



# Vision 2010



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India  
Smart Technology  
Water  
Absolute Return Funds  
Mergers and Acquisitions  
Income  
Asset Allocation

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# Vision 2010

Welcome to the third edition of Vision, our annual investment publication. Each January, Vision communicates Williams de Broë's view of the world for the year ahead by identifying, analysing and discussing the core themes which we believe will drive investment markets.

Remarkably 2009 was an exceptional year for both equity and bond markets. We look to 2010 with a sense of relief that the worst appears to have passed, but with a sense of caution as we move further into the unknown. With the global economy on a knife edge, the challenges and opportunities for investment managers have rarely been greater.

I hope that you find the articles interesting and stimulating in equal measure. They are a good reflection of the exciting times ahead of us.

Kind regards



**Alex Snow,**  
Chief Executive



# Introduction

## Against the odds

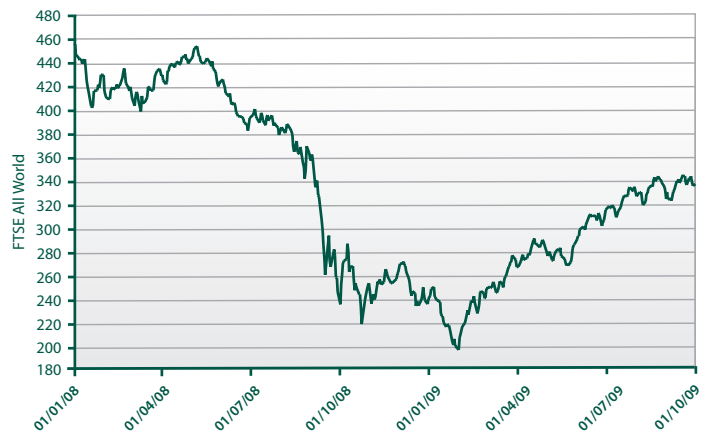
The last decade was one of the most extraordinary ten years in investment history, but it left its most bizarre twelve months until last. The mood swings of markets over the past year have been manic, from the despair of the first quarter to the disbelief in the rises seen thereafter. But markets are very rarely irrational and hindsight gives us the opportunity to explain these extraordinary gyrations with a degree of ease. Investors now perversely may have sounder ground for optimism than for many years although the future direction of the global economy is uniquely difficult to predict.

This time last year we argued that the world was likely to end 2009 in a better state than when it started. We would now grudgingly admit that even we had moments of doubt that this would happen during the first ten weeks of the year when it appeared that the world as we know it was coming to an end. But it did not, and a world that survived could then only get better. Anyone who had spent the last year or eighteen months on a desert island would now wonder what all the fuss was about.

The year on year moves in all major markets (and most minor ones) would prompt the question whether any of the events of the past year actually mattered. Having been proved right in our belief that the world economy and financial markets would end the year in better fettle than they started, we have to ask whether everything that happened in the meantime was any more than distracting short term noise? Have we witnessed anything more than an extreme incarnation of the normal day to day machinations of the market? Fortunately this is a simple question, and the one that holds the key to the outlook for the coming year. The answer is a resounding yes, it does matter. It matters because the medicine that was forced down the world's throat to cure the collapse of the banking system is the very reason that we are where we are.

In the aftermath of the bankruptcy of Lehman Brothers in late 2008 a small coterie of politicians and central bankers hatched the solution to the financial crisis. The argument ran that if these few individuals actually control monetary policy, then in theory they could create infinite amounts of cash. And if they could do this, then bailing out the banking industry was easy. This was more or less as complicated as the plan ever became; the delivery of this money had to be seen to be rationed, by means of what were named Asset Protection Schemes and Quantitative Easing. But once the banks and the markets understood that the apparently inevitable collapse into economic oblivion was so easily and simply solved, the world executed a swift 180 degree turn.

### Markets turned on a sixpence



Source: Reuters as at 01/10/09

The recession was unavoidable as the damage had already been done. World trade had stopped, credit had dried up, house prices had tumbled and companies had responded to the Lehman's debacle by adopting a corporate foetal position, cutting cost as quickly as possible by laying off staff. The fall out from this was inescapable. But to financial markets, the realization that the authorities possessed a magic bullet meant that they could look through the recession to what lay on the other side of the hill.

This was a powerful recipe for both equities and corporate bonds. Both provided returns in 2009 beyond anyone's expectations, including ours. The programme of quantitative easing appears to have been successful; gilt yields are still very low despite the immense issuance of government debt. This has undoubtedly helped the spread contraction in corporate bonds which in turn has been a powerful catalyst in the record issuance seen in 2009. And this means that UK plc's finances are now much less dependent on bank credit. Unequivocally this is a good thing.

The greatest concern of markets has been what will happen to the western world once the governmental umbilical cord is severed. The fear of relapse back into recession is keeping government bond yields at extraordinarily low levels and is largely responsible for the widespread lack of confidence in the sustainability of the rise in global equities. Whilst this is a wholly valid concern, and one

"The greatest concern of markets has been what will happen to the western world once the governmental umbilical cord is severed."

that is supported by early anecdotal evidence from the US auto and housing markets, it is too short-sighted. If economies show signs of sustained weakness as and when the support measures are withdrawn, governments and central banks have the simple option of restarting.

And these relapse fears ignore the good that will have happened in the meantime. The world's banking system is much more stable and better capitalized than the one that went into the crisis. It may not appear so, but previously banks were shown to be seriously undercapitalized and sheltering bad debts of unimaginable proportions. Now the bad debts are being underwritten by governments, all have raised capital to levels that would previously have had shareholders clamouring to have it returned in buy-backs as the balance sheets were not "efficient". As an aside the notion that if debt costs less than equity, then companies should finance themselves with as much debt as possible has been shown to be the most dangerous financial fallacy in history; we have always tried to like companies with cash rich, lazy and safe balance sheets.

Moreover, it is an easy mistake to look at the western economies in isolation. While we have been slumbering, emerging markets have been making hay. This is especially true of China and all those states in direct contact with the booming Chinese economy. One of the key lessons of 2009 is that investors disregard official Chinese forecasts at their peril. The authorities were mocked at the start of the year when they forecast that GDP growth would be 8%. The final outcome will have been very close to this, driven by Keynesian infrastructure investment and financed by years of trade surpluses. The virtues of putting money aside for a rainy day is one that has ironically been recognized by the communist party and conspicuously ignored by wasteful and dogmatic western governments. China remains one of our key long term investment themes; India, as we discuss at length, is no less exciting. Global recovery and global growth is very much driven by what we all still refer to as "emerging markets".

### Asia – the engine of growth



Source: [www.sourcefromasia.com](http://www.sourcefromasia.com) as at 01/01/08

But the outlook for all financial markets this year is trickier than for a considerable time. At the start of 2008 it was not difficult to look into the crystal ball and see that we were in for a rocky ride. Similarly, as we argued before, one did not have to be too much of a contrarian to see that the world was likely to end 2009 in a better state than it had entered it. As we now look forward to 2010 and towards the start of 2011, it is by no means clear which way the scales will tilt.

The consequences of introducing quantitative easing are still unknown, let alone what may happen as and when it is withdrawn. We have a general election in the UK in the first half of the year, with a change of government almost inevitable; this will in turn change the terms of reference for monetary policy, which is currently under very heavy political influence. Markets always like to test new governments and with inflation highly likely to be above target at that time, we should expect that there will be considerable pressure for interest rate increases. We can envisage a scenario towards the latter half of next year whereby inflation is at or above its 3% ceiling, base rates and gilt yields are on the up, taxes are rising for both individuals and corporates and earnings expectations for 2011 are being cut.

"The accepted standard means of portfolio construction, supposedly first argued by Harry Markowitz in 1952, has been put under the microscope by the events of the past two years."

It is equally easy to see a world in an economic boom. Led by Asia and Brazil, but with the west following on close behind, awash with free and easy money arising from the quantitative easing programmes. Inflation would be dampened by the large output gaps highlighted by so many economists at present, giving the impression that we have reverted back to the so-called Goldilocks economy of non-inflationary growth. Which is it to be?

At times like this we learn not to be greedy. Portfolios should stay diversified and should be content with modest returns; successful investment is not about being concerned about eking out the last basis point from volatile equity markets, it is rather based on sustainable and sensible asset allocations. There is a risk almost every asset class may provide strongly positive or negative returns in 2010. Returns this year may again be very good, but the risks of achieving these have taken a notable shift upwards. We like odds stacked in our favour when investing; at present it is far from clear that they are.

Our themes for 2010 follow this principle of diversity. We start with an examination of India. Our experience is that although many investors are aware of the importance of both China and India in reshaping the balance of global economic power, the level of understanding of the dynamics of India lags far behind that of China. This is despite the secular growth of India being every bit as important to the shape of the world's economy over the coming decades.

Second, we look at the extraordinary developments being seen in mobile applications. Arguably starting with the iPhone, we are seeing the primary use and point of access for the internet shifting from the PC to the mobile. This is bringing the internet into another new era, with another set of challenges and opportunities for the providers of hardware, software and networks.

