Investment Report: Q1, 2010

Market Summary

The first quarter of 2010 was generally a period of favourable returns of real assets (Figure 1). Apart from a loss of nerve midway through January, 'risk' remained in vogue even after the heady gains of 2009. The exception was the commodity sector where, led by oil, excess investment returns fell back. Although property continued its recovery, £ weakened steadily ahead of the election and in response to the more favourable economic progress being made elsewhere (Europe and Japan apart). The UK equity market, comprising strong exposure to resource-related companies and overseas earners, outperformed the global average. Credit spreads (the yield on corporate bonds over gilt) continued to narrow.

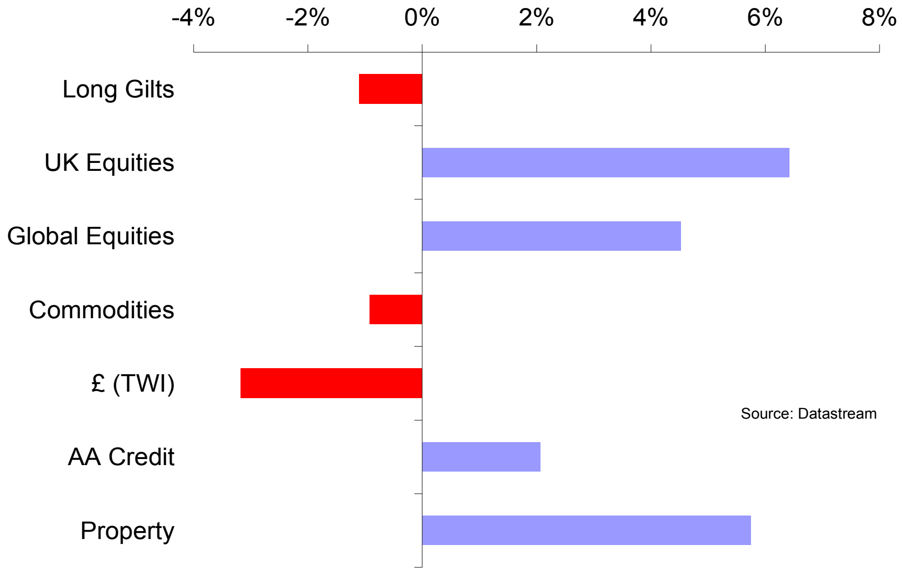


Figure 1: Market Performance – Q1, 2010 (total return)

Since the end of Q1, the picture has been quite different (Figure 2). The debt crisis that engulfed Greece and threatened a raft of nation states within Europe saw the next, inevitable stage of the Credit Crunch develop at the sovereign level. The threat of systemic failure within the European banking system increased sharply and investors duly sold out of positions. The severity of the European crisis led to marked € weakness, an unprecedented remedial package (see insert) and even managed to eclipse the political drama unfolding (at the time of writing) in the UK.

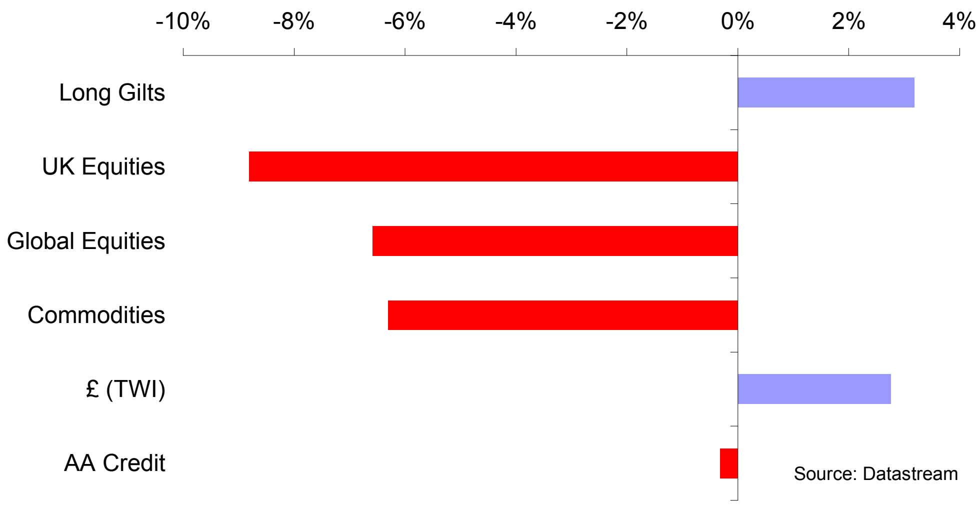


Figure 2: Market Performance – since end March (to 7th May)

Market Observation

We remain in an economic and market environment for which there is scarce precedent in living memory. Returning to conditions that we might perceive to be normal, is going to prove challenging.

