Investment Policy

2. Quarter 2016

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The volatility and negativity that characterised market performance during the first two months of 2016 were quite exceptional. We are now accustomed to sudden crises that lead to what is referred to in financial jargon as risk off, namely an indiscriminate sale of a series of heterogeneous asset classes that operators have decided, for that particular situation, to classify as "bad". After initial concerns fuelled by the trend in oil prices and the sharp slowdown of the Chinese economy, the last two months have seen a more orderly trend on the markets. Greater rationality appears to prevail over the recent period, allowing many heavily undersold stocks to recover a significant portion of the lost ground. In other words, investors appear to be saying: the situation is not so negative, and the central banks continue to ensure their presence by keeping rates often below zero. The volatility of prices, and consequently of portfolios, is becoming something we have to learn to live with. Such volatility makes it difficult to determine which trends are caused by market flows and which by economic and financial changes that require modification of the strategic asset allocation.
Consequently, it is not easy for an investor to choose between gradual erosion of one's portfolio, even in nominal terms, and acceptance of a volatility level that is often not very well understood and in the majority of cases not well tolerated. Nevertheless, there is no choice, and proper communication, just like a correct portfolio structure decision, takes on even greater importance.
We believe that rates in Europe, the USA and Japan will remain at these levels for a while. Commodities, particularly oil, seem to have found a stability level that is giving investors a certain degree of tranquillity. Global growth, although revised downwards, does not indicate a recessive situation in some areas, as feared during the initial part of the year. We have seen good recovery in market prices and corporate bonds, which had suffered the most. US market prices are back to near record highs, boosted by corporate profits at satisfactory levels and interest rates which are not expected to rise significantly over the next few months. Some signs of a return of interest in emerging markets are being noticed, in terms of currencies as well as equities. Areas that are showing very different trends from one another must be assessed selectively, although markets, backed by more positive situations, often tend to drive up even other areas that do not actually deserve such confidence.
On the currency front, we believe recovery of those particularly penalised by the decline in oil prices may continue. We are also of the opinion that the US dollar has found a certain equilibrium in current prices, compared to the so-called majors, while it may lose part of the significant value acquired with respect to an "emerging" world which, as mentioned, has seen a return in flow for some time now.
The Swiss franc remains in the area of around 1.10 against the Euro and, consequently, is moving with respect to the various currencies, in line with the trend in the single currency.

Scenario in the United States

After an extremely tormented start to the year, the second half of the first quarter saw an apparent return of confidence. The reasons that most contributed to the partial recovery of the climate were undoubtedly the rebound in the price of commodities and the activities implemented by central banks.

The US economy is expanding at a moderate growth rate. Household consumption remains at a satisfactory level, along with sales of new homes. The labour market is showing good signs of recovery as well. The creation of new jobs is steady; consequently, individuals who had left the labour market have recently resumed the search for employment. As a result, the participation rate (number of employed individuals/ active population) is once again growing, a sign that the economic recovery is expanding across several sensitive variables. Only net exports and corporate investments are still suffering.

More specifically, oil prices (WTI) are back at around USD 40 per barrel, recovering part of the loss accumulated in prior months. Inflation appears destined to remain low during the second quarter of the year as well. Over the medium term, we can expect a return of inflation to around 2%, when the temporary effects of the decline in commodity prices disappear and the labour market gains further ground, creating some upward pressure on salaries.

In any case, the Federal Reserve has expressed a preference for a more accommodating monetary policy, lessening the probability of a second increase in benchmark rates and leading to fewer increases in this cycle, in light of the economic problems outside of the United States. This wavering attitude risks undermining the credibility of the US central bank and increasing investor anxiety, already put to the test by a difficult beginning to the year.

