

Weekly Market Wrap-Up

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Analysts:

Andrei Damaschin, *Co-editor*

Max Stainton, *Co-editor*

Wodzik Kicinski

Swasti Gupta

Melson Chun

Financial Markets

Summer Rally and Optimism: Is it fizzling out?

By Melson Chun, 2nd year Law

This summer has seen some of the most amazing gains in the financial markets, pushing the S&P 500 to its multiyear high last seen in 2007, gaining up to 12.2% since summer started in late June. Other bourses around the world, such as the FTSE 100 and the Nikkei 225, have also reached their multiyear high, all rising on the back on the latest moves by the major central banks around the world.

The first jolt of adrenaline was offered by the European Central Bank (ECB). This was given after the ECB President Mario Draghi said the bank would do whatever it takes to save the euro-zone monetary union from falling apart. Hedge funds and traders around the world immediately jumped into the market, providing the markets with the much-needed boost after a very appalling performance in the lead-up to the summer. The ECB laid out its plan a month later, detailing that it would conduct unlimited, sterilised open-market bond purchase. What this seeks to achieve is to stop the rates that the indebted countries pay the market on the debts from spiraling upwards. Yield on 10-year government bonds on nations such as Spain has been rising, reaching as high as 7% - a level after which many say would not be sustainable for the government to maintain. By definition of sterilised, the ECB will purchase as much bonds as necessary, limited only by the asset sales of the ECB, largely done so as to appease the creditor nations such as Germany that the primary mandate of the ECB – which is to maintain price stability – is kept in check and that inflationary pressures would not spiral out of control several years later.

Yet, what appears to be a panacea for the euro-zone monetary union seems nothing more than a palliative treatment to an-already fragmented European Union, fraught with economic difficulties and challenges. What the euro-area currently needs is a strong political union, with the same single-minded objective to restructure and rebalance the debt and growth objectives of the entire region. Germany has proven to have the determination in the light of the Comprehensive Programmes introduced in the 1971 to create greater economic integration between the West and East Germany.

Financial Markets (continued)

Whether Germany can muster the required political will to lead the euro-area out of its current quagmire is largely still unknown.

The second jolt of adrenaline was given by the Federal Reserve (Fed). After a lacklustre and series of disappointing employment and factory output reports, the Fed unleashed a third instalment to the Quantitative Easing (QE). This time, Fed Charman Ben Bernake did not put any limits on the purchase amount and will purchase for as long as the economy requires it, up to USD 40 billion a month worth of mortgage-based securities (MBS) instead of long-dated government bonds. This seeks to reduce the yield of the MBS, encourage refinancing and encourage home purchase. Market participants expressed great relief upon the release of the news. Gold soared as investors seek to protect against the depreciating value of the dollar and against any inflation threats.

While many believed that QE 3 is a necessary evil and provides the much-needed short term relief in the greater credit easing and confidence in the financial markets, much more need to be done to shift the reliance on credit to drive the economy. Past research has shown that since 1971, every economic boom in the US economy is preceded by a major expansion of the money supply (M2). A shift from such a debt-driven economy to a more investment-oriented economy is required and it has benefits on many levels. Firstly, it provides the value-added process with each technological breakthrough, producing more efficient and effective means of production for the greater benefit of the economy. Secondly, it allows existing debt-laden companies to deleverage from the debts accumulated from the past few years. Lastly, it allows for greater showcase of the American spirit on the global platform, driving innovation and to keep the aspiration – the most understated intangible feature of any development.

Investors are weary of short-termed measures done to keep the economy trudging along. So far, few significant long-lasting measures have been enacted to create the necessary long-term viability of the global economy. Will the coming few months undo the confidence of the investors accumulated in the past few months? Only time will tell.

Eurozone

Is the OMT enough?

By Wodzik Kicinski, 2nd year Economics

In Greek myth Zeus turned into a bull to seduce and abduct a beautiful daughter of a king of Tyre - Europa. Today, just like at its mythical outset, Europe needs a bullish intervention to prevent disintegration and long economic stagnation. Although recently some important steps have been made to tackle the crisis, particularly the European Central Bank (ECB) announced Outright Monetary Transactions (OMT) on September 6th, such decisions are only temporary solutions to gain time.

