Keeping it Simple

# PanVIEW

Evercore Pan-Asset's Global Asset Allocation and Investment Review

2nd QUARTER 2011

www.pan-asset.co.uk

## Asset Allocation Overview John Redwood

The first quarter of 2011 was troubled. It began with markets in high spirits, looking forward to continued growth. Some were keen on Japan, expecting a recovery after many dull years. Generally commentators and investors preferred advanced country shares to emerging markets, which were felt to have done so well in 2009-10. Investors felt western interest rates would stay low for longer, the US would carry on with quantitative easing, whilst China, India, Brazil and the others would have to tighten money and slow things down to curb inflation.

The quarter was then hit by political waves of protest in the Middle East, and by the cruel tsunami in Japan. As the student and youthful protesters showed they could topple the Tunisian and Egyptian governments, and were prepared to try to wobble the oil producing states elsewhere in the Gulf, so the oil price rose. Some investors worried that there could be generalised chaos in the oil fields. Others just fretted about the likely impact on world inflation and output as the energy price went up quickly, heralding less consumption as people struggled to pay the petrol bill, and more monetary restriction as authorities fought inflation. The Japanese disaster led to a sudden sharp plunge in Japanese share prices, and some concerns about the impact it would have on the rest of the world's productive capacity. Crucial parts of the global supply chain were demolished by the flood or left with insufficient power by the impact of the water on the local nuclear power stations.

Towards the end of the quarter markets recovered sharply, as investors decided rates were still low in the West, growth would continue, and the riots and revolts did not seem to be undermining Saudi itself in the heart of the oil fields. The markets grew to live with the smouldering nuclear problems of Japan and the UN/Libyan war which broke out.

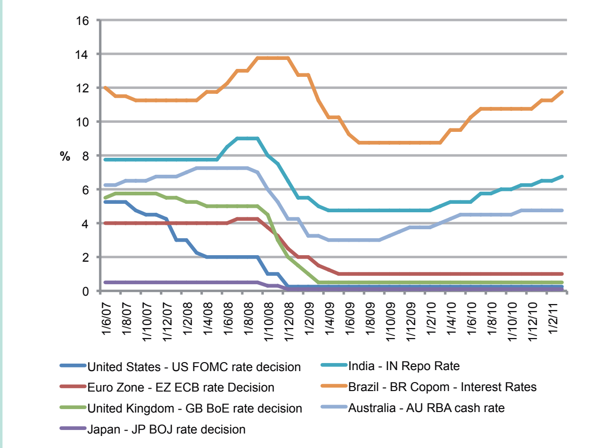
**Japanese Equity Market**


Source: Thomson Reuters

We moved most of our clients' money out of longer-dated corporate bonds. The combination of rising inflation, the resumption of growth in most parts of the world, and growing worries about sovereign debt risk and bank debt risks in some places make bonds unattractive. The emerging world is already well advanced with rising rates. We expect along with most forecasters the EU, US and UK to move interest rates up somewhat this year. We also fear more turbulence over sovereign debt in Euroland countries, and continued debates about whether bank bondholders should pay more bills for past banking losses. As interest rates rise bond prices tend to fall. We took our clients into much shorter-dated instruments or cash.

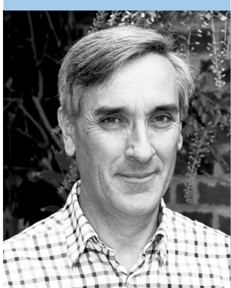
We continued to prefer property REITs around the advanced world. Although they had performed well in 2010, we expected more progress as they had suffered very badly in the Credit Crunch collapse of 2008. In the major business centres of the world empty space is being absorbed, rents are in many cases rising again and development activity has been hit by the shortage of money. We think China is good value, but will not make rapid share price progress until investors can see an end to the monetary tightening and confirmation that it has happened without plunging the economy into a downturn. We anticipate the Chinese authorities will curb inflation but manage to avoid overdoing the deflation, as they are well aware of social tensions which could arise if they fail to deliver reasonable growth, just as they know that rapid inflation also can destabilise their citizens.

