

# GSAM Fundamental Equity Team Update – Current Views on the Market

August 15, 2011

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## **Executive Summary:**

- The sharp sell-off in the global equity markets was sparked by heightened global economic concerns and fears of a double-dip recession.
- Europe's sovereign debt issues and the downgrade of US long-term debt coupled with protracted US fiscal negotiations fueled the increased equity volatility and drove markets lower.
- We are most concerned about the impact these events will have on consumer, corporate and investor confidence. The high-end consumer, an important ingredient in the recent recovery, could be disproportionately impacted by these stresses, both in terms of wealth and spending.
- The Fundamental Equity Team is highly focused on our client portfolios and the economic and market developments that could impact them.
- Across the portfolios, we are stress-testing our company-specific scenario analyses to understand the impact of a variety of potential economic and financial events to help inform our investment decisions and portfolio positioning in the current environment.
- We have not made major changes to our client portfolios. We are taking this opportunity to reinforce our high-conviction holdings by assessing entry points in quality ideas, which represent attractive longer-term opportunities and modifying more economically-sensitive exposures to maintain an overall balanced shape to the portfolios.
- We acknowledge that short-term uncertainty is high. However, we are constructive on the global equity markets and believe they represent an attractive long-term risk/reward opportunity.

## **Views from our Portfolio Managers<sup>1</sup>:**

### **GLOBAL DEVELOPED MARKETS**

- **US Value:** Client portfolios have been oriented towards names where we see quality characteristics emerging over the next few years with a continued economic recovery. Given this positioning, the recent, violent "risk off" transition has hurt portfolio performance. The biggest detractors in large- and mid-cap have been the more economically-sensitive stocks including select investments in telecommunication services, media, basic materials and large diversified banks. We've added to our technology positions, including boosting our semiconductor exposure, as these stocks now trade at 8-9X 2012 with lean inventory levels and short lead times<sup>2</sup>. We have reduced our media exposure and have focused on those companies with less advertising cyclicality. In addition, we have moderated our basic materials and energy exposures in the portfolios.
- **US Growth:** We are not reacting by adopting the prevailing emotion of the market. Given the market's recent sell-off, we are taking advantage of deep disconnects between valuations and fundamentals. We remain focused on risk management and understanding the intended risks that we are taking from both a company-specific and portfolio construction perspective.

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<sup>1</sup> This commentary pertains to the following mutual funds, except where indicated by an "\*\*": GS Capital Growth, GS Concentrated Growth Fund, GS Flexible Cap Growth Fund, GS Growth Opportunities Fund, GS Small/Mid Cap Growth Fund, GS Strategic Growth Fund, GS Technology Tollkeeper Fund, GS Growth and Income Fund, GS Large Cap Value Fund, GS Mid Cap Value Fund, GS Small Cap Value Fund, GS US Equity Fund, GS Asia Pacific Equity Fund, GS BRIC Fund, GS Brazil Equity Fund, GS China Equity Fund, GS Concentrated International Equity Fund, GS Emerging Markets Equity Fund, GS India Equity Fund, GS International Small Cap Fund, GS Korea Equity Fund, GS N-11 Equity Fund, GS Strategic International Equity Fund.

<sup>2</sup> GSAM. As of August 15, 2011.

