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Still value in the equity markets

European and Italian fund selectors are also looking at alternative and absolute return strategies to diversify portfolios

INVESTORS

Institutional investors hold the largest share of liquid alternative industry assets at European level [10]

FOCUS

Liquid alternative funds on platforms are 134 today, with 9 new products in the first quarter of 2018 [14]

PRIVATE DEBT

Asset managed by Global private debt solutions tripled in 10 years: now are over USD 600 billion [21]

ETF

March 2018 marked the 42nd consecutive month of net inflows into European ETFs [25]

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Dynamic allocations

For the coming months, European equities and US inflation-linked securities are at the top of the preferences of Italian fund selectors. In contrast, corporate high yield bonds and core European bonds collect more indications for a reduction in allocations. Moreover, looking at the funds to be favored, absolute return products gain the peak of preferences among Italian fund selectors, followed by unconstrained funds and ETFs (page 7). MondoInvestor have also contacted some European financial professionals to have their outlook for Global markets. According to them, in the equity markets there is yet value to be played in the coming months, despite the expected increase in interest rates and the coming back of volatility are bringing European managers to look with more and more attention to alternative and absolute return strategies. What is clear from an economic point of view is that Global growth remains strong, especially in the short term. But the increased correlation among traditional asset classes in recent years have driven to new asset allocation models: more dynamic and more diversified (page 3).

Focusing on liquid alternative funds, Italians continue to remain the largest investors in this segment of market, followed by the British and French, German and Spanish investors. Moreover, institutional investors now hold the largest share of the industry at the European level and they also prevail in the Italian market, reversing the trend of recent years, when the retail clientele dominated. For the near future, furthermore, according to 61.1% of the asset managers interviewed, the institutional clientele will drive the flows (page 10). At the same time, it is increasing the number of products available via specialized platforms. In fact, the liquid alternative funds platforms currently manage EUR 27.4 billion for a total of 134 funds. About a third (40) of these products belongs to the Long/short equity strategy, followed by Managed futures (20) and Credit long/short (12). Focusing on assets, instead, the Long/short equity strategy is still dominant with EUR 5.6 billion. Finally, it is also important to point out that in the first three months of 2018 this market niche launched 9 new products and achieved a net inflow of EUR 1.5 billion (page 14). March 2018 also marketed the 42nd consecutive month of net inflow into ETFs and ETPs listed in Europe. In particular, assets invested in ETFs and ETPs listed globally decreased from USD 4.97 trillion at the end of February to USD 4.92 trillion in March, despite positive net flows of USD 19 billion, while assets managed in Europe fall from USD 832 billion to USD 825.8 billion, although there have been monthly positive flows of USD 1.5 billion, that brings the inflows from the beginning of the year to USD 27.4 billion (page 25). Another market segment that has been registering net inflows in the last years is that of private debt solutions. With USD 638 billion at the end of June 2017, the private debt industry has more than tripled its assets over the last 10 years. According to the most up-to-date data from Preqin, halfway through last year the private debt funds could count on USD 227 billion of dry powder, compared to USD 411 billion of investments already made (page 21).

Marco Degrada

In the equity markets there is yet value to be played in the coming months

The expected increase in interest rates and the coming back of volatility are bringing European managers to look at alternative and absolute return strategies

by Marco Degrada

Italian fund selectors' top picks among absolute return strategies for the coming 6/12 months

Long/short equity	48.9%
Fixed income absolute return	39.1%
Equity market neutral	35.6%
Relative value	34.9%
Emerging markets	31.8%
Event driven	29.5%
Credit long/short	26.7%
Global macro	18.2%
Multi strategy	15.6%
Risk premia market neutral	9.8%
Multi Asset absolute return	8.9%
Managed futures	6.5%
Active currency	4.4%
Funds of funds	4.4%
Volatility trading	-2.2%

Percentage as difference between indications for an increase and a decrease in the allocation. Data based on a survey conducted in March and April 2018, 49 fund selectors answered. Source: MondoInvestor

What is the outlook for Global financial markets over the coming months? What asset classes are European financial professionals looking at now and what investment solutions and strategies are they looking for today? MondoInvestor asked these questions to **Jürg Bühler**, Senior Portfolio Manager at Systematic Absolute Return AG, **Jacobo Silva**, Portfolio Manager at Omega Capital, and **Christian Torres Lang**, Partner and General Manager at Solventis SGIIC.