**Interest Rates**




Source: Ned Davis/Thomson Reuters

We expect more difficulties in Euroland, with a Portuguese bail out likely to follow the Irish one. Although Germany has performed well recently, the peripheral Eurozone countries are in trouble. The policy mix of cutting spending, keeping the exchange rate high and raising taxes is not a winning combination. We expect to see the best of growth and market performance in the second quarter of this year, with worries about global slowdown increasing as the US and the EU turn to a tighter monetary policy.



**John Redwood** held senior investment roles at Robert Fleming and NM Rothschild in the 1970s and 1980s. Since, he has been a Pension Trustee, Investment Committee member for an Oxford College, Chairman of an investment company and a non-executive Director of a hedge fund and an Investment Trust. An early advocate of tracker funds, he has written extensively on economics and investment.

# Market and Investment Overview

Christopher Aldous

Investors' passion for emerging market equities cooled rapidly and unexpectedly at the beginning of 2011 – just after both Far East (ex Japan) and Emerging Market indices had reached recent highs. For a period of around six weeks there was instead a switch into developed markets, including Japan, which only abated around the time of the tragic earthquake and tsunami. Since then the emerging markets have started to outperform again. These big swings marked a difficult period during which investors came to terms with the fact that a period of easy returns driven by loose money and low inflation expectations was over. Instead they began discounting inflation by selling off bonds last November and then in January moved on to punish emerging market equities where inflationary problems were already well developed. More recently, some degree of calm has descended and there is a consensus that world growth is robust but inflation is becoming more of a problem and must be brought under control through higher interest rates.

This at least creates one certainty; bonds are unlikely to perform well during what could be an extended period of rising interest rates. We have long eschewed the debt of the over-borrowed western governments and invested instead in corporate bond ETFs. We have now moved the majority of this exposure to much shorter maturity investments with an average life of little over two years. Despite this, these ETFs yield over 3.5% which should help offset any capital loss caused by higher interest rates. Nevertheless, investing in lower risk portfolios is likely to be unrewarding for a while to come. In general, we think that 2011 will be a difficult year but have some core exposures in portfolios which we expect to generate returns over the longer term. These include Asia property ETFs, Chinese equity ETFs, timber ETFs, private equity ETFs and some Japanese equity ETFs.

| | Strategic View | Tactical View |
|---|---|---|
| **Economic Growth** | Up to 2007 there was strong economic growth based on globalisation, rapid technological progress, disinflation, moderate interest rates and the entry of populous China and India into the global economy. The Credit Crunch damaged this. These forces remain intact for the longer term in Asia and still have a long way to run. We foresee an increasingly Pacific-centric world economy, with Continental Europe in particular in relative decline. The large imbalances in the world economy need to be corrected and overall world growth will be slower over the next decade than it was in the debt-fuelled years to 2007. In particular, UK and US growth rates will be lower than in the past decades owing to the borrowing overhang. Our strategic view is firmly based on preferring investment in the faster growing areas of the world especially in Asia and in the commodity producing countries servicing their demand. | 2011 should see further good economic growth worldwide. However, markets could disappoint this year if China and India tighten monetary policy too far and damage performance of the leading economies. The US should enjoy good growth for this year, fuelled by the first half of quantitative easing, and by the favourable tax incentives, whilst the UK may experience some slowing of growth as high inflation hits living standards and as measures to curb the public sector deficit kick in, led by the VAT increase. Early rate rises have strengthened the Euro in Q1 however, Euroland is still in considerable difficulty and there may be a new phase in the Euro crisis in 2011 as EU authorities grapple with public defaults and broken banks. On the negative side, the US plans to end quantitative easing in June and interest rates worldwide are likely to rise. There is also the ongoing crisis in the Middle East which could spread to larger oil producers and drive up the oil price. |
| **Inflation** | Inflation has been relatively subdued over recent years. A rising world population, the movement of many more people from field to factory especially in Asia and the growing competitiveness of the new manufacturers have all helped keep inflation low. Digital technology has also worked to cut the prices of services and helped with cost reduction in manufacturing. In the first half of 2008 inflation did rise sharply, based on excessive credit and reflecting big increases in commodity prices. Western inflation rates have been cooled by the credit contraction that has happened since, and by the excess capacity around the world. The longer term outlook is for worldwide modest inflation, assuming the authorities rein in their monetary relaxations in good time as economies recover. | Indian inflation has been around 10%, and Chinese official inflation is at 5% and rising. Commodity prices, share prices, the price of well located property and the price of art, gold, fine wine and other precious items have all been surging over the last year. UK inflation has been particularly persistent, as we anticipated. Quantitative easing on a large scale helped drive down sterling, which led to substantial imported inflation. Tax increases, public sector charge increases, and margin rebuilding by companies have compounded the problem. The recent surge in oil prices has added to the inflationary worries. US inflation has been much more muted. Further political deterioration in the Middle East would worsen the short term outlook for inflation, but make a sharper slowdown more likely thereafter. |
| **Bonds** | The price of government bonds was driven higher in the Credit Crunch. Prices have been falling since, in countries where public finances are badly stretched and market confidence is lost. Government bond yields are low by historical standards due to a greater pre-disposition by portfolio investors to hold bonds, unprecedentedly large flows of trade surplus liquidity into bond markets and the wish of many investors to invest in higher quality assets. The Chinese have built large positions in US bonds. Over the longer term, equities are still likely to produce better returns as lending to governments borrowing large sums at 1-4% is unlikely to prove a good investment. The purchase programmes of the UK and US governments have kept yields lower than would otherwise be the case. | At the end of last year there was a sharp rise in bond yields in the US and Europe, including the UK, from the very low levels they reached last autumn. We continue to recommend no exposure to western sovereign debt, other than very short-term near cash instruments. Although yields have risen from their lows, they still do not discount the problems ahead in state finances in the US and Europe. High grade corporate bonds are backed by many companies with strong cash flows and improving profits. However, as interest rates rise generally even these bonds can be adversely affected. We have shortened the duration of bond portfolios to reduce risk against a background of rising rates. |