Figure 3 highlights that slope of the US yield curve (a proxy for all others) is incredibly steep. Such a slope portends of economic strength and developing pressure on inflation. Yet policy rates, across the major economies, remain at emergency levels – with no immediate sign of changing.

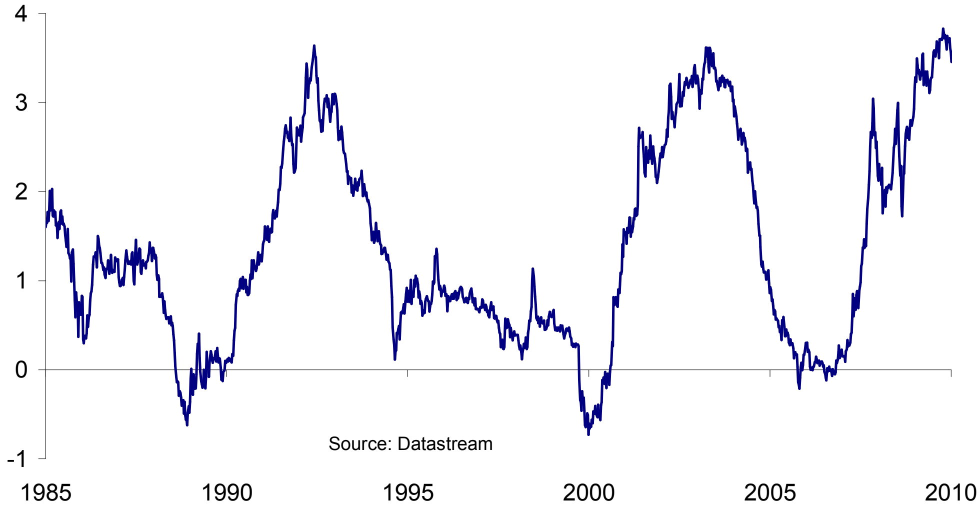


Figure 3: US Yield curve (long yields less two year yields - %)

Part of the reason is that one of the strongest challenges is the difference in conditions experienced between major companies and the much more numerous and just as significant, smaller employers. Figure 4 shows the yawning and unprecedented gap in corporate confidence between large and small companies.

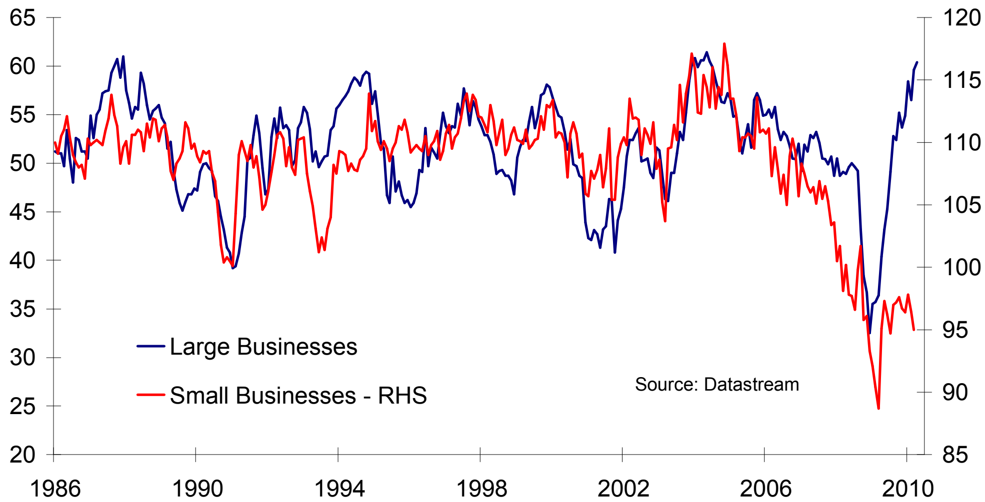


Figure 4: US Business sentiment (small versus large companies)

Large corporations have found it easy to access the capital markets and so avoid the need to deal with banks whereas smaller companies have yet to see any relaxation of bank lending. In addition, many small companies depend on finance secured on the owner's personal assets. The decline in house values thus feeds back negatively into the small company sector.

These contrasts – there are many more – illustrate the challenges - and manifest uncertainty - faced by policymakers. They support a market backdrop likely to be characterised by violent markets swings. The Appendix reprises a note provided for Officers that discusses this feature and its possible impact on pension schemes.