First of all, what is your outlook for Global financial markets over the next months?

Bühler: First, it is important to realize that we are in a secular equity bull market. Bull markets are often associated with target levels, like 100, 1,000 or 10,000 for the DJIA (you might guess which level is next). The 100 level was first reached in 1906 by the DJIA, and it was last touched in 1940: then, a bull market started reaching 1,000 24 years later. The 1,000 level was only left in 1982 three years after Ronald Reagan took over from Jimmy Carter in 1979. 16 years later, the DJIA reached 10,000 and we left this level in 2009. Since these secular bull markets last for around 20 years, we have only experienced about half of this Long Term Trend. Of course, during such moves, we experienced events like the 1987 crash, which in hindsight clearly was a correction. Could it be, that the transition from Obama to Trump could be compared to Carter handing over to Reagan who, as an actor, also had been frowned upon initially? Could it be that, rather than having a trade war that would throw the economy in disarray, we might get fairer trade relations between China and the rest of the world? What would that do to the US economy, trade deficit, tax revenues and corporate profits? Can we imagine reaching much higher levels of stock indices in the next ten years with the valuations not being too much stretched?

I hear a lot of talk about the "everything" bubble. Personally, I don't think that we are in a bubble territory in equity markets. One cannot compare current P/E ratios with those during periods of runaway inflation or when interest rates are at 15%. At the moment, equities in the US are fairly priced, in Europe and Japan they look even cheap when looking at the equity risk premia, given the low interest rate environment. In traditional assets, I cannot see better areas where to "hide". I don't expect that the FED is willing to raise rates in a way that would lead to a bigger correction or recession. That means there is a limited danger of a bigger correction in equities. Overall, it is important to keep an allocation to equities and we might already have seen the lows of a prevailing correction.

Of course, one should also keep a stable allocation to bonds that balances against the equity portion of the portfolio. Our asset allocation model risk-adjusts these investments and determines optimal allocations among different asset classes and distributes the amounts to each individual instrument that is chosen. If there were to be bigger troubles in stocks, I am pretty sure that bonds (mostly government bonds) is the place to hide. Rates would come down and we would see the negative correlation between long equity and long bonds that will protect our portfolios. From a fundamental view, I would want to be invested in bonds from countries like the US and the UK, where we already left zero interest behind us. I also believe that the interest rate differentials will help their currencies.

As a special situation I see quite some

value in gold mining stocks: I believe they will outperform the stock markets over the next year or two as I also expect the gold price move higher after quite some consolidation since 2011.

In house, we do our allocations based on a systematic momentum approach which, at the moment, favors German and Italian bonds. In equities we are invested in the Nikkei, the Hang Seng, the MSCI Singapore and we have small allocations to the Nasdaq. But as our asset allocation is adaptive and rebalances weekly, it can be that it changes significantly, shifting from more bonds to more equities and vice versa or changing the duration of our fixed income investments. Additionally, we improve our results adding the commodities with the best momentum according to our calculations (at the time of writing, April 13, 2018: soybean meal, brent and crude oil, cocoa and cotton). In our commodity basket we have also included Bitcoin and Ethereum, where we invest in through ETNs traded on the Nordic Nasdaq. But at this time the momentum is not keeping up with the other commodities and the model does not allocate to them, but the potential is there should cryptos make a big comeback.