**Guy Davies** was Head of Charities at Barclays Wealth in London. After a commission in the Army he began his career in investment management at Barclays Private Bank in 1994, followed by roles as private client and charities Director at UBS Warburg, Lazard and Barings. He is a Trustee and Investment Committee member of the Army Benevolent Fund and Army Central Fund.

**Jane Bransgrove** worked as an investment manager at Sarasin Chiswell (formerly Cantrade) for over 13 years with responsibility for private clients, charities and investment strategy implementation. She is an Associate member of the CFA Society of the UK and holds a degree in Accounting and Financial Management from Loughborough University.

| | Strategic View | Tactical View |
|---|---|---|
| **Equities** | Western equities passed through a golden era for company profitability between 2003 and 2007 without enjoying a re-rating. In many cases they struggled to break decisively above their highs of seven years before. We are likely to experience further months of substantial share issues as companies rebuild their balance sheets. Markets are looking forward to higher profits and some dividend growth. Equity markets also face the problem that distressed investors in other asset classes can always replenish liquidity by sales of equities. Long-term we favour Chinese, Indian and Far East equities. We only like UK equities to the extent that they are a play on global businesses and recognise that some companies will enjoy a windfall from currency appreciation on their overseas businesses. On a 5 year view it is very likely that reflationary action will work and equities will benefit. However, returns on equities will be adversely affected by slower growth. | Entering 2011 investors preferred developed markets to emerging markets, but now some emerging markets are coming back into favour. We did not favour Japan across the turn of 2011, but following a sharp market fall due to the dreadful earthquake and tsunami, we now think there is more scope for recovery driven by investment in new homes, roads and infrastructure to rebuild the damaged areas. The UK looks good value, but the high exposure to banks and BP is risky. Consumer spending is going through a severe squeeze. UK banks still have to deal with further regulatory tightening. US shares may have further to rise as we are more optimistic about US growth this year, but China remains the cheapest prospect at 12 times earnings and with a yield of 2.5%. Our decision to sell Indian equities late last year still looks justifies as the market remains expensive and inflation remains out of control. Middle East protests and high food prices have weighed on other emerging markets. |
| **Property** | Property is a core, income-generating asset class that offers many attractions yet remains under-represented in most institutional and private investment portfolios around the world. The long-term outlook remains attractive based on economic growth translating into rising tenant demand, with capital values assisted in some territories by land shortages or planning delays. Many property markets had overheated by the middle of 2007 driven by investors' equity aversion in recent years and plentiful cheap credit. This will take time to work off. The long-term growth prospects for Asian economies underpins Asian commercial property and should be a feature of long term diversified portfolios. Real Estate Investment Trusts accessed via ETFs are our preferred way of investing in property, as they are liquid and transparent. | After big falls, the better quality commercial properties in the UK have rallied as investors seek bargains and relatively high yields. However there have been many voids, and downward pressure on rents. London is performing much better than the rest of the country. Central London rents are rising again and there is considerable buying interest in good property there. Outside London the public sector may have to shed space in the next five years whilst private sector demand is often weak. We have bought into REITs, preferring Asian property, as recovery is well underway in centres like Hong Kong, and US and Global property. These REITs are now performing well, discounting future rental and dividend growth. There is some evidence of slowing growth in Hong Kong property, but the trend of valuations remains upwards. |