Situation in the Eurozone over summer was dire. Target 2 imbalances, the amount of money that national central banks in the euro zone owe to the ECB or are owed by it, skyrocketed. The core countries (Germany, Netherlands, Finland and Luxembourg) experienced rapid increases in their assets and peripheral GIIPS (Greece, Italy, Ireland, Portugal and Spain) countries' liabilities rose. Capital flight resulting in rising debt financing costs in the periphery and banking crisis in Spain pushed Mario Draghi, the ECB president, to unveil OMT an unlimited short-term (up to 3 years) government bonds purchase programme. The action resulted in Spanish 2-year government bond falling from a 15-year record high of 6.9% in July 2012 to around 3.2% now. With other GIIPS government bonds following suit, the further escalation of bond yields was prevented.

Compared to Securities Markets Programme (SMP), which was introduced in May 2010 and had the same objective as OMT i.e. "to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism", OMT is more likely to be successful in preventing governments from falling into bad equilibria due to mounting debt financing costs. Firstly, it is an unlimited programme whereas SMP was only temporary and hence had only limited, short-term effects on the bond market. Secondly, contrary to SMP OMT dropped its claim as a senior creditor equally distributing the burden of default between the ECB and private creditors.

Yet OMT is not a panacea for the EU problems. A country can use OMT only if it complies with macroeconomic adjustments programmes by the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM). Conditionality of OMT implies that the ECB's support for a given country would require fiscal austerity measures in already fiscally fatigued countries. External requirements create a political

Eurozone (continued)

stigma which hampers entering the programme. Social opposition to austerity is particularly strong given high unemployment above 15% in southern Eurozone member states.

This explains Mariano Rajoy's, Spanish prime minister, reluctance to apply for support and adopt mandatory reforms. Thanks to the ECB's credible pledge to act as a lender of last resort if necessary, Spain, the biggest European Union worry recently, benefited from falling yields on its bonds and as a result did not require assistance to service its debt. If the ECB implements OMT in Spain (and that should be the case after October regional elections in Galicia and when opposition to OMT in Germany dies down) then a real challenge would be to meet its 2012 deficit reduction target – 6.3% of the GDP – after registering a 9.2% deficit in 2011. With the International Monetary Fund (IMF) updated forecast of 1.3% GDP contraction this year in Spain achievement of the target is unattainable.

Problem of moral hazard also casts doubts over credibility of OMT. If a recipient country does not fulfil criteria of the adjustment program, then what will the ECB do? An abrupt stop of the purchases is likely to trigger market panic and considerably increase risk of the Eurozone breakup, whereas a continued purchase in such a situation can tarnish ECB's credibility. Such an unclear exit scenario can weaken the ECB control.

And finally, OMT cannot tackle any of the structural problems in the Eurozone southern member states. Fighting a recession with austerity, even with more liquidity, is not going to restore growth and can rather result in a vicious cycle. It does not solve competitiveness problem in the periphery either. In fact it has worsened the problem, because in contrast to Quantitative Easing it is fully sterilised. The ECB absorbs back money pumped into the system leaving money supply unchanged. By strengthening the euro it reduced prospects for increases in net exports.

Indecisiveness and partial solutions illustrate a process which we have been observing for couple of years now. On the one hand austerity fatigue in the periphery and on the other bailout fatigue at the core make the member states unwilling to bear short term costs of reforms. So far Europe has experienced a wave pattern of reforms, where activism happens in each subsequent through. Only when the disastrous breakup scenario seems dangerously close are the Eurozone leaders ready to make sacrifices. But the Eurozone disintegration constantly looms on the horizon and if the European

leaders do not embark on closer banking, fiscal and economic integration soon enough then only a divine intervention can restore bullish attitudes.

Global Macro: Currencies

CNY - Rising to the occasion

By Swasti Gupta, 2nd year Economics

Friday 12th October saw the Yuan (CNY) reach a 19 year high at 6.27 against the dollar, as reported by the Financial Times. With the upcoming US presidential elections and slowing world economic growth, all eyes will be on China's next move.

The People's bank of China (PBoC) operates a fixed exchange rate policy, only allowing the rate to fluctuate within 1% of its target level. For this reason, it has often been criticised by the US for being a "currency manipulator". But is this true in light of recent developments? What impact will it have on Chinese growth and what's in store for investors?

