

### EPIC PERSPECTIVES

#### Quarterly Investment Comment - Q2 2007

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The last year has been preoccupied with growth - the US slowdown, the possible squeeze on UK consumption. To date, the growth numbers have been as or better than expected. However, markets remain of the view that US and World GDP growth will trough out later this year. This assessment is underpinned by continued constructive news from the BRIC/emerging market sector. Perhaps we should have started here, because this is an emerging market-fuelled expansion.

*Table 1 - Real GDP Growth. Source: Consensus Economics/\*Citigroup*

	2006	2007	2008
US	3.3	2.3	2.9
UK	2.8	2.6	2.3
Eurozone	2.8	2.3	2.2
Japan	2.2	2.2	2.2
Eastern Europe	6.5	5.9	5.7
Latin America	5.0	4.4	4.0
Asia	7.9*	7.6*	8.1*
China	10.3*	9.8*	10.7*
World	3.9	3.3	3.4*

In the last issue, we identified a number of positive messages for equities against other asset classes and suggested that, while increased volatility had to be expected as we travelled through this period of uncertainty, the case was there for riding through the bumps - treating them as opportunities rather than threats. After a good start to the year, primed by good corporate results and better than expected dividend growth, equities faced their first test of volatility in early March, following a sudden and seemingly inexplicable sell off in Chinese stocks. The contagion spread, coinciding with spread widening in the sub-

prime segments of the US credit market. The subsequent recovery in equities allows us to reflect on what was different this time compared with May last year when the downturn in markets was prolonged. Clearly the sell-off originated in a hot speculative market. What underpinned the position in March and allowed a recovery in equities to build thereafter were steady bond markets. In May 2006, there were pronounced fears over inflation and a bond market derating, contributing to the equity malaise. The absence of a threat to equities from bonds this time reflected: first, comfort that inflation is under control and interest rates are more or less stable; second, caution on the growth outlook; third, continued rebalancing towards fixed income from UK pension funds; and, lastly, continued shortage of investment grade issuance in longer maturities. In the absence of a significant bond market de-rating, equities

*(Cont overleaf)*

#### EPIC Investment Advisers joins the Allenbridge Group - from Christopher Edge, Chief Executive, Allenbridge EPIC Investment Advisers Ltd (AEIA)

I am taking the opportunity in this issue of *Perspectives* to explain the reasons why EPIC Investment Advisers (EIA) has merged with the Allenbridge Group, and the benefits which will flow from this, both to our existing and future clients.

Also in this edition, John Heskett provides AEIA's current views on the global macro-economic scene and offers opinions on the outlook for securities markets and the relative valuation of various asset classes.

On page 4, Trevor Robinson an Associate with AEIA and an expert in the world of derivatives, provides an expose of the role of credit default swaps in modern pension fund portfolio

*(Cont on page 3)*

**AllenbridgeEPIC Investment Advisers provides cost effective solutions to trustees' investment-related problems**

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## Quarterly Investment Comment - Q2 2007 (cont'd)

and equity risk premiums still remain attractively priced.

Credit markets have also been 'hot' for some time as investors, encouraged by the idea of a long, benign macro cycle, trade credit quality and liquidity for yield. 'Hot' has turned to 'cold' in the US subprime area, but spreads in the quality area of the emerging market, debt market and the UK investment grade market have barely moved. The problem is specific and has effectively been quarantined. No contagion here. The corporate sector remains in good shape.

The competition to equity markets posed by rising bond yields has not gone away. The yield on 10 year government paper has risen some 40bp to 5.4% since early April, as concerns over interest rates and money supply rise. Equities can cope with this, because the inverted yield curve points to confidence that the Bank of England has matters under control and 'is on the case'. 5.4% is not a very high or attractive figure, given what we know inflation to really be. However, negative surprises here and a rise in yields to 6%+ represent the principal threat to equities - because, then, the elastic between equities and bonds will be becoming taut and equities will start to price in a possible slow-down.

IBES forecasts support the notion that the growth cycle and inflation are more or less in 'steady state'. The problem is that, after a long run of positive surprise, all the good news is in the front window and upside is now limited. Earnings revisions have shown a

broadly positive but mixed picture recently - particularly positive for Europe and emerging markets and particularly negative for the US.

