

Thesis Market Update

September 2011

The worst weather in August for some 20 years also coincided with a turbulent month in the markets, wiping out much of the progress made over the last year.

Not only was the weather bad...

At one point the UK stockmarket was down 13.9%, so to recover half of this fall towards the end of the month was actually relatively respectable. As always, markets go up and down and the level of volatility rises and falls - such is the nature of the beast. We have been bombarded by the US downgrade, the on-going Eurozone crisis and fears of a double-dip recession have all served to dent confidence. In respect of the latter, there is a definite danger that in the West, we do talk ourselves into another recession. Markets have a habit of looking ahead and fearing the worst. We are naturally concerned but sluggish growth seems more probable at present than a full blown recession and a return to the dark days of 2008.

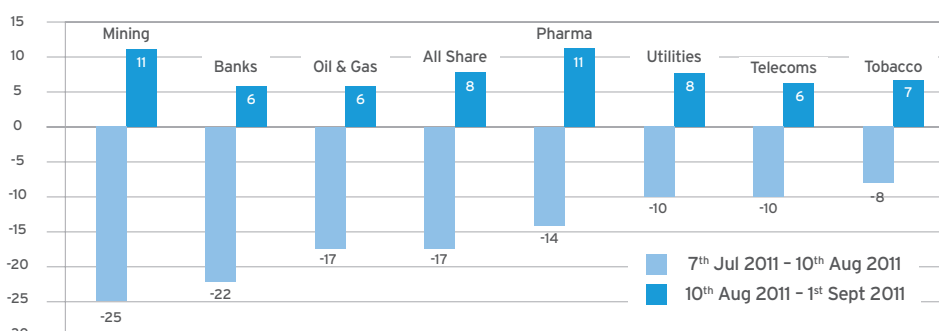
Even allowing for overly optimistic earnings numbers, equities are not expensive against historical trends. The key question is how much cheaper they may get in the short term. Whilst gilts and corporate bonds may remain steady based on low growth and low interest rates, it is difficult to get widely enthusiastic for these, particularly given the current inflation figures. Gold, on the other hand, has hit all-time highs as its safe haven status continues to gain popularity. Looking ahead, it's going to be an interesting few months as market participants return to their desks and focus on the future.

Finally, the interesting graph below shows sector performances during the falls of July and August and the subsequent rally in late August - an example perhaps of what goes down always comes up!

Comparative Index performance ▼

Indices	Value as at 31/08/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5394.53	-7.23%	-8.57%	3.24%
FTSE All Share	2800.51	-7.45%	-8.57%	3.85%
Dow Jones	11613.53	-4.36%	0.31%	15.96%
Euro Stoxx 50 EUR	2302.08	-13.79%	-17.57%	-12.23%
Nikkei 225	8955.2	-8.93%	-12.45%	1.49%
FTSE A British Government All Stocks	161.15	0.44%	3.05%	-0.54%
Sterling/US\$	1.625	-1.07%	4.09%	5.88%
Sterling/Euro	1.131	-0.88%	-3.03%	-6.57%

Absolute sector performance (% change) ▼



This Month

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- Insuring against financial failure



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Market News

Oils

The Falklands Islands oil explorer **Rockhopper Exploration** has more than doubled its oil estimates on its Sea Lion well to as much as 1.2 billion barrels.

Tullow Oil doubled its dividend and reported a staggering 312% jump in first-half profits before tax. The earnings came in slightly ahead of consensus and were driven by higher production and high oil prices.

Miners

BHP Billiton reported a record second-half profit driven largely by iron ore but just missed market forecasts and sounded a warning over costs and longer-term demand. However, the global miner sought to appease investors with a big hike in its dividend.

BHP Billiton has also agreed to buy a company providing mining contracting services to its Western Australian iron operations from **Leighton Holdings**, in a move towards a cheaper 'owner-operator' model.

Chilean copper miner **Antofagasta** doubled its half-year dividend after a 54% jump in earnings, confident that strong demand in China and a pickup in Japan and the United States would help underpin volatile copper prices.

Rio Tinto is raising its stake in **Ivanhoe Mines** by a further 2% (to 48.5%) by exercising its right to acquire shares in the exploration company led by well-known mining financier Robert Friedland.

Rio Tinto and the **Mitsubishi Corporation** have also raised their offer to acquire all of **Coal and Allied Industries** to roughly \$131 a share, from \$128, in a deal that values Coal and Allied at around \$11.6 billion.

Commodities trader **Glencore** met forecasts with a 50% rise in first-half profits thanks to rising commodity prices and rosy oil trading conditions in the first months of the year, and said it remained optimistic on global growth. Glencore is also moving to acquire complete ownership of **Minara Resources** in a deal that values the Australian nickel producer at \$1.07 billion.

