
JAPAN IN ONLY THE FIFTH INNING AND ALTERNATIVES FOCUSED DISCUSSION

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Last week on our podcast we spoke with Michael Churchill of Churchill Research, an independent research firm that provides commentary across the global markets, and Sal Bruno, Chief Investment Officer of IndexIQ, a division of MainStay Investments.

The discussion centered around investment themes that Churchill is focused on today and some of the developments in the exchange-traded fund (ETF) industry that IndexIQ is attacking—many of which are centered in the [alternative](#), fixed income and international equity arenas, areas both Michael Churchill and I share Bruno passion for innovating in to provide differentiated tools to traditional fund exposures.

With Bruno, we touched on the [active](#) versus [passive](#) conversation; his background as an active portfolio manager at Deutsche Asset Management provides good insight into the role for ETFs and how he sees ETFs serving many of the strategies historically applied by active managers.

Highlights of the conversations with each guest included:

With Michael Churchill:

- How a lot of Churchill's research centers around the price of gold as indicative of the current regime.
- Churchill is looking at several of the non-commodity growth stories in emerging markets—one of which is Sri Lanka. There was an interesting conversation about Sri Lanka through the financial crisis—which was less impacted by reduced global flows, due to its few investors, and thus was relatively unscathed at the time. He first went there in 2009, during a period of war, and saw how much modern development was going there. He thinks it is one of the nicest places in South Asia—better than India and Pakistan as a tourist destination for Europeans; it is just too far for most Americans.
- Japanese [small caps](#): Churchill has been focused on Japan for the last four to five years and thinks we are currently only in the fifth inning of the recent upward moves in the Japanese markets. With the election of Abe and Kuroda, there was political unanimity in ending [deflation](#). For 30 years, nobody cared about Japanese investments, evidenced by the wide swaths of stocks selling at very depressed multiples. Churchill points to Japan's very low unemployment rates, pickup in real estate prices and [margin](#) improvements that are starting to take place. He is very focused outside [large-cap Nikkei 225](#)-oriented stocks and much more small caps. He sees many examples of companies that had [operating margins](#) between 0% and 2% in the 2008-10 time frame and today are closer to between 4% and 6%. These margin improvements, combined with low [valuations](#), are

Leading to very strong returns.

- One of Churchill's focus points were his travels to various countries, the notes of which are being turned into an upcoming book called *Stock Analyst Trip Notes 2008-17: Crash and Recovery from Buenos Aires to Hanoi*. Churchill is reflective of his 2008 portfolios that were smashed during that period and ponders the lessons learned from that experience. His honesty was refreshing.

With Sal Bruno:

- Why he left the traditional active mutual fund world for the ETF side: the structural differences with the [creation/redemption process](#) to impact tax efficiency, the administrative costs that lead to lower expense ratios, transparency and liquidity.

- Focus on alternatives: Bruno is focused on [hedge fund](#)-oriented strategies such as hedge fund replication, merger arbitrage and [long/short](#) equities. In terms of where the potential future market is, Bruno believes we still have a lot of runway ahead of us for liquid alternative strategies. We touched on how hedge fund replication strategies can add value as a dynamic asset allocation strategy that take the best of hedge fund manager positioning, and more specifically, an idea surrounding merger arbitrage indexes.

o Bruno is seeing a large pickup in merger and acquisition activity—which is feeding interest in merger arbitrage strategies. He sees the [beta](#) of these indexes as being in the range of 0.15 over the long run, and the long-run returns to these strategies being in the mid-single digits, around 4%–6%. This has been the case for the last five years.

- Fixed Income smart beta development: while factor investing started with equities, Bruno and I agree that there will be further work around factor investing in fixed income. His team has looked at applying the [momentum factor](#) to fixed income subsector asset rotation and low [volatility](#) (low vol) as a factor within the [high-yield](#) bond market. We are also in agreement that investors need to look beyond the traditional [market cap-weighted](#) benchmarks and start looking to factors in the fixed income market—whether enhancing yield like some of WisdomTree's Index strategies, focusing on quality within the high-yield market, or the low vol factor. We both agree people should consider moving beyond fixed income beta.

- Finally, we also briefly touched on an international equity discussion and different approaches for managing [currency risk](#).

It was a great conversation with both Bruno and Churchill.

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DEFINITIONS

Alternative Investment: An investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investments typically include hedge funds, managed futures, real estate, commodities and derivatives contracts.

Active manager: Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Passive: Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Deflation: The opposite of inflation, characterized by falling price levels.

Margins: Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Nikkei 225 Stock Average Index: A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Operating margin: Operating income divided by total sales. Higher numbers indicate higher profitability.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Creation and Redemption Process: The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

Hedge fund: A hedge fund resembles a pooled investment vehicle administered by a professional management firm. It is often structured as a limited partnership or limited liability company. Hedge funds invest in a diverse range of markets and use a wide variety of investment styles and financial instruments.

Long (or Long Position): The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position): The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Volatility: A measure of the dispersion of actual returns around a particular average level.

High Yield: Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

Market capitalization-weighting: Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Currency risk: the risk that an investment will decline in value due to a change in foreign exchange rates.