friday view

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By Emma Cusworth

Is it just me or have pirates become more endearing in recent years? Perhaps it's the prevalence of children's books in my literary life, but it seems these once-maligned masters of skulduggery and cunning are more often revealed to be the good guys.

It's not just make-believe pirates I'm talking about. No doubt those invested with hedge Fund Elliot Capital will be raising a cheer at their bold and cunning seizure of an Argentinian ship in an attempt to recoup some of its losses when the country defaulted in 2001. Elliot Capital should also be on the radar for other transport companies, not least National Express. Elliot owns nearly 20% of the company's shares and has already shivered the timbers by failing to back the chairman, John Devaney, at this year's AGM.
Meanwhile, rebellious shareholders, including Invesco Perpetual, appear to have won a notable victory at BAE, as over 30% registered their objection to the proposed tie-up with EADS before the German and French governments ultimately scuppered the deal (for now at least). Even if those scurvy politicians manage to actually agree on something, which appears to be more pipe-dream than realistic hope, BAE would need over 75% of shareholders to support the deal for it to succeed.

Some may take offence at the suggestion activist shareholders (or even just those willing to raise an objection) should be considered pirates, but, in actual fact, the principles of good governance appear oddly in line with the rules of piracy. According to the Pirates Code, a victim can invoke the right of 'parlay', which allows them to seek an audience in order to avoid being forced to walk the plank.

This engagement between parties is exactly what many investors and companies are now seeking ahead of next year's AGM season in light of this year's shareholder spring. And companies like National Express would be wise to invoke the right of parlay to ensure heads don't role. Perhaps the Stewardship Code is more aptly named than many think.

In the meantime, the Cusworth ship is preparing to set sail for new adventures into parenthood.
I will, no doubt, be all at sea for the next few months before returning to these shores next year to once again plague you with strange and unusual tales of the investment world.

Till then,
me hearties!

Hard Times

Picture: stockphoto

By Nick Gartside, international CIO for fixed income, J.P. Morgan Asset Management

Bleak was the message from the IMF this week. Global growth this year was downgraded to just 3.3% versus 3.5% in July and 2013 is forecast to be a tepid 3.6% versus July's expectation of 3.9%. Drilling down, the details for selected countries are also poor: UK growth this year was slashed from +0.2% to -0.4%, whilst over in Spain, debt: GDP was revised up 10% to close to 100%. Across the pond the US deficit was revised down by 1% or so and debt: GDP up by a couple of percentage points.

All this begs the question whether central banks are pushing on a string? So far, the impact of a quite extraordinary amount of stimulus, both conventional and unconventional, seems to be having little impact. A theme validated by our own leading indicators which point to sluggish growth going forward.

Perhaps, though, we are now moving to a new phase where central banks are directing credit much the way they did during the war. QE 'infinity' in the US does that by unlimited purchases of Agency mortgages, the Funding for Lending Scheme in the UK aims to directly push credit to households and the purpose of the ECBs Outright Monetary Transactions is to channel finance directly to distressed sovereigns.

Where does this leave bond markets? Well, probably a little bit like Jarndyce vs Jarndyce*. There will be twists and turns as central banks continue to experiment with tools to shake economies out of the current malaise, but the real message is, as highlighted by the IMF, that deleveraging takes time.

This process remains one where the conditions for fixed income are ideal. Negative real returns force investors out of cash and into fixed income securities as they hunt for yield and inflationary pressures remain subdued. We are looking to add more credit risk on any back up. Although, it's as well we don't follow Jarndyce vs Jarndyce too closely. Remember how it ends: it's a case that took generations to resolve and, of course, when it was...the pot was empty."

*Charles Dickens aficionados will recognise this as the interminable and protracted court case tfrom 'Bleak House'

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Audit is for shareholders, not auditors

By Ben Levenstein, head of UK equities, Universities Superannuation Scheme

Between late 2008 and 2010, 114 European banks received some form of capital injection from governments. Yet all these banks had clean audit reports, often just weeks before going cap in hand to the authorities. Something seems to be wrong with the audit process. We believe structural change is needed in the audit market to restore investor trust in financial statements.