Weakening tension on China during second quarter

Major fears of a collapse in the Chinese financial system and a strong economic slowdown partly weakened during the last few weeks. Growth estimates for the Chinese economy have not undergone any significant changes, due to three main reasons: a more stable currency, which has contributed to facilitating capital outflows, recovery in residential construction and higher public spending by the government. Old remedies to sustain growth that do not hinder, however, the political willingness to carry out reforms in order to ensure a sustainable economic trend, particularly through a reduction of production capacity.

These new parameters should function as a support for activities at risk, as the heavy blow at the beginning of the year coincided with growing uncertainty with regard to the Yuan and the monetary policy implemented by the central bank.

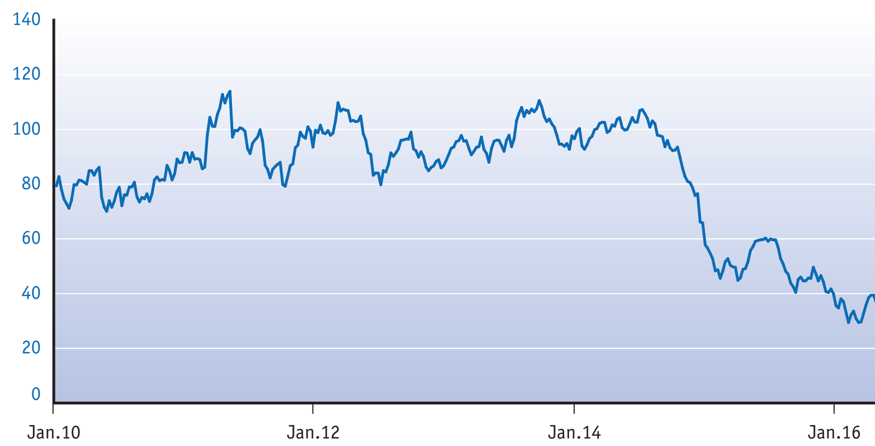
Recovery of the European PMI is struggling, under the weight of deflation and Brexit fears

The manufacturing PMI declined during the first two months of the quarter, highlighting the weak period in the European economy, due to the slowdown in the global one. Nevertheless, during the second part of the quarter, the measures adopted by the ECB (which surprised by opening the way to the purchase of investment grade corporate bonds, introducing the European Central Bank as a new major investor), stimulated sentiment and economic growth. The measures by the ECB should ensure an easing of the worrisome deflationary pressures which proved to be even stronger than those in the recent past, due to the drop in oil prices.

In the United Kingdom, the downward shift in the PMI during first quarter 2016 compared to the last quarter 2015 figure indicates a gradual decrease in sentiment with respect to the growth rate in production by English companies, pending the outcome of the Brexit referendum. We expect sharp uncertainty through the entire period prior to the 23 June referendum, with companies consequently adopting more cautious strategies.

USA: participation rate

WTI crude oil prices



Devaluation of the dollar continues

Towards the end of the quarter, the US currency lost over 5% against the Euro, following the Fed's stance to lower growth and inflation forecasts. In particular, what most led to devaluation of the greenback were the words of Janet Yellen: in fact, the Federal Reserve Chair implied that there would be no further increases in interest rates over the short-term, contrary to market expectations. An increase in the rates with quarterly maturity had been envisaged at the end of 2015. However, investors now exclude an increase in April and consider the probability of one occurring in June to be low.

We believe the EUR/USD exchange rate will fluctuate between 1.08 and 1.15. Most of the USD appreciation took place in the spring of 2014 and in the initial part of the subsequent year, and we do not believe the dollar can repeat such a significant upward shift. Central banks are placing too much attention on their currencies and on the desire to avoid excessive appreciation. In this respect, we do not exclude measures (verbal and non) by the European Central Bank if the Euro breaks through the upper portion of the range indicated above.

Long Norwegian krone and short Swiss franc

The beneficial effect of the rise in oil prices on the Norwegian currency was partly offset by the cut in interest rates and by internal growth that is struggling to restart. However, we maintain a constructive approach with regard to the potential trend of the Scandinavian currency, as the valuation level still appears to be low. The economy is solid and public debt is low.