*Table 2 - EPS and PER*  
Source: *Dresdner Kleinwort* / \*IBES

	2007 EPS Growth %	2007 PER	2008 EPS Growth %	2008 PER
US	8.1	17.0	11.7	15.2
UK	5.4	13.9	6.8	13.0
Europe ex UK	9.3	15.3	10.7	13.8
Japan	16.7	22.3	10.8	18.2
Pacific ex Japan	9.9	16.3	6.9	15.3
Emerging Markets	31.7*	N/A	11.0*	N/A

IBES earnings growth forecasts for 2009 fall in the 8-10% range for most markets. So, notwithstanding, concerns about high levels of profit margin and share of profits in GDP, we seem to be looking at the 'Goldilocks' scenario once more and investor behaviour is beginning to reflect this. The PER on the FTSE 250 is approaching 20x and takeover hopes in many instances have to be the prime driver. Behind this interest is cheap finance and a willingness to gear up businesses, as seen in the private equity arena, where significant amounts of equity remain to be deployed. Notwithstanding increased public scrutiny, it is difficult to see any moderation in private equity behaviour just yet - the prime risk here would be significantly higher interest rates and all that this implies - but we should recognise that, while we have enjoyed the pleasure of the updraughts in pricing caused by the private equity phenomenon, this cannot continue indefinitely. In many areas of the market, the big move in prices caused by multiple expansion is likely to be coming to a close; from now on earnings growth will be the prime driver.

Quoted equities - with the quality tag derived from a

quotation - remain a scarce resource for a naturally increasing audience of long term savers world wide.

Private equity is an interesting warrant on the equity market but is not for a mass market. Buy-ins of stock,

private equity interest and natural demand outweigh any institutional rebalancing. We have a situation where, on growth and valuation criteria, many stocks are well up to date with events, with only large cap showing demonstrable value. On liquidity criteria, the outlook remains just about positive but is in danger of getting stretched - unattractive bond yields (other than to immunise pension fund deficits); fully valued UK commercial property market; takeover interest; and buy-ins.

There are risks - a US dollar collapse; a boom and bust scenario as inflation accelerates; with a particular concern being Asia; a reversal in emerging markets - and risks mean uncertainty, which means short term volatility. We should remember the average year end forecast for equities at the start of the year - 6650 on the FTSE 100. We have made strides in achieving this forecast already, but we have to be patient in finally getting there. The message has to remain that there will be setbacks but these should be treated as opportunities to add rather than subtract risk. Looking at the constellation of asset classes right now, the income producing qualities of equities stand out as

relatively attractive for the patient long term investor. The first challenge for the UK pension world is to adopt this as best it can in the current regulatory framework. The second is to fashion and widen the equity/real asset segment - by style, by manager, by alternative approach - to improve risk adjusted returns going forward.

**John Heskett**  
Senior Adviser



John Heskett is a Senior Adviser at AEIA. He is also Chairman of Heartwood Wealth Group, sits on a number of investment committees and is a pension scheme trustee.

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Sources for 'EIA joins the Allenbridge Group':

\* All told there is a desperate need for trustees, who have been thrust into the limelight by the Myners report, to get access to more advice - not just to safeguard the interests of members but to protect themselves against legal and regulatory action." Philip Coggan, FT March 2004.

# Economist Intelligence Unit Report - [http://graphics.eiu.com/files/ad\\_pdfs/eiu\\_Pensions\\_wp.pdf](http://graphics.eiu.com/files/ad_pdfs/eiu_Pensions_wp.pdf)

## EPIC Investment Advisers merges with Allenbridge Group (cont'd)

management. As many readers will be aware, the explosion in the usage of credit derivatives in recent years has been a major influence behind the transformation in the way that markets operate today.

To recap, EIA was originally established by a group of senior City fund managers in 2003 to serve the growing demand for independent advice on governance and investment related issues in the pensions arena. AEIA currently advises pension, charitable and endowment funds with total assets under management of over £8 billion. The Myners review in 2001 (and a further report in 2004) highlighted the need\* to raise the level of knowledge and competence in trustee boards and to strengthen the decision-making processes of investment committees.

