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Winter 2011-2012

Hedge funds: fire raisers or alarm bell ringers?



By Ian Morley
Director & Senior Adviser

It appears that there were two contradictory trends last year. Hedge funds got attacked by regulators and the press, while investors selectively increased the investments they have with hedge funds. Does this seem strange? Not really. Only the hobgoblin of small minds looks for consistent logic. Reality is always more complex, and indeed perverse, at times.

Politicians who have made a mess of the economy, which usually means most of them most of the time, tend to claim to have provided the catalyst of economic success, when in fact the economy has grown, in spite of their efforts, not because of them. The last Labour government under Gordon Brown excelled in this arrogant misconception. When things go wrong then the public seek a scapegoat and the politicians need to serve the public's craven wants... and, my word, have things gone wrong in the last year!

Blaming the bankers was a fair target, blaming the hedge funds seemed



*Bishop: "I'm afraid you've got a bad egg, Mr Jones";
Curate: "Oh, no, my Lord, I assure you that parts of it are excellent!"* Punch, 1895

an odd choice. Hedge funds didn't make bad loans; didn't help Greece 'cook its books' (Goldman Sachs has that accolade); didn't allow tax payment in Italy and Greece to be a voluntary choice; didn't expand the public sector in Europe; didn't maintain unaffordable defined benefit pension schemes in the public sector and didn't recommend the ever increasing transfer of private debt to public debt.

All they did was point out the stupidity of these actions. They then judged the enormous financial consequences and backed their analysis with hard cash. They shorted the Euro, shorted Greek debt and hedged that by buying German debt. They shorted most financial stocks and continued to play the long yen game. However, they were attacked both sides of the Atlantic and especially in Europe.

The malignant AIFM directive is probably the most egregious of all. A socialist group attack originally aimed at private equity then just took hedge funds along, in its shotgun

approach. The ill-thought-through consequences will be greater costs, more bureaucracy, threats of extraterritorial law and implications for trade reprisals from other countries. It also happens to be a direct attack on London for the benefit of Germany and France.

The hedge fund crime? To have tolled the bell of the impending financial problems of failed banks and potentially failed governments, many of which would have defaulted if the IMF and ECB hadn't temporarily bailed them out.

During all of this, institutional investors tended to pull out of all financial assets and to bifurcate their hedge fund investments by withdrawing from the less volatile but underperforming fund of funds and increasing their direct investments with individual hedge funds.

Another interesting change was observable last year as well. Fund of funds and some consulting firms started to move into each other's territory. The fund of funds lost their

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appeal in direct correlation to the losses they made in 2008 and their failure to regain enough in 2009. As a result, many investors decided that they could make the same asset allocation mistakes themselves, while saving the fees. Some consultants, having spent years getting asset allocation wrong, have decided that they now have the skill to pick funds as well. In the past, when they got asset allocation wrong, their solution was to sack the managers. Now if they do both and get it wrong, as I expect many will, they will have nowhere to hide! Conversely, many fund of funds have now re-invented themselves as consultants. The message has now changed. It's no longer: buy my fund of funds. Now it's: let me help you select your managers. It still ends up as fund of funds, but it's now yours, not the one the fund of funds would have sold to you in the past. In some cases it's a combination of managed accounts. Better transparency but higher costs and many top managers may not agree to do this.

Certainly, results last year were a bit like the curate's egg: good in parts. However, they were better than the double digit losses experienced in most stock markets. Fees came under pressure and were more negotiable, apart from the top managers who had no need and could maintain a 'take it or leave it' attitude.

Overall, as my old school reports used to say each year: an overall improvement but could have done better!

We are delighted to announce that Ian recently received the Hedge Funds Review lifetime achievement award in recognition of his service to the hedge fund industry. One of its early pioneers, Ian was founding Chairman of the Alternative Investment Management Association (AIMA), serving on its council for the next 14 years. He has advised the OECD and the EU as well as other industry bodies and has written and lectured throughout the world on alternative investments. He is an industrial fellow of Kingston University. For the Hedge Funds Review interview with Ian please visit <http://www.hedgefundsreview.com/hedge-funds-review/news/2123398/video-interview-ian-morley-senior-consultant-allenbridge>

Residential property - a suitable investment for institutional investors?