An effective investment could be made against the Swiss franc. In fact, we confirm our bearish outlook on the CHF. The currency is overvalued and, persisting at these levels over the long term, causes a weakening in the competitiveness of Swiss companies, which are reducing personnel in favour of investment abroad. Since the abandonment of the minimum CHF/EUR exchange rate, private consumption has prevented the Swiss economy from falling into a recession, but it should weaken along with the deterioration of the employment rate. Moreover, inflation continues to be far (CPI YoY -0.8%) from the SNB targets and in this scenario - with highly negative interest rates - a weak currency appears to be the best way to ensure a recovery of consumer prices in our country.

Currency diversification on the yen and pound sterling difficult

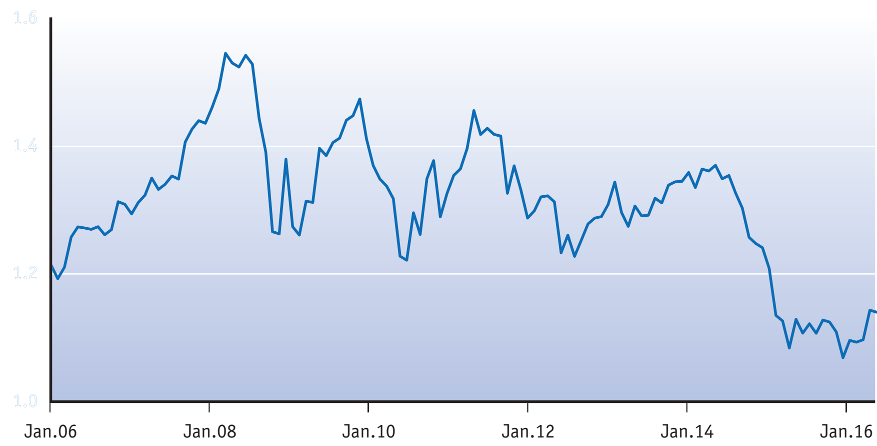
The yen's appreciation at the beginning of this year is mainly attributable to the Japanese currency's role as a safe haven currency. However, as the climate on the markets is becoming more constructive, and therefore unfavourable against the Japanese currency, we cannot recommend including the yen in currency diversification portfolios.

Even recommending the British pound sterling is momentarily suspended, as we believe the risks linked to the 23 June referendum on "Brexit" are too high.

Only some selected emerging currencies offer diversification opportunities

In general, we are moderately positive with regard to investment in emerging currencies, although we believe the levels achieved by some justify a partial profit-taking. Within the emerging basket, our preference undoubtedly goes to the Mexican peso and the Russian rouble: in fact, at the valuation level, we continue to prefer them over currencies such as the Brazilian real or South African rand, which, despite good recovery over the last few weeks, show a macroeconomic scenario that indicates significantly greater difficulty.

EUR/USD exchange rate



NOK/CHF exchange rate

Context

The quarter underwent a difficult beginning in the bond segment, with a general recovery observed in March. The ECB did not disappoint operators' expectations by lowering the benchmark rates, increasing the amount of bond purchases and purchasing corporate bonds as well.

On the other hand, the Federal Reserve has taken on particularly moderate tones, leading investors to believe that they will likely see only one additional increase in 2016. Therefore, once again, the behaviour of central banks has determined traders' sentiment and significantly influenced their decisions.

In a similar scenario, government and corporate bonds showed particularly interesting performance in the final weeks of the quarter. The German Bund returned to its minimum levels, approaching a yield of around 0%, while in the United States, a good part of the curve provided negative real returns, using core inflation as a reference. However, emerging markets benefitted the most from the central banks' intervention, as the recent weakness of the USD has helped to create conditions in favour of many countries with substantial debt in strong currencies.

