# Investment Policy

MORA WEALTH MANAGEMENT

January 2016

# Hope vs. reality? China's economic rebalancing

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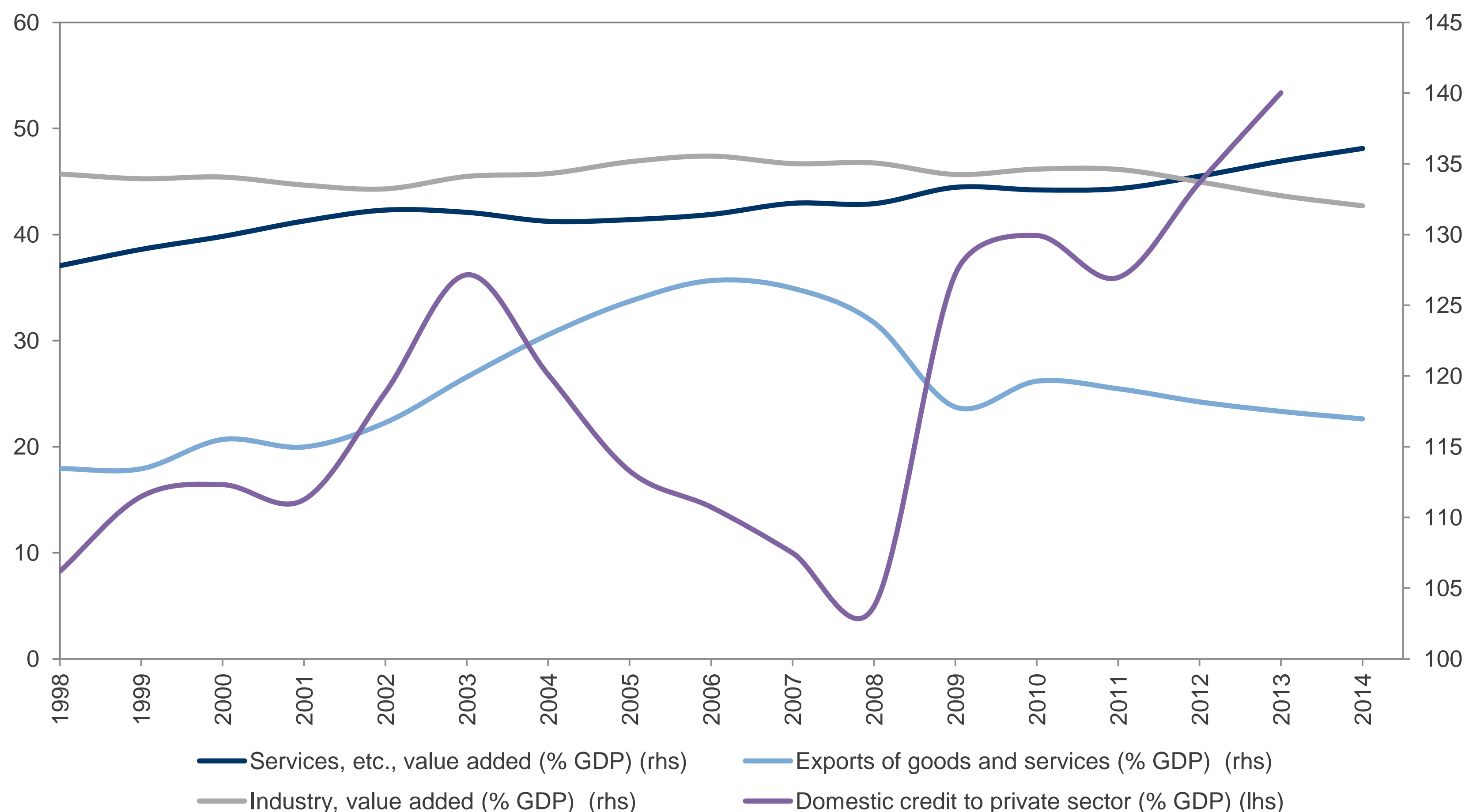


- The debate about the transition from the **"old"** economic model based in **investments**, **industry and exports**, towards a **"new"** economic paradigm driven by **services** and **consumption** in our view has more of hope than reality. First of all because no large country has made such a transition in a very short period of time
- Moreover, the pick-up in services is greatly influenced by the growth of **financial services** as a result of a sharp credit expansion, which cast doubts about its **sustainability**

