# MORPHIC GLOBAL OPPORTUNITIES FUND

## SEMI-ANNUAL REPORT

**July – December 2013**

## SUMMARY

For the half year to December 31st 2013 the Fund rose 20.09%, net of all fees, outperforming its benchmark (MSCI AC World Total Return in Australian Dollars) by 1.67%. For the full 2013 calendar year, the Fund was up 42.49%, outperforming its benchmark by a more meagre 0.04%. Since inception (August 2nd 2012), the Fund is up 57.39%[1] and has generated outperformance of 0.65%.

| | Fund | Index[2] | Relative |
|---|---|---|---|
| **Six months to December** | 20.09% | 18.42% | 1.67% |
| **Full Year 2013** | 42.49% | 42.45% | 0.04% |
| **Since inception** | 57.39% | 56.74% | 0.65% |

*Past performance does not guarantee future performance*

## COMMENTARY ON PERFORMANCE

Most of the Fund's performance in the half came from longer term positioning in stocks built up earlier in the year, to address a variety of what we feel will be longer duration themes, including:

- exposure to the Macau casino market as a play on rising Chinese consumption spending
- the recovery of the US financial sector,
- a large overweight to Japanese stocks, with the yen exposure largely hedged back into US dollars

[1] Not annualised
[2] The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in Australian Dollars

Over the course of the half the Fund also increased its underweight to emerging markets – and in some cases entered into outright short positions, most notably in the case of Indonesia. Slightly counteracting this, the Fund established a basket of global cyclical stocks that was seen as under-priced for the Developed Market centric recovery we felt was underway.

In addition the Fund also benefited from several more esoteric long and short stock positions adopted more for their idiosyncratic characteristics than any broad thematic driver.

Not all of the major themes worked as well as hoped – but in keeping with our general preference to try and find multi-year opportunities and persist with them until we lose conviction in their capacity to add value over the long term – all remain in the portfolio as at year end[3].

The Macau gamers gave us significant out-performance. The US financials positions generated mixed, but overall disappointing relative performance. Japan, while generally delivering overall excellent results, especially when the yen hedges are taken into account, suffered from a degree of under-performance from one of the largest sub-holdings: the drugstore basket, and losses on a long-short trade on two home-builders. Commentary on the outlook for the Fund's Macau gaming stocks, its selection of US financials and the Japanese drugstores basket is presented below in a series of special foci.

From an asset allocation perspective, one mistake the Fund did not make compared to the first half of the year was to jump at shadows and thus get trampled by the continuing bull market. The Fund stayed fully invested for most of the period and refused to take undue fright at the two major scares of the second half of the year: the US budget battle between the President and the Congress, and anticipation of a slowdown in the rate of money printing by the US Federal Reserve.

Indeed most tail risk hedges put in place to protect capital generally added value, rather than destroying it. This was especially true of the Fund's short position on US 10 year government bonds, established as a hedge against negative equity responses to reduced money printing, and its hedges against European deflation through long positions in short dated European rates.

Currency again had a large positive impact on Fund in absolute terms. The Fund spent the entire period without hedging back into Australian dollars and

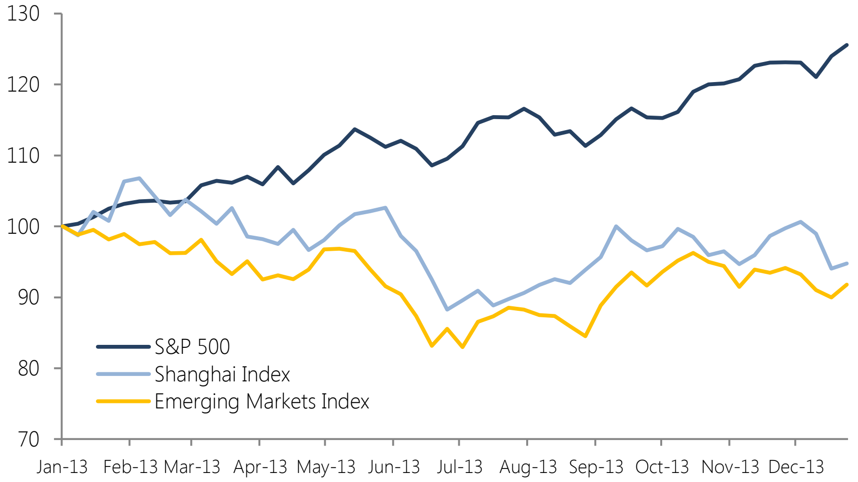
[3] Or as the fabled speculator Jesse Livermore put it:

> 'And right here let me say one thing: after spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time, and began buying and selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine -- that is, they made no real money out of it. Men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn. But it is only after a stock operator has firmly grasped this that he can make big money.'

sporadically established small short positions on the Australian dollar, as well as long US dollar positions vis-à-vis the yen and the Indonesian Rupiah.

**Exhibit 1**

**US market outperformed Emerging Markets by 37% in 2013**
Jan-Dec 2013, USD




Source: Bloomberg, team analysis
Note: Emerging Markets (EEM US)

Among the things that went less well in the second half were tentative investments in three emerging markets economies, mostly accessed through financial stocks.

We visited Istanbul in early July. Despite the smell of teargas (and in one case the taste!) the city and the country were impressive in many ways, and the management quality at the 12 companies visited generally also high.

Our thesis on Turkey remains that it will evolve into an investment grade market, and that gradually its links with the overall European economy will strengthen. However our initial small exposures were all stopped out after early gains, and we have resolved to let the current political turmoil bottom out before revisiting long-side investments there.

With regard to India, we believed we had identified another market and currency bottom, and re-established small positions in some of the banking positions we knew best there. The results were inconclusive, and our concerns that the economy could weaken further before recovering caused us to pull the plug when we decided that the overall outlook for emerging markets was deteriorating. We also felt India and the rupee could be especially vulnerable to tightening US monetary supply trends.

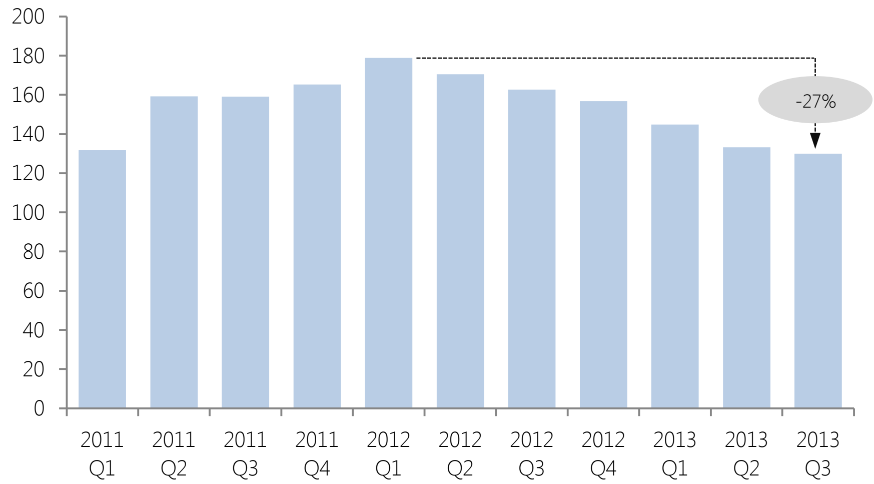
The situation in India is very poised. The elections this year remain to close to call, but will clearly have a major impact on the markets. In 2005 when the BJP party fell from power, the market fell 25% in two days. Until recently the BJP – with its controversial but probably also effective prime ministerial candidate, Narendra Modi – was seen as most likely to win. This in part had accounted for the rally in the stock market and the rupee. With the emergence of a 'third' force of anti-corruption campaigners, this victory is now less assured. All in all we mark this down as a market to watch from the side-lines at this stage.