Impact of intervention by the central banks on the yield curves

The German yield curve shifted downwards after the European Central Bank meeting in March. Forecasts of negative rates over the long term are keeping the curve in negative territory up to 8.5 years, with low volatility. The yield on the 2-year portion of the German curve, for example, is at around -0.50%, some 10 basis points below the minimum yield level indicated by the ECB to repurchase securities on the market.

Only the long end of the curve now shows some volatility, depending on the recovery expectations of the inflationary trend.

The US dollar yield curve continues to express reasonable uncertainty with regard to future prospects. Slight rises and dips are following one another based on the macroeconomic data published and on the changes in the tone of statements by FED Chair Janet Yellen. Like Germany, the curve has shifted decidedly downwards, with negative real yields up to over 10 years (net of inflation). Indeed, with the market stuck between expectations of rate hikes - very slow at that - and deflationary fears, the long end of the US curve is now at around 1.75%, although core inflation is above 2%. Seeing negative real yields on the 10-year US bond is cause for reflection.

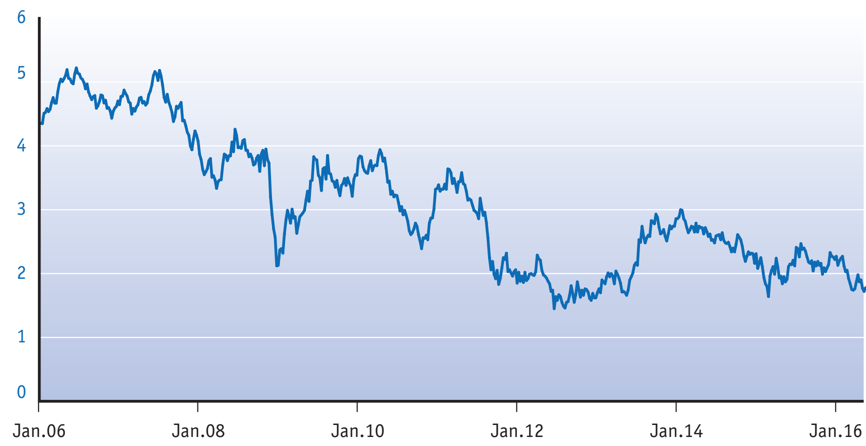
Yields in the western economies do not run the risk of "Japanisation"

We find it difficult to get used to a scenario in which inflationary risk is practically considered as equal to zero by the central banks and traders. For example, there is absolutely no value on the German thirty-year bond, if we consider that the long-term end of the European curve has a yield of 0.70%, with core inflation still at 1%.

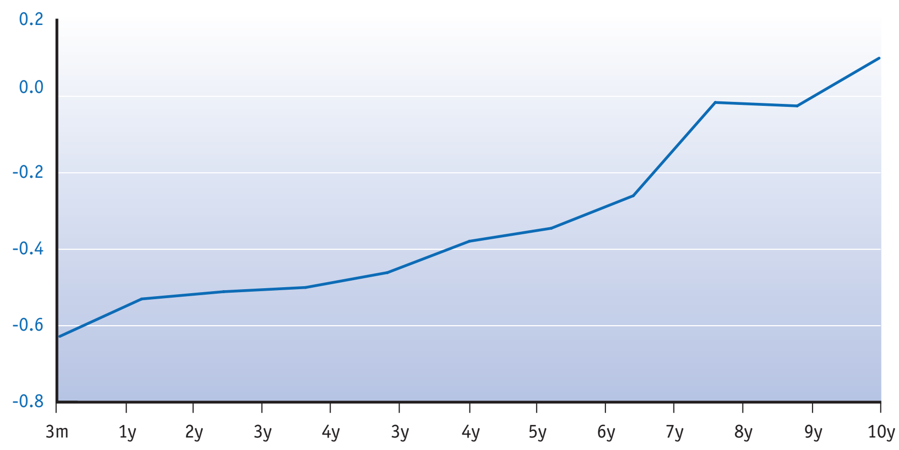
Essentially, we believe that the negative rates policy is not sustainable over the long term and leads to many negative collateral effects: we are of the opinion that the "Japanisation" of world economies that everyone is talking about is not likely. Rather, Japan is a story in itself, with respect to which Europe and the world in general are a venue open to migration and to economic and political changes. Therefore, we do not believe it is correct to assume the Japanese scenario anticipates the future trends in the western economies.