As long term investors, we rely on companies' audited numbers when taking investment decisions, and as a critical tool for holding executives to account. Auditor independence from company executives is essential to reassure shareholders that the audit is prudent and robust. We believe there are three structural problems that need to be addressed to protect auditor accountability to shareholders.

To begin with, shareholders have minimal insight into the audit process. Too often we are told little about why auditors are selected or kept on. Likewise, the key discussions between the auditor, company executives and the audit committee (who are expected to represent shareholder interests) over critical assumptions and risks are rarely disclosed. This lack of transparency means that neither auditors nor audit committees are fully accountable to shareholders.
To make matters worse, audit committees often delegate key aspects of audit management to company executives. Where executives are heavily involved in audit firm selection and remuneration, this introduces perverse incentives for the auditor. Whom should the auditor serve: management or shareholders?
Lastly, such conflicts of interest can be exacerbated by the desire of auditors to win lucrative non-audit service contracts from client companies. The incentive to avoid upsetting management threatens the independence and professional scepticism of the auditor, which are so vital to a robust audit process.

We are not suggesting that all auditors are conflicted, or that all audits are of low quality. But we do believe that the structural flaws highlighted above raise risks to auditor independence to unacceptable levels. We are not alone in pointing to problems with audit. Regulators in the EU, US and the UK have all initiated reviews of auditors' failure to ring alarm bells leading up to the financial crisis.

Three key actions would strengthen auditor accountability to shareholders and help to mitigate the damaging conflicts of interest described above.

First, audit committees and auditors need to be more transparent. Shareholders need to know the critical areas of debate between the auditor and the company, how these were resolved, and what steps are being taken to protect auditor independence.

Second, audit committees should ensure that audit firms are rotated at regular intervals, with a maximum tenure of 15 years. The current system of audit partner rotation, without a change in firm, does not ensure the requisite break with the past. Audit firm rotation should ensure regular and fresh challenge to past assumptions, and offer independent due diligence on the previous auditor.

Third, audit committees need to set a limit on non-audit services provided by the auditor's firm. Auditors seeking to win non-audit contracts from their clients are conflicted. Companies should be free to appoint the best possible service providers, but shareholders also need reassurance that the integrity of the audit is paramount. We suggest audit committees limit non-audit fees to no more than 50% of audit fees, and take remedial actions if this is breached.

These three proposals are a package. We believe any implementation costs are likely to be manageable, and far outweighed by the heightened assurance investors would gain over auditor independence and, ultimately, the reliability of company accounts.

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East China Sea Islands

By Andrew Rose, Japanese equities fund manager, Schroders

China and Japan have clashed over a cluster of East China Sea islands, known as Senkaku in Japan and Diaoyu in China. The islands are controlled by Japan but claimed by China and Taiwan. They are tiny, remote and uninhabited, but the surrounding waters are abundant in fish and have potentially rich mineral deposits. Anti-Japan demonstrations erupted across China after Japan nationalised three of the islands in early September, purchasing them from their private Japanese owner. This reignited a long-running dispute.

It should be noted that the government's nationalisation of the islands was at least in part motivated by a desire to pre-empt their purchase by Shintaro Ishihara, governor of Tokyo. Ishihara has well-known nationalist views and his purchase could have provoked China more overtly. The prime minister's effort has unfortunately backfired.

At the industry level tourism, retail and consumer durables have been most immediately affected. September sales of Japanese cars in China halved compared with a year earlier and producers are adjusting short-term production schedules accordingly.

