

We Predict a Riot

It's been a challenging year in many respects for the fund management sector, but does next year bring any relief? We sit down with some of London's top investment managers to find out

What surprised you most about the market in 2019?

PAUL MUMFORD, FUND MANAGER, CAVENDISH ASSET MANAGEMENT:
The surprising thing about the stock market in 2019 was the wide difference of performance of individual companies. In particular, the demise of the high street in terms of retail companies and property companies, construction companies and those with dodgy accounting were all negative performers. On the positive side, the out-performance of smaller companies was pleasing to see.

JERRY DEL MISSIER, FOUNDER, COPPER STREET CAPITAL:
I have been quite surprised by the speed and extent of the Central Bank capitulation to the market's demand for lower rates. The rush to reduce rates and contemplate further accommodative policies – despite the lack of supportive economic evidence (the US) or confidence in the efficacy of such policies (Europe) – has been surprising as well. This has resulted in a stronger recovery in risk assets than we were anticipating, with the exception of financials equities, which have suffered from the flattening of the yield curve.

SANJIV BHATIA, CIO, PEMBROKE EMERGING MARKETS – A BENNBIDGE BOUTIQUE:
We have been most surprised about how willing the markets have been to take an optimistic view on favourable trade war resolution. We believe this is the beginning of a more antagonistic relationship between the USA and China as they both vie for hard and soft power on the global stage.

CYRIL DELAMARE, CEO AT MONTLAKE:
The dislocation between equity markets and interest rates is most surprising. Equity markets have ripped powerfully

upwards in 2019, while the US ten-year rate has collapsed from 3.23% in October 2018 to 1.50% currently. Rates are signalling problems ahead, but equities, particularly in the US, just seem largely unaffected by macro factors.

RAJAT SHARMA, CHIEF INVESTMENT OFFICER, VAR CAPITAL:
After the US ten-year yields dropped from around 3.2% at the beginning of 2019, we expected it to stay in the region of 2.3-2.6%. The severity of the subsequent decline across the entire yield curve took me by surprise.

TOM RODERICK, EMERGING MARKETS PORTFOLIO MANAGER, TRIUM CAPITAL:
While neither a big bond market or equity market rally would have been surprising to see happening on its own, it is surprising to see both at the same time.

Which market sectors are likely to offer the best investment opportunities over the next 12 months?

RS: In the face of slowing global growth, companies capable of generating high revenue and earnings growth irrespective of the general macroeconomic environment will in our view continue to attract the attentions of investors. As a result, we are selectively overweight a few high growth companies in the tech space, and we maintain overweight exposure to high-quality stocks, which tend to perform better in periods of heightened volatility.

JDM: Looking at financials, credit will remain the best performing part of the capital structure in the first part of the year, as low rates feed demand for fixed income assets. I believe the market will start pricing in rate hikes again and we are likely to see coordinated stimulative fiscal policy, and this will lead to equity outperformance. ▶



► **CD:** More defensive areas of the market are likely to provide the best investment opportunities. This includes equity sectors like utilities and healthcare. We would also look for areas of the market that have high dispersion between winners and losers, which should create excellent alpha opportunities. Again, a sector like healthcare comes up as an area of the market which has consistently high dispersion.

SB: We believe that domestic consumption in emerging markets remains strong and will be boosted by growing incomes and demographics. The best opportunities are in domestic services like healthcare and banking.

Are you particularly bearish about any specific areas?

JDM: At a high level, I am very nervous about central bank overreach in their desire to find a 'monetary policy' solution for every problem. We are in uncharted territory in this respect, and the fact that we are also unfazed by the very high levels of government indebtedness means this is almost certain to end very badly. The question is when.

“ Potential hurdles for markets to overcome in 2020 include the US/China trade war, Brexit, inverted yield curves and slowing growth expectations ”

So I would avoid long duration and be cautious about any asset where valuations are dependent on unsustainably low rates and infinite liquidity.

CD: High yield credit could be an exceptionally tricky area if the market turns. The spread over investment grade is at multi-year lows and the absolute yield is also low, making these instruments highly vulnerable to a sell off, particularly as liquidity may become a problem as everyone tries to exit at the same time.

RS: High yield bonds as an asset class, both in developed and emerging markets. We think

credit spreads are not attractive enough to sufficiently compensate for the risks investors are taking by holding these positions.

TR: Eastern Europe as its success is in large part leveraged on the back of Germany.

SB: We believe industrials will continue to struggle due to global overcapacity and that Chinese industry will continue to hollow out global competitors.

What is the biggest risk to hedge fund performance in 2020?

TR: Not surviving 2019...