Lastly in China, we briefly held small positions in two of the better run state banks, Agricultural Bank and Industrial and Commercial Bank. Both seemed well-placed to profit from the reforms expected to flow from the recent Communist Party Plenum setting new mid-term plans for the country's economic development. We felt that their very beaten up prices more than discounted all but the very worst potential outcomes from a worsening bad debt cycle. However on further review we decided it was impossible to find any reliable indicators that would allow us to have conviction on this last point, so cut our small losses and exited early in January.

Despite the bullish tone of the market, some value was added through shorting in the half year, mainly in the US technology sector.

**Exhibit 2**

**US Data Centre rent pricing is under pressure, down 27% from peak**
Annual rent, trailing 12 months, 2010-2013




Source: Company reports, team analysis

Early in the period, we formed the view that the US data centre sector had become something of a bubble, and more encouragingly, one that was showing early signs of deflating, meaning we weren't risking the Fund's money into the prospect of an acceleration of irrationality! Selected stocks had share prices that implied continued high growth in demand for space and rising rents almost into perpetuity. However as we looked at what was actually happening on the ground we saw declines in new rents, signs that over-build might be occurring in new centres, and risks that the "Cloud" might be more of a threat than an opportunity for the sector, as customers in effect pooled their demand for services, rather than individually buying very under-used capacity. After making excellent returns in the December half, the position deteriorated slightly early this year and for now it has been closed out.

Slightly before this however a new short side opportunity was identified in US tech, where we saw companies that seemed to be in a new dot-com mania reminiscent of the late 1990s. The Fund is currently short a number of highly priced stocks where actual growth is sluggish, or in some cases negative. We expect to write more about this in our next semi-annual report.

The Fund also continued to use some short side equity positions to hedge its risks in the US financials and Macau Casino thematic positions.

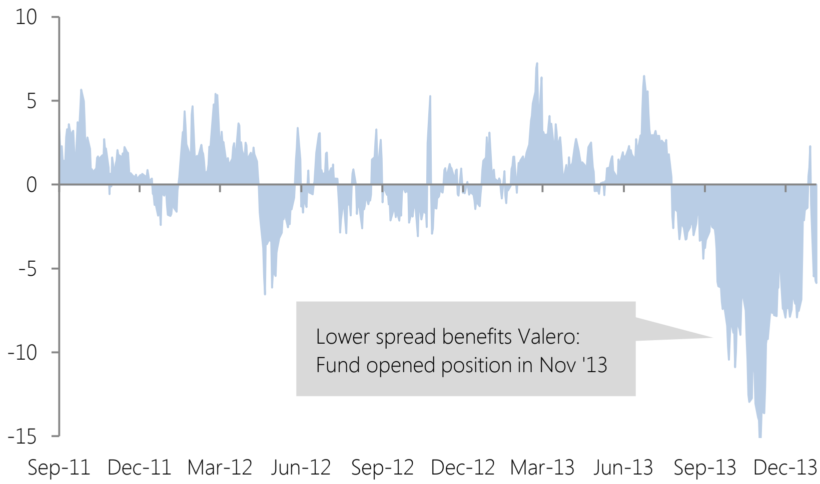
As ever, it should also be noted that the Fund always has a number of stocks that are chosen solely on their own merits rather than any identifiable thematic driver. In the latest half two stocks in this category that stand out for their excellent contributions are Valero Energy and Mentor Graphics.

Valero has consolidated some of the oldest continuously running industrial plants in the US in one of its oldest industries: oil refining. Even allowing for the emergence of what is now something of an oligopoly, buying shares in oil refiners is not for the faint-hearted. Profitability oscillates wildly around the so-called "crack spread" that refiners earn between what they pay for the crude oil and the prices they get for the refined products they sell. Capital spending requirements are continuous to deal with wear and tear in highly complex plants that operate with very hazardous materials, and which also need constant tweaking to produce the optimal range of products. Reflecting this, refinery stocks usually look cheap, but generally justifiably so!

US oil plants are generally somewhat subscale by global standards, as small as one tenth the size of monster new operations in Korea, China or India. However due to the shale oil and gas boom in the US they have several advantages that more than compensate for this. Firstly their feedstock is now a lot cheaper than many global competitors, partly because of US restrictions on exporting crude oil and natural gas; secondly a surplus of local gas has pushed their main operating cost: the energy to "crack" the oil, to world beating lows; finally what was previously one of their biggest problems, a nationwide surplus in capacity, has become a benefit as they have become so globally cost competitive they can export refined product to a world still thirsty for mineral fuels.

**Exhibit 3**

**Cheaper Gulf Coast crude oil vs. Brent benefits Valero**
Louisiana Light Sweet Crude less Brent Crude, 2011-2014, USD




Source: Bloomberg

Part of our gains in Valero came from understanding this broad picture, another part came from understanding its changing competitiveness within the overall US refinery industry (see Exhibit 3). As an operator of mainly coastal refineries, Valero had previously operated at a disadvantage to many inland refineries which had enjoyed access to otherwise 'trapped' oil and gas from the new production fields near them. As improving pipeline and rail infrastructure allowed Valero to close this disadvantage, we moved quickly to build a position. Refinery stocks are almost always a "trade" rather than a long term investment, but at this stage we still see upside from the changing industry dynamics.

In some ways the bull case for Mentor Graphics had surprising parallels with Valero. Mentor, which provides design solutions for companies building new computer chips, has gained from rapid consolidation in an industry that now has just three large players. In addition, like Valero, thanks to luck or some smart R&D, Mentor has gone from being the worst house on the best street to being much more equal with its two slightly larger rivals.

Our thesis on Mentor was that we didn't believe that the PE multiple discount at which it traded compared to its competitors was justified by the company's margins, growth prospects or scale.

Normally this discrepancy alone would not be enough to attract us, but this case the final kicker was the fact that Mentor had a fearsome agitator for change, legendary US corporate raider Carl Icahn, as its largest shareholder and with representation on its board. Icahn is famous for his patience – but also for getting what he wants. We felt we would eventually see tighter operational focus, better capital management through share buybacks and higher dividends, and potentially even a takeover by one of its two large competitors. We still expect these, and indeed have had some down-payments on most of them already. In the meantime we have also had an unexpected bonus as Mentor's ranking in its industry has benefitted from its leadership in so-called "emulation" a chip design process that effectively allows new designs to be tested before they even built.

