

# Global Perspectives

August 2010

## The chase for investment income in a deleveraging world

### What is investing all about and why is it so important?

Investing is buying future income. You lay out money now, for hopefully more money coming in later.

With the possible exception of income from lending to governments, investment income always comes from allowing people (organized in companies or not) to engage in some form of "value-adding activity". Even governments get some of their means from value-added services, some from providing the infrastructure necessary for others to add value and ultimately some from taxing the value-adding processes.

The concept of "added value" is therefore the cornerstone of all economic activity and of the returns that come from it.

**For those (individuals or companies) who do not add value, through their work or through their investments, there is no income to be expected!**

In other words, only value-adding work or value-adding investments can be consistent sources of income.

Investing one's capital intelligently is therefore very important, much more important than most people realize or would like it to be.

An investor's or an investment manager's job is therefore to allocate capital to "high added-value" activities, at reasonably low prices with acceptable risks.

### What is investment risk and why is it crucial to understand it?

Risk, in general, is the possibility that something unfavourable happens to something or to someone.

Investment risk, more specifically, is the possibility of having a lower than expected and possibly negative return on an investment or investment portfolio.

Investment risk has four components,

**1. Income risk:** the possibility that the hoped-for income does not materialize, in size (less than expected) or in timing (later than expected). There are of course a thousand reasons, a thousand risks, why expected income might not materialize.

**2. Currency risk:** the possibility that the currency in which the income is supposed to materialize, goes down significantly versus the currency in which the return is expected.

**3. Interest Rate risk:** the possibility that interest rates go up or down.

When interest rates go up, one runs price risk, because, everything else being equal, the value of future income discounted by higher rates is lower.

When interest rates go down, one runs reinvestment risk, because when the current investments are repaid, one will only be able to reinvest at lower expected returns.

**4. Liquidity risk:** this is the possibility of not being able to sell one's investments if and when cash is needed. To liquidate the investments, one might have to accept a divestment price, if any, significantly below the investments' intrinsic value.

The crucial issue is of course that if and when one wants to acquire future income through investing, one always gets investment risk as an inevitable by-product.

Watch out, don't get the direction of this simple but fundamental idea wrong!

One cannot have income without risk but ... taking risks does not necessarily lead to income!

Indeed, and contrary to what many people think and contrary to what many investment professionals advertise, taking significant risks usually leads to significant losses.

The amount of risk one gets by investing, or the probability of something going wrong, is very difficult, useless and maybe even counterproductive to quantify.

That unfavourable events cannot be predicted, that risks cannot be quantified does not mean risks cannot be understood and managed; they can however never be eliminated.

## How can we, in today's world, acquire future income and what are the risks involved?

### 1. General Environment – The world is still deleveraging.

Three years ago (July 2007), we were about to enter an unprecedented credit and liquidity crisis, on the back of a downturn in the US real estate market.

The credit-related problems which started in the by-now infamous US sub-prime mortgage market, spread to many other credit segments and to other geographies.

From a classic problem of misallocation of funds to risky assets at too low returns, we soon found ourselves in **a massive worldwide deleveraging** phase, which we think we are still in today and which we expect to last for the foreseeable future!

The excess leverage has partly been transferred from the private to the public sector. This means taxes on will go up. Taxes on capital and/or on income from capital will go up. As labour is already overtaxed and unemployment will be high, labour will contribute through longer working years. Government spending will go down. These are not mere possibilities, these are certainties.

**Worse news** is that the biggest liabilities are not yet on the governments' books. The governments' liabilities with regards to future pensions and future healthcare costs are dwarfing current liabilities, as you can see from the table below.

**Tableau 3 : Coût de la crise vs. Coût du vieillissement (valeur actualisée, % du PIB)**

	Crise	Vieillessement
Australie	30	482
Canada	21	726
France	31	276
Allemagne	29	280
Italie	35	169
Japon	35	158
Corée	20	683
Mexique	13	261
Espagne	39	652
Turquie	22	204
Royaume-Uni	48	335
Etats-Unis	37	495
<b>Pays développés G-20</b>	<b>35</b>	<b>409</b>

Source : FMI, Exane BNP Paribas

This "ageing of the population in an over-generous welfare state" problem cannot be overstated. We therefore cannot insist enough on this overarching theme: overleveraged actors, of which US and European governments and US consumers are the most significant ones, will continue to try to reduce their current and future liabilities.

For taxpayers and government insured, i.e. almost everybody, this is going to be a painful and lengthy process; one more argument in favour of **private savings and investments**.

