

Equitorial

A time-tested defence
against volatility



Key points

As market volatility has risen, the frequency and severity of rotations has also increased

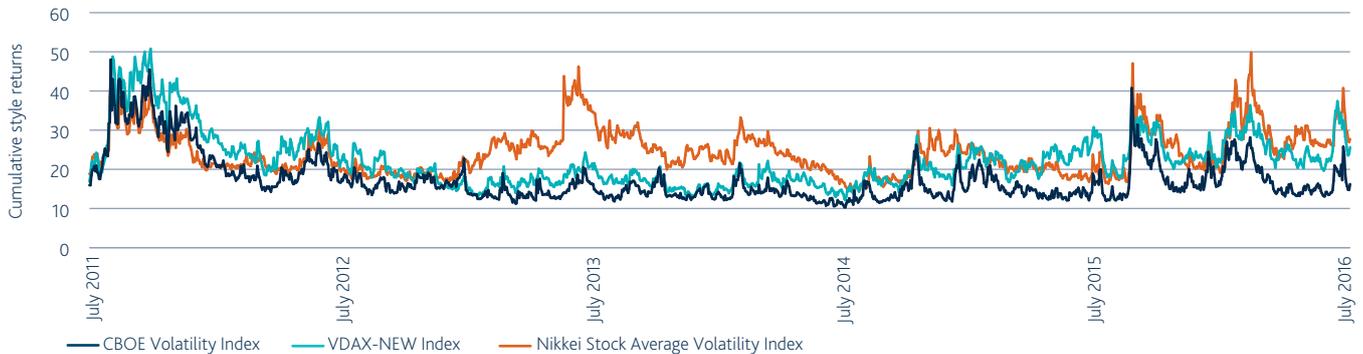
The areas of the market impacted most vary with each rotation, making it impossible to forecast the outlook for regions, sectors and stocks

Without such prescience, diversification is essential in defending a portfolio against these rotations

This, combined with a dynamic approach to risk and an emphasis on strong fundamentals, enables us to weather volatility and capture upside

Wild swings in sentiment have driven brutal spikes in volatility over the last year and are likely to continue doing so in the context of substantial macroeconomic uncertainty. How can investors gain exposure to the stocks that outperform in these conditions while avoiding short-term drawdowns? Our answer is time-tested: diversification reinforced by a focus on strong stock fundamentals.

Figure 1: Volatility indices of the US, Europe and Japan over the past five years



Source: Bloomberg as at 5 July 2016

The significant rise in volatility over the last 12 months can be traced back to October 2014, when the Federal Reserve signalled the end of quantitative easing. That announcement prompted the trade-weighted dollar to rise, which led to routs in commodities, emerging-market currencies and high-yield bonds. Macroeconomic factors, such as the decade-low oil price, China's economic slowdown and geopolitical concerns, have all exacerbated the subsequent turbulence.

Market instability has risen in the context of a long-term, global scarcity of growth. In developed markets, growth has averaged 1% per year since the financial crisis, according to the International Monetary Fund. This lack of growth initially prompted investors to flock to almost any company with rising profits, causing these to trade at stretched valuations. Subsequent speculation that these companies were unlikely to achieve their targets triggered sell-offs, leading to aggressive rotations in late 2015 and the first few months of 2016.

However, the market reversed in February when the trade-weighted dollar started to weaken, oil prices rose from trough levels and commodities – particularly iron ore and copper – began rising. The S&P500 Diversified Metals and Mining Index almost doubled in the ensuing month while previously popular sectors like consumer services, healthcare and technology were shunned as investors' appetite for risk grew.

Markets are likely to continue to be turbulent in the wake of the additional macroeconomic uncertainty caused by the vote for Brexit, the Italian constitutional referendum in October, which is arguably a bigger risk to Europe than Brexit is, and the forthcoming US elections.

Navigating the turbulence

Rapidly changing environments like these are difficult to negotiate and require flexibility. It is challenging – arguably impossible – to consistently predict when these rotations will occur. It is therefore equally hard to select the sectors and regions that will benefit from future rotations.