The stock has risen considerably since we first purchased, but we retain it as we believe even in the absence of a corporate transaction it is good value for business with at least modest growth, and huge barriers to entry.

## SPECIAL FOCUS: MACAU GAMING

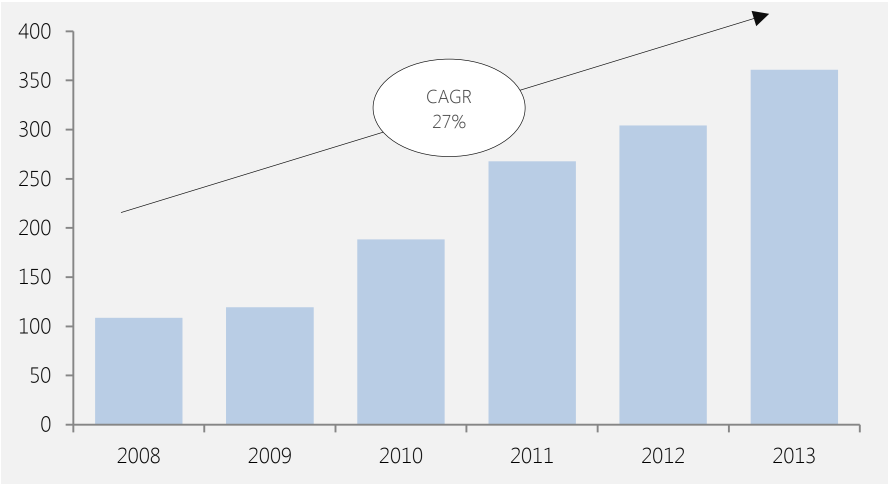
In a year when Chinese consumers began to shy away from ostentatious luxury purchases such as fine wines and Swiss watches, one area of conspicuous consumption managed to accelerate – gaming. During the second half of 2013 alone, gaming revenues in the former Portuguese colony of Macau grew by 21.8% to a staggering US$23.7bn. Since opening up to foreign casino operators in 2004, Macau has grown exponentially and now generates seven times the revenue of Las Vegas. The Fund has exposure to Macau through Melco International Development, Las Vegas Sands and Emperor Entertainment Hotel. These three names were chosen because they are all particularly strong in the so-called 'mass gambling market' in Macau.[4]

The thesis that money could be made out of the only legal casino gaming destination in China is not new. Especially to Australian investors who have had the good fortune to have backed James Packer's Crown Resorts. Exhibit A shows annual gross gaming revenue in Macau has been growing at an annualised rate exceeding 27% since 2008.

[4] Mass market is comprised of walk-in customers who gamble with cash rather than credit

**Exhibit A**

**Macau Gaming sector revenue has grown 28% per annum**
2008-13, Macau Patacas, billion

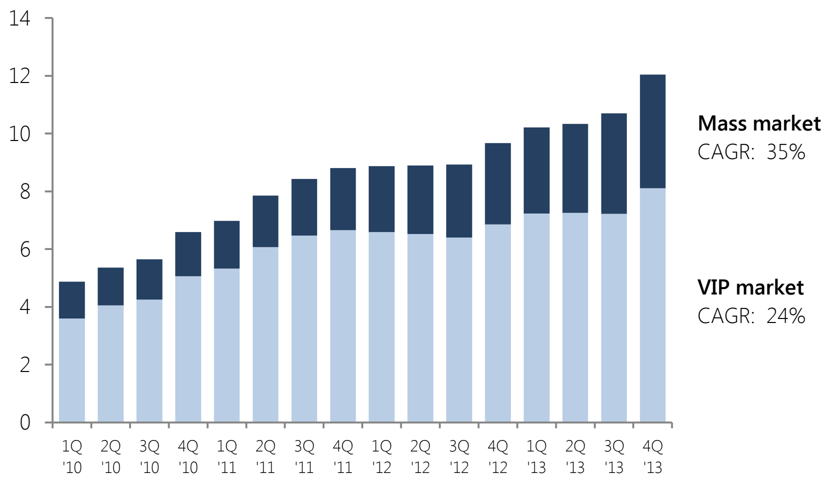



Source: Macau's Gaming Inspection and Coordination Bureau (DICJ)

The unsurprising surprise this year has been the strength of the mass market (Exhibit 2). Unsurprising: because it is simply a continuation of a trend that has been visible for at least three years. On the hand, surprising: because the market had obviously not been pricing the trend. To understand why this might have been the case, it is worth digging into Macau's industry structure.

**Exhibit B**

**Mass market has been the fastest growing segment in Macau**
2010-13, USD, billion




Source: Macau's Gaming Inspection and Coordination Bureau (DICJ)

Macau in its current incarnation has been driven forward by the so-called junket or VIP gaming market. Junkets can be thought of as akin to tour group operators who organise trips to Macau for high rollers, arranging everything from access to VIP gaming rooms to accommodation and, critically, credit in return for a share of the host casino's winnings. Junket business has never been highly rated by the market as analysts have struggled to come to grips with a revenue stream that is exposed to liquidity concerns, potentially non-official capital flows and a sub-sector run by characters with dubious backgrounds. Given that as recently as 2010, junkets contributed close to three-quarters of total revenue, Macau names tended to trade at a (growth-adjusted) discount to international peers.

This year we have seen outstanding mass market growth (34.7%) on the back of visitation from China (up 10% in 2013). Reduced travel and immigration queuing times due to infrastructure improvements along with a step-up in hotel room supply are the key reasons for higher visitor numbers. The most interesting true surprise this year has been the significant increase in spending per visitor (up 13.6%). Our view is that this is due to two factors. The first is simply organic growth in propensity to gamble amongst repeat customers. Overseas experience has taught us that gamblers do have a life cycle and Macau should be no different. Increasing minimum bet sizes at casinos provide evidence of this trend.

The second factor is that the casino operators themselves have been shifting tables from their VIP rooms to their mass gaming floors. A tipping point was reached this year where operators realised that although VIP tables delivered higher revenue, mass tables were in absolute terms becoming more profitable due to higher margins. This led to a table yield maximization strategy amongst casinos which can be seen in the increase in ultra-high limit mass tables and corresponding reduction in VIP tables.

As casinos have improved table yields, analysts have continued to upgrade estimates. At the same time, investors have become more comfortable with an industry whose economics that is beginning to look more like international comparators and have material re-rated the sector. Against this backdrop our Macau names have been outstanding performers. Most notably, Melco International Development is up 94% as Melco Crown Entertainment (of which it owns approximately one-third) has been the most successful operator at increasing its yield per table and currently has the most profitable mass market tables in Macau.

Looking ahead, the focus for the Manager is whether Macau can continue to hit 'natural 9s' or whether at this point froth is being priced on top of growth. Our three names trade at a PE ratio of 16x against predicted EPS growth for the sector next year exceeding 20%. The sector is not cheap, but is also not priced to perfection. As long as operating momentum remains strong, the Manager intends to keep our chips on the table.

