MONDO ALTERNATIVE

Testing the value of securities during periods of market volatility

Mergoni, CEO of Banor Capital, explains how value-based long/short funds are performing, from Europe to the United States to China

by Valerio Magni

Focusing on companies' value is more fruitful than hazarding guesses at index levels. Of this, **Giacomo Mergoni,** CEO at Banor Capital, is convinced, as he explains to MondoAlternative the approach followed by the firm's long/short funds. In this period of volatility we've seen in the markets from late 2015 and into 2016, the funds constantly question why a given security has been included in a given portfolio, and whether anything has changed in the companies themselves and in the general economic scenario.

What are the reasons that have led, and are still leading, first in August last year and then since the start of 2016, to the increased volatility and abrupt adjustments in share prices?

We feel that the current volatility, like that recorded in August 2015, arises from a number of factors that can be summarised as follows. China is slowing its rate of growth (a planned and healthy move, in our opinion). The world has found itself with an excess of commodity capacity, especially for oil, partly as a result of the shale oil revolution and the lack of coordination in the reactions of the major producers. In the face of the troubles in this sector the market reacted with fears of a new global recession and of the reactions of the central banks.

Investors are particularly worried that the Fed, which has just begun to raise rates again, doesn't want – or doesn't know how – to react to a new economic slowdown. Given these uncertainties the markets reacted by first selling securities and currencies linked to commodities and then American bank bonds. Other situations have their own explanations, such as the increase in non-performing loans and bail-in fears for the Italian banking sector.

In general, how does a long/short approach that starts with companies' fundamentals behave in situations like the present one?

There are various ways to manage funds using long/short strategies. Some managers buy securities and go short on the index, seeking to reduce betas and create a low volatility portfolio. Others aim to create pair trades and use trading and derivatives strategies in the attempt to create a market-neutral portfolio. In Banor's case, our long/short funds adopt a value approach that aims to generate alphas on both the long and the short elements. This

means, on the one hand, investing in securities that we think will outperform the market over the medium-long term, and on the other, selling irrationally over-valued stocks that in the short term will underperform with respect to the market.

In periods like this one, a traditional value manager keeps questioning his or her portfolio to try to understand what (if anything) has changed in the companies it contains or in the general economic situation. If volatility or the events that generated it have not undermined the estimated value of the stocks or the economic scenario, a value manager grasps that volatility as an opportunity to buy stocks at lower valuations and, as the market falls, can decide to increase his or her net exposure. The aim is to end up more heavily weighted and longer on your own stocks when the market overcomes its fears.

A high level of gross exposure of a long/short equity fund could be a risk factor during difficult periods for the markets, if combined with the wrong, or an inappropriate, selection of shares. What is your philosophy?

A mistaken or inappropriate selection of stocks can (indeed, will) be a risk factor for any level of gross and net exposure. For value-based managers, the selection of stocks underpins the construction of the portfolio. After the manager has put all this effort into selecting the stocks, the composition of the portfolio must also take into account how dear the market is and the differentiation between valuations within it (just *how* dear the dear sectors are, compared with the cheaper ones).

For example, in spring 2009 we would have recommended a lower gross and very high net exposure since everything was equally cheap and we'd have positioned ourselves long, with just a few short positions. In summer 1999, on the other hand, we'd have wanted a very high gross exposure to reflect the polarisation between the old economy (long) and the new economy (short) and a very low net exposure, because the technology-media-telecoms (TMT) bubble had pushed indices too high.

Ability in going short on the markets is vital to protect the downside. How do you manage this element of the portfolio?

In our long/short portfolios we only use individual stocks for the short element and rarely use futures and options. Our short stocks are bets against companies that we think are too highly priced in businesses we feel are intrinsically unsustainable and threatened by fundamental changes, and for which we expect a catalyst in the short term. For this reason, going short on the indices wouldn't give us the same result. Of course, there are times when it would be useful to be able to trade futures to cover or lengthen your position, but it's easy to get it wrong and we prefer to concentrate on the fundamental analysis. Another rule is that we never go short on good companies, even when they seem too dear. It's too dangerous.

Lastly, we keep our short positions much more diversified than the long ones. The average [short] position is about seven times smaller than the average long position. In that way, we seek to protect ourselves from any takeover risks and from the continuing rise of stocks that are already irrationally over-valued (irrational twice over is still irrational).

In the United States, in addition to securities linked to the performance of oil, which sectors or stocks were most badly hit when things were heading downwards? And which ones are bearing up best?

American financial stocks were hit by fears of greater provisions on exposure to oil stocks and a slower increase in rates (and so in gross income). Defensive sectors (consumer staples, telephony, utilities) performed better, out of fear of a new recession.

In Europe, the banking sector in particular is paying its dues. Are the reassurances from the Central Bank not working any more?

The European banking sector is suffering from the increase in non-performing loans following years of very low or negative growth. The action of the ECB has in part been neutralised by intermediaries' need to strengthen their assets, not least following the entry into force of the bail-in Directive. The effect of the ECB's moves on domestic consumption has so far been less than the markets' expectations. We think Draghi will soon be forced to increase the central bank's interventions by extending purchases to certain categories of corporate bonds.

In a dynamic economy like China's, which is undergoing profound transformations, how do you identify the winners and losers, and who you should be building your medium- or long-term portfolio around?

In China the continuing growth of the middle class, who want similar living standards to the West, is clear. These new consumers are buying cars, online services and smartphones, they're going to the cinema and eating out, they're travelling and studying like their counterparts in more developed countries. So our analysis focuses on this "worldly" trend and seeks to select the champions of the domestic economy. We take a negative view, however, of the "old China", the China of infrastructure and public spending that's got out of control.

Currency trends seem to have had a decisive influence on the performance of share prices in recent months. Is that the case?

Currency is certainly one of the instruments used by governments to compete in global trade. However, let's not place currencies upstream of our analysis. We view them as a variable that isn't easy to predict and prefer to concentrate on something we can measure, like the future cash flows of companies we view as high quality.

If you had to predict the level of the S&P 500 and EuroStoxx by the end of the year, where would you place them?

The American market seems to us right now to be within the “right” valuation range. So it could continue to move horizontally, without major changes from now to year-end. Some variables, such as geopolitical stability, the presidential elections and the price of oil could have effects that at present we can’t predict. In Europe valuations are generally lower but the macroeconomic risks are higher and growth is weaker. In this case too, therefore, we think that focusing on seeking out value is more fruitful than hazarding a guess at the level of the indices.

About the company

Banor Capital Limited is an independent investment management firm based in London. Banor was created in 2011 by a team of investment professionals working together since 2001. Banor’s goal is to be the partner of choice for institutional and private clients looking for a value-based investment manager. Banor Capital Ltd (UK), together with its sister companies Banor SIM S.p.A. (Italy) and Banor SICAV (Luxembourg), is part of a management-owned group whose sole focus is to provide the highest standards in investment management solutions. Assets Under Influence (AUI) amount to over 4.5 billion euro, of which 2.1 billion under discretionary management.

Banor SICAV is the group’s flagship UCITS IV umbrella fund with five sub-funds: three alternative long/short strategies (North America, Italy and Greater China), one equity (European Value) and one fixed income (Euro Bond Absolute Return).