Next, two years on we return to the global water shortage, one of our key long term investment themes. We make no apologies for going over this ground for a second time, believing that the shortage of fresh water is still the greatest challenge facing the planet. The needs and demands for water for drinking and supporting agriculture create unprecedented opportunities for companies developing purification technology and for the creation of the infrastructure needed to transport water from where it is to where it is needed.

We then look at the concept of absolute return investments. A fund that provides a positive return in excess of cash every month has long been the Holy Grail of cautious investors. It has also proved just as elusive, though the revelation of the extraordinary popularity of the totally fraudulent Madoff hedge fund last year shows the extent to which investors are prepared to worship such false idols. We argue that the absolute return concept is flawed, but that a small number of potentially attractive funds have emerged over the past year and that these have an important role to play in diversified portfolio construction.

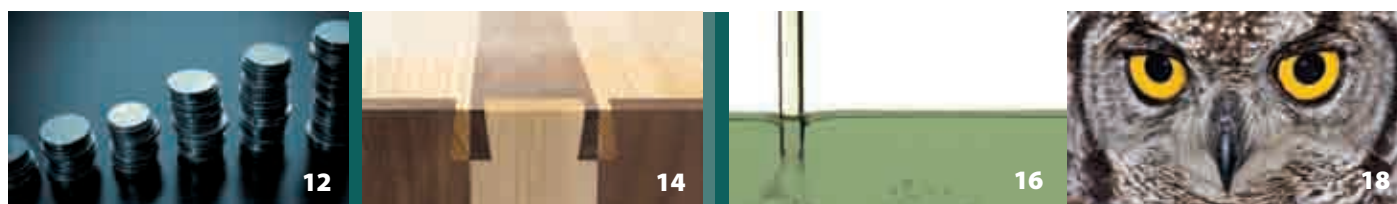
Our next article looks at the potential impact of corporate activity on markets. There is a widespread expectation that companies will increasingly seek to grow earnings through mergers and acquisitions, with their top line growth being restricted by the patchy nature of the recovery. We look at how companies and markets have responded in previous cycles and conclude that merger and acquisition activity will be a powerful force in 2010.

The penultimate theme is that of the search for income. The greatest challenge facing the majority of private investors is how to obtain a reasonable income from their portfolios in an era of ultra low interest rates, low gilt yields and widespread dividend cuts. We look at the attractions and drawbacks of a variety of potential solutions involving bonds, equities and commercial property.

Finally, we draw all these strands together in a critical examination of modern portfolio theory. The accepted standard means of portfolio construction, supposedly first argued by Harry Markowitz in 1952, has been put under the microscope by the events of the past two years. We argue that the principle of an optimized, static asset allocation will inevitably fail and that successful long term returns can only be achieved through a flexible and dynamic process.

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# Understanding India

## The sunrise of the Indian economy

As the first decade of the 21st century draws to a close, the might of Asia grows ever stronger. Hot on the heels of china, India is fast emerging as a fierce competitor for the investment dollar of the international investor. Domestic demand for Indian equities, fixed interest products and mutual funds is set to grow strongly over the next decade as domestic drivers increase, coupled with the country's already high savings rate.

For the next thirty years, amidst a world of countries burdened with ageing populations, India stands out as a supremely "young" country whose major asset will be its human capital. According to UBS, the Indian economy is forecast to deliver real GdP growth of 8 – 9% per annum for the next ten to twenty years as a huge investment is made in the country's infrastructure which in turn should accelerate reform. India is a country on the brink of huge structural change.

The potential is substantial. World Bank figures predict India will be the fastest growing economy in the world in 2010, with 2009 having seen the country exhibit phenomenal resilience in the face of strong global headwinds. Aggressive financial easing in late 2008 by the Reserve Bank of India, together with the provisioning of ample liquidity, helped insulate India from the global credit crunch. Consumers have continued to consume. Industrial production exceeded expectations in August 2009 with growth of 10.4% recorded against expectations of 9.7%. Buoyed by the decisive election victory of the pro-business government of Prime Minister Singh in May 2009, the election has paved the way for India to continue the rapid growth it has recorded in recent years of 7.8% per annum from 2000 - 2007. The win for the congress-led United Progressive Alliance (UPA) has kicked the once powerful communist Party into touch with the pace of reform in India expected to continue its upwards trajectory.

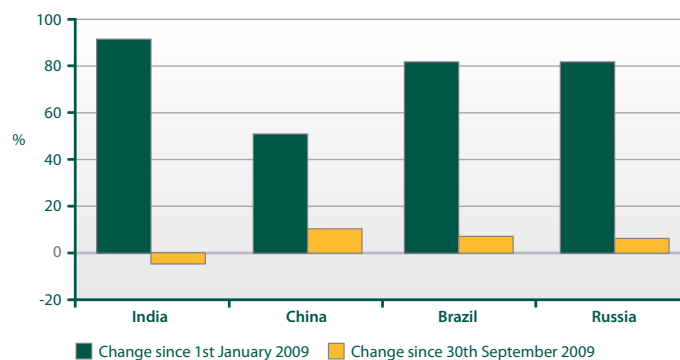
Unlike china, the banking sector in India has managed the credit crunch without the need for government intervention, with Indian banks having avoided the toxic debts which laid low many of their global counterparts. Fiscal policy has also remained supportive to shield the economy from the impact of the global economic slump, with large spending increases in the 2008/9 budget increased again in the July 2009 budget, targeted on infrastructure improvements as well as measures to increase the real incomes of India's rural poor. In recent years, the pace of reform has been constrained by the country's poor infrastructure. This is now being addressed with spending on roads, railways and power plants, as well as irrigation and water supplies being given a high priority. With the huge US\$2.5trillion of infrastructure investment planned over the next 15 years (source: UBS) India should be able to grow at a sustainably higher rate in the future than its capacity constrained infrastructure has allowed in the past.

Fiscal policy is expected to remain stimulatory, but at the price of running up a large fiscal deficit, which will need to be reduced in coming years. Public spending centred on rural infrastructure

projects is expected to climb 13% in the fiscal year March 2009/10, down from the 30% rise in 2008/9. India's fiscal deficit is undoubtedly high relative to other countries in Asia – Standard & Poors has India on a BBB+ (negative outlook) debt rating. However, as the economy continues to grow, it is hoped that corporate sector investment on the part of both domestic and foreign investors, coupled with the high savings rate in India, will pave the way for private sector funding to replace government aid. Improved tax collection, the setting up of special enterprise zones, improving loan relief packages for farmers and reducing oil subsidies are also expected to reduce the fiscal deficit. Furthermore, the Government has announced plans to step up the pace of its impending divestment programme which should attract foreign capital into the market – oil India, coal India and Indian Railways (the country's monopoly passenger railways provider) are but a few of the planned offerings. At a recent World Economic Forum in new delhi the target for the fiscal deficit to return to 4% of GdP by March 2012 from its current level of 6.8% was set.

during the first quarter of 2009, India's current account returned to surplus with overall credit to GdP remaining moderate for the region, with scope to rise. India is still a very debt averse country where both household and corporate leverage is generally low. Household spending has remained resilient as earnings have continued to rise for urban workers, with the cushion of high levels of household savings continuing to underpin the economy. The loss of wealth has been low relative to the rest of Asia as the vast majority of India's population does not invest in equity markets. This current low level of domestic exposure to the equity market is a positive for the longer term growth of domestic inflows into equities.

### Stock market performance in the BRICs



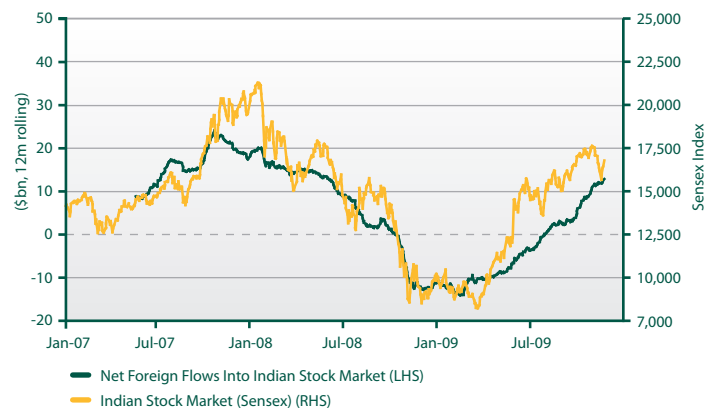
Source: Thomson Datastream as at 11/11/09

" Fiscal policy is expected to remain stimulatory, but at the price of running up a large deficit, which will need to be reduced in coming years. "

Consensus forecasts (JP Morgan as at 11/11/09) for the broad market are for corporate earnings growth of 9% and 23% for 2010 and 2011 respectively. With its relatively liquid stock market offering investors a host of diversified companies in which to invest, its stable government, coupled with the expected growth of its domestic consumer base, India looks well set to attract foreign investment flows as well as the continued growth in demand from the domestic institutional investor. According to World Bank figures, foreign direct investment into India in the year to March 2009 was \$27.3bn whilst the comparable figure for China is expected to be \$130bn. These factors should also contribute to a firm currency over the coming years. In terms of its development, India is believed to be lagging China by between five and ten years. Whilst a straightforward comparison between India and China is not simple, the obvious difference between the two economies is their political persuasion. This has meant that China has been able to impose reform more readily than the democracy in India has permitted. Trend growth in India will inevitably be lower than China's for this reason, although India is still expected to record strong earnings growth for the foreseeable future.