# SPECIAL FOCUS: JAPANESE DRUGSTORES

In the nearly three decades since members of the Morphic team first started visiting Japan, one of the most consistent trends, especially in Tokyo,  has been the expansion of convenience store chains. Since US chain 711 first set up in Tokyo the growth has been relentless, matched only by persistence with which sceptics declared the main chains, which also include FamilyMart and Lawson, had reached saturation point.

Today in downtown Tokyo it is almost impossible to pass a block without seeing an outlet of one the major chains or their handful of smaller rivals. Indeed so extraordinary has been the growth, that 711 parent Seven and I Holdings is now owner of the global brand, and has even, somewhat controversially, become a department store operator. In an environment in which Japanese retail sales as a whole have been almost stagnant for decades; convenience stores have exploded, and continue to expand to the point where they now account for nearly 15% of all food sold.

The core case for the Fund's investment in its basket of Japanese drugstore chains is that they appear to us to be at an early stage of a decadal growth pattern similar to those exhibited by the convenience stores, backed by scale benefits, and some special growth drivers which mean they benefit from Japan's aging population base.

Japanese drugstores are best seen as large format convenience stores selling four to six times as many different products as the 711s etc. Their main lines are pharmaceuticals, cosmetics, food, daily necessities and other goods. The differentiating factor is the provision of prescriptions and OTC drugs – and also the need to employ pharmacists is also the main barrier to entry for the chains.

Within this broad category are two models. The first of these might be likened to Australia's Priceline, where the emphasis is on competitive pricing, rather than service, and is exemplified by Sundrug in our portfolio. The second is more like a cross between Chemist Warehouse and Soul Pattinson: offering access to advice on pharmaceuticals and cosmetics, and a very high degree of prescription sales; and is represented by Welcia in our portfolio. Somewhere in the middle of this lies our third stock, Tsuruha, which has a high level of prescription sales, but also works on the "pile it high, sell it cheap" model for its other lines.

The aging population factor is helping the sector in some obvious ways, and one rather surprising one. From a demand perspective older people consume more medicine of all types, but also tend to want to purchase their general merchandise more frequently, in smaller lots. In addition they don't want to travel to far to do this, and ideally like to go less different shops. Since the only place they can get the medication is at a pharmacy, the opportunity to fill these 'captive' customers' baskets with other goods is clear. The more surprising benefit that drugstores are getting from the aging population is from the competitive perspective: aging is also affecting all 'mom and pop' retail formats in Japan, and high in this list is the traditional pharmacy, which is gradually disappearing as owners retire. Finally giving the sector a further boost the government has been actively encouraging hospitals, which used to dispense the bulk of Japanese prescription medicine to withdraw because of their high cost processes.

The drugstores in our portfolio initially stood out from our regular screening process, although members of the team had long been considering their appeal, and the position was established soon after the Fund was launched. Since then, the stocks have significantly outperformed both the broader market and convenience stores in both share price appreciation and EPS growth. However, drugstores continue to trade at a discounted multiple to convenience stores, despite higher historical and forecasted EPS growth.

**Exhibit C**

**Drug stores in the portfolio trade at lower multiples despite faster growth**
2013-15 estimates

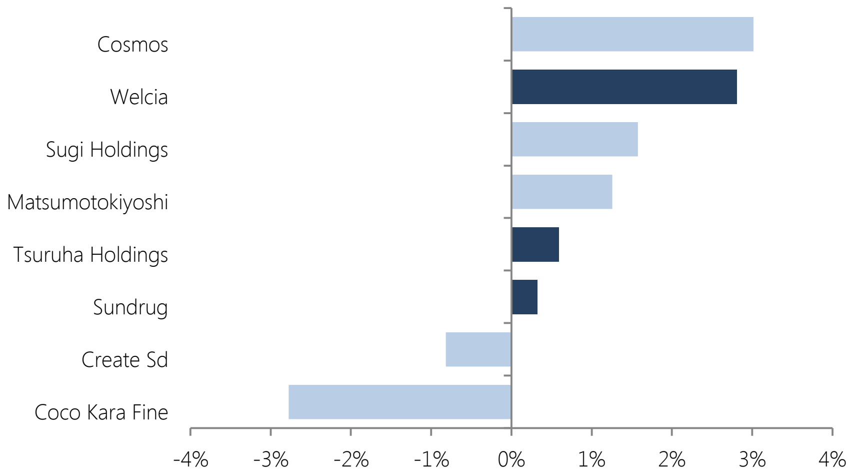
| | 2014 EPS growth | 2015 EPS growth | 5Y EPS CAGR | 5Y price growth p.a. | P/E | PEG ratio |
|---|---|---|---|---|---|---|
| Seven & i | 8.7% | 10.5% | 2.7% | 6.5% | 19.3x | 2.20 |
| Lawson | 7.8% | 7.4% | 9.1% | 8.7% | 19.2x | 2.45 |
| FamilyMart | 7.5% | 8.2% | 8.7% | 4.2% | 17.5x | 2.35 |
| **CVS average** | **8.0%** | **8.7%** | **6.8%** | **6.5%** | **18.7x** | **2.33** |
| Sundrug | 8.3% | 9.0% | 14.2% | 13.6% | 15.3x | 1.85 |
| Welcia | 7.0% | 13.5% | 31.2% | 27.8% | 14.3x | 2.03 |
| Tsuruha Holdings | 14.6% | 8.5% | 16.5% | 23.0% | 13.8x | 0.95 |
| **Fund holdings average** | **10.0%** | **10.3%** | **20.7%** | **21.4%** | **14.4x** | **1.45** |
| Cosmos | 11.5% | 13.2% | 34.2% | 52.6% | 20.6x | 1.80 |
| Matsumotokiyoshi | 3.9% | 7.3% | 12.1% | 14.6% | 14.6x | 3.77 |
| Sugi Holdings | 7.2% | 9.3% | 13.0% | 12.4% | 19.0x | 2.65 |
| **Drugstore average** | **7.5%** | **10.0%** | **19.8%** | **26.5%** | **18.1x** | **2.41** |

Source: Bloomberg, team analysis

Total sales have increased steadily over the past three years for all eight of the largest exchange listed drugstores. This has been driven by both continued new stores opening (generally between five to ten percent of existing stores) as well as same store sales growth (of up to four percent).

**Exhibit D**

**Healthy same store sales growth validates business model of Fund holdings**
2013, JPY




Source: Bloomberg

Over the last 18 months the Fund has held positions at various times in Sugi, Tusurha, Sundrug and Welcia. We have held Sundrug from inception and continue to hold because of its steady performance and low drawdowns. Although Tsuruha was in the basket at inception, it was sold after hitting a stop loss but we have since rebuilt a position. Sugi was also in the basket at inception but was sold after reaching our valuation target. Welcia is a recent addition because of its attractive valuation and strong growth prospects.