| **Hedge Funds** | This sector went through a major shake-out and period of turbulence in difficult and volatile market conditions. Style and fund selection is therefore crucial. Heavy redemptions were experienced and coupled with market movements, cut the value of funds. Shortcomings in liquidity, transparency and regulation, allied to concerns about fees, levels of gearing and the absence of an income yield, continue to argue for avoiding hedge funds. | This year hedge funds have started better than in recent years, but the headwinds of high fees still limit gains you can make. We continue to avoid them but we will watch for the emergence of a better model in terms of fees and risk management. We expect many to conclude that the 2% plus 20% fee model can no longer be justified. We hear of deals taking at least one quarter off these fees. |
| **Commodities** | Rising demand in the developing world, physical shortages, long-term dollar decline and the emergence of a new pool of financial buyers are all likely to result in continuing longer term upward price pressure in many commodities. Towards the end of 2008 we saw a sharp correction as some of the speculative froth was squeezed out and underlying demand was affected by the economic slowdown. Longer term, the sharp cut-backs in capital investment which resulted from this correction are likely to result in constrained supplies and further upward pressure on prices. | Demand for industrial materials has been strong reflecting a cyclical upswing, inventory rebuilding and Chinese passion for stockpiling and acquiring control of more mineral deposits. There is also some speculative money in commodities. Soft commodities have jumped in recent months. Fears of defective harvests have allied to the propensity of the emerging market economies to consume more as diets change. Speculators have also come in to add to the price pressures and there are rumours of excessively large positions in the market. Reduced oil output from Libya and Middle East fears continue to keep the oil price high. |
| **Cash** | A better asset class than many assume, provided that real interest rates continue to be available by virtue of being used by policy-makers as a primary tool in containing inflation. Reserve diversification and a persistent trade deficit are likely to mean secular dollar weakness. Relative economic progress will result in persistent upward pressure on certain currencies in the developing world, notably the Chinese Renminbi. | Cash has been unattractive ever since interest rates were pushed down to the floor in the West. The major currencies of the world have been engaged in a dangerous race to the bottom to assist exports. China has been reluctant to allow revaluation of an undervalued Yuan. As bonds are no longer such an attractive alternative holding some cash could be a wise precaution. We expect traditional strong currencies like the Swiss franc to do well. Several emerging market currencies led by the Yuan are cheap. It is the current paradox that whilst returns on cash are very low, it may be a better option than holding bonds where there could be capital losses ahead. |

**Christopher Aldous** has been involved in wealth management since joining Cazenove in 1981. He has since been a Director of Barclays de Zoete Wedd, an Executive Director of UBS and a Managing Director of Robertson Stephens, the US technology investment bank. He co-founded Absolute Fund Management in 2001, where he managed a fund of hedge funds and was Chief Executive Officer until 2007.