Most leverage-reducing measures are disinflationary, which means that for some countries like Dubai, Greece, Hungary, Spain or Portugal, deflation is a certainty. For most others a distinct possibility.

So the economic environment will remain very challenging to say the least, with continued focus on company productivity, high unemployment, low inflation and low interest rates.

The **good news** is that

- \* Low to very low interest rates are positive for the economy and very positive for asset valuations,
- \* Less government spending makes room for private enterprise, where the real added-value is to be found,
- \* A globalizing and growing world has huge needs in terms of infrastructure, energy-generation, water-management, healthcare, food production, leisure ...
- \* A tough economy does not mean a bad investment climate, on the contrary!

With inflation and interest rates low, investors, in search of income, have to look at **LONG-DURATION** assets.

Of course, the prices of long-duration assets are more volatile, however stable and predictable their expected income might be.

Most investors are just not mentally prepared to face up to this disinflationary environment, having just run away from volatility during the 2007/2009 crisis.

Not being able to take some manageable risks, has become a very big risk indeed!

## 2. Government Bonds.

The 1th Half of 2010 was unusually tumultuous in the Government Bond markets.

### **2.1. For the first time in many years markets began to worry about the state of some government finances.**

The focus has very much been on Europe, but the first very bad surprise actually came from Dubai. Greece quickly followed suit with the admission it had manipulated its statistics and cheated itself into the European economic and monetary union. Bond investors, long sold on the convergence dream within the EU, now started to panic. Borrowing costs for Greece, Ireland, Spain and Portugal shot through the roof.

The beauty of this turmoil is that it has clearly exposed where the unsustainable weaknesses are. The bond markets vigilantes are back in charge and politicians will have to listen. That really is good news.

And politicians finally got the message and shot into action. With a few exceptions (Belgium ...), all European governments announced deficit-reducing measures during the 2Q.

Of course, much more needs to be done and will be done and of course most countries outside the EU will have to follow the same path.

The big question is when will the US act ? It should have acted already but the Obama administration still thinks about deficit-increasing stimulus. By December, after the mid-term elections, they will start working on reducing the deficit, not to lose the presidential election of 2013 too.

For the first time, and thanks to unrelenting pressure from the bond markets, it is reasonable to envisage much healthier government finances 5 to 15 years from now.

## 2.2. From inflation to deflation worries.

As you can see from the below graphs, for the serious countries, rates have continued to come down to historically low levels, discounting the fact that inflation cannot and will not be a problem for the foreseeable future.

### 10 year German Government Bond Yields – 20 year Graph



Source: Bloomberg

At CapitalatWork we have been speaking about disinflation and deflation since January 2008.

Deflation does not need to be a big problem, provided you don't have too much debt and you have regular and stable income, from your work or from your investments.

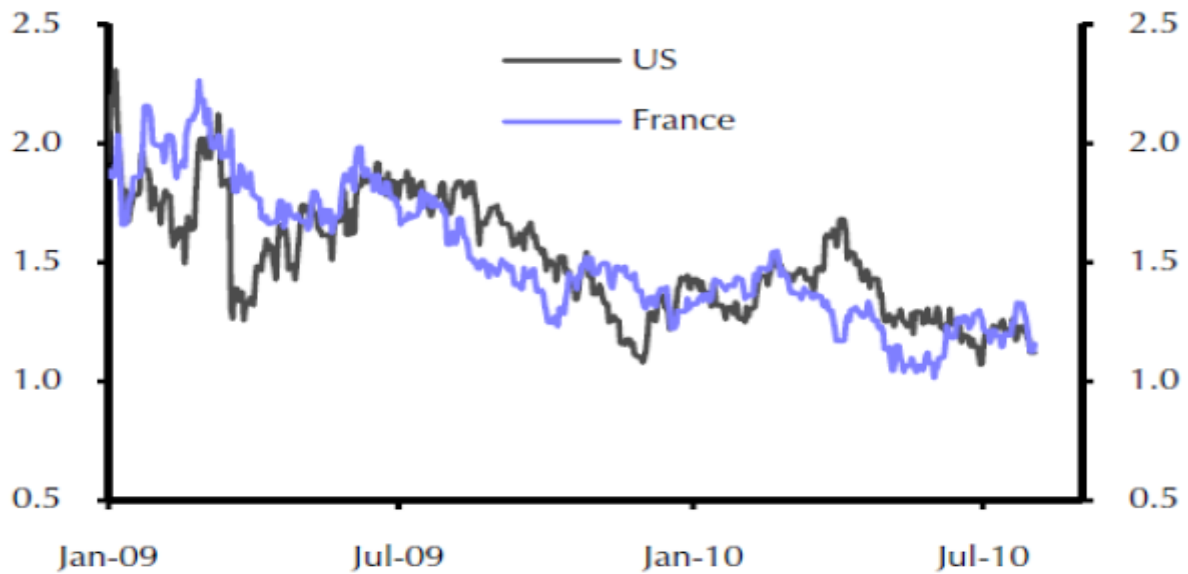
Buying regular and stable 2,5% to 3,5% yields with 10 to 20 yrs government bonds is not very exciting, except when you compare it with 0% to 1% short rates and -2% to +2% inflation.

