GAM Investment Meeting Notes

For accredited, professional, institutional and/or qualified persons only

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Japan

Ben Williams, Senior Investment Manager, GAM Star Japan Equity, GAM Japan Equity, GAM Japan Equity Hedge

- The key reason to buy into the Japanese equity market is the plentiful availability of stocks with high levels of cash on the balance sheet and high free cash flow yields. This has begun to benefit shareholders through both rising dividends and a greater number of share buybacks, as we have witnessed this year.
- However, as mentioned last week, the Olympus scandal is one potential spanner in the works for the market. To unlock the value in Japanese companies, investors have been hoping for improvements in corporate governance and shareholder returns. The revelations of a very large payment to unspecified facilitators of an acquisition and massive premiums paid for small company acquisitions in Japan suggest that, for Olympus at least, corporate governance is broken. The fact that the authorities had been dragging their feet in pushing for a probe raises concerns that this is an endemic problem. Almost all the valuation data in Japan is compelling but if the cash and cashflow has little chance of making its way to its rightful owners then a crucial piece of the jigsaw is missing.
- The best case scenario is that this scandal will encourage domestic investors to push for greater oversight of management in Japan, recognising that the current system is not working. The fact that large domestic shareholders and now regulators are pushing for greater disclosure is encouraging after a slow start. If however the issue is swept under the carpet, we feel this would be a big backward step for Japan. We will be watching these developments closely.

Pacific

Michael Lai, Investment Director, GAM Asia Equity, GAM Asia Equity Hedge, GAM Star Asian Equity, GAM Star Asia-Pacific Equity, GAM Asia-Pacific Equity, GAM Star China Equity, GAM Greater China Equity Hedge, GAM Star Emerging Asia

- In the past three weeks Asian equity markets have recovered some losses and bounced back from the lows of early October. We are now roughly at the level that we were in mid-September, but still far from the levels of June/July. Noticeable gainers include Korea and Indonesia, with the former being a highly cyclical market, while the latter was a favoured trade of emerging debt investors and had sold off on the back of overcrowding. Our view all along was that nothing was fundamentally wrong with Indonesia. In terms of sectors, cyclicals – such as autos, refiners and IT companies – have performed very strongly. Examples include Samsung Electronics, Hyundai Motor and Kia Motors, all of which have recovered most losses from August and September. We are also now in the midst of the third-quarter earnings season and so far earnings-per-share downgrades have been muted. In-depth meetings with company managements will provide further clarity in the coming weeks.
- We are encouraged by the latest market moves in Asia on Wednesday. It really was the first day that markets gained without reacting to earlier trading on Wall Street or in Europe. This was partly down to comments by China's finance minister about the need to fine-tune monetary policy – a hint that policy has been too tight. However, there is still not much room to manoeuvre, as inflation remains elevated. The authorities could redirect credit to small and medium-sized companies and to the private sector in general, which would be positive for equity markets.
- Chinese banks have been affected by negative sentiment, relating to the quality of their assets. There have been concerns over the property market and lending to local governments. Our view is that regulators have been sensible in asking banks for a non-performing loan coverage of 300%, meaning that for each dollar of potentially bad loans on their books, the bank must hold three dollars against that. In the West, that ratio is more like 60-70%. Furthermore, balance sheets are relatively unleveraged. The typical loan-to-deposit ratio for Chinese banks is in the region of 65-70% – certainly not more than 100%. There is therefore no need to worry about short-term financing issues. Where banks are involved in the property sector, again we feel comfortable due to the sensible loan-to-value ratios that they have imposed, which averaged around 65% in the past. Even assuming a correction in the property market, we do not expect that to spill over into the banking sector. Nevertheless, there is opaqueness with regards to asset quality, which relates to the enormous credit growth in the past three years or so. Including contingent liabilities, off-balance sheet items and lending to local governments, bank lending relative to GDP has increased to around 150%. That has clearly spooked the market and is a reason why the sector has underperformed. However, we are sanguine and do not expect banks to become a systemic risk for the Chinese economy overall.
- GAM Star Emerging Asia launched one month ago and is now around 62% invested. We are gradually investing the remainder on weak days to add individual stock positions. By country, Singapore represents around 19% of the fund's assets, Indonesia 16%, Thailand 14%, Philippines 8% and Malaysia 5%. By sector, consumer discretionary and staples make up around 17%, financials 16% and telecoms and industrials each around 9%.
- The floods in Thailand present a significant headwind to the country's economy, but this should be a relatively short-term phenomenon. We are therefore using the market's weakness to add to some Thai positions, for example in the consumer sector. Once the floods recede, the banks, which reported quite strong third-quarter figures, should also benefit from reconstruction activity.

