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Issue No. 8 • December 2008

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We are clearly experiencing the most extraordinary period in post-war financial history where the legacy of excessive liquidity has manifested itself in excessive leveraging and risk taking. This comes as institutional investors have spent almost a decade confronting a very different investment horizon from that which shaped their thinking and approach during the latter decades of the last century.

Seeking to address these issues, AllenbridgeEPIC Investment Advisers, in partnership with several leading sponsors, launched the first of its series of trustee seminars at the excellent University of Chicago Business School in the centre of the City of London on 6th November. Entitled 'Governance and the Credit Crunch', the event sought to help investors address such issues as:

- Where equity and credit markets are headed in the context of the global economic recession
- The extent to which investors should establish fundamental long-term investment beliefs and values, and how should these be re-examined and implemented in the current environment
- What are the most appropriate and effective pension scheme governance structures given today's challenges
- The value of truly independent advice in the context of an increasing recognition that investable assets need more active management on an increasingly real-time basis.

The recent equity market falls have coincided with a sharp increase in the correlation of returns between a significant range of asset classes, including real estate, commodities and hedge funds. This has given rise to questioning whether the modern portfolio theory principles that diversification of assets will enhance returns whilst improving risk-adjusted returns still holds true.

We believe that asset class diversification is still very much to be embraced and, that where trustee boards do not have genuine investment skills amongst their members or advisers, that some form of 'fiduciary' management of their assets merits serious consideration.

It seems increasingly likely that the developing pattern of greater volatility in the investment markets will be the norm rather than the exception, and that investors will need to be more fleet of foot than in the past, and have the ability to take advantage of 'tactical' asset allocation opportunities in a more dynamic fashion. Asset managers, investment consultants and continental fiduciary-style managers are increasingly offering such delegated investment models to UK pension schemes, with different propositions to take account of all fund sizes - large, medium or small.

These management styles are undoubtedly gaining traction in the UK and offer definite attractions, but also risks. On the positive side, lay trustees can comfortably embrace the full benefits of asset class diversification, gaining access to areas such as commercial property, commodities, infrastructure, private equity and hedge funds to complement their base allocations to fixed interest bonds and global equities.

The 'fiduciary/delegated' manager will also take charge of the decision to change individual asset class managers, without prior reference to the trustees. This is a big call, but should be considered given the current trustee model's indifferent record in effective decision-making - academic research shows that 'fired' managers often outperform 'hired' managers.

In addition, by effectively delegating the decision over shorter term or 'tactical' asset allocation decisions to the manager, the scheme's assets can be managed in a more progressive, real-time fashion. In times of uncertainty, skilled managers can take advantage of

market volatility and act opportunistically from time to time. The third key benefit, is that such an approach is clearly transparent and the manager, whether a fiduciary or a consultant by background, is more quantitatively accountable.

However, there are no free lunches, and there are risks associated with such approaches. First and foremost, trustees must be comfortable with the degree of delegation over investment decisions which they will undoubtedly be undertaking. Legal advice must be sought here. Trustees should also take care to consider, *inter alia*:

- What other manager-of-manager type offerings are available in the market-place?
- Who will provide independent monitoring of the managers performance, staff continuity etc?
- What are the fees chargeable, and where are performance hurdles set, together with high water-marks etc?
- How much does the promotion of such a service compromise a consultant's fiduciary duty to provide independent advice to the trustees?

In addition, trustees should ask regular questions about performance records for such approaches (only short-term in the industry overall to date) and, given the importance of the asset allocation decision, what demonstrable skills does the manager have in allocating capital beyond the basics of ensuring diversification?

In essence, delegated fund management propositions are attractive once the above due diligence has been carried out, and provided that a robust independent investment oversight platform is put in place and maintained.

Chris Edge
Chief Executive AEIA

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Overleveraged and illiquid investment banks; the aggressive and wholesale fund dependent mortgagor; the relentlessly acquisitive - and if, like the investment banks, they have departed the stage for good, they will not be missed...



By John Heskett
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12 November 2008

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We foresaw some of the problems.

Anything to do with gearing - private equity, commercial property, hedge funds - had been de-emphasised (although we thought wrongly - that hedge funds might prosper with rising volatility); credit had been avoided; we were concerned about market risk and the extent of shorting and unregulated derivatives trading. Falling house prices back to more sensible levels of income was seen as a short term risk to activity, which recapitalised banks could cope with. We were in the mild recession/uncoupling emerging markets camp - and then

came the shocking sequence of events in September. What we had failed to realise was the extent of overleverage in the financial system and the extent to which some banks had allowed asset quality to deteriorate.