With 10yr Yen yields around 1% and 10yr CHF yields around 1,5%, we cannot exclude long rates in a deleveraging and disinflationary Europe going below 2,5%.

There is little value left in government bonds. If we do own some, we think it is wise to own long ones, as a complement to corporate assets, well aware of the risk of a potential rebound in long rates, were the economy to recover significantly.

There is even less value left in inflation-linked government bonds, as real rates have come down to historically low levels too.

### 10 – year Government Bond Real Inflation-Linked Yield (%)



Source: Capital Economics

In fact, from current low levels, real inflation-linked rates could go up significantly in the case of inflationary or deflationary scenarios! This does not sound like a great proposition.

### 3. Corporate Bonds.

The performance of the corporate sector, with the exception of the banking industry of course, is one of the very positive surprises throughout this crisis and a healthy support for the economy going forward.

How is this possible?

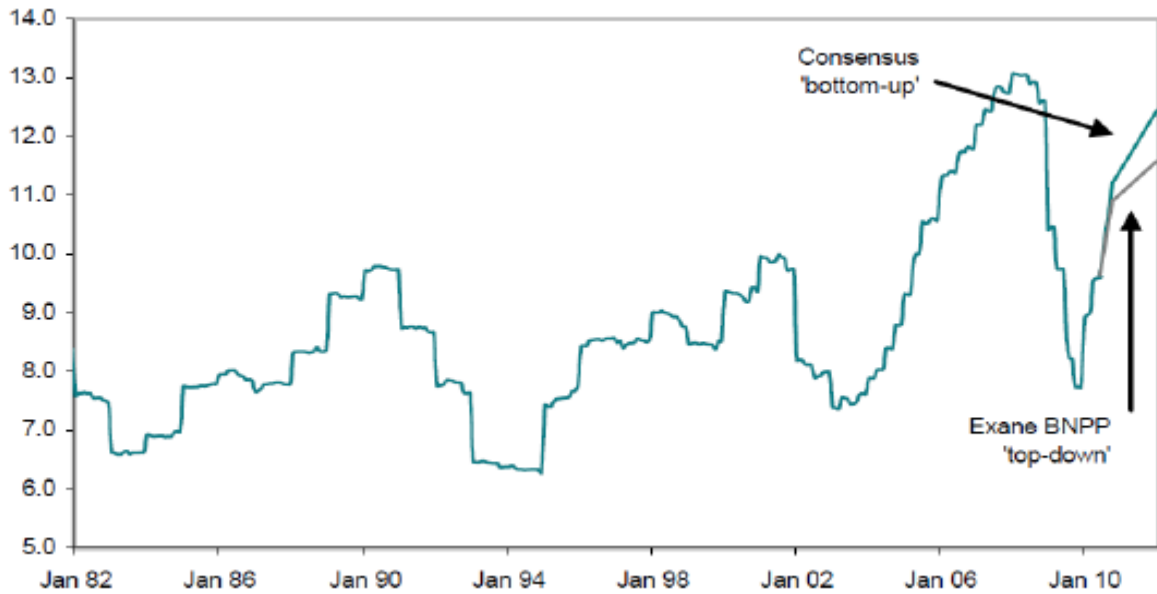
First, many non-financial corporations were not very leveraged going into the crisis. At CapitalatWork we even though some specific companies and industries were actually under-leveraged, which happened to be a blessing.

Second, because the previous downturn (2002/2003) was not so far back, companies were still working to enhance productivity.

Third, the so-called "emerging" economies are in much better financial shape, with regards to their public finances and their banks, than the traditional economic powers, and have therefore continued to grow throughout the 2007/2009 crisis. Most of the top-line growth of US and European non-financial companies has come from growth in emerging markets.

