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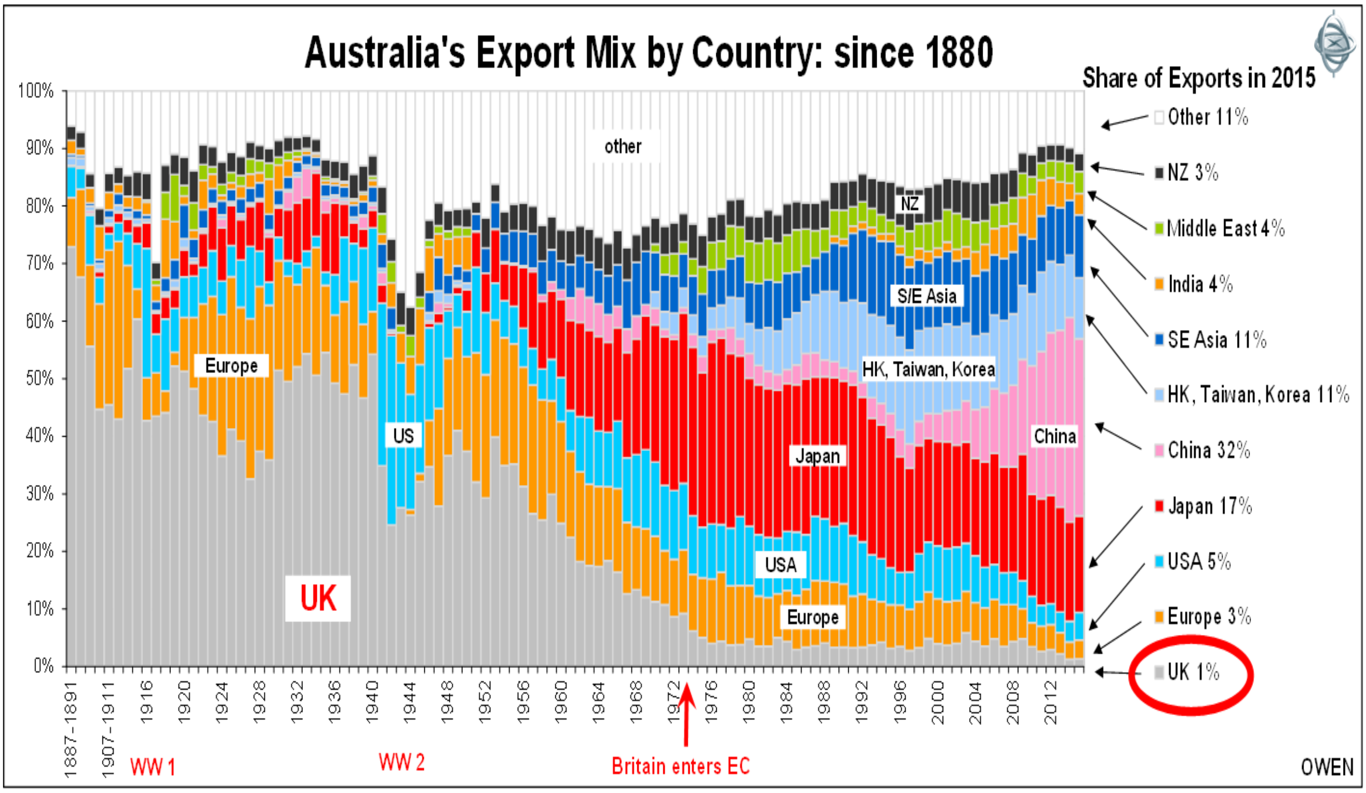
This Week's Top Articles

Britain, Brexit and Australia

Ashley Owen

Countless articles have been written already on the subject of Brexit, but most focus has been on the immediate panic selling after the vote. This commentary adds more context and common sense to the debate.

The chart below shows the declining role played by Britain in Australia's exports since the 1800s.