Taking the effect of inflation into account, the price of Chinese exports to the US have only increased by 5% over the last seven years, while the currency has been steadily appreciating by 30%¹. A closer look at the GBP/CNY exchange rate, which has been fairly constant over the last quarter, suggests that perhaps Yuan appreciation is synonymous to Dollar depreciation. With the US absorbing 18% of Chinese exports, this relative appreciation of the Yuan could have a significant impact on GDP.

Earlier this week, the IMF revised down world growth forecasts, with Chinese growth expected to decelerate from 8.2% to 7.7%. If correct, this will represent a decline in growth of GDP for a seventh consecutive quarter to the lowest in thirteen years. China will release its official GDP figures next Thursday.

Data from last month however suggests strong export performance (9.9% net increase from September 2011), despite the fall in exports to the EU by 10.7%². The EU is the largest recipient of Chinese exports accounting for 20% of total exports³, and is likely to face continuing uncertainty, instability and contraction in demand.

¹ US Bureau of Labour Statistics Index

² Bloomberg- *China Exports exceed estimates Oct 13, 2012*

³ World Trade Organisation- Trade profiles

Global Macro: Currencies (continued)

Never the less, while the current account stays in surplus, the balance of payments was actually in deficit for the second quarter this year, owing to a net capital payments outflow for the first time since 1998⁴. As a result, Chinese's reserves fell by \$11.8bn (0.4%).

Whether the optimism about growth remains, in an economy where trade comprises 37% of GDP⁵ will now depend on *how much* the trade surplus contraction will reduce GDP. One reason for optimism with investors is the five year internalisation plan, under which the People's Bank of China seeks to boost domestic demand by investing \$158bn⁶ into internal infrastructure projects between 2011 and 2015. With the Chinese 10-year bonds still trading at a healthy 3.5% yield, the markets appear confident.

Although direct investment into Chinese stocks may appear risky due to inflationary concerns, bullish investors are actively looking towards more cost effective Yuan denominated, exchange traded funds (ETFs). Amidst uncertainty in growth, ETFs are an attractive investment, as they establish low risk exposure to the currency and offer hedges against exchange rate volatility.

Looking more closely at why the Yuan has been allowed to appreciate, perhaps the answer lies in the upcoming US presidential election. With Mitt Romney offering a much tougher stance on trade policy, it would be in China's best interest to see Obama return. And what could be a better way of convincing the American voters than by submitting to the age old plea of letting the Yuan appreciate? Tim Geithner, US Treasury Secretary, stated that there had been "some progress" but China had to make more of an effort to improve trade relations, after the Peterson Institute reported the Yuan 7.7% undervalued against the dollar⁷.

Now that the US treasury has delayed its semi-annual report to congress on trade policy, exchange rates and trading partners until after the election (on the 6th of November), the ball is clearly in China's court. And for now, it looks like the PBoC will prioritise its relations with the US over a trade surplus. But while all this could change after the elections, clear winners have already emerged from the slow and steady growth of the Yuan.

⁴ China's State Administration of Foreign Exchange (SAFE)

⁵ US Bureau of Economic Analysis and Economist Intelligence data

⁶ FT: *China approves Rmb1tn infrastructure spend (07/09/12)*

⁷ Policy Brief no. PB12-14M: Estimates of Fundamental Equilibrium Exchange Rates, May 2012

Macro Thoughts:

The Volatility Conundrum

By Max Stainton, Co-editor, 2nd year EPAIS

Within Finance, and Particularly Modern Portfolio Theory (MPT), the measure of volatility, or standard deviation, is critically important. This is because MPT uses the volatility of returns as a proxy for risk. Consequently, the measurement of an asset's volatility has become a fundamental tool in the asset allocator's armoury because it is the basic building block needed to begin to consider the trade-off between risk and return. This importance of the measure of volatility in finance eventually led the Chicago Board Options Exchange to launch in 1993 the VIX Index which measured the Option Implied Volatility of the S&P 500 over the next 30 days. At the time, this was a relatively innocuous, almost an academic financial innovation, however, in the years after, and particularly during the recent financial crisis, the VIX has become known on Wall Street and the City as the fear index. This is because, as the below chart demonstrates, the VIX index (blue line) seems to be very well inversely correlated with large moves in the S&P 500 (red line), often before these moves occur. This can be seen when calculating the correlation between weekly VIX and S&P 500 data, adjusting to include only larger than +/- 5% moves, which yields a correlation of -0.864, indicating a strong negative relationship between the two. Consequently, the VIX has been tracked by more and more commentators and analysts, not only because of its perceived predictive power, but because the futures and options tracking it may well provide



excellent protection in downward markets.

