BFI InSights | Q4 2016

BFI

Editorial

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As I write this, updates on Deutsche Bank's woes keep rolling in. Its shares have plummeted to record lows and fears of its potential collapse are on the rise, all under the weight of a proposed $14 billion fine from the US Department of Justice. No help is forthcoming either, as the German government made it clear that there is no rescue plan in the works.

DB is not just another ailing European bank; it is one the world's largest lenders, and the ripple effects of its troubles are already manifesting in the markets, as contagion spreads across the continent. I believe that as the DB crisis is set to linger and its effects will be widely felt, it is not inconceivable that governments will be forced to rethink their position and work on another bailout.

After a period of what we could describe as relative calm following the 2008 recession, we are now seeing signs of upheaval in the markets once again. Troubled banks are not the only cause for concern in coming months: a number of upcoming political events also have great potential to disrupt the markets as well.

November 8th is Election Day for the US, the outcome of which is currently projected to favor Hillary Clinton. But a Trump surprise is not entirely out of the question and, if it were to occur, is bound to send shockwaves through the markets, even beyond the US. While Clinton appears to be a "known evil", financial markets appear to favor the "familiar" over any uncertainties, even if Trump might be a positive surprise. Psychology is a mysterious thing.

December will also be interesting. The Italian referendum, on December 4th, is aimed at streamlining the iconically chaotic Italian political system and it's a personal bet for PM Mateo Renzi, who made it clear he'd resign if he lost. On the same day, Austria will hold its election re-vote. The polls predict a close race between Norbert Hofer of the conservative Freedom Party and the center-left candidate, Alexander Van der Bellen.

The coming months certainly won't be lacking the types of tensions that have the potential of significantly impacting our lives and investment decisions. However, with every crisis comes an opportunity, and this is precisely what we are looking out for here at BFI.

In the Limelight: What redemptions in the hedge fund industry are telling us

Hedge Funds have been in the news lately due to increased levels of outflows. We analyze these figures and examine whether the bleak mainstream reports are justified or overblown.

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Swiss Private Banks: A dying breed?

We look into the true nature of the challenges faced by Swiss banks and the opportunities that have arisen in recent years, allowing many banks to thrive and to carry on the country's centuries-old tradition.

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The Zulauf Perspective

Overview

Minor improvements in major economic indicators have led investors to believe that the economy is finally back on track, fostering a false sense of security and encouraging complacency. The rise in bond yields is part of a cyclical bottoming process for rising yields. Rising yields are bad news for equities as most assets are priced off interest. In regards to gold, it has most likely topped on a medium-term basis. However, we could see another short-term bounce and should expect buying opportunities next year and beyond.

Where are the equity markets headed?

The recent sell-off should be seen as the start of something rather than the typical brief dip that one should buy. Felix, in his analysis, had already warned of a medium-term correction in global equity markets and still believes that there is reason to be cautious. This mid-term trend could persist and possibly reach its low prior to the US presidential elections, which, given the dangerous levels of investor complacency developed over recent months, could ultimately cause a sharp increase in volatility.

The "mini bull cycle" that started in Q1 this year, which is expected to continue into 2017, is also a part of a long-term topping process of the bull cycle that started with the 2009 lows. This long term-cycle will most likely be completed next year.

Has the economy really recovered?

Over the last 25 years, the world economy has grown increasingly dependent on China as a major contributing force for growth: as long as China kept growing by around 10% in real terms, it sustained and supported the global economy. Now, however, this vital driver has entered a slowdown phase, with its growth rate reduced to 6-7%, as the official figures state (and could be even half of that in real terms). This vacuum will need to be filled by the world's developed economies.

On the surface, the EU economy has indeed outperformed expectations, overtaking the US economy, while the EUR/USD declining from 1.60 down to 1.05-1.15 has been a major driver in making Europe more competitive. However, Europe's leading economic indicators (LEI) do not point to a decisive recovery, but instead a continued slowdown in the region's economic activity. Germany is perhaps the sole exception, growing at a 3% rate, as a weaker euro boosted its exports and employment figures. The fact remains, however, that a third of German jobs are dependent on the automotive industry, and when this sector slows down, it will have a significant impact on both Germany and their subcontractors in other regions. Still, some fiscal stimulus remains possible from Germany, as the country's finance minister recently confirmed the government is considering income tax cuts for private households; a plausible measure, in lieu of the October 2017 elections. Meanwhile, in the US, growth is also expected to remain weak, as all sectors, apart from the consumer, have been slowing down. Substantial improvement would require private investments and this seems unlikely to happen at the moment due to eroding profits.

