momentum

viewpoint

April 2012

global investment management

Growing political uncertainty in Europe during April threatened to take the shine off last quarter's gains. Dutch Prime Minister Mark Rutte's resignation on the last day of the month pitched another core Eurozone government into confusion, whilst in France investors readied themselves for the likelihood (now proven reality) of a change in leadership. The second round of France's presidential elections was contested on Sunday 6 May between incumbent Nicolas Sarkozy and Socialist challenger Francois Hollande, after the latter took the first round with 28.5% of the vote. In a potential sign of growing unrest amongst electorates in the region, Marine Le Pen's far right Front National party came third with a record showing of 18.1%. Whilst politics is often depicted as a race to occupy the centre ground, especially in times of plenty, the perceived capitulation of centrist politics may instead be pushing European voters towards the fringes.

Global equities suffered their first down month in 2012 during April, as the global aggregate declined by 1.1% in US dollar terms. Developed Asia was the only region to post gains, whilst elsewhere markets traded lower by between 0.3 and 5.9 per cent. Emerging markets fell by 1.2% over the period, with stocks in Latin America declining by 3.8% in US dollar terms. In contrast, global government bonds rallied by 1.6%, to edge into positive territory for the year, as investors increased their demand for perceived 'safe haven' assets.

Economic data has softened in recent months, although the outlook for global growth still remains evenly balanced. US gross domestic product grew by 2.2% (annualised) in the first quarter, behind forecasts for growth of 2.5%, and confirming the sluggish nature of the recovery. The ADP employment report, which compiles payroll data from approximately 365,000 of ADP's (Automatic Data Processing) 500,000 US business clients, disappointed forecasters, with 119,000 new jobs added in April versus 170,000 expected. The ISM manufacturing index, however, continues to outperform, registering 54.8 in April up from 53.4 the previous month. The strength of this series in the next few months will help decide whether fears over the persistence of the current uptick in activity are founded. Economic data has demonstrated an apparent seasonal bias in recent years, with strong reports at the start of the calendar year giving way to more depressed levels of activity from then onwards. The Citigroup US Economic Surprise index, which aggregates both the direction and size of deviations of actual data releases from consensus forecasts, appears to endorse this trend in the past two years. Researchers have suggested that the levels of seasonally adjusted series, of which the ISM is one, may be being distorted by events in 2008, and in particular the rapid deterioration in forward-looking indicators following the collapse of Lehman Brothers in September. Incorporating this data point when forecasting 'normalised' levels of activity at different times of year leads to the spurious conclusion that activity is habitually lower around September. Other one-off effects that may have had a bearing on economic activity in the US during the first quarter include the unseasonably warm spring, and changes to the tax code at the end of March, which created the incentive for companies to bring forward a portion of planned spending.

Europe's roll call of countries in recession has grown to include Cyprus, the Czech Republic, Denmark, Greece, Ireland, Italy, the Netherlands, Portugal,

Source: Bloomberg/Lipper Hindsight. April 2012

Slovenia, Spain and the United Kingdom, or approximately half of the Union based on contribution to aggregate gross domestic product. Germany is at risk of joining this list, after its economy contracted by 0.2% in the three months to the end of December. Only Belgium and Estonia have reported positive first quarter growth figures to date in 2012. This is a difficult time for governments, as faltering growth leads to lower tax receipts, whilst higher unemployment requires the state to increase its spending on social welfare. In sum, the need to borrow money may continue to rise in spite of government belt tightening. The average debt of the 17 nation euro area rose to 87.2% of GDP in 2011, up from 85.3% in 2010 and its highest level since the introduction of the single currency in 1999.

Eurozone unemployment rose by 169,000 in March to 17.4 million, adjusted for seasonal variations in employment levels. The latest figures from Europe's statistics office confirmed the 11th consecutive month-on-month rise in unemployment, to leave the number of people out of work at a new euro era high. Data from purchasing managers remains weak, with the Eurozone manufacturing PMI falling from 47.7 in March to 45.9 in April, its lowest level in almost three years. Spain's IBEX index traded through its March 2009 lows during the final week of the month. Standard and Poor's (S&P) downgraded 11 Spanish banks on the last day of April, following its decision to cut Spain's sovereign rating the previous week. The agency chose to downgrade Spanish government debt by two notches to BBB+ (negative outlook), following its double notch downgrade in January. To put these moves into context, Spain went into 2008 with a triple-A from all three major ratings agencies.

