thesis
asset management

# Thesis Market Commentary

## January 2012

**"The pushmi-pullyu is a gazelle-unicorn cross which has two heads at opposite ends of its body. When it tries to move, both heads try to go in opposite directions".**

Dr Dolittle

### This Month


- A 2011 Review
- Market News


Setting aside the Japanese earthquake and Middle East 'revolution', 2011 still proved to be a generally bad year for forecasters. Like the mythical pushmi-pullyu, the bulls and bears - at least until the summer - maintained their conviction at either end of the spectrum. Maintaining high cash balances (as we did in the second half) was a test of nerves for asset managers given the negligible interest rates on offer. Perhaps this explains why, for example, only around a quarter of active large cap managers in the US outperformed their benchmark (according to Merrill Lynch).

However fair play to the economists (whom I like to dub the Victor Meldrews of the City). Often vilified for tending to focus on the - actual or potentially - negative aspects of economic data and political or financial issues, it was a foolhardy asset manager who, last year, ignored all the many warnings.

The net result was another year of high volatility, or to coin the latest well-worn phrase, "risk on, risk off". I suggested last January that "...as the various scenarios play out most market scribes will revise their predictions at least once, and probably considerably more, before the end of the year". Given the uncertainties as to how the Eurozone crisis would be dealt with, then - for equities in particular - this was probably the easiest prediction to make!

So, how did all this play out in terms of our own forecasts, and what was the impact on clients' portfolios? Next month, thanks to our membership of ARC (Asset Risk Consultants), I hope to show how our four most common portfolio mandates have performed within our peer group. As a prelude to this I have looked back at the main forecasts we made in 2011 and compared them with what actually happened. Bear in mind that our strategy was consistently precautionary, ie. focusing on capital preservation rather than appreciation.

### Fixed Interest

As background the consensus was generally bearish on gilts and expected interest rates to start rising in Q2.

**Interest rates:**
**Our forecast -** we see little if any change in UK interest rates.

**Result -** base rates remain at 0.5%

**Gilts:**
**Our forecast -** best value at the long end of maturities, prices to drift in the first half of the year and pick up in the second half, index-linked expensive if inflation falls below 3.5%.

**Result -** the FTSE Gilts All-Stocks index rose by 11.5% (long dated by considerably more), most of the rise coming in H2. Conventionals outperformed index-linked but inflation remained stubbornly high. We banked part of clients' profits in Q4 switching to an HSBC structured note.

**Corporate Bonds:**
**Our forecast -** cautious on High Yield, looking to sell into any further excessive rallies. Expect modest upside in Investment Grade bonds with most of the return being yield.

**Result -** high Yield bonds index falls 11% (in capital only terms), Investment Grade bonds index virtually unchanged (down 0.6% but up 5.4% including income). High Yield, unfortunately, never hit the selling levels we were looking for and we revised these down in Q4.

### Equities

**Our forecast -** positive on Emerging Markets (overweight), which we expected to outperform developed markets, UK our preferred developed market. Neutral on US (underweight, no significant upside), whilst Europe and Japan (both heavily underweight) likely to be the most volatile – currency risk on both hedged out.

**Result -** emerging Markets down nearly 21%, UK (FTSE100) 5.5% lower, US (S&P500) no change, Europe down 18% and Japan 17%. Euro falls 2.5% but Japanese yen rises nearly 6% (safe haven status!). In Q1 we increased US exposure (on improved data) at the expense of Emerging Markets (short term sensitivity to general risk aversion).

### Alternative Assets

**Our forecast** - maintain our Gold weightings, 10% upside likely. No change in commercial property values expected but still positive on infrastructure.

**Result** - gold price rises by 10%, commercial property up 2% and the infrastructure index down nearly 3% (of our two high yielding infrastructure investments, one gained just under 4%, the other recorded no change). We banked part of clients' gold profits at the end of Q2 on concerns of a short term speculative bubble (at around 4% below the year end level).

Overall there were no major changes to our strategy, only cosmetic tweaks. The next section of our commentary focuses on our views for this year, but I will close on an interesting statistic announced last week. Despite the latest business confidence reading matching its post-recession low, the UK PMI figures beat most forecasts in all three underlying areas (manufacturing, construction and services) - and it was the services sector (75% of GDP) which outperformed by the biggest margin. And guess which bête noire (and current hate target of politicians and the media) is by far the largest sub-component (and 29% of GDP)? Yes, financials! So maybe the golden goose won't be killed after all, even though it has hatched more than its fair share of bad eggs.

**Michael Lally**
**Investment Manager**

Email Michael with any feedback:
michael.lally@thesis-plc.com

# Market News

Looking ahead with one's crystal ball is always popular at this time of year but predicting the future is fraught with difficulty and even the best City analysts are renowned for adjusting their year-end targets for markets, usually in or around September.

So whilst short term market directional predictions are tricky, looking at longer term investment themes is perhaps an easier option, although more patience than anticipated is often required. Some may come good in the subsequent twelve months, others may take more time or simply vanish completely due to changing circumstances. All of us involved in selecting investments can think of multiple examples of all of these situations, although we are naturally programmed to remember the winners rather than the losers!