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- **US Core:** Strong corporate profits in the second quarter give us confidence in US companies' ability to sustain profit growth and post gains amidst macro uncertainty. We are selective buyers of structural growth companies with attractive valuations. We reduced our weighting in the Industrials, Energy and Materials sectors.
- **Europe:** We entered the second quarter underweight the Financials sector, and we have further reduced our exposure in response to heightened risks. During this past week, our holdings in the Financials and Materials sectors have outperformed their industry peers while select names in the Consumer Staples and Health Care sectors have lagged. While conditions remain very volatile and fluid, the team is very focused on balancing near-term downside risks with long-term potential.
- **Global Equity Partners\*:** We have not made any changes to the portfolio since the recent market turmoil. Stock selection in the Financials sector has proved to be resilient while our positioning in the Energy and Health Care sectors has been tested more over the past week. We will be reassessing the Energy sector and the more volatile names to ensure the positions are the right size, and we will revisit our investment theses in light of the current environment.
- **International Small Cap:** The sensitivity of the strategy, as measured by beta, to the broader equity market was marginally defensive when we entered into the downturn. As a result, the strategy has weathered well on a relative basis. We have added to more cyclical positions, which have suffered more than the market, and where our conviction levels are high. We believe this positioning will help retain an optimal portfolio structure in a fast-moving market.
- **Japan\*:** The market has been responding to global macro events rather than local issues, with concerns about the slowdown in US economic growth as the main driver, followed by the strength in the Yen. We believe the latter is due to rising risk aversion driven by the news in the US relating to growth and the recent downgrade by S&P, as well as Europe's sovereign debt issues. Despite these developments, we continue to believe that the Japanese economy will positively surprise in the second half, driven by a faster than expected recovery from the March earthquake. We remain overweight domestic sectors.

## **GLOBAL EMERGING MARKETS**

- We have witnessed three key themes:
  1. Small- and mid-caps have underperformed large-caps on the back of heightened risk aversion,
  2. Export-orientated markets (such as Taiwan, South Korea and Mexico) have suffered on the back of a weaker global macroeconomic outlook, and
  3. Commodity-driven markets (such as Russia and Brazil) have been hit hardest as growth expectations are revised down. Markets that are inversely correlated with commodity prices (such as India and Bangladesh) have proved more resilient amid weaker sentiment for energy and commodity prices
- **India:** India has been one of the more resilient markets, as oil and other commodity prices have pulled back from recent highs, relieving inflationary pressures and reducing the expectation of further interest rate hikes by the Reserve Bank of India. If oil and commodity prices stabilize around current levels, we believe inflation may start to come down towards the end of this year, which should be positive for the market and allow greater confidence in forecasting 2012 numbers.

- **South Korea:** Prior to this month's sell-off, we had significantly increased our consumer exposure while trimming more cyclical sectors, which has worked well. We are starting to reduce our underweight in cyclical industries such as chemical, energy, and technology, which have suffered steep declines. Overall, as large state-run funds step in to provide support and the three-month ban on short selling becomes effective, we believe these should act as tailwinds for the market to recover.
- **Russia\*:** Our defensive positioning and underweight position in the Energy sector performed well amidst the market sell-off, while our Financials exposure detracted. We retain our high-conviction positions in the retailers and banks, and remain underweight the Materials and Energy sectors, where we see risks of earnings downgrades.
- **Brazil:** Our stock selection within the Financials sector has worked very well. However, our overweight position in the Consumer Discretionary sector and underweight positions in the more defensive Telecommunication Services, Utilities and Consumer Staples sectors have detracted from relative performance.
- **China:** Stocks have sold-off across all sectors and market caps despite the majority of second quarter results beating expectations. We expect inflation to peak in the next month or two and now believe the key question is whether the People's Bank of China will loosen monetary policy. We do not expect them to lower interest rates, but believe they may use expansionary fiscal policies—restarting social housing, renewable energy and high-speed rail projects—to stimulate economic activity instead. As a result, we are increasing our exposure to beneficiaries of fiscal project expansion and taking profits in positions that have outperformed.
- **BRIC:** Our positioning in India and Brazil has generated positive alpha so far this month, while China and Russia have detracted.
- **N-11:** So far this month, within the N-11 portfolio, alpha generation has been strong, with positioning in Mexico and South Korea positively contributing to relative returns. While our substantial underweight position to Turkish banks has contributed to performance recently, our holdings more broadly within the country have suffered from uncertain government policy actions and uncertainty around the macroeconomic outlook. While South Korea and Turkey have faced considerable selling pressures, the ASEAN markets of Indonesia and Philippines have shown greater resilience, bolstered by robust domestic demand and a more stable economic outlook.
- **Asia Pacific ex-Japan:** So far this month, our portfolios have performed broadly in-line with the market. South Korea and India have contributed to relative performance helped by our positioning in the Consumer and Energy sectors respectively. Taiwan was the top detractor as global demand is expected to decline, which would adversely affect technology stocks.

## **Disclosures**

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