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INVESTMENT MANAGEMENT

# Crash in instalments

*Investment Report – 31st December 2018*

# Crash in instalments

The financial markets suffered a crash in instalments during the fourth quarter, turning 2018 into one of the worst investment years since the financial crisis ten years ago. Hardly any asset class managed to deliver a positive return contribution. This was in spite of the economic environment not being so dire. Are economists blind or are exchanges exaggerating on the downside?

At the end of September, it still looked like a quite passable investment year. Then, however, the storm of the fourth quarter broke and swept through nearly all asset classes. There was no shelter to be found. Equities in particular came under pressure. Here, only Brazil and a handful of minor markets managed to deliver a positive return (measured in local currency).

Change in **Equity Markets since the beginning of 2018:**

| | | Dec. 2017 | Dec. 2018 | Change |
|---|---|---|---|---|
| Asia ex Japan | DJ STOXX A/P | 538.7 | 463.0 | -14.1% |
| Germany | DAX | 12'917.6 | 10'559.0 | -18.3% |
| Europe | DJ STOXX 600 | 389.2 | 337.7 | -13.2% |
| Japan | TOPIX | 1'817.6 | 1'494.1 | -17.8% |
| Switzerland | SPI | 10'751.5 | 9'830.1 | -8.6% |
| USA | S & P 500 | 2'673.6 | 2'506.9 | -6.2% |
| World | MSCI World | 513 | 455.7 | -11.2% |
| Hedge Funds | HFRX Global HF | 1'275.5 | 1'186.2 | -7.0% |

Development of index in local currency.
Exceptions Asia ex Japan and World in USD.

Some commodities, including palladium, would have been a rewarding, if not a practicable or diversified alternative, and government bonds (in parts) at least a guarantor for a "black zero". Gold stemmed itself against the red tide a little. Alternative investments, although equally negative, did better than most equity markets. The Euro declined against the Swiss Franc by about 4%, whereas the US Dollar increased by about 1%.

In the meantime, the reasons behind this negative mood have emerged from the gun smoke. After all the trials and tribulations of the political power centres globally, it does not come as a surprise that economic growth is stalling. Being cautious about investing in equipment and labour cannot be held against a company in times of uncertainty about tomorrow's customs duties, other trade barriers, or further regulation that may render sales opportunities for its products more difficult or even impossible.

Particularly between the USA and China, a dangerous tit for tat spiral has been set into motion, evidenced by traces of a slowdown in the economy. Currently, a temporary truce is in place regarding the customs dispute. But the ghost of a backward-looking globalisation wave is hovering, and it is not only being nourished by Trump and Xi Jinping. This is scaring investors around the globe well and truly.

### Traces of slowdown

Regulatory delusion is rampant too, adopting grotesque traits in places. An example of this can be found in the German car industry, once an important driver of German prosperity. Today, politics is dragging the industry down with its imposition of excessive, bureaucratically drafted regulation so badly that it almost scares you to death. In Germany alone, car production declined by 9% to 5 million units in the past year due to (regulatory enforced) production disruptions and hard-to-sell stockpiles of new cars.

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**Trust is paramount in asset management.**

The **equity funds employed by us** achieved the following returns since the beginning of the year:

| Fund | Return |
|---|---|
| Aberdeen Asia Pacific (USD) | -11.2 % |
| Swiss Rock Emerging Markets Equities (USD) | -14.8 % |
| GAM Japan Stock Fund (CHF hedged) | -19.7 % |
| GAM Japan Stock Fund (€ hedged) | -19.6 % |
| Strategy Certificates SIM–Swiss Stock Portfolio Basket | -13.7 % |
| iShares Stoxx Europe 600 ETF (€) | -13.0 % |
| Performa European Equities (€) | -19.4 % |
| Performa US Equities (USD) | 2.4 % |
| BB Adamant Medtech & Services Fund (USD)* | -13.1 % |
| BB Adamant Medtech & Services Fund (CHF)* | -12.3 % |
| BB Adamant Medtech & Services Fund (€)* | -11.7 % |

Performance in fund currency. Source: Bloomberg or respective fund company. *) Performance since purchase.