Britain replaced as Australia's major trading partner

As a British colony, Australia was heavily reliant on Britain for investment capital and export revenues. Prior to Federation in 1901, Britain bought virtually all of our exports (mainly wool and gold), and the export revenues from Britain made Australia the richest country per person in the world. Britain continued to be our largest export buyer until 1940, when the US overtook the UK in World War 2. After the War, our export mix changed dramatically and our exports played a major role in the reconstruction and re-emergence of Europe and Japan. In 1967 Japan, mainly buying iron ore and coal, overtook the UK as our largest export buyer, from the 1970s and China over-took Japan in 2010.

When Britain entered the European Community in 1973, it dismantled the system of preferential access for exports from its former colonies like Australia, and this caused much panic in Australia at the time. But it made little difference to Australian export revenues because by then Australian exports to the mother country had already declined significantly in importance. By 1973 Britain was buying less than 10% of Australian exports, less than Europe, and less than one third of what Japan was buying. Today the UK buys just 1% of the total Australian export revenues, a mere historical footnote.

Where to from here?

Britain was a late entrant into the European Community and it never adopted the Euro as its currency. What was surprising about the vote was the fact that the majority of voters rejected the advice of the major political parties in England, all of which urged voters to 'remain'. The final result defied opinion polls taken in the days and hours before the vote. The surprise explains the sudden knee-jerk reaction in financial markets. Across the world 'risk assets' like shares, high yield bonds and commodities (except gold) were sold off in a 'sell first – think later' wave of panic selling. The money went into 'safe havens' such as cash, government bonds and gold.

Much of the sell-offs have since reversed as investors think more about the consequences. The implications for Britain in the long term may well be benign or even positive. An exit would remove a seemingly unnecessary extra layer of unelected government that interferes with every aspect of daily life and costs tax-payers money. In addition Britons will win back control of immigration, which was the catalyst for the sudden upsurge in dissatisfaction with Europe's open borders policy. This sense of renewed 'independence' and self-determination should boost confidence in England and boost spending, investment and employment.

Britain has always been a major source of investment capital for Australia and this may well increase if the Brexit proceeds. The impact of a British exit on trade should be minor in the medium to long term. As Europe accounts for half of British trade, the lower pound will help British exports. The pound fell 10% against the Euro after the vote, and is down 17% since this time last year. But it is still 5% higher than what it was three years ago, so the pound would have to fall a lot further to provide real benefit to Britain. A more likely impact will be on British companies that operate in Europe under the EU passport system that allows firms to operate across the EU without extra licencing in each country. Obtaining new licences should not be a problem for most companies but there will be inevitable disruption in the transition. Some very successful economies operate in Europe but outside the EU, like Switzerland and Norway.

Fragmentation may accelerate

While Britain negotiates new treaties, short-term disruption and uncertainty will probably cause an economic slowdown in Britain and it may also slow growth rates in Europe, which has been stagnant since the GFC. The Brexit may also accelerate the end of 'Great' Britain. Scottish and Northern Ireland voters and governments favoured the 'remain' case and there are renewed calls for Scottish independence and the reunification of Ireland. The Brexit may also accelerate the fragmentation of the EU and Eurozone. It will give anti-EU parties and movements new strength. Already there are calls for more exits, for example, in France ('Frexit'), and the Netherlands ('Nexit'). It may also give voice to independence movements within several European countries – like Catalonia in Spain, Flanders in Belgium, Basque in France, and many others. Further uprisings would cause people to delay spending and investment, leading to slower economic growth and higher unemployment.

More worrying is if the Brexit is seen as a backward step in globalisation of trade and investment. The European experiment was undoubtedly good for European recovery after World War 2, but since the GFC we have seen increasing signs of protectionism and currency wars between the big players – US, China, Japan and Europe.

Ashley Owen is Chief Investment Officer at independent advisory firm [Stanford Brown] and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities.

Technology update and Mary Meeker's amazing report

Marcus Tuck

[Editor's Note: Each year, Mary Meeker of venture capital firm Kleiner Perkins Caulfield Byers (KPCB) produces a report on Internet Trends. It has become the 'must-read' for the technology industry, and the 2016 Report fills 213 pages, linked here. There is so much in it, including global macro trends, it's almost impossible to summarise, and the following article picks out some highlights.