Silva: Over the next 12-24 months the global markets will be overheated from a valuation point of view. A move toward a normalized environment for interest rates around the world can create market dislocations that can affect the asset allocation decisions of many market participants and therefore we anticipate capital moving from equities and credit to interest rates as investors shift their focus from risky to "safe haven" assets. As we have recently seen, market volatility is coming back and we believe absolute return driven strategies are the best fit for this environment. We currently have a barbell approach with long-only equity investments on one side and Long/short and Event driven on the other side, so we can benefit from price and sector dispersion as well as earnings disappointments.

Torres Lang: What is clear from any economic matrix looking at past, present or future data is that global growth remains strong, especially in the short term. We even have the added short term lift coming from US fiscal and infrastructure spending package. For 2018, GDP growth is expected to be of 2.8% in the US, 2.4% in the Eurozone and 6.5% in China. Central Banks rates are still accommodative with a continued targeted slow-up bias in US and a possible uptick in Europe starting in 2019. China GDP grow is well away the doom scenarios, coming from a strong 2017 of 6.9%. We still see consumer confidence sentiments across Developed regions still on a high note. So, in absence of any particular temporary geopolitical risk (Siria, North Korea, etc..) the outlook is promising and blue skies look like remaining in place. Having said that, it is also true that we shouldn't forget that we do have some historical and relevant pending assignments, mainly our current and increasing high of Government Debt to GDP across many nations and in some countries still with budget deficits out of control.

Having said all these, we, as investors, need to focus on long term expectations in order to avoid playing the "price" game and concentrate on the "value" game of the capital markets. Here as well, irrespectable of the sky rocket high prices that the general media tends to portrait of the current stock market, EPS (earning + buyback) have been on the rise as well, and those current 17x P/E in USA or 14x PE for Europe, to us, still do not appear as an irrational high abnormal number from a historical perspective or more important going forward, especially if you consider as well the current/forward level of interest rates. Yes, it is true that we do not come across as many "jewels" as we used to see some years ago, but we can still find some fairly attractive investments with good allocators of capital trading at forward looking P/E that for us are at discount.

So, overall, not only the global macro perspective looks supportive for equity investments with interest rates under a fairly low band range for longer, but the fundamentals of stock picking analysis shows that there is still value to be played which is as well backed-up by conversations we have with the management of the firms we follow. As we are just seeing from 1Q earnings season in US and in Europe, capital investments are still on the

agenda, with further productivity cost reductions on top, with modest revenue growth, will bring further bottom line upward revisions in net income further down the line, which translates into attractive forward normalized P/E, EV/EBITDA or free cash flow yield to come.

In the fixed income space, we are not that keen to invest as a pure long term "buy and hold" investor, either because the needed minimum absolute threshold return is not there or because on a risk-adjusted basis we see better value and cost control on other asset classes. As a consequence, some of our fixed income investments in debt is either short term duration or relative plays such as across the 2-10 years curve, between curves or credit rating revisions.

On the alternative asset class, our focus is mainly via Long/short equity or debt plays either directly or via third party specialists. Other possible investments in the area of real estate, private equity and commodities (natural resources and/or agricultural) are of course in our radar and we do find attractive ideas.

Correlation among traditional asset classes has been increasing in recent years. What impact is this trend having on your portfolios? Have you increased the use of alternative investments?

Bühler: We are running an adaptive asset allocation model which we consider an alternative investment. We are not so much looking at longer term correlations, but we rather look at a horizon of 1-3 months. Lately, we have seen that, as stock markets corrected, government bonds were recovering, so we have some negative correlation contributions that we like. Our models are improving the asset allocation amongst different traditional assets considering both correlation and volatility. This keeps us out of troubles most of the time, so that we can ride the markets that perform better. In my opinion, institutional investors need also to look for "real alternatives". Let me explain what I mean with this term. They are investments that make money when the stock markets drop (highly negative correlation), but are positively correlated in a positive stock market environment.

While I am quite confident in the markets, it looks that volatility is here to stay, at least for some time. So, apart from base allocations to traditional assets, we think that there are great diversification benefits when investing with such "real alternatives". They are mainly systematic strategies in the CTA space.