Source: World Bank – World Economic Indicators

# CNY in a reversing trend

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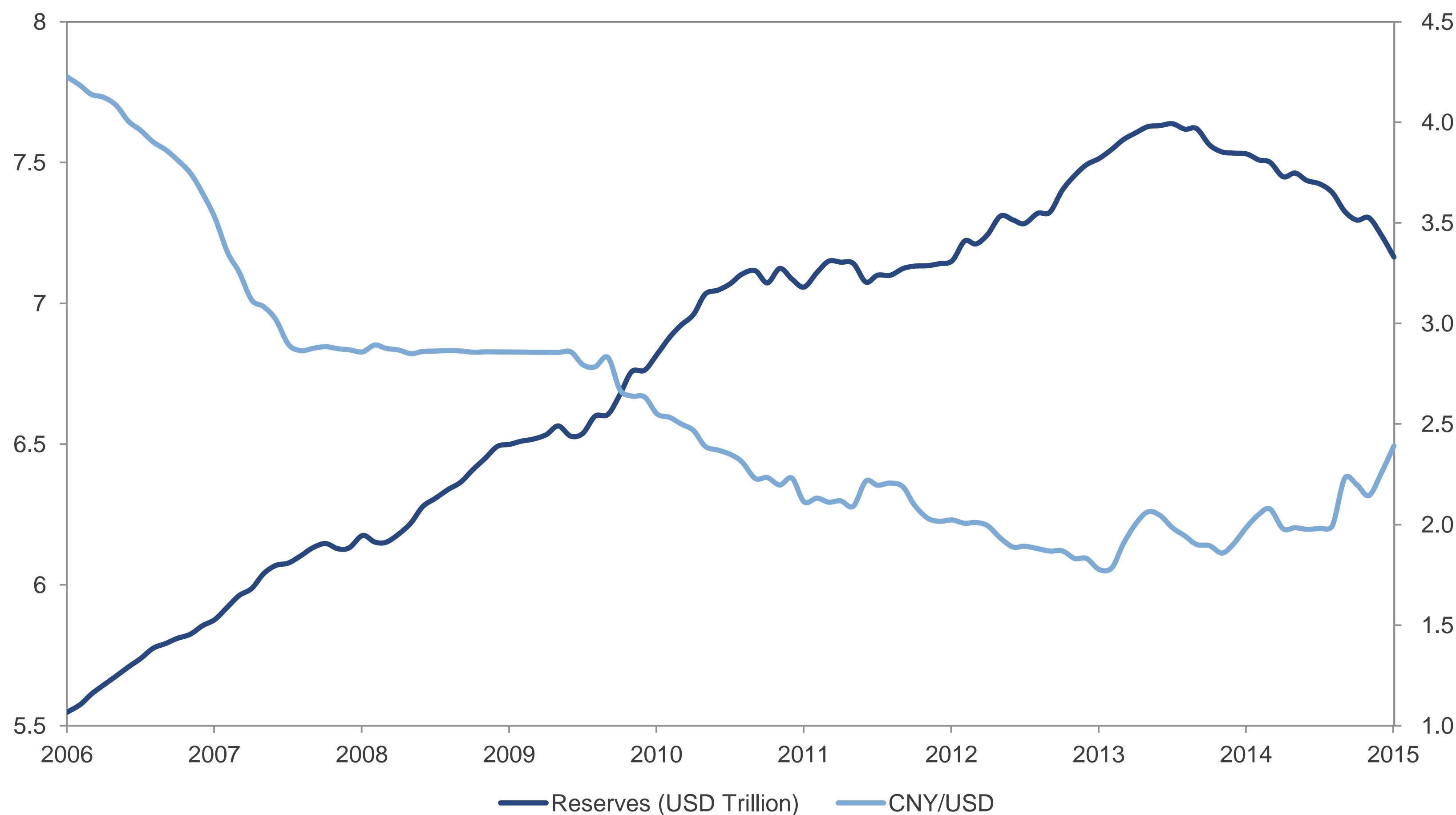


- The long time accumulation of **reserves** by Chinese authorities has been a result of a positive current account balanced coupled by currency interventions to keep a **weak Renminbi**
- A reversal of this trend started in 2013 as Chinese exports **started to stagnate**, and reserves had to be used to keep the value of the currency instead of curving its appreciation
- The **strong capital outflows** the country is currently experiencing is further accelerating the decline in investments

Source: Bloomberg

# Commodities as a leading economic indicator?

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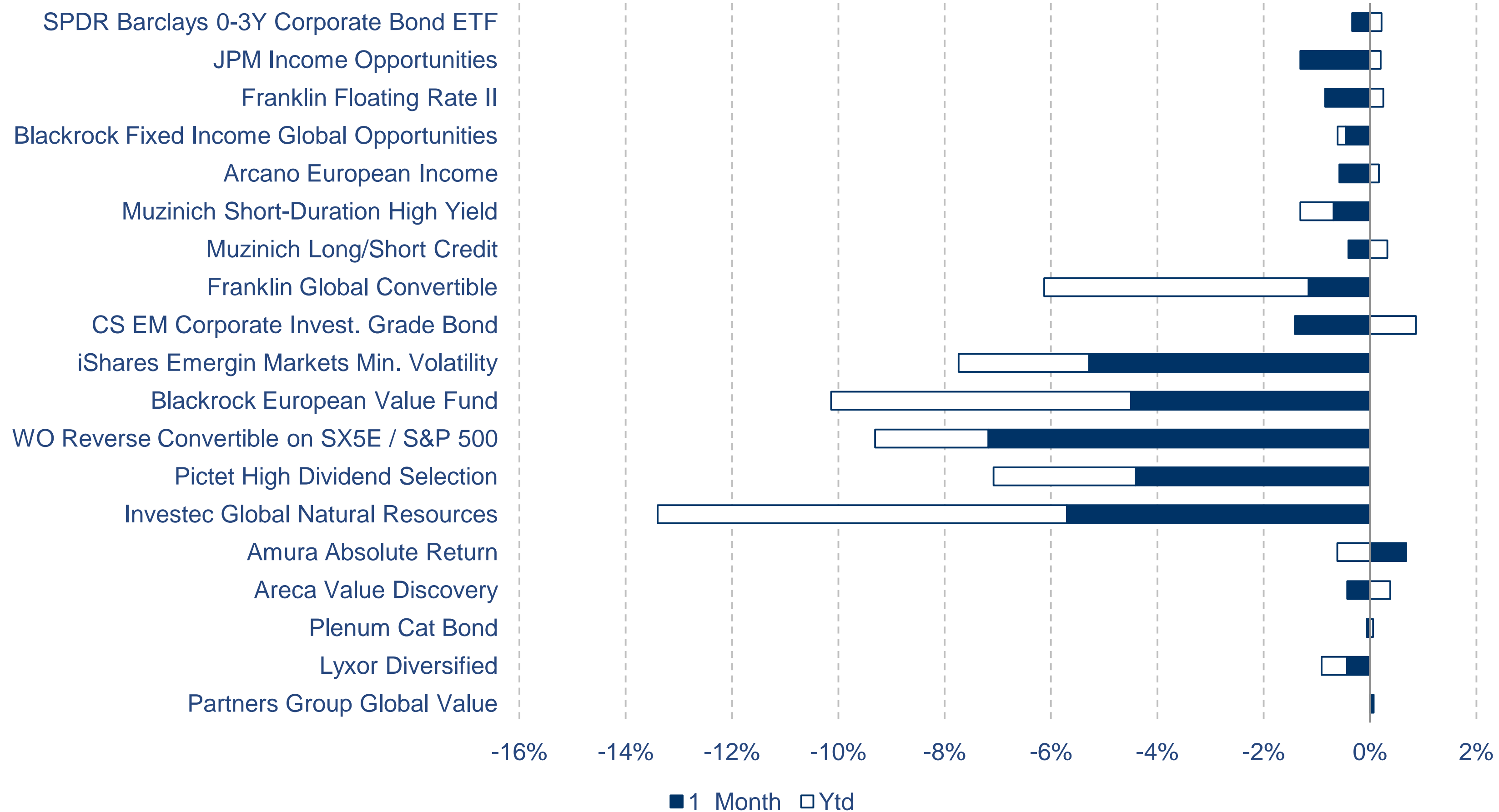
- The slump in commodity prices is both a function of **excess supply** and a **deceleration in demand**. The former has worsen due to the **OPEC's inaction** and the addition of **new suppliers** to the market, whilst the latter has been exacerbated by **speculators** betting on a sharp economic decline
- The prices of **long-term contracts** have accommodated a large part of the decline, indicating current spot prices are becoming structural, with the **speed of the adjustment** pointing towards bleak economic expectations

