

WHY INVEST LONG TERM IN A CRISIS ENVIRONMENT

**THE GLOBAL ECONOMY:
IRRESISTIBLE FORCE
MEETS IMMOVABLE
OBJECT**
GAVYN DAVIES

**THE CRISIS OF 2008:
ITS LONG-TERM IMPACT
ON WEALTH
MANAGEMENT**
JOHN AUTHERS

**A LONG-TERM
DIVERSIFIED PORTFOLIO
CONCEPT EVEN IN A
CRISIS ENVIRONMENT**
FRITZ BECKER

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A new service for our clients

N+1 manages specialised direct investments and provides financial advisory services to companies, institutions and family groups. In the course of these activities, we acquire significant know-how and develop high value added relationships with our clients, providers and competitors. A way in which this know-how can be extended to our clients is by producing and editing highly selective and specialised information in the form of “papers”. The goal of these papers is to go beyond the generalities commonly discussed of current market conditions and explore the causes and possible consequences of current trends and events. N+1 aims to position this new publication *N+1 Investment and Corporate Papers* halfway between financial research academic papers and the reports that are daily produced by financial institutions and agents and specialised press. Additionally, N+1 intends to offer an independent vision, without any commercial influence of any kind. Finally, we intend to feature and count with professionals who are highly recognised in the investment and financial industry.

This first issue of this new publication tries to provide answers to the numerous questions being currently raised in the investment arena. Under the title, *Why invest long term in a crisis environment*, three highly recognized global investment professionals offered their views in a seminar organised by N+1 last February. Following are their speeches and reflections.

Santiago Eguidazu

Summary

The current global economic crisis is unprecedented in many instances. The extent and the coordinated nature of the collapse in global activity have not been seen in the last decades. Consumer and business confidence are at the post Second World War level and there are signs that this downward process is not over yet. Additionally there are significant risks that this crisis deepens; (i) further extension of the “vicious circle” as households and corporations continue cutting spending and investment; (ii) strong inflation without economic growth and (iii) lack of demand for government debt as institutional and individual investors lose confidence on public sector ability to repay debt.

On the other hand, there are market factors and policy measures being implemented which effect is still uncertain. On the fiscal policy side, governments are implementing huge public spending and “stimulus” packages that are driving public sector deficits to the 8-11% region and public debt to GDP ratios to the 80-90% level. Second, aggressive expansive monetary policy measures are being adopted, with the US Federal Reserve being more active than the European Central Bank. However the issue is that there is no sign that the commercial banking sector is passing these improvements through to households and corporations. Finally, commodity prices have come down from their 2008 peak to more normalised levels which can add as much as 3% to countries’ GDPs.

The effect of this global economic crisis on investment markets has been likewise enormous. There has been an indiscriminate sell off of all asset classes as a result of the massive deleveraging process that has taken place in the past six months. The consequence of this crisis is that there will be a move to fundamental value analysis and low-levered investments. Additionally, there will be a preference for active management of investments.

By asset class, equities are still highly volatile and will remain so until there is a clearer picture on the outcome of the monetary and fiscal policies being adopted. Fixed income might be an interesting opportunity in the short term but it is more risky on the medium term in an inflationary scenario. Investing in real assets, such as infrastructure or clean energy can be an attractive opportunity as it will be in line with government investment plans. In private equity these are the times for opportunity and small and mid size specialized managers which can find opportunities in which there is fundamental value. Finally hedge funds will have to adapt to a credit-scarce environment.



THE GLOBAL ECONOMY: IRRESISTIBLE FORCE MEETS IMMOVABLE OBJECT

Gavyn Davies

Last year almost all financial markets became extremely coordinated, they all moved very similarly to each other according to the risk of recession and now fears of global depression. It seems most financial markets are going to respond badly or well to whether public policy succeeds in avoiding a global depression. The credit markets are certainly pricing in something worse than a normal recession, and the equity markets are beginning to do that as well, and so the private equity prices in the secondary markets and many other asset prices... Therefore, the key question that we have to face, in trying to produce a financial market strategy for the next 12 to 24 months, is whether the policy measures that are now being adopted are going to be sufficiently powerful and successful enough to correct the recessionary forces and produce a recovery in the global economy next year. Hence, I would like to focus on some elements of those questions, because I believe that they are critical to any analysis of financial markets for the period ahead. They come down to a series of sub-questions, prior questions:

The key question is whether the policy measures that are now being adopted are going to be sufficiently powerful and successful enough to correct the recessionary forces and produce a recovery in the global economy next year.

How severe are the recessionary shocks that are now hitting the system and to what extent are they becoming self-reinforcing?

Are the major governments and Central Banks likely to produce a coordinated response to those shocks, which is sufficient to address the recessionary forces?

What are the pitfalls and disadvantages going to be of what the governments and the Central Banks do? Will they in particular trigger either inflation or upward pressure on bond deals as an unintended consequence of the measures that are taken to fix the recession? And then finally: Will it work? So those are the issues that are going to be addressed in the next paragraphs.

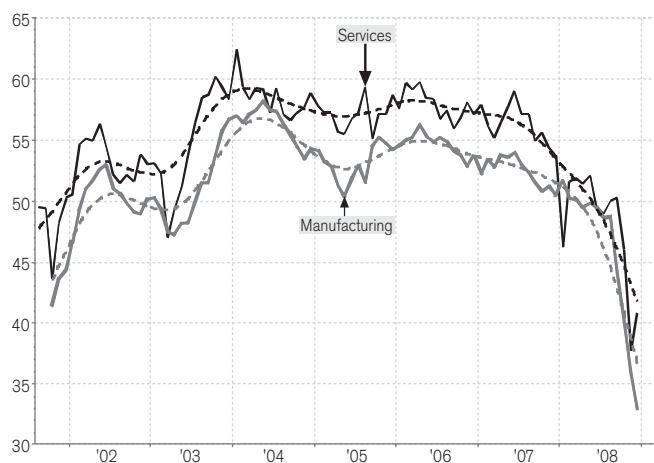
In terms of the downward pressure on the global economy, the extent and the coordinated nature of this collapse in the global activity is unprecedented. Economies are going to need help to stabilize.

In terms of the downward pressure on the global economy, we have never ever seen anything like what we have observed since last September 15th, when Lehman was allowed to go under. Probably, Lehman Brothers failure is going to be seen as a big mistake in policy making terms, although it should be admitted that some other mistake may well have happened if Lehman had not occurred, given the mess that the financial industry was in.

But as the chart shown below depicts, the extent and the coordinated nature of this collapse in global activity is pretty much unprecedented. It is worth noting that although the graph does not reflect January data, which has slightly improved (meaning that the pace of deterioration has slightly improved), the deterioration is still happening, and there is a lot of sentiment bound up in the graph so we should not really place too much weight on the improvement that we have seen.

We are now seeing the kind of readings for most economic data that we have only seen very rarely since the war: business and consumer confidence for the US going back to 1946 or 1948; survey of consumer confidence, is down where it went to in 1980 (previous low point for the series); manufacturing survey similarly is down towards the kind of levels that we have seen in the worst recession since the war, etc. Momentum is still negative and in GDP terms we have seen data that we have not seen in previous post-war downturns.