A poor monsoon in 2009 has contributed to rising food prices in India which has in turn fuelled inflationary concerns – wholesale prices look set to accelerate to 6 – 7% year on year to March 2010. However Agriculture is much less important to the economy than it was even five years ago and to concentrate on the monsoon issue would be to miss perhaps the most interesting facet of the Indian story currently. Whilst growth in the ten major cities in India has been subdued as a result of the global slowdown, "Middle India" is propelling the growth of the whole country. For the past two years, 55kms of rural road have been built every day – the impact of this is mind-boggling. For the first time ever villages are being connected to roads. Crops can be transported to markets in larger centres where mobile phones are being used to track the market prices of goods. Rural sales of Honda motorcycles are up – urban sales are down. Semi urban small towns and larger villages are growing rapidly. This growth is domestic and totally independent of external factors and is the reason why the Indian story presents so many opportunities for the investor. The "internal globalisation" of India and the formation of a single market as opposed to a collection of separate provinces each with their own markets and infrastructure is as powerful as the external globalisation India is currently experiencing. Together with the fact that penetration levels for most products and services in India is so low in an economy where the rural population is still so high, the growing consumer boom presents a strong case for investment in India.

**Foreign flows into Indian stock market & Sensex**



Source: Bloomberg as at 11/11/09

The demographic argument is also crucial to India's future development. As a young country in an ageing world, India's population of 1bn people (one sixth of the world's population) is now being seen as an engine of growth rather than the burden it was seen as in the past. The South and Western regions of India are already experiencing fertility rates equal to that of a Western European country, indicating the pace of development which has already taken place. It is in Northern India where particular challenges remain in harnessing this "human capital" by means of investment in areas such as better education, healthcare, roads to go to work on and lights with which to study at night.

Other strong drivers for the future of the Indian economy include a more positive stance towards India's entrepreneurs, an acceptance that knowledge of the English language is a huge asset in terms of growth in the international outsourcing industry as well as a perception that technology is liberating and empowering rather than something to be feared.

India is a democratic country which is growing at rates rarely seen. Per capita income is set to double over the next nine years. Indians feel more confident that they can participate in globalisation which, with its young population, it is uniquely placed to reap the benefits of. The Government's challenge will be to move forward from an era in which bureaucratic restrictions and regulations, fragmented markets, poor literacy and infrastructure have caused capacity constraints, to an era when the abounding positives can translate into a sustained period of strong economic growth.

# The World In Your Pocket

How smart technology is changing the face of the internet

Mobile handsets may not be able to make the tea or do the washing up, but soon their smart cousins will be able to turn on ovens and dishwashers and pay the paper bill. Ever more sophisticated applications will be available on a variety of portable devices, be they laptops, netbooks, e-books, smartphones or items which are still a gleam in a technology developer's eye.

It is 40 years since the birth of the internet, 30 years since the development of PCs, 22 years since the first mobile phone, 20 years since the launch of the World Wide Web and 10 years since the mobile phone companies around the world were paying billions of pounds, dollars and euros for 3G mobile licences, which were supposed to link mobile phones to the internet. Back in 1999 it was recognised that there had to be applications which added richness to the lives of customers for this technology convergence to get started, but this took a while. Now the rate of introduction of new words from the internet into ordinary life has been stellar. To "Google" is almost old hat these days, "Facebook" is fast becoming a verb as the eponymous website is used to keep people in touch in a world where travel is relatively cheap and easy. "Blogging" is now carried out by millions of people and social networking activities are displacing TV as a leisure pursuit. Twitter, which was only started in 2006, has now spawned a new meaning for the verb 'tweet' and has become the fourteenth most visited website on the global internet (source: Alexa.com, November 2009). The speed at which business has picked up on Twitter is spectacular, the hope is that it will help enterprises interact with their customers, offers going in one direction, feedback in the other. Once it gets going, absorption of technology into our lives is very quick.

But these services do cost money to provide and the question facing businesses globally is how to generate revenues and hence a profit. Although the computer and telecommunications industries have produced many billionaires, there is always a strong element of wanting things for free on the internet, so extracting revenues from the user base is often an issue. In the business environment this is a lot easier to achieve and the willingness of enterprises to pay for their staff to be contactable by e-mail even when away from the office provided the impetus for BlackBerrys. In the consumer arena it was not until Apple launched its iPhone with its ease of operation and range of apps to tickle users' fancy that the use of the internet away from the desk took off. The tens of thousands of applications (termed apps by Apple and sometimes called widgets) can have wide or very narrow uses and most are developed by third parties, both large (e.g. Sky) and small. Apple charges these developers to make their applications available in their App Store function on the iPhone, then take a 30% share of any revenues generated. Currently these revenues are earned on a pay as you go basis and paid for through the phone bill, but the potential to offer subscriptions would of course simplify their use. This proliferation of things to do with

your smartphone is part of the attraction of owning it, which is why Apple is happy to improve the tools which these developers use. Other apps are widely available on Facebook while Google, which has a more collaborative style than Apple, is encouraging developers to adopt its mobile operating system, Android, as the foundation on which to build an array of apps.

These apps have the ability to change the way people across the world live their lives. At present the most popular offer access to major websites like Facebook, education, driving navigation, shopping comparison, playing games and getting the latest news and sports results. Looking into the future, we see mobile devices being able to pay for items in shops, the cost being added to your monthly phone bill, to access entire libraries of books and to connect to the electrical equipment in your home so you can change settings while you are out and about. If the legal issues are sorted out then gambling would be another popular application. The ability of mobiles to know where you are has already spawned both practical and quirky apps. Schools are starting to give their pupils smartphones with appropriate controls as educational tools. In the developing world, where there is limited telecommunications infrastructure in existence to support internet access, mobile computing will open it up to a substantial portion of the population, enabling money transfers as well as access to news. As Sergey Brin, co-founder of Google, has said "While about half the people in the world are online today via computers and mobile phones, the Internet will reach billions more in the coming decade".

In the chart opposite it can be seen that many more mobile handsets are sold than computers each year. These do not have as long a life due to wear and tear and their short product cycle, many own more than one and large numbers of mobile owners will also have access to the internet via a computer at home and/or in the office, but it does give an idea of how many more users will be able to go online if a fairly modest proportion trade up to a simple smartphone. This is why Vodafone is so keen to make a success of its Indian acquisition and both Microsoft and Google see the mobile internet as a crucial area to address.

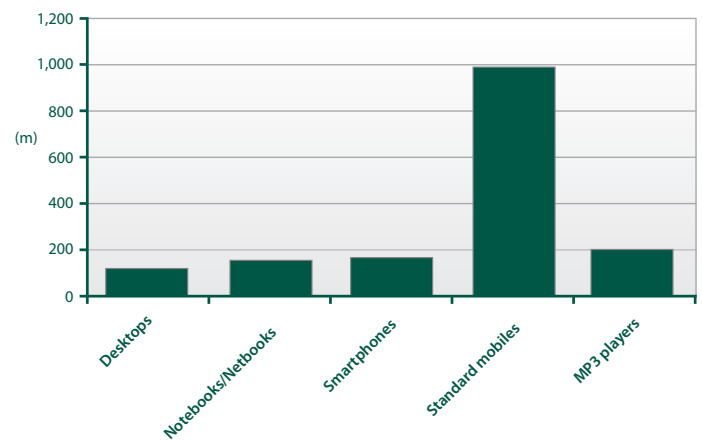
It is not just the applications and the devices that will evolve and grow in the coming years (3D handset screens are apparently not far away), but also the infrastructure that they all run off. This comprises the mobile networks operated by Vodafone, O2, Orange, Verizon and Bharti for instance, the broadband

"While about half the people in the world are online today via computers and mobile phones, the Internet will reach billions more in the coming decade."

connections operated by suppliers such as BT and Verizon, various Wi-Fi and Wi-Max services, the huge data centers operated by Google, Microsoft, Apple and others, and the operating systems which make all this hardware work. For standard computing Windows is the best known operating system, Apple's Mac is another, but others are coming onto the market in increasing numbers. Microsoft and Google are both launching new operating systems, Azure and chrome, and Apple has recently launched Snow Leopard while for mobile devices we have iPhone OS, Windows Mobile, Android from Google and the current market leaders Symbian and RIM BlackBerry. All these will allow greater functionality while using less power than the standard operating systems and support the other key change in the IT landscape, the move to "cloud" computing. More and more computing power and data storage is moving onto data centers which together make up "the cloud". The benefits of the cloud will be several. For the companies involved it will enable them to offer even more services, some of which they will be able to charge for, and for the end user it will mean that the loss of a portable device need not be a major disaster. Most of the information stored and services used on it will be backed up in the "cloud". It will also help the different devices talk to each other, as they will be able to do it via the cloud. This would leave battery life as one of the remaining practical limitations to mobile computing, alongside the substantial increase in security issues.