Source: Bloomberg

# Sell-off in equities ameliorated by low correlation






- The increase in **correlation** between **equities** and **credit** witnessed in August has **not repeated** during January's sell-off
- **Alternative investments** have continued proving its value as a source of **diversification** and **low volatility**

Source: Bloomberg as of January 18, 2016

# Model portfolio de-risking process continues

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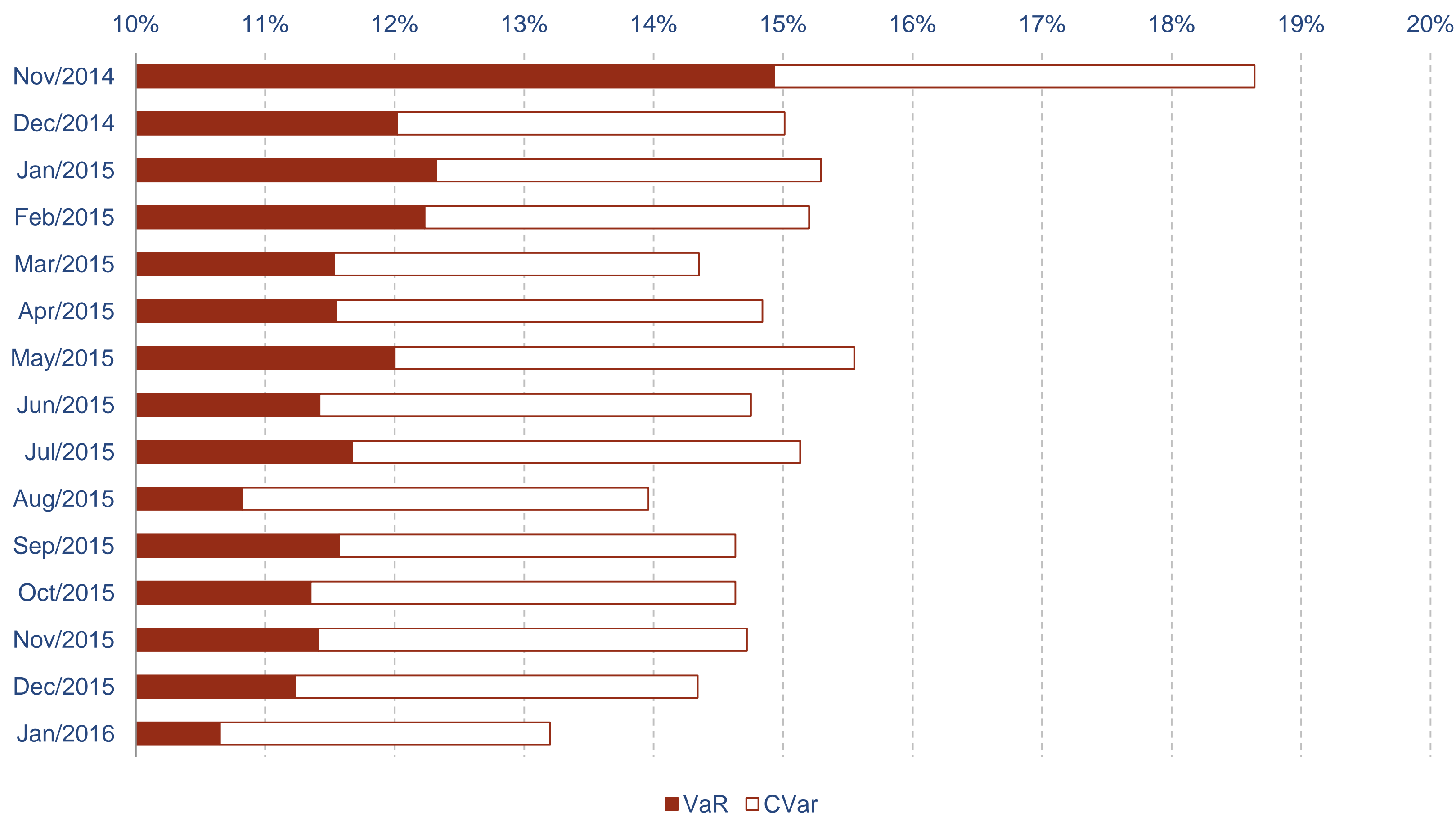


- Since **one year ago** the model portfolio has been significantly **de-risked**
- Since **August's** correction, we have **further taken out risk** from the portfolio; a process continued in **January** this year by further **reducing exposure to credit** (High Yield and Emerging Markets)
- The **reduction in risk** has been greater than that indicated by the VaR, as **volatility has markedly increased** throughout the year, which causes the VaR to increase automatically