GLOBAL ECONOMIC ACTIVITY - PMI BUSINESS SURVEYS FOR DEVELOPED COUNTRIES



Source: Fulcrum Asset Management

The process is not over yet. While past data (where the economy has been growing in the last 13 weeks) evidences a contraction of about -3%, lead indicators (where the economy is going in the next 13 weeks) points towards a -7% rate. Until recently more forecasters had the US economy declining at about -5% in Q4 and around -4% or -5% in Q1, suggesting that the worst period for the downturn was the Q4. That is no longer believed. The US economy build up inventories in Q4 to an extent that was not expected, is likely to have to shed those invento-

ries in Q1 and Q2. So at the moment we are not seeing the bottom, in terms of negative growth rates in Q4 last year, we may see it in Q2, but probably the United States have not hit the bottom yet.

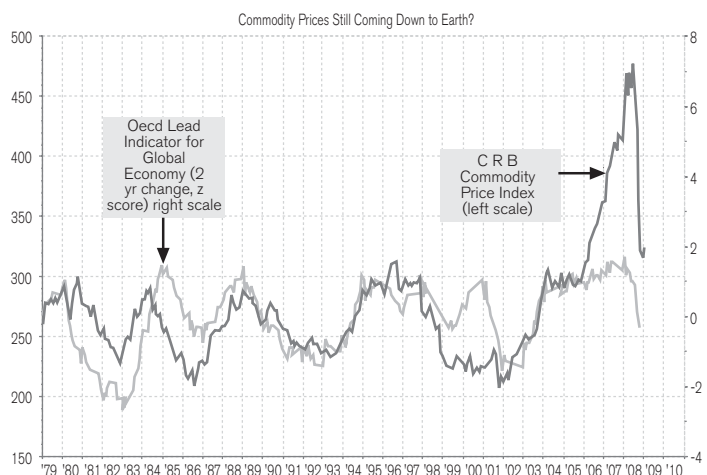
For a while it was believed that the European economies would be more immune from this downturn and indeed, in 2007 when the US slowed that was true, but since the failure of Lehman the European economies have started to decline at about the same pace as the US, there has not been very much difference. And there has not actually been very much difference between the UK and the Eurozone either, surprisingly enough. As we enter this quarter, Q1, business surveys are indicating about a -4% rate of decline in European GDP. The situation is not very different from what we have recently been seeing in the United States.

The Asian economies are a little bit different, some are worse than Europe and the US, and some, one in particular, are a little bit better apparently. On the one hand, China is slowing but not as dramatically as other countries. On the other hand, Japan is slowing even more than other countries. The collapse in Japanese activity is very remarkable: industrial production is now declining at a rate that we have never seen in any developed country since the post war period; Japanese economy has proven itself extremely affected by a downturn in global demand. Meanwhile, China is showing some slight signs of improvement in the December and January data and policy is becoming aggressively supporting of Chinese activity. The one sort of bright spot, with some question marks at the moment, in world activity numbers is in China, where the worst of the downturn seems, with considerable question marks, to have been in October and November of last year.

But elsewhere in the world economy, we are emphatically seeing what looks like a self-reinforcing process of deterioration and is applying in the household sector and in the corporate sector together at the same time. So the issues that have been faced by the major fiscal authorities and Central Banks are very severe and there seems no signs at the moment that the economy is stabilizing on their own accord, they are going to need help to stabilize.

Now, the help is coming in three main ways, one is lower commodity prices, the second is a major change in Central Banks policy and the third is the fiscal authorities. So lets just look at this and see whether the extent of the change is big enough.

GLOBAL COMMODITY PRICES AND WORLD ECONOMIC ACTIVITY



Source: Fulcrum Asset Management

Help is coming in three ways: 1) lower commodity prices; 2) Central Banks policy; and 3) Fiscal authorities.

in a way which is creating spare capacity that will keep commodity prices low and under downward pressure.

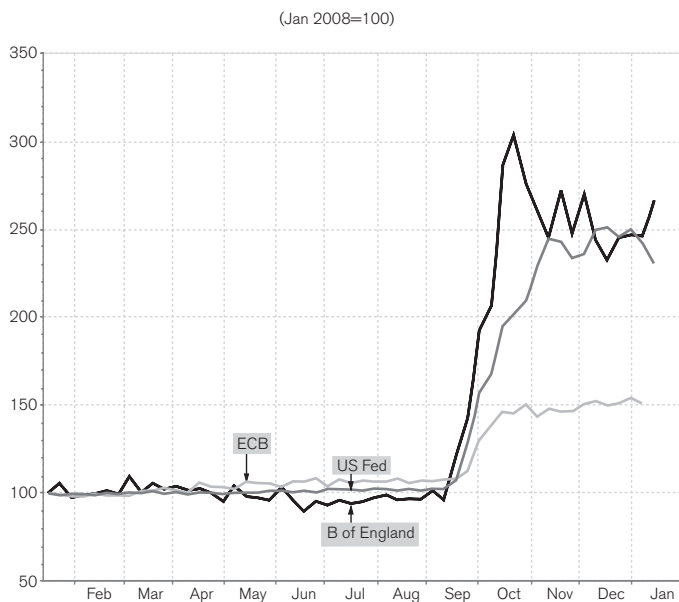
This is good news; this is adding about a 3% to developed country GDP growth this year. That 3% was subtracted last year, in the middle of the year anyway and we are now seeing about a 3% positive effect from commodity prices which is likely to be maintained.

Now, if I am wrong on that, if oil prices back significantly higher, and certainly as high as 80 to 100 dollars, I think we are going to be faced with a much more severe problem across the global economy. But if we assume that commodity prices stay down, this is a major reflationary force.

However, consumers have taken the lower energy prices and have saved the gains. This is very unusual; consumers are not spending, in the United States or in Europe, the gains they are seeing from lower petrol prices and lower energy prices. Consumers are saving all of that gain and passing none of it through into spending, showing how they want to increase their saving ratios. Nevertheless, in the absence of this gain we would have been in a lot of more trouble, because consumer probably would have increased their savings ratios with their real incomes less buoyant and we would have had a much more severe downturn.

As the graph shown before illustrates, the bubble in commodity prices is now collapsing; commodity prices are back more closely in line with where you would expect to see them, given what is happening to global activity. With a lot of extra commodity capacity coming on stream on the next 18 months, I do not personally believe commodity prices are going to rebound very soon. The global economy is shifting

LIQUIDITY INJECTIONS BY THE MAJOR CENTRAL BANKS



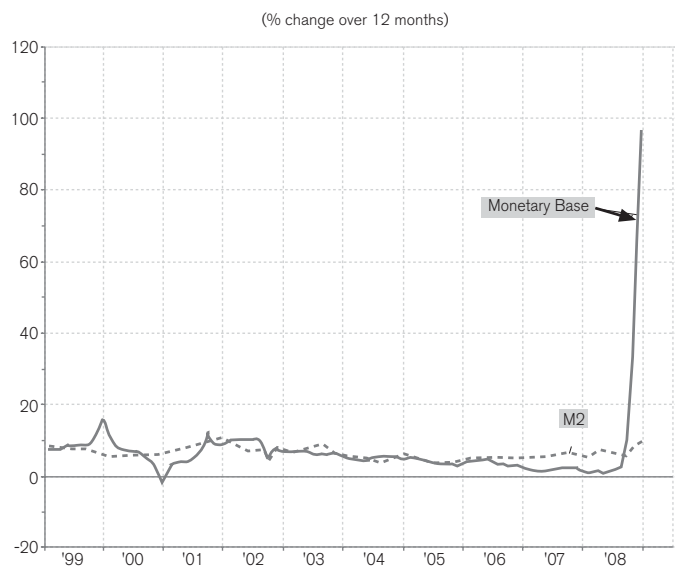
On the Central Banks we are seeing some signs, in some markets, that things are improving, but what we are not seeing so far is any sign that the commercial banking sector is passing these improvements through to households and corporations and we are seeing worrying signs that households and corporations are now reducing their demand for borrowing by cutting back spending.