In conclusion, we recommend avoiding the long ends of the government bond curves and maintaining short durations.

10Y US government bond yield



German government bond yield curve



Significant differences in the performance of the main stock market prices

The year's first quarter started off badly and with sharp differences between the performance of the US stock markets and those in the rest of the world. Indeed, performance of the S&P 500 index was slightly positive, while the Eurostoxx 50 recorded an approximate 8% loss, with the Nikkei even worse at -12%. The main reason was the Federal Reserve's decision to reduce the intensity of the rate hike. This is keeping the USD weak compared to the other major currencies, encouraging exports and profits by US companies. On the other hand, it is damaging European companies, as well as Japanese ones, which are dealing with a particularly strong Yen.

Market volatility will continue throughout the entire year

The quarter underwent significant volatility across all stock market indexes. This was mainly due to the belief of an approaching collapse of the Chinese financial system, in the wake of the country's economic crisis, fears of a significant slowdown envisaged in the United States - with recession danger already underway in 2016 - and, lastly, excessive rigidity in the rules applicable to the European economy. The measures implemented by the ECB alone are not able to increase the economic growth rates in the Eurozone, and structural reforms by governments are necessary.

For the second quarter, we expect a temporary decline in volatility, as the forecasts of a catastrophe in China have dissipated, the ECB apparently succeeded in ensuring a minimum cyclical recovery for the European economy (apart from the numerous structural issues) and the US economic data appear to be gradually improving (rising PMI and employment rate).

Generally speaking, however, we will have to get used to significantly greater volatility on the equity markets in the current year than in previous years, as the existing problems cannot be solved over the short term. Strategically, as a rebound in US prices has already taken place, we recommend partially taking profits over the short term, while sticking with a constructive approach over the medium term.

Valuations and EPS Momentum

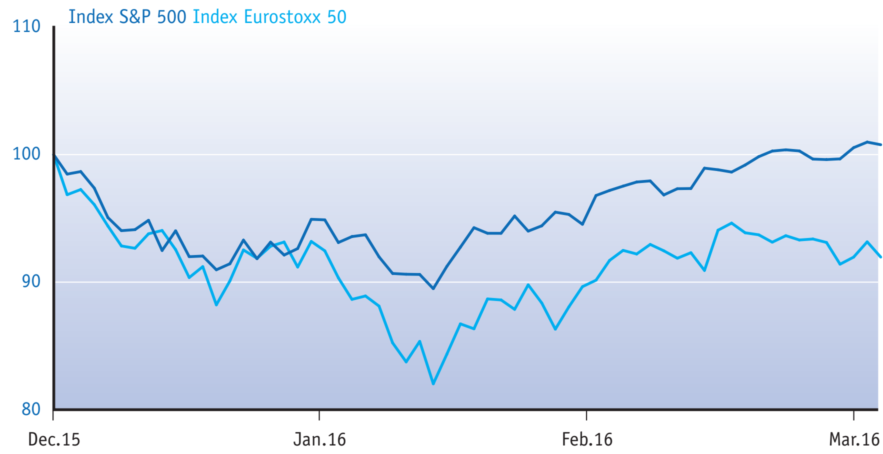
With regard to valuations, the USA has a P/E ratio of around 17 times future profits (next 12 months). The same multiple in Europe is approximately 14x. This divergence is undoubtedly significant and historically high.

