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INSIGHTS

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Add Some "Oomph" To Your 2013 Portfolio

Robert Rountree

Global Market Strategist

When talking to investors, I find the typical response is one of almost universal gloom. Battered by an avalanche of on-going bad news, many seem shell-shocked into submission.

And who can blame them? The Eurozone lurches from crisis to crisis. The US economy is again (apparently) on the brink of recession. China seems to be replacing its economic challenges with concerns as to the state of its companies. And sliding onto the fear radar is the potential fallout from any escalation of the Syrian crisis let alone rising political concerns as China strikes a more strident attitude in its territorial claims.

Yes, many uncertainties remain.

Yet when I look at the Asian (exc. Japan) stock market index, I see that between mid-2012 and early December, it rallied nearly 17½%[1]. Even the Eurozone markets rose some 10%. And that is despite all the additional uncertainties that surrounded the US presidential election and the US "fiscal cliff".

We were in five-month bull markets. It certainly did not feel like it. These were "stealth rallies".

Now I love stealth rallies; they suggest that investors see value in equities despite the gloomy outlooks. This is because equity markets are discounting mechanisms; they will rally when it looks as though the bad news has been discounted. But no one pretends it is an easy ride. Those concerns listed above can still rock the boat; there are plenty of investors who fret that, as in 2010, 2011 and 2012, 2013 will start well only to see a sharp sell-off. And one has to admit, statistics are on their side.

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Recovery rallies start long before any clear evidence of a recovery.

But equally, there comes a point when markets bottom; China's equities, for example, will not remain in the cold forever. But recovery rallies generally start long before there is any clear evidence of a recovery (and markets do not always get it right). Spotting turning points always involves risk.

Entering 2013, that is the issue I think investors should be addressing. Are valuations today adequately discounting the risks such that there is more investment risk in being out of equities than being in them? Each investor will have his or her own take, as do our fund managers.

We started 2012, for example, with a strong bias towards income yielding investments whether they were corporate bonds or dividend income strategies. We were heavily overweight corporate bonds (US high yields in particular) and underweight equities. Our broad message was that 2012 would be a year of positioning, buying value as it appeared but not chasing the markets. "Playing investment chess" was our tagline.

In 2012 we bought value as it appeared while still retaining our cautious bias.

But as 2012 progressed, our funds generally moved towards neutral stances (while retaining a bias towards caution). How this was achieved depended on the individual fund but methods ranged from buying cyclical consumer related stocks to establishing exposures in the highly cyclical (but cheap) metals and mining sectors. Part of the shift was driven because cyclical valuations, particularly within Asia, looked increasingly attractive when compared with increasingly expensive defensive stocks.

Going in 2013, we continue to favour a measured increase to risk.

The overall impact was to position our funds less defensively. But it is too early to be aggressive, I caution. We are talking about a measured increase to risk, not a "boots and kitchen sink" full frontal attack. My personal view is that while equities could yet see more downside, the risk of being in equities (and more possible downside) is today more balanced with the risk of being out of equities (and missing any rally).

To put it another way, investors who bought Asian equities at the start of 2012 would still have clocked up a return of over 15½%[2] (albeit with a stomach-churning 12% fall in May).

The coming year, I argue, is presenting a window in which investors should reassess if they want to add risk to their portfolios. If so, how should this be done and how much?

My take is that there is no great pressure to act quickly. Many bond investors, for example, ask me if it is time to sell their bond funds given that yields are near record lows.

My initial response is to ask, "What would you do with the money?" There seems little point in selling even a low yielding bond to receive even less in a lower yielding bank account, unless, that is, one wants to increase his or her exposure to some undoubtedly attractive cyclical opportunities that exist today. This is a risk decision.

QE infinity is changing the ground rules….

….bond yields could fall further than thought

Adding to the complexity are the changing ground rules, courtesy of QE "infinity" – the US Federal Reserve's program in which it is pumping some US$40bn per month into the US economy via its purchases of mortgage-backed securities until unemployment falls to "acceptable" levels.

The Fed had been coy in saying what level was "acceptable" but it clarified its stance in mid December when it said it would consider raising rates once unemployment had fallen to 6.5% as long as inflation remained under 2.5%.

A back-of-the-envelope analysis suggests that the Fed's trigger point will thus occur around mid 2014. I arrive at this figure by extrapolating the current rate of decline in unemployment until it hits the Fed's target. The market, of course, would not wait this long and would likely react well before this.