Speaking for myself and our team of investment advisers, we are all delighted to have joined Allenbridge Group. Our move to a recognised impartial advisory business establishes an independent base, underlying the integrity of our advice. We believe that the timing of the merger is particularly significant in a market where research by

the Economist Intelligence Unit# shows that trustees need access to good quality expert advice in a number of specialist areas. We are particularly looking forward to working closely with Allenbridge's highly regarded hedge fund research team, adding to our existing knowledge of alternative asset classes. We are also talking to other independent firms capable of supplying private equity and real estate research.

Anthony Yadgaroff, Group Managing Director of Allenbridge, says that the fit of AEIA's business model with his own established advisory business to banks, funds and institutions is attractive. He says that he is excited by the prospect of working with AEIA's talented and experienced team to develop the many opportunities for growth in the pensions market.

The creation of Allenbridge EPIC has been welcomed in the pensions industry generally, the Financial News (FN) commenting that: *"A new force in pension consulting has been created through the takeover of EPIC Investment Advisers by wealth adviser Allenbridge". The access to strong and independent sources of research into a widening range of asset*

### About Allenbridge Group plc

It might be helpful to provide some background about the Allenbridge Group, which was founded in 1985, and provides a performance measurement and fund management selection service for the wealth management industry. Its Hedgeinfo division provides rating, research and consultancy to banks, institutional investors and family offices on the hedge fund market.

Allenbridge also offers advice to private individuals on investment products and tax shelter vehicles. Allenbridge won the "Best EIS Research" EISA award in 2005 and won "Best EIS Publisher" in 2006. Anthony Yadgaroff, Group Managing Director, was awarded the "Lifetime Achievement" distinction by CityWealth Magazine in 2007.

Websites - [www.allenbridge.co.uk](http://www.allenbridge.co.uk); [www.hedgeinfo.com](http://www.hedgeinfo.com)

### About AllenbridgeEPIC Investment Advisers

Allenbridge EPIC Investment Advisers will in future be based in London's Mayfair, whilst we shall be retaining our existing representative offices in Glasgow and Lancaster. Through our panel of investment experts, we shall continue to provide each client with an experienced adviser to act as their knowledge bridge between trustees and company management, and the actuarial consultants and investment managers, who provide a range of inputs and potential solutions.

Website - [www.allenbridgeepic.com](http://www.allenbridgeepic.com)

*classes, FN continued, "will help AEIA to advise pension schemes from a position of strength and provide a further challenge to the position of the traditional consulting firms as accountants, investment banks and asset managers join the war for talent in the sector".*

**Chris Edge**  
Chief Executive



NB: Sources for this article are stated at the end of page 2.

In each issue of Perspectives we gave a list of ten questions trustees should explore with their investment managers. Here is our updated list:

1. How serious is the apparent inflationary threat?
2. Is the switch to alternative fuel sources, such as biofuels a sustainable, investable investment theme?
3. Chinese equities have become more unstable - how seriously should we consider the knock-on effects on global markets?
4. To what extent should we be using the continuing strength of sterling to rebalance equity weightings away from the UK? How should this diversification be conducted?
5. Commodities - how attractive are the investment opportunities and what are the most suitable vehicles? Are softs more attractive than metals?
6. Hedge funds - are the majority of hedge funds merely delivering market beta returns at high cost? Which particular hedge strategies are delivering alpha and are suitable for trustee boards to consider?
7. Is there any point in holding credit? Should we be seeking opportunities in the enhanced bond/high yield sectors?
8. Should the yen carry-trade bubble burst what would be the effects on conventional securities markets? How would tightened liquidity impact the M&A boom?
9. With regard to securities class actions, have your fund managers duly followed through any claims which might have occurred during the most recent reporting period?
10. Has the current "fad" for LDI got any longer-term investment currency?

Please let us know if you would like our help in discussing these issues with your fund managers.

## Credit Default Swaps

In a recent article in London's Evening Standard newspaper, City Editor Anthony Hilton wrote about the potential problems with Credit Default Swaps - "All Geared Up for an Economic Disaster". This article explains the mechanics of these instruments and also how they are used by institutional investors today.

Unfortunately, Credit Default Swaps are badly named; they are not a swap - such as an interest rate swap - and they are triggered by more events than simple defaults. A more accurate name would be 'Credit Event Insurance Policies'.

