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Challenging Conventional Wisdom
NEWSLETTER

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A Note from Theo and Warren

Investing for a downgrade?

It seems we live in a time where outcomes are only good or bad, heads or tails, yes or no – this is what mathematicians call binary outcomes. If we consider the battle against state capture, for example, it feels as though the outcome will either be great for our country or terrible: it's hard to see a middle-of-the-road scenario in the near future.

Similarly, the ratings agencies will give their verdict on our economic future by the end of the year. A positive announcement will be very well received by markets, while people will probably panic if we are downgraded. How do investors make rational decisions in this binary world?

Beware the prediction

Very few investors can consistently make money by basing their strategy on predictions. This is called market timing and it's a costly way to invest your capital. First you have to accurately predict an event – for example, the verdict of the ratings agencies on South Africa's economy or the outcome of the Brexit vote. Currently the verdict of the ratings agencies might seem obvious, but so was the Brexit vote and look at what happened there.

Second, you have to predict how other investors will react to this news. Let's consider the aftermath of the Brexit vote. While the UK stock market dropped initially, it has since been on a very strong upward trend and is more than 15% higher than it was 12 months ago!

If you're wondering about the prospect of a downgrade in SA and decide to sell all your shares as you are concerned that the stock market is going to collapse, you might be making a huge mistake. The most recent comparable country to study is Brazil. They were downgraded in February, but their stock market has since jumped by nearly 40%. It is higher than it was a year ago, so investors who sold out in the months before the downgrade are really losing out.

Who can say what will happen in South Africa with our stock market and the rand? It would be very risky to assume that the stock market outcome will only be negative.

Diversify

In these circumstances, with such uncertain outcomes to potentially significant political and economic events, it does not make sense to be too specific in your investment planning. Rather aim to spread your investment risks as much as possible. That means you should have a range of assets including cash, bonds, property and shares.

This form of diversification will ensure that at least portions of your capital might not lose value in a major downturn. If the downturn does not materialise and markets go up, your shares and property will rise.

It makes sense to spread your investments across different countries and currencies. If you have most of your assets in rands, then you should consider increasing your allocation to overseas investments. However, do this carefully and not all in one batch. We are not too concerned about owning a range of different offshore currencies. If you own a global portfolio that is denominated in US dollars, you will still have exposure to other countries and their currencies within the global portfolio.

In summary, don't be too concerned about making major changes to your investments when political and economic events become media sensations. The hype in these situations is never good for rational behaviour.

- Theo and Warren

Deutsche Bank and your ETFs

For some time now Deutsche Bank has been under pressure. It is central to global trade in many derivative and risk products (particularly in Europe) and its exposure in assorted derivatives amounts to trillions of dollars. Combine this sort of exposure with a negative interest environment, and you have makings of severe profit pressure on the bank.

The International Monetary Fund (IMF) issued a damning 63-page report on the German banking and insurance sector in July. It is a long and thorough report, with the key point buried on page 42: "Deutsche Bank appears to be the most important net contributor to systemic risks in the global banking system."

It's important to realise that news of pressure on Deutsche Bank is not some hushed up secret (as the "penny-dreadful" newsletter websites will tell you). Rather, it is a long unfolding and painful transition, which the 'new' CEO, John Cryan, has been hard at work on for over a year now. Banks, by their very nature, are fragile – they are inherently quite highly geared and need the implicit backing of a country's reserve bank to ensure that depositors stay content – and stable.

A couple of aggravation points have been raised recently. First, the US subsidiary of Deutsche Bank did not pass a Fed imposed stress test. Second, the US Department of Justice (a division of the US government chock full of non-lateral thinking bureaucrats that would make any post office envious) decided it was time to loudly announce its opening position on fines to impose on Deutsche Bank for mortgage securities violations prior to 2008.

The amount was USD14-billion, almost as much as Deutsche's market cap. Never mind that the DoJ had settled the American banks it fined for the same issues many multiples below their starting points.

Third, this prompted Angela Merkel to wade into the fray, to say that there would be no German state bail-out of Deutsche Bank.

We can guess that she was saying to the DoJ: “We are not going to support Deutsche just so they can pay your fine.” Unfortunately, because of the importance of confidence in banking, that was plainly the wrong thing to say. The genuine truth is that Deutsche Bank is so important to the German economy and payments system, that the German government has no choice in the matter. Nevertheless, this is the kind of fumble that can snowball.

So what is the impact for our clients holding Deutsche ETF products here in South Africa and abroad?

One thing that has become very well established for investment banks since the 1980s is the segregation of client assets and bank assets. It’s something that regulators have down pat, and the correct structuring for such assets is a well-established path. Thus the assets held for the Deutsche Eurostoxx 50 ETF are held well away from bank assets. We are very comfortable to continue to hold the DB Eurostoxx, Japan, USA, UK and World ETFs listed on the JSE.

Where things may be murkier is in relation to ETN (Exchange Traded Note) products. Banks issue these because they are easier to list than an ETF. However, the note is secured against the bank balance sheet – not against segregated funds.

At Galileo Asset Managers, we have taken the strategic decision not to hold any bank ETN products in client portfolios for the time being. We took this decision with regret, because we liked the exposures that the DBEMER (DB Emerging Markets) and DBCHIN (DB China) ETNs provided. The decision is prudential and hopefully unnecessary. Should Deutsche issue ETFs in these products, we would snap them up immediately.

We will not, however, stand by and do nothing if the pronouncements and bungling of politicians and technocrats place client wellbeing at risk.

- By Warwick Lucas

If you would like to discuss this comment contact me on warwick@galileocapital.co.za or 011 502 8810.