One of the reasons why Japan got stuck in a very prolonged downturn, in the 1990's and this decade, was first of all credit availability from the banks dried up, and then later the demand for credit actually fell almost as much or more as the supply of credit. So as the economy got stuck into a recession with very low price expectations, the demand for credit fell as much as the supply and for a long time in Japan it was not clear whether if you fixed the financial system there would be actually any demand for borrowing from households and corporates. We are beginning to move into that trap as well in the West and certainly in the United States. So we have to move fast on this.

After the explosion we had in LIBOR rates, inter-bank rates, in October, money markets have come back down under control and Central Banks are now getting inter-bank rates down, not yet in line with target rates that the Central Banks would like to see them but they are coming down. Commercial paper markets are returning as well to normal, some credit markets are beginning to reopen, we are seeing investment rate credit doing better in terms of the number of issues of investment rate credit. But the problem is that the banks are not passing on those improvements to their customers and are still tightening credit standards.

Bubble in commodity prices is collapsing. Global economy is shifting in a way which is creating spare capacity that will keep commodity prices low and under downward pressure.

PASS - TROUGH FROM MONETARY BASE TO M2 IN THE US



Bernanke's analysis of the Japanese crisis is that policy methods were available to fix the problem, but they were not applied with sufficient speed and sufficient force to work. This won't happen this time.

According to the latest surveys on US credit offices, situation is improving slightly from Q4 numbers but not dramatically. Basically, what an improvement means here is that credit standards are continuing to tighten, meaning credit is getting harder to obtain, but at a slower pace than we have seen recently. These numbers have all come down a little bit, but in the UK and the US and increasingly in the Eurozone, we are not seeing commercial banks pass-through the improvements in the inter-bank market to their costumers. And the customers are responding, particularly corporate, by dramatically cutting back their forecast need for bank credit and they are doing it by reducing capital expenditure, and reducing inventories, and reducing employment very rapidly.

So this is getting into a chicken and egg problem now, where it is not as clear that this is solely a banking system problem, and that it may actually become a wider problem in the demand for credit across the major economies.

All this things tell us that Obama's administration is right when it says we need to have aggressive action quickly to fix these problems. The Bernanke, Federal Reserve board chairman, analysis of Japan in the 90's is that the policy methods were available to fix the problem, but they were not applied with sufficient speed and sufficient force to work. And what we are now going to see, is an American attempt, and probably a British attempt as well, to use maximum economic force to try to fix these problems before these economies get stuck in a permanent downturn and in a permanent recession.

In my view, that is the right judgement, things are looking bad enough and are becoming self reinforced sufficiently, for fiscal and monetary authorities to have to make dramatic, quick, measures to try to fix the problem. The difficulty is that we have seen problems like these in the past, somewhat, but we have never seen them fixed by an aggressive movement in policy of the type we are now thinking about. When I learned economics in the 1970's, we were taught that the depression of the 1930's could have been avoided with this type of policy response, but we have never tried it. We are in uncharted territory in terms of the type of policy that is now been pursued, and in terms of how much of it to do. We have fairly good rules and experience in deciding how much changing interest rates or small changing budgetary policy will impact spending in the real economy, in normal periods, but we do not have any guidance to tell us what is happening in this kind of environment.

One thing that I would like to share with you here, which is quite dramatic really, is how different the monetary response in the United States has been this time compared to anything we have seen in the past. And this is increasingly also happening in the UK, and may well be happening one day in the ECB.

The increase in the monetary base in the United States, running at about 100% year over year, contrast strongly to what was done in the 1930's, which was much less and also much less consistent than it will be this time. The FED is printing a lot more money now than it did in wartime. Bernanke has said that if he does this with sufficient vigour and sufficient force and consistency, he will prevent deflation. And he is on the record as saying: "We know how to prevent deflation". Well, we are about to find out if that is true.

In my judgement this is the best that can be done in these circumstances. However, this is not yet being passed through into broader monetary aggregate, we are looking a little bit like Japan in the 90's, where the monetary base went up a lot but the broader aggregates did not because the banks held this liquidity. And so far, I would say that despite the United States are beginning to look like that, there are dramatic changes underfoot with very unconventional measures happening.

Will this cause inflation? It is going to be extremely difficult for the Central Banks to generate any inflation, at least this year and probably next year. The reason is that the amount of spare capacity that is developing in the world system is so big. There are ways you can generate inflation in a recession, they have done it in Zimbabwe, and they have done it in Latin America on many occasions. So it can be done, but it requires changes to inflation expectations which seem quite improbable, in the West given this environment.

Moreover the relation between change in OCDE output gap (basically the amount of spare capacity existent in the world) and the movements in core price inflation suggest we are heading to declines in core price inflation, excluding food and energy, of around 2% to 2.5% per annum. And those declines are continuous for as long as spare capacity stays in this speed, at this rate. As a consequence, we are absolutely facing the possibility of deflation and we need aggressive Central Bank action to offset that.

In my opinion the really bad outcome which is, the Central Banks generating inflation with their actions, is somewhat improbable given the extreme nature of the spare capacity that exists in the world system.

Finally, I would like to remark the fiscal response. Not only are we seeing unprecedented easing by the Central Banks, we are also seeing very substantial easing by the fiscal authorities too, particularly in the US (probably more than in Europe).

Currently, 2008 public sector budget deficits in the major economies, they are in the 3% to 4% of GDP region, except Germany which is basically flat. The combination of

We have been taught that the depression of the 1930's could have been avoided with this type of response but it had never been tried. We are in uncharted territory.

Weak economy outlook with a hyperinflationary environment is improbable given the extreme nature of spare capacity. We are facing the possibility of deflation and we need aggressive actions.

automatic effects on budgets as the recession takes hold, and fiscal easing together, is probably going to add at least 5% to 7% points to those budget's deficits. That would leave budget deficits in the 8% to 11% of GDP region. We have barely ever seen that on the West before, outside of war time. Some countries have seen it but is very rare and here we are going to see it in most countries. On the debt ratio (ratio of outstanding debt to GDP), we will be lucky if this crisis costs Exchequers and Finance Ministries less than 20% of GDP in terms of the increase in outstanding debt. They are trying to disguise

this: they are doing insurance policies, they are trying to keep the debt off balance sheet, etc. They are putting some of this into the Central Bank's balance sheet, money rather than debt creation, but even so we are going to see these deficits rising by about 20% of GDP. Probably, they are all going to somewhere around the Japanese level of 80% to 90% of GDP for the debt ratios. Again, we have not seen this in the past.