Thus with the VIX recently approaching multi-year lows, and still at a relatively subdued 16.1, investors are starting to ask themselves whether the VIX has started to lose its “scare factor”. The level of the VIX is particularly surprising given all the risks ahead that could send markets into a tailspin. These range from the US falling off its fiscal cliff, the ugly head of the Eurozone debt crisis re-emerging, or a full-scale war in the Middle East, and these are just the known unknowns. The overarching explanation for such subdued levels is that market participants are becoming increasingly reliant on central bank intervention and hence do not see the necessity of buying the apparent protection that volatility products provide. However, this relies on the rather large assumption that; A) all this intervention will in fact work, thus continuing the trend of lower volatility and higher equity prices, and B) that a large, market moving event, will not occur in the near future. This complacency is worrying because as more and more participants sell protection against volatility, expecting it to remain subdued, there is the increasingly real possibility of negative feedback loops emerging in the volatility market if renewed market turmoil erupts. As James Dailey, a portfolio manager at Team Financial Managers, exemplifies, “investors are working on the premise that central bankers have removed tail risk and provided financial markets with a backstop”.

Before we can jump to the conclusion that we should all go out and buy products linked to positive moves in volatility, it is first necessary to consider how exploitable these low levels of volatility are. On the face of it, it appears distinctly exploitable because of the range of volatility ETNs that are present on all major stock markets. For instance, in the US, there is such a variety that one can choose between ETNs that hold short-term futures to ones that hold longer dated ones. However, it is this exposure to the VIX futures market that makes these ETNs distinctly unappealing. As the second chart demonstrates (see next page), even over short periods of time, these ETNs (red line) dramatically underperform the underlying index (blue line). This is because of the construction of these ETNs, whereby as the shorter dated futures near expiration, the fund is required to sell these and buy longer dated ones in order to maintain its exposure to the market. As the VIX futures market is in severe contango these longer dated futures are more expensive than the shorter dated ones the fund is selling. Consequently, because the fund is selling low and buying high taking a long-term position in these ETNs is most inadvisable. So the question remains, how can one take

advantage of this apparent disconnect between the volatility market and the variety of foreseeable risks to global stock markets. One way, would be to simply utilise ETN's, but for only short periods of time thus capturing most of the gain in the VIX index without exposing oneself to the bankrupting effects of long-term contango. The problem with such a strategy is that it relies on exceptionally good timing and, frankly, a good bit of luck. An alternative strategy would be to buy VIX call options, which will pay off if the VIX rises by January. The problem with this is the sophisticated nature of such a trade. Thankfully, there are alternatives. The first is to simply allocate to a VIX ETN but one that gives exposure to mid-term, rather than short-term, VIX futures. The benefit of this is that you are still in control, you still have exposure to the VIX market, but, because of the longer dated futures exposure, one is less exposed to the effects of contango. An alternative to this would be to allocate to a "Dynamic" VIX ETN. These ETNs, as the name suggests, dynamically allocate between short-term and medium-term VIX futures with the intended aim of minimising the effects of contango in the long run while still granting exposure to short-term futures when volatility rises. As a long-term hedge of market turmoil, these dynamic ETNs prove to be surprisingly effective, with year-to-date return of the iPath S&P 500 Dynamic VIX ETN (XVZ) at -11.2% compared with the iPath S&P 500 VIX Short-Term Futures ETN (VXX) at -75.1% and the iPath S&P 500 VIX Mid-Term Futures ETN (VXZ) at -47.6%. However, the fundamental problem of this strategy is that as you extend the duration of the futures exposure you are also reducing your exposure to large gains if volatility quickly rises. This, is the volatility conundrum.



Investing Special:

Warren Buffett: Have the secrets behind the oracle of Omaha's success been unraveled?

By Andrei Damaschin, Co-editor, 3rd year Accounting & Finance

Much has been written and publicised about the investment style of Warren Buffett, one of the most famous financiers alive. His performance is remarkable in several respects. Looking at all U.S. stocks from 1926 to 2011 that have been traded for more than 30 years, we find that Berkshire Hathaway, the conglomerate run by Mr Buffett, has achieved the highest Sharpe ratio (0.76) of all U.S. mutual funds (an indicator developed to measure risk-adjusted performance of a portfolio of assets).

