

Thesis Market Commentary

November 2011

Endgame: the closing stage of a game of chess, in which only a few pieces are left on the board. *Collins English Dictionary*

This Month

It is tempting to pour scorn on the politicians involved in the Eurozone debt crisis as it evolves from a Greek tragedy to an early Christmas pantomime, with Silvio "Widow Twanky" Berlusconi currently centre stage, no doubt to the relief of PM Papandreou. And all the time heckled by the two "Ugly Sisters", Merkel and Sarkozy.

However, the sheer scale and seriousness of the problems cannot be underestimated. Italy's debts (ie. €1.8 trillion of which €300 billion needs to be refinanced next year) dwarf those of Greece and without a credible budget the likelihood of haircuts and defaults becomes a closer reality. Although the prospect of (another) imminent election in Italy is about as surprising as a rainy day in Manchester, it only serves to distract, or delay, the tough decisions which must be made. Markets are already voting with their feet and sending Italian government bond yields close through the 7% level at which IMF (International Monetary Fund) and EU intervention becomes inevitable. Next stop Portugal, where the Troika are already ensconced and going through the books, then Spain, Ireland and possibly France.

The Endgame - what are we doing?

We believe that this is not a time for risk taking but instead have made a number of strategic moves (some commenced last year) designed, we believe, to best position portfolios against the various headwinds and for the resultant opportunities that current events are likely to produce:

- **Increased liquidity:** cash positions in most portfolios have been accumulating rapidly this year and currently stand at record highs. It is unfortunate that yields are so derisory but we believe capital protection is far more important. Subject to market and individual stock levels then these are earmarked for either equities, an (probably FTSE100) i-share (for trading volatility) or bonds
- **Reduced high yield exposure:** the rebound in equity markets since September has fed through to the riskier end of bond markets and we are using this as an opportunity to reduce exposure given the sector's high

sensitivity to deteriorating economic growth, tighter bank lending and the potential impact of a shift in investor appetite given the poor liquidity

- **Reduced gilts:** very recently we cut gilt weightings following exceptional growth this year. Although underpinned by QE (Quantitative Easing) and safe haven status, they are now vulnerable to political U-turns and any run on the pound. Also falls in investment grade corporate credit markets make them now a more demanding (and much higher yielding) alternative
- **Hedged currency risk:** earlier this year we switched our Japanese and European equity exposure into funds where the currency risk has been hedged out. In the case of Japan the yen's temporary (and surprisingly robust) safe haven status has worked against us but we firmly believe this is only temporary
- **Refocused equity weightings:** in the UK we are increasing exposure to highly cash generative companies with strong balance sheets and in sectors less sensitive to cutbacks in general consumer spending. A ratings system has been developed in conjunction with Cranfield University as a significant tool in our decision making and monitoring process. On the global front, as mentioned later by my colleague Giles Marriage, we have selected three thematic areas, ie. Healthcare, Agriculture and Technology all of which benefit from population growth
- **Gold:** an important stabiliser in portfolios already this year, although we did bank part of clients' profits in the summer in anticipation of a lull in the feverish speculative activity (a little premature but the price did eventually correct sharply in September - driven by short term futures selling). We are maintaining current positions, seeing the correction as consistent with its performance during previous risk asset corrections. We don't expect significant upside although overall rises to date (despite media hype) have been nowhere near the spectacular rises in the 1980's

■ The Endgame - what are we doing?

■ What goes down must come up?

■ Market News

■ Opportunities out of a growing population

■ **Emerging markets:** despite their underperformance this year we are not taking flight with the crowd but maintaining our overweight position. Key economies such as China, Russia, India and the emerging Latin American nations do not have the same scale of either sovereign or banking debt issues which are haemorrhaging many of their G20 counterparts. Nor, thanks to stronger central banking controls, are they experiencing the hyperinflation scenarios we all remember so well from previous 'false starts'.

Whilst we had believed that the Eurozone debt crisis would take many months, or even years, to play out it now seems possible that we are approaching the endgame referred to earlier. The question is how many pawns will be sacrificed to protect the queen?

CONTINUED ON P2 ▶



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Comparative Index performance ▼

Indices	Value as at 31/10/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5544.22	8.11%	-6.03%	-2.31%
FTSE All Share	2860.86	7.78%	-6.59%	-2.56%
Dow Jones	11955.01	9.54%	3.26%	7.52%
Euro Stoxx 50 EUR	2385.22	9.43%	-14.59%	-16.16%
Nikkei 225	8988.39	3.31%	-12.13%	-2.33%
FTSE A British Government All Stocks	168.35	1.14%	7.65%	5.95%
Sterling/US\$	1.6087	3.23%	3.04%	0.31%
Sterling/Euro	1.1608	-0.27%	-0.48%	0.91%

What goes down must come up?

After the worst quarter for many moons, even worse than the third quarter of 2008, October saw a significant improvement in markets - recouping half the losses of the previous three months. The only consolation for investors may be that so far at least total drawdowns are well below the levels experienced during the crisis of 2008/2009. Indeed investors are still ahead of where they were at the start of 2009 during the depths of the banking crisis.

The mood on the street is that we've all had enough of European problems. A never ending cycle of a Euro summit, subsequent half-baked solution, leading to yet further worries has been dragging on for well over eighteen months now and still the Eurozone seems no further forward.

