December 2014

Still walking on thin ice

- Selective price rally – large caps the main beneficiaries
- Is "buy & hold" a suitable risk strategy for 2015?
- 2014 ends on a conciliatory note for stock markets

The rebound in share prices that began in mid-October continued through November as well. Defensive large-cap shares were the main beneficiaries of this rally. The S&P 500, the main index of US heavyweights, posted a solid gain of 2.45%. One of the biggest drivers of this performance was Apple, whose shares rose by more than 11% within the space of a month, thereby contributing almost 0.5% of the index gain. By contrast, the broader Russell Index, which tracks the performance of America's top 2'000 companies, was almost unchanged from the previous month. The Swiss Market Index, which includes the main heavyweights, also advanced 3.5%, an outperformance of 1% relative to the Swiss Market Index Mid, which contains such well-known names as Lindt & Sprüngli, Sika and Bucher. European equity markets also shrugged off a prolonged period of weakness and moved back into positive territory across a broad front, with the Dow Jones Euro Stoxx posting an impressive gain of 4.55%. Investors' defensive stance was not only evident in equities, however, but also in bonds. High-yield paper and bonds of various emerging-market countries were unable to make good the price losses of the previous month. On the other hand, the prices of high-quality bonds continued to rise. It is no exaggeration to describe the significant drifting apart in the relevant asset classes over such a short period as "extreme".

Is "buy & hold" a suitable risk strategy for 2015?

As we approach the end of 2014, it's an opportune moment to review our strategic allocation for portfolios for the coming year. One conclusion can already be drawn for 2014: investors who shied away from making clear decisions or struggled to cope with the occasionally erratic stock market trends generally tended to favour a combination of passive ETFs, complemented by a typically static mix of equities and bonds. It's fair to say that this simple as well as low-cost approach proved to be the most successful strategy over the course of 2014. By contrast, an active management style combined with broad diversification at best only partly paid off. However, we believe it would be wrong to jump to premature conclusions and abandon active management entirely. Even though the strategy of simply "doing nothing" turned out to be successful for once, history shows that this is an exceptionally high-risk approach, as it ignores the inherent risks that an investor assumes in adopting a passive strategy. What actually are these risks?

- Past experience shows that investors achieve the highest returns by avoiding major price setbacks. Even though there has not been an actual stock market crash in the past six years, the level of volatility has recently increased significantly. We therefore advise against a pure "buy & hold" strategy – based on a fixed portfolio of equities and bonds, for example. The only way to successfully cushion or avoid price shocks is to adopt a systematic process that excludes every possible human emotion, continuously analyses the relevant data and then delivers appropriate signals for decision-making.
- Even investors who covered their Swiss equities allocation through ETFs on the Swiss Market Index managed to achieve a handsome return in 2014. Conversely, a broadly diversified share portfolio – for example one based on an equal weighting of all stocks – only managed to generate a marginally positive return. Whether they realise it or not, however, investors who follow the first strategy have 70% of their money invested in the shares of just three index heavyweights: Novartis, Roche and Nestlé. In doing so, they expose themselves to a significant cluster risk, which from the perspective of

diversification can only be classed as a strategy bordering on the negligent, even though it turned out to be successful on this occasion.

- Investors who chose ETFs on the main bond indices to cover their allocation of high-quality Swiss, European or US bonds were also able to pocket impressive gains. This is attributable to the increasingly long residual maturities of the bonds contained in the indices. On top of that, it is worth remembering that any reversal in interest rates (however unlikely it may seem at the moment) could lead to substantial losses in the price of ETF investments. Given the current interest rate level of less than one percent, it would actually take about five years to recuperate the losses caused by a one percent hike in interest rates. We think investors should avoid such a risk/reward profile, even if it did pay off in 2014. Furthermore, this type of allocation also exposes investors to a high sector risk, as the financial services industry is by far the biggest issuer of bonds.

The forecasts for stock markets in 2015 are fairly worthless in our opinion, purely because of their general inaccuracy. However, it does not take a clairvoyant to see the absurdity of a situation where the financial system continues to enjoy generous liquidity, while at the same time liquidity will diminish in the securities exchanges. This is down to the changing regulations that make financial institutions less willing to act as market makers. One of the potential consequences will be more exaggerated fluctuations in a number of different asset classes. This view is also shared by the Committee on the Financial Global System (CGFS), set up by the Bank for International Settlements. As price volatility increases, this will mainly impact investor behaviour and ultimately have more of an effect on their investment decisions than on the macroeconomic environment, which was after all the original intention of the regulations. The success formula for the clever investor in the forthcoming year is therefore unchanged: they should base their decisions exclusively on a systematic, disciplined and unemotional approach that also takes into consideration macroeconomic factors and aspects of behavioural finance, and implement this strategy through a broadly diversified portfolio of individual investments that spans a large number of sectors.

2014 ends on a conciliatory note for stock markets

As we approach the end of the year, the situation is no different from previous months: the fundamental part of our asset allocation model is still signalling a benign environment for equities. Strong support continues to come from the loose monetary environment, with the European Central Bank in particular still left with ample room for manoeuvre in the Eurozone. The valuation of the market as a whole currently seems to be more or less neutral, whereby Europe still has a cheaper valuation than Switzerland or the USA. When it comes to the real economy, consistently robust US consumption will sustain the appeal of equities. By contrast, the industrial sector will remain sluggish, especially in Europe.

The indicator of risk appetite, which reflects the market psychology component of our asset allocation model, is showing signs of stabilisation and continues to support the case for equities. Four out of five categories are giving a buy signal, and only the “market risk” category has been stuck in the sell range for the past month. Investors still seem to be reluctant to pay for higher valuations – apparently they consider the prospects of higher earnings in future to be too small.

Viewed overall, the case for equities is supported by both the fundamentals and market psychology. We therefore expect markets to remain calm and benign as the year draws to a close.

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