FP FINANCIAL PARTNERS

What lies beneath

Weekly Digest

17 June 2019

– *Alex Harvey*

Hidden from view on the dark side of the moon, researchers last week discovered a vast unidentified mass hidden below the moon's South Pole. A gravity map revealed an accumulation of material below the colossal 1,550-mile-wide Aitken basin impact crater, ever hidden from our view on earth by tidal locking. Just because we can't see something though, it doesn't mean we can ignore it. Part of our role as fund researchers is to look where the light doesn't shine, as thorough due diligence may draw attention to red flags lurking in a fund's shadows.

One of the most important attributes of any investment fund is the structure within which it sits and the mechanism by, and the frequency with which, its clients access their capital. In a nutshell, I'm talking about liquidity, which manifests itself largely in two ways: the awareness of capacity that sits alongside an investment strategy, and the suitability of underlying investments to a given fund's structure. These are innately linked, yet subtly different, and whilst liquidity can be managed to capacity, it comes at the expense of the opportunity. The larger you get, the more market-like you become. The more market-like you are, the harder it is to outperform.

Clients and managers who know us will know the importance we place on capacity. It is important to ascertain early on the expected capacity of a strategy, and what factors might cause that to change. If the narrative for their capacity changes over time, then it could be cause for concern. As early adopters of a successful bond strategy in 2012, once the manager's indicative capacity budget was blown we reviewed and ultimately sold out, well before its assets peaked at a multiple of the £1.5bn we noted in our early meetings. The fund remained liquid throughout but at the expense, we would say, of being able to generate meaningful alpha from bond selection.

In terms of asset suitability, at Momentum we are acutely aware of the potential liquidity mismatch between underlying investments and fund structures. For example, we do not advocate buying direct property through daily dealing funds. When did you last market, view and exchange on the same day? Let alone complete three days later? The seizing up of the daily dealing property market post the 2016 Brexit referendum attests to the problem, yet it persists. Closed ended investment funds with fixed pools of capital are a more suitable way for investors to access less-liquid markets. Liquidity risk is transferred to an exchange, but there is at least an observable market.

Recent events in the UK's fund market highlight the issue. A flurry of redemption requests saw one of the UK's most high-profile fund managers having to gate his flagship strategy. In this instance, (in)capacity and (un)suitability conspired together to lock down the fund. The market for stocks of which you are the majority owner is unlikely to accommodate you at your time of need. Pleasingly, our process identified the risks in 2016 and we promptly sold the holdings that were transferred to us via an acquisition from a third party. We raised similar concentration concerns in 2015 when reviewing an absolute return bond fund which subsequently fell to earth, having passed on the opportunity to invest.

Whether a celestial body or an investment fund, size does matter. Critical mass is needed to launch a strategy, but too much mass and you risk pulling others into your sphere of influence, distorting the natural market order. Any subsequent impact will be hard, the crater large and the outcome painful. Interestingly, we recently also learnt that water molecules have been detected at the Moon's south pole. But in an illusion of liquidity, it happens to be ice.

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The **Marketplace**

- Global equity markets were relatively flat on the week
- The US reached an agreement with Mexico to avoid tariffs
- Brent crude fell 2.0%, ending the week at $62.0 per barrel
- Gold prices remained relatively flat, up 0.3%, ending the week at $1347.2 per ounce

Market **Focus**

US

- US equities started the week with strong performance thanks to the news that the US had reached a signed agreement with Mexico to avert tariffs, but remained relatively flat overall, ending the week up 0.5%
- US CPI inflation rose 1.8% year-on-year in May, a slowdown from the 2.0% recorded in April and slightly below expectations for a 1.9% increase
- Weak inflation data pushed yields on Treasuries lower with the 10-year Treasury yield ending the week below 2.10%
- Futures continued to price in high odds of a rate cut this summer, with markets now anticipating a rate cut at the July meeting
- 3-year inflation expectations fell to their lowest level since May 2017 at 2.59%

Europe

- Just like most equity markets in the last week, continental European equities also showed minimal activity ending the week up by 0.4%
- Fall in European inflation expectations put downward pressure on yields. The 10 year German Bund yield ended the week at -0.26%
- There are a number of key central bank meetings in the coming week including the European Central Bank's annual three-day forum in Portugal

UK

- UK equities performed in-line with global equity markets, returning 0.2%
- The pound weakened -1.2% against the US dollar, stemming from both political uncertainty and news of a weak April GDP reading of -0.4% month-on-month compared to the -0.1% decline expected
- The latest UK employment data release was positive, with UK unemployment estimated at 3.8%, the lowest estimation since 1974