Long Only and Absolute Return Fixed Income

Tim Haywood, Investment Director, GAM Absolute Return Bond Fund, GAM Star Dynamic Global Bond

- GAM Absolute Return Bond Fund has had a reasonable month so far, gaining approximately 1.3% (as at 18 October). The disconnect between economic outcomes and market expectations has been particularly stark in recent weeks, as illustrated by the Citigroup Short Term Macro Risk index, which hit maximum pessimism on 22 September before retracing substantially. Since late September, market performance has been led by credit, due to spread contractions, and convertibles due to their link to equity markets.
- On a one-month view, most of the lower-rated high-yield markets have returned around 4%, with gains largely occurring in the past week. The week also delivered the highest inflows into high-yield bonds since August 2003. Such occurrences indicate there is a lot of cash sitting on the sidelines, which investors, including hedge funds, are being forced or tempted to put to work, resulting in increasing demand for certain assets. That said, there is a nervous atmosphere ahead of the next round of EU discussions regarding the debt crisis. Indeed, we have taken off our cross-over long position following a tightening of 30 bps towards subordinated financials.
- The funding pipeline for banks is finally starting to loosen up following no issuance in August or September. Many bonds are being offered at premiums of as much as 30-40 bps in order to attract demand. We have not seen the raft of senior financial bond issuance that we might have expected, but as banks remain unsure about capital requirements their reticence to avoid issuance is understandable.
- Currently, there have been few defaults – politicians are determined not to let institutions fail, whatever the long-term cost. However, this scenario may be tempered by future events in Greece. For the moment, we have been buying short-dated US dollar bonds issued by the top-rated US banks in order to take advantage of yields of up to 5-6%.
- Our Greek exposure is approximately 1% long with 1% of credit protection, and we are constantly assessing the risks associated with such a position to avoid future pitfalls. We believe the latest debt resolution proposals bode well for the fund. A 60% haircut to Greece's debt, with no penalties for those not entering the tender, should mean we either get paid on the bonds were own, or our CDS will trigger, meaning we should not lose, and stand to possibly gain. In GAM Star Dynamic Global Bond, the 1% position in Greece is hedged by bank protection.
- New areas we are looking at are largely based on real estate, particularly in Canada – a hitherto 'safe' market. We have learned that 120 tower blocks are being built in Toronto, indicating the country is possibly facing a real estate bubble. Obtaining protection against such a theme is proving challenging. In contrast, the protection we hold against the Spanish real estate market has been working well, and we are taking a more constructive view on the US housing market despite the latest release of disappointing S&P/Case Shiller numbers.
- We remain long credit risk, long equity risk and have hedged out almost all of the duration risk to leave our absolute returns funds with low duration, and our benchmarked funds with maximum underweight duration. That said, our biggest bet for the final quarter of the year remains emerging market currencies. So far in 2011 they have under-whelmed, which is surprising when you look at their equivalent stock markets and CDS spreads. The Polish zloty and the Mexican peso notably remain cheap. We anticipate driving returns forward via an emerging market currency bounce-back. We have been selling Indonesian government bonds at yield lows, taking profits and exiting a crowded market.
- The Italian bond market remains a big question mark for us. The bonds are rallying in price during 'risk-on' markets and so are exhibiting negative duration. We have a small position in Italian paper, both in euros and in US dollars – the latter to capitalise on low demand in the US market.

Source: GAM