It's worth flicking through in full while drinking a strong cup of coffee. Look for:

- Slide 10, global smartphone usage
- Slide 31, global debt by type
- Slide 38, five epic growth drivers of the past 20 years
- Slide 45, advertisers still spend too much on legacy media
- Slide 59, the rapid rise and impact of Millennials
- Slide 70, how quickly internet retailers reach $100 million in annual sales
- Slide 78, massive increase in user-shared videos
- Slide 99, growth in messaging with more detail
- Slide 116, voice is becoming the new computer interface
- Slide 132, computing industry inflection points, obvious with hindsight
- Slide 148, can technology make the US the centre of the auto industry again?
- Slide 162. The rise of China's service industry
- Slide 186, major internet incumbents aggressive, growing and acquisitional
- Slide 195, global data growing while infrastructure costs falling.

The Report confirms many technologies are now crossing over from prototype to mainstream creating a challenge of staying on top of the trends. GH]

Technology is disrupting traditional business models around the world, with US and Chinese companies leading the way. The pace of change is only going to accelerate, with new technologies such as artificial intelligence, 3-D printing and blockchain security likely to disrupt traditional manufacturing, finance, services and much else. Australian investors should make sure they participate in the upside by owning some of the stocks that are in the vanguard.

Of the 20 most valuable tech companies in 2015, 12 were American, seven were in China and one was in Japan. None came out of Europe or anywhere else. The US companies represented 76% of the group's total market capitalisation and 87% of the revenue. Of the dozen companies based in the US, only one was not in Silicon Valley. They are some of the facts contained in the Internet Trends Report written by the ex-Morgan Stanley analyst, Mary Meeker.

Global internet usage reached 3 billion

Although the number of global internet users has recently hovered around 3 billion due to slow global GDP growth, it will increase over time as affluence increases in emerging economies and with more communications infrastructure investment globally.

Mobile ads will grow by tens of billions of dollars in the coming years and will mostly line the pockets of Facebook and Google. The two Silicon Valley giants account for 76% of all US internet advertising. Google's share of the pie is far larger, but Facebook is growing more rapidly. Ms Meeker sees mobile advertising growing another $US22 billion in the US because the time consumers spend on mobile devices (about 25%) is more than double the share of ad dollars the platform receives. (One concern of note is the 420 million smartphone users who utilise ad-blocking technology.)

Alphabet, Google's parent, controls 12% of all money spent globally on media advertising, according to Adweek. No company has ever controlled such a large percentage of global ad spending in the past. In 2015 Google sourced 54% of its $US75 billion in revenue from overseas.

The global success of Silicon Valley

Newsweek recently reported the number of internet users is growing faster in India than anywhere else in the world. Almost all of that growth is from people using mobile phones. The top three phone apps in India are owned by Facebook (Facebook, WhatsApp and Facebook Messenger). Also, almost all of India's mobile phones run on either Google's Android or Apple's iOS operating system. That means a significant proportion of India's dynamic growth industry is sending money to Silicon Valley. That kind of thing is happening in almost every country. In recent years, the payments going to Silicon Valley have been moving beyond pure technology and into businesses that used to be non-digital and entirely local. Uber is a good example. The company takes a 20% cut of the fare for every ride in every country it operates in. Previously the money would have stayed in the home market.

More than 3 billion photos are shared everyday on Facebook, Facebook Messenger, Instagram, Snapchat and WhatsApp. This number has more than doubled in the past two years. The report also highlighted the rapid rise of Snapchat in just a few years. While there are plenty of other platforms for photo-sharing, they are all controlled by Facebook. The world is creating and sharing more videos online. Consumers are increasingly sharing videos via platforms such as Facebook and Snapchat. Now advertisers are looking for ways to co-opt these videos to reach potential customers. In general, the Meeker Report illustrates the dominance of Facebook's properties, whether it is its messaging apps or the flagship social network. We are living in the age of Facebook at the moment.

Although smartphone users are still growing around the world, the rate of growth has been slowing in the Western economies. In 2007 only 34% of smartphone users worldwide were in Asia Pacific; now the figure is 52%. In North America and Europe the biggest gains appear to be in the past. This has big implications for Apple, which leans on the iPhone for most of its profits. Apple has been losing market share to some of its Asian competitors.

