



April 2019

FOR PROFESSIONAL INVESTORS ONLY

Global Value and Income Dispatch

Blink and you might miss it! – The bottom-up advantage



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We believe the recent volatility bursts are symptomatic of changes in market structure years in the making

Value investing strategies, when properly configured, can take advantage of this volatility

We have witnessed a remarkable end to 2018 and a equally remarkable start to 2019. After staring into the abyss in December, investors had to process an almost equally stark recovery, leaving many quite unsure of what is going on.

While there are fundamental forces at play, we believe these volatility bursts are symptomatic of changes in market structure years in the making, for which investors need to be prepared.

Blink and you might miss it!

In our Q4 2018 "Dispatch", we discussed how changes in market structure have made flash crashes and mini-panics more common and sought to chronicle some more recent examples. With non-fundamental trading activity (quants, index, factors, etc.) on the rise, market liquidity can vanish when volatility spikes.

The corollary to this is that **the return of liquidity can overwhelm prices** in the other direction, as investors engage in fear-of-missing-out (or "FOMO") once the market seems to be recovering. Momentum and risk budgeting investors who sold during the decline have to scurry back in lest they miss a rally. As a result, such strategies can face challenges in sideways (or "sawtooth") markets.

Flexibility can pay ... dividends

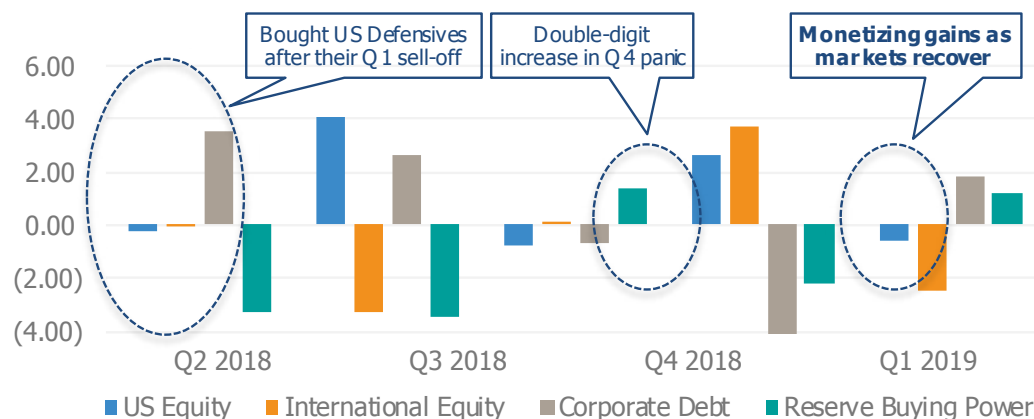
Bottom-up value strategies, when properly configured, are able to take advantage of this volatility. As illustrated in the chart below, we seek to deploy capital into asset classes when they are under stress (as in Q4 2018) and become sellers when valuations become more extended (as in late Q1 2019).

Q1 2019 returns & indicators

| | |
|---|--------|
| MSCI World Index | 12.70% |
| Bloomberg Barclays US Agg | 2.90% |
| ICE BofAML BB-B Global High Yield Constrained | 6.40% |
| USD vs. EUR | 2.20% |
| USD vs. JPY | 1.10% |
| Gold | 0.80% |
| US 10-Year Yield (12/31/18) | 2.68% |
| US 10-Year Yield (03/29/19) | 2.41% |

Source: Bloomberg as at 29 March 2019.

Capital Deployment – Trailing 4 Quarters



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



The portfolio has returned to a more conservative positioning, with equities once again slightly below 50%

The portfolio has returned to a more neutral positioning, but not quite as conservative as it was for much of 2018

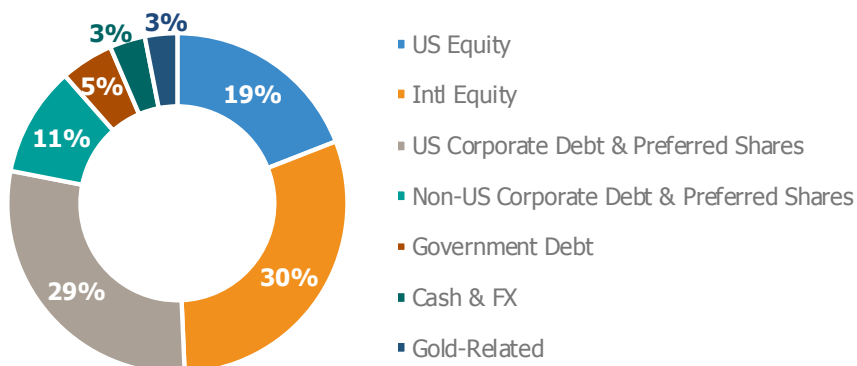
Portfolio positioning at quarter end

With markets rebounding sharply, we withdrew capital from various equities and reduced the risk of our credit holdings. In some cases, we found ourselves exiting investments made only a quarter earlier after returns of 20+%.

In broad brushstrokes, the portfolio has returned to a **more conservative positioning**, with equities once again slightly below 50% of the portfolio.

We are, however, not as defensive as we were during most of 2018. This is partly the result of our having deployed capital into some “compounder” equities (companies that have the potential to sustainably grow earnings with high returns on capital) during Q4 and early Q1. We typically do not exit compounders as quickly as we do more capital intensive businesses, since intrinsic value of compounders can grow nicely over time.

GIB strategy by asset class and region



Source: JOHCM as at 31 March 2019. Asset allocation is subject to change without notice.