Fourth, even the US and Europe are growing again, albeit unevenly. Growth does come from restocking after the dramatic destocking of 2008 and thanks to government support, but not only. Extremely low interest rates and renewed capital expenditures thanks to über-healthy balance sheets are sources of growth.

**EBIT margin (Europe ex Financials) Exane top down vs bottom-up consensus**



Source Exane BNP Paribas

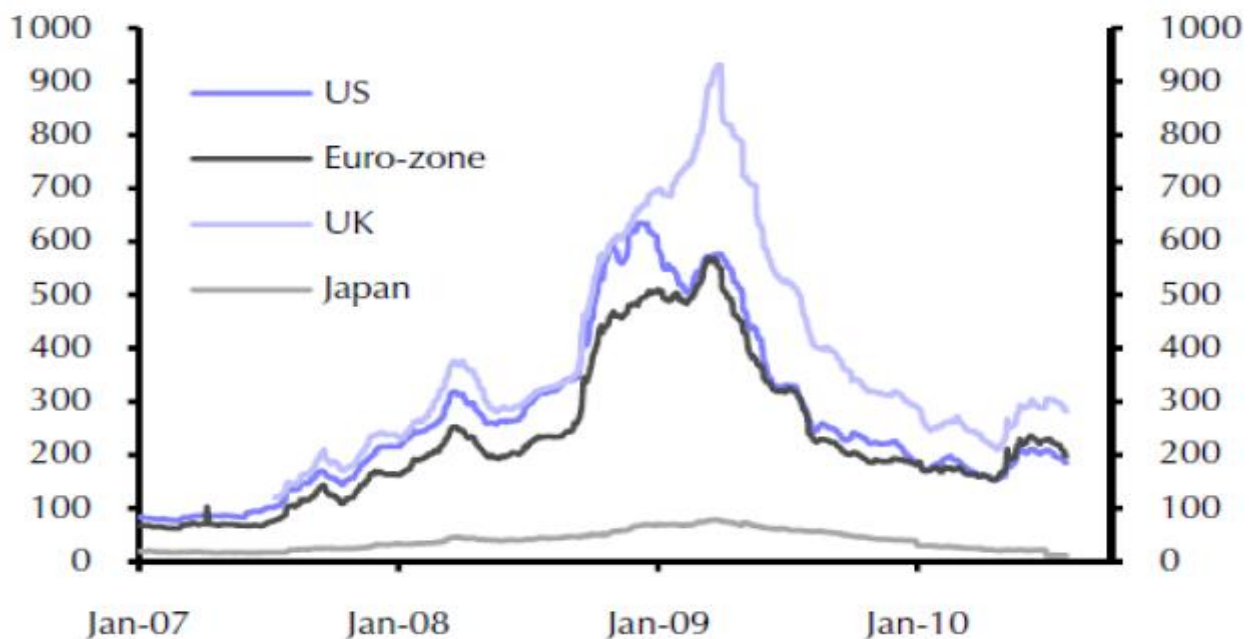
In any case, in a world with deteriorating public finances, the health of corporations feels like an oasis in the desert, even if corporations, especially the most profitable ones, always face the danger of government intervention, regulation, taxation and even robbery as we have seen in Russia or Venezuela.

At CapitalatWork we think there is still value in corporate bonds.

We feel comfortable owning diversified portfolios of bonds of corporations for which we have clear forward-looking cash-flow tables.

In doing so, we feel we have a margin of understanding and a margin of safety on top of a decent compensation, as you can see from the below graph.

**7-10 Year average Corporate Bond spread (bp)**



Source: Capital Economics

#### 4. Corporate Equity

This is the asset class where investment and work, the two sources of income, come closest together and also where our idea of long duration assets come to its most extreme conclusion as equities have, in theory, an infinite duration.

Does this mean we are bullish on equities?

Well, being bullish is usually understood as expecting higher market prices in a not-too-distant future.

At CapitalatWork we are first and foremost impressed by the consistent profitability of non-financial corporations, by their very healthy balance sheets, and by their very low valuations.

Consistent profitability coupled with healthy balance sheets, allow companies to return cash to shareholders under the form of dividends or share buy-backs. Before any price appreciation or depreciation, shareholders, on average, can expect **2% to 4% annual dividends** from their equity holdings. Obviously some companies have dividend yields which are above (4% to 6%) that and some below. In the US, the culture is more geared towards share buy-backs.

Valuations?