In Asia, China's official manufacturing PMI rose for the fifth month in a row in April, to 53.3 up from 53.1 in February. HSBC's manufacturing index, which has a bias towards small and medium sized companies, rose to 49.3 from 48.3 previously, indicating continued modest contraction. The Bank of Japan announced additional asset purchases of JPY 10 trillion during the last week of the month. Bank officials were equally bullish on the prospects for inflation to rise to 1%, a positive sign for an economy that has experienced persistent deflation since 1998. South Korea's GDP grew by 0.9% last quarter in line with market expectations. Nonetheless, the year-on-year increase in gross domestic product of 2.8% represents the country's weakest rate of growth in two and a half years.

Companies continue to make money in this environment. As we approach the end of earnings season in the US, 69% and 71% of S&P 500 companies have beaten sales targets and earnings per share targets respectively, on par with the strongest earnings season since the second quarter of 2010. Average margins are yet to moderate, and have persisted above their long run average since late 2009

Global property securities gained 2.4% last month in US dollar terms, led by Australia which saw stocks rallying in anticipation of cheaper financing from the Reserve Bank of Australia (RBA). The RBA cut its benchmark lending rate by 50 basis points to 3.75% at the start of May. Whilst consensus expectations had suggested a 25 basis point cut, only 2 of the 29 economists polled by Bloomberg foresaw the eventual half point reduction in rates. Listed property failed to add diversification to investors' portfolios in 2011, with returns moving in tight formation with the broader equity market. Indeed, of the 10 sectors in the Global Industry Classification Standards, the range of correlations to the broader market was between 0.84 and 0.99 in 2011. Over the preceding 12 years, however, investing in sectors has offered more genuine diversification opportunities for investors.

In currency markets, the yen appreciated by 3.1% versus the US dollar. Despite the sizeable depreciation of the pound in recent years, UK exports have not seen a strong rebound, perhaps due to the importance of Europe as a destination for British exports and the reduced size of the country's manufacturing base.

Commodities fell by 0.7% last month, with oil and gold prices declining by 3.2% and 0.7% respectively. Talks between Iran and six leading countries at the start of April were described as constructive by EU diplomatic chief Baroness Ashton. The news appeared to catalyse a fall in oil prices, with Brent crude for delivery in June declining by 2.0% over the remainder of the month. Developments in Argentina were less positive for the global oil supply, as the government announced plans to seize control of YPF, the country's largest oil group, from Spanish company Repsol. The move is likely to discourage foreign capital from investing in Latin America's second largest economy, and may cast a pall over the region, an area well-known for populist/socialist politics.

Source: Bloomberg/ Lipper Hindsight. April 2012.

Asset class/region	Index	Currency	Currency returns Week ending 18 May	Month to date	YTD 2012
Developed markets equities					
United States	S&P 500 NR	USD	-4.2%	-7.2%	3.6%
United Kingdom	FTSE All Share TR	GBP	-5.4%	-7.8%	-2.5%
Continental Europe	MSCI Europe ex UK NR	EUR	-4.8%	-6.6%	-1.4%
Japan	Topix TR	JPY	-4.3%	-9.8%	0.7%
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	-6.4%	-11.1%	0.5%
Global	MSCI World NR	USD	-5.1%	-8.7%	0.7%
Emerging markets equities					
Emerging Europe	MSCI EM Europe NR	USD	-9.3%	-15.7%	-2.2%
Emerging Asia	MSCI EM Asia NR	USD	-5.6%	-10.3%	1.5%
Emerging Latin America	MSCI EM Latin America NR	USD	-8.0%	-13.3%	-4.4%
BRICs	MSCI BRIC NR	USD	-6.7%	-13.2%	-3.0%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-6.5%	-11.4%	-0.1%
Bonds					
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.7%	1.2%	1.4%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.0%	1.2%	4.2%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.2%	0.2%	3.7%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-1.7%	-1.2%	5.2%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.5%	2.7%	1.0%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.1%	1.0%	3.7%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.5%	0.2%	3.5%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.7%	-0.3%	5.5%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-2.1%	-1.9%	10.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3%	0.6%	1.5%
Australian Government	JP Morgan Australia GBI TR	AUD	1.2%	3.1%	4.8%
Global Government Bonds	JP Morgan Global GBI	USD	0.0%	-0.1%	0.5%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-0.4%	-0.7%	1.2%
Global Convertible Bonds	UBS Global Convertible Bond	USD	-2.8%	-4.7%	2.9%
Emerging Market Bonds	JP Morgan EMBI+	USD	-1.9%	-2.4%	3.4%

