<u>Samuel Terry Absolute Return Fund</u> – May 2014 monthly report

The Fund's performance (net of fees), and those of the Australian All Ordinaries Accumulation Index and the MSCI World Equities Index, are as follow:

To 31 May 2014	STAR	All Ords	MSCI ($A)
1 month	1.30%	0.61%	1.86%
3 months	1.47%	2.17%	-0.75%
1 year	19.16%	16.20%	20.58%
3 years (%p.a.)	19.40%	9.32%	14.42%
5 years (%p.a.)	24.26%	12.17%	11.01%
Since inception on 1 Nov 2003 (%p.a.)	11.31%	9.47%	5.63%

The Fund's biggest winner in May was **AIMS Property Securities Fund** (5.7% of the Fund), which rose 38% after winning a long-running court case. Part of our gain was offset by a 31% fall in **P-REIT** (0.9% of the Fund), which lost the case. Overall, resolution of the court case added about 1.2% to the Fund. Both AIMS and P-REIT continue to trade at substantial discounts to net asset value. In recent months, AIMS has bought back 8% of its own shares, an action we applaud.

We continued buying call and put options on the Australian ASX 200 Index at very low implied volatility. The purpose of these purchases is to protect us from large falls in the index, and provide exposure to large rises in the index. As neither occurred, these positions cost us about 1% of the Fund during the month. The attached FT articles provide some background on why we like options at present.

We also bought put options on the **Commonwealth Bank of Australia**, Australia's largest bank. CBA is regarded as one of the world's best banks, and the structure of the Australian banking industry is (from the perspective of a bank shareholder) highly attractive. CBA generates a return on equity of about 20%, suffers almost no bad debts, and pays out about 80% of its earnings as dividends. Its attributes are well known in the Australian investment community and the shares are (perhaps rightly) priced for continued perfection at 3.5x book value, and a P/E ratio of over 15x. If the Australian economy, a derivative of the Chinese economy, were to hit problems, CBA is vulnerable on a number of fronts. For these reasons, we view cheap CBA put options as an attractive proposition for less than 1% of the Fund.

The Fund's net asset value per unit was $1.6054 at month end. The Fund owned securities issued by 26 companies. 13.1% of the Fund was in $A cash. 1.8% was in call and put options. The put options covered 135% of the Fund's net assets.

Fred Woollard
12 June 2014

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Key US gauge signals investor complacency

By Nicole Bullock in New York Author alerts

US equities are at record highs, but a key measure of investor sentiment for future performance indicates a reluctance to chase the market higher.

S&P 500 call options, which give the buyer the right, but not the obligation to own the index at a future date, are at their cheapest level since the current bull market began five years ago, according to research from Credit Suisse.

A call option becomes profitable when the underlying asset rises in value beyond the cost of the premium paid by the investor.

“The options market is not seeing a lot of upside potential,” said Mandy Xu, an equity derivatives strategist at Credit Suisse.

This comes as the S&P 500 rose to new highs above 1,900 on Tuesday. It has been largely range-bound so far this year, however, rising only 3.4 per cent after 2013’s 30 per cent gain.

Cheap call options are a reflection of the current regime of low volatility, said Ms Xu. The CBOE’s Vix, a measure of equity volatility known as Wall Street’s “fear gauge”, has fallen to 11.51, a historically low level.

It is not unusual for the price of call options and cash equities to move in opposite directions at times when the market is rallying. But, unusually, volatility and, in turn, the price of call options, are cheap across asset classes.

That includes not just equity but also oil and gold, where implied volatility is currently at one year lows, Ms Xu said. The volatility for rates and foreign exchange for G7 countries is also low.

Low volatility has been a consequence of interest rate suppression by central banks in the aftermath of the financial crisis, which has put pressure on the trading revenues of banks.

While options investors are not making large bets on a rally from here, they are also not too worried about a substantial correction either. The equity market has not experienced a major correction since 2012.

“Put options are also cheap,” said Randy Frederick, managing director of trading and derivatives at the Schwab Center for Financial Research, the research arm of Schwab. “Some of the big catalysts like the debt ceiling negotiations and the sequester, which caused the pullbacks that we saw in 2013, do not exist at the moment.”