We believe that diversification offers the best solution to this challenge. By being exposed to a breadth of sectors and geographies, we are able to benefit from market movements regardless of which industries or regions gain from market rotations. We couple this

diversification with a focus on the long-term fundamental characteristics of each stock we invest in, meaning that we aim to pick the best stocks available in each sector. Our risk management model shows us which risk factors we are most exposed to and prompts us to adjust these exposures, depending on external factors.

Mitigating macro risk

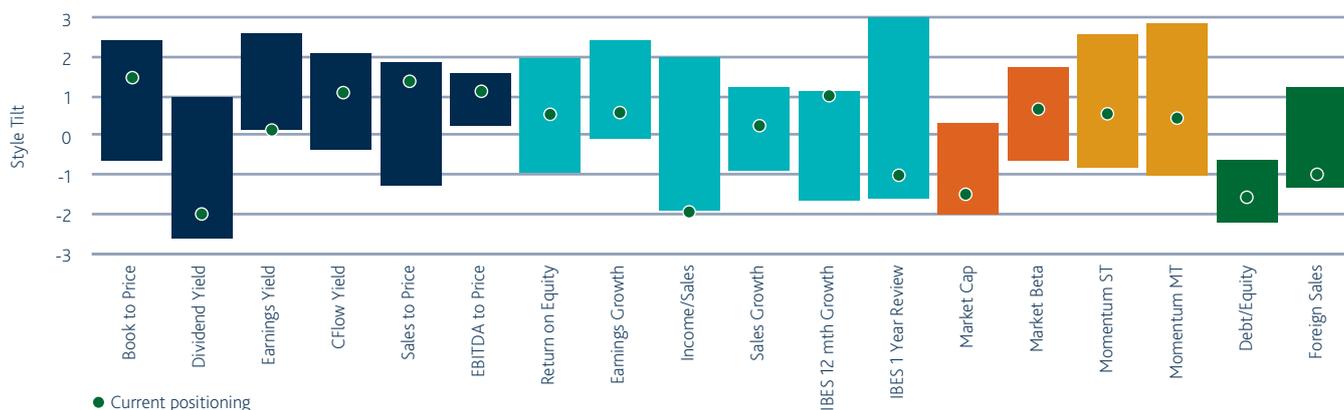
The investment world's infatuation with diversification, or not putting all your eggs in one basket, has waned as high-conviction, highly concentrated investment strategies have risen in popularity. However, we firmly believe that diversifying away the factors outside of a company's control is a vital tool in achieving consistent excess returns.

The failure of almost all forecasts and the sheer number of dynamics at play in the global economy make diversification essential. Since the inception of our first strategy in 2008, we have experienced a series of tumultuous events that have caused some funds to collapse, not least the financial crisis but also the advent of quantitative easing and the resultant low-growth market we currently invest in. We have also witnessed a commodities boom and bust, in which oil prices climbed and then collapsed. Many, if not all, of these scenarios were not anticipated by investors.

We manage our macroeconomic exposure through our proprietary risk model, MultiFRAME. It determines the portfolio's sensitivity to any quantifiable macroeconomic risk factor over different time periods and durations. This allows us to respond nimbly to sudden macroeconomic changes, making it a particularly important tool when markets are volatile.

In December 2012 Japan Prime Minister Shinzo Abe introduced his 'three arrows' policy to boost the economy: fiscal stimulus, monetary easing and structural reforms. The explicit objective of the first two was to jolt Japan out of economic stasis by targeting inflation and debasing the yen. This had a major impact on the domestic equity market; after years at sea, this favourable wind drove it almost 60% higher in the next six months. We quickly assessed the portfolio's sensitivity to the falling yen and, identifying weakness, increased its exposure to Japanese exporters. This flexibility is essential in turbulent markets.

Figure 2: Hermes Global Equity Fund style skyline, December 2008 – May 2016



Source: Style Research as at 31 May 2016

Riding the waves of market volatility

The flexibility, breadth and focus on quality that typify our approach have been particularly helpful during the repeated bouts of market turmoil over the last year.

American Water Works is a company we selected on the basis of its quality and has climbed steadily all year. The company has generated consistent earnings growth, healthy margins and a strong balance sheet – the kind of long-term structural safety nets that investors fled to as markets turned over. It is also one of the better companies in the sector from an environmental, social and governance (ESG) perspective, which further boosts its defensive qualities.

