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View From the Trenches

When we last wrote this piece, the stock market was 50% off its October 2007 peak and credit spreads were at historically wide levels. Now, the stock market is nearly 65% ahead of its March 2009 low and spreads have compressed significantly. So once again, we interviewed some of the most talented managers across asset classes to learn what they see as the risks and opportunities ahead.

Equities

Early last year, value managers were finding lots of bargains. This year the “for sale” bins are emptier with managers looking much harder to find attractively valued companies. Financials, which contributed strongly to many value managers’ returns during 2009, are now underweight due to quality concerns over commercial banks’ balance sheets. Growth managers are emphasizing the technology sector, with the software and mobile technology industries of particular interest. Otherwise, little consensus exists on sector views, suggesting the increasing importance of stock selection.

Among all equity managers, global exposure remains an important theme. While some managers, particularly in the large-cap segment, allocate directly to non-US holdings, all managers are looking for companies with significant revenue or market share outside of the U.S. Emerging markets is an area of emphasis for both international and domestic managers. Key risks that managers are watching include increased taxation and government intervention near term, and inflation longer term.

Fixed Income

Many bond managers believe we are facing what PIMCO has famously defined and termed the “new normal” – an extended period of low growth as unemployment and deleveraging of the consumer put a cap on spending, and low interest rates as the Federal Reserve remains accommodative. Inflation is likely to remain muted over the next year or two, but nearly every manager believes inflation will reach high levels over the longer term due to the Fed’s accommodative stance and an inability to unwind its various asset purchase programs to withdraw excess liquidity from the market.

For the most part, managers are avoiding the intermediate portion of the yield curve and cautious on the long end. Intermediate rates have been very volatile due to mixed economic data, while long rates have been pressured by massive government supply and increased concerns on the US government’s creditworthiness. Several managers are expressing very negative views on Agency MBS, given rich valuation levels and an expectation that they will sell off as the Fed’s \$1.25 trillion MBS purchase program winds down by the end of the quarter. Views on credit are somewhat mixed, suggesting increased importance on security selection.

Hedge Funds

Managers are diversifying away from dollar denominated assets as the long term expectation is for dollar depreciation, with a big emphasis on the emerging markets. Among credit managers, concerns are that developed market country yields, including the U.S., Japan and Europe, are insufficient given burgeoning budget deficits. By contrast, many emerging market countries are in better shape while their credits provide much higher yields. Global long/short managers cite the stronger economies, more stable fiscal conditions, and unleveraged consumers as reasons to emphasize emerging market equities.

Natural gas and shale investments are attractive for equity, credit and MLP managers. Many express that new drilling techniques have resulted in large discoveries that could result in energy independence for the US. Natural gas is much cleaner than coal and diesel and cheaper than “green” alternatives like wind and solar. Africa, particularly sub-Saharan Africa, is viewed as a source of burgeoning opportunities, especially in the natural resource area, although true investment opportunities are slim.

Hedge Funds (continued)

Similar to comments expressed by traditional fixed income managers, distressed debt managers are rotating out of broad plays in leveraged loans and high yield and focusing on higher quality, idiosyncratic opportunities that require a great deal of research to extract value. Trade claims and bankruptcies are areas of focus.

Private Equity

Private equity secondary transactions did not materialize at the record levels expected in 2009. While most managers anticipate a large volume to materialize in 2010-2011, expectations vary widely. Corporate acquisitions are expected to be slow, but overall deal activity should be much stronger in 2010 due to lower valuations, lots of “dry powder”, and easing credit conditions. Additionally, a large number of sellers including some private equity funds, need realizations. The new capital gains tax that goes into effect at the beginning of 2011 may induce a number of investors to look for exits in the second half of 2010 to avoid the tax increase.

The fundraising environment will remain competitive as firms delayed fundraising in 2009 and investors have scaled back commitments to the space. This is expected to result in friendlier terms for LPs. Energy was one of the only sectors to experience strong fundraising in 2009. This trend is expected to continue in 2010 as investors look to hedge inflation risk.

Real Estate

Managers of private real estate are cautiously optimistic, believing the precipitous fall in values should end in 2010. Modest price declines in the first half are expected to be offset by income. Income levels (7-8% on core properties) could decline as vacancy rates across all property types are at or moving above 1990 peak levels. High legacy debt levels with upcoming maturities and tight credit may force sales and help set equilibrium price levels. During the past 18 months, transactions have been limited to primarily high quality properties. Investment opportunities are growing in distressed situations (value-add, opportunistic).

During 2009, REITs recapitalized their balance sheets, raising approximately \$60 billion of new equity and debt. This reduced balance sheet leverage from 90-95% to 60-70%. Also, many REITs paid dividends in the form of stock instead of cash. Well capitalized REITs with the capacity for growth are likely to make accretive acquisitions over the next few years. In some respects, REITs are in better shape than private real estate managers, nonetheless, they appear fairly to slightly overpriced. Historically, REITs trade at an average premium over their NAV of 2%. Currently, REITs trade at a 4% to 15% premium to their NAVs.

Bottomline: With the beta play largely over, managers agreed that security selection will be critical. Trends are difficult to identify in the current environment, but two themes did emerge – a move away from US dollar-denominated assets, particularly to the emerging markets, and that inflation will be a key risk factor within a few years. Private equity and real estate are still recovering. Although transactions have been limited, tight credit and investor liquidity issues are moving prices to attractive levels.

The opinions contained within this document are those of Stratford Advisory Group, Inc.