By Philip Ingman
Sector Specialist

Historically UK pension funds owned residential investment property, not only as part of mixed use assets such as flats above shops but also as rows of terraced houses and blocks of flats (also known as 'multi-family' by US pension funds which regularly invest in residential). The changes to the legal rights of tenants in the 1960s and the growth in the owner occupier culture here in the UK rather put paid to that sector for investors. Demand from occupiers fell, the ability to charge "market" rents was constrained and the ability to 'remove' unwanted tenants became more difficult.

At this time, these actions were unique to the UK and did not happen in other European or Global markets. To this day, many international pension funds still own a large portion of residential assets in their property portfolios and these residential holdings have proved most beneficial as their performance has been stronger than commercial property, equities and bonds over most measurable periods and they have provided a great diversifier, smoothing returns in a multi asset portfolio.

So why have UK pension funds not gone back into this sector despite the fact that the rent controls and constraints on landlords have been lifted for many years and there is a perfectly workable ownership and letting structure in the Assured Shorthold Tenancy (AST)?

Having discussed this with many pension fund managers over the years there are



a number of 'issues' that have made the sector appear less appealing.

- Small individual lot sizes - each unit in itself is on average well below the level one might seek in an individual deal, it would take a long time to invest £50m.
- Disparate management - there are few large national managers of residential assets so an owner ends up with many managers reporting to it, all probably in a different format.
- High management costs - the gross to net cost on rent is high for residential assets compared to commercial assets.
- Brand risk - the perceived difficulty in letting directly to members of the public and/or bad press from evicting a politically sensitive person or group, or for poor asset management. These are risks pension funds might feel it unwise to take.
- Exposure to residential – I have heard it said that given an individual has a large exposure to residential property already, via the house they own, they would not need further exposure through their pension fund. I would tend to say that a first house is part of the utility function one requires to live;

further exposure beyond this is an investment. We are all born 'short' on residential and owning a house merely puts one in a 'neutral' position!

So what changes have occurred in the market to make now a sensible time to reconsider the sector?

As mentioned, the AST has regularised the landlord/tenant relationship making this a more market driven investment. Comparing residential and commercial property performance in the UK we immediately see that pension funds have been missing out.

The Investment Property Databank (IPD) has been measuring commercial and residential property performance here in the UK, and more latterly worldwide, for nearly 30 years, although the residential sample has only become meaningful over the last 10 years. Looking at the relative performance over this most volatile of decades we see the following.

- Residential has seen an average compound growth of 2.5% per annum compared to commercial which had just 0.2% per annum.
- The best sector of commercial was retail at 1.3% pa.

• Looking at total return adjusted for RPI, we see a similar picture, residential property showed an average total return of 6.4% per annum versus commercial at 3.7%. Looking at equities and bonds, these showed 1.7% and 3.1% per annum over the decade ending June 2011. (Source IPD)

In other words, residential assets have delivered capital growth well beyond wages and GDP growth over all time periods measured by IPD. Some commercial assets such as offices lose real value over time.

Commercial property also appears to be more correlated with the wider economy in the same way that equities are; therefore a residential/equities exposure might be a good way to match liabilities. Residential property is also negatively correlated with cash. (The negative correlation is not unique to residential however... as the rates drop the demand and pricing for all risk assets rise including equity & high yielding bonds.)

The issue therefore appears to be about practicality rather than performance and an indirect approach becomes the preferred route into this market for many investors - ie. not owning the assets and dealing with the tenants directly but having a dedicated and specialist fund and manager between the investor and the public.

There have however been a few recent changes which should see growth in the number of 'funds' specialising in this sector.