Crossing from prototype to mainstream

A new generation of technologies such as artificial intelligence, 3-D printing and blockchain security - all likely to be developed primarily by Silicon Valley companies - are about to cross from prototype to mainstream and challenge the status quo in manufacturing, finance, services and other industries. When you think about the amount of change since 2007, when smartphones, social networks and cloud computing combined to usher in the current tech era, the next 10 years are likely to be just as revolutionary. The established players have projects under way in some of the new technologies to try to stay in front.

Picking winners in emerging technology is always difficult. The pace of change can disrupt even the big tech names of today so vigilance is always required. But for now Facebook and Alphabet in the US, and the e-commerce business Alibaba in China, are three stocks worth considering in the growth portfolios of investors. The 12-month forward, PE ratios of those stocks are 29x, 19x and 24x respectively, which should be more than justified by their future earnings growth rates.

Marcus Tuck is Head of Equities Research at Mason Stevens.

10 factors to watch when buying expensive shares

Romano Sala Tenna

There is no such thing as a perfect stock, but there are stocks that are priced to perfection. Some examples in Australia include REA Group (REA), Domino's Pizza (DMP), Aconex (ACX), Bellamy's (BAL), and Cochlear (COH).

All of these companies are trading on earnings valuations between 150% and 300% above the market average. And, give or take, all these companies continue to trade higher day after day.

For many investors, this can elicit emotional responses ranging from envy to despair. So as a professional investor, how do we treat already high-priced stocks that just keep on rising in value?

As with everything in investing, we cannot determine the right course of action until we understand the cause of the action. In other words, we need to understand what is driving the share price in each instance. For purposes of illustration and simplicity, I have broken these causes down into three categories: The Good, The Ok and The Ugly.

The Good

1. Above-average earnings growth

The best reason for a highly priced stock's continued rise is a very high level of underlying earnings growth. In this instance, a stock that is over-priced now has earnings that are growing at a rate that will make the current price look 'cheap' at some point in the not-too-distant future.

The price to earnings growth ratio (PEG) has been steadily growing in prominence as a way of better-reflecting and analysing future growth. It is calculated by dividing the price to earnings ratio (PER) by earnings per share (EPS) growth. For example, in the case of Cochlear, the 2016 financial year consensus PER is 36.5 times – well above the market average of 15.1 times. However, the PEG ratio (36.5/EPS growth of 30.2%) equals 1.2 times, reflecting the fact that EPS is growing at a rate well above the market.

It is possible to generate above-average earnings growth in the short term without a sustainable competitive advantage. However, to generate long-term EPS growth the company must have a sustainable competitive advantage – some 'moat' or barrier to entry. This, of course, is the Holy Grail of investing.

2. High-quality earnings

A company may also trade on a high valuation where its earnings are considered 'high quality'. There are many views as to what defines high quality, however, it should contain some or all of these attributes:

a) Consistency and certainty of earnings (~transparency)

b) A high percentage of recurring revenue

c) Operate in a structurally sound sector with the right pricing power (suppliers vs clients), industry concentration and rational competitors

d) Client concentration (a large number of small clients vs a small number of large clients)

e) Profit drivers inside management control

f) High gross and net margins.

3. Early-mid stage thematic

High-priced stocks may also rise where there is some significant macro thematic. For example, China-facing consumer brands are benefitting from the emergence of the Chinese middle class. Ultimately, the prices are moving higher because of the anticipated change in earnings (ie point 1), but often it is the sentiment around the macro theme itself that is driving the price ahead of the curve.

Identifying the theme early can be hugely advantageous, but, as we shall see below, if you are late to the party you'd better dance close to the exit.

The OK

4. Trending stock price

There is a body of evidence that shows that if a stock price is in a defined trend (up or down), it is significantly more likely to continue in that trend than to reverse. Some believe this likelihood is as high as 80%. Therefore, buying an up-trending stock is an 'ok' reason in itself. However, investors often lack conviction, and volatility – known in trading circles as 'whipsaws' – can scare investors out of a position.