Randgold reported a 253% jump in profits to a record \$128.4 million from \$36.4 million in the same quarter last year, as production almost doubled to 184,711 ounces due to contributions from its new Tongon and Goukoto mines.

Retail

Tesco is bidding 'sayonara' to its 'unscalable' Japanese business - announcing that it intends to sell off this division after eight years trying to break into the market. The firm owns 129 small stores in the Greater Tokyo area, only half of which are profitable.

Technology Media & Telecoms (TMT)

Autonomy, the UK's largest software company, is being bought by **Hewlett-Packard** with an enterprise value of \$11 billion; the US tech group will also spin off its personal computer business and discontinue its TouchPad tablet in a major reshaping of the company.

WPP, the world's largest advertising group, said like-for-like sales were up 6.1% in the first half of the year, in line with its recently upgraded annual forecast of at least 6% growth.

Other news

Axis-Shield, the Scotland-based diagnostics group, has stood firm against a takeover bid from **Alere**, its US rival, as it reported a 10% rise in turnover for the first half of the year.

The distribution company **Bunzl** has said it has more than £300 million available to expand into new territories through acquisitions.

Evolution Group agreed the purchase of the UK private investment management business of **BNP Paribas Wealth Management**, shortly before itself becoming a bid target of **Investec**.

Aegon has confirmed the sale of its Guardian UK life and pensions company to private equity group **Cinvenfor** for £275 million, whilst the asset management division has been renamed **Kames Capital**.

Manchester United is reportedly preparing to sell shares in an initial public offering on the Singapore Exchange later this year and is hoping to raise about \$1 billion. Elsewhere in footy land, Tony Fernandes, the Malaysian entrepreneur, completed his takeover of **Queens Park Rangers**.

In a bid to fend off a hostile takeover attempt by **SABMiller**, the Australian brewer **Fosters** said that it would return at least \$525 million to investors, potentially through a share buyback.

Unilever has agreed to sell several hair care brands to satisfy the United States Justice Department's conditions on the company's \$3.7 billion acquisition of **Alberto Culver**. The company has also sold its Chicken Tonight and Ragu brands in the UK and Ireland, almost a year after putting the cooking sauces on the block.

Thesis Market Commentary

As Giles referenced earlier in his summary of the past month, markets continue to be rattled by gloomy prospects for certain countries around the world. In a special feature Michael Lally enlightens us on the murky world of insuring against financial failure.

"Cost of insuring RBS, Lloyds against default at new high"

Daily Telegraph headline 6th September 2011

Insuring against failure

I'm thinking of changing my car which, like me, is beginning to show its age and consequently requires more intensive servicing and expensive replacement parts. As I have a preference for older V8 or V12 powered dinosaurs, then, in addition to the obligatory insurance and road tax, I could of course also mitigate against unforeseen mechanical or other failure by taking out a warranty. For a German 'panzerwagen' I probably wouldn't bother, but for an Italian 'diva' then, as also for their sovereign bonds, it would be reckless not to insure.

In the stockmarket it is also possible to insure against failure, of the financial variety - usually the default of a borrower - by means of a Credit Default Swap (CDS). Given the high profile these instruments have been accorded in the media this year, and in particular the widespread assumption that they are accurate barometers of both corporate and sovereign financial health, then a closer examination is, I believe, merited.

History

Not surprisingly the origins can be traced to early in the latest credit boom. As banks pursued an adventurous lending policy, fuelling the seeds of a global explosion in credit, some clever wag at JP Morgan thought it might be a good idea to protect themselves against some of their largest corporate loans. Their client, oil monolith Exxon, was facing a potential \$5 billion in punitive damages for the Exxon

Valdez oil spill - and the bank had extended a \$4.8 billion credit line! So they sold the credit risk from the credit line (to the European Bank of Reconstruction and Development). The clever part is that this also enabled them to beef up their balance sheet by removing the reserves required to hold against Exxon's default.

With banks focusing on the benefits of freeing up more regulatory capital (and in many cases using this to lend even more recklessly) then the CDS market grew dramatically - to \$300 billion in 1998 and \$62.2 trillion by late 2007. The value halved as a result of payouts following the 2008 credit crisis then more than doubled. It took 10 years before a semblance of regulatory control was introduced - before this they were largely unregulated, being treated as private agreements because they weren't traded on any exchange.

