Q1 COMMENTARY

25/04/2016
Daniel Tubbs I Charles Walsh I Neville Shaw

PERFORMANCE UPDATE

The Mirabaud GEM fund rose +2.8% during the first three months of the year, underperforming the benchmark MSCI index by around 2.9%.

The three biggest contributors to relative performance were:

BB Seguridade Participacoes (BBS): BBS is the second largest insurance company in Brazil which is benefiting from the low but rising penetration level of insurance in Brazil. The stock performed particularly well in Q12016 as it is a large, liquid and high beta play on economic recovery in Brazil. Therefore the recent excitement about the potential impeachment of President Dilma helped propel the stock up 40% (in US dollar terms) in three months. We still own it in the GEM fund although we scaled the position back in mid-March due to valuations.

Credicorp: The largest financial holding company in Peru rallied 30% (in US dollar terms) before we sold the position in mid-March. The share price went up due to the strong economic growth outlook in Peru, the rebound in commodities and in anticipation of the election of a new market-friendly president in the elections.

CCR: The Brazilian toll-road operator climbed 42% (in US dollar terms) from its low in January to when we sold the position in early March. During this 5 week period valuations went from being 2 standard deviations below its 5 year average to over 1 standard deviation above. There was limited company specific news during this period. Instead the shares were driven by improved investor sentiment towards Brazil due to the political developments. We therefore sold the stock due to stretched valuations.

The three largest detractors to relative performance in Q12016 were:

Fawaz Abdulaziz AlHokair Co: The Saudi retailer underperformed the benchmark index despite a recovery in the oil price and an upgrade with a ‘buy’ recommendation from JP Morgan. The stock breached our stop loss levels and so we sold the position.

China State Construction International (CSCI): Frustratingly the stock underperformed during Q12016 despite reporting strong operating data with new contract orders running ahead of schedule. We marginally trimmed the stock in line with our process in mid-March after the stock breached our stop loss review level. We continue to hold a position in the company as operationally it is performing well, valuations are attractive (2016 p/e of 9.7x) and we believe it will outperform when sentiment towards to Chinese H-shares improves.

China Overseas Land & Investment (COLI): Having outperformed the benchmark in 2015, COLI struggled in Q12016 despite strong operating data. As one of the largest property developers in China, COLI has benefited from the recent rebound in property sales and prices. The recent news that property restrictions have been introduced again in tier 1 cities, which have experienced the greatest property price appreciation, should not actually impact COLI very much. The company has the bulk of its property portfolio in tier 2 cities and below. The primary reason for the company’s underperformance was because China (in the form of H-shares) was the one of the worst performing markets in 1Q16 and COLI is a large, liquid and high beta stock. Given Chinese H-shares is the second cheapest asset class (on a p/e of just 7x), we expect the market and COLI to recover in the medium term.

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MARKET REVIEW

After a sharp sell-off in the first three weeks of January, when the GEM index dropped 13%, the index recovered and finished the quarter up 5.7%. By contrast, developed markets ended the quarter broadly flat. Unusually LatAm was the best performing region (+18.5%), followed by EMEA (+12.1%) and then Asia (+1.5%).

Within LatAm the best performing markets in US dollar terms were Brazil (+27.4%) and Peru (+27.0%). We were overweight both markets until around mid-March when we reduced our positions, as mentioned, in companies such as BB Seguridade, CCR and Credicorp.

Turkey was the best performing market in EMEA. We continue to be overweight the market with holdings in Emlak (property developer) and Dogus Otomotiv (Volkswagen distributor). The worst performing markets in EMEA were Greece (-12.2%), Saudi (-9.3%) and Egypt (-7.1%). Unfortunately we were marginally overweight Saudi and Egypt.

Asia was the biggest disappointment as it fell behind the other two regions for the first time in a while. The best performing markets were Thailand (+15.9%) and Malaysia (+12.5%). We were underweight both markets during the quarter due to expensive valuations and limited interesting investment opportunities. The worst performing market was China (H-shares) which dropped 4.8%. We were overweight China as we believed investors were too bearish and we believed there were many interesting companies at attractive valuations.