Source: Bloomberg. April 2012.

Asset class/region	Index	Currency	Currency returns Week ending 18 May	Month to date	YTD 2012
Property					
US Property Securities	MSCI US REIT NR	USD	-6.9%	-6.8%	5.8%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-3.6%	-2.0%	8.7%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	-3.4%	-2.9%	4.4%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	-2.5%	-2.2%	10.9%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	-4.4%	-9.9%	7.7%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	-5.7%	-7.5%	6.9%
Currencies					
Euro		USD	-1.7%	-3.9%	-2.0%
UK Pound Sterling		USD	-1.8%	-2.7%	1.7%
Japanese Yen		USD	0.8%	0.7%	-2.9%
Australian Dollar		USD	-2.0%	-5.3%	-3.8%
South African Rand		USD	-3.0%	-6.9%	-3.0%
Swiss Franc		USD	-1.7%	-3.9%	-1.0%
Chinese Yuan		USD	-0.3%	-0.3%	-0.5%
Commodities & Alternatives					
Commodities	RICI TR	USD	-0.5%	-6.3%	-2.2%
Agricultural Commodities	RICI Agriculture TR	USD	3.9%	-2.3%	-1.9%
Oil	ICE Crude Oil CR	USD	-3.5%	-8.9%	1.4%
Gold	Gold Index	USD	0.4%	-3.7%	3.8%
Hedge funds	HFRX Global Hedge Fund	USD	-0.9%	-1.7%	1.5%
Interest rates				**Current rate**	**Change at meeting**
United States	25 April 2012	USD		0.25%	-
United Kingdom	10 May 2012	GBP		0.50%	-
Eurozone	03 May 2012	EUR		1.00%	-
Japan	27 April 2012	JPY		0.10%	-
Australia	01 May 2012	AUD		3.75%	-
South Africa	29 March 2012	ZAR		5.50%	-

Source: Bloomberg. April 2012.

FOCUS: managing currency exposure in global portfolios

As one moves away from the familiar choice between equities and bonds, or between property and commodities for example, there is a tendency for investors of varying degrees of sophistication to overlook currency as a distinct investment decision. This month's Focus aims to highlight the importance of the currency decision in global portfolios.

It is vital not to underestimate the impact of currency on a well diversified portfolio. The choice of base currency together with the exposure to international currencies is critical to the success of any investment strategy.

Chart 1: Risk-return profile of major asset classes (reading from left-to-right: LIBOR USD 3 months; Citigroup WGBI Unhedged USD; JPYUSD spot rate; MSCI World NR USD; FTSE EPRA/NAREIT Developed TR USD)