Commentary

There is usually a lag between a financial crisis erupting and the discovery of its biggest victims. The 1990's boom and the dotcom bubble burst in March 2000. However, the poster children for that era did not emerge until Enron and Worldcom folded in 2001 and in 2002 (respectively). The housing bubble, and the structured products built around it, began to burst in early 2007 but it took over a year for Lehman Brothers to go under. The Great Recession probably ended in the summer of 2009 yet here we are, almost a year later, and the poster children are being revealed; Greece is one. Goldman Sachs may, or may not, be another. And the €, arguably the ultimate structured product, could even end up as a prominent feature on the poster.

Markets are still supported by cyclical tail-winds. Evidence of economic strength on both sides of the Atlantic has come through in recent weeks, not least in better-than expected labour market data in the UK. Corporate announcements have validated market expectations that earnings would be strong, with approximately 75% of companies in both the US and Europe beating estimates. Balance sheets are generally exceptionally strong, providing support to credit markets. Earnings momentum is proving a powerful support for equity markets; valuations are not yet a challenge.

However, market reaction to the fears over the bailing out of Greece has been sobering. It is a reminder that structural headwinds, such as sovereign risk, will become a serious hindrance at some stage. The problems catalysed by Greece are likely to postpone the time when major central banks around the world raise interest rates. Nonetheless it is possible that the sell-off in markets has partly been caused by the tightening of policy in major emerging and commodity based economies. Brazil raised interest rates by 0.75% from a record low of 8.75% on April 28. Australia raised interest rates to 4.50% on May 4 and Canada's central bank has hinted strongly that it will raise interest rates in June. On May 2, China raised the reserve requirement ratio for banks for a third time this year and has limited loans for property purchases. This could be seen as a harbinger of events in the likes of the US.

Although a 'tweak' to US interest rates would, in reality, have little real impact, its impact on sentiment could be huge and we can understand why policy makers would be reluctant to do so while financial markets are jittery and significant imbalances remain. They have spent or lent trillions of dollars, euros and pounds propping up the financial system, individual financial firms and now individual countries. It would be foolhardy to jeopardise that investment by premature policy tightening. Note also that there are fiscal woes in the world beyond those evident in Greece. A catalyst for the recent sell-off in mining stocks has been the planned introduction in 2012 of a 40% tax on mining company profits in Australia to pay for changes to the retirement savings system and for infrastructure.

Australia's action is a reminder that fiscal challenges go beyond paying for the clean up after the Great Recession. There is not a developed economy in the world that does not face huge costs associated with its ageing population, the promises made to retirees about the size of their pensions and the payment of their medical expenses. This structural headwind is far enough in the future to be unlikely to affect markets in the near-term. It is also worth noting that political interference remains a potential headwind with the SEC action against Goldman Sachs appearing to be an escalation of the political pressure on Wall Street. Wall Street was perceived as the beneficiary of a more generous bail-out than any other industry. And now Wall Street is leading the recovery in profitability. No financial firms in the S&P500 have produced earnings below estimates in Q1 and the sector has had the largest increase in earnings forecasts in the wake of those earnings.

This is socialisation of losses and privatisation of profits – a combination that is bound to produce a backlash from the general population. Goldman is the leading Wall Street firm and it is therefore in the eye of the storm. Goldman has powerful friends (Warren Buffett and Bill Clinton have spoken out in support recently) but it is also loathed by politicians and envied by competitors and could easily continue to be a target of a political system that needs scapegoats. Every country has its own 'Goldman'.

The temptation for politicians to interfere is understandable and, perhaps, irresistible. There is considerable precedent for seeing such intervention as a long-term negative. Markets have yet to focus on this threat.

Insert: The ECB Bailout (Stabilisation Fund)

Running into the weekend of May 8th/9th there were significant concerns that some European banks would be unable to re-open on the Monday morning; several 'Northern Rock's' lay in prospect. It was against this backdrop that the ECB and EU devised a set of unprecedented rescue/remedial measures to act, effectively, as a war chest against further market instability.

The detail of the plans can be summarised as:

- €60bn of loan's from the EU's existing budget;
- €440bn of loan guarantee's provided by the EU;
- €250bn of loans from the International Monetary Fund;
- the ECB will purchase the bonds of member states;
- measures to provide emergency access to funding and US$ implemented during the early part of the Credit Crunch are reinstated;

The Stabilisation Fund is expected to ensure that, in future, the provision of emergency funding measures to the likes of Greece, can occur much faster than previously, not least because it avoids the need for lengthy ratification through the various national parliaments.

