Lincoln Private
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Investment Letter – Q4 2014

"Even the intelligent investor is likely to need considerable willpower to keep from following the crowd." – Benjamin Graham

In our last quarterly investment report, we anticipated a return of equity market volatility, which had until then been artificially suppressed by central bank policy. The market seemed to agree with us. Within the first fortnight of October, the S&P 500 had dropped over 7% since its peak in mid-September; the FTSE 100 lost over 9% during a similar period, and European equity markets were down over 11%. Yet as the bears declared that the day of reckoning was finally upon us, panic selling turned into panic buying, and US markets promptly made back all their losses to reach even greater peaks. But these market movements are still a cause for concern. What is most worrying is the speed at which certain markets dropped; sharp falls like these tell us that there are no buyers at any price when market sentiment turns negative. And it was an important lesson that an absence of volatility, such as that seen over the last few quarters, should not be mistaken for financial stability.

Monetary policy was once again one of the biggest stories of the quarter. The policy divergence we spoke of in our last letter is now unquestionably pronounced. As the Federal Reserve's announcement of the end of quantitative easing and potential rate rises in 2015 caused market anxiety, the baton of loose monetary policy was passed on to other central banks.

By the end of September, it seemed like the Bank of Japan (BoJ)'s efforts to break deflation's vice-like grip on its country's economy were becoming less successful. Many market participants wondered why Abe and the BoJ's Governor Haruhiko Kuroda were allowing their earlier success to fade away unrewarded. It was then that the BoJ dealt its next hand, ramping up quantitative easing to 80 trillion yen each month, and increasing the allocation of its Government Pension Investment Fund's investments to equities. Japanese equity markets soared on the news of this powerful combination of easing, while the yen weakened considerably. Following his re-election and a popular decision to postpone a further rise in VAT, Abe announced at the end of December that the corporate tax rate would be lowered by about 2.5%, in the hope that businesses will use some of the extra money to raise salaries, a crucial step in combatting deflation.

In comparison, Mario Draghi and the European Central Bank (ECB) seemed to be dragging their feet. This quarter UBS revised its profit estimates for the Eurozone down for the 42nd consecutive month. The record number of consecutive downward revisions is 51, with the dubious honour awarded to Japan's economy during its long deflationary period. Facing troubling data, Draghi's rhetoric at the end of November signalled an increasing readiness to pursue quantitative easing (QE) on a grand scale. But the Eurozone is still undergoing the same type of recession that Japan experienced, with low growth and record levels of debt. Deflation is the enemy of bad businesses, and we only need remember the demise of the 'Nifty Fifty' (a group of 50 large US companies that were credited with leading the buoyant equity market of the early 1970s) in the bear market of the mid-1970s and early 1980s to see the potential fate of similar companies that have been leading the bull market this year. Profits are becoming squeezed and revenues are not growing. Ultimately, the build-up of debt means that, without policy action, this could take many years to wash out.

Yet the Eurozone (and many other economies) are now benefitting from an unexpected tailwind. The price of oil has declined almost 50% since June. The downward pressure on prices caused by weak demand from oil-importing economies such as China, coupled with stagnating global growth, was compounded by oversupply from both OPEC and the US shale-gas industry. As the cartel-bashing continues in the media and the conspiracy theorists don their tin-foil hats, we are more interested in the positive effects of cheaper oil for corporates and consumers. It is for this reason that we are looking for better opportunities to enter this market; if the ECB is true to its word and implements looser policy, we could see equity markets supported in a similar way to those in the US.

In the UK, equity markets have struggled this year ending 2.3% down as the focus has shifted from a smattering of positive economic data to the country's precarious political position. It is currently almost impossible to call the May 2015 election; UKIP has split support for both Conservative and Labour parties, while Labour has lost much ground in

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Scotland to the SNP. It is difficult to envisage a very positive outcome from the upcoming election. With a Labour or SNP/Labour majority we could see a move back towards a spending-driven approach when continued austerity may be more beneficial for the economy in the long term, while a Conservative majority or coalition could see an EU referendum, which could prove destabilising to both UK equity and currency markets. For this reason we are also watching the UK closely until the outlook changes. In the US, as one of the biggest monetary policy experiments in history comes to an end, we remain vigilant; fundamentally we still believe that equity markets are overvalued at current levels.

While equity valuations are stretched in some parts of the world, compared to bonds they appear relatively cheap. Yet flows into fixed income assets have remained surprisingly strong as investors became anxious about the prospect of tighter US monetary policy; geopolitical concerns and the threat of deflation in Europe also influenced this move. We have taken a sizeable underweight across all fixed income assets - but with the FTSE Government Bond Index posting a 13.9% return in Q4, it would be easy to question our decision to avoid the asset class. We remain firmly of the opinion, however, that this is the right decision for our clients in terms of capital preservation. With government bond yields at historical lows any investment would warrant taking on considerable risk for little return. In terms of corporate bonds, developments within this market mean that liquidity is incredibly scarce. Should there be a rush for the door, we worry that the exit point will be very small indeed.

Benjamin Graham, the celebrated godfather of value investing and Warren Buffett's teacher and personal hero, recognised the difficulty of blocking out the noise of the crowd. While many of our calls so far have worked out, the US equity market and conventional bond markets have continued to outperform against our cautious stance. And it could go on: bond market returns will likely be well supported amid increased equity market volatility going into 2015, and there is every possibility that the US economy improves further without the support of quantitative easing. Of course, we are not too stubborn to reconsider our thesis if it looks like we are wrong. But when it comes to our clients' money (and our own) we would rather be wrong in a bull market than get caught out on the way down; buying into these markets at current valuations feels too much like picking up pennies in front of a steamroller.

Fred Hervey
Chief Investment Officer

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