Figure 3: American Water Works vs. MSCI World



Source: Bloomberg as at 30 June 2016

The benefit of combining diversification with an emphasis on quality was reflected in the performance of a number of portfolio holdings exposed to the oil sector, notably Oasis Petroleum, Marathon Oil and Hess (performance shown in figure 5 overleaf), as the oil price began to rise from the record lows it had reached over the previous two years. These companies are quality operators with strong balance sheets that were excessively punished as the oil price fell. While we did not make a call on the oil price, we instead maintained exposure to companies in the sector with the greatest ability to withstand the pressure, and increased this as external conditions improved.

The devaluation of these companies was partially driven by the perceived safety and attractive yield of the oil majors, whose continued pursuit of a high, unsustainable dividend at the expense of capital expenditure and growth presents a significant risk. Oasis, Marathon and Hess do not have the same dividend obligations and are recovering faster than the oil price, reflecting the advantages of seeking high-quality businesses in a previously troubled sector.

Randgold Resources, the Fund's top performer in the first half of 2016, also benefitted from the recent market environment, including the flights to safety at the beginning of the year and after the referendum, alongside the resource-led rotation.

Figure 4: Randgold Resources vs. MSCI World



Source: Bloomberg as at 30 June 2016

Figure 5: Oasis Petroleum, Marathon Oil and Hess vs. MSCI World



Source: Bloomberg as at 30 June 2016

The obvious downside of diversification is that it engenders exposure to underperforming areas of the market. The banking sector is a current case in point. The Bank of Japan's decision to set negative interest rates for the first time in its history led to a sharp sell-off in stocks of the country's financial institutions. Similarly, negative real interest rates in Europe and increased regulation are souring capital ratios and have taken their toll, leading to the financials sector being the biggest detractor from the Fund's relative returns. However, our focus on fundamentals often leads to the omission of lower quality companies from the Fund, which has benefitted it.

All-weather investing

Diversification, coupled with our focus on companies' long-term prospects, has played crucial roles in the consistent outperformance of the Fund. In the three years to 30 June 2016, the Fund outperformed the benchmark in 62.2% of months, returning 26.7% against the MSCI World Index return of 22.3%¹. Meanwhile, our focus on long-term fundamentals and a dynamic approach to managing macro risks means the strategy has evolved and adapted to changes in the underlying economic environment.

Our incremental short-term outperformance, such as the 0.22% achieved amid the turbulence of the first quarter¹, may not make headlines, but our positive returns, compounded since the Fund's inception, demonstrate the effectiveness of our strategy. Our approach has worked in all environments and it is for this reason that we are confident that it will be successful in negotiating the turbulent waters in the coming months.

¹Source: Hermes as at 30 June 2016. Performance shown is net of fees in USD, calculated arithmetically.

² Source: Hermes as at 31 March 2016. Performance shown is net of fees in USD, calculated arithmetically. Past performance is not a reliable indicator of future results.

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Hermes Investment Management

Hermes Investment Management is focused on delivering superior, sustainable, risk-adjusted returns – responsibly.

Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

Our investment solutions include:

Private markets

International real estate, UK commercial real estate, UK private rental sector real estate, infrastructure and private equity

High active share equities

Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit

Absolute return, global high yield, multi strategy, real estate debt and direct lending

Multi asset

Multi asset inflation

Responsible Investment Services

Corporate engagement, intelligent voting and public policy engagement

Offices

London | New York | Singapore

Why Hermes Global Equities?

Transparency

Our accessible investment process and analysis is based on clearly defined statistical and economic evidence. It is not a 'black box' and the drivers of returns can be clearly explained.

Expertise

Our bottom-up stock-selection model systematically analyses companies' financial statements and gauges investor sentiment to generate an optimal portfolio. The team draws on its deep investment experience to identify unquantifiable risks such as negative news flow and regulatory change.

Flexibility

We partner with clients to create portfolios addressing their needs, amending the risk profile, investment universe and benchmark, and portfolio characteristics such as dividend yield and ESG exposure as required.

Broad risk awareness

MultiFRAME, our proprietary risk modelling system, detects exposures to all quantifiable risks. The Hermes Investment Office performs independent risk management services for clients and sustainability risks are identified by our ESG Dashboard.

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