The current landscape – policy is driving liquidity

A big driver of the rebound in risk asset prices was the significant improvement in the global economic and monetary policy backdrop. **Politicians and policy makers are often chastened by volatility.** This has recently been the case as well, with everyone from President Trump (trade war), to the Fed, ECB, and even the dysfunctional Italian government becoming more market supportive. **Favorable policy may continue to provide a tailwind for economies and asset prices for the moment** – assuming the trade war does indeed get resolved. In H2 2019, markets may have to face waning stimulus, slowing earnings growth, US Presidential campaign uncertainty, EU election fallout, etc.

In Q4 2018, we had found value in market areas we felt had been overly penalized by macro risk perceptions. We found favorable entry points across a variety of sectors including analog semiconductor producers, software companies, luxury good makers, and testing and inspection businesses.

With an improving policy mix, including trade war negotiations and accommodative central banks, many of these kinds of **businesses have largely recovered their previous valuations quite quickly.**

While we were surprised by the magnitude and rapidity of the recovery, we had seen some evidence even during Q4 2018, that the market was undergoing a liquidity air-pocket, with various quant and momentum strategies potentially contributing to a broad-based imbalance that furthered our conviction to act and deploy capital into risk assets.

We also deployed capital into international cyclicals which have also recovered somewhat, but **many cyclicals still offer good value.** Investments made into the energy service sector during Q4 2018 also proved opportunistic.

We have continued to make a few investments following the market run-up, **but recent investments have tended to be more idiosyncratic and in some cases feature “self-help” components** like restructuring, asset sales or unique capital investment

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It is possible that the increasing prominence of passive and quantitative investing could actually be making markets more and more macro inefficient

The bottom-up advantage stems from the fact that it can often be easier to estimate the intrinsic value of an individual business, rather than to ascertain the next directional move of the overall market

Even for bottom-up investors such as ourselves, some understanding of how quantitative strategies work and where they are advantaged can be very helpful.

opportunities, which we believe may be less affected by the ebb and flow of the business cycle.

What's "next?"

These days it is imperative to pay attention to the changes and evolution of market structure in trying to understand how a value investing philosophy must evolve in order to stay relevant in what we call the **"next market."**

There are a variety of emerging relationships that are not particularly well understood by the investing populace at large. One powerful explanatory concept is an idea theorized by the Nobel Prize-winning economist Paul Samuelson, which states that markets are relatively efficient on a micro level but can exhibit pronounced **"macro inefficiency."**

While this concept is a couple decades old, it is possible that the increasing prominence of passive and quantitative investing could actually be making markets more and more macro inefficient.

On a short term, security-specific or **micro level**, quantitative algorithms that parse news flow and detect sentiment are constantly improving their ability to respond to new information faster than human beings.

However, **at the macro level**, the interplay between different quant or factor-based strategies can provoke rolling unwinds which can be compounded by broad based retail selling through passive/index products.

While there is the risk of systemic negative feedback loops, these air-pockets can be largely non-fundamental, allowing markets to recover quickly once these temporary liquidity imbalances are absorbed.

The bottom-up advantage

As a result, we believe that in this next market, an increasing amount of **investment alpha will accrue to approaches that are able to invest across asset classes** and deploy capital into market areas that are experiencing bouts of macro inefficiency.

In terms of taking advantage of these opportunities, bottom-up cross asset investors may have an advantage over top-down investment committee-led approaches.

This bottom-up advantage stems from the fact that it can often be easier to estimate the intrinsic value of an individual business, rather than to ascertain the next directional move of the overall market. Hence, a bottom-up investor may be able to act with more conviction.

By focusing on durable businesses, a bottom-up investor can further increase the likelihood that they will be able to take advantage of market stress. These businesses themselves are often able to increase value during downturns by gaining share or acquiring weaker competitors.

Lastly, bottom-up approaches by definition **deploy capital in a very focused manner to pinpoint areas of market dislocation**, rather than investing in broad based funds or indices, which is more common among top-down strategies.

For bottom-up investors in particular, however, we believe it is critical to stay small and limit capacity. Part of the bottom-up advantage will be mitigated when the size of an investment vehicle or team grows to the point where it is difficult to move quickly or act decisively.

Bringing together macro and micro inefficiencies

We also remain confident of the ability of long term, fundamental strategies to generate security-specific alpha. The signal to noise ratio in long-term financial data is quite low, making it more difficult for algorithms to find exploitable patterns.

To be precise, the problem (known as overfitting) is that **algorithms are actually too good at finding patterns**. They end up finding far too many of them and have difficulty distinguishing the causal from the spurious, such as the "Super Bowl Indicator." For the benefit of our international readers, this indicator suggests that markets will decline when the US National Football League champion comes from the AFC conference (as was the case this year with the New England Patriots victory).



Even for bottom-up investors, an understanding of how quantitative strategies work and where they are advantaged can be very helpful, as this can improve our sense of where fundamental investing continues to have a sustainable (and in some cases even growing) advantage.

For instance, at the macro level, approaches like volatility targeting, risk budgeting and risk parity may contribute to the bouts of macro inefficiency (and thus provide sources of alpha for us), as such strategies may become forced sellers when markets decline and volatility spikes.

Regardless of the alpha source, we believe that **a bottom-up process that is configured to exploit both macro and micro inefficiencies continues to stand a good chance of generating attractive risk adjusted returns.**

Concluding quotations

Value investing is a timeless philosophy, but the manner in which it is implemented has had to adapt many times. From Benjamin Graham's "net-nets" and statistical value concepts to Warren Buffett's focus on quality and moats, the value investing tent has, in Jean-Marie Eveillard's words, always been a big one.

Value investors will have to continue to be students of market structure as it evolves in order to follow the oft-quoted advice of ice hockey legend Wayne Gretzky's father and "skate to where the puck is going ... and not to where it has been."

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