The long-term impact will be broader if unrest persists or escalates. Is this likely? Not to judge by the most recent comparable incident in 2005, provoked by then prime minister Mr Koizumi, visiting Yasukuni Shrine, where Japan's war dead are enshrined. The souring of relations was relatively brief and resolved at a diplomatic level. One difference this time, though, is the political agenda in both countries: the short-term leadership transition in China and a likely general election in Japan. This could accentuate intransigence. The greatest test the Chinese leadership face in the near term will be how it addresses this dispute.

Picture: Hung Chung Chih / Shutterstock.com

Despite that, there are other reasons to think that tensions will ease, at least for the time being. Japan and China are now sufficiently important to each other economically to render the avoidance of prolonged or escalated tensions an absolute policy priority. China is Japan's largest export destination. In China there is a danger that if anti-Japanese demonstrations continue to be given a 'green light', they morph into something broader, less controllable – and more threatening to the authorities. In addition, whilst Japanese companies currently bear the brunt of the unrest, it is not difficult to imagine the implications for foreign direct investment in China in the event of a deterioration of events.

The most likely outcome is another diplomatic compromise, perhaps after leadership changes in both countries. Military conflict seems unlikely. Equally, a lasting solution looks difficult and history suggests similar friction is likely to recur.

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Europe's dwindling supply of AAA rated investments

By Patrick Janssen and James King, fund managers, M&G Lion Credit Opportunity fund

The age when you could simply select sovereign debt for AAA rated bonds is long gone.

Some of Europe's sovereign debt remains AAA-rated. There is a choice of the Republics of Germany, Austria and Finland, the Kingdoms of Denmark, Sweden and Norway, the Swiss Confederation, the United Kingdom and the Isle of Man.
Of course some, such as the UK, are on negative downgrade watch.

Moreover, none of them yields much. Norway's 10 year bond offers a comparatively high 2.06% but Denmark's sits at 1.26%, Sweden's at 1.47% and the UK's at 1.70%. The Isle of Man's are small and traded too infrequently to price accurately.

One glimmer of hope sits in credit markets: many residential mortgage backed securities (RMBS) are just about the only corporate bonds available today with an AAA rating.

Europe's ABS market held up very strongly since the crisis, unlike much of its larger counterpart in the U.S. The data tell a stark story: European ABS had a cumulative five year default rate that didn't exceed 1.0%. The nearest US equivalent, which includes riskier home loans, was 13.1%.

So why are some of these residential mortgage bonds rated higher than just about every other credit investment in Europe, including their near bed fellows, commercial mortgage backed securities? They could well be the most robust investment available in Europe. For an investor in an AAA prime UK or Dutch RMBS to experience an interruption of income or loss of capital they would need:

1. A fall in domestic house prices by 50% and for those prices to remain at that depressed level for around four years
2. The rate of repossessions to rise from its current level of around 0.6% per annum to an unprecedented 10% and, again, stay there for about four years

Of course when an AAA rated RMBS defaults, or the issuing bank enters restructuring, your recovery rate tends to be quite high. Depending on the structure of the bond, you also have access to the underlying collateral – the mortgage repayments and, behind them, the actual houses.

It seems highly likely that, should the conditions arise that create this scenario, then just about every other type of investable security, including government bonds, would fail.

These bonds also yield a little more than most equivalent rated sovereign debt. Today, a basket of AAA rated prime RMBS offers an income of about 2% - this is about 1% above libor and so it should rise when interest rates pick themselves off the floor.

Given there are next to no other AAA rated credit investments available, a working comparison is with the unsecured, 1.5% yield of a typical 'A' rated corporate bond issued by a UK non financial company.

Banks are issuing new bonds, although not as many as they used to. That's because they are lending much less to residential mortgage borrowers, meaning fewer such loans to package up into RMBS and sell on to institutions, but the market remains large at about €1.2trn and new RMBS are issued with much greater frequency than other types of ABS.

Many investors have flown the low yields and newly-noticed riskiness of sovereign bonds, seeking unsecured bonds issued by global blue chips as a safer haven. A better bet, and one that could well pay more, is AAA rated RMBS.

Have a nice weekend.

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