5. Index weighting

A large number of fund managers anchor their portfolios around a stock's index weighting. As a company's share price increases, so too does its market capitalisation and hence index weighting. This may cause fund managers to purchase more stock if they are underweight. This added demand drives the price higher, further increasing its index weighting and hence driving further demand. This may be particularly noticeable when a company's size increases to the point where it moves into a larger index (eg from the S&P ASX300 into the S&P ASX100). Index buying can be a powerful force driving high share prices even higher. But remember, this can also work in reverse.

The Ugly

6. Media coverage and investment hype

Often, share price movements are driven by the amount of airtime or publicity the company attracts. Strong media exposure, parochial management, investor and analyst hype can all drive share prices higher in the short term. However, these influences are often symptomatic of being late to the party.

The key as always is to look behind the headlines and focus on the fundamentals – ie what tangible impact is there to the underlying earnings growth?

7. Momentum trading

This is where someone buys a stock simply because they believe someone will buy it at a higher price. There is no reference, understanding, or for that matter interest in any fundamental driver. The stock quite often may not even be in a properly defined up-trend. The buyer simply believes they can sell the shares at a higher price.

This is the realm of 'hot money', and history has proven time and time again that those who try to make money quickly are destined to lose it.

8. Fear of missing out (FOMO)

Our desire not to miss out can drive our investment decisions, to the disregard of other considerations. Sometimes we resist FOMO all the way up, only to finally capitulate and buy at the peak.

Early in my career, I worked with an old broker who would continually ask: 'Who is the marginal buyer; who is left to buy?.' There is much wisdom in that question. In short, a stock price needs new buyers to drive the price higher. If everyone is already 'set', then there's often nobody left to buy.

9. Late stage thematic – the band wagon

Boarding a macro theme early can be lucrative, but most investors don't recognise a bandwagon until the band is about to stop playing. And as we highlighted above, the exit door in a dance hall is small. Being late to the party can hurt in the ensuing stampede.

10. Populist research

'Success has a thousand fathers and failure is an orphan.' For the majority of analysts and fund managers alike, being associated with a failing investment is professional suicide. However, being linked to the best performers is a wonderful way to disguise failures. Even if the reality is that the group was 'late to the party', there is the possibility of creating a different perception. This type of behaviour is hard to analyse, and when the sentiment changes it becomes self-perpetuating on the downside.

Summary

The Good	1. Above average earnings growth
	2. High-quality earnings
	3. Early-mid stage thematic
The Ok	4. Trending stock price
	5. Index weighting

The Ugly	6. Media coverage and investor hype
	7. Momentum trading
	8. Fear of missing out (FOMO)
	9. Late stage thematic – the band wagon
	10. Populist research

The key is to determine what is really driving the share price and your compulsion to buy. If your buying decisions are being driven by a lack of emotional quotient rather than earnings growth, the best thing you can do is turn off the screen and dust off your copy of Warren Buffet's *The Snowball.*

Romano Sala Tenna is Portfolio Manager at [Katana Asset Management](). This article is general information and does not consider the circumstances of any individual.

How will the global productivity slowdown affect investors?