## SPECIAL FOCUS: US BANKS

Having been standout performers in the first half of the year, the Fund's banking stocks, while making solid gains, underperformed the broader US market, and indeed the US banking market significantly over the half. The investment thesis is largely unchanged from what we laid out in our last half-yearly report[5]

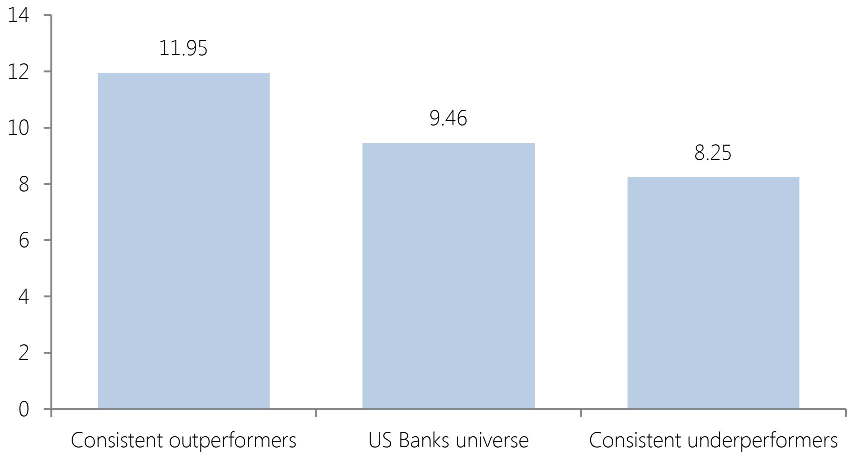
The main reason for this dual underperformance (and its substantial reversal in January) probably relates directly to the overall frothiness of the US market. The core stocks we hold are all at the 'quality' end of the spectrum, in terms of their returns on equity and assets, their cost to income ratios, and their margins, and all also generally operating with lower risk profiles by industry standards. Two,

[5] http://morphicasset.com/wp-content/uploads/2013/01/Half-Year-Report-June-2013-and-Full-Year-Report-August-2013.pdf

Wells Fargo and US Bancorp are also large to mega-caps, and only one Bank of the Ozarks is a mid-cap. By contrast most of the better performing banks in terms of share prices in the second half of 2013 proved to be higher risk, lower quality names, where the market, mistakenly in our view was keen to buy into speculative recovery stories or hopes that banks with low returns on equity would somehow mean revert to the average, and therefore justify trading higher price to book ratios.

**Exhibit E**

**Banks with consistently high ROE tend to continue outperforming peers**
2012 ROE, %, average 1990-2011, USD



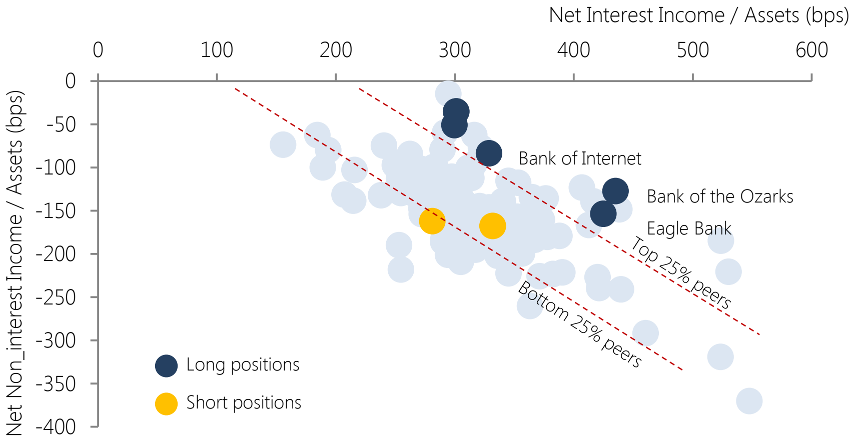

Source: Bloomberg, team analysis

As can be seen from Exhibit E, this approach flies in the face of history, which suggests that in US banking, good banks tend to stay good and grow, while bad banks stay bad or deteriorate and shrink.

More recent work we have done looking at the overall investable universe for us (about 150 different banks) suggests that the better banks in the US can be categorised as experts in banking services, i.e. generating very high returns for their fee based activities, with US Bancorp and Wells Fargo being particular standouts in this regard, or very good at 'spread banking', i.e. getting the best net interest margin. A very small handful, led by Bank of the Ozarks, are very good at both.

**Exhibit F**

**Fund's core holdings are more profitable than peers**
2013 or latest available, USD

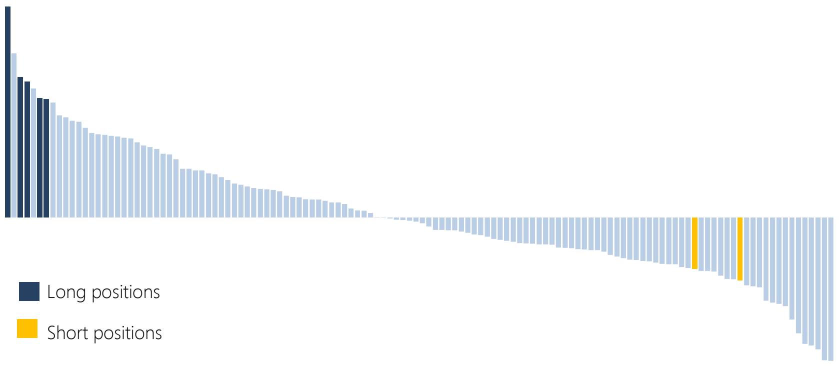



Source: Bloomberg, team analysis

Reflecting this view we have more recently added to our US bank portfolio by re-entering Washington DC based regional Eagle Bank, and the strikingly named Bank of Internet, and established short positions in two banks with bad track records that we believe have poor franchises and tired managements.

**Exhibit G**

**Fund's positions are attractive from risk-reward perspective**
Upside potential




Source: Bloomberg, team analysis

However we should also note that the second reason our banks underperformed the overall US market in the last six months, despite generally growing their earnings in line with or slightly better than expectations, is that the second driver of performance we expected from the US bank basket – loan growth has not yet materialised.

Our view remains that the US is fundamentally set on a reflationary course, and that we are presently just in a pause until this kicks in. In the meantime continued gains from previous asset recoveries from the GFC period, and active capital management is driving earnings per share growth on a reasonable basis at the two big banks, while the three smaller names are gaining market share as well.

## RISK MANAGEMENT

As discussed in previous semi-annual reports our approach is to recognise, somewhat uncomfortably, that the Fund has to be run on the basis of a dual mandate, in that we are expected outperform its benchmark <u>and</u> also to attempt to protect capital somewhat.

This results in us scoring itself monthly based, on the Fund landing in one of the following four quadrants:

| | **Under-performance** | **Out-performance** |
|---|---|---|
| **Positive returns** | Lucky but lacking skill **(6)** | Heaven **(9)** |
| **Negative returns** | Hell **(1)** | Skilful but lacking luck **(1)** |

The numbers shown above show how many "visits" the Fund has made to each quadrant in its first 17 months of operation. During the most recent half the Fund was in "Heaven" a record four times, but also made its first ever visit to "Hell".

