

A MARKET IN ONE DIRECTION

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We have completed a quarter of exceptional returns in the financial markets. The injection of liquidity by central banks is creating a financial inflation that some expect will revert in a wealth effect that will encourage greater consumption and increased business investment. In other words, that it will generate a bonanza effect leading to an exit from the current economic crisis. I have already mentioned in the [preceding article](#) the great disjunction prevailing between fundamentals and financial markets and our doubts that the economic recovery will be of the magnitude the stock markets are discounting.

Followers as we are of the philosophy of Value Investing we might think that our strict selection of assets showing good economic fundamentals and a significant discount on their intrinsic value is immune to a potential market correction. Not so. As good investment portfolio managers, we can not underestimate market fluctuations. We know that few assets are safe when markets correct widely.

History shows that it is very difficult to beat the benchmarks systematically by a careful selection of assets, but it is less so when avoiding market corrections in times of overvaluation.

At this time of new highs in the stock markets and new lows in the yields of sovereign debt there is a need to find out whether financial markets have still some way to go. Predicting the evolution of a market or an index is very complex. In recent financial history different theories have attempted to predict the fair value of a stock index. Some examples are the Dow Theory, the model of the Federal Reserve, or the use of the differential between the dividend yield and the 10-year bond yield. All have worked at some point but have also failed at some other. We do not intend to predict future market trends but we do mean to do what may be necessary to protect the invested funds and this implies progressively reducing risk in our portfolios at times like the present.

Any market correction is preceded by an excess, either of valuation, participation of new investors, debt, etc. We believe that the present moment shows signs of overload in valuations and in the level of optimism.