Obviously it is right and proper that global exhaust emissions have to be reduced massively. However, it is doubtful that instead of economic measures (e.g. road pricing), driving bans for diesel cars, or the promotion or funding of electro mobility financed by subsidies, are the correct measures. It appears unlikely that CO2 emissions, or in general environmental pollution, can be reduced by a combination of more petrol-driven cars on the roads and increased coal-fired electricity production. This even more so if the environmental pollution is not only measured at the exhaust, but across the entire lifecycle of a car.

Whether or not society is prepared to accept such a radical, and for the individual, cost-inflating change in transportation is quite another matter. The “Gilets-jaunes” (yellow vest) movement in France is already giving us a foretaste of things to come.

### Exaggerated fear?

Having said that, let us return to the general status of the economy and exchanges. Indeed, the augurs have cut their forecasts for 2019 economic growth in the past weeks. However, a recession, defined as two consecutive quarters of negative growth, is not in sight. Apart from on the exchanges, of course, where at times it looked as though the global economy would come to a standstill during the past weeks. So, either the majority of the economists are deluded and unable to see the misery to come, or investors and exchanges are bedevilled by exaggerated fear. There is evidence to support either thesis.

Average **growth and inflation forecasts** from the “Bloomberg Composite Contributor Forecast“ poll of economists:

| | Real GDP Growth | | Inflation | |
|---|---|---|---|---|
| | 2018 | 2019 | 2018 | 2019 |
| China | 6.6 % | 6.2 % | 2.2 % | 2.3 % |
| Germany | 1.6 % | 1.6 % | 1.9 % | 1.8 % |
| EU | 2.0 % | 1.8 % | 1.9 % | 1.8 % |
| United Kingdom | 1.3 % | 1.5 % | 2.5 % | 2.1 % |
| Japan | 0.9 % | 0.9 % | 1.0 % | 1.1 % |
| Switzerland | 2.9 % | 1.7 % | 1.0 % | 1.0 % |
| USA | 2.9 % | 2.6 % | 2.4 % | 2.2 % |

Regarding the economy, China in particular gives rise to comment. It has now been noticed that the growth expectations (see table) are much too high, and the Middle Kingdom’s economic problems much more severe than was previously generally thought. This is difficult to gauge. Bearing Peking’s recent verbal pressure vis-a-vis Taipei in mind, this thesis may indeed have gained in substance. At the turn of the year, China’s head of state again insisted on the reunification of, as he sees it, the rogue province with the homeland. This is a proposition that is firmly rejected by Taiwan. Is Xi Jinping’s feint perhaps only a distraction to deflect public attention away from the economic to the political arena?

A year ago, we entitled the Investment Report, “A good vintage”. We were able to look back on a very successful 2017. At the same time, bankers, brokers, media and economists exuberantly pointed to all the good things 2018 held in store for us. As we now know, it has turned out quite differently. Under the shadow of the recent crash in instalments, voices everywhere are very negative today. Hardly anyone still sees any opportunities. Is it possible for the mass of public opinion to be wrong this time as well, with markets already exaggerating on the downside?

### Sensible valuations

We think so, yes. A lot of negatives have already been priced into equites. Valuations have been reduced significantly and once more have come to lie in normal territory. Stocks of high quality companies, particularly those of small and medium-sized companies, have suffered massively as investors fled to the perceived security of large capitalised groups

Based on markets as a whole, there are attractive operating figures to be found. In Germany (as measured by the DAX Index), for example, the dividend yield is 3.4%, the price/earnings ratio (P/E) is 11 (19 a year back). In Europe, the index of 600 companies is trading at a P/E of 14.9 and a dividend yield of 3.9%. With ten year European benchmark bonds (primarily German and French issues), an investor achieves just about a 0.24% annual distribution. The Swiss market also achieves a passable performance with a dividend yield of 3.4% (federal bonds -0.25%), quite apart from some individual stocks that offer markedly above 5%.

Which brings us to the question, are the exchanges in an "official" bear market, and if so which ones? A bear market is defined as the index having declined at least 20% from its highest mark. To a certain degree, this definition prompts sounding the all-clear, as based on it, only China (Shanghai Shenzen Index) and Germany (DAX), out of all the major markets, qualify. From this perspective, we are simply in a marked correction, but not in a general bear market.

**Asset Allocation**

At its meetings, the Investment Committee decided on the following changes to the asset allocation for medium-risk balanced Swiss Franc portfolios, not subject to client's restrictions (mandates in different reference currencies at times display different nominal weightings and weighting changes).