All in all, it seems that the world economy has settled in to low levels for now, yet the potential for sustainable, real growth is unlikely for the next few quarters. Leading indicators are not as reliable as they once were, while the financial leverage globally is higher than ever before, thus raising serious concerns and risks for the year ahead.

Bond Yields still in a bottoming process

As the global bond market has been fundamentally distorted by Central Bank interventions, some have called it a bubble. Yet Felix sees the trends more as part of a long-term bottoming process, in which occasional sharp yield rises are expected. Nevertheless, their upside is limited by the weak global economy. Although yields could soften once more after the current medium-term rise is complete, it is expected that this bottoming process

will continue and yields will be rising through 2017.

When this mid-term yield rise ends, as a result of an eventual increase in volatility indices, the consensus' hopes of a global economic pick-up will be gone again, as the big-picture outlook is indeed worrisome. Since global debt doubles roughly every decade, the world could go from $200 trillion to $400 trillion by 2025, while money supply injections and systemic leverage will be gigantic. Meanwhile, the rise of populism, nationalism and protectionism in the West, not to mention the rest of the world, has a dangerous inflationary potential as the middle class is expected to continue to shrink.

Gold Expectations

While gold's advantage as a protection against aggressive governmental interventions in the economy remains unquestionable, it has recently demonstrated a rather underwhelming performance during this risk-off period in other markets. However, another great buying opportunity lies ahead next year, as well as a multi-year bull market in gold to follow, as we eventually enter a more inflationary era.

Investment Implications

During the most recent correction phase, we saw both bond prices and equity markets correcting at the same time. This confirms our strategic view at BFI of the importance of including assets that are uncorrelated with traditional asset classes, such as hedge funds. In addition to our diligent selection process for high-quality hedge funds, and while we continue to closely monitor their performance as well as all relevant developments in the markets, we remain confident of their effect as a diversifier leading to a more stable, resilient and robust portfolio, particularly during these turbulent times.

Felix Zulauf, founder of Zulauf Asset Management, has worked in the financial industry and asset management arena for almost 40 years. He was one of the first successful hedge fund managers in Switzerland, and he is well known for his excellent market timing and market-cycle predictions. He has also been a prominent member of the Barron's Roundtable for almost 30 years. The Outlook above is a summary of his thoughts conveyed to BFI in our regular meetings and discussions with Felix.

In the Limelight: What redemptions in the hedge fund industry are telling us

2016 has definitely been a rough year for hedge funds in the press, with an avalanche of negative stories in the mainstream media painting a bleak and gloomy picture of the entire sector.