From a sector perspective, materials (+15.5%) and energy stocks (+13.8%) were the best performers. Material stocks rallied due to a weak US dollar, short covering and the reports of seasonal restocking in China. Energy stocks had a good quarter after the Brent oil price dropped 25% in the first 3 weeks of January before rallying 42% to end the quarter up 6%. We were underweight material stocks but had direct exposure to energy stocks through CNOOC and indirect exposure through our holdings in Middle Eastern companies.

The worst performing sectors were Healthcare (-1.4%) and industrials (+2.2%). We were underweight both during the quarter.

PORTFOLIO ACTIVITY

During the quarter we added new positions in the following: China Life, SundayToz (a Korean mobile gaming company) and Finetex (a Korean manufacturer of nano-fibre). We also initiated a position in Delphi, which we expect to benefit from increased automation in vehicles. Finally we bought back into Chlitina Holdings, the Taiwanese franchisor of beauty salons, which had pulled back meaningfully on a relative basis since we held it last year.

We sold positions in Wonik IPS (a Korean semiconductor equipment manufacturer), Parade Tech (a Taiwanese fabless semiconductor company) in order ensure relative outperformance. We also sold a position in Hansol Technics following a meeting with the management in Seoul.

From a country perspective, we significantly reduced our positions within LatAm. As explained above, we sold out of Brazilian operator CCR and Peruvian bank Credicorp due to high valuations after a very strong rally. We also trimmed our Brazilian holdings in Kroton, BB Seguridade and Brazil Foods. We are now around 3% underweight Brazil having been moderately overweight Brazil at the start of the year.

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PORTFOLIO POSITIONING

We finished the Q12016 overweight China, UAE, Indonesia and Turkey, while being underweight Korea, South Africa, Malaysia, Mexico and Brazil. From a sector perspective we were overweight financials, consumer discretionary and technology sectors. At the quarter end our biggest underweights were energy, materials and telcos.

SUMMARY AND OUTLOOK

GEM equities had a difficult start to the year before recovering more recently. Renewed concerns about global economic activity along with the Federal Reserve's tightening policy weighed on investor sentiment and GEM equity markets sold off aggressively. GEM equities dropped 13% in the first 3 weeks before staging a strong recovery. The recovery was largely led by value stocks (materials and energy sectors) while growth stocks underperformed. This was the principle reason for the underperformance of our fund which maintains its 'quality GARP' investment style.

In the very short term both developed and emerging equities look vulnerable to profit taking in our view. As a proxy for developed markets, the S&P 500 is less than 2% from its all-time high despite a lacklustre start to the Q12016 reporting season. So far 58 out of 500 companies have reported and on average their earnings have contracted 11% YoY. Nevertheless, the market is trading on a 12 month forward p/e of 17x, which is 2 standard deviations above its 10 year historical average.

In addition, attention is likely to return to political risk in developed markets with the upcoming UK Brexit referendum as well as presidential elections in the US where Trump is on target to win the Republican nomination.

GEM markets, especially in LatAm and EMEA, appear vulnerable to profit taking after the strong rally. We believe Brazil is likely to underperform after the Lower House voted to pass the motion to impeach President Dilma. The Senate is expected to follow the lead of the Lower House and suspend Dilma from her duties in the next couple of weeks. We believe the Brazilian market, which trades more than 1 standard deviation above its historical average, has run ahead of fundamentals. Dilma's replacement, whether it is VP Temer or Speaker of the Lower House Eduardo Cunha, will face extreme difficulty in pulling Brazil out of its worst recession in decades. Not to mention that Temer is also at risk of being impeached and Cunha faces corruption charges. We are much more constructive on the outlook for Asia versus LatAm or EMEA at this juncture.

We believe the medium-term outlook and long-term investment case for GEM equities remains very positive. GEM equities still remain under-owned and are one of the cheapest asset classes within global equity markets, whilst having the strongest earnings outlook. We remain focused on investing in quality companies with structural growth opportunities whilst being cognisant of managing the risks within the current environment. In our opinion, we are well positioned to outperform during the remainder of the year. We believe the recent 'trash rally' exhibited by the strength in materials stocks and the irrational exuberance in LatAm will be short-lived. We firmly believe that fundamentals will prevail and focus will return to companies with strong growth opportunities and attractive valuations. On that basis, our overweight in Chinese H-shares and our positions in companies operating in areas of strong growth within the financials, consumer and IT sectors should perform well.

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