Still opportunities in the US equities for Long/short bottom up managers

For Banor Capital, the American market does not seem to be at bubble valuations, however the possible change at the Fed's helm could be a source of uncertainty

by Luca Damiani

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Also in September, a historically negative month for the equity market of the United States, the S&P 500 index closed in positive of around 2%, bringing to +12.5% the increase in the first nine months of the year. Despite the continued rise in prices, which has been almost unbroken since March 2009, in accordance with **Eddie Ramsden**, advisor of the Banor Sicav North America Long Short Equity, the American equity "seems somewhere in a broad range of fair value, perhaps nearer the top of that range than the bottom", with some pockets of pronounced overvaluation that are "providing us with attractive opportunities on the short side of the portfolio". Most worrying, however, are the upcoming appointments of the members of the Fed's board: "It's hard to predict which factors Trump will decide are most important when filling the vacant positions, but we can certainly think of candidates who we would consider to be likely to be marginal negatives for the American economy".

Since the Fed's first rate hike in December 2015, the S&P 500 index shows an annualised positive return of 11%. At what level is the American market today? What are your prospects for the coming months?

We are now in the ninth year of the second-longest bull market on record. Equity market volatility is at, or close to, all-time lows. The S&P 500 trades at around 18x after-tax earnings. The market as a whole does not seem mouth-wateringly cheap to us, nor does it seem precipitously expensive. It seems somewhere in a broad range of fair value, perhaps nearer the top of that range than the bottom. We continue to think that a long/short value approach to equities is an excellent way to try and generate positive risk adjusted returns in the medium to long term. As usual we try not to form expectations for what markets will do in any particular quarter or year. We see our job as focusing primarily on analysing the value of businesses over longer periods. Over the years we've found that provides plenty of opportunities to be wrong; why step up a rung on the difficulty ladder? So we make no predictions here about the short-term movements of the US stock market. Instead, when making investment decisions we are guided by the level of valuation of the market as a whole and the valuations of the individual stocks within it.

What is your view about the current political situation in the US? What are the variables that cause you most fear today?

We can sympathize with the market's benign reaction since the election, at least as a base case picture of a more business-friendly government policy environment. But we also wonder whether the distribution of possible economic outcomes may have simultaneously widened a bit at the tails. As noted above, if we had to focus on one economic variable it would be monetary policy under the current administration. While the consequences of many government policies are often quite hard to predict, it is more straightforward to do central banking rather badly, and terrible central banking would matter. Janet Yellen's term as Chair of the Board of Governors of the Federal Reserve ends less than four months from now, and Vice-Chairman Stan Fischer resigned earlier month, for personal reasons. We don't yet know who will replace them, and President Trump is now in a position to appoint a majority of the Fed's board. It's hard to predict which factors Trump will decide are most important when filling the vacant positions, but we can certainly think of candidates who we would consider to be likely to be marginal negatives for the American economy.

Is there a bubble risk in the American stock market?

While the overall equity market does not seem to be at bubble valuations, we are finding some pockets of pronounced overvaluation. This is currently providing us with attractive opportunities on the short side of the portfolio. Many of these are companies that have stable but low growth prospects in quite competitive industries, but don't seem particularly vulnerable to online competition or other secular threats. The type of companies that are sometimes referred to as "bond proxies". While we do not disclose the names of our individual short positions we can give anonymized examples. We recently initiated a short position in a company that is expected to grow 3-4% organically per year and operates in a mature, competitive service industry with no technology or proprietary assets. Investors are currently paying nearly 50x forward net income for this mundane, albeit stable, business. At this price, a large stock buyback would likely be dilutive. We rarely see this kind of valuation outside of a technology company or a young company in rapid growth phase. We are currently finding plenty of short ideas that fit this profile.

How did you change the allocation of your Banor SICAV North America Long Short Equity during 2017?

We are long-term investors and our portfolio typically changes quite slowly. Furthermore for the most part we are not thematic investors, and do not look to make top-down allocations to particular sectors or categories of investment. Instead our approach is to construct a portfolio of longs and shorts from the bottom up, based on a fundamental appraisal of each idea. We have found a number of promising ideas on both sides of the book this year, and have trimmed and removed existing positions to the extent that their underlying investment theses have played out during the year.

Could you tell us the names of those companies that you think are interesting and why?

Despite the fact that rising valuations generally make it more difficult to source new long ideas, we recently found a special situation that we believe is an excellent risk reward, Chicago Bridge & Iron (CBI). CBI fabricates large-scale energy and infrastructure projects on a fixed cost contractual basis. The company has significant financial leverage and recorded a large charge for cost overruns at several projects in their most recent quarter. Concurrent with the disastrous quarter, in order to placate the banks, the company announced its intention to sell its prized segment before the end of the year for a price that would enable the company to repay all of its outstanding debt. The market was unpersuaded by the potential sale and the stock sold off significantly, at which point we initiated our position. We believe there will be a high degree of interest in this business and that management's estimate of the sale proceeds is conservative. Using our best estimate of the sale price, we believed we were paying approximately 3x pro forma operating income for a business that would be unlevered post-sale and not a full tax payer. While we could clearly be wrong on the price ultimately realized in the sale process, we have a wide margin of safety and believe this position provides an excellent risk reward.

This year you reduced the net exposure of your fund compared to the historical level. Why?

The fund's average net exposure this year has been around 33%, compared to 54% average net exposure since inception. The level of the fund's net exposure at any point in time is primarily a function of overall market valuation. With the S&P 500 trading at around 18x after-tax earnings, compared to a little over 13x after-tax earnings at the fund's inception in, we would expect net exposure to be somewhat lower now.