Source: Bloomberg as of January 18, 2016

# Option markets increasingly pricing a recession

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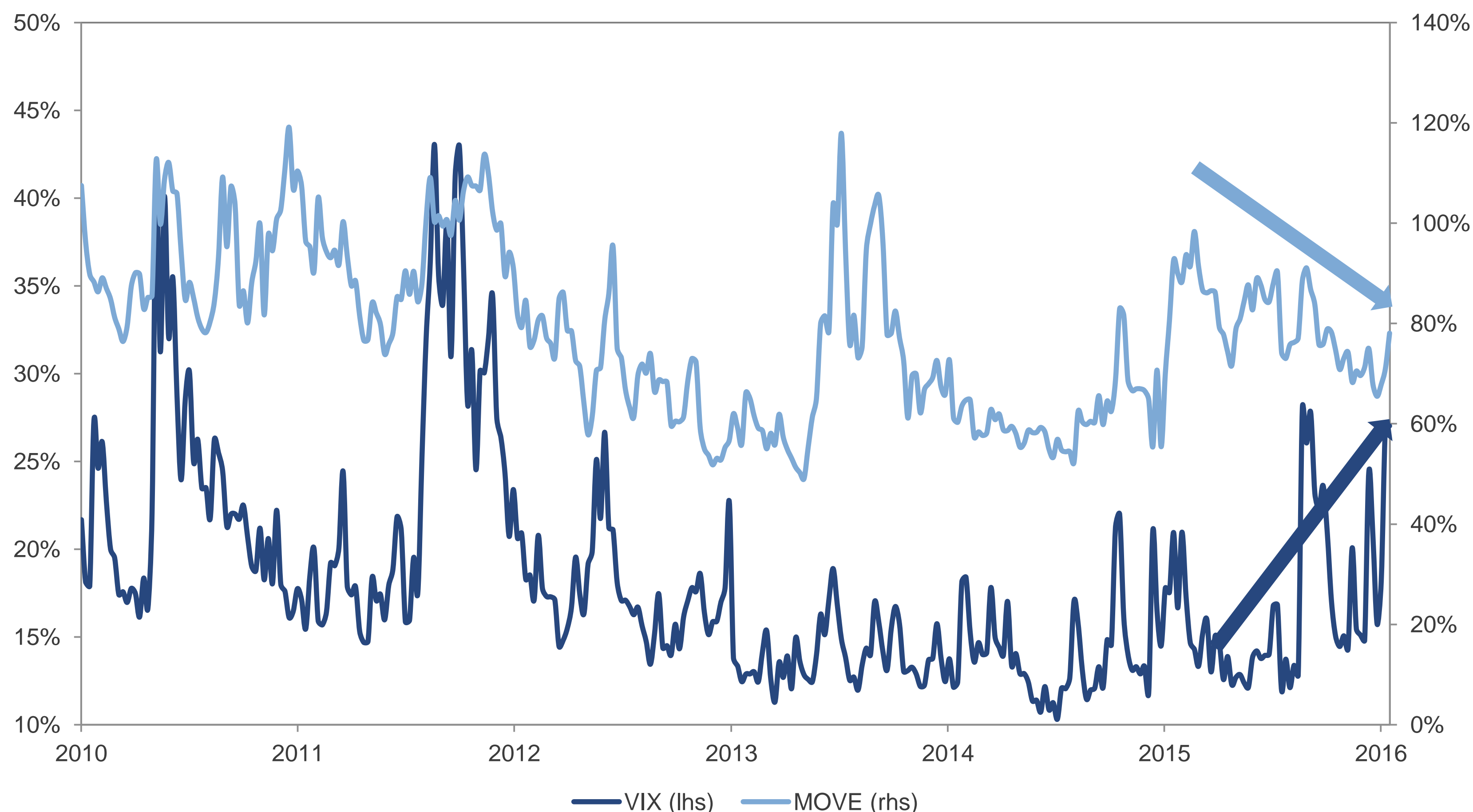


- **Equity volatility** has increase throughout 2015, and may continue doing so in the future as uncertainty about global economic growth and diverging monetary policies grows
- On the other hand, **Treasury bonds option volatility** has decreased despite the Fed raising rates in December, indicating that the bond market has anchored its growth expectations at the low end, which is being confirmed by **disappointing macro data**

Source: Bloomberg

# Three broad scenarios

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| | Scenario 1<br>Global economic slowdown | Scenario 2<br>Muddling through | Scenario 3<br>Inflation surprise |
|---|---|---|---|
| Drivers | • Global economic slowdown led by a hard-landing in China<br>• Fed delays rate rises indefinitely<br>• Strong deflationary scenario due to a combination of low growth and structural factors (demographics, low aggregated demand, deleveraging) | • Chinese authorities stabilize the market and halts economic rebalancing (weaker yuan, higher IP). US, Japan and Europe continue exhibiting low but stable growth<br>• Fed rise rates at an accommodative pace<br>• Low inflation due to structural factors (demographics, low aggregated demand, deleveraging) | • Growth concerns dissipate, with economic activity accelerating in Europe and Japan<br>• Inflation in US unexpectedly increases<br>• The Fed is behind the curve and is forced to rise rates aggressively |
| Market impact | • Correction in credit due to a rise in defaults and a widening of corporate spreads<br>• Correction in equities due to lower projected earnings, though low rates will offer support<br>• Sovereign and IG credit to profit due to flight to quality and the continuation of an ultra-loose monetary policy globally<br>• USD neutral to weak as flight to quality is counterbalanced by low interest rates<br>• Commodities to remain depressed | • Equities recover moderately, particularly in Europe<br>• Credit spreads remain stable as the credit cycle is further elongated<br>• Sovereign and IG suffer as monetary policy is progressively normalized<br>• USD appreciate moderately due to higher interest rate differentials<br>• Commodities remain weak in short term, but rebound in long-term as supply and demand balance out | • Correction in equities due to higher rates. Impact will be mitigated if higher inflation is the consequence of an acceleration in growth<br>• Sovereign and IG bonds will face steep losses due to higher rates, particularly if long-term inflation expectations rise<br>• Corporate credit will correct moderately if inflation comes together with higher growth<br>• The USD will appreciate, particularly against those currencies facing deflation<br>• Commodities will gain from higher inflation |
| Probability | 40% ↑ (+5%) | 40% ↓ (-5%) | 20% |