In exchange for access to the resources of the Fund, recipient states need to agree rigorous austerity measures supervised by the IMF, the EU and, in all likelihood, the ECB; there is to be no 'free lunch'.

The immediate reaction in the financial markets was unambiguously positive however, the enduring consequence can only be clear once some of the following aspects/issues are understood:

1. It has taken the EU etc several weeks to understand the severity of the market crisis. There can be no guarantee that those responsible for operating the Stabilisation Fund will react any faster.
2. The IMFs involvement appears conditional on exhaustion of EU etc monies and the currency swap facility is only being offered on terms so onerous that few banks are likely to access it.
3. The political independence of the ECB is clearly under threat. Only 2 days before, the ECB had denied that the outright purchase of government bonds would occur. A politicised ECB – especially against the backdrop of European politics – would lead to a significant loss of credibility.
4. The EU have declared that they "will defend the € at all costs". This, together with the knowledge that a financial 'safety net' exists could easily weaken the resolve of recipient states in implementing the appropriate fiscal adjustments. A large part of the Greek crisis was down to market fears over the preparedness of the Greeks to 'stomach' the cuts required.
5. The announcement represents a big step forward towards full fiscal union and the joint issuance of government bonds; it is then a small step towards the issue of ECB bonds. It is unclear whether all nations are willing to move quickly to this position.
6. At present, that bond-buying programme does not constitute Quantitative Easing as understood in the UK – liquidity within the financial systems will not be allowed to increase. As events of recent days have shown, this can change quickly. If it does, the dynamics of the market will also alter sharply; inflation will be firmly on investors' agenda.

Overall, European policymakers had to be press-ganged into an understanding of the severity of the situation; nothing it seems has been learned from 2008/9. It remains to be seen just how much of the package is bluff; governments will hope that the promise of their support ensures that it will never be needed.

Standing back, the policy based on debt-for-debt replacement is ultimately flawed. Some investors are going to have to face facts; some of the money that they lent all too easily, will never be paid back.

Strategy Guidance

The Pension Fund is inherently 'long' risk assets. On this basis, any assessment of unexpected events is best biased to the negative.

1. Notwithstanding the rise in equity markets that has taken place, we have not yet extricated ourselves fully from the severe global economic slowdown foretold by a raft of leading economic indicators in 2008/9. Sentiment rallied strongly off the lows last year but has been jolted by the re-emergence of the Credit Crunch at the sovereign level. Job creation is patchy in the developed economies. Investors are beginning to realise just how miraculous it would have been had the global economy emerged simply from the cataclysm of Q4, 2008.
2. Movements on the foreign exchanges are likely to remain accentuated as national contrasts form a greater part of investor thinking; the € fares badly in any such assessment. The currency of choice (within the developed nations) remains the US$. Politics will limit the ability of £ to be dragged higher by the US$ but £ remains a more attractive currency than the € - outside of protracted political confusion / ineffective leadership.
3. Risk mitigation strategies will likely prove crucial in the months ahead, as we are not yet "out of the woods". The markets remain poorly positioned to absorb any petering out of this nascent recovery. A severe (20+%) sell-off in financial markets is unlikely but the consequences will be more severe simply because of the poverty of remedial policy options.
4. Prudence requires that systemic and economic fractures must still be examined for their possible (negative) impact on the PF. Possible areas of specific concern are listed below.
   - A strong move towards greater protectionism still cannot be discounted.
   - The systemic crisis was averted as the problems were 'nationalised'; fresh weakness has been characterised by issues of a sovereign nature as events in the peripheral European states highlight (see insert). The EU etc have 'upped the ante'. Markets may yet call their bluff.
   - Higher commodity prices threaten, once again, to depress disposable incomes and, combined with persistently subdued economic growth, threaten to foster an environment typically characterised as 'stagflation'; this is a poor backdrop for investing generally but specific asset classes, e.g. commodities, can be attractive.
   - Led by moves in developing and commodity economies, risks surrounding extrication from the current emergency monetary policy setting are growing. Central banks will be keen to avoid slipping into a Japanese style policy paralysis but too swift a move to tighten policy threatens to kill the recovery.
5. In the face of these risks, the case remains that policymakers will do whatever necessary to rebuild confidence and avoid a sharp economic recession. Against this backdrop risk-free inflation protected assets are ideal if priced attractively. Unfortunately, UK index-linked stocks are very richly priced. Other, more attractive, index-linked markets exist.
6. Despite suggestions to the contrary, official interest rates are set to remain low for some time. Longer dated, forward rates are set to fall further and offer the PF protective potential (risk mitigation). Markets such as Australia and NZ provide the best opportunity for these strategies.
7. The multi-year outlook remains that of a broad but ultimately trend-less, trading range for equity markets. Timely, though ideally infrequent, adjustments to the broad asset allocation may be considered; 'contingency' cover will be important.