A closer look

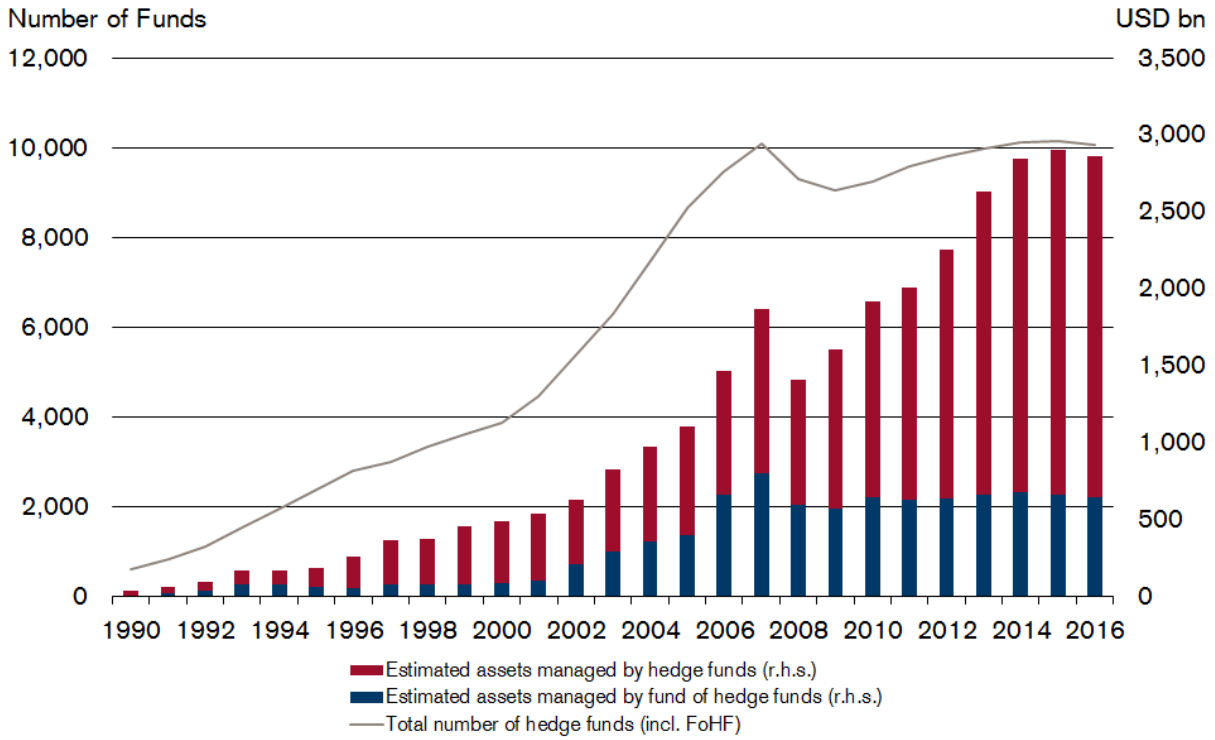
"Hedge funds recorded their highest monthly outflows in July since February 2009, continuing a downward trend that began in January. For the first seven months of 2016, hedge funds suffered withdrawals of nearly $60 billion", according to analytics firm eVestment. In July alone, investors withdrew $25.2bn, according to the report.

These figures sound staggering, and indeed they are. However, to get a clearer understanding of what these absolute numbers actually mean, we have to put them into context.

As shown in the chart below, assets under management in the global hedge fund industry are still hovering around the $3 trillion mark. In this light, the losses appear much less dramatic than the headlines have suggested. In fact, in the historical context, as illustrated by the chart below, one can hardly notice the "massive outflows" reported by the media. To the contrary, it is clear that after the significant losses of the 2008 recession and its aftermath, the assets managed by hedge fund still remain at almost record highs.

Even though it is evident that the mainstream media has blown the hedge fund "crisis" out of proportion, it is true that some managers have indeed faced challenges and increased pressures this year. Given the diverse variety of different investment philosophies and approaches within the hedge fund industry, it is interesting to see what kind of strategies investors favor in the current environment.

Figure 1. Assets managed by hedge funds (incl. FoF)



Source: Bloomberg,Credit Suisse

As we can see in the chart below, Figure 2, the most popular strategies for the first half of 2016 have been equity long/short and equity market neutral. This marks a significant change of outlook and a repositioning from the past years. It appears that now the majority of hedge fund investors, which are mainly professional money managers themselves, see trouble ahead in the equity markets, thus opting for more conservative positions not correlated to the stock market.

What is driving the redemptions?