The first big test was the series of bank failures in the US in 2008. Lehman Brothers, for example, collapsed owing \$400 billion. However, the net amount that changed hands was around \$7.2 billion. This difference is due to the process of 'netting'. Market participants co-operated so that CDS sellers were allowed to deduct from their payouts the inbound funds due to them from their hedging positions. Dealers generally attempt to remain risk-neutral, so that their losses and gains after big events offset each other. It did however necessitate the Fed bailing out American International Group (AIG) because it had been excessively selling CDS protection without hedging against the possibility that the reference entities might decline in value, exposing the insurance giant to potential losses over \$100 billion. The CDS on Lehman were settled smoothly, as was largely the case for the other 11 credit events occurring in 2008 that triggered payouts.

Nowadays one can buy CDS on a whole company, not just an individual loan or bond, also market indices or a package of debts. The latter are known as collateralized debt obligations (CDOs). These synthetic structures provide credit exposure to a portfolio of fixed income assets without owning those assets and it was their proliferation - in particular of packaged 'toxic' mortgage debt - that triggered the 2008 credit crisis.

How do they work?

Originally, like any insurance policy, a bank would insure against a potential non-performing loan by paying a monthly premium to an insurance company. With a CDS instead of a 'premium' the payment is called 'spread'. The person wanting 'protection' against credit default pays a monthly or quarterly spread to whoever is willing to take the money and assume the risk of having to pay when the loan defaults. All European CDS are issued using the 'master agreement' issued by the International Swaps and Derivatives Association (ISDA), a trade association of the entire world's leading investment banks and investors in so-called OTC (over-the-counter) derivatives.

Generally, this involves an exchange or 'swap' of the defaulted loan instrument (and with it the right to recover the default loan at some later time) for immediate money - usually the face value of the loan.

The cost of this insurance is measured in basis points, or hundredths of a one percent. For example, a credit default swap trading at 100 basis points would imply an annual cost to insure £10 million worth of bonds of £100,000. Typical duration is 5 years (same as my cars!) but can be from 1-10 years.

Naked and physical swaps

This sounds like the title of a Barbara Cartland novel but is in fact a key reason behind the phenomenal growth in the CDS market. A buyer of a physical swap actually holds the debt instrument (eg. a loan certificate) and in the event of default delivers this up and receives the full par value. However, a cash (aka naked) buyer doesn't hold any physical debt instrument and therefore, in the event of default, will receive the difference between full par value and the market price of the debt obligation of the reference entity. For example, a hedge fund buys £10 million of protection from a bank on the senior debt of a company. This company has now defaulted and its senior bonds are now trading at 25 (ie. 25p in the pound) being the market's expectation of what bondholders will eventually receive. Therefore, the bank must pay the hedge fund £7.5 million (ie. 100%-25%).

Thesis Market Commentary

Potential pitfalls

Self-fulfilling prophecies: It could be argued that the proliferation of CDS have actually caused or accelerated the demise of corporate and sovereign entities. In the days and weeks leading up to Bear Stearns' collapse, the bank's CDS spread widened dramatically, indicating a surge of buyers taking out protection on the bank. It has been suggested that this widening was responsible for the perception that Bear Stearns was vulnerable and therefore restricted its access to wholesale capital, which eventually led to its forced sale to JP Morgan. More recently, many politicians feared that speculators were making the Greek crisis worse although some suggest that without CDS, Greece's borrowing costs would be much higher.

Systematic risk: As the majority of transactions are 'naked' - and also speculative - consequently the amount of CDS issuance is significantly higher than the value of the debt being insured. For example, at the time it filed for bankruptcy, Lehman Brothers had approximately \$155 billion of outstanding debt but around \$400 billion notional value of CDS contracts had been written that referenced this debt. Because naked credit default swaps are synthetic, there is no limit to how many can be sold; therefore risk of default is magnified leading to concerns about systemic risk.

Transparency: Unlike the listing of securities on the stockmarket, the seller of a CDS has no obligation to disclose material facts about their financial position. Sellers can hedge their exposure by buying CDS from another company (usually a bank or insurance company) but the buyer has no knowledge of the various counterparties in the 'chain', hence if the reference entity (ie. the borrower against whom the product is sold) defaults, and one of the companies in the chain also fails, this would create a domino effect of losses.

Who can buy them?

Before you get your cheque books out I should point out that CDS are not retail transactions and most CDSs are in the \$10-20 million range. Or you could buy one of the specialist 'Distressed Debt' funds, or hedge funds, which trawl the bottom of the credit ladder buying bonds and CDS of defaulting companies at nominal prices usually with a view to trading out before liquidation.

Tighter regulations are urgently needed given the current fragile state of the financial sector. In simple terms, would you feel comfortable if your psychopathic next door neighbour, with whom you've had a longstanding border dispute, told you that he has just taken out fire insurance on your house?

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

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