A dollar invested in Berkshire Hathaway in November 1976 would have a value of more than \$1500 at the end of 2011 (with current stock price at \$132 501). The average returned realised by the stock was 19.0% in excess of the T-Bill rate, significantly outperforming the market average of 6.1%. Berkshire stock also entailed more risk, realizing a volatility of 24.9%, higher than the market volatility of 15.8%. Nonetheless, the performance of the stock relative to its degree of risk was still high (Sharpe ratio of $19.0\%/24.9\% = 0.76$). Buffet's performance is even more impressive when considering he rebounded after a 76% shortfall between 1998/99.

Most of academic researchers have regarded Mr Buffett's performance as a statistical outlier and have not provided a rigorous empirical analysis of his conglomerate's performance. However, this recently changed with the publishing of a new paper⁸⁹ by academics at New York University and AQR Capital Management, a hedge-fund adviser, which claim to have identified the main drivers behind the consistent market outperformance of Berkshire Hathaway. Although the Sharpe ratio of 0.76 might not look extremely impressive at first glance, Mr Buffett has augmented his performance by leveraging his returns. However, this raises the questions of how does Buffett obtain an attractive return stream which subsequently can be leveraged? The researchers attribute

⁸ <http://pages.stern.nyu.edu/~lpederse/papers/BettingAgainstBeta.pdf>

⁹ <http://www.econ.yale.edu/~af227/pdf/Bufett's%20Alpha%20-%20Frazzini,%20Kabiller%20and%20Pedersen.pdf>

Investing Special (continued)

it to a strategy of buying stock which are “cheap” (i.e. value stocks with low price-to-book ratios), “safe” (with low beta and low volatility) and “high quality” (profitable, stable, growing, and with high pay-out ratios).

A brief detour into investment management theory is required to fully understand Mr Buffett’s success in his investments. Academics perceive stock in terms of their sensitivity with respects to market movement (beta). Stocks described as having a higher beta respond more violently to market movements (rise of 20% when market increases by 10%). The CAPM model (Capital Asset Pricing Model) suggests that investors would demand a higher return for owning more volatile (i.e. riskier) stocks. Studies show that in reality low-beta stocks have performed better, on a risk-adjusted basis, than their higher beta counterparts. A lucrative strategy in this scenario would be to purchase low-beta stocks and enhance your return by leveraging your positions. Big investors, such as mutual funds, are unable to do this due to their constraints from borrowing money and take alternative action by investing in high beta stocks to increase their returns.

But Mr. Buffett has exploited this anomaly and is well known for investing in high-quality companies (Coca-Cola, General Electric), during crisis periods, when they are underpriced, using leverage to boost his returns. The academics estimate that Berkshire has a leverage ratio of 1.6 (i.e. total assets minus total cash, all divided by total equity), which is sufficient to justify 10% of Berkshire’s 19% average excess return. Another crucial factor explaining the abnormally high return is the source of its leverage. The conglomerate’s insurance and reinsurance operations provide more than a third of its funding. An insurance company takes in premiums upfront and cashes out later on; Berkshire is therefore borrowing, in effect, from its policyholders. The average borrowing cost averaged 2.2%, more than three percentage points below the average short-term financing price in the U.S. during that period. In addition, the company was AAA rated from 1989 to 2009 and was therefore able to issue debt cheaply compared to other organisations. Berkshire also finances part of its capital expenditure using tax deductions for accelerated depreciation of property (in essence representing deferred tax, which does not accrue interest). In 2011, it reported a noteworthy \$28 billion of such liabilities.

Investing Special (continued)

The study demonstrates that classic factors which capture the market, size, value and momentum premia cannot explain Mr Buffett's performance. Instead, the low-beta nature of the portfolio combined with leverage explains a significant amount of Mr Buffett's abnormal returns (particularly in public stock portfolios). Nonetheless, a significant component of the abnormal return remains unaccounted for. So before running off to the markets and replicating Mr. Buffet's success, consider this: the Oracle from Omaha made his fortune by recognising the abovementioned principles almost half a century before the authors wrote their paper.

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Many thanks.

The Warwick Investment Club Research Team

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