thesis
asset management

Thesis Asset Allocation

September 2011

Stock selection delivers outperformance in July

The attribution analysis on our Balanced model shows that our asset allocation returns for July were in line with the APCIMS Balanced Portfolio. Our underweight allocations to the UK and other developed equity markets and our overweight emerging markets weighting gave a net gain of 25bp. The thematic equity weightings were broadly in line with the benchmark, with a 9bp underperformance from the alternative energy area offset by positive contributions from the other themes. Our fixed interest allocations lost us 23bp, as gilts performed very strongly as a safe-haven asset and credit spreads widened resulting in lower gains for corporate bonds. In the alternative assets space, infrastructure cost us 15bp, and gold added 12bp.

Our stock and fund selection gained us 58bp, as the trend we highlighted previously reversed and many active managers beat their benchmark indices. Overall the model's capital return was -0.87%, against -1.45% for the APCIMS portfolio.

Debt concerns lead to lower growth and earnings estimates

The uncertainty over the sustainability of sovereign debts in the US and the Eurozone, which was building through July during negotiations over the US federal debt ceiling, reached a crescendo at the start of August. Appetite for risky assets diminished, as it became clear that deleveraging in the public and household sectors is likely to result in lower growth. In this environment corporate earnings will be lower than previously estimated, and we believe that equity markets will be range-bound around current levels, with a new trading range having been established for the FTSE from 4,800 to around 5,500.

Although equities are unquestionably better value than they were two months ago, we would advise caution. Market sentiment is currently very sensitive to events, and with trading volumes having generally been relatively thin we could see further movements if institutional investors return from their summer holidays and start repositioning their portfolios. Should the 4,800 level on the FTSE be breached then there is very little technical support above 4,000.

Risk reductions across all models

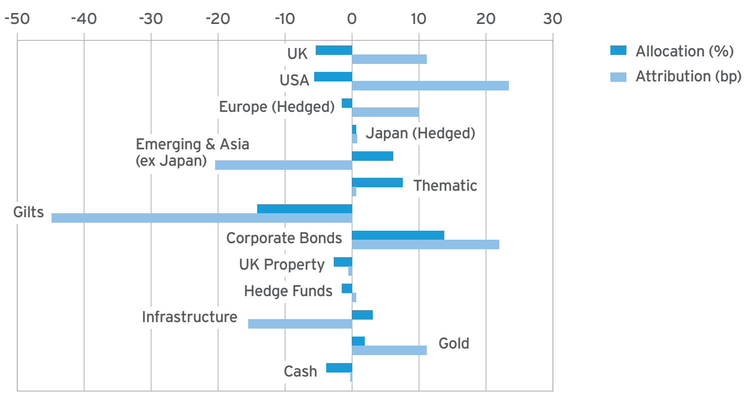
To position portfolios for these changed conditions we have reduced the *ex ante* level of risk in each of our models by a tenth (as measured by 3 year standard deviations.) The reductions are focused in areas that we believe have the greatest potential to under-perform in a period of deleveraging where developed economies will struggle to grow. We are not rushing to the exit for existing holders, but will look to sell into any period of market strength that allows us to achieve a price towards the upper end of our perception of the current trading range for the asset class.

- UK smaller companies have performed strongly over the last two years, and held up reasonably well during the recent correction. Small cap stocks will generally have less pricing power and less diversified revenue, and so are more vulnerable to under-performance during an economic slow-down than their larger cousins, and so this seems an appropriate time to take gains. Their restricted liquidity also potentially leads to large price movements if many investors decide to exit the sector.
- Slower economic growth is likely to reduce the impetus towards higher spending on environmental technology, so we are removing this theme from the models. Many of the companies in this area are small, and so are vulnerable from that point of view also.
- The balance of the reductions has come from the geographical allocations to developed market equities. Debt levels are likely to result in a headwind for growth in the US, Europe and Japan, and we prefer being overweight in emerging markets, where demographics and debt levels are more favourable.

The proceeds from these reductions are being held as cash with a view to offering some insulation to portfolios through any further falls, and providing funds to increase equity weightings when we reach the lower end of our trading range. This is likely to be via a highly liquid instrument such as an ETF or structured product to allow us to react quickly to further market movements and developments.

In addition to the changes in our equity allocations, concerns over corporate earnings has led our Fixed Interest Committee to recommended a reduction in high yield bonds to not more than 15% of the fixed interest component of any portfolio. The proceeds of any reductions here are being reinvested in investment grade corporate bonds.

Thesis balanced model compared to APCIMS



CONTINUED ON p2

This Month's Asset Allocation written by:

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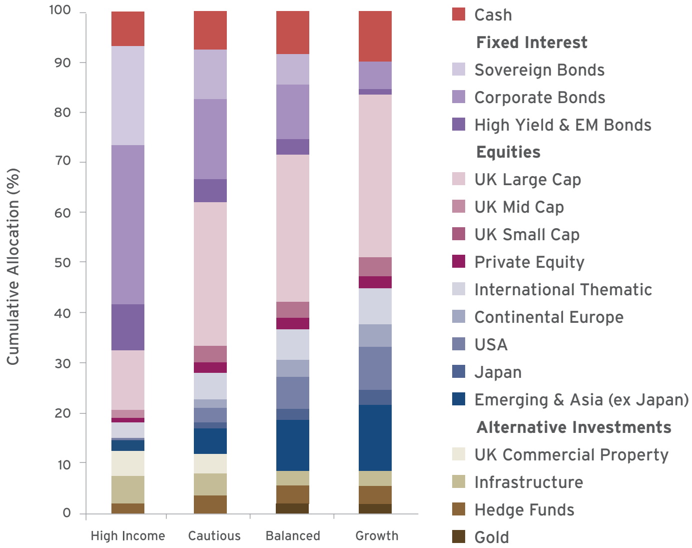
Current allocations

Following these changes our model weightings are as follows:

% Allocation	High Income	Cautious	Balanced	Growth
Equity				
Large Cap	12.05	28.54	29.47	32.55
Mid Cap	1.4	3.31	3.38	3.72
Small Cap	-	-	-	-
Private Equity	0.89	2.11	2.18	2.41
Total UK	**14.34**	**33.96**	**35.02**	**38.68**
Alternative Energy	-	-	-	-
Agriculture and Food Production	2	2.5	3	4
Pharmaceuticals and Biotechnology	0.6	1.41	1.46	1.61
Technology	0.6	1.41	1.46	1.61
Total International thematic	**3.2**	**5.32**	**5.92**	**7.22**
Continental Europe	0.13	1.6	3.33	4.38
US	0.25	3	6.35	8.58
Japan	0.1	1.12	2.38	3.14
Emerging & Asia (ex Jpn)	1.98	5	10	13
Total Equity	**20**	**50**	**63**	**75**
Alternative Assets				
UK Commercial Property	5	4	-	-
Infrastructure	5.5	4.4	3	3
Gold	-	-	2	2
Hedge Funds	2	3.5	3.5	3.5
Total Alternative Assets	**12.5**	**11.9**	**8.5**	**8.5**
Fixed Interest				
Sovereign Bonds	20	10	6	-
Corporate Bonds	31.72	16.1	11	5.52
High Yield & EM Bonds	9.13	4.6	3	0.98
Total Fixed Interest	**60.85**	**30.7**	**20**	**6.5**
Total Cash /Trading Liquidity	**6.65**	**7.4**	**8.5**	**10**

Current allocations in our model portfolios



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