**Short-term catalyzers**

Chinese QE, Fed pauses, macro-data (particularly in China) showing resilience

**Other risks**

Commodity prices lead to political destabilization (Russia, Saudi Arabia, Iran, Venezuela, etc.), US elections, Greece, Terrorism, Brexit…

# Where to shelter?

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- The only good news of the current investment environment is that with the **widening of spreads** that has taken place since mid 2013, **investment grade corporate debt** in USD offers now a **favorable risk/return**
- On the other hand, **treasury rates have also picked up** with the exit from a zero interest rates monetary policy by the Fed, which provides a higher yield base
- Nonetheless, we prefer **short maturities** over long ones in order to have low interest rates risk exposure

Source: Bloomberg

# Tactical positioning

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- We remain extremely cautious in **fixed income** due to a very unattractive combination of risk and return. We no longer **favor credit exposure** as we think the macroeconomic picture has deteriorated significantly. On the other hand, **high quality bonds** – particularly **corporate investment grade** – have turned attractive following the widening in spreads. In this context:
  - **Liquidity** of the underlying instruments has to be assessed when investing in mutual fixed-income funds
  - **Low duration** limits the impact of interest rate rises
  - **Currency hedging** is needed. Unusually high volatility erodes diversification benefits from FX exposure
- Central banks have created an environment where **valuations** are largely **dependent on interest rates to remain low for long**. Hence, the incoming normalization in US monetary policy is causing **investor anxiety**. From a **valuation** perspective, we favor **European equities** and **high-dividend stocks**
- **Alternative investments** offer a much needed source of **diversification** and (partially) **uncorrelated returns**. We recommend allocating a significant part of the portfolio to Multi-Strategy Hedge-Funds, Private Equity, Cat Bonds, Commodities and derivative strategies (covered-calls)
- A **larger than usual cash allocation** is advisable as the **opportunity cost** of holding cash has decreased dramatically, and it offers **flexibility** to enter the market in an opportunistic manner

# MWM Investment Policy

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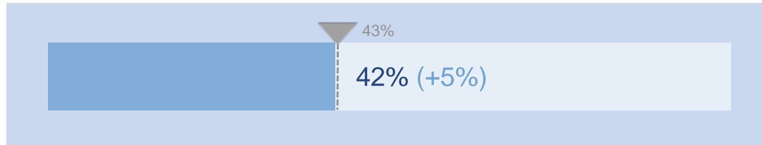
## Cash

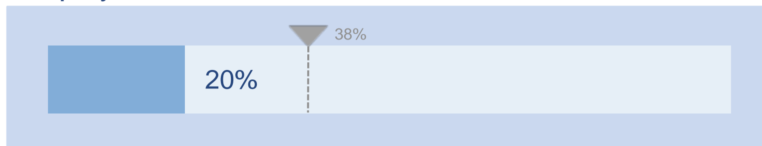
- In the current interest rate environment the opportunity cost of holding cash has significantly decreased, hence, waiting for good investment opportunities is a sensible investment strategy
- Nonetheless, we have reduced the allocation to enhanced cash strategies as we have taken a more conservative stance on credit

## Fixed Income



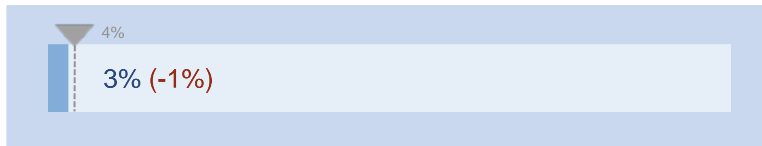

- Highest-quality fixed income in USD currently offers a better combination of risk and return since credit spreads have significantly normalized during last year
- On the other hand, high-yield, emerging markets and convertible bonds start to look less attractive in the light of the bleak global economic outlook

## Equity



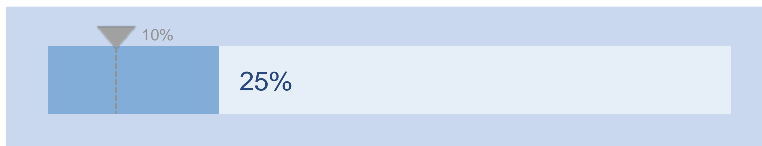

- Despite the correction experienced over the past months, equity valuations remain greatly supported by low interest rates. A potential normalization of interest rates poses a risk of returning to lower valuation multiples
- In relative terms, Europe looks still more attractive than US and Asia

## Commodities




- The sell-of in commodities can no longer be solely explained due to an oversupply in the market, and needs also to be reflecting expectations of a deceleration in global economic activity
- Despite we think that the price decline was too pronounced and current levels may be a good entry point, we prefer to cut exposure to mitigate downside risks in case we are proved to be wrong

## Alternative investments




- Alternative investments as a source of low volatility and uncorrelated returns are more attractive than ever in the wake of the current latent risks in the market
- However, there is always a certain degree of correlation with traditional asset classes and double digit returns cannot be expected in the current environment

▼ Strategic Asset Allocation

# MWM Model Portfolio

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| Asset Class | Category | Fund | Weight | Total |
|---|---|---|---|---|
| Cash | Cash | • Cash | 6% | 10% |
| | Money market | • Mora Money Market | 4% | |
| Fixed Income | US Treasuries | • iShares Treasury Bond 3-7yr | 8% | 42% |
| | Short-Term Corporate Bonds | • SPDR Barclays 0-3Y Corporate Bond ETF | 8% | |
| | | • iShares USD Short Duration Corporate Bond | 8% | |
| | High Yield US | • Muzinich Short Duration High Yield | 3% | |
| | High Yield Europe | • Arcano European Income | 3% | |
| | High Yield Absolute Return | • Muzinich Long/Short Credit Yield | 3% | |
| | Emerging Markets | • CS EM Corporate Investment Grade Bond | 3% | |
| | Leveraged Loans | • Franklin Floating Rate II Fund | 3% | |
| | Convertible Bonds | • Fundlogic Salar Convertibles | 3% | |
| Equity | Europe | • Blackrock European Value Fund | 3% | 20% |
| | | • THEAM Quant Equity Europe Income | 3% | |
| | Volatility | • Reverse Convertibles on Blue Chips | 6% | |
| | Emerging Markets | • iShares MSCI Emerging Markets Minimum Volatility | 3% | |
| | High Dividend Yield | • Pictet High-Dividend Selection | 5% | |
| Commodities | Diversified | • Investec Global Natural Resources | 3% | 3% |
| Alternative Investments | Multi-Strategy | • EDR Prifund Alpha Uncorrelated | 5% | 25% |
| | Multi-Strategy | • Amura Absolute Return | 5% | |
| | Relative Value | • Areca Value Discovery | 5% | |
| | Cat Bonds | • Plenum CAT Bond Fund | 5% | |
| | Private Equity | • Partners Group Global Value | 5% | |