## Investments that may come good in the next twelve months

At a time of turmoil in the Western world, with low growth and spiralling debts, there remains hope for the future of global growth and the world's ongoing development in the form of **emerging markets**. In the so-called developing world, there is a new industrial revolution taking place and there are a number of ways of accessing the growth of emerging markets.

The first option, often overlooked, is via shares of leading UK listed companies. Businesses like **Vodafone, Unilever, Rio Tinto** and **BHP Billiton** (to name a few) are all benefiting from emerging market economic growth and are strategically focused on developing within these countries. The mining sector in particular is now looking attractive again from a valuation perspective with decent dividend yields on offer.

The second more commonly used option for emerging markets exposure is through the use of funds, of which there is a wide range of types. At Thesis we like a number of funds managed by the First State Emerging Markets team, one of which is the **Pacific Assets** investment trust, and the **Lazard Emerging Markets fund** is also a core holding. We generally prefer to use broadly-based regional funds, as opposed to single country funds, which can be highly volatile. During difficult periods for investors, emerging markets can be far more precarious than developed markets, as we have seen recently. However, they tend to recover faster when stockmarket conditions improve. Perhaps 2012 could be their time again...

Comparative Index performance

| Indices | Value as at 31/12/11 | % Change on Month | % Change on Year |
|---|---|---|---|
| FTSE 100 Share | 5572.28 | 1.21% | -5.55% |
| FTSE All Share | 2857.88 | 0.78% | -6.69% |
| Dow Jones | 12217.56 | 1.43% | 5.53% |
| Euro Stoxx 50 EUR | 2316.55 | -0.60% | -17.05% |
| Nikkei 225 | 8455.35 | 0.25% | -17.34% |
| FTSE A British Government All Stocks | 173.57 | 1.69% | 10.99% |
| Sterling/US$ | 1.5543 | -1.03% | -0.44% |
| Sterling/Euro | 1.1987 | 2.65% | 2.77% |

Although still relatively unknown, infrastructure funds are gaining popularity, not only due to government initiatives but also because they offer investors a good dividend with an income stream that is often inflation-linked. The number of listed funds on the London Stock Exchange is currently in the process of being doubled and this trend is likely to continue as new projects will require more private funding in the future. The **3i Infrastructure** investment trust also offers investors some exposure to India and is our preferred pick in the sector, along with **International Public Partnerships**.

Quality defensive Blue Chips with decent yields and the IMA equity income sector, which focuses on these types of stocks, could see a return to form next year, similar to the period enjoyed between 2003 and 2006, where equity income typically outperformed growth funds. Unfortunately, the focus on yield led to overweight positions in banks and financials in 2008 and these funds suffered accordingly. However, the make-up of these funds now is quite different and in some cases, like the **Artemis Income fund**, the projected yield is a mouth-watering 5%. In addition, utilities, like **National Grid, Drax** and **Property REITs,** such as **Land Securities** all look solid bets for 2012.

## Opportunities that could come good in 2012 but in reality could take a bit longer

At Thesis we like specialist engineering companies such as **IMI, Melrose** and **Weir** Group. Highly skilled technical design and engineering services are areas of expertise that we can still offer the world, and although the sector is relatively small, we have high hopes for its expansion and we can perhaps export our way out of trouble. This is an exciting long term story, which is finding favour with value investors as stocks look cheap, yet also offer investors real potential for growth - Weir's recent acquisition of a US company, Seaboard, is a good example of strategic expansion.

The private equity investment trust sector had a tale of two halves in 2011. In the first six months we saw a stunning recovery and then as risk appetites waned in July, these funds sold off heavily. Currently there are some excellent discounts on offer in funds that have many solid investments, with decent underlying profitability. **Electra** and **HgCapital** investment trusts are our preferred vehicles in this space. However, market confidence will be critical for this sector, particularly if Eurozone worries continue.

## Possible vanishing tricks

**Life Settlement** funds have shown us all recently how something that is 'flavour of the month' today can be shot down in flames tomorrow, albeit that the problems here are FSA induced.

The world of government bond rankings and credibility has been turned upside down in 2011 and bizarrely Standard & Poor's recent Eurozone action further elevated an unlikely winner – the UK (see table showing performance of **Gilts**). The UK is now the only major government bond market in the world to have a triple-A rating with an accompanying stable outlook from Moody's, S&P and Fitch – but how long can this continue?

Don't be surprised if we lose yet more UK household names in the retail space, with **Blacks Leisure** and **La Senza** already under the cosh. Another Euro bank, or two, could easily disappear from view.

If cost and performance issues loom larger as the FSA's Retail Distribution Review implementation date approaches, absolute return funds, particularly funds of hedge funds are likely to come under increasing pressure from advisers and their clients. If recent trends continue we could see further fund wind-ups and consolidation.

Whatever 2012 eventually brings, it is certainly bound to be full of surprises...

**Giles Marriage**
**Investment Manager**

Email Giles with any feedback:
giles.marriage@thesis-plc.com

This update is for information only and is not an invitation to engage in investment activity.

Thesis Asset Management is authorised and regulated by the Financial Services Authority. Investors should be aware that the value of their investments and the income from them can fall as well as rise and investors may not receive back the full amount they invest. Past performance is not necessarily a guide to future performance. Investments denominated in foreign currencies are subject to fluctuations in exchange rates which can be favourable or unfavourable.