Some observers have sought to cast blame on the US administration for allowing Lehman to fail and thus causing the sequence of events that followed. There was no buyer for Lehman - so failure was inevitable and almost certainly healthy in the long term. Piecemeal fire fighting has progressed to an all embracing recapitalisation of the global banking system, which is now slowly beginning to function once more. The financial institutions which have really suffered in this process are the ones you expected to - over-leveraged and illiquid investment banks; the aggressive and wholesale fund dependent mortgagor; the relentlessly acquisitive - and if, like the investment banks, they have departed the stage for good, they will not be missed.

It is more than likely (but by no means certain) that the financial crisis has been dealt with, but the shock of recent events, and the accompanying loss of confidence, has blown away any thoughts of a mild recession.

A crisis means a refocus on macroeconomics. 2009/10 will see: a) deep recessions for imbalanced, overleveraged

economies (eg. UK and US, where up to 4% of gnp could be 'lost' over the next two years if past IMF studies are to be believed); b) milder recessions for the better balanced (eg. Eurozone, Japan) and significant reductions in growth in the more robust economies in the emerging world (eg. Brazil, China, India). These last economies are onlookers in what is a Western developed world financial problem and they will be important in keeping the World economy ticking over and in shaping the recovery.

The good news is that there is some good news. Finally, Central banks, blindsided by the commodity and oil price boom, are facing the same direction, as are governments. Growth, not inflation, is back on centre stage. Monetary and fiscal policy is loose and will get looser, as Europeans take a more American approach. Yield curves have steepened (good for banks) and bond markets, for now, discount Japanese style deflation. The oil price has collapsed, providing welcome relief. More importantly, currencies have significantly corrected, providing relief to the Eurozone and the UK at the expense of the Dollar zone and the Yen. Sterling has been centre stage, reflecting the relatively poor prospects for the UK.

The UK economy will have been given a big shot in the arm by the above. What impact it will have as house prices fall, unemployment

rises to 3 million and savings are rebuilt is unknown. Because of past profligacy, UK government should be restrained in what it can do on the fiscal side; deficits will compare very badly with our neighbours, whatever the outturn, and great care has to be taken on what stimulus measures are introduced to re-establish confidence - so they have the desired transmission effect without introducing a heavy burden for future generations. Otherwise economic strain has to be ameliorated by very low interest rates and, in these circumstance, the prospects for sterling remain very uncertain.

Markets should have responded earlier to what appears to be successful government intervention but they have been overwhelmed by forced hedge fund liquidations to meet redemptions at end September and December. 25-30% of the \$1.5 trillion in this asset class could leave, in the face of awful performance, which has to reflect geared embedded long and very crowded biases inter alia in credit, commodities and currencies. There will be a large number of fund restructurings, to move into orderly runoff - and, in the meantime, credit markets remain dislocated.

If we look at the damage caused by commodity price gyrations (oil), the current bust in the credit area and the volatility in equities, we have to wonder how markets can hope to

offer a reasonably reliable source of value to investors and their savings unless something changes. It is true to say that speculation does not of itself cause volatility - real world events do that - but recent focus on geared speculative activity and short term investment outcomes must have contributed to the chaos that has characterised all markets this year.

We need better oversight, less OTC trading and more transparency. What is the point of marking to market, as required until recently for banks, or of formulating pension fund deficits as required by FASB 14, if the market price is a function of dislocated supply/demand and no liquidity, which bears no relation to long term value.

Forced selling has created very attractive valuations in both the equity and bond space. Credit is priced for severe recession. Previously cautious commentators (eg. Grantham, Smithers) are suggesting equities have reached sufficiently attractive valuations that investors should get on the front foot and begin averaging in. The issue out there is duration - **how long is this going to last and can we take the pain in the meantime**, before markets begin to discount recovery? We probably have up to nine months bumping about, facing very depressing headlines, before markets begin to identify trough earnings and move forward, in anticipation of better top line and earnings numbers in mid to late 2010.

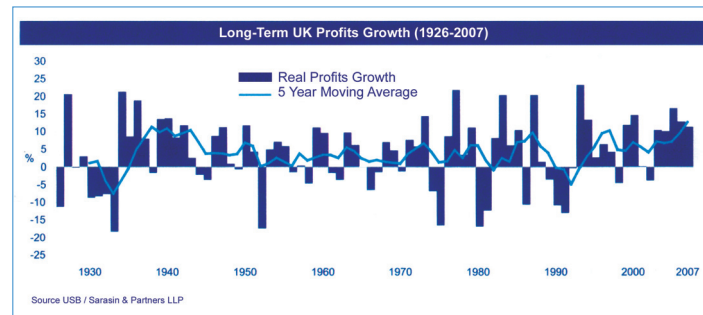
If equity price is known, what about earnings and valuations? At 31st October the IBES figures, representing current analysts' forecasts, were as follows:

	EPS Growth 2008	EPS Growth 2009	PER 2008	PER 2009
US	-3.1	14.7	12.0	11.2
Europe ex UK	-6.6	11.0	8.9	8.0
UK	1.4	0.8	7.4	7.3
Japan	-13.6	12.4	12.1	10.9
Asia ex Japan	-5.7	13.4	9.5	8.4

Source: IBES/Thompson /HSBC

The 2009 earnings conundrum is still with us, with estimates held up by

recovery in bank profits and single digit increases elsewhere. HSBC itself says - what we already know - **that IBES remains way behind the curve**, and is looking for a 15% fall in 2009 EPS. Citibank suggests a 50% fall overall is possible.