The second horror scenario (horror scenario number one is Central Banks creating inflation with no recovery) is public losing confidence in government debt. If that happens, it will curtail the amount of easing that they can do on the fiscal side and probably make this recession much harder to emerge from. I do not know if that will happen, I am not assuming it will happen. Debt ratios seem to me to be somewhat alarming, but the demand for this debt is probably in place, given the rise in demand for government assets and the decline in risk preference which is going on in the global economy. So I am assuming that this does not trigger rises in bond deals, in fact I think is more likely that bond deal will decline because the supply is going to be met by even bigger increases in demand, but is a big risk.

Last thing I want to say, if this policy measures work and they are massive, the world economy can recover about the fourth quarter or the first quarter of next year. And if that happens, financial markets are not priced for that outcome. In my opinion they are priced for this policy failing, or to a large extent failing. In my judgement, is more likely that that policy will work, than the two measures of it failing, inflation and bond deals rising are not the most probable outcome, and we will see a recovery in risk assets. But I think we are going to have to wait a while till that happens.



THE CRISIS OF 2008: ITS LONG-TERM IMPACT ON WEALTH MANAGEMENT

John Authers

I would like to frame what seems to be the most important macro issues for me and explore how they will have an effect on assets allocation and on the various alternative investment strategies. My general take is that equities are broadly speaking, fairly valued by the historical metrics that appear to me to have worked best. They are neither obviously expensive, nor obviously cheap, which argues against making a particularly big sectoral bet on equities as an assets class in either direction. To make any big bet on equities at the moment is to make a bet on the success or failure of the hugely ambitious policy initiative that has just started. For government bonds, they certainly look overvalued and the overwhelming consensus on Wall Street, where I am based, is that they are genuinely in a bubble. I would argue generally that they are not, just as we need the demand for governments bonds to continue. However it's hard to see any great argument for investing in bonds if there are other things you can invest in.

To make any big bet on equities at the moment is to make a bet on the success or failure of the hugely ambitious policy initiative that has just started.

Corporate debt plainly remains priced for disaster; again the problem is that we still do not know whether we are indeed going to suffer that disaster. Commodities are sharply corrected and I think the key issue looking forward for asset allocators trying to work out how to play the next year, is that debate between deflation and inflation. The problem is that in many ways is a very bipolar outcome; nobody thinks we are going back to steady, gradual, inflation that we seem to have.

The most popular alternatives being suggested are either out rate deflation for a while or return to a much more aggressive kind of inflation.

Obviously they have extremely different implications for assets allocations starting now

I do believe that there are interesting opportunities for fundamental investors and for value investors.

Lets start with equity valuations. I have been given, proving to me conclusively that equities are going to fall another 90% or that they are going to double by Easter. An after such extreme events you can find the historical parallel for almost anything. The cyclically adjusted price earnings ratio (which is where you take the price as a multiple of the earnings over the previous ten years) accounts for the fact that price earning multiples will naturally adjust for the cyclicity of profits, so a high PE multiple might merely reflect where people think they are in the profit cycle. This shows where that PE has been relative to its own average, going back to the beginning of the 20th century. It has worked beautifully in timing terms in the market. There was the first very big spike in 1929, and another very big spike in 2000, and the points when it reaches lows are all points when historically it turns out to have been a great idea to buy equities. As far as I can see is the most effective measure out there.

The other thing that is fascinating about this is that this was one of the best measures that showed the falseness of the rally we had in this decade. After the internet bubble in 2000, it came to rest and started to rise again without ever getting anywhere close to hit its historical average. Therefore it was a very useful indicator, plenty of bears, as they are called on Wall Street, were sighting this as strong evidence that there was more harm to come in stocks. And what is fascinating is that now, after the disaster of 2008, this measure is exactly on its historical average.

The good news about that is that over a medium to long term, that should imply that there is at last value in equities, that equities are not ridiculously overpriced as they have been for many years. The bad news is that historically it is not enough for stocks to be fairly valued before you get a big rally, they need to be very cheap, as they were in 1920 or in 1982. When you are at fair value, as we appear to be now, ultimately to make a big call on equities again, is to make a decision that you are very confident one way or the other about how this very aggressive policy response is going to work out.

Moving on to bonds, this would be a fairly good demonstration of why people would say that there is a bubble in government bonds and also why people would say that there is a buying opportunity in relatively risky high yield bonds.

Risky assets have become remarkably cheap compared to bonds.

High yield bonds have done relative to government bonds both in the US and Europe. It is almost impossible to tell the difference between them. This is a truly international crisis and note that risky assets have become remarkably cheap compared to bonds.

If you want to see this as a sudden bubble in terms of bonds, there are other things to argue in that favour. I remember the Wednesday after Lehman collapsed people prepared to pay the government bonds for three months. And those rates still are at incredible low levels. So you do have an argument that there is a bond bubble. The actual return you would have generated from US treasuries last year and it actually looks like an equity chart. It is extremely unusual to make more than 20% in a year buying a security as fundamentally boring as a US Treasury bond.

The reason I suspect and, in many ways hope, that this is not a Treasury bond bubble is that everybody seems to think it is. It suggests that there are other dynamics in place if there is such a strong consensus on this. One of the key points here is the incentives on banks, they have been lent money basically at zero, they need to reduce their risk profile as much as possible, if they buy bonds they will get a return on it and they count as zero risk. So one of the corollaries of what is happening in the credit markets is that banks are buying huge amounts of treasury bonds because they have to.

Ultimately, the issue on bond valuation comes down to the position on inflation. I have just tried to summarize the problem as I see it, the arguments of inflation versus deflation. Governments certainly want inflation because that is, as far as they can see, the easiest way to get out of the debt problem, if you make the debt worth less is easier to deal with. The problem of course is that managing your way to an amount of inflation that will help gently deal with the credit's overhang over a few years is difficult if not impossible. If you print money on the scale that is happening at the moment, like Zimbabwe and Latin America for example, you can get inflation if you want it but it may be the kind of inflation that makes it difficult or impossible to run an economy.

Similarly you have the deflationist's argument which is put very clearly, that credit creation, the credit engine, is still broken. We have all the concerns at the moment about global trade and the risks of protectionism, there are plenty of reasons that will lead us to fear a steady diminution in activity and a steady deflation.

The problem for this of course is when it comes to assets allocation, if you really have a bipolar world, and I will say that the people that I talk to, I know nobody who expects inflation of between 2% and 4% or 5%, people are either believing that there will be genuinely deflation for a matter of years or you will get the kind of argument that is usually associated with Jim Rogers, that we will see inflation suddenly go back to double figures. They have almost completely different implications for how you should allocate assets, bonds, protect against deflation in some ways, the last thing you want to have if inflation returns.

They have almost completely different implications for how you should allocate assets, bonds, protect against deflation in some ways, the last thing you want to have if inflation returns.

At the end of last year, the inflation-linked treasury market (TIPS) was signalling for a brief moment a negative inflation rate for the next ten years, giving reasons to think the market is somewhat inefficient but also showing there is a strong believe, after many years believing that inflation will roll along at about 2.5%, that we are headed for rate deflation.

In the last few weeks, we have seen a lot of people retreating from that, as they are seeing the various money printing initiatives and reading a lot of speculation. We can see a change in that consensus view. Another take on this, the real yields on nominal bonds, now they are highest in two years, gives another argument that perhaps they are not in a bubble, partly obviously because the headline rate of inflation dropped very sharply. But still intriguing is that real yields have dropped that low.

