

Thesis Market Commentary

April 2011

“You have to take things to an extreme and then bring them back to reality” Calvin Klein

Unsettling events in the first quarter

As we pass the first quarter of 2011 there has been no shortage of news to keep markets on their toes, or arguably send them into a tailspin, e.g. political upheaval in the Middle East, the sovereign debt crisis in Europe, the earthquake in Japan and Budgets in the UK (quickly forgotten) and US (nearly never happened).

Yet despite all this, and more, overall volatility has remained subdued with most markets ending the quarter little changed (i.e. equities and commodities a few percentage points higher, gilts a couple of points lower and corporate bonds unchanged). The main reason for this is an increased appetite for risk based on recognition that equity markets generally are not expensive. This is thanks to the growth in Emerging Markets and, with the help of low interest rates, healthy position of the average (non-financial) company balance sheet.

This is in sharp contrast to the precursors of previous stock market crashes in 1974, 1987 and 2000 for example. On these occasions either whole markets, or significant sectors within them, were acknowledged to be high but, given the rate at which prices were rising, no one wanted to be the first to jump - in case they were left behind - and it therefore needed an external trigger to send the herd in the opposite direction.

In other words if an asset class is innately higher risk then it is inevitable that, at some stage, either an internal or external event will trigger a dramatic fall - and often completely out of the blue (or black in the case of swans!). This perhaps explains the increasing focus of the FSA in ensuring that both asset managers and product providers clearly explain to investors the potential risks they are taking on. What the FSA don't do, however, is tell asset managers how they should manage this risk.

How should we respond?

At Thesis we believe that the answer is simple, i.e. first understand the potential risk of each asset class, and individual

stock, then, irrespective of how bullish is the general perception, impose a strict maximum weighting (and minimum for lower risk assets) commensurate with the risk profile of the client. QED? Well it might be for the professionals, but explaining to a virgin investor isn't always so simple. I saw one recently, an elderly widow, whose late husband had controlled all the finances, and as we reminisced over days out as children in Brighton, eating fish and chips on the beach (we have a very comprehensive “Know Your Client” questionnaire!) I likened our risk process to that first dip in the sea.

Testing the waters

There are hundreds of other people already in the sea, so it must be safe (and not too cold) and with the reckless abandon of youth I would dive straight in. As the years passed by I have become more cautious and not being a strong swimmer (the only characteristic I share with Duncan Goodhew being a conspicuous lack of follicles adorning the Lally crown) then total immersion now becomes a more formal process. With trousers carefully rolled up over calves and sporting duly knotted hanky on head, I will first test the temperature of the water, incline of beach, direction of the tide and for any other dangers (such as sharks, jellyfish, jet-skis or timeshare salesmen). Only then will I cautiously venture in, but however warm and welcoming the sea is, and however many people are swimming or playing much further out, I will always stay within my comfort zone, i.e. my feet can touch the bottom.

The reason I mention this story is that, even outside the restrictions of institutional mandates, there is still a widespread belief in the asset management industry that risk is determined not so much by the nature of the asset classes used, but more by to what degree your application of them differs from the benchmark. Every one aspires to outperform, but the fear of underperformance is always much greater - hence the attraction of passive management, using funds which replicate or track indices. Tell an average cautious investor, however, that you've outperformed - by only losing 30% of their money when the benchmark was down 40% - and they won't be impressed.



Flying in the face of convention

Speaking of risk, out of chaos often comes opportunity. Shortly after the political upheaval in Tunisia, when travel companies couldn't give holidays away, a colleague in the office bought a family holiday there, in a 5 star hotel, for just a few hundred pounds. Fortunately, as events turned out, he won't need to pack flak jackets along with the buckets and spades!



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Market News

➔ US remains top of the pops

Markets have taken the mixed data on the domestic and global economic recoveries in their stride. UK equity prices fell in mid-March, but subsequently bounced back in line with those abroad. However, the US was the only major market gainer over the month. Amazingly the VIX index of expected stock market volatility is now below its level of a month ago, despite events in Japan and the Middle East.

Interest rate expectations and Gilt yields are virtually unchanged on their levels of a month ago. This might be due to the fact that while the further rise in oil prices has raised the near term inflation outlook, many fear it may ultimately have a deflationary effect.

Sterling has weakened against the Euro, reflecting growing expectations that the ECB will hike rates sooner and faster than the MPC. In contrast the pound has held steady against the dollar, reflecting little change in the markets' assessment for the interest rate outlook in both regions.



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Stress testing of Ireland's banks has recently revealed the need for more support than first thought. As a result, the Irish government also announced a shake-up of the industry which is hoped will restore investor confidence. **Allied Irish**, which had been told to raise €3.5 billion, must now find a whopping €13.3 billion, whilst **Bank of Ireland** must find €5.2 billion.

Lloyds Banking Group announced a series of management changes as the new chief executive, António Horta-Osório, moved to put his mark on the financial firm. Elsewhere, **Barclays** awarded Bob Diamond a bonus of £6.5 million for 2010, for when he ran Barclays' investment banking business. Mr Diamond, who took over as chief executive of Barclays at the beginning of this year, came under pressure from some lawmakers to give up his bonus for 2010 after pledging that the bank would "show restraint" in handing out bonuses. He has received his 2010 bonus in stock, 72% of which is being deferred.

Schroders saw its funds under management hit record highs, while profits in its asset management division more than doubled to £381 million from £174.7 million last year. As of 31 December, total funds under management stood at £196.7 billion, after record net inflows of £27.1 billion.

Prudential revealed that operating profits had risen 24% to £1.9 billion from £1.56 billion on strong worldwide sales in its full year results. It revealed it would make £75 million of cost savings from Prudential UK, after having previously announced it had met its cost savings target of £195 million.