Market News

Financials

Royal Bank of Scotland made pre-tax profits of £2 billion in the three months to 30 September, against a £1.6 billion loss in the same period last year. In a statement, RBS said that its retail operation was "holding up well" but that the investment bank side was "only modestly profitable". Bailed-out RBS warned of further job losses and said the global economic slowdown was delaying its recovery.

Barclays has reported a better-than-expected rise in third-quarter profits to £2.42 billion, with a strong performance from its retail business offsetting a sharp fall in profit at its investment bank.

The oddest thing about this quarter's bank results is how they turn bad into good by the method in which the banks account for bad news. The banks have for a number of quarters been applying the following make-up to their balance sheets. When their credit quality deteriorates, the value of their debt falls. This looks bad. It reflects their inability to finance and directly affects the future costs of the business when they come to refinance their debt. However, the banks are allowed to take this loss that has been suffered by their bond holders and book it as a profit. You therefore get the oddity that as the outlook for the bank deteriorates, its credit spreads widen and it is able to book the spread widening on its own debt as a profit!

This has been very significant in the last quarter by a multitude of banks, typified for example by Morgan Stanley, which made \$1.14 per share but with \$1.12 per share coming from a widening of its own credit spreads.

The banks and their auditors think this accounting use is sound. We, however, wonder how correct it is. Presumably, using their logic, the accountants and management of Lehman Brothers would argue that the quarter it went bust was the most profitable ever because its debt traded at near to zero. In fact, that last quarter of trading could well have earned more for the company than its previous 100 plus years of existence. Trick or treat?

Insurer **Prudential** posted a 10% rise in nine-month group insurance sales, helped by a continued strong performance in Asia and the US and said it expects to outperform its rivals in the medium term. Sales of £2.7 billion were up from £2.46 billion in the same period last year.

Resources

Anglo American is to take control of diamond company **De Beers** after agreeing a £3.2 billion deal to buy the Oppenheimer family's 40% stake. The deal raises Anglo's stake in the world's largest diamond distributor to 85%, with the remainder owned by the Botswana government. The Oppenheimers have been in the diamond industry for about 100 years.

Retail

Next's third quarter update was good and reaffirmed the resilience of the business as well as the quality of management. It reported strong directory sales growth at 16.9% and margins and costs remained in line with expectations.

Telecoms and Tech

The latest quarterly results from **BT Group** show growth in broadband customer numbers, which in the face of the competition from other providers such as Virgin Media, Sky, TalkTalk and others has to be seen as impressive. BT Retail had some 166,000 net additions in the quarter (63% of the total new broadband connections) and this took the company past the six million broadband customer milestone.

Vodafone raised its profit outlook for the full year, despite posting an 11% drop in first-half net profit, hurt by higher costs and tax as well as another impairment charge on its operations in Greece.

Eastman Kodak has warned it must raise new funds to survive the next year. The 131-year old photography firm said it may raise the cash through patent sales or by taking on additional debt after it ran up a \$222 million operating loss over the preceding three months. Analysts have continued to report that Kodak has taken too long to move from its traditional film business into digital cameras.

Shares in daily deals site **Groupon** jumped by nearly 50% on the company's first day of trading in New York. The company said it had sold 35 million shares for \$20 each. This represented only about 5% of the company and raised \$700 million.

Other news

Lufthansa has said it is selling **British Midland (BMI)** to **International Airlines Group (IAG)**, which owns British Airways and Iberia.

Rolls-Royce is selling its share in the International Aero Engines (IAE) joint venture to **Pratt & Whitney**. Rolls-Royce owns 32.5% of IAE, which makes engines for the Airbus A320.

The hits keep coming for private equity firms, as **Kohlberg Kravis Roberts** can attest. The private equity giant said that it lost \$622 million in its third quarter as it marked down the value of its portfolio companies low enough to reverse some of its performance fees. During the same time last year the firm earned \$270 million.

Feature - Investment opportunities arising from a growing population

Following the news that the seven billionth person has recently been born it is worth considering the investment opportunities arising from a growing population.

Population growth is fastest in lower income countries. This is due to a combination of a high birth rate and an improving life expectancy. In these countries food makes up a very large proportion of overall spending - over a third in China and 47% in India for example.

As GDP per Capita rises, so does spending on food - more meat, fish, cereals, dairy products, fruit vegetable and palm oils etc. Year by year the demand increases as the average calorie intake per person rises.

To capture this secular growth we have bought the **Sarasin AgriSar** fund for clients. This fund invests across the food and agricultural value chain in companies leading the way to meeting demand growth: from farmers in the Black Earth region and North American fertiliser producers, to global soft commodity traders and African retailers.

Although population growth is often seen as an emerging world phenomenon in terms of investment there are also opportunities arising in the developed world, arising from an ageing population. To capitalise on this theme we invest in the **Worldwide Healthcare** and **Polar Capital Global Healthcare** Investment Trusts.

Another interesting investment opportunity is the increasing demand for infrastructure - this theme stretches across both emerging and developed markets. Energy projects, utilities, transport links, schools and hospitals are all in demand due to an expanding population. Our preferred investment choice in this sector is **3i Infrastructure**, which has exposure to developed markets and India, as well as offering a 5% dividend yield.



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