According to the Goldman Sach's commodity index, there was a true and quite remarkable deflation scare after Lehman, the markets suddenly, drastically, rethought whether it really believed commodities were going to keep moving up like that.

That has not been rethought to the same degree, if we see people again believing in the deflation hypothesis you could see commodities continue to decline, if you see a return to the believe in inflation, then obviously commodities become one of the most obvious places to be. But it is fascinating that there is a lot of confusion with different markets contradicting themselves on this key question.

That, as I see it, is the outlook for the main asset classes and I would like to try to focus on the alternatives. There is great excitement in Britain at the moment because is the 200th anniversary of Charles Darwin's birth, Andrew Lo who is a very interesting academic at the Massachusetts Institute of Technology, made a study on hedge funds, describing them as the Galapagos islands of the world of financial services, as this is the place where many different strategies survived and evolved becoming extremely adapted to their specific conditions. However, many of them were much more dependant on the eco system, the environment that they lived in than they realized. And 2008 saw huge changes to that ecosystem.

Hedge fund performance was extremely linked to the availability of cheap leverage.

Broadly speaking the winners were anybody who made macro bets and made them successfully and particularly obviously anybody who sold short stocks. And the losers were basically everybody else. What is particularly concerning is the question to which a lot of the

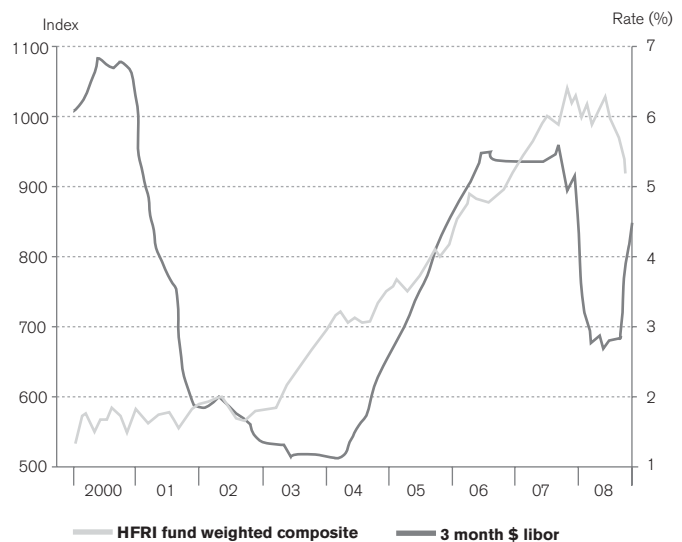
strong performance by hedge funds in particular as an asset class over the last few years relied on leverage. Hedge fund performance was extremely linked to the availability of cheap leverage (using libor rate as a proxy). The funds really started to flow into hedge fund complex in the early years of this decade when they managed to actually stay stable or actually gain while the stock market was correcting and that obviously coincided with extremely cheap leverage rates.

One particular way in which leverage is very important to hedge funds is the concept which long term capital management used to call hovering up nickels. This is the idea that you find tiny discrepancies between markets, they are only worth a nickel each but if you hover them up, meaning that you leverage yourself up to 50 times and make each bet 50 times over you can still make money out of them: statistical strategies based on a very sophisticated analysis of past patterns were the mainly troubled. Just trying to continue the analogy, leverage is the hover in

that analogy and the fact that you can identify very clear historical market patterns, the nickels. However, the patterns broke down, the leverage was removed and in many ways of course we also saw investors withdrawing capital meaning all power to the system was removed; and then we are yet to see exactly how much damage the Madoff affair will do to investor's confidence in the sector.

Madoff did not run a hedge fund himself, but many hedge funds and funds were invested in Madoff, and now, many hedge funds are admitting that they were extremely distorted by Madoff. The risks that general field of alternative strategies will need to adapt rather drastically or become extinct seems to me to be extreme. There were however opportunities last year, specially in macro trends:

HEDGE FUNDS PERFORMANCE AND 3MTH \$ LIBOR RATE



Source: Thomson Datastream; Hedge Fund Research

For example, last year oil price outperformed banks by 200% that was in the space of six months, but then the bubble burst and by the end of the year would actually have been very slightly better to have money in a US bank stock that you would have been to have bought a barrel of oil and hold it for the year. A quite extraordinary statistic, given where we reached in July.

Last year there was a huge bet on decoupling and inflation under the assumption that the US had a terrible financial crisis and that it would cut rates to deal with it, but that was not going to affect the rest of the world and so the cheap money in the US was going to spare inflation and spare growth elsewhere. Therefore bank stocks were a sell opportunity and oil a buy opportunity. The turning point of that trend could have been spotted by midsummer as levels for oil prices were completely self contradictory: there was no way you could have the disaster the markets feared was coming for the US financial system and still see commodity prices rocket ahead like this. Spotting the turning point of this trend, would have been a strategy that would have made an awful quantity of money last year. Various ways to do that, obviously long bonds, short equities, the whole emerging markets carry trades collapsed at the same time so going long on the yen, short sterling would have been an extremely good investment last year, basically, getting out of emerging markets stocks, betting aggressively that the various emerging markets like Brazil and Russia were over extended on the back of this thesis.

There were a lot of ways in which CTAs and global macro hedge fund managers found ways to make money making these bets. What is fascinating is the way so many different asset classes moved together.

According to a research done by Rob Arnott of Research Affiliates, which keeps track of a broad range of asset classes (16 different asset classes including loans, bonds of different durations, corporate credits of different quality, stocks large cap and small cap, emerging markets US and non US), until Lehman disaster overall you would have lost 2.2% in these asset classes and seven of them were out for the year. During the two months of total panic and terror all 16 of them managed to go down by an average of 20%. There were only three that did not fall at least 10% in those two months. And then, starting about three months ago now, there had been some of those asset classes that began to correct back upwards.

What is bizarre about this is that normally when we say that something is overvalued we mean is overvalued with respect to something else. Is very difficult for all of those different asset classes I mentioned to fall so sharply all at once. This is evidence for what George Soros calls the super bubble, the artificially cheap credit left many different asset classes to be overvalued and so once the oil price had broken and then the Lehman accident had happened many different investors in many different asset classes simultaneously decided that the game was up.

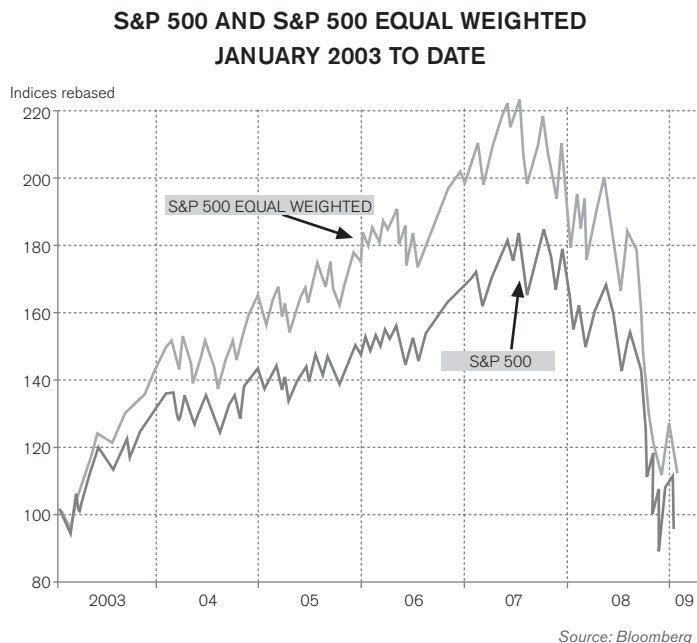
The other implication of this however is this sell-off was, while it was going on, totally indiscriminate. It was a rush for the exits that should create opportunities for those who knew to look for them. The equal weighted index has managed to fall much further even than the S&P as a whole, indicating this was a completely universal indiscriminate sell-off. During the bursting of the internet bubble the equal weighted index outperformed very strongly because the overvaluation was famously concentrated in technology media stocks.