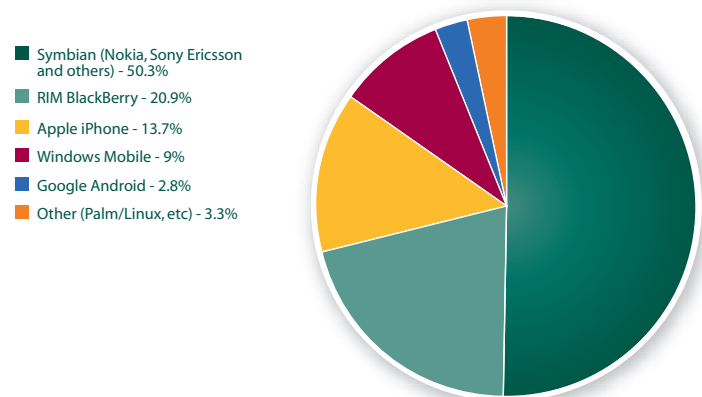
The future of portable devices is getting more complex, making the current search for a handset that just makes calls seem a minor problem. But help is at hand. Both Google and Microsoft are keen to make life simpler for us, after all that is one of the ways that Apple has been able to make such an amazing comeback – it produced devices which were easy to use. Natural user interfaces will enable spoken instructions to be given, letters and e-mails dictated, but users will have to be careful what they say to their devices in the future, since they may be understood! As the mobile ecosystem changes so there will be shifts in who derives the greatest value out of the revenues flowing through it. These revenues arise from sales of devices, subscriptions to networks and other services or apps and of course advertising. In the first instance the mobile telecoms companies delivered large customer bases and network capacity, in the next few years there will be a multiplication of devices, but increasingly it will be those that supply the intelligence to understand and make best use of the burgeoning scope of the internet who will benefit.

### Estimated annual worldwide unit sales of portable devices and desktops



Source: Williams de Broë and Gartner estimates as at 01/11/09

### Market share of smartphone operating systems as of Q2 2009



Source: Canals as at 01/11/09

Market share of Smartphone operating systems as of Q2/2009 by canals. (data does not include Palm WebOS, which was introduced in June, 2009)

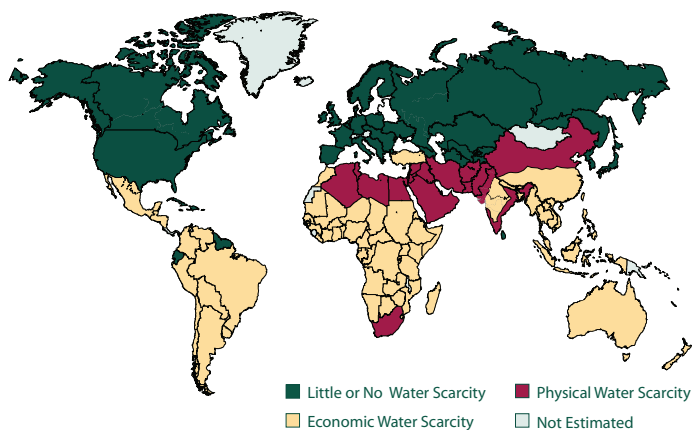
# Blue Gold

A startling reflection on water

We make no apologies for returning to a theme that we first discussed in 2008's Vision publication: the shortage of fresh water is still arguably the greatest threat that the world faces today. Viewing Earth from space, it would appear that our self-applied nickname of the "blue planet" is well deserved. Over 70% of the Earth's surface is water, the problem is that it is the wrong type and in the wrong places to support the development of the human race.

Population growth, rising incomes per capita and climate change are all boosting demand for water. It may seem to be a common substance, but fresh water's growing scarcity means that it is quickly becoming known as blue gold in development and investment circles. The amount of water in the world is finite – and fresh water only accounts for 1 percent of the total as demand for water is growing rapidly.

## Projected water scarcity in 2025



Source: International Water Management Institute, World water demand and supply, 2000 to 2025

There are three main reasons for this. First and most important, the world population is still growing. According to the UN, the global population is expected to reach somewhere between 8bn and 11bn by 2050. Each additional person on the planet will consume water, both directly through drinking and indirectly through eating. What is more, some of the fastest growing regions such as Sub-Saharan Africa are also the regions with the least rainfall. Second, rising per capita incomes in emerging economies such as China and India as well as parts of Latin America - which together account for about a third of the world's population - will also boost the demand for fresh water. This is because there will be an increasing demand for food, for plumbing and we also see the industry expanding. Take into account that agriculture accounts for about 70 percent of global usage of fresh water, but is very inefficient, with an estimated 80 percent lost before it reaches its final destination, and you start to see how much water we will need. As an indication of what this all means, once you take into account the growing, shipping and production, it takes 140 litres of water to produce one cup of coffee according to industry analysts. Third, climate change is starting to play its part

in fresh water scarcity by reducing the water table in low-lying coastal countries such as Bangladesh and South Africa.

These three factors mean that very significant investment will be required in the water industry in the coming years. Even for a developed country like the US, it is estimated that around \$325bn will have to be invested in drinking water over the next 20 years. All of this will increase the attractiveness of companies that develop water treatment technology and those who provide it, such as utilities companies. But aside from investing in such businesses, it has been difficult for investors to gain exposure to water, which is not yet a centrally traded commodity.

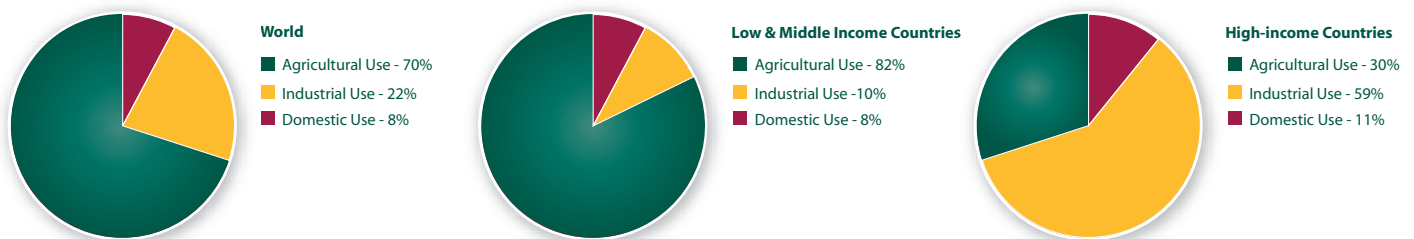
Water provides a dynamic alternative to the now established hard and soft commodity investment stories and it is one that is currently underexploited. There are only a handful of water funds available, as yet mainly based in continental Europe, investing in companies based worldwide. These "wet" funds will gain in number and prominence as we move towards 2010 and can be expected to play a significant role in portfolios equating to that of both hard and soft commodities.

1.6 billion people have obtained access to a safe water source since 1990. The proportion of people in developing countries with access to safe water has improved from 30 percent in 1970 to 71 percent in 1990, 79 percent in 2000 and 84 percent in 2004. This trend is projected to continue. One of the millennium development goals (set up by the United Nations in 2000 aiming to impulse development by improving social and economic conditions in the world's poorest countries) aims to halve, by 2015, the proportion of people without sustainable access to safe drinking water.

A 2006 United Nations report stated that "there is enough water for everyone", but access to it is hampered by mismanagement and corruption. UN ESCO's World Water Development Report from its World Water Assessment Programme predicts that, in the next 20 years, the quantity of water available to everyone is predicted to decrease by 30 percent. 40 percent of the world's inhabitants currently have insufficient fresh water for basic hygiene. More than 2.2 million people died in 2000 from waterborne diseases (related to the consumption of contaminated water) or drought. In 2004, the UK charity Water Aid reported that a child dies every 15 seconds from easily preventable water-related diseases; often due to the lack of sewage disposal.

"Water is not like oil. There is no substitute. If we continue to take it for granted, much of the earth is going to run short of water or food - or both."

