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**Alternative liquid funds**

# In the present situation, defensive stocks are winning over more cyclical sectors

## Banor Sicav Italy Long Short fund currently has a low beta on the market, allowing it to weather renewed volatility

by Marco Degrada and Barbara Radaelli

There is still optimism regarding energy stocks, although valuations are less tempting than in the past, and the outlook for financial stocks is cautiously positive according to Luca Riboldi, Chief Investment Officer at Banor Sim. He also advises keeping a watchful eye on monetary policy normalisation by the central banks and on geopolitical tensions: either could trigger recessionary effects.

**What does your Banor Sicav Italy Long Short Equity investment process envisage?**

The fund adopts a value strategy based on a sectorial approach. After years in which asset allocation has been built up starting from a geographical point of view, we are now convinced that the real driver is sector-based. Sectorial positioning is what determines whether you are overweight or underweight in a given country. Moreover, although our fund is oriented towards the Italian market, it doesn't exclude investments in other countries' stocks when they appear attractive and interesting. That said, when selecting stocks for our portfolio we use three main parameters: the dividend discount model, historical multiples (P/E, EBIT, etc.) and free cash flow.

The first of these parameters produces an absolute valuation in terms of the company's price, which we then follow with a momentum analysis using historical multiples. Lastly, we look at its capacity to generate cash, preferring companies with a larger cash flow. This value approach produces a two-part portfolio. The long part consists of undervalued stocks, which will stay in the portfolio until they reach or exceed their fair value. The short part includes stocks with high market valuations and a worsening profit momentum or companies with futureless business models (for instance, Yellow Pages after the advent of Google).

**In February we saw a return of volatility on the markets. How has the fund reacted? How have you changed the portfolio's asset allocation?**

The fund has had a limited exposure to the market since the end of 2017: about 20% net long compared with a historical average of around 45-48%. This is because many stocks are too expensive for a long position and, on the other hand, are difficult to short because they have good momentum for profit expectations. Our low market exposure has meant that the volatility experienced in February did not overly affect the fund, which at the beginning of May showed a yield of 3.6% from the start of the year. The team behind the fund wanted to take advantage of the situation created by the increased volatility to sell some calls on stocks in the long-term part of the portfolio. On the short-term side they closed some positions that had already sufficiently lost value.

**Despite the correction in February, the Italian market has been performing very well since the beginning of 2018. How are you positioned now and what are your expectations for the coming months?**

For the reasons I've already mentioned, our fund currently has a low beta for the market and this means that in the first half of 2018 we were able to generate alpha. However, we're still bullish on energy stocks, even if today's valuations are less attractive than in the past. We're cautiously optimistic about financial stocks as well. They're bolstered by the prospect of a rise in interest rates, the good performance of the economy, and an improvement in banks' bad debts.

We do have a significant long position on the financial segment of the market that we don't plan to increase any further. The sector is very sensitive to movements in the BPT/Bund spread, which, as we've seen recently, is too heavily dependent on the political situation in Italy. Instead, we've increased our long position in defensive stocks and increased our short position in some small caps and industrial stocks that we think have become overpriced. Lastly, we have some short positions in sectors that are structurally bound to flounder, like physical retailers, which are competing poorly with e-commerce.

**In Europe, the Citigroup Economic Surprise Index has indicated that the economy is slowing...**

As I mentioned, the fund's team has increased the portion of defensive stocks in the portfolio (such as Enel and Snam Rete Gas), in preference to those of cyclical sectors. They did so after some indexes had already, as early as January, signalled an economic slowdown in Europe. We think it's a temporary phase, largely due to the sudden, sharp drop in the dollar in recent months. The dollar is already picking up and the global economy is doing well, so we think the slowdown will not continue beyond July/August and then there will be a new upturn in Europe. Again, we can exploit this situation to play the market with the defensive stocks that we've just incorporated in our portfolio.

**What are the main risks overshadowing the markets today?**

The first risk we need to consider is a rise in interest rates, owing to the normalisation process that central banks are implementing. In the coming months it will be important to monitor the inflation rate carefully. If it goes significantly over 2%, particularly in the US where it might be driven by a rise in wages and commodity prices, the central banks will be forced to speed up their monetary policy normalisation. This would lead to negative performances on the market, not least because the economic cycle is well advanced and there would be a serious risk of recession. Let's not forget that the US has already avoided a recession this year through Trump's fiscal policies and that the risk could surface again in the US and global scenario after the second half of 2019.

Apart from this, the geopolitical risk is always present at the global level. A particular source of concern, at present, is the possibility of conflict in the Middle East because it could aggravate oil price tensions as crude oil production has been halted for some time. There is a real risk of a price increase, not only because most of the demand for crude oil linked to economic growth is being met by increased US production, but also because stocks have been significantly reduced. In addition, new sanctions against Iran might trigger not only a rise in prices and drop in demand, but also a recessionary effect.

**You conducted a study with the Milan Politecnico School of Management, and have also discussed the subject of environment, social and governance (ESG) with the Harvard Business School. What have been the results?**

The analysis of market yields has shown that the stocks of companies in the quartile with the highest ESG rating perform best. These companies also show stronger profit growth and better margins. When selecting the stocks in which to invest, in our analyses of the financial parameters we ourselves are beginning to include ESG among the factors that determine a premium or a discount. This means that the companies that are sensitive to the sustainability issue are awarded more points when we select them for our portfolio. We are living in a world with environmental problems that can no longer be ignored: from pollution to disastrous climate change. Moreover, the social tensions linked to enormous global inequality should not be underestimated.

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