

Insights, Tacit Thought | Weekly Investment Insights

Using Volatility to Our Advantage

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Speak to anyone in the financial world right now and they'll say the same thing. "It's a jungle out there!" Well if they don't quite use those words that's what they mean. At Tacit we've been using the market volatility to tactically trade out of and in to certain holdings.

Our headlines? These are they.

We've actioned key trades. Top sliced selected overseas equities – Scottish Mortgage, Jupiter Financial Opportunities, Loomis Sayles US Equity Leaders, GLG Japan CoreAlpha. And we've topped up JOHCM UK equity Income, Gold Bullion, Finsbury Growth & Income, JOHCM UK Opportunities and M&G Recovery

This market instability has been driven by the tightening in US\$ liquidity globally. It follows the Federal Reserve raising interest rates and pulling back US\$ funding from extremely loose levels over the past decade.

We've discussed the impact of loose monetary policy on assets prices and investor behaviours in the past and we now believe this risk has finally come to the fore. Ultra-loose monetary policy leads to a deterioration in credit standards and sets a very low bar for investors looking for growth. The lower a discount rate, interest rates in this case, the higher the net present value of a future cash flow such as a dividend from an equity or coupon from a bond. This all results in higher asset prices today and has led to significant returns over the last decade for investors willing to embrace the view that interest rates would remain low for an extended period following the financial crisis.

But things are different now as monetary conditions have been tightening over the past two years. We believe that this has forced a repricing of risk in global markets on a scale that we've not seen since the dot com bubble crash of 2000.

It will mean a higher day to day volatility but importantly it will refocus investors' minds on the price they're paying for future cashflows as well as the sustainability of those cashflows through the economic cycle.

History shows us that as competitors enter a market and erode the competitive advantage barely a handful are able to generate sustainable growth. Most will struggle to maintain their initial high advance.

Our exposure to funds at Tacit is dynamic as we invest in managers that have disciplined processes in place and they'll reallocate exposure based on how they see the prevailing market conditions. They deliver an extension to our top down thinking and action by dynamically altering their stock positions.

It means right now the Fund Managers do the work for portfolios but at other times, as in the latter part of 2016, we fundamentally change the funds within the strategies as our top down view also changes.

Importantly at present, our view hasn't changed and this market volatility is delivering opportunities that our managers are taking advantage of.

For example, the largest underlying equity holdings in our strategies are BP and HSBC. Both have announced solid results this week and have seen their share prices rise by 5%. This is because the valuation that they're trading on didn't reflect the central value in the business.

Three years ago, Amazon was the largest holding in our strategies and showed similar valuation characteristics. But not today. Investor sentiment has, in our opinion, pushed this beyond fair valuation levels even though Amazon remains a fantastic growth company and one which we may well return to in the future.

The key to our overall approach is that we take a view and then allocate capital to managers who are best positioned to exploit it. Our assessment for 18 months has been that markets are distorted and this is being ignored by investors chasing returns in a low interest rate world.

We don't claim to be perfect in our timing. We will inevitably be early or late but our approach mostly results in one outcome – better returns. This is due to our methodology compelling us to move away from expensive areas of the markets and to invest in those areas that have been left behind.

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