In house we run such strategies: one is taking intraday positions through futures if, according to our proprietary indicators, there is a strong enough directional move. We expect to make money with this strategy when the stock markets move in excess of 1% during the day. Another strategy takes hedged positions in the term structure of the VIX futures or trades VIX futures against the S&P futures. This strategy was able to make exceptional returns in the VIX squeeze on the 5th of February of this year.

Silva: It is a fact that correlation between credit, equities and interest rates have increased over the last 3-5 years and have made it more difficult to build all weather portfolios. In order to reduce this correlation and as we mentioned above, over the last 6 to 9 months we have increased our allocations to alternative investments through three buckets: Equity long/short, Event driven strategies and uncorrelated strategies (mainly Systematic managers). With the use of these three pockets we have targeted a reduction in both the overall beta and correlation of the portfolio to global equity markets to around 0.3 and 0.5, respectively. We have also increased the use of an option hedging overlay in order to protect the portfolio during market corrections in order to reduce the downside capture while maintaining the ability to participate on the upside.

Torres Lang: It is true that higher correlations across asset classes, especially between debt and equity, has been the norm in recent history and, as you well pointed out, that makes portfolio construction based on some type of mean variance optimization (MVO) in order to arrive to an efficient frontier (Markowitz, Black-Litterman, Reverse Optimization, Resampling,…) less manageable since the theoretical diversification benefits of mixing various asset classes which are theoretically not there at the start of the process. That could actually provoke that you end up over leveraging your position and eventually creating a potential time bomb if a more normalized level or as always some needed stress test scenario considerations are not taken into consideration.

Under that search for adding new de-correlation features as well as "returns" of course, to a balance portfolio, it is true that we have seen a huge increase in appetite for private equity and debt capital raising and investments. Here we need to alert our reader, that it maybe that part of that theoretical attractive un-correlation feature which may come from the "stale" valuation dynamic of the valuation process and less from real un-correlated/idiosyncratic characteristics of the investment. Anyhow, we have not being isolated, we have also seen the attractiveness of such asset class. The till we have done to make it really complementary to a balance portfolio has been to really look for investments in private equity that are out of the world of the correlation matrix of the mainstream investments. To give you one particular example, we are working on a Cuban industrial private equity fund, Buenavista FCR, that due to the idiosyncratic of the Cuban transformating economy we believe it may add not only returns but also that much needed "real" de-correlation features to a portfolio.

How do you use ETFs in your portfolios? What kind of ETFs do you use and why?

Bühler: We are using some ETFs in our allocation. They help us in getting exposure in markets where there are no futures to invest in or where it is cheaper (tighter spreads). With ETFs we can allocate also to high grade credit, convertible bonds, emerging market debt, REITs, MLPs and even cryptos. Since we are sensitive to our execution cost, we only use ETFs that are traded with a sufficient volume on an exchange, which excludes most of the Smart ETFs.

I also want to add something to the topic of factor investing. Many investors have been disappointed on what they received when investing especially in Value funds. When you are told that you invest in stocks that are "60 cents on the dollar", then you would also assume to lose less

than the overall market in a crash or bear market. Value in that sense has clearly disappointed in the Financial Crisis of 2008. On the way down, this approach had a "negative momentum" tilt. What I mean with this is that stocks that went from bad to worse (especially stocks in the financials) got selected but their internals deteriorated as the crisis unfolded. Value should always be combined with Growth and if other factors like Momentum are added in the portfolio, then it looks more promising.

Silva: We do not use ETFs very frequently; normally we use ETFs as a way to quickly gain access to a particular region (or sector) while we are identifying the managers that we believe can generate alpha over the medium term. We are worried about the potential snowball effect that some of the high yield ETFs can have in credit markets and by extension in equity markets if liquidity evaporates quickly and bid-ask spreads widen considerably. We believe that in this situation active managers will be able to extract an additional source of alpha that ETFs won't be able to due to their passive approach.