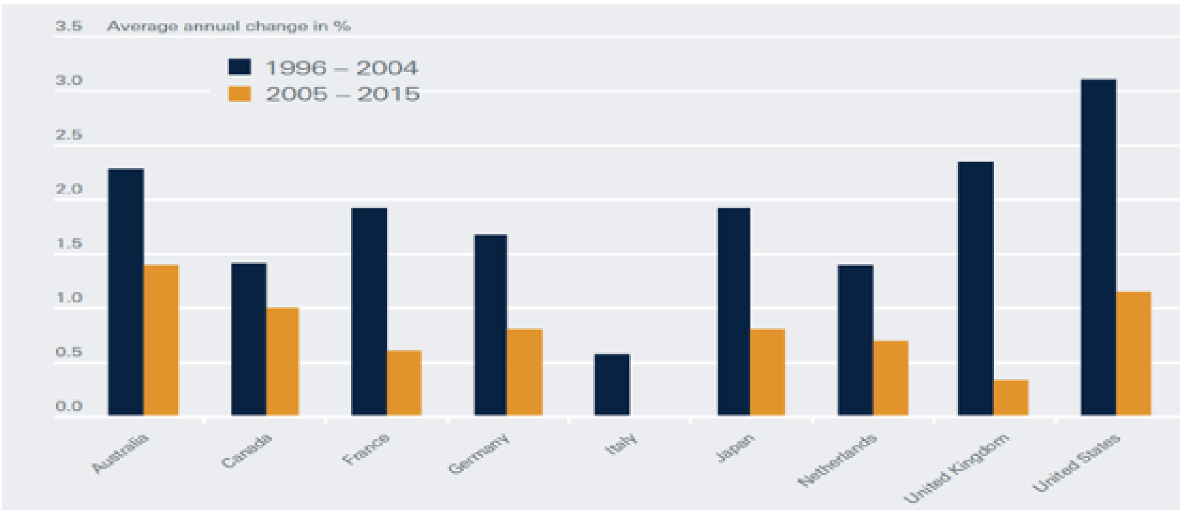
Don Stammer

Over the past decade, productivity growth has markedly declined. This slowing is significant – it's global and it started before the global financial crisis threw the international economy off course.

Moreover, this slowdown has occurred at a time when the rapid pace of innovation and technological change was generally expected to turbo-charge productivity.

The Productivity Downturn is Widespread

Source: Deutsche Bank



And there's more to come. Productivity seems likely to decline in the US in 2016, while growth is tepid in other affluent countries.

Productivity measures the output of goods and services relative to the input that goes into their production. The often-quoted observation of Princeton University professor Paul Krugman is spot on:

"Productivity isn't everything, but in the long-run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."

Krugman could well have added that productivity growth is also the main source of returns for investors over the medium term and longer, and a sustained fall in productivity growth means a reduction in those returns.

In the short term, however, it can help reduce unemployment. The US, Germany, Australia and New Zealand are creating more jobs from small increases in GDP than they would have had productivity growth been stronger.

Productivity is difficult to measure

Alas, productivity is hard to measure: the numbers jump around from quarter to quarter, and are subject to wide revision. Let's put those problems aside for now and follow the suggestion of Jeffrey Kleintop, chief global strategist with US broking group Charles Schwab:

"The focus for investors shouldn't be on the exact number [for productivity growth], but instead on the general trend that productivity is lower now than in the past."

Kleintop outlines five strategies to help investors cope with the diverse effects of the productivity slowdown.

1. The return of inflation. Low growth in productivity, if sustained, will probably result in output increasing at a slower rate than demand – and thereby contribute to the return of inflation. Share investors would need to focus on companies that can best pass on higher costs – and, I'd add, those with money in interest-bearing investments would likely be attracted to floating-rate debt and inflation-linked bonds.

2. Shortages of tax revenue. With tax receipts likely to grow much slower than outlays on welfare and health, governments will face additional budget strains and deepening worries over high debt levels. Over time, interest rates would push higher.

3. Emerging market growth. In general, emerging market economies will have fewer problems than developed economies in adjusting to the global productivity slowdown, as they have greater scope to boost productivity by adopting innovations already in place in developed-market economies.

4. Profit margin pressure. Low productivity growth generally means faster growth in labour costs, which can squeeze margins. Share investors may need to favour companies "that can more easily substitute technology for labour or are less exposed to labour costs as a percentage of total costs".

5. Less creative destruction. The US could see fewer business start-ups as the result of the slowing in innovation and in adoption of new technologies.

There's a view widely held by those involved in international technology hubs that the slowdown of growth in measured productivity mainly reflects the difficulties in calculating productivity – particularly in service industries, that have been keen adopters of new technologies. However, as New York University's Nouriel Roubini notes:

"if this were true, one could argue that the mis-measure of productivity growth is more severe today than in past decades of technological innovation."

Slow productivity growth seems likely to be prolonged by the low levels of business investment most economies have experienced since the GFC. The risks, too, are that productivity growth is further constrained by the populist backlash against policies such as globalisation and market-based reforms. These policies offer the best prospects for raising the rate of productivity growth.

Investors, among others, have a lot at stake regarding how the global productivity crisis is resolved. If near-zero rates of productivity growth persist, long-term average returns on investments will disappoint, inflation will return, government finances will be even harder to balance, and cycles in the economy and investment markets will widen.