**Money Market**

As a consequence of the sale of the New Capital Wealthy Nations Bond Fund (see bonds), the money market allocation rose slightly, so this asset class is now slightly overweight.

**Bonds**

During the fourth quarter, we sold the units in the UBAM US Dollar Corporate Bond Fund and invested the proceeds in Dollar bonds of good quality names, with about a five year maturity for Swiss Franc based investors. The rationale behind this is the markedly higher hedging costs as a result of the rise in short-term interest rates, making hedged US bond positions less attractive. In addition, we consider the currency risk of the US Dollar versus the Swiss Franc as limited. For Euro referenced portfolios, the proceeds were partially invested in Euro-denominated bonds. Units in the New Capital Wealthy Nations Bond Fund were equally sold. On the one hand, the fund also holds bonds of issuers that may be affected negatively in a weaker economic environment. On the other, we were unable to maintain as close a contact with the fund manager as we wished.

Since the beginning of the year, yields on **10-year government bonds** developed in a non-uniform manner:

| | Dec. 2017 | Dec. 2018 | Change |
|---|---|---|---|
| Europe | 0.43% | 0.24% | -44% |
| United Kingdom | 1.19% | 1.28% | 8% |
| Japan | 0.05% | 0.00% | -100% |
| Switzerland | -0.15% | -0.25% | -67% |
| USA | 2.41% | 2.68% | 11% |

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**Equities Switzerland**
Swiss equities suffered their biggest annual loss since the 2008 financial crisis. The Swiss Performance Index (SPI) fell by 8.6%. This figure, however, only tells half the story as the performance is sanitised by the highly-weighted and relatively stable performing heavyweights, such as Nestlé, Novartis and Roche. In contrast, losses on many small and medium capitalised stocks were markedly higher. The worst affected was the group of mid-caps (-19.4% for the year), some of which were punished massively as they were unable to fulfil the high expectations of the investment community.

The calendar year performance of the directly-invested "Swiss Stock Portfolio" (SSP) amounted to -13.9%, including dividends. Since 2010, the SSP's annual performance amounts to 9.4%, a result that clearly beats the benchmark performance of 6.4%. Since 2010, this strategy's cumulative total return amounts to about 125%. The SSP figures bear transaction costs and withholding taxes, whereas the benchmark index does not bear any costs. The "Strategy Certificates linked to the SIM Swiss Stock Portfolio Basket" (Valor: 36524524, ISIN: CH0365245247) closed the year with a performance of -13.7%.

**Other funds employed by us**
developed as follows:

| Fund | Performance |
|---|---|
| Acatis IfK Value Renten Fond (€) | -6.7% |
| Acatis IfK Value Renten Fond (CHF hedged) | -7.1% |
| BCV Liquid Alternative Beta (€ hedged) | -6.9% |
| BCV Liquid Alternative Beta (CHF hedged) | -7.2% |
| BCV Liquid Alternative Beta (USD) | -4.1% |
| Franklin Templeton K2 Alternative Strategies Fund (€ hedged) | -4.7% |
| Franklin Templeton K2 Alternative Strategies Fund (CHF hedged) | -5.3% |
| Franklin Templeton K2 Alternative Strategies Fund (USD) | -2.0% |
| Lyxor ETF Euro Corp. Bond Fund (€) | -1.3% |
| Pictet CH-CHF Bond Fund | -0.4% |
| Swiss Rock Absolut Ret. Bond Fund (€ hedged) | -2.9% |
| Swiss Rock Absolut Ret. Bond Fund (CHF hedged) | -3.3% |
| ZKB ETF Gold (USD) | -2.5% |

Performance incl. reinvested dividends where applicable.

**Equities Europe**
European equities also had to come to terms with an unfavourable year. They suffered from the cooling economies of the Old World, not least due to significant homemade political uncertainties. Amongst these were; the confusion about Brexit, Italy's budget tussle with the EU, an adverse environment for the German car industry, as well as the protests of the "Gilet-jaunes" (yellow vests) movement. During December, we implemented some changes to our directly-invested "European Stock Portfolio" (ESP). Part-profits were taken on Eutelsat, Meggitt, Merck as well as Tate & Lyle. The proceeds were used to add to the particularly troubled stocks of Aurubis, Barratt Developments, Covestro, Fresenius and Renault.