At current market conditions (Mid August, 254 on the Eurostoxx600 and 1080 on the S&P500), companies are expected to post **earnings for 2010, of which 50% is already realized, equivalent to roughly 8% of market prices, or a P/E of 12x.**

#### Valuation – Consensus estimates

##### *By index*

	P/E (x)		
	2009	2010e	2011e
MSCI Europe	16.4	11.8	10.2
MSCI Europe Large Cap	15.6	11.3	9.8
MSCI Europe Mid Cap	22.4	15.3	12.3
MSCI Europe Small Cap	28.8	14.7	11.2
MSCI Euro	15.0	11.2	9.7
CAC 40	16.0	11.3	9.7
DAX 30	17.6	11.9	10.1
SBF 250	18.2	11.5	10.2
IBEX 35	11.5	10.7	9.6
FTSE 100	17.0	11.6	9.7
SMI	16.3	12.1	10.7
MSCI USA	19.3	13.7	11.8

Source Exane BNP Paribas

Again, this is on average. CapitalatWork owns a lot of companies who generate cash in excess of 8% of market prices.

One example is **Intel** which at current prices (19,5 USD) is expected to generate +-2,0 USD cash per share, equivalent to **10% of equity and 13% of enterprise value.** Intel has 17 Bln USD of cash and no debt!!!

This would be attractive in normal (what is normal?) circumstances. In current circumstances, with government yields at all-time lows of 0,5% to 3,5%, this is simply compelling!

Why such low valuations?

Investors just don't seem to believe current profitability can be maintained, let alone be increased.

The good news is that **current equity valuations don't need growth to be attractive** based on 9% to 11% required returns. Sometimes valuations are so low that they actually imply negative growth of earnings going forward.

There is no doubt that there will be growth going forward, but it is not urgently and imperatively required.

**Such low valuations are rare occasions to acquire equity in top quality corporations for the longer term.**

### As a conclusion, where do we see value ?

At CapitalatWork, we think there is ...

- 1. Defensive Value** in long government bonds of serious countries, if we are going into a disinflationary or deflationary environment , which happens to be our view.
- 2. Value** in long corporate bonds of corporations with great balance sheets.
- 3. Exceptional & Contrarian Value** in corporate equities with very low expectations being discounted.
- 4. Emerging Value** in EM currencies, of countries with sound public finances and solid growth prospects.
- 5. Opportunistic Value** in some specific derivative strategies.

### CapitalatWork's funds ?

CapitalatWork Funds	16 <sup>th</sup> of August 2010 - Ytd return - in Euro
Cash+ at Work	2,00%
Cash+ Opportunities	0,63%
Inflation at Work	7,77%
Government Bonds at Work	9,33%
Corporate Bonds at Work	10,85%
European Equities at Work	1,70%
American Equities at Work	9,79% (-1,65% in USD)
Asian Equities at Work	11,48%
Contrarian Equities at Work	5,59%
Contrarian Euro Equities at Work	0,16%
Best of Equities	6,36% (11 <sup>th</sup> of August)
Global Opportunities at Work	7,89%

## CapitalatWork's portfolios?

Our portfolios have been doing very well, with a positive return and low volatility, which is of course no guarantee for the future.

We have NO money allocated to any of the most troubled countries like Greece, Portugal, Ireland or Spain, the so-called PIGS.

We have NO money allocated to any company based in those same countries.

We have LITTLE or NO money allocated to banks, which is the industry with the most significant direct exposure to the PIGS-countries.

Our exposure to the PIGS is only mildly indirect as most multinationals have some revenues in these specific countries.

With regards to our fixed income investments we have above-average durations in line with our basic deleveraging and disinflation thesis.

We own some non-Euro currencies as defense against further intra-Euro tensions. We own some Norwegian Kroner, Norway being a very small but very rich country with vast oil reserves and a huge sovereign wealth fund.

We own some US and AUS dollars, Australia being also a country with vast natural resources and acceptable public finances.

We own further emerging currencies through a third party fund with good performances.

All the above leads to really exceptional performances of our fixed income funds and portfolios; performances which will, with 99,99% certainty, not be repeated as rates have trended down almost without interruption.

On the equity side there have been less significant differentiating factors to mention but we do own great global companies, with very healthy balance sheets and, great growth prospects, at low valuations.

It is difficult to convey how confident and even enthusiastic we are, owning the companies we own, going into a challenging and changing world.

Our mixed, equity and fixed income, funds have therefore done very well indeed and we feel very serene with regards to the future.

Don't hesitate to call upon us for more explanations, for a portfolio discussion or for any other subject which relates to the management of your assets and liabilities.

CapitalatWork Foyer Group, 18<sup>th</sup> of August 2010.

Responsible editor: Ivan Nyssen

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