Finding Return in a Low Yield Environment

Q3 2019

It was a mixed and somewhat turbulent quarter in the markets, with developed equities barely ending in positive territory while smaller cap U.S. equities were down over 2%, emerging equities were down by more than 4%, and oil was down over 7%. These returns reflected slowing growth in the world economy and a continuation of U.S.-China trade tensions. Most dramatic was the change from last year when the Fed raised rates four times, only now to lower rates—twice during the quarter and then once more in October. Accommodation by central banks is also occurring in Asia and is now a global phenomenon. U.S. ten-year yields declined 50 basis points to 1.5% p.a.—not far from their all-time lows—before ending the period at 1.7% p.a. Real inflation adjusted yields are now around zero.

This low yield environment is different from anything we have seen before in the capital markets, and the implications are stark. If passive global equities were to deliver 5% real—the same return as over the last 30 years—then with bonds providing a zero real return, a 60/40 global equities/bonds portfolio will deliver only 3.0% per annum after inflation, well short of its 5% real return over the last century. To achieve higher returns for comparable risk will require a value-added approach to risk management and the ability to generate significant alpha.

Finding Return in a Low Yield Environment

Central bank easing is symptomatic of genuine risks in the current economic environment. Yet, at HighVista we are optimistic about our prospects for generating return. We believe we are continuing to find interesting opportunities in inefficient spaces, within private as well as public markets. The strategies we are pursuing fall into several broad categories:

- Long time-horizon public market investments in quality firms
- Shorter duration mispricings and catalyst driven opportunities
- Dislocated and distressed market opportunities
- Opportunistic private credit and private equity, including co-invests
- Quantitative, mostly factor-driven active security selection

Some of the firms we invest with have flexible mandates and pursue investments that span multiple of these buckets, while others are domain specialists within niche markets. Some mandates are long-only, while others are long/short. Niche mandate opportunities are our primary focus today, and we increasingly are finding situations where our involvement is highly valued and where we can obtain preferred terms and access. In this commentary we highlight two of the above categories—the opportunities we are seeing in quality public equities and in niche quantitative investing.

Quality Public Equities

It is always desirable when one can invest in businesses with good growth prospects, defensible economic moats, and attractive valuations. Such investments provide a way to compound returns when held for the long term, and particularly in a thirst-for-yield environment they can rapidly increase in price when their true fundamentals become recognized in the marketplace.

Of course, growth firms that underperform expectations are heavily penalized. To invest successfully in these equities takes a bottom-up focus and a very sharp pencil as well as the ability to invest with a longer-term perspective while maintaining hyper vigilance. The managers we have been pursuing in this area fit this description. Together, their areas of investment span a wide range, including pockets within developed and emerging markets (primarily China and India) and focused primarily in the healthcare, consumer, technology and business services spaces.

In China, the bottom-up opportunity set is particularly interesting. Today, the A-Share market is gargantuan, with some 3,500 listed firms—the same as in the U.S.—and an equity capitalization of around $8 trillion. That this market is over 80% retail dominated gives skilled investors a significant edge. Moreover, there is a beneficial tail wind because China is still greatly underrepresented in the world indexes. Currently, China A Shares constitute only 0.4% of the world index (ACWI) yet it is the world's second largest equity market. Our managers' focus in China is on a very narrow subset comprising quality growth firms trading at very significant discounts to their U.S. peers. These investment firms are close to company management and moreover have the wherewithal to offer them advice on business, strategic, and capital allocation questions. This opportunity set has been growing in attractiveness and we have been cautiously increasing our exposure there given the macro risks related to China broadly.

Closer to home, we also have exposure to very liquid large cap U.S. names that answer to similar criteria. Interestingly, these firms are well followed and have strong balance sheets (most have no net debt), yet their prices are excessively volatile, and they have continued to provide attractive entry points in turbulent markets.

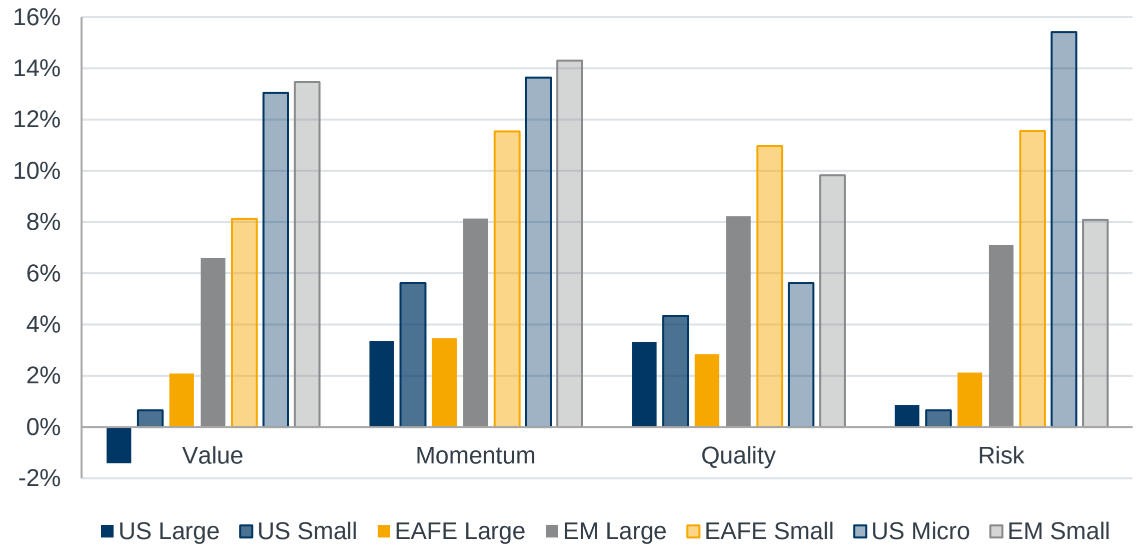
Always being vigilant about capital preservation, we view the risks of investing in growth equities first through the lens of price, where the projected returns must meet a very high bar, and second through the lenses of risk and diversification, where the correlations between these investments and other portfolio exposures will affect the sizing of these as well as other exposures.

Niche Quantitative Investing

We have long utilized directly-executed systematic strategies to complement the investments we have with external managers. One of these is a global factor-based equity selection approach in which we favor "well rounded" stocks, ones that score well on multiple criteria, like value, quality, momentum, and low risk. These factors have been well documented to capture risk premia and behavioral anomalies, and we have been able to generate excess returns since 2012 when we launched the strategy.

The approach, not surprisingly, works considerably better in less crowded and smaller cap market segments as illustrated by the excess returns from factor exposures in **Exhibit 1**. The return opportunity is attributable to the retail-driven investor bases, low informational efficiency, and barriers to entry in these markets which leads to slower price discovery. In addition, and as a result, trading itself is inefficient and it takes relationships and specialized knowledge of the market structure to effectively invest. We believe that the alpha opportunity in these markets can be captured provided that sophisticated approaches to transaction cost and risk management are employed. We are excited to be investing in this area and have been devoting significant resources to doing it well.

Exhibit 1: Global Factor Excess Returns[1]



In summary, we are approaching the task of obtaining attractive returns in a low-yield environment through a range of approaches.

[1] Chart represents long/short factor return data from 01/31/2010 – 12/31/2018. All factor returns are calculated on a sector-neutral basis. Results indicate the Q5-Q1 return spread. Please refer to the Important Legal Disclosures for further information.

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