Don Stammer is a former director of investment strategy with Deutsche Bank Australia. He now writes a fortnightly column on investments for The Australian.

CEO letters cut through the white noise

Jason Sedawie

Company annual reports have come to resemble novels in size. In 2013, the average annual report required by the U.S. Securities and Exchange Commission was 42,000 words (up from 30,000 in 2000), due in large part to increased regulation and greater input from lawyers and accountants, putting many investors off or off to sleep.

The Wall Street Journal recently reported that General Electric's annual report was downloaded a mere 800 times and only a handful of people called investor relations with questions. Apparently it takes GE roughly two months to compile the report, requiring input from about 200 people, which in 2014 resulted in 103,484 words or 257 pages.

CEOs add a personal touch

While the annual report itself can be intimidating, the CEO letter to shareholders can be inspiring and educational. The most famous of these is Warren Buffett's Berkshire Hathaway letter, which is understandable given its exceptional quality. But there are some other great letters, written mainly by CEOs that are also upfront about their business risks and strategy.

In my opinion there is only one letter that comes close to Buffet's – the one written by Amazon CEO Jeff Bezos. He doesn't do many interviews so his letters are a must read if you want to understand how he thinks about his business. The 2015 letter contained this gem of a paragraph:

"One area where we are especially distinctive is failure. We are the best place in the world to fail [we have plenty of practice!], and failure and invention are inseparable twins. To invent you have to experiment, and if you know in advance that it's going to work, it's not an experiment. Most large organisations embrace the idea of invention, but are not willing to fail to get there. Outsized returns often come from betting against conventional wisdom, and conventional wisdom is usually right. Given a 10% chance of a 100-fold payoff, you should take that bet every time. But you're still going to be wrong nine times out of 10. If you swing for the fences, you're going to strike out a lot, but you're also going to hit some home runs. In business, every once in a while, you can score 1,000 runs in one hit. Big winners pay for lots of experiments."

Amazon's cloud computing business (AWS) and free-shipping Prime service are the results of this 'swing for the fences' innovation. AWS reached $US10 billion in sales faster than any other enterprise software business. He also adds that "We want Prime to be such a good value, you'd be irresponsible not to be a member." It's quite a statement. His customer-focussed approach remains the same every year, and he attaches a copy of his original letter from 1997 as a reminder that nothing has changed

Another letter I look forward to is from Bobby Kotak, the CEO of Activision Blizzard, the company behind games like Warcraft, Starcraft, and Call of Duty. It might seem strange to recommend a gaming company whose report has lots of pictures, but don't hold that against them. Kotak is a fan of Buffett. He explains the ups and downs of the business and even compares his company's performance to Buffett's. Over the past 25 years, Kotak has grown Activision's book value per share at the extraordinary rate of 30% annually, beating Berkshire.

Their opportunity is explained simply, gaming has become a sport and they plan to be the ESPN of gaming. In 2015, users spent 14 billion hours playing their games, up 16% year on year. This doesn't include time spent watching people play games which was 30% more than all major sports leagues on TV combined in the US. In future, they believe they can generate extra revenues through sponsorships and broadcast rights.

Q&A format works well

An honourable mention goes to JP Morgan. Banks are famous for their lengthy disclosures, but its comprehensive question and answer letter format gives readers a better understanding of their business. CEO Jamie Dimon lays out potential business risks and also gives a great overview and insight into the global economy.

The annual report is being increasingly influenced by regulation. Thankfully, the annual letter helps set the tone. If the CEO can explain their strategy in an easy-to-read way and map out their long-term goals they will attract the right shareholders. As Warren Buffet says, "Either hold a rock concert or a ballet but don't hold a rock concert and advertise it as a ballet."

Jason Sedawie is a Portfolio Manager at [Decisive Asset Management](), a global growth-focused fund. Disclosure: Decisive's fund holds Amazon shares. This article is for general purposes only and does not consider the specific needs of any individual.