We likes to think that given the strong bull market, and the expectations on the Fund to minimise volatility and avoid large month on month capital drawdowns, this outcome reflects an appropriate balance between risk management and profit maximisation. However as stated previously, the true test will come in a severe downturn[6], which the Fund has yet to experience.

Taking a more conventional measure of risk management, the Fund continues to operate with daily "Value at Risk" metrics substantially to the bottom end of its allowable risk appetite, and its realised volatility is considerably lower than the main funds it sees itself competing with in the Australian market place.

Another key risk and return measure that we like to target is for each monthly cohort of new investors is on average enjoying both absolute returns and out-

[6] Which we define as greater than a 20% fall

performance. As at the end of December all monthly cohorts had made money investing in the Fund, and only four had experience underperformance, none of them substantially.

## OUTLOOK

*"Prophesy is a good line of business, but it is full of risks."*[7]

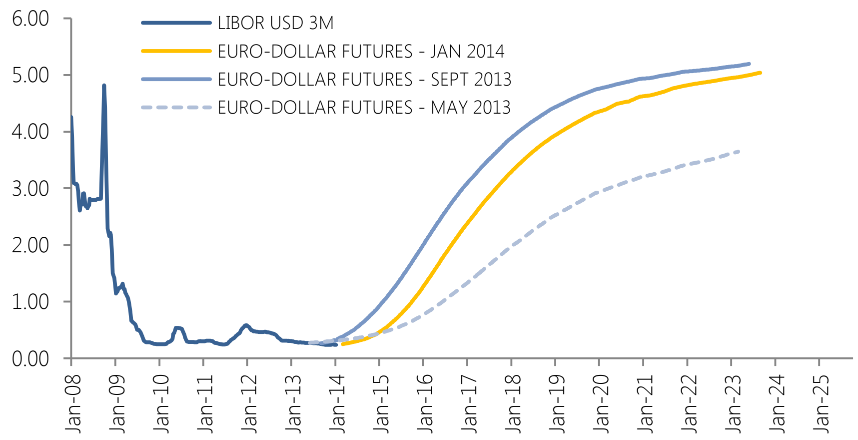
It's that time of year again where everyone tries to forecast the coming year. We have always found this a somewhere between odd: choosing an arbitrary start date for events that are already underway - and dangerous: it can lead to anchoring if done poorly with point estimates.

In general we prefer to look at some of the stronger undercurrents that would appear to be flowing as we come into 2014 and then assess whether the tide is waxing or waning on these.

The biggest change relative to this time last year is the Federal Reserve has gone from a stance that can only be described as extremely stimulatory (printing new money to buy US bonds at the rate of US$85b a month) to "tapering" whereby this is reduced ultimately to zero by some point this year. Whether being less stimulatory is the same as contracting has been argued out between the Fed and the market over the course of the year, but more importantly, Fed has successfully talked down (via its so-called 'Forward Guidance") the implied increases in the bellwether Fed Funds Rate that were there at the end of June.

**Exhibit 4**

**USD LIBOR and Euro-Dollar Futures**
%, 2008-2014




Source: Minack Advisors

[7] Mark Twain in "Following the Equator"

Thus, despite the rise in long term bond rates over the last year, market expectations of shorter term rates have actually fallen over the last six months. Nonetheless, when it comes to what it actually does with policy rates, the Fed is ultimately dependent, like private investors trying to predict its moves, on the actual economic data as it emerges. To date this data has continued to remain strong. It is therefore our view that in some respects it is less important to argue about whether the first Fed Funds rate increases come in early 2015 or late 2015 than to recognise that on its current glide path the US economy is on the path to rate increases.

This places the US at odds with large swathes of the world - Europe would appear to be a candidate for its own dose of Quantitative Easing at some stage; Japan is actively trying to inflate its way out of deflation via Abenomics; even in Australia the main arguments are over whether the rate cut cycle has ended.

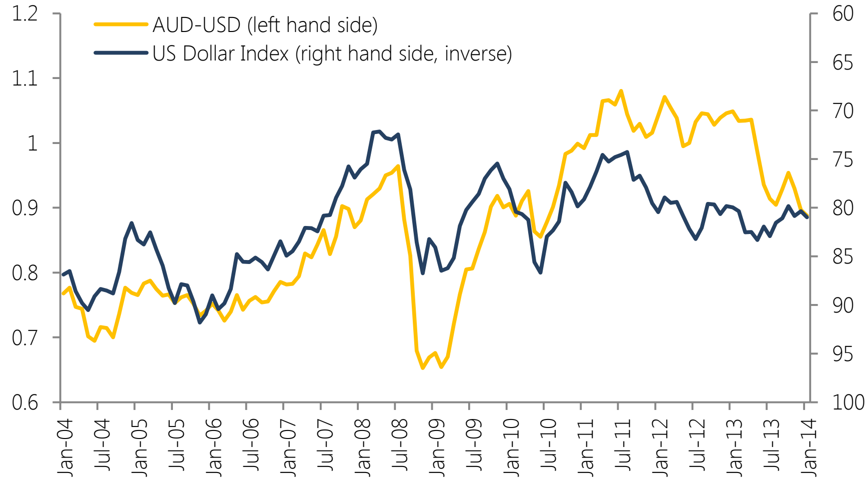
As such, a key belief of the manager is that the most likely outcome is the US dollar continues its strength, including a broadening of the currencies against which it is making gains. Most likely this will include the Euro as the latter, which makes up 57% of the US dollar index (DXY), has been so strong that the DXY gains have actually been quite modest.

The real strength of the US dollar has been against the commodity currencies and twin deficit countries. This began in 2013 and we think this will be a theme of 2014.

**Exhibit 5**

**USD strength is evident against commodity currencies like Australian Dollar**

2004-2014




Source: Bloomberg, team analysis

## THE US VORTEX[8]

*Brazil is the country of the future, and always will be*[9]

One of Morphic's less successful non-ideas of 2013 was that QE3 would lead to an improving situation for Emerging Markets (EM). This died with Ben Bernanke in May and we reversed our positioning. EM has under-performed, but thus far it has all been rather orderly.

One view of markets is that equities are just another "widget" and in the short term supply and demand sets the price[10]. So rather than looking at the fundamentals (which do of course matter of the longer term, but 1 year or even 3 are not long term), let's consider the supply and demand for US equities versus EM in the context of supply and demand for capital.

One of the less commented on factors globally, is the US Dollar still remains the funding currency of the world. In the same way more gold used to need to be mined to provide money supply, more US Dollars need to be shipped out offshore to enable credit expansion in the "dirty pegger" economies (countries with that formally or informally manage their currencies against US Dollar) . The primary symptom of this supply or demand is the US Current Account Deficit (CAD).

Now the last few years have seen a cheap US Dollar combine with higher onshore oil production to result in more "onshoring" and less need for imported oil.

