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Monthly Commentary 1st September 2011

Equity markets fell hard in August and are now mostly at levels not seen since early 2010. Especially hard hit were Europe and Emerging Markets. Government bonds in the US, UK and Germany rose strongly and are at levels equal to (and in the case of the UK, higher than) those at the peak of the credit crisis. Commodities mostly fell, with the exception of precious metals. Major currency exchange rates were surprisingly mostly flat for the month.

What are the markets telling us? For one, the highly-indebted developed world economies remain fragile. It does not help that investors have no confidence in policymakers to resolve the difficulties. One of the main stories in the Wall St Journal yesterday was that the US Central Bank is itself deeply divided over how to revive the economy. No wonder most strategists and economists are also giving very confusing signals.

While we are now experiencing a reasonable bounce from the recent lows in equity markets, we view this with caution. The most serious of concerns are the funding tensions in the European banking sector which remains at the epicentre of systemic risk globally. Another concern is that emerging markets, while still growing at a good pace, will not in themselves be able to carry the burden of world growth alone.

To be sure, there are still many positives that could drive markets higher. As we have said in the past, interest rates are very low and will probably remain so for a while. Corporations are still looking healthy, and the recent retreat in energy prices should provide additional support. Yet for now we suspect that the negatives are tipping the scale.

Our portfolios suffered in August, but in general have fallen by fractions of what broader markets experienced. We have always maintained that small falls are easier to recover from than more substantial ones.

Hedge funds in particular had a difficult month as managers seem just as confused about the macro picture as economists. On August 29th alone, the Financial Times had no less than three main articles on the subject, titled: "**Hedge funds burned by August market heat**", "**Not so happy returns**" and "**Market turmoil lands hedge funds with big losses**".

The alternative funds we use have mostly done as expected, with one notable exception – the DB Paulson Advantage fund, which had a 15% fall in the first half of August. As a result, and in keeping with our risk management guidelines we placed orders to sell the fund for all portfolios, less than two months after buying it. We have always endeavoured to choose funds carefully, and the fall in Paulson highlights the fact that no matter how thorough our due diligence is, there are no guarantees. The main reasons we bought the fund in the first place were:

- It is one of the most famous global macro funds and not benchmarked to an index (i.e. absolute-return focused)
- We considered 18 years of track record with more than 20% annualised returns.
- He dared to be a contrarian in 2007 and made 95%.
- It was up by 37% in 2008
- **42% of the $30B fund belongs to Paulson and his partners**. This is rare.
- He has very good portfolio managers that are well connected worldwide
- The fund was already down 10% YTD when we bought
- The DB platform through which we invest is liquid, transparent and has very low fees

Despite the above, Paulson is known to make big bets on themes. This had served him well in the past but it has backfired as he lost a lot on financials, Hewlett Packard and one China forestry play. Our discipline demanded taking action and cutting losses.