Asia/Rest of The World

- Brent crude fell early in the week, hitting a 4-month low, due to a US government report showing a large increase in US crude oil inventories. It regained some of its losses after explosions on two oil tankers in the Gulf of Oman to end the week down -2.0%
- Equity markets in Japan and the Asia Pacific ex Japan region gained 0.9% and 0.6%, respectively
- In China, the benchmark index advanced 1.9% on the week
- The highest equity market growth was experienced in the MENA (Middle East and North Africa) region with returns of 3.0%

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 June 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	0.5%	5.0%	15.9%	5.2%
United Kingdom	GBP	0.2%	2.7%	11.6%	-1.1%
Continental Europe	EUR	0.4%	2.9%	14.9%	0.3%
Japan	JPY	0.9%	2.3%	4.8%	-11.2%
Asia Pacific (ex Japan)	USD	0.6%	1.7%	7.3%	-7.8%
Australia	AUD	1.7%	2.5%	18.3%	13.7%
Global	USD	0.2%	4.2%	14.4%	1.5%
Emerging markets equities					
Emerging Europe	USD	0.8%	3.8%	16.1%	12.3%
Emerging Asia	USD	0.9%	1.6%	4.8%	-12.2%
Emerging Latin America	USD	0.3%	2.8%	9.1%	14.7%
BRICs	USD	1.0%	1.7%	8.9%	-6.6%
MENA countries	USD	3.0%	3.2%	9.8%	6.3%
South Africa	USD	1.0%	1.7%	6.5%	-8.4%
India	USD	-1.0%	-1.0%	9.2%	7.4%
Global emerging markets	USD	0.9%	1.9%	6.1%	-7.5%
Bonds					
US Treasuries	USD	0.0%	0.3%	4.8%	7.5%
US Treasuries (inflation protected)	USD	-0.8%	-0.4%	5.1%	4.5%
US Corporate (investment grade)	USD	0.1%	0.7%	7.9%	8.8%
US High Yield	USD	0.4%	1.3%	8.9%	5.8%
UK Gilts	GBP	-0.5%	0.6%	5.4%	5.9%
UK Corporate (investment grade)	GBP	-0.1%	1.1%	6.5%	5.7%
Euro Government Bonds	EUR	0.1%	1.3%	4.9%	6.1%
Euro Corporate (investment grade)	EUR	0.2%	0.7%	4.5%	3.8%
Euro High Yield	EUR	0.5%	1.0%	6.3%	3.0%
Japanese Government	JPY	0.2%	0.5%	2.7%	3.2%
Australian Government	AUD	0.8%	0.8%	7.5%	11.9%
Global Government Bonds	USD	-0.4%	0.9%	4.1%	4.8%
Global Bonds	USD	-0.3%	0.9%	4.2%	4.8%
Global Convertible Bonds	USD	0.2%	1.4%	5.6%	-1.5%
Emerging Market Bonds	USD	0.9%	2.6%	9.3%	10.4%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 June 2019	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	0.8%	3.0%	19.3%	15.2%
Australian Property Securities	AUD	0.8%	4.4%	18.8%	16.8%
Asia Property Securities	USD	0.6%	2.6%	10.7%	3.4%
Global Property Securities	USD	0.6%	2.5%	15.0%	7.5%
Currencies					
Euro	USD	-1.2%	0.4%	-2.1%	-3.7%
UK Pound Sterling	USD	-1.2%	-0.3%	-1.2%	-5.3%
Japanese Yen	USD	-0.4%	0.0%	1.0%	1.7%
Australian Dollar	USD	-2.0%	-1.0%	-2.5%	-8.5%
South African Rand	USD	0.9%	-1.5%	-3.0%	-9.9%
Swiss Franc	USD	-1.3%	0.3%	-1.6%	-0.4%
Chinese Yuan	USD	-0.2%	-0.3%	-0.7%	-7.6%
Commodities & Alternatives					
Commodities	USD	0.5%	0.3%	4.6%	-9.8%
Agricultural Commodities	USD	2.6%	1.6%	0.6%	-7.4%
Oil	USD	-2.0%	-3.8%	15.3%	-18.3%
Gold	USD	0.3%	3.3%	5.1%	3.3%
Hedge funds	USD	0.6%	1.3%	3.6%	-3.2%

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For more information, please contact your adviser or alternatively contact:

Financial Partners Ltd.
泛柏資產管理有限公司
Unit 01 - 03
24/F, Kinwick Centre
32 Hollywood Road
Central, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
client.services@f-p.hk
www.f-p.hk

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