RS: The major risks relate to political or geopolitical events. We are concerned about the potential binary outcomes of a few specific issues; on a global scale particularly trade wars and the relationship between the US and China, and in the European context the seemingly never-ending Brexit negotiations. The Fed is also walking a tightrope walk in the face of presidential threats and growing market turmoil and could impact performance.

JDM: A reversal in policy and a move to higher rates would significantly hurt markets. This is by far the biggest risk. There are also likely to be several key elections where the outcomes – and the extreme divergence in economic implications – will lead to increased uncertainty.

SB: Agreed. The biggest risks to hedge fund performance will come from further policy uncertainty around trade and interest rates. We believe the trade issues are part of a wider China containment strategy and there is significant room for a policy misstep.

CD: Position concentration. We are late cycle and during this phase of the market, people get surprised to the downside in their positions. Being too concentrated is a big risk. A more diversified approach tends to work better.

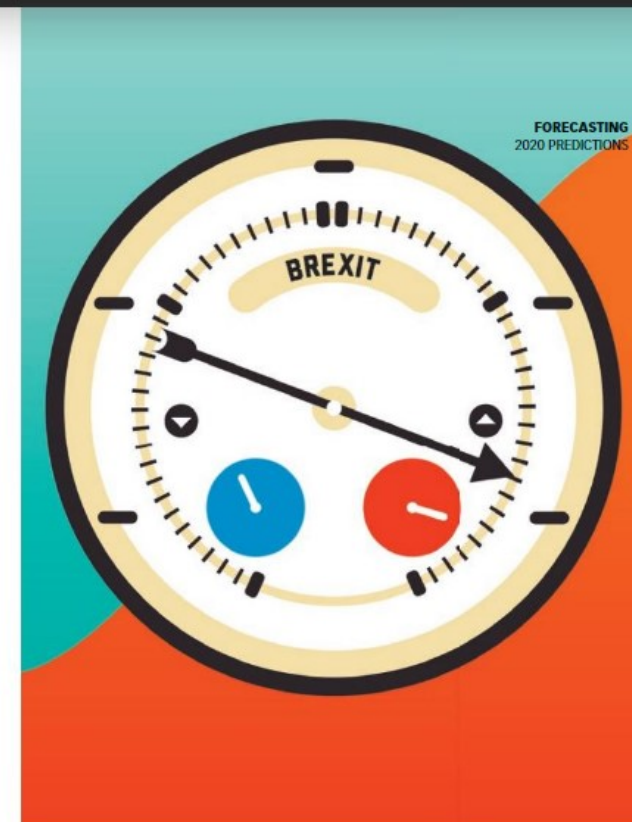
How do you expect the realisation of Brexit to impact the market?

TR: I don't expect Brexit to realise for quite some time. The most likely outcome is continued extension until there is a clear majority for any specific outcome.

RS: With the outcome highly uncertain, we expect the UK market as well as Sterling to stay volatile and returns to stay under pressure compared to other developed market peers. It's a market that we are underweight for the time being.

JDM: My central probability remains that the realisation of Brexit and the consequent reduction in uncertainty will lead to significant outperformance of UK assets, deal or no deal. The biggest threat to this outcome is a political change to a government committed to higher taxation and confiscatory policies, which would be bad for both the economy and markets.

CD: Certainty as to the road ahead will allow markets to correctly price assets. From that perspective, the realisation of Brexit should provide a positive impact to markets, not necessarily in terms of pushing equity markets higher, but in terms of allowing asset prices to be driven by fundamentals and not speculation. The actual impact on fundamentals though depends on what the realisation actually entails and



at present this is not really something in which anybody has an edge. Fundamental driven markets though are typically good for active managers, which could help their performance relative to passive indices.

What should investors expect from a performance perspective in 2020?

CD: There are potential hurdles for markets to overcome, including the US/China trade war, Brexit, inverted yield curves and general slowing growth expectations. After a strong 2019 so far, investors should lower their return expectations from more risky markets generally and focus on more defensive and alpha allocations.

SB: We think there's scope for a global deflation trade similar to 2016/17 if central bank policy is supportive and we get a reprieve from the US-China trade war. Current cheap valuations and low interest rates provide a favourable entry point for emerging markets as many downside risks are already priced in.

RS: We expect a continuation of the most recent trends from the second half of 2019, with both equity and bond markets generating considerably lower return alongside higher volatility further amplifying overall market uncertainty.

JDM: I believe markets will do better in the first half of the year than the second, and most likely the first quarter will see the strongest performance. In any event, I don't think it will be a vintage year, and given some of the potential shocks it could actually be quite challenging.

TR: I think it depends on the result of the 2020 presidential elections. A democratic victory would likely mean higher inflation and lower equity price. Whoever replaces Trump is unlikely to care as much about the S&P 500 than him. A republican victory would mean the opposite, more of the same with equity markets continuing to do well even as the consumer suffers. ■