According to Jeremy Grantham who is another very respected fund manager, if you believe previous historical experience this was a full standard deviation event for the equal weighted index to have done this. Perhaps more realistically what this meant is that the performance in the years leading up to the crash was in some way artificial and in some way boosted by cheap credit. But as I said I was going to try to say something positive.

First of all if there are opportunities, there is a huge attempt to stimulate the economy out there,

generally it does not make a good idea to bet against the government. The obvious opportunities are infrastructure and clean energy on which tax payers are going to be spending a lot of money in the future and for which there is an obvious need. Perhaps, the only problem I see with both of those ideas is that they are so obvious, everybody is looking for good opportunities in infrastructure and clean energy, but those who really know what they are doing in those sectors should be able to produce very strong returns.

Furthermore, I think there are advantages for those who can make money without credit, without leverage. If you think of the companies that did well during the last depression, there is a possibility to see the return of the conglomerate. If you can make money from other subsidiaries rather than needing to raise credit from a credit generation system that no longer works, that is an advantage.



There are advantages for those who can make money without credit, without leverage.

Regarding foreign exchange, there is an interesting argument that foreign exchanges are zero-sum game, but there is also an argument that it is a zero-sum game where you are playing with some people who are not trying to win, so there will always be some activity in foreign exchange and that provides the possibility for those who make the poles correctly. I can not imagine the spasms that we have seen in foreign exchange are over; I suspect

therefore that you will see the same kind of opportunities for future funds and global macro funds.

And finally, then we come to corporate credit and stocks, there has to be an opportunity for truly advanced fundamental analysis finding opportunities, whether is in emerging market stocks or corporate credit.

One coincidence that fascinates me is that the week of the crash, the second week of October when stocks fell 20%, we saw the publication of a new edition of the Benjamin Grahams security analysis, a thick book set out in the 1930's that founded value investing: how to look for value by the basics of seeing what the cash flow potential of a company was, what your margin of safety was if the worst came to the worst. I suspect that for those who take those skills or reacquire those skills, whether is looking at dividends on stocks or on interest payments on corporate credit, and those who have the patience to wait a few years, there really is a strong opportunity. There is an opportunity in going back to basics and with any asset class simply asking the question: Do I trust these cash flows? And perhaps to end it is a terrible shame that banks did not ask that question to themselves. In many cases they lost that skill and instead decided they could trust the alchemy of securitization rather than do the hard work of looking at balance sheets and deciding whether they trust the cash flow or not. I suspect that after such an indiscriminate sell off there is going to be a great opportunity for value investors.

There has to be an opportunity for truly advanced fundamental analysis finding opportunities, whether is in emerging market stocks or corporate credit.



A LONG-TERM DIVERSIFIED PORTFOLIO CONCEPT EVEN IN A CRISIS ENVIRONMENT

Fritz Becker

The Harald Quandt family is one of the best known German family offices. In Harald Quandt we do not have a crystal ball, but we have the need to invest money. We do not do prognosis but we have to invest our money every day, so even in this crisis environment, we stick to our long term diversified portfolio concept.

As a family, Harald Quandt came from industrial ground at the beginning of the last century and it has become a pure asset management company as of today. The Quandt family was founded just before the World War I. They made their first money in the period between 1920 and 1930.

After World War II, the two sons Harald Quandt and Herbert Quandt together built up the most well known conglomerate of industrial investments. They had a majority stake in BMW, a 15% of Mercedes Benz and other investments in logistics, pharmaceutical and chemical industry. But when Harald Quandt died in 1967 in an airplane crash with no descendants able to run the business, the trustees decided to sell everything.

Both Quandt families were separated. Our family side sold the 15% of Mercedes Benz (you may remember Mercedes Benz in the 1970's, which was a big political distraction in Germany and Europe) and then the trustees started to sell step by step all the industrial investments. By 1981, my predecessor started to build up an unprecedented new family office, the Harald Quandt Holding. He realized that the family did not want to invest any more in industrial sectors but in consumption needs. He also realized that it was not worth it to invest in one only asset class like fixed income. So he started in 1983 with private equity and in 1989 with hedge fund investments. The family had managed to build up some expertise and therefore we were approached by different friends &

The Harald Quandt Holding: from a successful conglomerate of industrial investments between 1920-1970, to a family office and wealth management firm for the last 25 years.

More than USD 14bn of assets under management over a wide range of alternative assets: private equity, hedge funds, venture capital, real estate, etc.

families, foundations and insurance companies that wanted to invest. That is the reason why the family was founded in 1988 and it is still doing this today, adding new different financial service companies every two or three years.

Starting with our own purpose and then offering it to third party money, nowadays, the Harald Quandt family is a single family office (I am responsible for) and a wealth management company called HQ Trust.

We have different financial investments in asset managers, alternatives, meaning private equity, hedge funds, real estate, venture, etc:

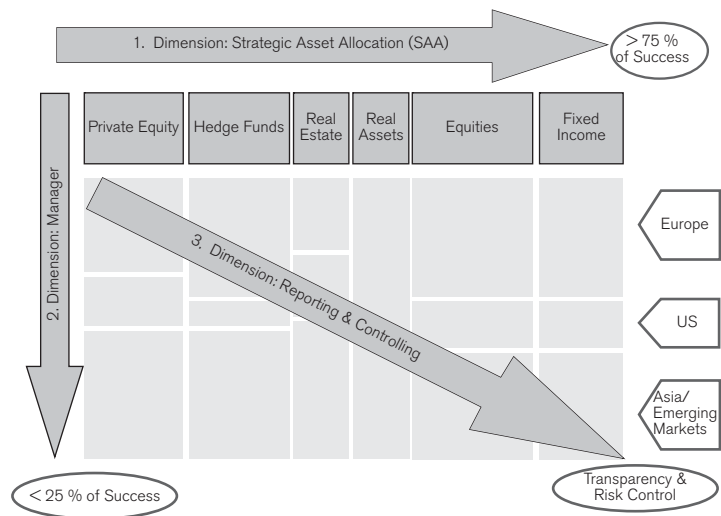
- Auda International is the company running private equity and hedge funds, with USD 5 billion and 80 professionals in Hong Kong, Germany, New York and London.
- We also have a company that invests in real estate in the US, only for German investors, running USD 5 billion and with 60 people.
- We have an evergreen structure that invests directly in mid market companies in the German speaking area, Germany, Switzerland and Austria, running around USD 600 million and with 13 professionals.
- We are founding part of MPM, which is one of the best known venture funds in Boston and San Francisco.
- Three years ago we founded Penjing Asset Management, a hedge fund business in Hong Kong together with some Hong Kong Chinese families and some institutional investors.
- Finally there is the wealth management company.