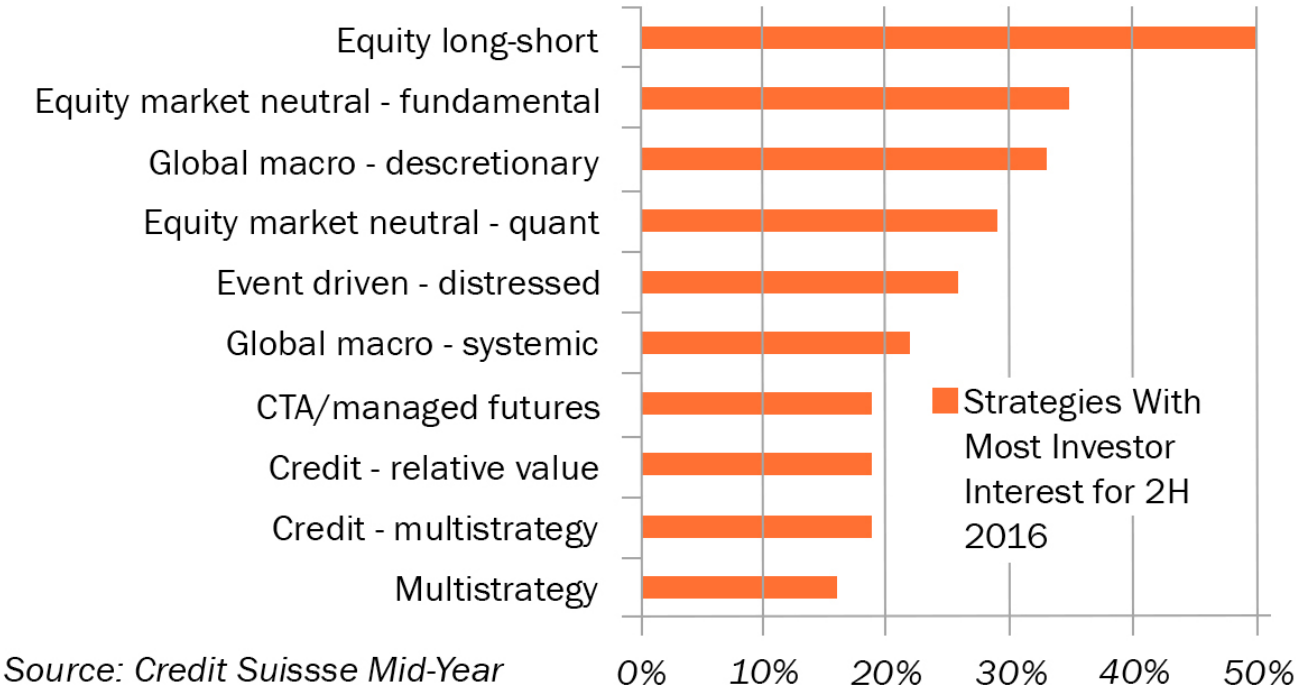
The main reasons that led investors away from many hedge funds were high fees and underperformance. Many investors have been disappointed with their performance and questioned whether certain managers and the results they delivered were worth the fees incurred.

After experiencing a multi-year extreme bull market after the crash in 2008, many institutional investors, like pension funds, recently sought to increase their performance by taking on more risk. Their mix of hedge funds might have generated positive returns over the years, but failed to keep up with the stock market. Investors expected equity-like performances from the hedge funds, and when that failed to materialize, they complained about the higher fees hedge funds charged in general, compared to mutual funds or ETFs. Nevertheless, it is important to note that this behavior is purely "missed-performance"-driven and does not take into account wider risk considerations. Therefore, it might not take long before those investors that shifted from hedge funds to equities start missing the stabilizing effects and downside resilience associated with hedge funds. The chart in the following page (Figure 3) shows a pertinent historical example. From October 2007 to March 2009, the Hedge Fund index for Market neutral funds was down 1%. In that same period, the S&P lost 52%!

Conclusion

The whole point of a hedge fund is to provide an alternative source of returns that is independent of the stock market's movement. The original "promise" to investors was to protect them from market ebbs and flows. Some have indeed failed to deliver on that promise and they are the ones now paying the price. However, there are ones that did

