MONOGRAM

NEWSLETTER *March 2015*

The MONOGRAM Portfolio returned an estimated +1.86% (net) for the month of February 2015. The investment landscape was mostly favourable to risk assets as the three generally perceived risks to further improvement in equities markets have somewhat receded over the course of the month.

First, the structural threat to the European Union project presented by the newly-elected anti-austerity Greek party Syriza largely vanished when Prime Minister Alexis Tsipras accepted the conditions for a continuous financial support demanded by the Troika. Secondly, tensions between pro-Russian troops and the Ukrainian army eased as the two parties agreed on a cease-fire. Thirdly, the US Federal Reserve indicated (once again) that interest rates are likely to remain lower for longer, which is perceived as supportive to business conditions. But the most important development that took place in financial markets in February was perhaps a stabilisation in the price of oil.

After five years of stability, the oil price has fallen by more than 40% since the summer of 2014, when it traded above $100 a barrel. This price dynamic is at odds with the global recovery that started after the Global Financial Crisis in 2008 since growth must be fuelled (no pun intended) by higher demand for energy sources in general, and oil in particular.

The dynamics behind oil prices is of course, more complex than that. As oil is a free market, the price of a barrel reflects an equilibrium between supply and demand. Despite global growth, overall oil demand is trending lower mostly because of the growing importance of cheaper alternatives and increased efficiency. Speculation also plays a growing role and could amount to up to 60% of global oil demand, according to GlobalResearch, a Canadian think-tank.

The supply side is changing rapidly too. New means of production, including hydraulic fracturing, or “fracking”, have emerged recently, notably in North America. This has allowed the United States to become the largest oil producing country since the 1970s. Since political instability in Libya and Iraq, two major oil-producing countries, has not affected their output, Saudi Arabia, the second largest producer behind the US at 9 million barrels a day, seems to have decided to play the long game. This means forcing high cost producers –essentially American frackers- out of the market by keeping prices low, which has the additional benefit of hurting two of the country’s main rivals, Iran and Russia. Since the Saudis sit on more than $900bn of currency reserves and enjoy very low costs of production ($5 a barrel), they can afford lower prices for a long time. Having driven the price of a barrel to the $40 region, the Saudi are unlikely to let it rally back to previous levels and the odds are for oil to remain around the $50 mark for the medium term.

This fascinating dynamic at play has collateral implications. Oil remains the main source of energy and a reduction of $40 a barrel transfers an estimated $1,300bn per year from producers to consumers, or 2% of global GDP. The political agenda of countries such as Russia and Iran is highly dependent on oil revenues and it is unclear whether the economic pressure induced by lower oil-related revenues would weaken them or force them into desperate moves. Finally, countries with deep pockets that strategically need to secure access to sources of energy, such as China, can now buy strategic assets at bargain prices.

Oil is the largest component of the S&P GSCI, the most commonly tracked commodity index, and it is therefore no surprise that the whole index has followed lower oil. While there are times when the odds favour investing in commodities, we find that more often than not investors are better off staying out of it: a passive investment in commodities has lost two-thirds of its value in a generation (25 years) in real terms (i.e. adjusted for inflation). Since our goal is to double the real wealth of our investors every generation, our portfolio will only rarely invest in commodities and only when the probability of making money is substantially higher than average. Accordingly, there is no commodity investment in the portfolio.

Instead, the portfolio remains invested for approximately 50% of its net value in equities, which is the maximum allocation to equities allowed by our investment approach. This, of course, appears initially inconsistent with our views that US equities are expensive, perhaps more expensive than at any point in the last 50 years. The Price to Sales ratio, statistically the best predictor of forward returns, for the median stock in the S&P500 is at the highest level ever recorded, with the aggregate market capitalization to GDP ratio only modestly below its record level.

This apparent inconsistency resolves itself when we remember that the primary objective we maintain is to deliver returns within the context of diminished drawdown and when we recognise the enormous difference in the characteristics of a “diversified” versus “drawdown resistant” portfolio. Investing in US equities is, in fact, a strongly defensive position within pro-cyclical assets. Over the last 10 years, non-US equity markets have exhibited a drawdown beta of 1.25, on average, with respect to US equities: that is to say, buy a diversified non-US equities portfolio and an “air-pocket” should statistically incur losses 25% higher than those of a US portfolio.

Over the same period, non-US equities and US equities have gone down in sync more than 80% of the time, so confidence in a positive de-correlation of non-US equities to limit portfolio drawdown would be misplaced. Our “drawdown resistant” approach positions a balanced portfolio of US equities and medium term investment grade bonds in such a way that we benefit from any further strength in equity markets whilst having a stronger drawdown resistance.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. The management team has over 55 years of investment management experience, having met and worked together at Goldman Sachs before holding leading investment positions at other institutions.

We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms.

There are two options for investors to access MONOGRAM’s investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM’s bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are contained in the subscription documents to the fund.

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