• With the financial crisis and continuing difficulty in borrowing money, first time house buyers and others now require much larger deposits. 95%+ mortgages are no longer readily available and this looks set to remain for some considerable time. This has pushed the private rented sector forward with huge demand for limited available stock especially in London and the South East. The lack of new house building has also exacerbated the supply demand

imbalance; we have consequently seen rising rents and prices for investment stock and some very healthy performance over the recent past. So the occupier side looks robust with low voids and rising rental income.

• The government has for a long time been trying to stimulate the private rented sector. The introduction of Real Estate Investment Trusts (REITs) back in 2003 was initially aimed at this specific sector. Due to technicalities, no residential REITs have so far been launched and only commercial based portfolios have been converted. REITs offer investors a tax efficient way to invest in real estate as long as certain rules are followed; this makes them ideal for pension funds since being mainly listed vehicles they offer liquidity, tax efficiency and indirect access to the sector. Recent changes to the REIT legislation now make it easier to establish a residential REIT and the abolition of the conversion charge will

make it easier for currently listed residential property companies and indeed unlisted funds to convert to REIT status. A REIT cannot readily recycle its net operating income into new acquisitions as it must distribute a minimum of 90% of its income to shareholders.

Taking the market and legislative changes together there seems to be a rapidly growing institutional interest in residential property.

After all it must be remembered that residential is over 10 times the size of the commercial real estate market on a capital value basis but only accounts for about 3% of institutional property holdings. This is a big gap to fill!

Philip Ingman is a main board member of the Investment Property Forum and Real Estate Sector Specialist for AllenbridgeEpic Investment Advisers

Welcome to our new team member



Philip Hebson
Senior Adviser

Philip Hebson has over 30 years' experience in the securities industry. He was with Charterhouse Securities (formerly Tilney & Co) for 20 years and was appointed as a Director in 1992. Whilst there he was a member of the UK Equities sales team, responsible for marketing the firm's analytical output to a wide range of institutional clients. He also acted as investment adviser to a major local authority pension fund.

In 2000 Philip joined Merseyside Pension Fund as Head of UK Equities, responsible for research and portfolio structure decisions for the internally managed portfolio; managing over £2bn of assets. He was also involved in the monitoring process for the Fund's external investment managers and advising on the risk profiling of the Fund, including asset allocation. Since 2010 Philip has been providing independent specialist advice to

quoted companies in the areas of Corporate Governance, Investor Relations and Business Structure. He is also a Non-Executive Director of Aberdeen Private Equity Fund, and Treasurer and Investment Adviser to Chester Municipal Charities.

Philip is a Chartered Fellow of the Chartered Institute for Securities & Investment and a Member of the Institute of Directors.

Our current team of industry experts

AllenbridgeEpic Investment Panel

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Grant Ballantine	Jonathan Barber	Nick Broadhead	Alistair Hadow	Philip Hebson
Stuart Hepburn	John Heskett	Bill Horwood	Ian Morley	Peter Murray
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	Alick Stevenson		Philip Williams	

Sector Specialists

Seamus Gillen	Marisol Hernandez	Philip Ingman
Ray Maxwell	Trevor Robinson	James Walton

A resume for each adviser and specialist is available on the AllenbridgeEpic website

Peering over the precipice...



By John Heskett
Senior Adviser

We are so near the edge of the European precipice that it is sometimes difficult to get the World in proportion. When the financial crisis broke in 2008 we were resigned and conditioned to a long period of economic convalescence, as both household and public debt was pared back. It has been a bumpier journey than forecast, as the extent of quantitative easing has testified, and the process – a fragile one – has some way to go. So it is not surprising to see 2012 as another year of slow growth for the world economy and for the UK, there will be more to come. Slow growth is the 'new normal' for the developed world, with risks in 2012 on the downside. However, despite fears of slower growth from the BRICs and elsewhere, the world ex Europe is more or less stable. One reason for this is that there is no dislocation of credit within the financial system; the second reason is that the US may have finally troughed out and 2012 could well be better than forecast.

