GLOBAL ALPHA

June 7, 2013

Dear clients and colleagues:

The current equity rally around the world continues to be greeted with skepticism. Commodities, basic materials stocks and emerging markets have not participated at all, a divergence not often seen in prior "bull" markets.

The risk trade is very much "on" though. The most-indebted U.S. companies are rallying more than any time since the financial crisis. According to Bloomberg data, the companies in the S&P 500 with the lowest working capital, the smallest earnings and the highest debt ratios have surged 27% this year, double the return of companies with the most cash.

Another research piece published by UBS showed that quality has underperformed in the US and Japan, the two leading markets this year-to-date. Momentum outperformed in the US, Europe and Japan.

It is difficult for fundamental managers to outperform in such an environment. In fact, they don't. Major benchmarks are first quartile, indicating that over 75% of managers don't outperform the current stock market.

A few things could happen from here:

Global growth accelerates and lagging sectors catch up. We had a first taste in May when more defensive sectors such as Real Estate and Utilities underperformed, in part due to rising interest rates.

Mergers and acquisitions pick up, highlighting the undervaluation of quality stocks. This also started in May, the busiest month in two years for M&A.

Rising interest rate anxiety. This would continue to support equities and could even lead to the "great rotation" from fixed income into equities.

A healthy correction. The S&P has not had a correction of more than 5% in almost 6 months. The market is overbought and a correction could take place. Riskier companies will be most affected – a phenomenon that we are already witnessing in Japan, with the market down 20% in one week, and the small cap growth index (TSE Mother's) down 13% yesterday alone.

Our portfolio has high-quality companies. We emphasize on superior sales growth: 14.3% vs. 6.8% for the index; better gross margins: 49.5% vs. 44.5% for the index. A few of our companies are now the subject of takeover rumors, such as SodaStream (SODA US), Comstock Resources (CRK US), Homeserve (HSV LN), and Chico's (CHS US). All these companies would attract substantial premiums in a takeover, highlighting our confidence in the portfolio.

Have a good week.

The Global Alpha Team