# MWM Investment Profiles

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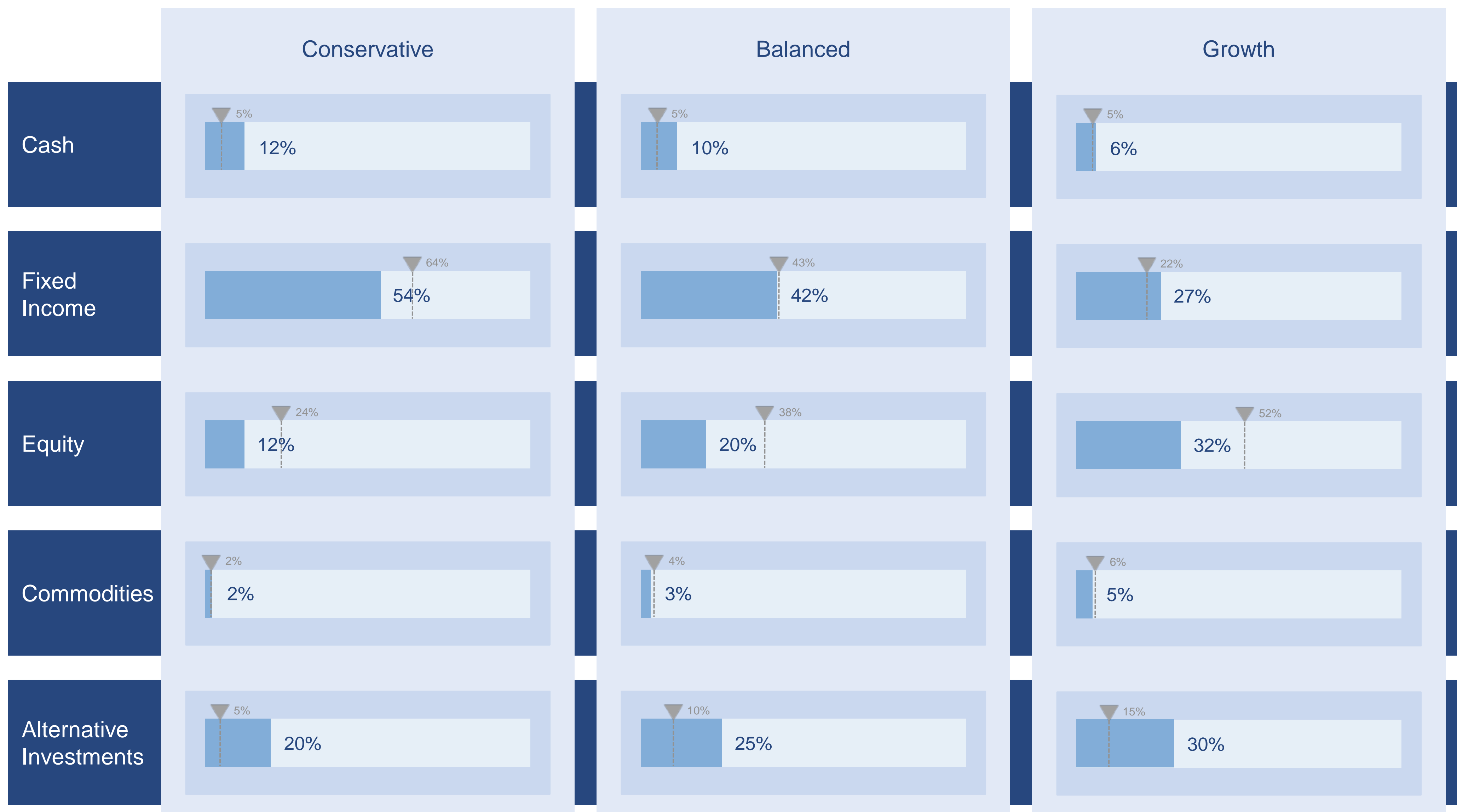