## Competing water uses for main income groups of countries

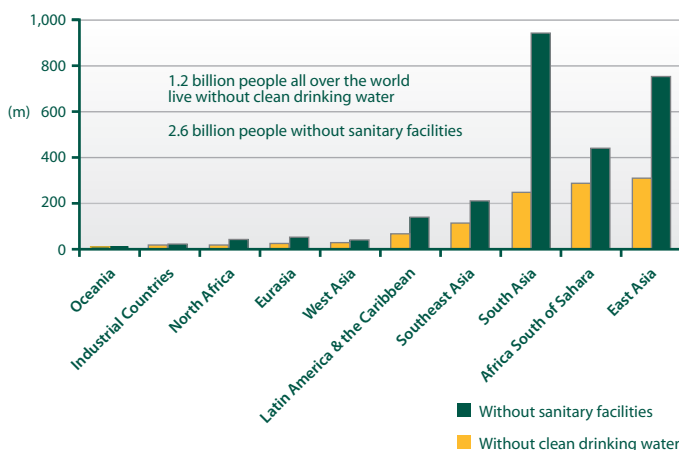


Source: Executive summary of the WWDR (World Water Development Report), Unesco, 2007

Rich countries too increasingly face water shortages. A combination of climate change and poor resource management is leading to water shortages in even the most developed countries, thus urging water conservation on a global scale and putting pressure on rich states to set an example by repairing ageing water infrastructure and tackling pollution. Meanwhile southern Europe is becoming drier as a result of climate change and, further north, Alpine glaciers - a significant source of water - are shrinking. The production of clothing, fruit, vegetables and even jewellery all need water. The demand for cheap produce often encourages wasteful use of scarce water resources. As the world population is set to grow from around 6.5 billion to over 9 billion by 2050, demand for food production will increase along with the competition for scarce water resources from industries and private households.

Responding to growing climate change threats and feeding the world sustainably requires new concepts and a strong political will to solve the world's growing water problems. The international community is also calling on wealthy countries to encourage more international co-operation over water because this is the one element no one can do without. And while money may be no protection against climate change, it can at least be invested in preserving the existing fresh water supplies. Of all the planet's renewable resources, fresh water may well be the most unforgiving; difficult to purify, expensive to transport and impossible to substitute. Water is not like oil. There is no substitute. If we continue to take it for granted, much of the earth is going to run short of water or food - or both.

## Water shortage



Source: SZ-Grafik / Quelle: Globus, UNICEF, 2002

After the publication of our first article in January 2008, we started work with Société Générale on creating a means of making water a more accessible investment proposition. Our wish was to avoid the natural pitfall of equating investment into water with buying the major global utility companies and instead to concentrate on those companies developing purification technology and which could add value to the creation and maintenance of water infrastructure and transportation. To do this, we wished to invest across as broad a universe of specialist companies as possible; to this end, we created, with help from Société Générale, an index of water funds operating under the UCITS III regulatory environment, and subsequently launched a fund to track this index; in other words, a fund of water funds. Although this is as yet only available on an institutional basis, we do not believe that there is a comparable product available anywhere in the world.

# Absolute Return Funds

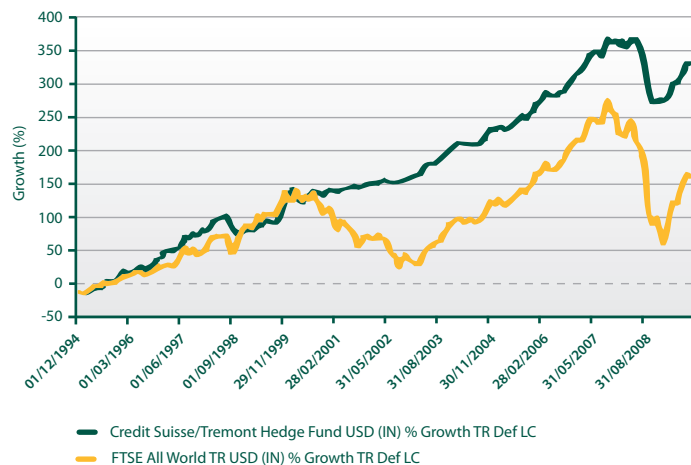
Just another money spinner?

With the large investment houses falling over themselves to launch absolute return funds, we discuss whether this is simply the latest investment fad or something of greater substance. With high management fees it is conceivable that the fund management houses are simply lining their pockets, but whilst this may be the case the funds may still deserve a place within portfolios.

## It's nothing new

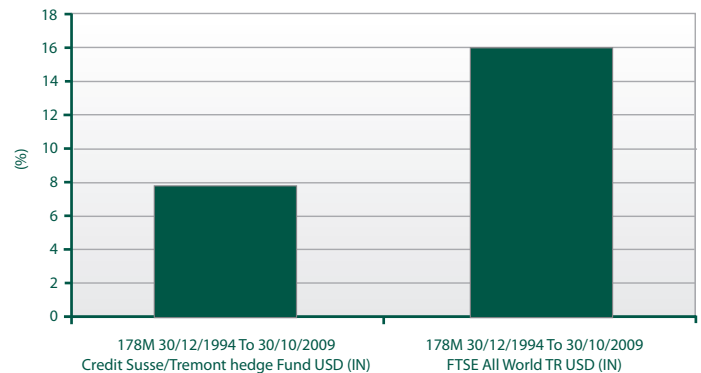
The Investment Management Association (IMA) launched the Absolute Return sector back in April 2008, reflecting the growing number of funds and interest of retail investors in the asset class. However, the aim of generating consistent positive returns regardless of market direction is not a new concept. It is the core investment philosophy of the multi-billion dollar hedge fund industry, which up until 2008 had been enjoying an ever greater slice of managed assets. The attraction of such an approach becomes clear when we look at long term historical returns versus traditional strategies. Since 1995, the cS Tremont Hedge Fund index has provided a 322% return with 7.8% annualised volatility, whilst over the same period the FTSE World has delivered 161% with 16.1% annualised volatility (source: Lipper Hindsight).

## Percentage growth



Source: Lipper Hindsight as at 30/10/09

## Annulaised volatiltiy



Source: Lipper Hindsight as at 30/10/09

Past performance is of course no guide to future performance and there have been some key changes to the industry which have and are likely to continue to act as a drag on returns. Prior to the shake out of 2008, where many weak and/or overleveraged hedge funds were wiped out, the sector was hugely more competitive than at the turn of the decade. More money chasing the same trades has the effect of diluting the number of opportunities and therefore acts to reduce potential returns. This was the key reason behind the massive build up of leverage in the sector, as performance incentivized managers sought to achieve high returns from otherwise mundane opportunities. With a large amount of capacity taken out and with huge dislocations following the volatility of 2008, 2009 has proved a fantastic year for many hedge funds. However, assets are already starting to flow back into the sector at a rapid rate and this is a trend we see continuing in the years ahead. Although funds have once again begun to borrow, they are unlikely to offer or indeed desire to gear up as much as they once did. Less leverage means investors should have more realistic targeted returns.

In theory, more competition should logically give rise to more competitive pricing or in this case lower fees. However, this has not been the case. Fees have generally risen over the years as demand for hedge fund exposure has grown. The combination of higher fees and greater competition has served to drive down average returns from hedge funds over the past few years.

## Similar but not identical

The absolute return funds being marketed at retail investors adopt a similar investment philosophy to traditional hedge funds but

" Funds managed with the aim of delivering absolute (i.e. more than zero) returns in any market conditions. "

with some key operational differences. The primary differentiator is that they offer far better liquidity, allowing for redemptions or purchases on a daily or weekly basis as opposed to monthly, quarterly or annually. As such, the underlying investment strategies tend to be highly liquid. The standard strategies employed are equity or bond long/short or multi-asset investing. In the case of the former, a fund manager can profit from both the rise and fall in share prices and therefore in theory can make money in any market environment. The multi-asset investor has the freedom to invest across a wide range of asset classes which should have low correlations to each other. By varying the weighting to each asset class at any one point in the cycle, it is possible to deliver consistent positive returns. Due to the liquidity constraints you will not find highly leveraged credit strategies that many hedge funds employ.

Regulation and tax treatment are also important considerations. The typical hedge fund is based offshore and is unregulated, whereas funds targeted at retail investors are now usually governed by UCITS III regulation. Gains on hedge funds are also more likely to be liable to income tax, unless the fund has distributor status.

### The proof is in the pudding

The IMA defines the universe as: 'Funds managed with the aim of delivering absolute (i.e. more than zero) returns in any market conditions.' It goes on to state that performance comparison between funds is inappropriate. This is a valid point due to the varying performance objectives and underlying strategies that each fund may employ.

Although comparison of individual funds is often pointless, we can look at the sector as a whole. Out of the 33 IMA sectors, the IMA Absolute Return has delivered the fourth best return over three years. The 18.32% total return over the period has been achieved with an annualised volatility of just 3.78%, far lower than any other sector apart from money market funds. In terms of risk adjusted returns, only global bonds have offered a better return profile. Absolute return funds, on average, have certainly lived up to their promise over the past three years. They have delivered positive returns, with a low volatility, to give investors one of the best risk adjusted returns of any asset class (source: Lipper Hindsight).

It is also interesting to observe performance versus gilts and property over the period. The fees on absolute return funds can be expensive and their very existence is questioned by those who believe sufficient portfolio diversification can be achieved through

the use of traditional asset classes such as gilts and property. Whilst gilts have offered good diversification (albeit not to the same degree as ABR funds) property has not. Despite the high fees that some funds charge, the evidence suggests they are worth coughing up for. Whilst the past three years has been conducive to such an investment strategy, in a bull market the sector will undoubtedly underperform equity. Since March 2009, returns from the sector are in the high single digits – far behind all equity indices. However, on a risk adjusted basis returns remain attractive and as a portfolio diversifier they appear to deserve a place.

