August 2019

JOHCM Funds

Global Value and Income Dispatch

Q2 Review: Quality traps, liquidity voids and central bank puts

Highlights

Portfolio shifts during the second quarter continued to be out of equities and into fixed income and reserves, as risk assets continued to appreciate and margin of safety declined

Q2 was another volatile quarter. April's continuation of the Q1 market recovery was sharply interrupted by trade war fears in May, which were – in turn – mollified by a resumption of trade talks and dovish central bank rhetoric. This largely repeated the pattern we saw in December and January.

Income investors were once again challenged to find yield in the wake of the more than 100 basis point decline in ten year bond yields to 2% from the November 2018 highs of almost 3.25%.

Q2 2019 returns & indicators

MSCI World Index	4.19%
Bloomberg Barclays US Agg	3.08%
ICE BofAML BB-B Global High Yield Constrained	3.04%
USD vs. EUR	1.38%
USD vs. JPY	2.75%
Gold	9.07%
US 10-Year Yield (03/29/19)	2.41%
US 10-Year Yield (06/28/19)	2.01%

Source: Bloomberg, as of 6/30/19.

The comfort of quality

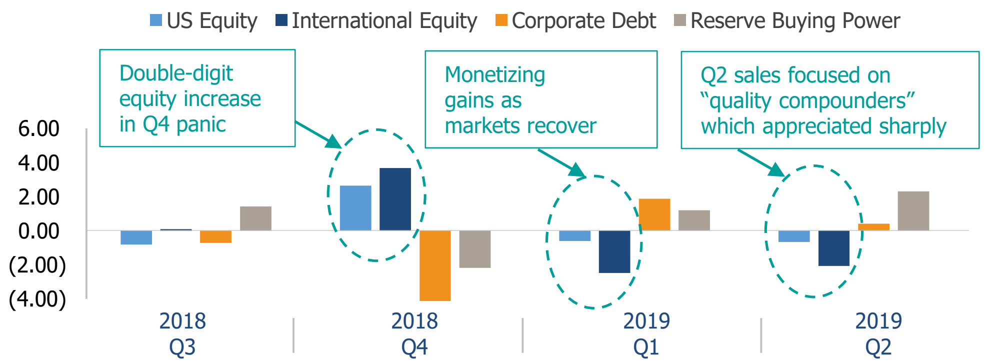
We have observed a **pronounced quality premium** that seems fueled by **three key elements: (1)** heightened economic and geopolitical uncertainty; **(2)** low interest rates; and **(3)** the prevalence of momentum strategies.

These three components interact in the following fashion:

The prevailing uncertainty (#1 above) prompts investors to seek earnings streams with resilient and/or idiosyncratic growth prospects. These earning streams are rendered more valuable by the decline in long term interest rates, which (#2) increases the present value of far-off cash flows (from growing businesses). This, in turn, leads momentum capital to (#3) pile into this narrow sliver of securities and *amplify* the trend.

As cross asset investors, we are seeing this flight to quality play out in various asset classes, which increases our confidence in our observations. This quality bid has been one of the leading drivers of portfolio changes in the past quarter.

Capital Deployment – Trailing 4 Quarters



Source: JOHCM, Bloomberg. Represents estimated capital shifts net of asset class performance.