Earnings forecasts were significantly adjusted downwards during the first quarter, recording a worse EPS Momentum than in 2011 both in the United States and Europe. There is still a risk of a drop in profits, but the majority of downward revisions appears to have already occurred. The intensity of cuts to earnings forecasts has declined, a sign that has historically resulted in a rebound in the stock markets. We believe the non-US market - albeit faced with major problems that cannot be ignored - is currently discounting an excessively negative scenario. Although Europe is considered to be more attractive in terms of valuations and trends in profits, even a rebound in the emerging markets may be fostered by the low valuations and a dollar that has recently weakened. Therefore, given the expected high volatility, a tactical approach is probably the most recommended during the year: accumulating with moderation.

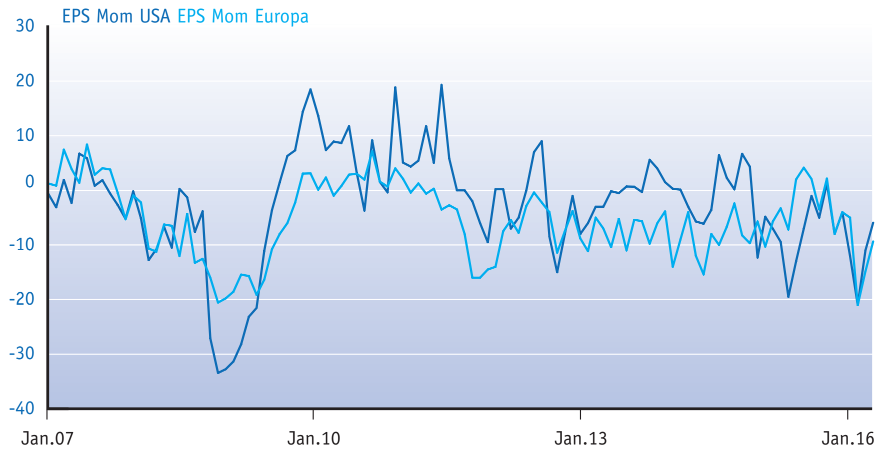
Most interesting sectors: pharmaceuticals and consumption

The pharmaceutical sector recorded significant losses due to the controversy regarding the exorbitant prices of some drugs, as well as due to the political pressure linked to the possibility that Hillary Clinton, notoriously an enemy of the sector, becomes president at the next elections. In this respect, we recommend a gradual accumulation of stocks in the pharmaceutical sector, given the fact that we believe a significant portion to have already been discounted in prices. The private consumption sector is also of interest, given the latest macroeconomic data, which signalled a moderate momentum in both the USA and Germany and excessive concerns with regard to the emerging countries.

Year-to-date S&P 500 and Eurostoxx 50 performances



EPS Momentum of European and US equity markets



Objectives

Our main asset management objective is total return. Over a 12-month span, we want to achieve capital growth, while containing as much as possible downward price swings due to bearish financial market conditions.

Investment Philosophy

To achieve this result, we apply a management philosophy based on the following points:

- simple benchmarks with broad fluctuation bands to ensure wide flexibility in investment choices;
- high dynamism in, and sharp focus on, managing individual positions, featuring a near-term time horizon for making buy/sell decisions;
- constant search for investment opportunities over all asset classes;
- currency diversification;
- wide portfolio diversification;
- sharp focus on risk, managed in part through use of hedging instruments;
- portfolio liquidity: in no more than five days we can liquidate almost all open positions.

Portfolio Structure and Benchmarks

		Maximum investment limits (%)					
Investment Profile	Risk category	Cash	Investment Grade Bonds (>=BBB-)	Non Investment Grade Bonds (<BBB>)	Equities	Other Funds*	Currency Diversifi-cation
Income	Low	100	100	0	0	5	15
Income Plus	Medium-low	50	100	15	15	15	15
Dynamic	Medium	30	100	20	30	25	25
Balanced	Medium-high	30	80	20	50	25	25
Growth	High	30	50	20	75	30	25
Equity	Very high	30	50	20	100	30	25

* Non-directional funds, total return funds, funds of funds

It is worth emphasising that the portfolio structure is a starting point, determined by the individual client's propensity to risk. Once this is decided, we do not want to statically replicate the benchmark, but offer meaningful portfolio management flexibility (see chart). For example, regarding equities, which are the most volatile component of the portfolio, we want to maintain the flexibility to drastically reduce them in case of an unfavourable stock market view and to increase them when we think it is advisable. This rule also applies to the other assets classes when, based on our analysis, they offer opportunities for gain or there are dangers that signal a sale. Flexibility, then, combined with a sharp focus on risk in the attempt to regulate asset growth.

