



Lincoln Private  
Investment Office

London

30 June 2015

## Investment Letter – Q2 2015

“How much easier it is to join bad companions than to shake them off!” Winston Churchill

The second quarter of 2015 has been fraught with uncertainty. Well-established trends in currency, commodity and fixed income markets reversed. Mainland Chinese equity markets soared as they were opened up to international investors for the first time, before a sharp correction saw them end the quarter barely above where they started. And a shock Conservative victory in the UK gave a slight boost to sentiment in European equity markets, as investors took solace in a modicum of certainty in the midst of tensions on the continent.

Ultimately, however, it was the Greek tragicomedy that took centre stage as the quarter drew to a close. Since 2010, the Greeks have followed their Italian, Spanish and Portuguese counterparts in doing little more than attempt to restructure their state finances. The Greek economy is racked with inefficiency and bureaucracy. Take the Greek metro system as an example. It takes EUR80m in annual tickets sales – a worthy effort, some might argue, until they realise that it spends EUR500m each year on salaries alone. The madness continues into the welfare sector, with pension liabilities a constant, crippling blow to the nation’s finances. Greeks working in service-based sectors can retire at the age of fifty and receive a pension equal to 54% of their salary. With over one-fifth of the population a pensioner, government pay-outs are extreme, and there continue to be very few Greek taxpayers that are willing to contribute to them. In a population of twelve million, fewer than five thousand report taxable income greater than EUR90,000. Even those that do go to great lengths to disguise their true level of wealth. In 2010, Greek tax authorities attempted to tackle the widespread subterfuge by using satellite imagery to identify Athenian homes with swimming pools, a sign of wealth. 324 such homes were officially registered with government officials; the satellite study unearthed nearly 17,000. That is, until one particularly enterprising Greek businessman began selling pool covers that look like a normal lawn.

Last quarter, tensions came to a head. Austerity measures to combat these inefficiencies and an onerous debt burden led to the election of Syriza, the far-left Socialist party headed up by Alexis Tsipras. What ensued felt oddly like the game of cat-and-mouse played by his predecessors over the last five years: public statements of compliance from the Greek government, followed by obstinacy behind closed doors with EU officials. And so it was that at midnight on June 30<sup>th</sup> the proverbial can was not kicked down the road again as scheduled. Instead, the Greeks kicked back, defaulting on their loan to the IMF and calling a shock referendum over whether to accept the ECB’s bailout terms. At the time of writing, there is a chance that the Greeks could deliver one final boot to the status quo in the form of a resounding ‘No’ vote. Because by defaulting on their debts, the Greeks have shattered an illusion: namely that Europe’s economically weak nations will continue to acquiesce to whatever onerous eleventh hour arrangements might be concocted by the ECB to avoid political embarrassment.

US markets suffered alongside their European counterparts as the issues in Greece and concerns over the timing of a rate rise in the US continued to weigh on equity markets. The Federal Reserve (Fed) is in a quandary: they desperately want to normalise interest rates but the mere mention of a rate rise in the face of mixed data continues to cause volatility. The Fed’s impact is felt widely, in particular in the Emerging Markets. With memories of the taper tantrum still fresh, debt and equity markets in these regions have struggled to perform as the US dollar has strengthened. This strengthening has negatively impacted the measurement of GDP in US dollar terms, as well as increasing the local cost of servicing US dollar-issued debt. In Asia, Japanese markets continued to perform well. Mainland Chinese equities, known as A-Shares, underwent a rollercoaster ride this quarter. Hardly a day went by without reports of Chinese investors fuelling a bubble in A-Share markets. Many A-Shares are wildly overpriced, and the average price-earnings ratio of one of the main A-share indices stands at 23x. The H-Share index, on the other hand, trades with an average price-earnings ratio of 12x, which compares favourably both to its mainland counterparts and other equity markets around the world. While the H-Shares have suffered in the sell-off in A-Shares over the second half of the quarter, they remain compelling from both a valuation perspective and as a growth story. And the People’s Bank of China has considerable monetary firepower still remaining to help support equity markets.



Ultimately, Greece may leave the Euro project, it may not. Either way, those who remain will likely enjoy the fruits of even more aggressive monetary stimulus from the ECB. Negative interest rates and quantitative easing will continue to weaken the Euro, force banks to lend to generate returns and in the process drive asset prices higher and higher. Policies like these are now familiar to us all, as is the ensuing bubble in debt and equity markets. But economies are not cars, and monetary stimulus is not the gas pedal. Rather, it plays a critical role in aligning output with society's demand across time: fiddling only creates an ever-growing misalignment between supply and demand which requires an ever larger and more painful adjustment. When times were good, and the rising tide lifted all boats, no one questioned these decisions. Germany, an exporting nation, benefitted from a weaker Euro. The Greek government was more than willing to take on debt made artificially cheap by loose monetary policy, debt that it cannot ever hope to service. And as the lines continue to grow at cash machines across Greece, the human cost of these decisions is clear, and for the Europeans how to "shake off" bad company is not.

The second quarter has been one of extremes. If you had bought a 10-year German Bund on the 14<sup>th</sup> April, you would have received a yield of less than 0.1% for the pleasure; if you had waited until the 10<sup>th</sup> June you would have been paid a yield of almost 1.0% for the same instrument. This is a wild move. The compression in rates caused by quantitative easing has created imbalances and skewed incentives. Since the middle of April, assets thought of in traditional terms as some of the safest have suffered sizeable losses in value: German Bunds have fallen by 6.6%, while UK Gilts have fallen by 4.8%. These moves represent a change in sentiment; when we get a change of circumstance in the form of higher interest rates, then we will see real value destruction. With this in mind we continue to have limited exposure to traditional fixed income assets and hold no conventional bond funds, preferring absolute return managers, convertibles and alternative bonds to gain access to the asset class. We have also maintained a small exposure to emerging market debt: from a valuation perspective we are becoming inclined to buy more rather than sell.

In equity markets we were keen to increase our exposure to the UK following the election, with an opportunity provided during the market selloff around concerns over Greece, although we have still maintained an underweight position in the asset class. US equity markets appear lacklustre, and with the threat of rising rates well known but unquantifiable we maintain a sizeable underweight to the region. Our preference remains for Japanese equity markets; while they have performed strongly over the past year, we continue to believe that the changes being made in the corporate space will be favourable for equity markets going forward. We have also introduced some exposure to Hong Kong-listed Chinese equities. While there has been a lot of noise surrounding the region over the quarter, in particular around mainland Chinese markets, our view is based on building a position for long term exposure.

We have maintained significant exposure to absolute return funds during the period: we believe that in a rising rate environment – or indeed in an unchanged one - we need to continue to identify alternative sources of positive return. We remain pleased with the performance of the Core Portfolio. While we lost some ground in absolute terms during the quarter, compared to equity and bond markets we have performed well. We are now a year into running client money and a good track record is beginning to be established. We are grateful to the fund managers in which we have invested as they have helped us achieve a very positive return, in a year when equity indices have struggled to make headway and where a more thoughtful fixed income asset allocation has been crucial to achieve any return whatsoever.

Fred Hervey  
Chief Investment Officer