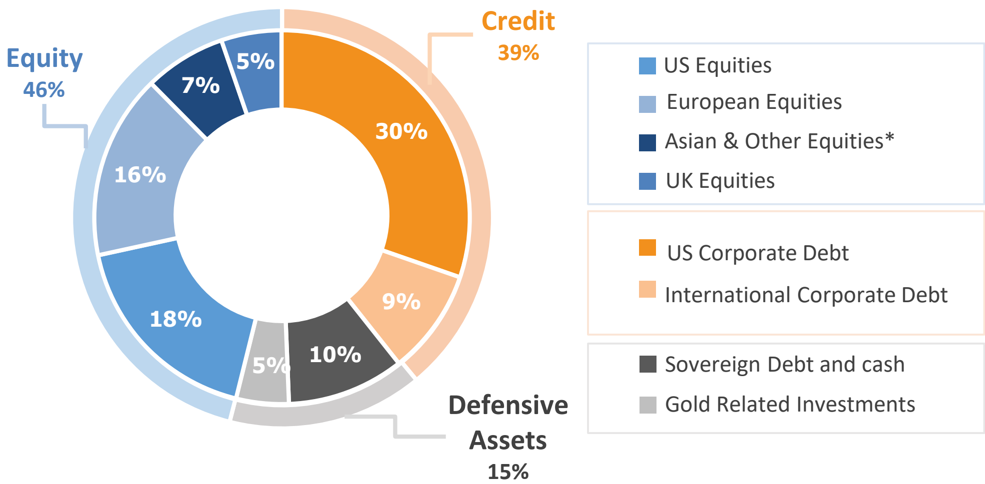
Portfolio positioning

As indicated by the chart above, portfolio shifts during the second quarter continued to be out of equities, on balance, and into fixed income and cash, as risk assets continued to appreciate and margin of safety declined. This was true generally across the quarter, although there was a point during the May mini-swoon when it seemed as if we were going to become net buyers of equities again. The June market rally quickly quashed our hopes of a pronounced buying opportunity, and when the quarter ended, roughly 300bps had come out of equities.

Despite our net sales, as a result of market appreciation, equity positioning is still a bit higher than where it was at the September 2018 market peak. Our credit exposure has continued to improve in quality, with almost 40% of our corporate bonds rated investment grade and 80% rated BB or higher.

Duration has continued to shorten, in response to the decline in long term interest rates, which has made it less attractive to extend capital to borrowers over longer time periods.

GIB strategy by asset class and region (as of 6/30/2019)



Source: JOHCM/Bloomberg as of June 30, 2019. Please note that due to rounding totals may not add to 100%.
*Other equities include: Japan, North America and Emerging Asia.

The discomfort of high valuations

We have begun to see opportunities in more volatile businesses with cyclical elements. In some cases, these businesses are already valued as if a recession were upon us.

With market participants seeking comfort in high quality businesses with resilient and/or idiosyncratic growth prospects, we have begun reducing our holdings of such "quality compounders," some of which we bought in Q4 2018 at quite attractive valuation levels.

At the same time, we have begun to see opportunities in more volatile businesses with cyclical elements. In some cases, these businesses are arguably being valued as if a recession were already upon us.

We are not alone in observing this dynamic. JP Morgan's Quant and Derivatives Strategy team writes that "there is a record divergence between value/cyclical stocks on one side and low vol/defensive stocks on the other." (JP Morgan, Market and Volatility Commentary, July 16th 2019)

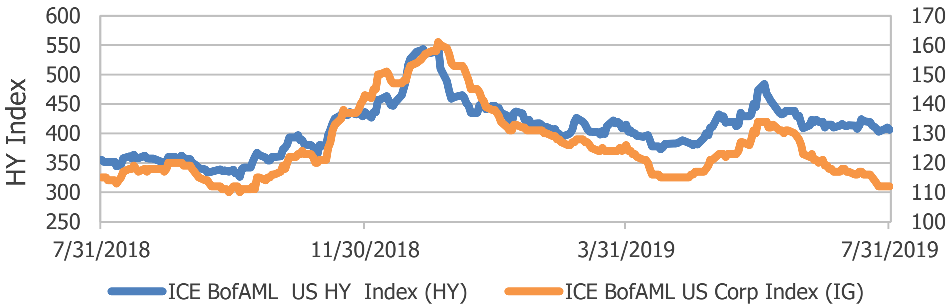
The challenge is that such volatile/cyclical businesses will likely fall further in a broad market sell-off, while the quality/defensive companies' share prices may hold up as even more capital seeks a safer haven.

Our answer to this dynamic has been to move patiently, but at a consistent pace to continue to reshape the portfolio in response to individual security valuations. While on the margin, capital has been directed into some more cyclical businesses, at the same time our overall equity exposure has been reduced and our credit holdings have been somewhat de-risked.

As mentioned, dynamics have been similar across capital markets, with investment grade spreads contracting more than high yield spreads in Q2. While we do not yet feel we are being compensated adequately to take more credit risk, we continue to monitor developments carefully.