[8] Vortices are a major component of turbulent flow. In the absence of external forces, viscous friction within the fluid tends to organize the flow into a collection of so-called irrotational vortices. Within such a vortex, the fluid's velocity is greatest next to the imaginary axis, and decreases in inverse proportion to the distance from it. The vorticity (the curl of the fluid's velocity) is very high in a core region surrounding the axis, and nearly zero in the rest of the vortex; while the pressure drops sharply as one approaches that region http://en.wikipedia.org/wiki/Vortex

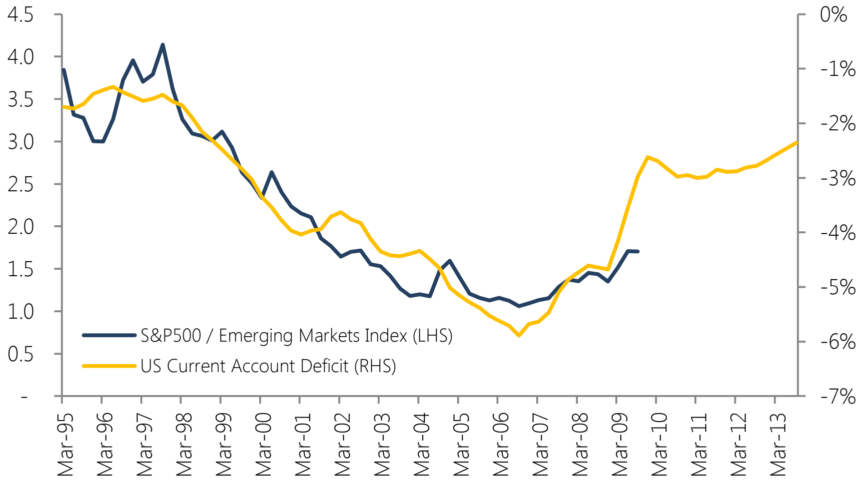
[9] Charles De Gaulle

[10] As encapsulated in the famous quote by Warren Buffet that in the short term markets resembled voting machines but in the long term they were more like weighing machines, but probably originally from Ben Graham

**Exhibit 6**

**US Current Account Deficit changes foreshadows relative weakness in Emerging Markets**

1995-2014, relative performance lagged by four years & US Current Account Balance




Source: Bloomberg, team analysis

What does this mean? Overlaid above is the US CAD and the relative performance of EM vs the US, but lagged by 4 years. It shows clearly the long cycles in both directions since the mid 1990's. The forces mounted against EM are strong when one considers this along with the discussion on US rates: Higher real rates are attracting capital (or causing it to stay in the US) at the same time the CAD has continued to close.

## WHEN DOES THE BEAR COMETH?

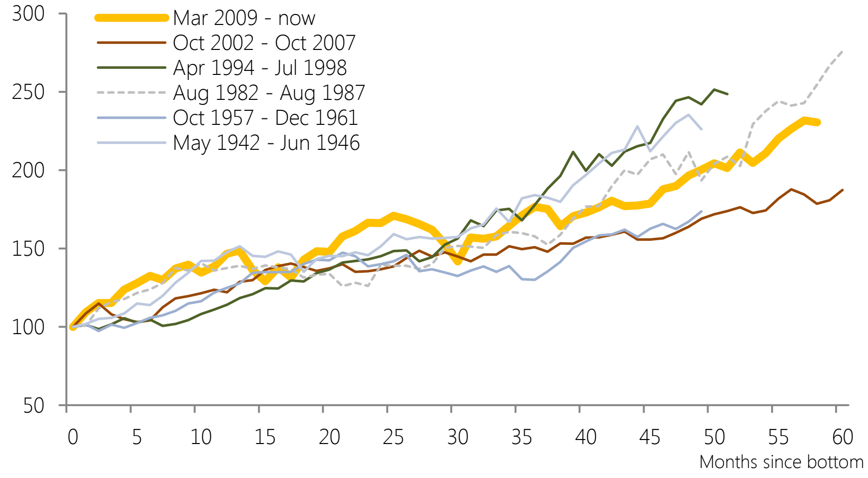
*"For most of the post-war period, economic expansions did not die of old age. They were murdered by the Federal Reserve in the name of fighting inflation[11]"*

The final point is when does one turn bearish? Summers raises an excellent point in the above quote and thus far since Morphic began, every attempt to worry, has been costly in a relative sense. Nevertheless by most reckonings, this is already a mature bull market (see Exhibit 7).

[11] Lawrence Summers - http://m.asia.wsj.com/articles/SB10001424127887324549004579066992343811698

**Exhibit 7**

**Current bull market is neither the longest nor the most explosive**
Bull markets lasting over 250 weeks, 1940-2014




Source: Bloomberg, team analysis

As a nervous January in the markets comes to an end, we still believe the ending of active monetary printing is unlikely the derail the economic recovery in the US, especially as 2014 will not see the pressure of fiscal contraction experience in 2013 due to run-off of the effect of the budget sequester.

On the other hand we don't expect equity markets in the US to deliver anything like the returns of 2013, because even if inflationary pressures are sufficiently absent to prevent the Fed from raising short rates, we suspect nascent cost pressures may lead to lower margins in the USA and a risk of earnings disappointments. However nor do we expect sharp declines – and the weight of money from offshore investors, and also locals switching out of cash and bonds may even pushes equity valuations up still further.

As noted before, central bank activities in Japan and Europe are going in the other way, and likely to be more supportive of equity prices – especially if investors maintain confidence that money printing and other economic initiatives really are revitalising these still somewhat moribund economies.

For emerging markets, and those developed markets which depend on them like Australia, we are a lot more sanguine. Avoid, and where necessary short, is our expected course of action.

## HOSTAGES TO FORTUNE

As usual we finish this report with a series of "non-predictions" for things we don't think will happen between now and June 30th, 2014.

First, however we have to reflect on the slightly shabby performance of our last set of "anti-forecasts":