Quant plus fundamental: two methods are better than one

Adam Myers

When it comes to market forecasting, too many people thinking the same thing is almost always cause for concern. That said, in the current environment, an enormous amount of creative optimism is required to formulate a contrarian view. Central bank activity saved the financial system from collapse in 2008 and stimulated the second longest bull market in stocks ever. Unfortunately, the tools at their disposal were insufficient to engineer a return to high and inclusive rates of economic growth or durable financial stability. Terms like the New Normal, the New Neutral, or Secular Stagnation describe a global economy with sluggish growth, rising inequality, high unemployment and ever increasing market volatility.

Rising demand for absolute returns

There has been significant asset price appreciation since the global financial crisis. However, over the last 10 years, a traditional balanced portfolio allocating 60% to equities and 40% to fixed interest securities has only outperformed what most would consider a reasonable investment objective of CPI+5% in 41% of months on a rolling five year basis. It is therefore not surprising that financial advisers and their clients are increasingly looking for new ways to build absolute return portfolios, where the investment objective is wealth creation rather than beating a traditional benchmark.

Portfolio construction, diversification, and the incorporation of alternative investment strategies all have roles to play in this endeavour. An ideal portfolio would likely contain non-correlated assets with positive return expectations. This means that all the assets in the portfolio would go up and down at different times - although the general direction would be positive. The ups and downs would partially cancel each other out and the investor would have a smooth, stable and stress free journey. Unfortunately, such assets are very difficult to come by, particularly for retail investors in Australia.

A fundamental approach to managing equity funds is normally associated with human insight and in-depth forward looking analysis across a narrow range of companies. With quantitative funds, the association is usually unbiased, disciplined, repeatable and scalable across a broad universe of stocks.

For some time, fundamental managers have recognised the value of incorporating quantitative techniques into their processes. Common examples of earlier approaches are: fundamental managers relying on quantitative screens to filter a large universe of stocks; and using multi-factor models help managers to control and eliminate exposure to unwanted risks.

Quantitative plus fundamental using unique data insights

The recent arrival of big data has ushered in a new era of investing, sometimes referred to as 'quantamental', which requires the seamless integration of quantitative and fundamental techniques. Obtaining valuable insights, often relating to future corporate earnings, from unrelated and unstructured sources requires the skills of creative analysts, expert programmers and significant computing power.

Twitter offers an intuitive example of this. It is now possible to obtain insights and indications of current stock trends by accessing all real-time tweets (approximately 6,000 per second) delivered via the Twitter Firehose service. People are better at many things but such analysis is beyond human capability. The demands are even greater for those managers who store tweets historically in order to reveal a changing pattern of sentiment and provide an advanced signal for a short term trading strategy.

The most valuable data is also the hardest to obtain and insights should be fundamentally generated from unique data sources, many of which would only ordinarily be used by the members of individual industries. Quantitative techniques are then used to scale these insights across a vast universe of industries and global stocks. Our new fund aims to deliver market neutral returns by simultaneously going long the companies with the best long-term prospects and short-selling those with the worst.

In the pharmaceutical industry as an example, the portfolio manager has developed an automated process to extract data from websites that allow doctors and patients to log complaints about the side effects of drugs. This frequently provides glimpses into future issues these companies or others providing drugs with similar chemical compositions may encounter. Trading strategies may then be developed which short sell these companies and go long on the companies marketing drugs with similar therapeutical application, but with fewer complaints.

The airline industry provides another good example of how the manager combines generally accepted valuation metrics with unique but common sense insights. In most developed countries, departure and arrival times of all flights are published electronically. If flights of a particular airline tend to take off late but arrive on time, it is likely that they have burned more fuel to catch up. That airline is thus operationally inefficient. An astute quantamental analyst can also rank airlines in order of baggage lost. Used in conjunction, these signals provide insights about future revenue because airlines with more late flights and more lost baggage are unlikely to retain their customers.

At its most simple, the quantamental approach involves two things. The first is the obtaining, aggregating and processing of information from numerous sources. The second is applying fundamental principles to generate differentiated returns. The result should be the construction of a well-diversified investment portfolio that provides superior outcomes in these challenging market conditions.

Adam Myers is Executive Director at Pengana Capital. They have brought the Pengana PanAgora Absolute Return Global Equities Fund to the Australian market.