



Monthly Commentary 2nd November 2012

October was a slightly down month for risk assets as equity markets fell about 1% and commodities fell more than 4%. The US markets, which are still the best-performing YTD, fell more than the rest of the world, not least because of the more than 6% falls in technology shares.

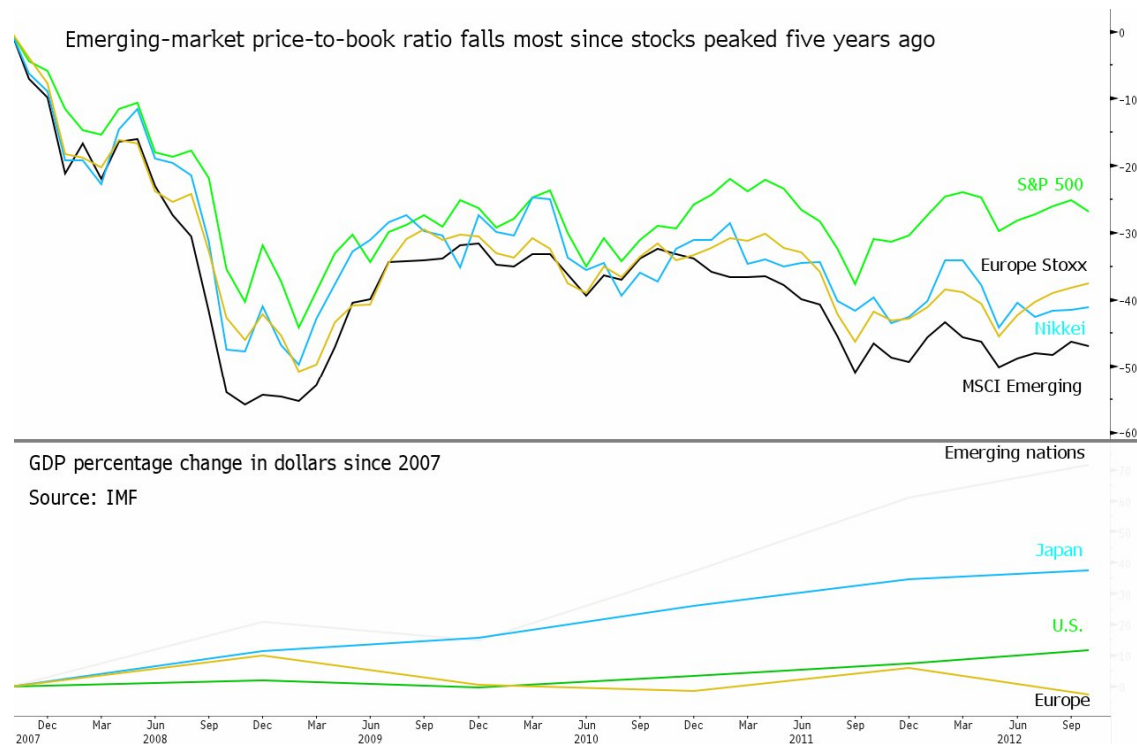
It is interesting to note that following the announcement of QE3 by the Fed on September 12th, the initial euphoria has subsided somewhat. In fact the US markets are down since then.

The consensus is quite bullish about risk assets. A few brave souls are not so sure. One of these, Michael Belkin, predicts a US recession (a completely contrarian call), which, in his opinion will result in a 30% equity market drop. He has correctly called the last two big falls, as well as the subsequent rises. Should we be worried?

Thoughts on Emerging Markets

Emerging market equities have given back half of their initial gains following the announcement of QE3, while EM currencies (expected to be major beneficiaries of more quantitative easing) have given back all their gains.