All this only describes an originally industrial family getting rid of all the industrial stakes and starting with financial investments over the last 25 years.

How do we organize ourselves? How do we invest? The table below is a very simple chart describing that we believe asset allocation is still the best way to generate profits on the long run. That means own experience, own knowledge and how we allocate the money.

The second dimension is manager selection, meaning to find the right talents worldwide. We do not have any single stock, we do not have any single bond, we are looking for the best people in the world to run our money or to have our own structures to run that money. We do not think we are able to know tomorrow which stock is the best or which one is the worst, so we normally use six asset classes, private equity, hedge fund, real estate, real assets, equities and fixed income: more alternatives than public equity and bonds.

HARALD QUANDT INVESTMENT APPROACH



And finally, if you do such an investment process you need to have a very sophisticated control in risk management procedure because liquidity is one critical issue and you have to know how your liquidity is managed and run.

Let's just go into dimension two, manager selection. Where do we invest our capacity and our knowledge to generate value? The Yale Endowment analysis on the dispersion of active management returns (ten years ending 30 June 2005) shows a dispersion of only 50 points between the best manager return over ten years of the best fixed income and the average return. It is not difficult to find the best fixed income manager. And the same happens with large cap assets. We believe it is not worth it. That is our experience, you don't have to follow that, but it is our experience. Russell Investments made an analysis on the annual value added of the best investment managers com-

More value added through manager selection. Alternative asset classes have the highest potential for active management.

pared to the average in each asset class. In that study, if we take, for instance, emerging markets, there is a lot you can do in the emerging markets as there is a 5% difference in return between the best top managers and the medium and the average. And you can go further to buyout funds where the difference is 12%, hedge fund where the difference is 17% (that means a lot of hedge funds were lousy even before the crisis, a lot of private equity funds are lousy or have been lousy much more in the venture business where the spread is tremendous). There are also venture business with minus something and some with 60%, 70% difference.

And then we approach those markets where we think it is worth to do analysis and worth to find the right talents to invest. That is different to what most traditional investors do.

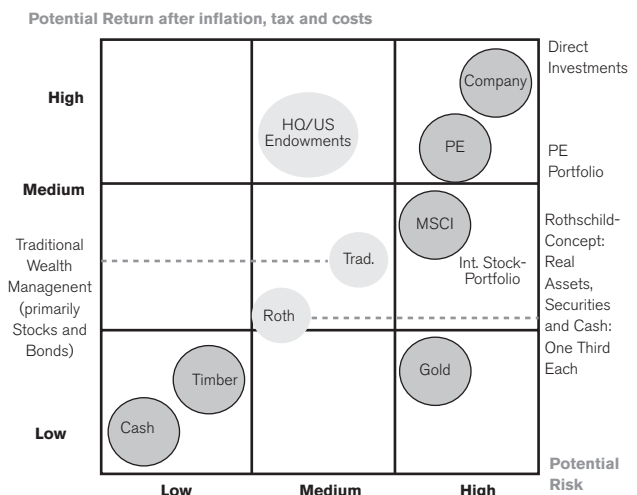
We have three examples of investment policies:

- The traditional one, that is normally what it is done in the market. Stocks and bonds makes 50-50, 40-60 plus a little bit real estate. That is the traditional approach.
- Then there is an old style, I think it is more than 100 years old. One third each invested on real assets, securities and cash.
- And finally, the concept, which is different. And I want to describe why it is different. The Yale concept of last year, fiscal year: real assets, real estate and commodities were around 28%, 19% in private equity, 23% in hedge funds, only 4% in bonds and 26% in equities. This allocation is completely different to the 99.9% of the total market.

We can also analyse the results of the European single office survey from Merrill Lynch in 2007 on how European ultrahigh network families are allocating. I was surprised by the fact that families have increasingly moved towards the Yale concept over the last years. Ten years ago allocation was more traditional: fixed income, stocks, real estate and still a very high allocation on equities. That is the reason why our returns last year were very under pressure. However, on the other hand, the other asset classes helped them to make a 50% downturn.

And then we approach those markets where we think it is worth to do analysis and worth to find the right talents to invest. That is different to what most traditional investors do.

BEST RISK RETURN RELATION ON A DIVERSIFIED PORTFOLIO



Source: Harald Quandt Trust

I usually compare our asset allocation to institutional investors (insurance is on my background). German insurance companies and pension funds allocate an 80% to fixed income (not only German governments but structure, mortgages, etc). Allocation to public equity is actually around 5% (it has ever been more than 12 or 13, in the last years). Alternatives are far below 5% and real estate is around 10%. In our strategic asset allocation fixed income is only 6%. Even public equity is only 13%, ranging between 9 and 17%. That means we have never been exposed to these asset classes. That is not stable over the years.

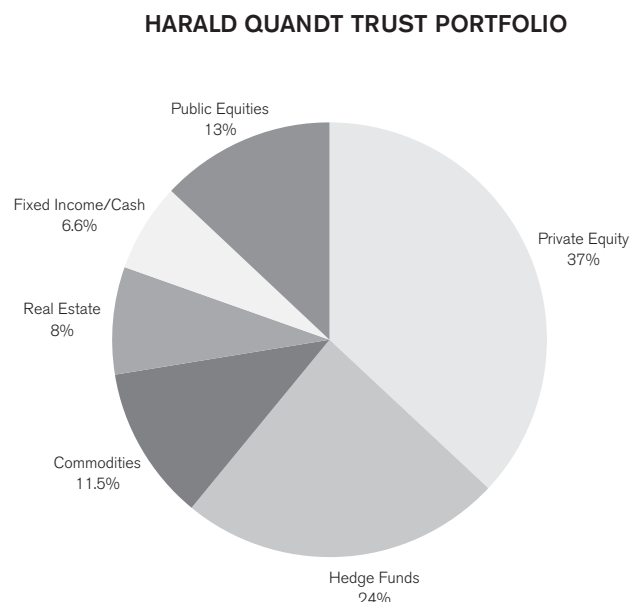
More than 75% of the portfolio allocated to Alternative Investments.

We discuss our asset allocation every year in September as a family and decide our strategic allocation for the next five years on a rolling process. We sometimes add new asset classes. Commodities were integrated in 2002, and so was the Asian region in 2003. So we could do changes as those ones, but the allocation is quite stable, with high exposure to alternatives meaning private equity, hedge fund, real estate and commodities.

But, how do we come to such a process? What are we doing here? It is a traditional process, meaning we use a forecast from banks research, asset managers, etc. We also use our own models, not predicting how a five year perspective in real estate will be but anticipating what our relation between real estate, commodities and equities will be. A more comparative model instead of an absolute model.

And finally, we use the judgment of the management. Models are good but they have lots of limitations. For instance, most of the models that can be found in the market use normal distribution and that is not correct. Nearly no asset class is normally distributed. A comparison between hedge fund data frequency over the last ten years from HFR and a normal distribution will show that normal distribution does not fit hedge funds frequency.