**Evercore Pan-Asset believes in Keeping it Simple. We say, don't take the risk of individual stocks, buy the index. That way you can keep costs down and avoid taking too big a bet on a share which lets you down. Remember what you are trying to achieve and just pick the degree of risk and income you need. We can do the rest.**

**You cannot avoid having an asset allocation. Everyday markets trade a portfolio has to stand up to the market test. So why not have someone watching it every day, making changes when necessary? That's Big Picture Investing - concentrating on the decisions that make a real difference.**

# How stock lending can reduce overall investment costs

**The most important reason why charity or pension trustees might consider stock lending against their fund's investment portfolio is to reduce or offset entirely the investment management fees they would normally be charged and thereby improve overall returns.**

## What is Stock Lending?

Stock lending helps increase the liquidity of the securities market by allowing securities to be borrowed temporarily, reducing the potential for failed settlements. It takes place through the temporary transfer of securities by a lender to a borrower, with agreement by the borrower to return equivalent securities to the lender at a later date. The two participants in the transaction have different motivations; one is securities-driven and one cash-driven. The securities-driven participant seeks to borrow specific securities (equities or bonds), perhaps to facilitate their trading operations. Our clients are more likely to be cash-driven and seeking to increase the returns on an underlying portfolio or offset their investment management costs by taking in a fee for making investments in their funds available to a borrower.

## What sorts of securities can be used in stock lending?

Securities lending covers all sorts of securities including equities, government bonds and corporate debt obligations. There is an active and growing market in the lending of Exchange Traded Funds (ETFs).

## What are the legal underpinnings for stock lending?

Parties to a stock lending transaction generally operate under a legal agreement such as the Global Master Securities Lending Agreement that sets out the obligations of the borrower and lender. In securities lending the lender effectively retains all the benefits of ownership, other than the voting rights. The borrower can use the securities as required - perhaps by lending them on to another party - but is liable to the lender for all the benefits such as dividends, interest, or stock splits.

## Is stock lending safe?

Where clients wish to boost returns by stock lending, Evercore Pan-Asset, along with the custodian, ensures that all lending is fully collateralised, with over-collateralisation of up to 105% to protect against currency risk or equity price movements where lending is secured against equities. When bonds are lent the collateral is generally provided as cash, but where equities are lent, collateral may be taken in appropriate high quality equities, subject to the 'haircuts' mentioned above to ensure that the lending is over-collateralised. To keep the process simple and safe client collateral received is not 're-hypothecated' (itself lent out ).

## Can I get easy access to the stocks and bonds I lend?

We ensure that all stock loans are structured on an 'open basis'. This means that liquidity is managed to ensure a lender has instant access to their stock and that there is full right of recall at all times.

## Who are the major stock lenders?

Any significant investor can lend stock but normally it will be most appropriate for institutional investors holding investments on behalf of charities, pension funds, collective investment schemes and insurance portfolios, often using an agent such as a custodian to manage the mechanics of the process. Evercore Pan-Asset will only use Financial Services Authority (FSA) authorised and supervised counterparties when setting up stock lending arrangement for clients. They are expected to follow the provisions of the Stock Borrowing and Lending Code, produced by the Stock Lending and Borrowing Committee, a committee of market participants, chaired by the Bank of England.

## Voting rights

The voting rights of stock are transferred to a borrower in a stock lending transaction. However, Evercore Pan-Asset invests primarily in Exchange Traded Funds (ETFs) which are highly suitable for stock lending, but where voting rights are not important in the same way as they are for individual company shares.

## What are the tax consequences of stock lending?

For a gross or tax-exempt fund the proceeds of stock lending are normally treated like other investment income, but the tax position in relation to stock lending is complex and varies from country to country and between different types of investor. If in doubt those involved in stock lending should obtain professional advice from their tax specialist.

We hope that the brief description above gives a useful overview of how stock lending works and how it can be used to offset all or most of a fund's investment management fee. Although it may sound complicated, there is no additional work for trustees and we take care of all the paperwork and monitoring of stock positions. The full or over-collateralisation of the lending serves to protect the client's funds. If you would like to know more about reducing costs in this way please call **Christopher Aldous** or **Guy Davies** on **020 7398 5840**.



## About Evercore Pan-Asset

We are an independent firm providing asset allocation advice to pensions, charities, IFAs and private wealth. This can be on a stand-alone basis or as part of a low-cost integrated investment management service. We use Exchange Traded Funds (ETFs) extensively to implement our asset allocation views and our investment approach allows us to tailor bespoke solutions to match the needs of most investors. We also offer a range of low-cost, risk-profiled PanDYNAMIC Funds and Model Portfolios for smaller investors

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