### Absolute return funds

Name	Standard Deviation*	Percentage Growth**
IMA Money Market	0.59	6.93
IMA Absolute Return	3.89	18.30
IMA Protected	4.44	-0.25
IMA UK Gilt	7.25	12.87
IMA £ Corporate Bond	7.50	1.02
IMA Global Bonds	8.40	26.06
IMA £ Strategic Bond	8.55	-1.40

\*Annual TR Deficit LC 3Y 31/10/2006 TO 30/10/2009

\*\* TR Deficit LC 3Y 31/10/2006 TO 30/10/2009

Source: Lipper Hindsight as at 30/10/09

Whilst we have established the merits of absolute return funds, fund selection remains vital. For example the UBS Absolute Return fund has dropped in value by 34.15% over the past two years, a significant drawdown for a fund branded as being able to deliver consistent positive returns. Conversely, the top fund in the sector over the past year, C F Octopus Partner (Absolute Return), has returned 64.59%. Whilst this is a highly commendable effort and the fund may well deserve a place in a portfolio, the risk taken in order to achieve such a return should throw up questions as to whether this is a true absolute return vehicle.

Absolute return funds have clearly proved their worth in what has been as challenging a 36 months as has been seen in almost 80 years. Whilst the sector will lag if risk assets continue to head higher, the diversification benefits these funds offer portfolios are undeniable. This is one investment fad that looks unlikely to be forgotten 18 months down the line.

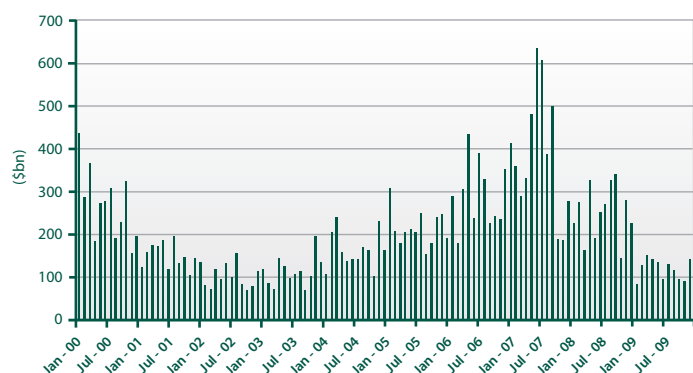
# Mergers and Acquisitions

A year for deals

Merger and acquisition activity (M&A) is an important underlying driver for equity and bond markets. The propensity for companies to consolidate by either merging, or more frequently, buying competitors offers the prospect for equity investors to receive significant premia for individual holdings of equities. Clearly this is an enticing prospect, but it is easier to identify particular companies or sectors that are likely to consolidate than it is to know when they will actually do so. We know from experience that a company can be a likely bid target for many years without anything happening; Standard Chartered for example has been attracting rumours for almost 25 years since it successfully fought off a hostile approach from Lloyds Bank in 1986.

There are however a number of factors that help us identify when M&A activity is more or less likely to occur. In this article we examine these and conclude that rising corporate activity is highly likely to be an important element of markets for some time.

## Global M&A volume 2000-2009 (monthly data)



Source: Bloomberg as at 31/08/09

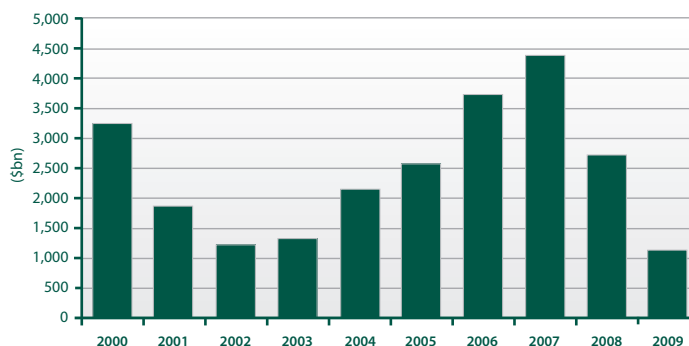
M&A was a regular feature of equity market activity during 2003-2007. This is illustrated in the chart above, which shows the level of global M&A volumes over that period. Having reached a low in 2002, towards the end of the last US recession, activity steadily climbed, peaking at \$4400bn in 2007. 2008 saw a year-on-year decline, in the midst of a global financial crisis, and 2009 is set to be the weakest year this decade. The progression over the course of 2002-2009 illustrates the fact that M&A occurs to a much greater extent in 'the good times' and to a much lesser extent in 'the bad times'.

This 2003-2007 period was the primary era of the private equity mega-deal. The ethos of that time was that any company not using its balance sheet efficiently was potentially at the mercy of private equity. Even Vodafone was not immune to the speculation, its \$100bn price tag allegedly being no bar to a bid. 2006 though was arguably the year in which the frenzy reached its peak, with six deals of more than \$17bn completed, including two take-overs of over \$30bn (the acquisitions of Equity office Properties by Blackstone and of Hospital Corporation of America by a consortium of Bain, KKR, and Merrill Lynch). (source cnnMoney.com).

We can take our analysis further. The level of M&A largely depends upon two key factors – confidence and access to debt finance. As an example of the former, companies are much more willing

to take the plunge and buy a competitor when the economy is growing and with the prospect that it will continue to do so. This gives the company confidence that it will enjoy an increasing return on its investment, as cost synergies are realised, debt is reduced and profits climb. The second prerequisite for M&A activity is access to debt finance. When purchasing a competitor, issuing new shares is often the largest component of the offer but the target's shareholders usually require a substantial cash element if they are to agree to the offer (much more cash than the acquirer usually has at hand). In addition, the company should wish to maintain some kind of balance in its capital structure, between debt and equity, particularly if the cost of debt is low. debt finance typically takes the form of either issuing corporate bonds (to debt investors) and/or a loan facility provided by its bank(s).

## US corporate bond spread 2000-2009



Source: Bloomberg as at 31/08/09

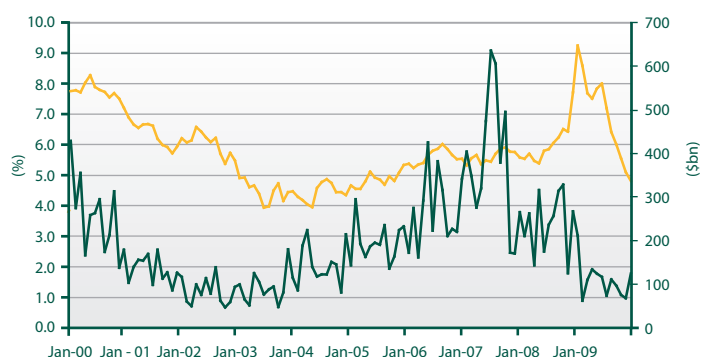
The behaviour of corporate bond spreads is demonstrative of both confidence and access to debt finance. The spread is the difference between the rate at which companies and the government can borrow. This is called a premium. In the chart above, we can see that US corporate bond spreads peaked during 2002 and then declined over the period between 2003-07. This was a period of economic recovery, as growth resumed and steadily accelerated. As a result of an improving economic background, companies were required to pay a progressively lower premium to borrow. In this sense, we can use declining corporate bond spreads as a good indicator of business (and market) confidence. declining spreads are also indicative of increasing availability of debt finance. As spreads decline, banks also feel more confident and will be progressively more willing to lend. As the perception of corporate credit worthiness improves, banks will be able to justify large scale lending to deemed low risk on increasingly thin

" US corporate bond spreads have tightened considerably since early 2009 which we view as a precursor to an upturn in global M&A volumes. "

premiums. debt investors will also feel more confident, more willing to buy high yield debt used to fund leveraged buy-outs and private equity firms will find it easier to raise cash from investors. Together, increasing confidence and availability to debt finance indicate higher levels of M&A to come.

The relationship between corporate bond spreads and M&A is illustrated very clearly in the chart below. Here we plot US corporate bond spreads against global M&A volumes (of which the US forms the largest part, given it is the world's largest economy). There is a clear inverse relationship between the two. As spreads decline (increasing confidence and availability to debt finance), M&A volumes rise. These rose steadily throughout 2003-07, peaking in 2007 which also coincided with the low being reached for spreads (which by this time were trading at an almost insignificant premium to government debt). The opposite is also true. As the crisis in the banking sector started to emerge during 2007, corporate bond spreads started to widen. As the scale of the crisis became ever clearer during the course of 2008, spreads ballooned as the market anticipated a recession and widespread corporate failures. We can use the sharp increase in corporate bond spreads as a proxy for collapsing business confidence and the evaporation of bank lending. As a result 2007 marked the peak in global M&A activity, with a decline of almost 40% in 2008 and a further sharp decline in 2009.