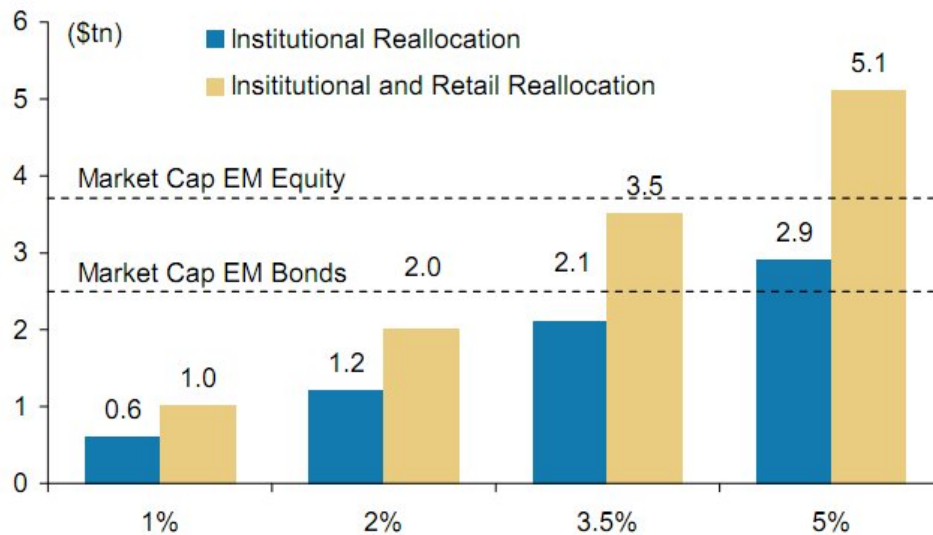
We still believe that Emerging Market assets will benefit more than the US economy (and assets) from QE3. Excess liquidity should find its way to assets that are more reasonably valued, and which have the best growth prospects. Below is one measure of valuation – Price-to-Book, which clearly shows that EM equities are relatively “cheap”. Also shown is the superior growth in EM GDP versus developed countries.





Another EM-supporting factor is a less tangible one that Morgan Stanley brought to our attention. By their reckoning, only 6% of globally diversified portfolios are allocated to EM equities and bonds - a historic low. They expect that these portfolios will allocate an extra 3.5% to EM over the next five years, leading to \$2,000 Billion in flows. As the chart below shows, this is equivalent to 33% of all tradable EM equities, and a staggering 83% of existing EM fixed income.

Increasing Portfolio Allocations to EM Will Lead to Large EM Fund Flows



Source: Morgan Stanley Research estimates

It is difficult to predict when EM equities will come out of their current sideways movement (they are at the same post-crisis level as they were almost three years ago), but we would still feel more comfortable investing in them than developed market equities. Similarly EM bonds – especially in local currency – should benefit from the above flows.

On Hedge Funds

Hedge funds have continued to be challenged in the current, apparently euphoric, risk-on environment. As a group, hedge funds are down in the last two years, and they do not seem able to gain traction. As they form a big part of our managed portfolios we are not immune to the pain.

The three strategies that we especially favour – managed futures, long-short equity and global macro – are having a hard time assessing the current investment climate. The chart on the next page shows that in the performance of broad hedge funds, global macro funds, and long-short equity funds since the end of 2010. As you can see, they are down about 7% as a whole, while long-short equity is down double that amount. This is in sharp contrast to what they had achieved previously.



<HELP> for explanation.
 Enter all values and hit <Go>

Security	Currency	Price Appreciation	Total Return	Difference	Annual Eq
1. HFRXGL Index	USD	-6.74%	-6.74% **	.03%	-3.76%
2. HFRXM Index	USD	-6.76%	-6.76% **		-3.77%
3. HFRXEH Index	USD	-15.98%	-15.98% **	-9.22%	-9.12%

** No dividends or coupons



Total Return
 Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000
 SN 156674 EET GMT+2:00 H178-787-0 02-Nov-2012 10:06:56

HEDGE FUND PERFORMANCE SINCE DEC 2010 – HAS SOMETHING CHANGED?

Yes, we are invested in some of the best hedge funds available, yet we are concerned whether this time is indeed “different”. Do the managers we use have the ability to revert to their mean performance by producing solid risk-adjusted returns going forward? The only way to answer this question is to be in constant communication with them and to determine if they are changing their strategies and/or adapting to what is perhaps a “new normal”.

We shall not hesitate to cull any of the funds we use if we believe that they will not perform according to our expectations. Additionally, we shall keep seeking good funds, as rare as they are, in this space.

Finally, while the hedge funds we use have not produced the expected returns, they have as a whole, preserved capital. It’s the upside that we need them to capture...