   Operation of some of the market specific / contingency related strategies should form part of the mandate of the specialist asset allocation manager that is currently the subject of a selection exercise (see Appendix).

Appendix: Self-exciting Flutter

Those who have never watched the videos of the Tacoma Bridge collapse should do so now[1]. It proves clear evidence that huge structures, although built solidly to endure, can collapse. The physicists attribute the bridge's demise to the self-exciting oscillation born of aeroelastic flutter. The bottom-line is that once something big gets out of control, it is very difficult to stabilise it again.

It is telling that, despite the apparent global economic recovery, the European financial system is still incapable of dealing with the debts created by a country representing just 2% of its overall economic mass – Greece. The banks remain highly fractured and unable to withstand the capital write-downs consistent with the degree of value destruction obvious in assets e.g. property exposures.

Dating back to the onset of the Credit Crunch (January 2007), asset markets have been characterised by extremely violent behaviour. Readers will obviously recognise this in the slump in equity, credit and commodity markets of 2008/9. However the subsequent rise in the same markets were just as dramatic; they weren't described as 'violent' because, of course, they suited investors.

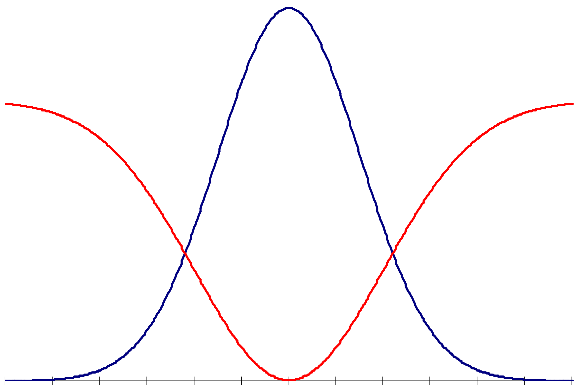
Based on the behaviour of markets in recent weeks, it is clear that the 'violence' hasn't ended. The speed of the moves remains incredibly fast, reinforced by the clamour of investors trying to join or bail from market swings or trends.

Extraordinary challenges:
- the obsession that lenders are, largely, indemnified from their actions
- Über-easy interest rates,
- the counterfeiting that is QE,
- the fiscal adjustments necessary to deal with the mountain of debt,
- demographics,
- socioeconomic upheaval, and
- the inevitable end to the folly of debt-for-debt substitution,

all conspire to ensure that, <u>to any reasonable forecast horizon</u> and regardless of what happens in the real economy, market behaviour will not be *normal.* In its place will remain a bias for polarised outcomes; prices marked sharply up <u>or</u> sharply down. [In the graphic, the stylised distribution of outcomes is going to that of the red line, not that in blue.]

It is essential that those responsible for pension fund portfolios recognise this 'self-exciting' nature of markets and modify their portfolio design accordingly while they still have time. The correct response is, and neatly described by such as Ruffer, through the use of complementary exposures. However, this approach can only be effective if these offset exposures created are managed, i.e. gains are adroitly monetised.

The essence of the approach is to augment the strategic investments with other, smaller (by value) exposures which are likely to perform with a high degree of convexity in – otherwise hostile - market extremes. These are investments which will have merit on their own account but are likely to be substantially re-rated should markets jump to a polar extreme. When this happens it is essential that the resulting gains are harvested for they will evaporate when, during the next flutter, markets swing back in the opposite direction. This is a 'long vol' approach to portfolio construction and quite different from the standard 'long risk' approach.



Just as bridges aren't meant to violently gyrate, major asset portfolios aren't meant to be subjected to frequent rebalancing. The approach described shouldn't require major upheaval, just maintenance appropriate to the complementary exposures. Some may still see this as synonymous with trading; it isn't.

[1] *http://www.youtube.com/watch?v=3mclp9QmCGs*

If markets continue to move violently within the very wide trading ranges established in recent years, then we can be confident that there is likely to be more value in the range than the trend (which is to go nowhere). We might also fear that each oscillation, as at Tacoma, was far from constructive. Driven by the issues described earlier, the global financial system undoubtedly has its own self-exciting, aeroelastic flutter. Getting it to calm down is going to be no small challenge.

Pension fund portfolios can close their eyes to the threats embedded within this environment believing, in error, that it will end soon. Alternatively they can amend their behaviour as suggested. In practice, few will change much and this will ensure that, for those that do, the benefits will emerge.