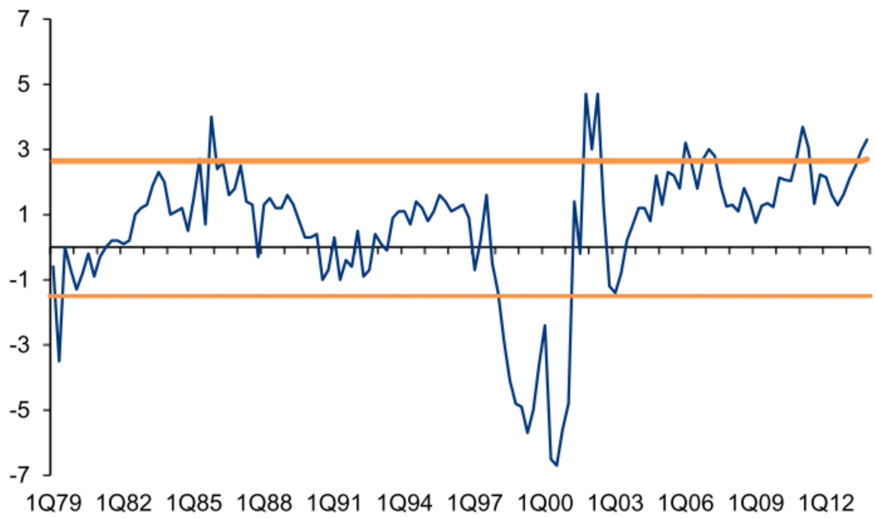
1. **US Equity markets (S&P 500) will NOT break out of their option implied range (+/- 9%)**
   ***Miss!*** The S&P 500 was actually up 15% in the six months to December 31st. Fortunately as our approach is to be fully invested unless we believe there is an substantial risk of excess volatility or long term loss of capital, the Fund itself suffered no pain from this lack of exuberance.
2. **The US borrower (as measured by the Consumer Discretionary sector ETF XLY) will NOT be a better investment than the US lender (XLF)**
   ***Miss!*** The XLY beat XLF by 3% over the half. This one did hurt the Fund, in that the fund was heavily overweight selected financials and quite underweight stocks in the consumer discretionary sector.
3. **The Indonesian equity market will NOT finish the year higher in US dollar terms**
   ***Hit!*** The Indonesian equity market and the Indonesian rupiah were two of the worst performing assets over the second half of the year, and the Fund did very well from its positioning in this regard.
4. **Japanese equity markets will NOT disappoint into year end**
   ***Hit!*** The Japanese market took a while but eventually regained all the ground it had lost in the sell-off it saw late in the first half of the year, and the Fund's heavy overweight the country more than compensated for the slight underperformance of the drugstore sector as discussed above. In addition the Fund managed to hedge away the bulk of its yen exposure resulting in US dollar performance very close to that achieved by the underlying market in its native currency.
5. **Australian Rates will NOT be above 2.5% before 2015.**
   ***Probable Miss:*** the timeframe anticipated in this anti-forecast gives us a little wriggle room, but as at the end of 2013, Australian interbank cash rate futures for late 2014 were yielding 2.57%. This did hurt performance a little as the fund had been running a small long position on longer dated Australian 90 day bank bill futures.

And now to our new hostages to fortune in terms of detailed non-forecasts for the six months ahead, some of which are presently reflected in the Fund's positioning.

1. **US small cap (the Russell 2000) will not outperform US large caps (the S&P 500)**
   The valuation gap between the two appears to have widened to the top of its long term band, and now appears stretched, and perhaps approaching a period where a sell off into at least relative weakness seems likely:

**Exhibit 8**

**Small cap stocks are at historically high valuations vs. large caps**
Difference in forward P/E between Russell 2000 and Russell 1000

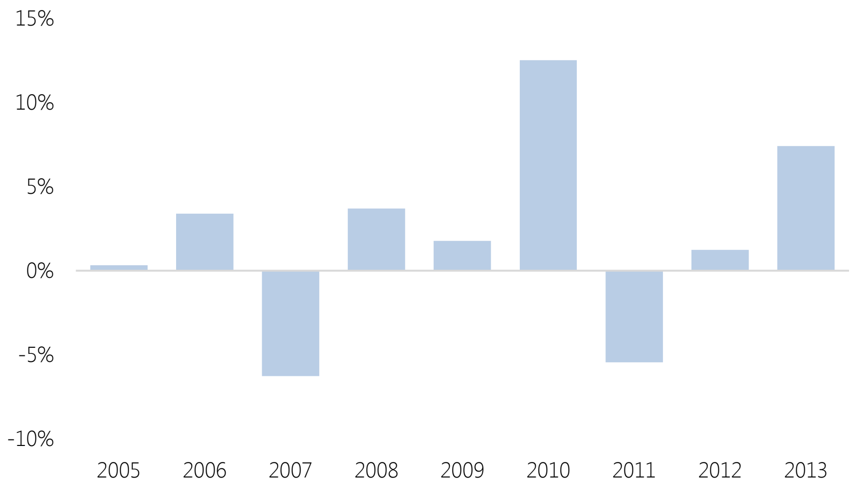



Source: Russell Investment Group, BofA Merrill Lynch

The Russell has outperformed for the last two years, and two or three successive years of out-performance tends to be the limit for this trade, especially after a year of massive out-performance:

**Exhibit 9**

**Small cap stock outperformance tends to reverse every 2-3 years**
2005-2013, relative performance of Rusell 2000 Index vs. S&P 500 Index




Source: Russell Investment Group, BofA Merrill Lynch

2. **Gold will NOT close the half above 1250**
   As some investors would know, one member of the team was well known for being an exuberant and successful gold bull from 2009-11. So this call may come as a surprise to some! Gold had an awful year last year and many contrarians consider it a buy. History says the opposite: trends that are busted don't resume their prior trend until a new trend emerges, and we see nothing in the current trading patterns that suggests this is happening
   Just as importantly, gold is also up against a full suite of macro-economic headwinds: rising real nominal and real rates in the USA; removal of tail risk (as priced by the equity risk premia and VIX); and a likely stronger US dollar. With no inflation in sight, and investors underwater, only a collapse in markets and a reversal of the Federal Reserve's stance seems likely to change its outlook over the next six months. 2015 may be a very different story however....

3. **US Capex will not remain dormant**
   Capex has been one of the main missing ingredients in the US Economic recovery. For the last few years Companies have preferred to cut costs, hoard cash, buy back equity or pay higher dividends. As Fiscal headwinds abate and confidence continues to rise we see the US moving back to 3% to

4% GDP growth. For the last few months forward looking indicators have been pointing to acceleration in new orders, the magnitude of which is typical during periods of strong growth. Historically this has been a good lead on Capex spending and thus we expect to see this accelerate higher driving the next leg of the US recovery story.

4. **US 10 Year Bonds will not close above 3.5%**
   Being bond bears last year proved to be correct and we continue to believe we are in a multi-year bear market, reversing over 30 years of good times for bond investors. However the view has become consensus with bond sentiment at seven years lows and although we remain bearish the pace of selling should slow. At the crux of our argument for now is the Federal Reserve will be deploying more verbal ammunition and support for controlling the front end of the curve through forward guidance. Getting rates much higher from here will in part mean fighting the Fed and as the old macro adage goes "Don't fight the Fed".

5. **Frontier (FM US) markets will beat emerging markets (EEM US)**
   On a valuation basis many FM markets remain very reasonably priced compared to EM and have better momentum. As discussed above our general view is the travails of selected larger EM countries (e.g. China, Brazil, Indonesia, Thailand, Turkey) more than offset possible recovery stories in Mexico and India. On the other hand many FM countries either have sufficiently closed capital accounts to be somewhat immune to a tightening US monetary policy, or are (as the Gulf countries) so strong from a fiscal and/or external account point of view to be impervious to such changes.

Wishing you a belated Happy New Year

*Jack Lowenstein, Chad Slater, Tim Cheung, Geoff Wood, Ronald Yu, Mike Walpole-Skwarczynski*