Strategic Asset Allocation

# MWM Model Portfolio – Ytd performance (Net)

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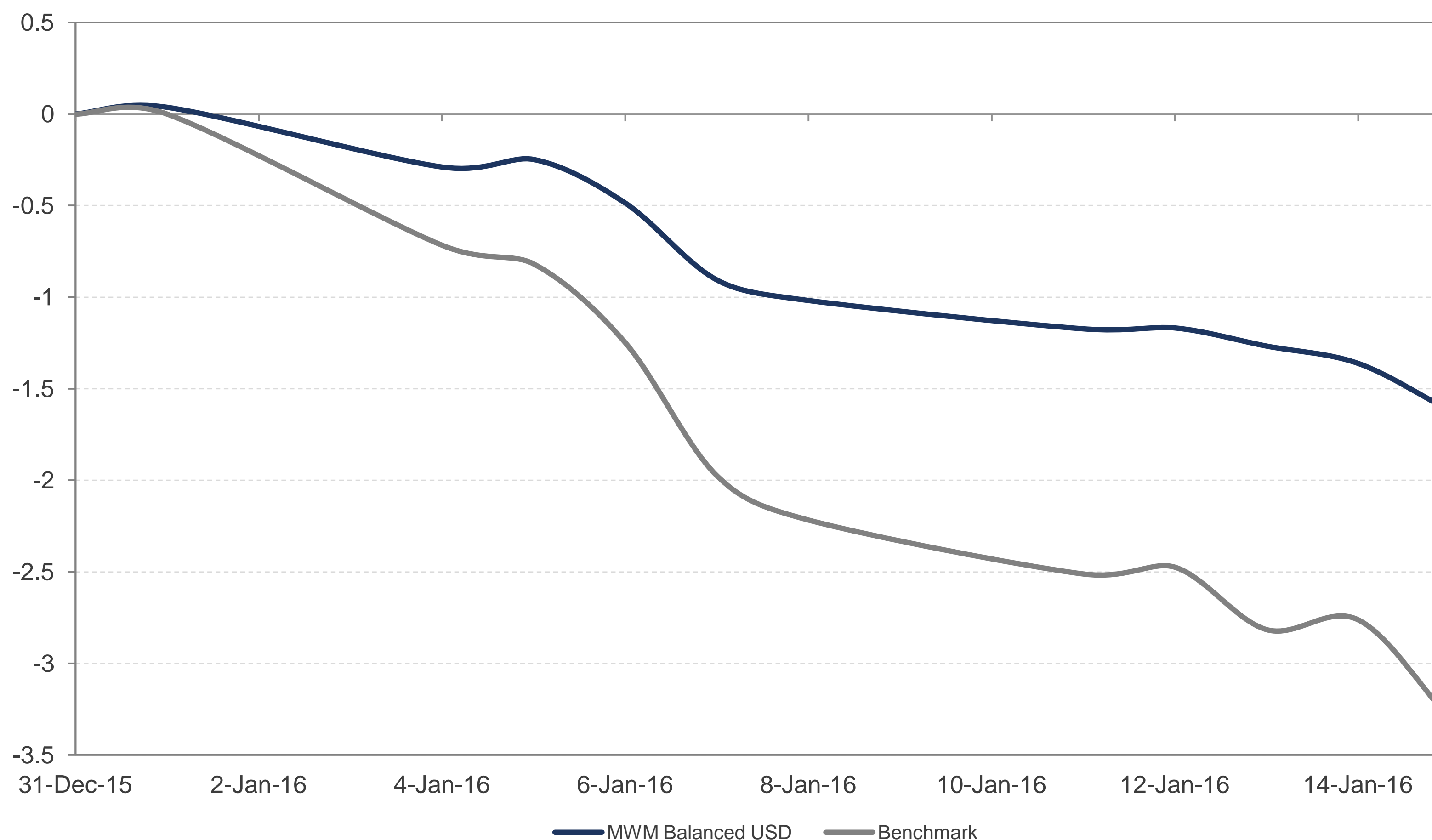


- **Total Return** (Ytd[1]): **-1.61%** vs. **-3.30%** Benchmark[2]
- **Standard Deviation** (Ytd[1]): **2.43%** vs. **4.63%** Benchmark[2]
- **Downside Risk** (Ytd[1]): **1.82%** vs. **3.37%** Benchmark[2]
- **Var 95%** (Ytd[1]): **-0.37%** vs. **-0.73%** Benchmark[2]

[1] As of January 18, 2016

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

# MWM Model Portfolio - Historical performance (1)

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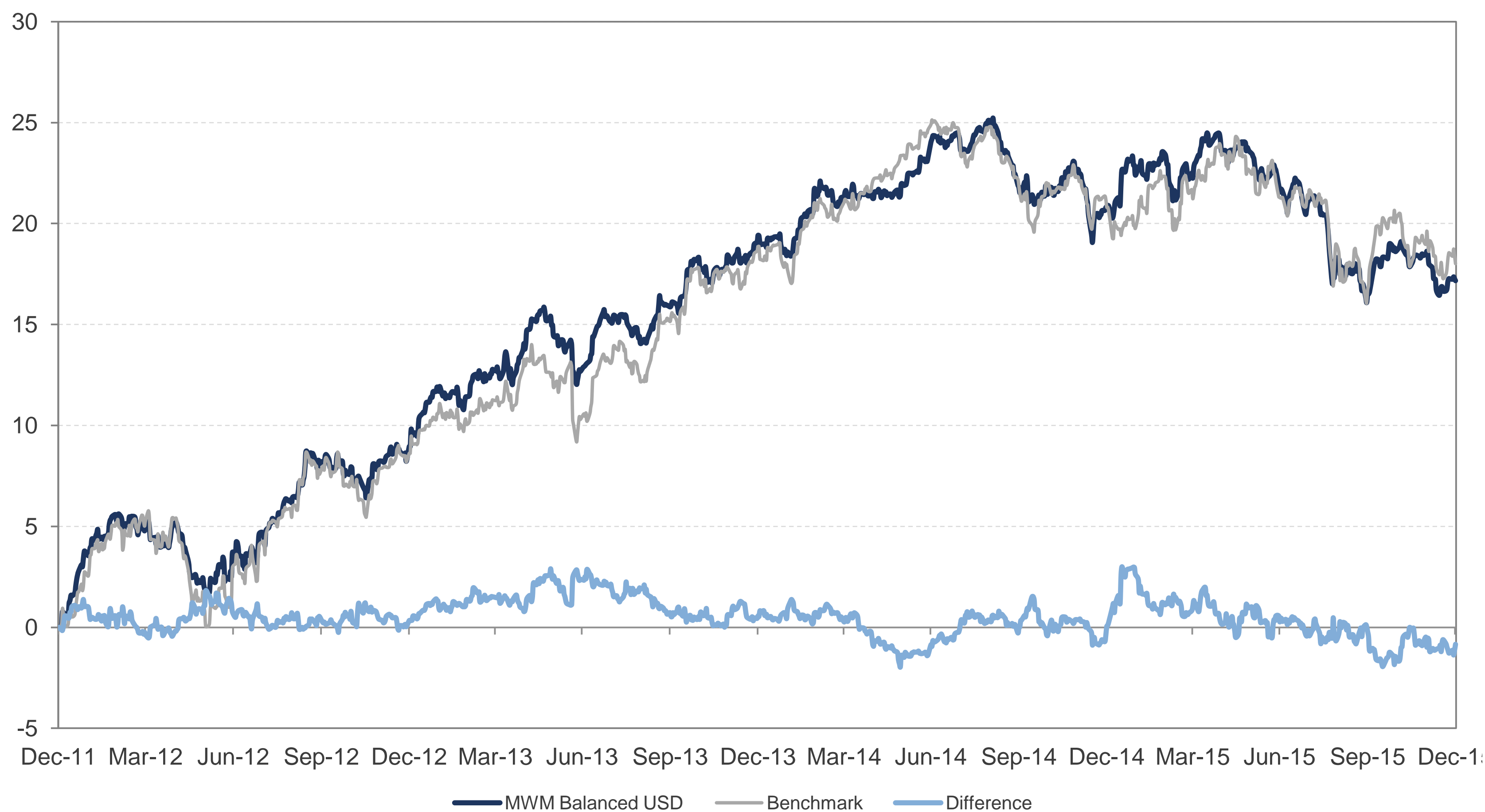