Following the stock market’s gains, valuations for equities are above historical averages. The trailing price to earnings ratio, for example, for the S&P 500 is 19. That compares with a long-term average of 17.5 dating from 1948, Mr Frederick said.

“One of the views is that after five years of the gains in the stock market, investors have grown tired of paying for portfolio protection, both calls and puts,” said Mike Arone, chief investment strategist for the US intermediary business at State Street Global Advisors. “It signals a certain degree of complacency in the market.”

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FINANCIAL TIMES

May 29, 2014 5:16 pm

Tranquil markets are enjoying too much of a good thing

By Gillian Tett Author alerts

After years of monetary experiments, central banks will do 'whatever it takes'

Something peculiar is happening in western capital markets. This month almost every measure of volatility has tumbled to unusually low levels. If you look at the degree of actual (or "realised") price swings – and projected (or "implied") future movements – investors are behaving as if the world is utterly boring.

This is bizarre. Financial history suggests that at this point in an economic cycle, volatility normally jumps; when interest rate and growth expectations rise, asset prices typically swing (not least because traders start betting on the next cyclical downturn). And aside from economics, there are plenty of geopolitical issues right now that should make investors jumpy. European elections have just propelled populist leaders into power, and events in Ukraine and the Middle East are tense.

But investors are acting as if they were living in a calm and predictable universe. Take a look, for example, at Wall Street's so-called "fear index", the Vix, which measures the implied volatility of S&P 500 equities. During the financial crisis this surged above 80, and later sank to half that; it is now just above 11, a low level not sustained since 2007.

Similarly, the "implied equity vol-of-vol" index (a derivative of volatility measures) is at its lowest level since 2006, and implied volatility in the euro-dollar currency markets is at its lowest since 2007. Bond price swings are very low too, and realised and implied price volatility for oil prices is also at a decade low.

"There is no demand for protection [against turbulence]," observes Mandy Xu, an equity derivatives strategist at Credit Suisse. "[Investors in] the options markets are not pricing in any big macro risks. This is very unusual."

Why? If you want to be optimistic, one possible explanation is that the economic outlook has turned benign. For while western economic growth rates have been disappointingly slow since 2008, the good news is that recovery is now afoot, at a surprisingly steady pace. The disaster scenarios that used to spook investors – such as an imminent break-up of the eurozone or technical bond default in Washington – have not materialised; or not yet. More important still, after several years of wild monetary experiments, investors are more willing to accept that western central bankers will do "whatever it takes" to support the markets; they thus expect rates to remain stable and low for a long time – even if some central banks, such as the Federal Reserve, reduce their level of stimulus.

But there is a second, less benign possible reason for low volatility: markets have been so distorted by heavy government interference since 2008 that investors are frozen. One issue that may account for the pattern, for example, is that tougher regulations have prompted banks to stop trading some assets. Another is that ultra-low interest rates have made investors reluctant to deploy their cash in public, liquid markets.

And there could be a more subtle issue at work too: investors are so unsure what to make of this level of government interference that they are unwilling to take any big bets. Far from being a sign of sunny confidence in the future, ultra-low volatility may show that investors have lost faith that markets work.

In reality, nobody knows which of these explanations holds true; I suspect that government meddling and low interest rates are the key factors here, but academic research on this issue is thin. However, one thing that is clear is that the longer this pattern remains in place, the more wary investors and policy makers should be.

For while ultra-low volatility might sound like good news in some respects (say, if you are a company trying to plan for the future), there is a stumbling block: as the economist Hyman Minksy observed, when conditions are calm, investors become complacent, assume too much leverage and create asset-price bubbles that eventually burst. Market tranquillity tends to sow the seeds of its own demise and the longer the period of calm, the worse the eventual whiplash.

That pattern played out back in 2007. There are good reasons to suspect it will recur, if this pattern continues, particularly given the scale of bubbles now emerging in some asset classes. Unless you believe that western central banks will be able to bend the markets to their will indefinitely. And that would be a dangerous bet indeed.

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