The chart above, recording UK EPS over time shows pronounced falls in the 1930s and the 1990s. So, if we take Citibank's suggestion as correct, the UK equity market is trading on 15x trough earnings - attractive - to the extent that the UK's current PER has rarely been this low - but still susceptible to bad news.

Government bonds - how safe are they? They have to cope with huge issuance; the inverted curve at the long end in the UK is at risk. If deflation is the central case, then conventionals are attractive. Index linked look exposed in any scenario.

What should trustees be thinking about? In our last Perspectives, we suggested that it was too late to take risk off the table - it was more a matter of moving risk around; now, as suggested above, high volatility and low valuations make a move onto the front foot appropriate. **Do not be afraid to rebalance portfolios** - sell index linked, buy credit in the bond space? Sell down expensive to run absolute return,

which has failed as a diversifier, for cheap to run equity or property?

In the equity area, the key questions

remain - firstly, active vs passive? - active managers continue to have a torrid time and the case for passive continues to become more compelling. What passive? Fundamental indexing is on the map and every-one should be looking at this.

Save money on active fees and spend part of this saving on accessing good information feeds to produce better asset allocation decisions.

Geography vs sector? Does geography work in producing diversification? The answer is 'up to a point' and emerging markets should be treated separately for now. However, maybe global as core with sectors (resources, financials, technology) as satellite strategies would work better. Continue to monitor those funds which sell efficiency - 130/30 funds and dynamic asset allocation funds, although both strategies have precious little actual track records as yet. Continue to monitor structured products. They have a place.

Finally, commercial property. Valuations again are beginning to become attractive in the premium end of the market, which has to be the only area to consider. The news from City and Retail over the next six months is going to be bad, at least and during this time we need to be drawing up plans to add and how.

All the above is suggested on the basis that a) the banking system continues to recover and credit growth resumes, b) the stimulus work. These are big assumptions that we should keep a close eye on.

We have to hope that 2009 is a less eventful year. We need a relaxing and enjoyable Christmas and New Year!

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. As asset classes have become more positively correlated during the market meltdown are benefits of diversification over?
2. How much should we rebalance away from UK equities to overseas equities - in the overseas segment, how much should we focus on Asia and Emerging Markets?
3. What do we do about currency overlay now that sterling has weakened?
4. Commodities/energy/resources infrastructure - should we still get involved? How and when?
5. Hedge funds - what is the right exposure, given the turbulence in the traditional asset classes? Which strategies should we favour?
6. Commercial property - do we add now or continue to wait? Do we diversify into overseas property markets?
7. Private equity - as credit spreads have widened to what extent is the party over?
8. What do we sell if we want to add to equity risk - reduce cash weightings, or sell government bonds?
9. Is the time yet right to consider high yield corporate bonds?
10. For medium and smaller sized funds, should we be considering diversified growth/dynamic asset allocation strategies, where governance budgets are limited.



The credit crunch: how did we get here?



By Trevor Robinson
Associate AEIA

In his second inaugural address, President Roosevelt stated "We have always known that heedless self-interest was bad morals; we know now that it is bad economics". Just as in his day, those words ring true in our own day.

The aim of this article and a subsequent article in the next issue of Perspectives is to look at the current credit crisis and to try to identify its origins. We believe that the seeds of the crisis were sown decades ago and we point out the errors that have been made over time. The "Law of Unexpected Consequences" can be seen to have been at work, along with stupidity and also - the Courts may yet find - simple fraud. Few financial market participants come out of the analysis smelling of roses.

The crisis started in the USA, but a lot of the investment techniques were imported by many other, supposedly sophisticated, Western nations. We do not believe that the current crisis is restricted to, nor was caused, solely by the housing market; however, it is a major contributor and that is why we focus on it in this article. A future article will focus on broader categories of debt and offer some solutions to the credit crisis.

In the USA in 1977, the CRA (Community Reinvestment Act) became law. Its objective was to encourage banks to provide financial services to everyone in their service area and to stop the practice of writing home loans **only** to the best credit risks buying properties in the best neighbourhoods. Banks mostly adhered to such principles until 1995 when the Clinton Administration changed the CRA to facilitate lending to less creditworthy customers. This was an explicit social policy (akin to Margaret Thatcher's sale of council houses in the UK) to increase home ownership amongst those people who had traditionally rented - mainly the poor and the socially underprivileged.