Asset Classes and Instruments

Along with cash, bonds and stocks, we also invest in alternatives, such as funds of hedge funds, convertible bonds, commodities and precious metals. Currencies are also an alternative investment. Currency diversification allows us to add yield and so, through selected transactions, contribute to achieving our objective. More in detail, we rebalance the currency position arising from investments according to desired exposure, to which we add currency trading transactions which are constantly monitored and actively updated.

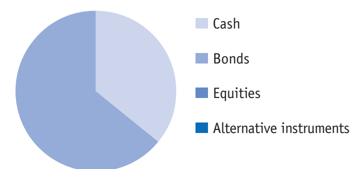
We choose investment instruments based on the objectives. We can distinguish between investment vehicles that give structure to the portfolio and others that take maximum advantage of investment opportunities and enhance risk control. Our bond and stock SICAV funds give structure to the portfolio, while funds of hedge funds are its "core". Part of the equity allocation is invested in stocks with a shorter time horizon, always on the search for new investment opportunities. If deemed more attractive, equity exposure is implemented through options or options structures on individual shares. On the bond side, we focus sharply on maturity and prefer certain segments of the yield curve. Our SICAV bond and equity funds and third party funds of proven reliability representing the core portion of the portfolio are part of the first category. We constantly evaluate the proportion between government and corporate bonds, with a focus on the risk/reward ratio for individual investments.

Our sharp focus on risk is also expressed through the use of index options to hedge the equity allocation if our analysis signals probable corrections.

Allocation by asset class

Income

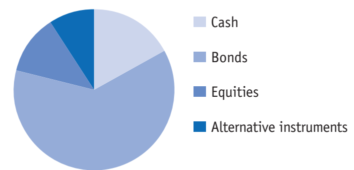
Cash	36
Bonds	64
Equities*	–
Alternative instruments	–
	100



Asset classes

Income Plus

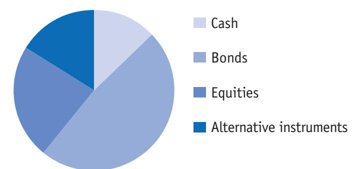
Cash	17
Bonds	62
Equities*	12
Alternative instruments	9
	100



Asset classes

Dynamic

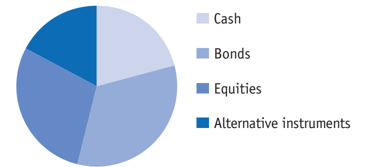
Cash	13
Bonds	48
Equities*	23
Alternative instruments	16
	100



Asset classes

Balanced

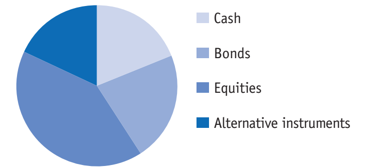
Cash	21
Bonds	33
Equities*	29
Alternative instruments	17
	100



Asset classes

Growth

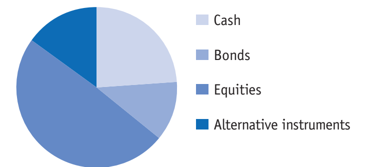
Cash	19
Bonds	22
Equities*	41
Alternative instruments	18
	100



Asset classes

Equity

Cash	24
Bonds	12
Equities*	49
Alternative instruments	15
	100



Asset classes

* Part of equity allocation is hedged with index options or futures

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