The ESP suffered a loss of 17.6% during the year and with that, underperformed its benchmark index Dow Jones Stoxx 600 for once, which closed at year end with a negative of 10.8%. Both figures are total return, meaning they include price changes as well as dividends.

Since 1993, this equity selection's average annual performance amounts to about 8%, compared to the 6.4% achieved by the above-mentioned broad benchmark. The transaction costs, as well as taxes withheld, are deducted in ESP figures, whereas the index is calculated without bearing any costs. The cumulative performance of the ESP since 1993 amounts to 712%, that of the benchmark to about 438%.

Measured on the **price/earnings ratio** using the latest 12 months profit figures, most equity markets have become more attractive:

| | Dec. 2017 | Dec. 2018 | Change |
|---|---|---|---|
| DAX Index/DE | 19 | 11.6 | -38.9% |
| DJ STOXX 600 Index/EU | 20.8 | 14.9 | -28.4% |
| MSCI World Index | 20.7 | 15 | -27.5% |
| S & P 500 Index/USA | 22.5 | 17.1 | -24.0% |
| SPI Index/CH | 13.2 | 17.9 | 35.6% |
| TOPIX Index/JPN | 16.3 | 11.7 | -28.2% |

Source: Bloomberg

**Equities USA**
As announced in our last report, we bought the Adamant Medtech & Services Fund at the beginning of the fourth quarter. This fund, from the Swiss provider, Bellevue Asset Management, invests in companies in the healthcare sector excluding pharmaceutical producers. Under the headline "digital health", these companies seek to improve efficiency and cost effectiveness in the healthcare sector. Minimally-invasive techniques

and optimised processes aim to cut treatment periods and cost, as well as to increase the well-being of patients. The fund carries a 5-Star rating from Morningstar, as well as an AAA-rating from Citywire. As the bulk of the capital is currently invested in American companies, we will attribute this investment to the US equity allocation in our reporting.

**Price / Book** and **Dividend Yield** of major equity markets:

| | Price / Book | Div. Yield |
|---|---|---|
| DAX Index / DE | 1.6 | 3.4 % |
| DJ STOXX 600 Index / EU | 1.6 | 3.9 % |
| MSCI World Index | 2 | 2.8 % |
| S & P 500 Index / USA | 3 | 2.2 % |
| SPI Index / CH | 1.9 | 3.4 % |
| TOPIX Index / JPN | 1.1 | 2.5 % |

### Equities Asia (excluding Japan)

Equities of developed as well as emerging Asian countries suffered badly from the changed trading environment. In particular rising US Dollar interest rates (increasing their Dollar debt servicing cost), as well as the trade war, are impacting export opportunities negatively. This on top of the fact that emerging countries are always first in line to fall victim to nervous investors repositioning their money to safe havens.

### Equities Japan

In 2018, the Japanese equity market was amongst the weak performers of the established markets. Slow growth, high export dependency and at the same time, intense linkage with its Asian neighbours weighed on sentiment. We have not made any changes to the position.

### Alternative Investments

The positioning in alternative investments too, remained unchanged during the fourth quarter.

### Precious Metals

Gold benefited from equity weakness during the fourth quarter, with a rise of about 6 %, bringing the year's total near to a break-even. No changes were made to the Gold ETF position, leaving the precious metal allocation overweight vis-a-vis our own strategic asset allocation.

Summary of our current **Asset Allocation:**

| Asset class | |
|---|---|
| Money Market | overweight |
| Bonds | underweight / short duration |
| Equities Switzerland | neutral |
| Equities Europe | neutral |
| Equities USA | overweight |
| Equities Asia | neutral |
| Equities Japan | neutral |
| Precious Metals | overweight |
| Alternative Investments | overweight |