Which brings us back to a stressed Europe, where there remain big credit dislocations, with a weak financial system facing the possibility of a Euro collapse. If the ECB cannot stand as the bank of last resort for the Euro area, the Euro is unlikely to have a future in its present form. The provisions of the

new treaty represent only a very modest improvement to Maastricht and, as such, are inadequate for the Euro area as it stands now. The position of the PIIGS group of countries is hopeless, in the absence of growth and the absence of control over the traditional levers used to effect change. Monetary aggregates are falling or are likely to fall in these vulnerable areas, as cash transfers to safer homes within the Eurozone; banks borrow huge sums from the ECB to plug the gap and more, but cannot or dare not lend given the weakness of their balance sheets.

European leadership points to the threat of a major falloff in activity (plus general instability and possibility of future wars!) to justify the maintenance and intensification of the present European construction, but the journey of intellectual travel is leading to a complete dead end. The rational person would be looking to loosen existing political and monetary ties, to restore momentum, provided the banking



system can take the strain. Maybe we have to wait for the banking system to re-liquify itself, before we see movement.

While the Euro issue remains so uncertain, it is difficult to see what is going to support equity markets: if we look at the three legs to the equity market stool – growth, valuation, liquidity – the latter two are positive, but, while the euro issue remains, the growth dimension remains unclear and patchy. For the long haul, equities represent better value than long dated government bonds - where nominal yields are now risky in the light of official determination to keep deflation at bay; index linked may finally lose their lustre as RPI comes down to below 3% and cash rates harden. These observations may be interesting, but it is difficult to see pension funds and their sponsors acting on them. There is too much at stake and too much can go wrong, in a period which has already been disastrous for pension fund funding levels.

The only good news is that there is no good news and everyone is - justifiably - very cautious. In this murky environment, where returns could remain subdued for a while, we can think about portfolio construction and we can think about costs. Hedge funds have closed on a pedestrian year, with returns mostly negative and all over the place, and there is a case for asking – what is the point? There is sufficient beta around in these funds that a fund could well be in a better position adopting a buy-and-hold strategy in passive or smart beta equities. Alternatively, the absolute return orientated, multi-asset portfolio - transparent, ungeared and cheap - the new dynamic 'balanced' approach - could well have attractions for portfolios which want to limit downside. With big uncertainties out there and volatility still there as a threat, there is a case for keeping things simple and cheap as we wait for better times.

In each issue of Perspectives we give a list of ten questions trustees should explore with their investment managers.

Here is our updated list:

1. If final salary schemes continue to close, how do you see that affecting capital markets?
2. Given our liability profile, what is your appetite for risk over the next 12 months?
3. What strategic response would be appropriate if we thought the risk of a 1930s style depression were rising?
4. How do you see value versus growth in equities over the next year?
5. Last year the consensus was that the bond bubble would burst as inflation picked up and economic growth gained traction. Has the 'burst' just been postponed or has the game changed?
6. Emerging markets were amongst the poorest performers last year. Will this be followed by a year of outperformance and should we use current levels as a buying opportunity?
7. Would a reduction in Chinese GDP growth to, say, 6%, be a good or a bad thing?
8. What is your exposure to European equities, corporate and sovereign bonds denominated in Euro, why have you positioned the portfolio in this way and what are the risks of these positions in the current climate? Is investing in Europe at present anything other than a speculative punt?
9. How convincing are the improving economic releases from the US?
10. Is the government right to push infrastructure investment at the present time, given the current uncertainties in the global markets?

Customers should seek professional advice specific to their circumstances and requirements. Please note the value of investments, and income from them may fall as well as rise, this includes equities, government or corporate bonds, and property whether held directly or in a pooled or collective investment vehicle. Further, investments in emerging markets or private equity may be more volatile and less marketable than in established and quoted markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance of asset classes and/or investment managers is not necessarily a guide to future performance.

Contact: London Office 3 Queen Street Mayfair London W1J 5PA T: 020 7409 1111 E: info@allenbridgeepic.com
Glasgow Office PO Box 26524 Glasgow G74 9ES Lancaster Office PO Box 785 Lancaster LA1 9DB T: 01524 389326

For more information about AllenbridgeEpic Investment Advisers visit www.allenbridgeepic.com