- **Total Return** (1 year[1]): **-5.55%** vs. **-4.43%** Benchmark[2]
- **Total Return** (3 year[1]): **4.16%** vs. **3.91%** Benchmark[2]
- **Total Return** (Since Jan 12[1]): **17.16%** vs. **18.01%** Benchmark[2]

[1] As of December 31, 2015

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

# MWM Model Portfolio - Historical performance (2)

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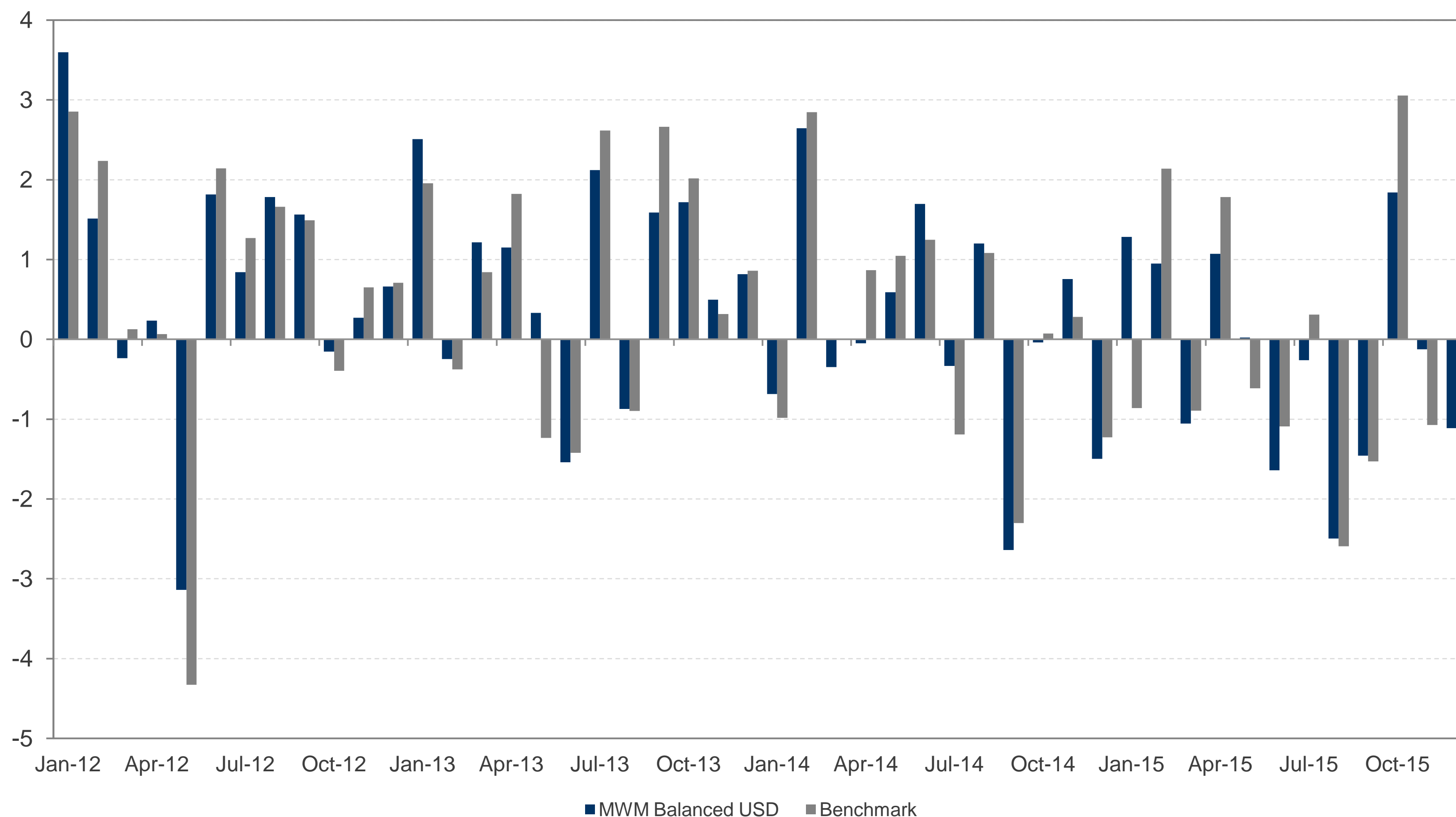


- **Standard Deviation** (1 year[1]): **4.01%** vs. **5.48%** Benchmark[2]
- **Downside Risk** (1 year[1]): **2.98%** vs. **3.92%** Benchmark[2]
- **Sharpe Ratio** (1 year[1]): **-1.37%** vs. **-0.78%** Benchmark[2]
- **Var 95%** (1 day[1]): **-0.43%** vs. **-0.56%** Benchmark[2]

[1] As of December 31, 2015

[2] Benchmark = 5% Fed Funds + 43% JPM Global Aggregate Bond Index + 38% MSCI World + 4% S&P GSCI + 10% HFRI FoHF

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