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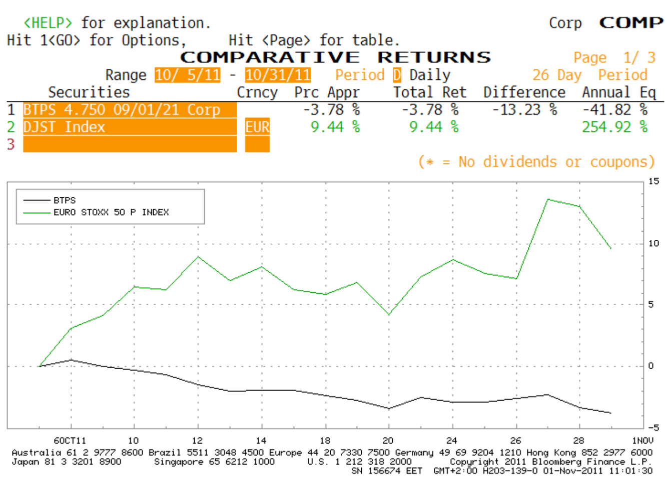
Monthly Commentary 1st November 2011

Risk-taking returned strongly in October, with Equity markets in particular up about 10%, for one of the strongest monthly gains ever. The result of the European summit on October 27th was the catalyst for almost 50% of the market gains. As one financial journalist at Barron's put it: "Sometimes when enough investors are positioned for the world to end rapidly, the mere suggestion that it might occur gradually is enough to energise bidders".

So together with the relief that the politicians provided, perceived "cheap" equity valuations created the melt-up. The big question of course is will the euphoria last?

While we do not subscribe to the gloom and doom scenarios, we remain sceptical of riding this wave. It is well-telegraphed in the press recently that there are too many unresolved issues in the Eurozone, and any part of the implementation of the summit agreements could go wrong.

Could things get worse, and if so, how should we be positioned? The answer to the first question is yes. We do not see how the eurozone crisis can be meaningfully resolved without a much more active and decisive action from the ECB (read QE). The problem with this is that Germany opposes this vehemently, so as long as this chasm persists the odds will probably favour the bears. The chart below raised alarm bells for us. It shows the Italian 10-yr government bond versus the Euorstoxx 50 Equity Index from Oct 5th to the 31st. While equity markets were rising as risk-taking returned, the Italian bond kept falling in value – not a good sign. Italy paid more than 6% to borrow money for 10 years lately, a level that is considered unsustainable.



As for positioning, our traditional portfolios have large (and stabilising) Absolute-Return components. Nevertheless, the equity portion, which served the portfolios well in October, would detract from performance if markets start to head down again. Depending on your risk profile, your portfolio could suffer by varying degrees. We are certainly not advocating changing your risk profile, as this is not a tactical decision, but one that should be based on your long term goals. Still, it is perhaps a good time to ponder what these goals are, and whether you are willing to take the risk associated with highly volatile markets. Should you wish a review of your risk profile please contact us.

The Absolute-Return (AR) funds we use had a decent October with the exception of managed futures funds, which depend on medium and long-term trends. This has made it very difficult for them, and as a result all four managed futures funds we use lost money in October. We do not consider this as a reason to sell, as they have proven that the rewards from investing in such funds are better than investing in almost any other asset.

One fund that has done very well in October is Nevsky. Being a long-short equity fund it had fallen only 6.5% in August/September vs a 25% fall for the EM Index. In October Nevsky was up 10%. Martin Taylor's ability to read the macro picture while at the same time being nimble as he moves his net positions between long and short exposure, makes him unique. As you may know, the fund is hard-closed to new investors. We had secured a small amount at the end of September, and we have now been informed that we have access to some more at the end of this month. The fact that we are co-investing in such a fund, where the manager has a huge chunk of his own net worth invested gives us a measure of satisfaction.

Finally, we recently approved three new AR funds, in which we shall gradually start investing in the coming months. The managers are Ruffer LLP, Brummer & Partners, and Liontrust.