Man Group, the world's largest publicly traded alternative asset manager, will sell its 25% stake

in **BlueCrest Capital** back to the hedge fund for \$633 million, ending an investment that has lasted more than seven years. The sale will deliver profit before tax of about \$250 million and comes just a year after Man's merger with **GLG Partners**. Elsewhere the group is buying the rest of the credit-focused hedge fund **Ore Hill** that it does not already own. It had acquired about 50% of Ore Hill in 2008.

Royal London has reported that profits after tax have fallen 37% to £274 million, but it has still increased its dividend.

Taylor Wimpey has announced it would sell its North American business for \$955 million to a group of private equity investors that includes **TPG Capital** and **Oaktree Capital Management**. The divestiture is part of a broader effort to refocus on the UK market, improve the company's financial position and cut its pension deficit.

Terra Firma, the private equity firm run by Guy Hands, is putting the **Odeon** and **UCI Cinema** chain up for sale in a deal likely to be valued at between £700 million and £1 billion.

Bwin, the Austrian sports book specialist, and UK-based **Party Gaming** have merged to create the world's biggest listed online gambling company.

Vodafone is to sell its 44% stake in the French mobile phone operator **SFR** to **Vivendi** for £7bn. The deal gives Vivendi, France's biggest mobile phone business, full control of SFR and ends months of talks. The company has been slimming down some parts of its portfolio and recently sold stakes in Chinese and Japanese mobile operators. Vodafone will return £4bn to its shareholders by buying back shares.

Comparative Index performance ▼

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Indices	Value as at 31/03/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5908.76	-1.42%	0.15%	4.03%
FTSE All Share	3067.73	-1.25%	0.16%	5.41%
Dow Jones	12319.73	0.76%	6.41%	13.48%
Euro Stoxx 50 EUR	2910.91	-3.39%	4.23%	-0.69%
Nikkei 225	9755.10	-8.18%	-4.63%	-12.04%
FTSE A British Government All Stocks	153.14	0.35%	-2.07%	0.74%
Sterling/US\$	1.6028	-1.41%	2.66%	5.56%
Sterling/Euro	1.1321	-3.86%	-2.94%	0.73%

Market News

However, in India, **Vodafone** is buying out a partner and is paying \$5 billion in cash for the **Essar Group's** one-third stake of an Indian joint venture. The deal will increase Vodafone's exposure to one of its most important and fastest-growing markets. "We're adding about three million customers a month," said Ben Padovan, a Vodafone spokesman. "India has a population of 1.2 billion, and penetration is about 60%, so there's a lot of market share to go for!"

Royal Dutch Shell has agreed a deal with independent firm **Eland Oil and Gas** and local company **Starcrest Nigeria Energy** for the smallest of four Nigerian oil blocks it has put up for sale.

BP has agreed to sell its controlling stake in a Colorado natural gas plant to the **Anadarko Petroleum Corporation** for \$575.5 million, as the energy giant continues on its path to divest assets worth \$30 billion.

Tullow Oil, the British energy company, is selling stakes in its Ugandan oil exploration project to **China National Offshore Oil Corporation** (CNOOC) and **Total** of France for \$2.9 billion. Tullow is selling a one-third interest to each company and keeping a third for itself.

Rio Tinto has said that it would move forward with its bid for **Riversdale Mining** of Australia even if a majority of shareholders did not accept the offer. While the deal originally hinged on obtaining acceptance from 50% of investors, Rio Tinto now says it will buy any shares that are tendered by the deadline, potentially leaving the company with a minority stake. Currently, 41% of Riversdale shareholders have accepted the bid.

Daimler and **Rolls-Royce** have announced a joint takeover offer for the diesel engine maker **Tognum**, in a deal valued at 3.2 billion Euros. Daimler and Rolls-Royce are forming a joint venture to execute the deal.

A group of major British media companies has filed a legal objection to the **News Corporation's** plan to take over the pay-television company **BSkyB**; just weeks after the British Government cleared the way for the deal. The group, which includes **BT**, the **Guardian Media Group**, **Associated Newspapers**, **Trinity Mirror**, **Northcliffe Media** and the **Telegraph Media Group**, said the Government's announcement this month favouring the takeover represented "an unprecedented departure from normal standards as applied under the U.K.'s merger control regime."

Morrison's has acquired a 10% stake in **FreshDirect**, the online grocer, for £32 million. The transaction is as much about what it can learn, as it is about the investment. The company has lagged behind competitors like **Sainsbury's** on the Internet front. Morrison's is hoping to open its online ordering-and-delivery platform in the next two years. Although it plans to grow mainly organically, the company is also looking to gain much-needed knowledge and infrastructure. Morrison's has also recently bought **Kiddicare.com**, a baby goods retailer, for £70 million.



When the census doesn't make sense...

In keeping with our inclusive times, a census form has reached a car park ticketing machine at Dorset's Moors Valley Country Park. Addressed to 'The Occupier: Pay on Foot Shelter', the machine now faces prosecution - with a fine of up to £1,000 and a criminal record if it fails to fill in the form. Staff at the park have formed a committee to consider what to put as the machine's job, language and religious beliefs.

Meanwhile, question 17 is baffling the English. On the English version of the form, the box is blank, stating: "This question is left intentionally blank. Go to 18." A spokeswoman at the Office of National Statistics has defended the omission, saying: "On the English form it is left intentionally blank, but on the Welsh form it says: 'Do you speak Welsh?' The reason it is left blank is to keep consistency across all the forms as we only have one scanner."

Sources: Capital Economics, Artemis, Reuters, Citywire, BBC News & Dealbook.com

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