#### US corporate bond spreads and global M&A volumes 2000-09



Source: Datastream as at 31/08/09

However we believe there are early signs that we are witnessing a turning point in the M&A cycle. US corporate bond spreads have tightened considerably since early 2009 which we view as a precursor to an upturn in global M&A volumes. Indeed, Kraft's surprise £10bn offer for cadbury is just one of many pieces of

evidence so far of increasing business confidence. The banks also appear to be increasingly confident that the worst is behind us. Banks in the UK, Europe, and the US are progressively shunning emergency government assistance in favour of relying upon the resources of their shareholders. Lloyds Banking Group has gone so far as to say that it believes that bad debts have peaked. on the other hand, the sheer level of impaired loans and the likelihood that banking regulators around the world will require higher capital cushions to be maintained from now on means that banks will have to manage their balance sheets carefully for quite some time yet. However, in terms of M&A volumes it tells us that finance will be available, perhaps on a rather small scale to begin with, but it is a start.

one aspect we have not yet discussed is equity valuation. clearly a potential acquirer needs to be able to justify a deal economically. This is much easier when equity valuations are low, but experience tells us that even when much higher prices need to be paid, underlying assumptions (however unrealistic) can be re-worked to justify almost anything. Having the confidence and the financing are key. However, when equity valuations are at low or reasonable levels, like now, it does help companies with cash and access to debt finance that they wish to put to work. This may be particularly appealing if organic growth is proving difficult in an environment of low economic growth. Smaller, bolt-on acquisitions offer the prospect of boosting sales growth, and if in a similar sector, the prospect of cutting costs and driving margins. As an example, Unilever has recently announced the purchase of the Personal care business from the Sara Lee corporation of the US for €1.275bn in cash. Brands such as Sanex and Radox will strengthen Unilever's positioning in this category in Western Europe and Asia.

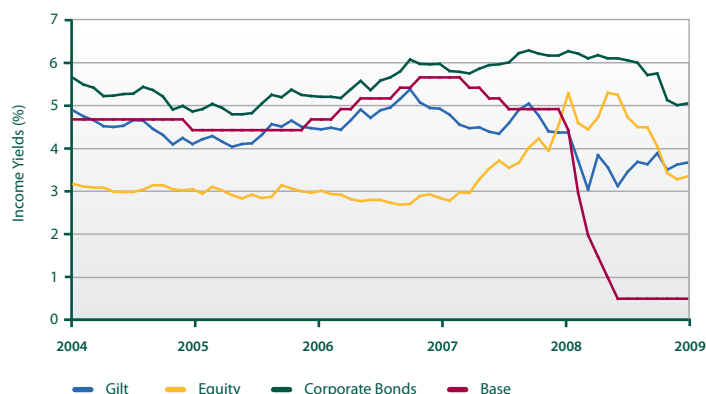
We believe that confidence and the related issue of debt finance are essential prerequisites for M&A activity. This is demonstrated by the clear inverse relationship between US corporate bond spreads and global volumes of M&A. Having peaked in 2007, global volumes of M&A are at levels not seen since 2002. However we believe there are early signs that we are witnessing a turning point in the M&A cycle. US corporate bond spreads have tightened considerably and some degree of business confidence does appear to be returning, including in the banking sector. This bodes well for global M&A activity, which we expect to gradually recover from current levels.

# Finding Income

## The importance of income

With UK bank rates at 0.5% and likely to remain at a low level for a considerable period of time, returns on bank savings accounts have been reduced to almost nothing. The yield on government bonds is little better. At a time when the baby boomer generation is reaching retirement age, we believe that demand for income will only increase at the same time as becoming ever more scarce. In a potentially low growth economic environment, we also believe that it will have a more meaningful part to play in total investor return. We search for income and discuss the various merits and valuation of bonds, equities and property.

### Yields falling across several asset classes



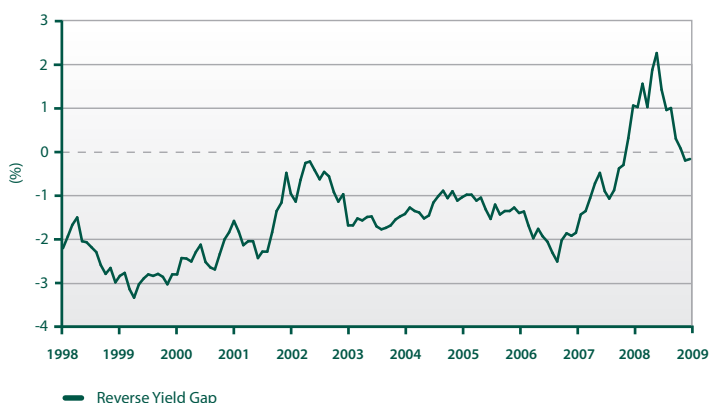
Source: Datastream as at 30/10/09

At the end of October 2009, yields along the gilt curve varied from a paltry 0.5% for one year money, only 1.7% for three years and 2.8% for five. The longer the maturity the higher the rate, but at 3.7% for tying up money for ten years and only 4.2% for thirty, returns are still historically very low. If we look overseas to the United States or to Germany the situation is little different and turning to the corporate sector, bonds yields have also fallen back and spreads narrowed as confidence has returned to UK plc. Investment grade bonds, and gilts in particular, can be a reliable way of generating a safe and steady stream of income over a set period of time but unless held until redemption, capital returns are uncertain. Bond yields and therefore pricing, fluctuates in the market depending on supply and demand which in turn, is influenced by expectations of the future direction of interest rates and of inflation. Due to weakness in the UK economy, the bank rate has been 0.5% since March 2009 and throughout most of the period, inflation has been on a sliding scale. As we enter 2010, with market hopes that the global economy may be stabilising, it is not unreasonable to consider that following the UK government's quantitative easing programme, both inflation and interest rates will slowly start to rise. Logic suggests that bond yields will also start to rise and prices fall. Index-linked gilts will continue to provide some protection against inflation, but in this scenario, we doubt it will be sufficient to offset the resulting fall in capital value.

Over most of the past fifty years, the yield on UK gilts has been above that recorded for the UK equity market and the reverse yield gap (equity yield minus the 10 year bond yield) has traditionally been used to measure the relative value of each. However, in

November 2008, the equity yield crossed the bond yield for the first time since 1958 and continued to rise as equities fell (and gilts rose) during a period of extreme economic uncertainty. By the end of March 2009, the equity yield was more than two percentage points above that for gilts. For comparison purposes, the reverse yield gap over the past 10 years has averaged around a negative one to two percentage points, and in recent years the closest the two have previously come to parity was in February 2003 when the gilt yield was just 0.38% more. Equity markets subsequently staged a rally that lasted for the following five years. In retrospect it could be argued that when the gilt yield fell to 2% below equities in March 2009 it was a signal that equities were undervalued. The strong rally in the stock market during the remainder of 2009 means that the relative valuation has started to correct, but with the yield on the UK All-share at 3.4% and the 10 year gilt yield at 3.7% (both at 31st October 2009), the margin is still very narrow. If history repeats itself, this means one of two things, either gilts are expensive and yields will rise or equities are still cheap and have further to rally. The evidence is inconclusive, but we suspect that a combination of the two factors will eventually return the reverse yield gap to its normal equilibrium, in keeping with previous trends.

### Reverse yield gap



Source: Datastream as at 30/10/09

dividends matter. In theory, the returns on equity markets are driven by the sum of future cash flows (dividends) discounted back to net present value as illustrated by the dividend discount model. Their payment not only provides investors with income, but also reflects confidence in the future and therefore potential for capital growth. 2009 was a disappointing year for income investors and consensus estimates indicate a 25% cut in payments

" We expect property to remain on investor radar screens throughout the coming year. "

for the market as a whole. However, although the UK Banking sector is no longer the bedrock of income funds, Pharmaceuticals and oil, amongst others have sprung into its place. We also point out that, more companies actually increased payments in 2009 than reduced (source: Williams de Broë research) and apart from the financial sectors, very few big companies actually cut. The pool of dividend payers has shrunk however and just seven companies, BP, Vodafone, Royal dutch Shell, HSBc, GlaxoSmithKline, BHP Billiton and AstraZeneca will have contributed over half the UK market's total income in 2009. despite the cuts, the yield on the FTSE All-share is still a relatively healthy 3.4% (as at october 2009) and dividend growth is expected to return in 2010 with consensus indicating an 8% rise as several companies return to the distribution list.

At this point, we note the power of re-invested income. The importance of dividends to total return is demonstrated each year in the Barclays Equity Gilt Study. The 2009 study showed that £100 invested in the UK stock market in 1945 would have a capital value of £5,721 by the end of 2008 in nominal terms, but on the same basis if gross income had been re-invested it would have grown to £92,460. (As a comparison, gilts would have produced £5,135 and cash £6,091.) Even if not income for income's sake, dividends have an important part to play. In the current low growth economic environment we expect these payments to play an increasingly meaningful part in total shareholder return.

