GAM Investment Meeting Notes

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Japan

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- August has so far been a very challenging month for equities around the world. Since its lows following March's earthquake, Japan has outperformed other global markets. However, this performance is clearly only relative and has to be viewed in the context of very weak global returns.
- From our perspective, the sell-off in global equities is probably due to the concern that, after the recent debt ceiling wranglings in the US and the S&P downgrade, the leeway for fiscal policy in the US is now very limited. Given recent economic data has been disappointing, having one of the economy's insurance policies taken away – whether it is used or not – is not very helpful. It suggests politicians in the US have not learned the lessons of Japan's lost two decades.
- At a time when the private sector is trying to repair its balance sheets, monetary policy is generally ineffective. This is what Japan learnt and it explains why economic data in the US remains sluggish despite QE2. In this environment, fiscal policy has to be available to take up the slack if necessary. The concern is that a Republican congress, itself held to ransom by the tea party movement, poses a risk if economic data in the US does not improve.
- Why has Japan outperformed? While economic data globally has been sluggish, the data coming out of Japan continues to beat expectations, as shown in the Citigroup Economic Surprise indices. Another factor is perhaps the performance of the banking sector. In the US and Europe, banks have been leading the market down on sovereign debt and liquidity worries. Japanese banks have less exposure to European bond markets and with loan-to-deposit ratios in the region of 70%, they suffer less concern over liquidity than some of the European or UK banks. Although only modestly, Japanese banks have outperformed the TOPIX index over the past couple of months. However, it should be noted that the TOPIX is currently only trading at approximately 5% above its 2008 Lehman-associated lows. Other global indices have enjoyed a much stronger bounce, inducing a degree of profit-taking, whereas in Japan, there has been very little upside to capture.
- First quarter 2011 results have been and gone. Sales fell 2% and pre-tax profits fell 15% year-on-year as a result of the earthquake impacting business. However, aggregate first-quarter profits have achieved 53% of their aggregate first-half forecasts, which suggests to us that forecasts look conservative, especially given the trends in industrial production.
- Everyone feels battered and bruised after the past few weeks. Following such a sharp sell-off, it is perhaps not surprising that investor sentiment and risk appetite data are at oversold levels. Barring another 2008 Lehman-type crisis, these indicators suggest downside is limited.
- Japanese equities are now trading below book value on current estimates of 12.1x earnings and an ROE of approximately 8.2%, with bond yields hovering around 4%, although these figures may come down if weakness continues. With equity valuations on the low side, the current alternatives are yen bonds which are yielding 1%, or on a global level, US Treasuries, which are yielding 2%. If US Treasury yields fall to Japanese levels, you only have a 10% upside on a capital basis and a 1% yield. So versus bonds, equities look attractive, provided we are only facing a mid-cycle slowdown rather than a prolonged economic deterioration.
- Japanese companies continue to have record levels of cash on their balance sheets. We have seen a modest pick-up in domestic M&A activity over the last few months. Some of the larger brewery names, such as Kirin and Asahi, are looking overseas for opportunities, but the majority of acquisitions have been within Japan. There has also been a slight rise in share buy-back activity, with approximately 79 firms announcing buy-back programmes over the last month.
- Export figures have been picking up following a sharp decline in April, although it is difficult to distinguish between rebuilding efforts following the disaster and activity that represents a genuine increase. However, most of the weak economic figures we are seeing in the press are the outcomes of surveys and estimates rather than actual readings – which is doing nothing to calm the market's anxiety.

Convertible Bonds

Ben Helm, Investment Manager, GAM Convertible Bond Hedge Fund, GAM Star Global Convertible Bond

- We came into July and August with the view that we were facing a possible slowdown in growth, but not a recession. We continue to hold this view. There is currently a bit of a tug-of-war going on between the economists, who are focused on the top-down fiscal issues such as European sovereign debt, and the equity analysts, who look purely at companies and their prospects. For example, in the last month, the earnings expectations of DAX-listed companies for the next 12 months have been lowered by 1%, whereas the DAX index itself has dropped 23% in absolute value, which seems slightly extreme. The forward looking P/E ratios of Euro Stoxx companies are now at the same levels as in the fourth quarter of 2008.
- It is clear that the market is oversold. GDP expectations for 2012 have generally been lowered by about 1% across Europe and more widely, indicating a slight slowdown in growth, but not at the cataclysmic levels that are currently being priced into equity markets.
- Cash currently accounts for approximately 15% of European balance sheets, which makes it very surprising that the iTraxx Main index is currently trading at 165. However, debt markets

tend to move on the basis of immediate demand and are prone to knee-jerk reactions.

- Convertibles have fared reasonably well during the August downturn, with less forced selling than in July although one or two of our names – such as the TUI Travel convertible – have been slightly affected by redemptions.
- One positive contributor to our performance this month was Autonomy, which is a UK software developer. We had a substantial holding in the bonds of the company. As with all convertible bonds, it had a ratchet, which is a make-whole of the long-dated option in the event that the company gets taken over. There is some irony in the fact that Autonomy is to be taken over by Hewlett-Packard. In the late 1990s and early 2000s, Hewlett-Packard, along with Compaq, was one of the leaders in hand-held devices, but it dropped the ball and now finds itself predominantly a software company. This kind of shift in strategic focus is an indication of what is happening to companies these days.
- Given events of the past month, we have shifted our stance from being cautiously optimistic – based on our expectation that a recession would be avoided – to being focused on capital preservation. GAM Star Global Convertible Bond has had its options rolled down six times in the last month, which is a record for our strategy in the last six years, including in 2008. Given we are seeing quite remarkable downward moves in the markets, we are not particularly interested in running high levels of risk at the moment. Instead, we are seeking to position our portfolios for a potential equity uplift in the fourth quarter of the year. While we do not expect equities to return to their peaks of earlier this year, we do expect to see a slight correction, with earnings underpinning valuations. We are keen to capture any market upside and so it clearly does not make sense to eradicate all risk from the portfolios. In this environment, we believe it is important to focus on fundamentals and own the names that are likely to benefit from ongoing trends, such as continued growth in Asia.

Source: GAM