Figure 2. Long-Short Equity to Draw Most Interest in 2H



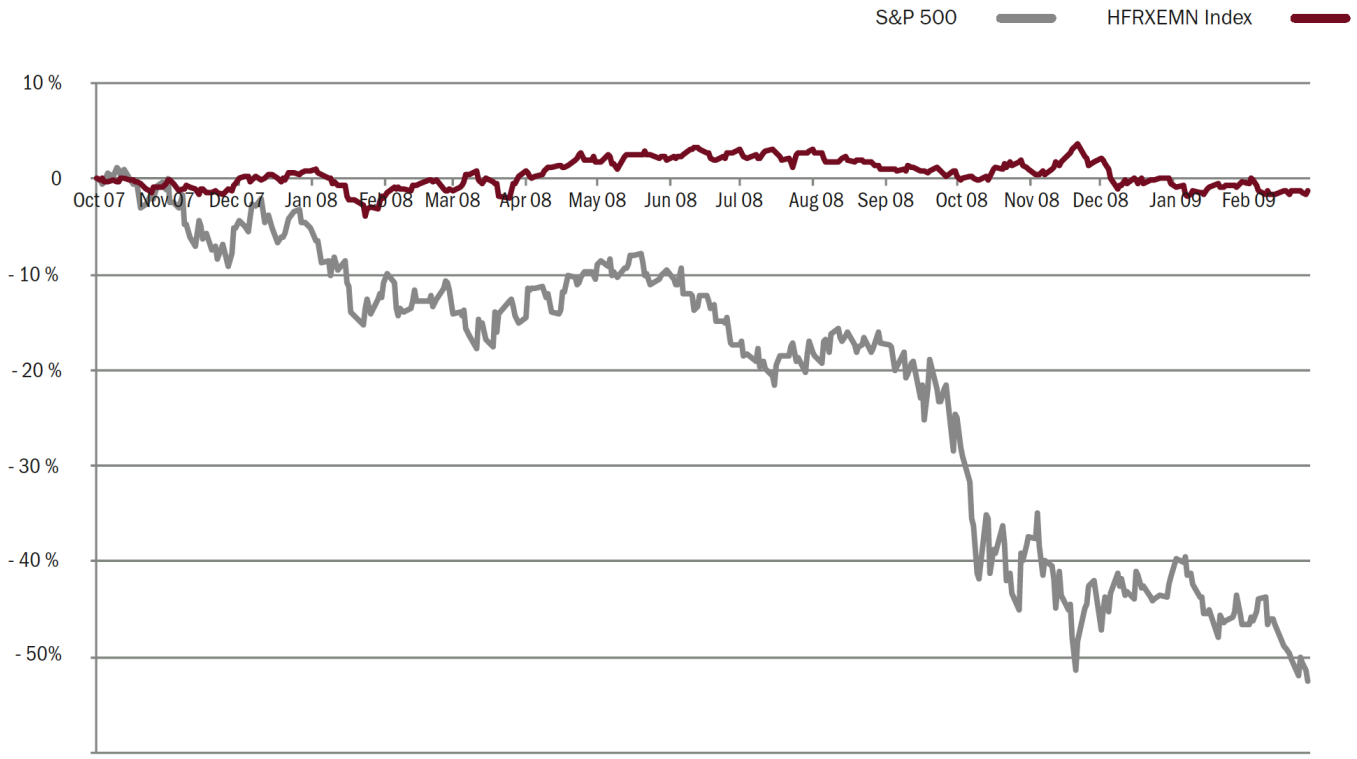
Source: Credit Suissse Mid-Year

Source: Bloomberg,Credit Suisse

deliver. According to a recent report by Preqin, "Over the course of the first half of 2016, there were some bright spots", showing that investors saw value in some of their hedge fund holdings.

Thus, we don't believe that it is justified to condemn all hedge funds. Even during this tough period for the sector, there have been notable outliers and winners. In our view, one can still find good options after a careful examination and selection, according to individual needs and expectations. Here at BFI, we have focused on the Hedge Fund index of market neutral strategies because we see this strategy as a viable and reliable alternative in the type of environment we're facing now. Some of market neutral strategies we currently have amongst our current mix of hedge funds were even able to generate gains of 14.22% and 19.83% in 2008.

Figure 3. Hedge fund index of market neutral strategies vs. S&P performance



Source: Bloomberg

Swiss Private Banks: A dying breed?

A wave of negative reports and pessimistic commentary has cast an unfavorable light on Swiss private banks in recent months. Alarming headlines of "Swiss private banking in the middle of a historic upheaval" and "One in ten of Switzerland's private banks disappear" have tried to paint a sinister picture of a Swiss banking sector "in crisis", and of the country's long-term money management tradition coming to an end. Bearing in mind that the private, global banking sector in general has faced significant challenges in these trying times, is it justified to single out Switzerland as the terminal patient?

Taking it into perspective

In order to evaluate the validity and accuracy of these reports, let's look at the actual facts. There is some truth to the claim that Swiss banks have faced an uphill battle, but the specific details - the nature of this battle, and its consequences - might be surprising to the average financial news consumer. The numbers of banks operating in the country fell for the 10th consecutive year, led by foreign company exits; there were 266 banks at the end of 2015, down from 275 at the end of 2014. Assets under management slipped 1.3% to CHF 6.57-trillion ($6.70-trillion) in 2015 and fell further, to CHF 6.42-trillion by the end of May 2016. But what are the reasons behind this trend?

In recent years, Swiss private banks have witnessed a sweeping increase in both the density and complexity of regulation, a multiplication in various legal barriers, and a pile up of ensuing compliance costs. Additionally, the continued low interest-rate environment and the anemic European economy in the background are also putting significant pressure on their margins. And then there were the widely publicized campaigns by the US and the EU to weaken Swiss banking secrecy targeting one of their most publicly known "selling points".