We must also not ignore the commercial property sector. According to the IPd (Investment Property databank), the yield on its UK All Property index was 7.7% at the end of September 2009 and capital growth of 1.1% was the largest monthly increase since June 2006 despite continued downward pressure on rents. not without risk, but an attractive return when compared with the market yield on equities or bonds and reflective of the steep fall in property valuations since the peak in 2007. Historically the yield on property has been compared to bonds. yields on property have not stayed more than two percentage points above the 10 year gilt yield for any length of time. The current yield gap of four percentage points (7.7% minus 3.7%) confirms our view that although there are still uncertainties ahead, the income argument is so compelling that the prime property market may have already stabilised with the possibility of a slow recovery in 2010. This view is confirmed by a

number of transactions that have recently taken place, and by several industry experts (such as London & Stamford, British Land, Land Securities) that have already invested, or expressed the intention to invest in the market should opportunities arise. Although we acknowledge that gaining exposure to this income stream can be difficult for private investors, we expect property to remain on investor radar screens throughout the coming year.

#### Historical gap between property and bond yields



Source: Datastream as at 30/10/09

The search for income is not an easy task. The diminished yield on gilts reflects the current low interest rate environment as well as the UK government's supportive buy back plan. Analysis of the reverse yield gap reveals that compared with history, bonds appear overvalued and with many issues trading above par, income generated insufficient to offset a fall in capital value, especially for tax payers. In comparison, the growing yield on equities with potential for capital growth over coming years is potentially a much more attractive proposition and many 'blue-chip' companies (such as GlaxoSmithKline, Vodafone, British American Tobacco, Unilever and diageo) are increasing payments on already above average dividend yields. The relatively high yield on direct property is attractive and historically this has provided a steady income stream.

# Dynamic Asset Allocation

## Why static asset allocation is a dangerous tool

One of the less appreciated aspects of the gyrations in global markets over 2008 and 2009 is that these have very largely undermined the basis of asset allocation used for most of the past 50 years. This is the financial equivalent of being told of the illegitimacy of one's children at one's Golden Wedding Anniversary; the way of managing money that has been accepted wisdom and which has been drummed into financial students for decades has been shown to be deeply, possibly terminally, flawed.

The concept of "Modern Portfolio Theory" is widely accepted to date back to Harry Markowitz's paper on "Portfolio Selection", published in the *Journal of Finance* in 1952. The idea is terribly simple: that a diversified portfolio can achieve better risk-controlled returns than a single asset class.

If we think of the basic example of equities and bonds, the former is accepted to be likely to produce higher returns, but at the cost of greater volatility and therefore potentially larger losses. Bonds, on the other hand, will provide an investor with lower returns, but with a greater degree of security. A simple trade-off of risk and return. But the best news is that as performance of equities and bonds is not necessarily correlated on a one for one basis, then by blending the two it becomes possible to construct portfolios that have different characteristics. It should be possible, for example, for the investor to forego a small amount of potential performance in exchange for a much larger reduction in volatility. Thus this trade-off between risk and return is non-linear.

Now if we throw every possibility into this asset allocation food blender, then we can see that we can create a potentially infinite number of portfolios with a similar number of outcomes. But for every possible portfolio return, there is an array of possible volatilities. Modern Portfolio Theory assumes that investors naturally want to achieve returns for the lowest possible risk: for example, it is inherently more attractive if a return of say 10% can be expected for an annual volatility of 15% rather than 25%. If this 15% is the lowest volatility that can be taken on for a potential 10% return, then this is the optimum portfolio for an investor targeting this.

There are a number of obvious pitfalls here. If we imagine the perfect asset for investment, it will provide the best returns for the lowest volatility. And if we can imagine the perfect asset, then surely we should allocate the maximum possible amount of a portfolio to it, if not all of it? It is a persuasive argument. But we

need to think of it in practical terms, so let us skip back in time to 2005 and 2006 and think of UK commercial property. At that time, all reasonable analysis of UK commercial property showed that it provided the best returns of all investible asset classes and at the lowest volatility. Thus the very clever spreadsheets of a number of asset allocators would place 100% of portfolios into commercial property.

Here the problems begin to stack up. First, this ignores any notions of diversification or contingency planning. Second, the analysis was based on historic performance which as we all know to our cost is not necessarily a totally reliable guide to the future. Third, the analysis of volatility tended to ignore that commercial property portfolios were valued at best monthly, but habitually six monthly, rather than being beholden to the daily swings of equities. And fourth, and most significantly, it absolutely ignored any element of valuation. Thus that commercial property funds were returning roughly 2% or 3% less than the then risk-free rate was deemed not to be relevant. This was the investment equivalent of allowing the satnav to take you up a forest track instead of Manchester airport.

There is an underlying principle that higher returns must be linked to higher risk. An investor seeking 20% a year must necessarily be taking more risk than one wanting 10%. In golfing parlance, it should be more difficult to go for the green than to lay up short; for the batsman, hitting a six should take on more chance of being out than nudging a single. But this is where the problems start to kick in; 2008 and 2009 have been so extreme that over almost any reasonable period of time, investors have received precious little compensation for taking on extra risk. Moreover, over shorter periods of time (meaning up to 15 years) investors have even been penalized for taking risk.

"The asset allocation of portfolios has to be able to respond to changing market conditions."

The table below shows the returns on UK and overseas equities, the FT Government All Stocks Index and cash over the past three, five and ten years, as well as back to the starting point of our data at the beginning of 1994:

%	UK Equities	Overseas Equities	Fixed Interest	Cash
3 Years	(6.26)%	5.31%	19.82%	15.24%
3 Yr Annual	(2.13)%	1.74%	6.21%	4.84%
5 Years	35.80%	38.71%	34.98%	26.61%
5 Yr Annual	6.31%	6.76%	6.18%	4.83%
10 Years	18.21%	16.70%	73.87%	60.40%
10 Yr Annual	1.69%	1.56%	5.69%	4.84%
Since 31/12/93	153.08%	136.47%	172.72%	129.81%
Annual	9.73%	8.99%	10.55%	8.68%

Source : Thomson Reuters as at 30/10/09

Now we know that all assets tend to correlate at times of crisis. When investors want their money back because they will only feel happy with notes stuffed in their mattresses, they will sell anything at any price, as was amply demonstrated in the fourth quarter of 2008 and the first quarter of 2009. But this was then combined with an insatiable desire to buy government bonds, again irrespective of the price. It seems very odd to try to explain this now, but the markets were prepared to buy UK and US government bonds at negative yields, as it was believed that the guarantee of a small loss was the best deal available.

This creates a very considerable challenge for Modern Portfolio Theory. The data is now telling us that portfolios should be comprised of the lowest risk assets, as these provide the same returns as risky ones over time, but at much lower volatility. Equally it is possible to argue that Modern Portfolio Theory has created no value for investors; the correlation of performance has meant that all portfolios have suffered more or less equally.

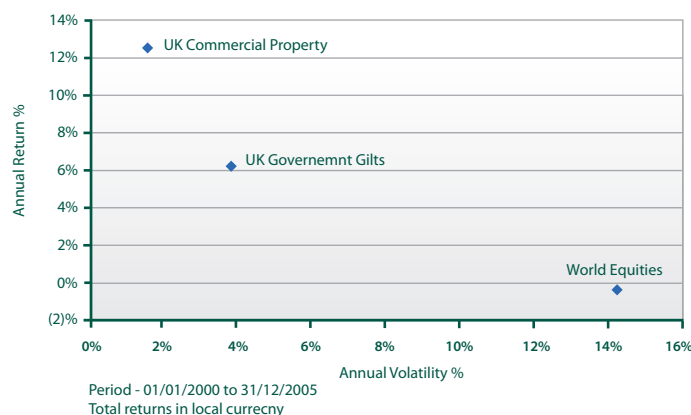
And here we get to the heart of the problem of asset allocations set by Modern Portfolio Theory. They are believed to be optimal and are therefore fixed; or at the most subject to occasional rebalancing. As with the example of the satnav, this is the

equivalent of punching in the same postcode to try to get out of the field that it drove you into in the first place.

Instead, asset allocation can only be truly effective when it is dynamic. The asset allocation of portfolios has to be able to respond to changing market conditions. We need to be able to cut equity weights before markets fall and raise them again after they have fallen. Portfolio Theory will only tell us that volatility has increased after a fall and that the asset class has thus become less attractive. This is the same principle that forces insurance companies to sell equities to raise solvency levels after markets have fallen.

Where does this leave us now? Readers of previous editions of Vision will know that we were very cautious going into 2008 and hopeful at the beginning of 2009. This year is one where the potential outcomes are much more difficult to predict and poles apart. It is a year when more than ever active, dynamic asset allocation is an absolute prerogative for successful portfolio management.

### Asset allocation



Source: Thomson Reuters as at 30/10/09

# Vision 2010

## Conclusion

I hope you have found the themes discussed in Vision 2010 both topical and thought-provoking. I would like to take this opportunity to thank the team who have produced this publication:

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Kind regards



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# Vision 2010



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