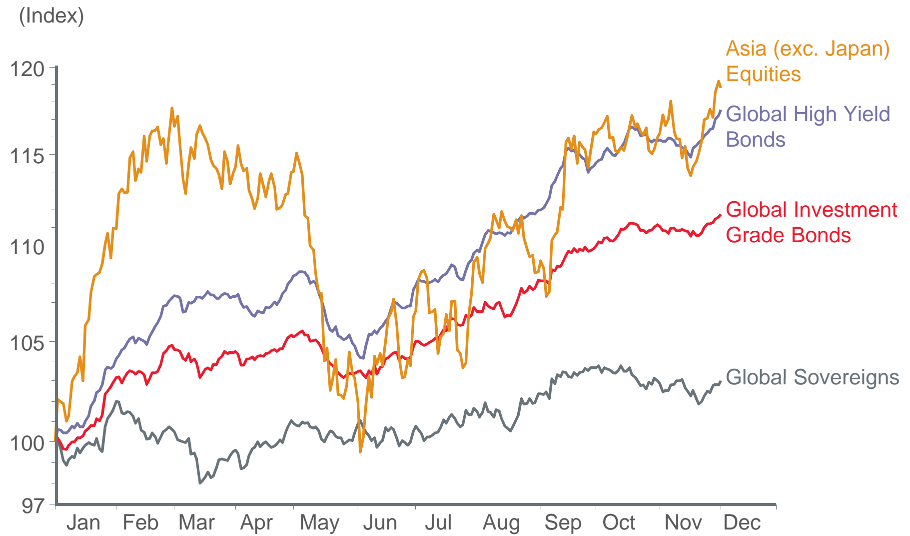
In a nutshell.

But my basic message is that if one wants to reduce one's exposure to corporate bonds because yields are historically low, it is worth considering that the rally may have further to go thanks to QE infinity. We all know it will end one day (possibly nastily), but it does not look as though 2013 will be that day.

So, in summary, one can have one's cake and eat it. If one wants to stick with bonds and yield plays in 2013, there are reasons for doing so. But if one wants to switch out of low yielding bonds into more attractive cyclical equities adding some risk to one's portfolio, positioning for any upturn, there are good reasons for this as well.

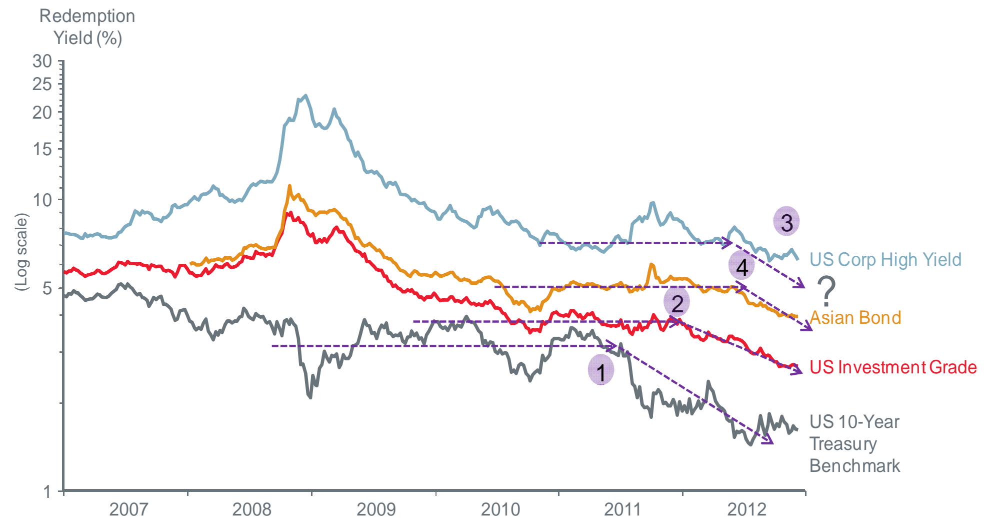
What am I doing? I am adding some "oomph" to my portfolio.

Chart 1 : Asian Equity and Global High Yield "stealth" rallies point to returning investor risk appetite



Source : Barclays Capital bond indices and MSCI Asia (exc. Japan) index from Datastream as at December 4, 2012. The graphs are all showing total returns and are in USDs. Note that past performance is not indicator of either present or future performance.

Chart 2 : Bond yields could fall further than thought



Source : Barclays Capital and JP Morgan from Datastream as at November 20, 2012. All data are in USDs. Note that past performance is no indicator of either present or future performance. Any views expressed above may alter without notification. Please note that this chart is plotted using log scale instead of linear scale.

SOURCES

[1] MSCI Asia (exc. Japan) index in USD as from the 4 Jun 2012 low to 3 Dec 2012 from Datastream as at 4 Dec 2012

[2] MSCI Asia (exc. Japan) index in USD as from the 1 Jan 2012 to 3 Dec 2012 from Datastream

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