It therefore seems that this proclaimed "crisis" has a lot more to do with politics than with financial robustness, managerial competence, service quality, or actual performance of the banks. Swiss private banks have been repeatedly targeted and used as scapegoats in recent years, all through the widely used, crowd-pleasing political rhetoric of "the global clampdown on tax evasion". This has generated more bad press for the country than warranted, especially considering that it was the practices of just a few banks, or even just a few individuals within them, that were used to paint the entire Swiss banking sector as unscrupulous or, at best, suspicious.

The press echoed and amplified this sentiment, prematurely announcing the "end" of Swiss private banking based on the erroneous assumption that secrecy was the only benefit the country's bankers had to offer. It is a factually flawed assumption to think of Switzerland merely as a place to hide one's assets away from prying eyes. It would be hard to believe banking secrecy alone accounted for the main reason why investors have preferred the country's banks for centuries.

All doom and gloom?

Is it reasonable to believe that this trend is enough to threaten the long tradition of Swiss Banking? "Private banking was invented in Switzerland," as Boris Collardi, chief executive of Julius Baer, put it, invoking a history that stretches back to the 15th century. "This is a place where you keep your money…An island in the world for stability, solidarity."

Even under the current conditions, not all Swiss banks are affected equally. There are small and agile private banks that still fare well, while quite a few have even found ways to actually thrive in this environment. Fierce competition and external pressures have wiped out many of their competitors, those that were to slow to respond to the changes, and those that had based their business models on the shaky grounds of the gray areas of international tax laws. The banks that have survived, today boast a clean bill of health, achieved by quickly adapting to both the regulatory environment and the market

itself. They have specialized and found profitable niches to build on. As a recent KPMG report on Swiss private banks found: "Provided a bank can specialize and offer a product, service or market which isn't readily available elsewhere, it can thrive." The higher standards for legal and regulatory compliance have actually driven mid-size and smaller banks to focus on specific markets, amass experience and expertise, and build their relevant client base. Especially in connection with the US, the war-on-tax-evasion may have managed to close the doors of Wegelin, the oldest Swiss private bank at the time, but it offered an opportunity for smaller and more agile players. Regional compliance specialization emerged as major competitive advantage.

The Swiss Banks' real USP

"The reputation of Switzerland in the world with clients is better than you would think when you read the press," proclaimed Tobias Unger, deputy chief executive at Falcon, a midsized Swiss private bank, in a recent interview. "If you have something to hide these days, the first destination is not Switzerland, it's the US."

Contrary to mainstream public perception and to mass media reports, the real advantage that Swiss banks have to offer is not tax-dodging, nor has it ever really been. It always was the service quality, the expertise, and the uniqueness of Switzerland itself.

With a centuries-old banking tradition, Swiss banks have amassed profound knowledge and insights in asset management, as well as a pool of truly high quality managers and advisors, resulting in a quality level of banking services that can't be found anywhere else. This is why, despite all the headlines and the commentary, Switzerland still remains the largest offshore jurisdiction in the world. According to a report by Swiss Bankers Association (SBA), Switzerland remains the global leader for cross-border private banking, with USD 2.4 trillion managed in Switzerland; a market share of 25.0 percent.

The client relationship also plays an important role in establishing a significant competitive advantage. Swiss bankers protect their clients' interests and privacy and, particularly with the smaller banks, are able to give financial and investment advice that is tailored and specific to each client's needs. It's personal relationship: a relationship of trust and reliability.

Switzerland itself provides a solid guarantee for investors, especially for those seeking a conservatively and responsibly planned financial future. In these uncertain times, Switzerland offers political and economic stability. Located in the heart of Europe, yet not a member of the EU, Switzerland is well positioned as a financial services center, being better insulated and better equipped than most other countries to respond to and tackle the economic and political challenges over time. Moreover, in Switzerland, there is no realistic way or mechanism for the state to transgress or to overreach against private property and financial sovereignty. The confederate system and the country's direct democracy processes, calling Swiss citizens to vote on legislative and constitutional decisions every three to four months, limits central government power and reigns in actions that go against constitutional rights.

The Swiss banks' real advantages, therefore, still stand and the fundamental added-value they provide remains intact and competitive as ever, despite the political campaigns and the press misrepresentations of the banking sector. Switzerland is still the best and safest choice for investors and savers alike. Switzerland's private banks that remain today are robust, providing reliable solutions and wealth management advice. The challenge that remains for investors is finding the right bank, or the one point of contact that works with numerous banks in Switzerland, that matches best to their individual needs.

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