

Macro uncertainty: keep calm and wait for opportunity

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Michael Clements
European Equities Expert

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— *Michael Clements*
European Equities Expert

It is difficult to make predictions it was once said, particularly about the future. Last year, I failed to foresee Brexit and the unstoppable ascent of Donald J. Trump to the White House. I also had misplaced faith that France would prevail in the European Football Championships and didn't even consider the prospect of Leicester City winning the Premier League. It is lucky making calls on sporting events or political outcomes is not part of my investment process.

We are currently undergoing a macro-economic and geo-political maelstrom on both sides of the Atlantic, and it is difficult to know how the market will react to impending elections and economic flashpoints. This is naturally unnerving for investors, but, fortunately, it is possible to separate politics from portfolio decision making. Indeed, despite failing to predict or factor in any of the big political events of last year, our European equity strategies outperformed both the benchmark and peer group averages.

Active opportunities set to ripen

With this in mind, as usual, we put our crystal ball to the side and favour an opportunistic ‘wait and see’ strategy. Following seismic political events of 2016, there will be plenty of aftershocks which can be exploited to generate alpha. Impending macro upsets or short-term economic shocks do not concern us. However, that is not to say changing political winds or other unexpected shifts cannot provide windows of opportunities.

Importance of scenario planning

Indeed, investing is often about timing. Our bottom-up investment philosophy focuses on high-quality companies with a strong competitive edge and solid balance sheets suffering from short-term pressures. Sometimes we unearth companies that pass our rigorous process but fail to get the green light on valuation grounds – the timing is just not right. Hence, we keep close attention to bouts of indiscriminate selling precipitated by political or economic flashpoints.

We also undertake rigorous scenario planning exercises to assess what various outcomes may look like. Of course, some of this analysis will ultimately be fruitless as there will always be multiple potential outcomes, but, crucially, it allows us to strike when an opportunity arises.

Italian turmoil presents opportunity

The Italian market has offered some good examples of this phenomenon. This market has suffered price weakness fuelled by political turmoil and a struggling banking system. While we are staying away from Italian banks given the difficulty in assessing future risk, we are seeing attractive opportunities in broader financials. We believe the best positioned businesses are the loan servicers, such as Eurocastle, and asset managers including Anima.

Eurocastle is the leading NPL servicer in Italy and will invariably play a key role in managing the enormous stock of NPLs in Italy. Anima is the largest independent asset manager in Italy, and its shares have been under pressure mainly due to the troubles of some of its distribution partners including Monte Dei Paschi. However, at current levels we feel much of the risk is priced in and actually there is considerable upside from its developing relationship with Poste Italiane.

Banca Sistema is a specialty finance company that acquires trade receivables owed by Italian Public Administration. Its core product, invoice factoring, purchases receivables at a discount to face value and then recovers the full amount generating an attractive IRR.

This is an overlooked and under-researched stock that has an attractive, low-risk business model. The low valuation reflects lack of wider interest from other investors and general antipathy towards Italian financial stocks.

Following the Italian government's referendum defeat, we fully expect more uncertainty. This suits our contrarian style as it could throw up further opportunities to buy good companies like these at attractive valuations.

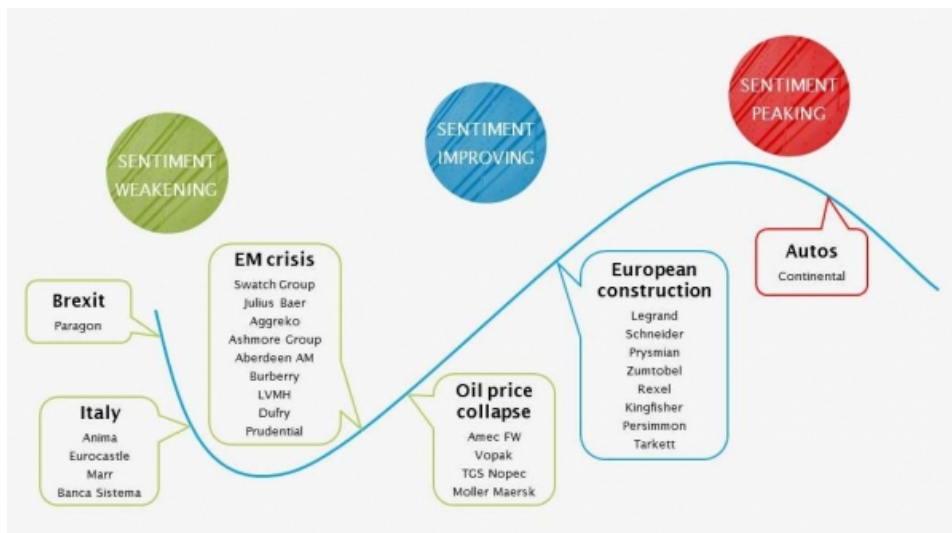
Hawkish sentiment weighs on infrastructure plays

We are also currently assessing at a number of infrastructure plays on the continent, including toll road providers. Toll companies are often labelled as long-duration bond proxy stocks, due to the perception they are sensitive to rises in interest rates – causing recent price declines.

However, this is an over-simplistic way of looking at the business model and opportunity for price discovery. The reality is a hike in rates is unlikely to dramatically deter drivers from using toll roads and these companies will continue to generate high levels of free cash flow. We are currently invested in Atlantia and Snam, and continue to hunt for further opportunities as sentiment weighs on the sector.

The evolution of the portfolios will depend on the opportunities given by the market. The fund's long term, contrarian style tends to react to events that cause short term weakness in share prices. It will be an interesting year ahead: for investors, we believe it is better to capitalise on opportunity than be hostage to prediction.

Contrarian investing: the sentiment cycle



Source

SYZ Asset Management, data as at 30.04.2017

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