"Quotas" were set by government authorities, which the lenders were expected to meet. Lending standards - amount of deposit required, security of employment, ability to pay - were lowered. As interest rates came down and were maintained at very low levels by Greenspan's Federal Reserve, it became easier to encourage the above groups into home ownership.

Gradually, lenders became concerned about the long term quality of the loans that they were being "encouraged" to make, so they securitised them - i.e. packaged various mortgages into a vehicle ("Mortgage Backed Security" - MBS) which could then be sold to someone else. The income from the mortgages paid a coupon on the MBS and whenever the mortgages were repaid, the capital amount of the security could be repaid. An initial fee could be taken by the lender for creating the security and then once he had sold it, not only did he have cash ready to make new loans, but also he did not need to worry about whether the loans would default, because somebody else - the buyer of the security - now owned the mortgages.

The buyers of these securities were happy to add them to their portfolios, because the coupons were higher than they could get in the Government or corporate bond market. Moreover, the asset underlying the security was house prices "which always go up"; mortgage defaults were at record lows and the rating agencies were happy to give these securities a very favourable credit rating.

As interest rates came down, investors went on a search for yield and sought to buy more and more of the above securities. An interesting change then gradually took place. Instead of the lenders originating the loans, packaging them and "pushing" them out to investors such as pension funds, the investors started demanding greater numbers of these securities, so "pulling" them through the system. The mortgage lenders suddenly found that they were being asked to provide ever increasing quantities of these MBS.

As the demand for MBS increased, so the lenders started to motivate their sales staff to make more loans. As bonuses started to rise, quality standards started to slip. Gradually, fraud began to rear its head, sometimes tacitly encouraged by the lenders! If lenders choose to offer

mortgages based upon what the borrower says he can afford and then omit even basic checks on his income and assets, such lenders cannot be surprised when borrowers lie to them. When the same lenders are offering mortgages for more than the value of the property - "to help buy furniture", "to cover the taxes on the house" - such misleading behaviour will only escalate.

House prices started to rise to reflect the increased demand. House builders noticed the increased demand and started to increase the prices at which they would sell newly built homes. Surveyors and appraisers were encouraged by their bosses to agree to the asking price demanded by the builder, who was paying their fees. Whether bribes were widespread is suspected, but not yet proven.

In summary, there is a strong case to be made that stupidity - if not direct fraud - took place **throughout** the system. In far too many cases, house buyers misled lenders about their incomes and assets; mortgage lenders dropped their standards and undertook insufficient background checks; the securitisation of these risks meant that it was no longer the problem of the original mortgage lender, but of the security buyer; the buyer did not do his own due diligence, assuming that it had been done for him; computer risk models that had been used successfully to manage the risk of portfolios of mortgages in "the old days" - 10% deposit, mortgage not greater than 3.5 times income, borrower in full time employment - were used for the new paradigm - 0% deposit, 120% mortgage, mortgage greater than 5 times "stated" income, with no proof of that income nor other earnings / assets. Clearly such risk models were unsuited to this new paradigm. But, whilst house prices were rising, there were apparently no disadvantages.

The spiral continued to grow - until house prices started to fall.

The homeowners who misled lenders about their income found that they could not, or did not want to, continue paying their mortgage. As many of them had none of their own money invested in their house, they could walk away with equanimity - especially as most mortgages in the USA are "non-recourse", so the lender cannot demand full payment of the loan if the borrower walks away.

As these defaults took place and the

mortgage payments stopped arriving, the MBS issued by the lenders started to trade at lower prices. New products, created by investment banks, that had taken these MBS and added leverage or gearing to them, saw massive price falls. Investors were furious, pension funds also suffered. Suddenly market participants realised that, when so much gearing is involved in an investment, it only takes a slight loss of faith, a slight change in the prices of houses, to start a sell-off in the MBS market. This started a panic and some of these investments became illiquid. When investors in the funds that bought these MBS wanted their money back and the "bad" investments could not be sold, then the "good" investments had to be sold in a modern-day working of Gresham's Law. Stock markets and commodity markets collapsed.

Worse still for the wider financial system, banks kept some of these securities themselves. Worse still, they have hidden them off their balance sheets so that the regulators cannot require them to keep additional prudent capital in place. Arguably, this is fraudulent. Certainly, *prima facie*, this strategy was designed deliberately to mislead the regulators and therefore it may well be that the directors of certain banks could be banned from the financial services industry as not being "fit and proper" to conduct investment business. Worse still, because these securities are hidden, no-one knows what quantities are hidden away, nor what the value is.

There has been so much bad practice committed - in the UK as well as in the USA - that the only certainty over the next few years is that the lawyers will get rich.

How do financial markets resolve this crisis? That is for our next article.

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