Torres Lang: It's a work in process for us at Solventis. We have being used to implement our own direct investment till in our direct investments in equity Solventis Eos European Equity Fund/Sicav which is a Value Style investment approach and the same could be said for other products that we run such as our Spanish Direct SME leasing private debt fund, Spanish Direct Leasing Fund FIL, or our L/S equity fund of funds, Solventis Apolo Absolute Fund FI, and in essence creating our own ETF replica (style, factorial, market cap or Smart beta ETF) but it is true that, with the increasing number of ETFs niched varieties and sometimes, lack of liquidity in the underlines, we will be looking more deeply into the ETF market in the years to come. In particular, we are having another closer look in some thematic ETFs in the area of robotics, climate change and health as well in ETFs in emerging corporate debt. We will be glad to see an ETF, going back to your earlier question of correlation, that simply provides return on correlation index/asset class pairs, etc.

More and more investors care about sustainability aspects of their investments. Do you pay attention to these factors?

Bühler: Since we are rather focusing on indices and not single stocks in our Adaptive Asset Allocation, we can't really implement the sustainability aspect. One exception was PCY, the emerging markets sovereign debt ETF. My concern there would be if they would buy up new emissions from Venezuela that would prolong the time, the regime can stay in power, the monies would be misused and it could increase the suffering of the people. But since US institutions can't buy such issues anyway, that concern is gone and we also don't have any signal to buy this ETF anyway.

Silva: We like to see our investment managers include this type of approach in their process and try to persuade the management teams to be more respectful with the environment as well as return to society some of their profits. However, we also have an open-minded approach and believe we are remunerated on our ability to generate risk adjusted returns above market expectations and therefore if a tobacco company is well managed, with good dividend payout ratios, solid balance sheet, good corporate governance, good ROCE and stable cash flow we are more understanding.

Torres Lang: Yes, all the added features of SRI is something we are monitoring closely and will be most likely an increasing feature in our valuation process when looking for direct investments as well as third party products. It is not only a trend, marketing included, but a possible plus of better returns for the long term. Our more sophisticated investors do ask for such features and in more recent years also our mass affluence investors. We, as portfolio manager of third party funds or direct investments, are increasing and including such features in our due diligence/analysis process.

On the same note, the Buenavista Fund FCR which I did previously mention, for some investor is considered an "impact investment" since it will be investing in industrial development projects in Cuba in exclusive co-investment with leading industrial players in order to capture the new "actualization" of the island economy. These selective new joint ventures, partly participated by the Cuban state, should benefit from the fast-growing tourist & related industries, providing high quality locally generated products and services within local human capital.

Currently, what type of products and strategies are you looking at and why?

Bühler: We are looking at the universe of liquid futures to cover the international markets that we want to be able to invest into. In areas where such products are not available we are looking if we are able to find liquid ETFs that we can trade at reasonable costs. If I had to run a big diversified institutional portfolio that doesn't need daily or even monthly liquidity, I would be looking to add some investments where I can get some illiquidity premiums: part of the fixed income would go to direct lending, mortgages and some allocations in the equity space would go into private equity when interesting opportunities arise.

The crypto space also looks interesting to us since it has interesting movements. We see price movements in this space on a daily basis that in traditional assets would take weeks and months, however a lot of money can be made or lost. In my opinion a very small allocation of 1-2% of the portfolio to hedge funds in this space makes sense after having done a proper due diligence on them. But I would always be looking to have a big portion of at least 20-30% in "real alternatives".

Silva: In general, we are spending a lot of our time analysing how the portfolios will behave under different stress scenarios. We have focused most of our research efforts on alternative strategies so we can reduce the overall correlation and beta of our portfolios to credit spreads and equity markets.

Torres Lang: We are always looking for great products either in the form of funds, ETFs, listed equities, etc, but more important to us is the alignment of asset manager's/executive board with performance, independent of investment style, geographic or the till investment process. It is mandatory that they can show us a transparent and understandable investment process with recurrent returns above their category/benchmark classification.