend to use a combination of these techniques rather than relying on just one, which further adds to the robustness of the risk management strategy.

Allan Gray

See [attached](#) Commentary from Allan Gray.

Important Information

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