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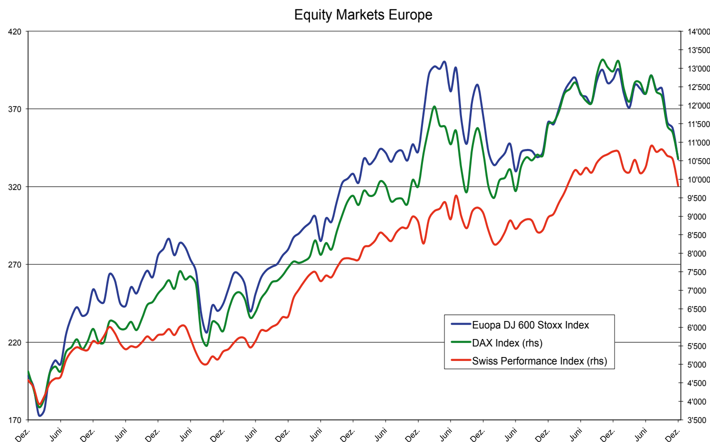
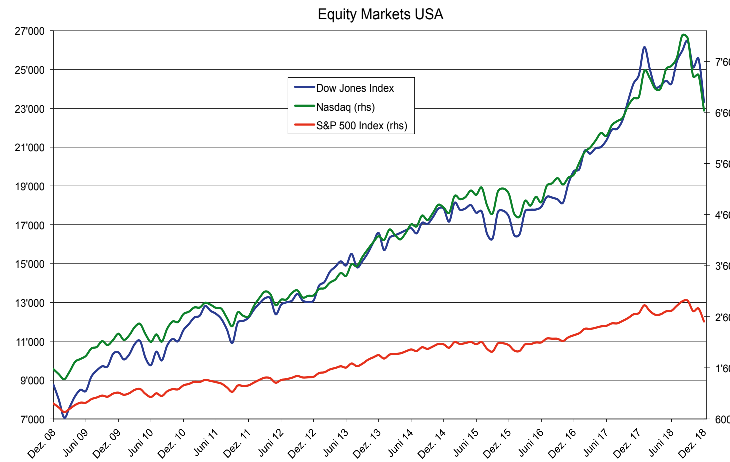
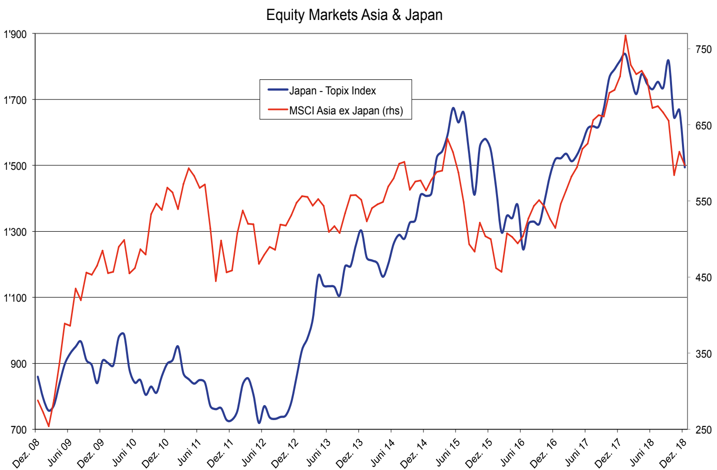
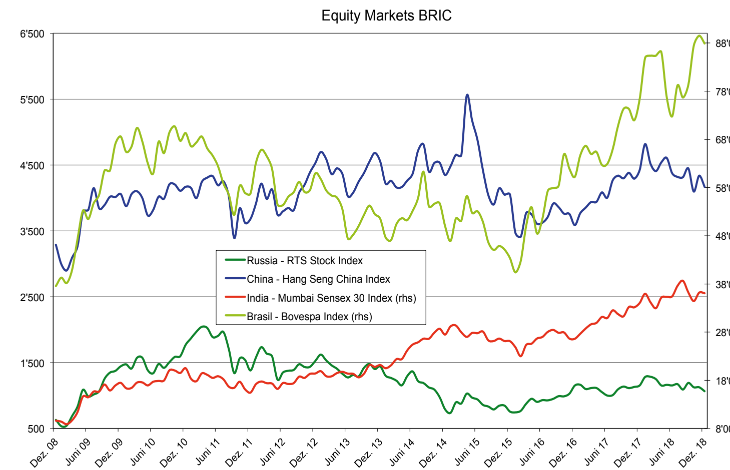
# Equity markets at a glance