"Quality trap" is a term we use to describe a high quality business purchased for a price at which one is unlikely to generate attractive long term returns

IG spreads continued to tighten relative to HY



Source: Bloomberg, as of 7/31/2019

Beware of the quality trap!

"Quality trap" is a term we use to describe a high quality business purchased for a price at which one is unlikely to generate attractive long term returns, even if the business continues to perform well. At such high valuations, the consequences of a hiccup in execution or growth could be extreme. To some extent, a quality trap is the opposite of a "value trap," a business purchased at an optically cheap valuation, which only deteriorates and impairs capital, despite the low purchase price.

Today, investors need to be particularly mindful of the risk of investing in quality traps and be aware that momentum-oriented capital can push valuations to extremes.

With the cost of capital low, and flight to safety furthered by non-economic capital flows (like those spawned by momentum and trend following strategies), it may be as dangerous as ever to assume that market valuations are reasonable and that markets are efficient.

The coming years may prove to be profitable for those willing to endure some volatility or those positioned to take advantage of it.

Helicopter Ben meets helicopter parenting?

The decline in fundamental, active investment pools in favor of passive and/or momentum-driven strategies, might actually be making financial markets less resilient

<u>We continue to be surprised by how little willingness there is among investors and policymakers alike to stomach market choppiness</u>. There seems to be an expectation that markets must rise consistently and that every pullback necessitates intervention.

A recent example of this could be the Federal Reserve rate cut of July 31, 2019, which was originally signaled by Fed officials following a relatively modest pullback in May from near market highs.

Committing to a rate cut pre-emptively with a labor market that is still close to full employment and a US economy that is growing reasonably well could even seem a touch panicky.

Fed Chairman Powell sought to explain the cut through trade tensions, broader global growth concerns and the undershooting of inflation targets. But there may be another explanation as to why repeated Fed intervention seems to be needed, which involves changes in market structure.

Specifically, it is conceivable that the decline in fundamental, active investment pools in favor of passive and quantitative strategies might actually be making financial markets less resilient, requiring more intervention.

The Fed begins to take note of market structure

Changes in market structure may require central banks to become more interventionist to protect markets from severe one-way flows.

Fed officials have begun exploring whether changes in market structure have undermined financial stability. This is illustrated by an August 2018 staff working paper titled *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?*

With an active debate about the effectiveness of rate cuts near the zero bound, the primary transmission mechanism for policy actions these days may be through asset prices and the "financial conditions" they support. Chairman Powell seemed to say as much in his July 29, 2019 press conference, when he responded to a probing question from Bloomberg's Michael McKee by insisting repeatedly that Fed actions made financial conditions "move up."

This heightens the importance of stable asset prices precisely at a time when certain changes in market structure might be making them less stable, efficient and reliable.

Along with the shift to passive, Fed officials may also need to pay greater heed to the change in the *nature* of strategies being deployed in markets. The issue is that risk budgeting, risk parity, momentum and trend following approaches all tend to sell risk assets at times of market reversals, price declines and volatility spikes. In this sense, they all exhibit a type of "stop-loss" behavior.

This may be perfectly rational ***locally***, at the individual strategy level. However, on a ***global*** level, this stop-loss behavior in aggregate can lead to rolling liquidations and one-directional markets that risk free-fall liquidity voids like we saw in December.

With fewer active investors to step in, markets may have difficulty pulling out from these nosedives. Central banks may have to be ever more active in intervening in markets to protect financial conditions from these one way flows.

The end of the central bank put … someday?

<u>The problem is that it may be these repeated central bank interventions *themselves*, which may have allowed trend-following approaches to perform well, raise more assets and become ever more systemic.</u>

It will be very interesting to see if future Fed research focuses further on changes in market structure, or if this dynamic continues – at least in our view – to be underappreciated. Could this be grounds for the Fed – some day – to plead moral hazard, say no more and tear up the central bank put?

As multi-asset value investors, we will continue to try to take advantage of liquidity voids and provide liquidity when and where we believe we are well compensated for doing so and can invest with a margin of safety.