During the 2000-2003 bear market in equities, institutional investors were advised by their actuarial consultants to move their portfolio weightings away from equities and into bonds. Bond prices moved higher and therefore their yields moved lower. The total return on bonds proved to be much lower than the usual returns that had been experienced by investors in equity markets in the Nineties - and when the bear market ended, also proved to be lower than the annual returns actually experienced in equity markets after March 2003. Not wanting to reverse the asset allocation decision, institutional investors sought ways to increase returns from their bond portfolios. A move from risk-free bonds such as Governments into Corporate Bonds increased the yield on the portfolio, because of the increased credit risk of the corporation issuing the bond. However, an increase in yield of one percent is small benefit if the bond defaults and the owner loses 100 percent of the capital invested in that bond. Therefore, the market for "insuring" these credit-risky Corporate Bonds against "default" grew dramatically. A "Credit

Default Swap" is the formal version of this insurance policy.

In a similar manner to life insurance, this insurance policy is set up between a "protection buyer" and a "protection seller". The former typically owns a Corporate Bond and wishes to insure against its default; the latter believes that the default will not occur, or believes that if he builds up a portfolio of these insured risks, he will have reduced his total risk via diversification. The protection buyer pays an annual insurance premium to the protection seller for the duration of the insurance policy.

In the event of a default, the protection seller guarantees that he will buy a specified amount of a specified bond from the protection buyer at the maturity price (typically 100 or par), even if those bonds are worthless.

These insurance policies can be purchased on an individual corporation, covering just its own bonds, or an index of corporations, covering a specified group of their bonds.

After a short period of buying such insurance, paying annual premiums to protect their credit-risky bond portfolios, institutional investors realised that they could further increase the return on their portfolios by selling such insurance and receiving the annual "insurance premiums". As a result, nowadays, the total expected return of a bond portfolio might consist of not only any expected increase in the price of the individual bonds as yields continue to fall; not only the coupon (interest) payments from the individual bonds; but also the annual insurance premium. Of course, the selling of such protection introduces far more risk into a portfolio, as well as far more return.

Credit Default Swaps now constitute the most rapidly growing part of the worldwide derivatives market. As the market has developed, it has become divorced from its original intention, so that now an investor can buy or sell, transfer or manage, pure credit risk, without necessarily holding any underlying corporate bonds. To return to our earlier analogy of life insurance, it is like being able to buy and sell life insurance policies regularly on certain well-known people and so take advantage of - ie. make a financial profit from - any news that they have become ill, or that they have recovered from an illness.

Investment Banks have built a large business in packaging Credit Default Swaps into financial instruments called CDOs - Collateralised Debt Obligations - and selling them as investments to institutional investors. These CDOs contain cash plus lots of the above sold insurance policies. The interest payments ("coupons") on these CDOs come from the insurance premiums received plus interest on the cash. If there are no defaults during the life of the CDO, the CDO pays out to its buyer a high annual return and then, at the maturity date, also pays back his full initial investment; if there are defaults, a high annual return is still paid out by the CDO, but some of the cash in the CDO is paid to the protection buyers because of the default and therefore less cash is available in the CDO at the maturity date.

Typically these CDOs are geared, or leveraged, so that still more insurance policies can be sold, still more annual insurance premiums received, and still higher annual returns paid out by the CDO. Unfortunately, the higher the number of insurance policies sold, the higher the chance of a

default reducing the capital value paid back on maturity. In this way, a default affecting one corporation in a CDO portfolio which contains 100 corporations might not have a one percent adverse impact on the value of the CDO, but a ten percent adverse impact.

Having now learnt something about these new derivative instruments, you might ask, "How does an investment institution, such as a pension fund, keep track of its risk and reward when selling such insurance policies via CDS or CDOs?" The quick answer is that these instruments are "risk-analysed" in terms of "Value at Risk" (VaR) parameters by specialised computer models. In our opinion, these models are sharp instruments if small changes occur in markets, but blunt instruments if large changes occur. In a "perfect storm" in financial markets, VaR models will be useless.

However, a more important question might be "Why do pension funds want to transform themselves into insurance companies by selling insurance on corporate defaults?". That is a question that bewilders us also!

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