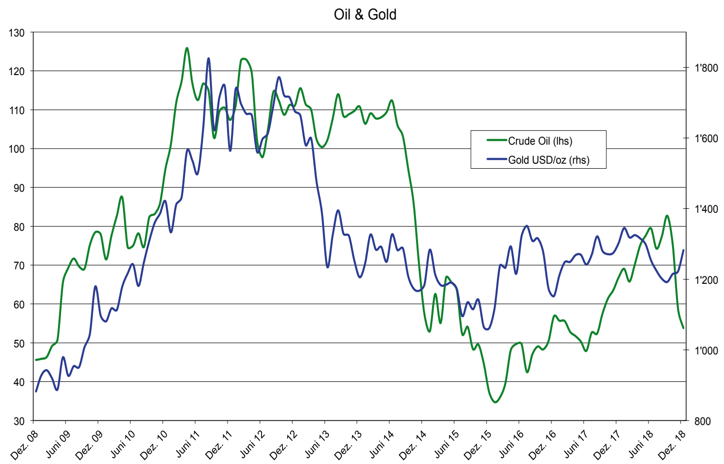


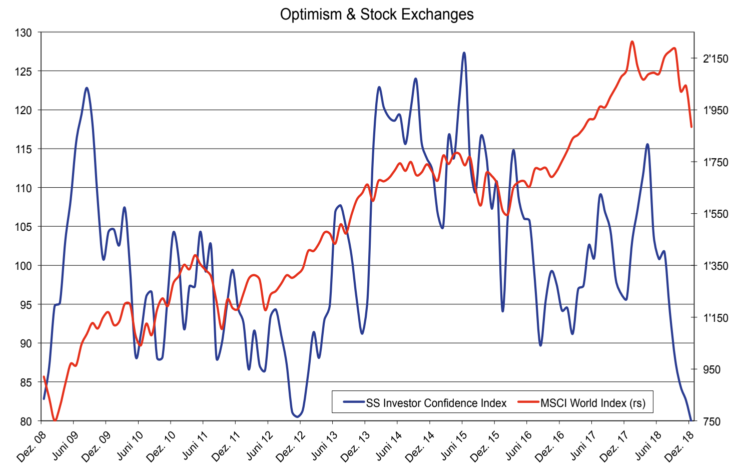



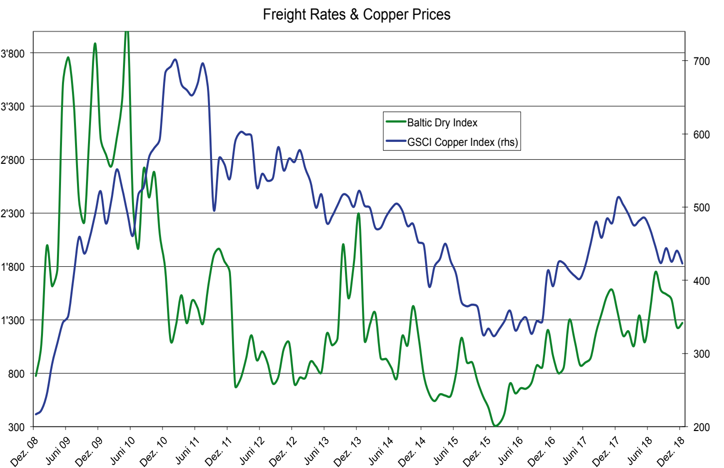



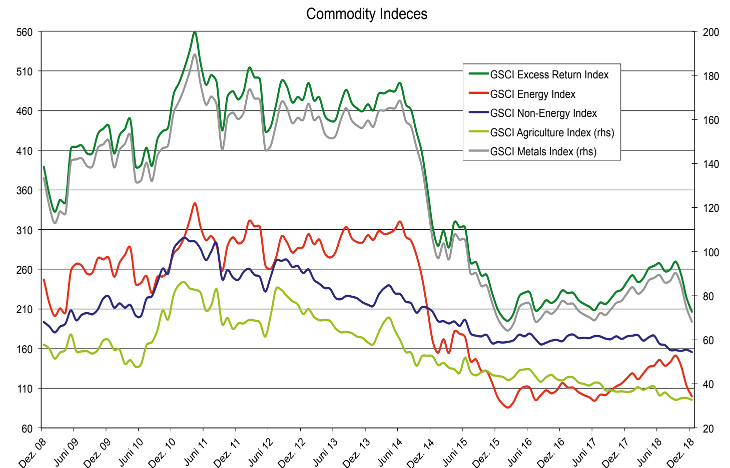



## Commodities and other indicators



## Notes

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## Closing words

We wish you a healthy, happy and successful New Year and thank you for the trust placed in us.

**Alfred Ernst**
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