When using, for instance, an extreme distribution, there will be much more extreme out layers, especially on the equities side. If we try to find a five year expectation to be below 3% return, with a normal distribution the frequency will be 10%, whether without normal distribution, frequency distribution will be 20%, it doubles your risk in a five year perspective.



Bearing certain volatility, long term returns on alternative assets exceed the average. Harald Quandt Trust has obtained an annualized return of 8.1% for the period 1997-2008.

That means lots of models from research houses not covering the reality. Reality is much more volatile, it is much more extreme. That is why we think you have to focus on how to use those models, how to run them and not only use easy to handle PC programs that can be bought.

And what has been the return out of all this? Our return of liquid assets over the last 12 or 11 years has been about 8.1% on average. In 2008 return has been -16% which is not bad, but it is negative. The family is not amused, as you can imagine, but, on the other hand, returns of other family offices have been even lower. One of the biggest families in the US that manages USD 42 billion has just published last week a -22.5% return for the balance portfolio in 2008, the growth portfolio was -33% and most of the families we know in central Europe are below -20%.

But on the long run, and that is my message, if there are investors ready and willing to accept volatility in such a way like here, you can generate with non traditional asset allocation much more returns, much more long term performance compared to traditional asset management.

And there is another example I do not usually like to show, but actually Yale Endowment has around 12% return, even with a -25% in December. You may have read that Svansson had lost some billions from 22 down to 17, but people usually forget that he started with one billion in 1985. So on the long run (ten years), return reaches 11% and if you go ten years back further it is about 14%. That means that even today this concept of focusing on alternatives instead of traditional assets management gives you high potential for far above average returns.

In our case we did not have an emergency meeting between the Lehman crisis and today. The family was willing and able to take that risk and we talked to them in December in a regular meeting, and we will do it again in February. If the family is really able to take that risk, to take that long term perspective, they will get above average return.

What is our expectation for the next year? We do not have a crystal ball but we have some ideas:

- **Public equity** is not focused on specific analysis. Volatility is high and it will stay high. Volatility was going down to 15, 16 in 2002 and in 2007 and now it is again above 20. In German banks volatility is about 20, going up to 30. For us, public equity is one of the most dangerous asset classes because of the volatility. But at the end of the day assets recover. We believe on the recovery of emerging markets, specific sectors just mentioned before like infrastructure, health care, clean energies, commodities, not in the short run, but in the long run.
- I am sure that **bonds** are attractive after the situation last year but there may be only tactical decisions involving bonds. In the midterm there may be negative impact of expected inflation.
- **Real estate** will move to more liquid assets. On the housing side, at the end of the day there are demographic limits in old Europe and Japan. Immigration is the only driving force for real estate markets. So, if migration movements occur in Europe, housing market will go up again. However, we do not believe that will happen.
- **Commodities** in the long term, not short term, meaning three, five, six or seven years. We have limited resources and that is why there will be a chance to be in that market.
- **Hedge funds**. Hedge funds data of 10 or 15 years ago was completely different. Last year or last five years the dominated strategies were special strategies, meaning event driven, fixed income, highly leveraged (50 or more). But these strategies are now under pressure. Most of these teams will disappear because they have watermark incentive schemes, so they will never get any performance fee in the existing fund.

Public Equities: Highly volatile. Recovery potential in emerging markets, healthcare, infrastructures and commodities. Fixed Income: only in the short term and for tactical decisions. Risk in the mid term because of inflation.

Real Estate: move to more liquid values.

Commodities: long term growth.

Hedge Funds: Back to basics, alpha strategies with less leverage and non-directional strategies.

***Private Equity:
Attractive vintages 2009-
2011. Opportunity for
small/mid sized
specialized GPs.***

We will see a lot of run offs in the hedge fund business. But we are lucky, we have no hedge fund going busted until now. We did not get affected by Madoff. In the hedge fund industry there will be a back to basic strategies process, meaning long short equity and knowledge driven instead of leverage driven. And there are lots of funds in the market which are excellent. Global macro will stay as an attractive strategy, and

the same will happen to CTAs, because they have two things that most of other strategies do not. They are highly liquid. And there are lots of hedge funds that use no gates, so there are a lot of opportunities. But certainly, the number of hedge funds will go down from 10,000 to 5,000 or maybe 3,000. That is fine, we do not need so many hedge funds.

- **Private equity.** We still believe in private equity being excellent in 2009, 2010 or even 2011. If we look backwards to 2001, 2002 and 2003, those were the best years of the last 20 years. I think none of our funds in 2002 was below 30% IRR. Nobody was willing to invest in private equity in 2001. Actually nobody wants to invest in private equity now. We think that if you are able to invest in this business, which is not primarily leverage driven, there are a lot of teams in the market which are much more knowledge driven, process driven and operational driven instead of using 80% or 90% leverage. I think that will not work for the next few years but there will be private equity deals which are attractive. Focus on small and mid-size instead of going to the big ones. We are focusing on small deals, smaller deals where you know what they are doing instead of only financial engineering.

So we are positive, we invest, we believe there are a lot of opportunities in these markets but it is important to manage liquidity, to manage risk and to invest in the right people.

***It is important to manage
liquidity, risk and to invest
in the right people.***

Gavyn Davies



Mr Davies graduated with a degree in Economics from St. John's College, Cambridge in 1972. He joined the Policy Unit at 10 Downing Street as an Economist in 1974 and was an Economic Policy Adviser to the Prime Minister from 1976 to 1979. He then pursued a career as a City economist, first with Phillips and Drew then with Simon and Coates. He joined Goldman Sachs in April 1986 and was a Partner or Managing Director from 1988-2001. Mr. Davies was also the firm's Chief Economist over that period and Chairman of the Global Investment Research Department. From 1979-2001, he was repeatedly ranked as the City's top UK, European or global economist in surveys of institutional investors. From 1992-1997, he was a member of H.M. Treasury's independent Forecasting Panel. Mr Davies was appointed Chairman of the BBC in October 2001 and resigned his position in January 2004. In 2005 he set up a \$1.35 Billion hedge fund to invest in macroeconomic situations. He is currently working as a founding partner and Chairman of Fulcrum Asset Management as well as founding partners of Active Private Equity and Prisma Capital Partners.

John Authers



Mr Authers is currently Investment and Markets editor of the Financial Times. He joined the FT in 1990. In previous posts at the newspaper, he has been US markets editor, US banking correspondent and Mexico City bureau chief. He holds a degree in Philosophy, Politics and Economics from Oxford University and MBA from Columbia Business School. He is currently based in New York.

Fritz Becker



Dr Becker has been the Chief Executive Officer and Managing Director of Harald Quandt Holding in Bad Homburg since 2002. He has 23 years' experience in the finance and insurance business. From 1999 until 2002 he was an executive board member in charge of finance and capital investments at AMB Generali Holding in Aachen, Germany. From 1985–1999 he worked for the Basler Versicherungs Group in Hamburg and Bad Homburg in Germany and Basel, Switzerland, ultimately serving as a member of the executive management team of the holding company in Switzerland. Dr. Becker began his career as a consultant/project manager focusing on financial services with McKinsey in Frankfurt. He studied business administration at Mannheim University and completed his doctorate in 1981. Dr. Becker is a member of supervisory boards and advisory bodies of a number of companies, including Equita Management GmbH, Auda International L.P., Marshall Wace (London) and Penjing Asset Management Ltd. (Hong Kong).