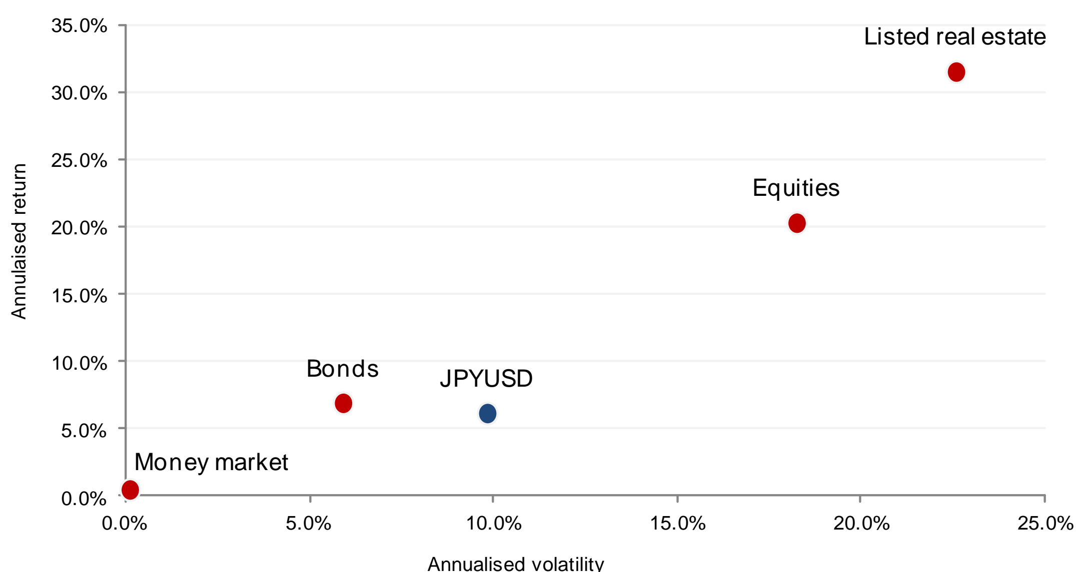
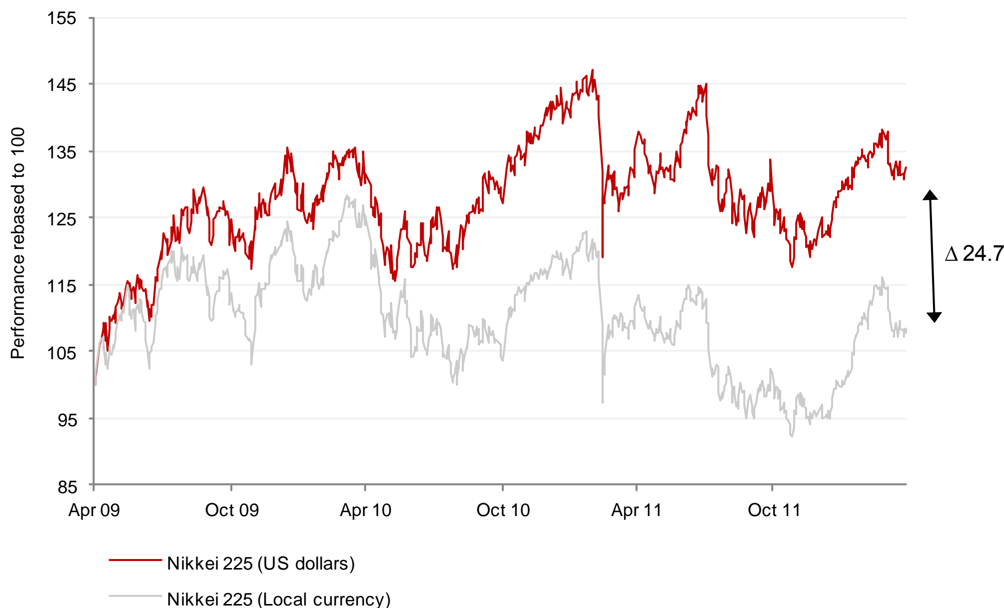


Chart 1 shows the returns of major asset classes over the last three years to the end of April, versus their realised volatility. The Japanese yen:US dollar currency pair has been added to this list, representing the return to a US investor of converting dollars into yen at the start of the period and subsequently reversing the trade at its end, excluding any interest considerations. Chart 1 serves to illustrate how currencies can have both a wide range of potential outcomes over the course of any given year and at the same time make a significant contribution to portfolio returns. In this instance, a 5% allocation to the yen would have added 30 basis points per year to a US dollar based investor's portfolio, with an expected range of outcomes of between -18 and +80 basis points.

The currency decision can make a bad investment choice a good one. Looking at Chart 2, the decision to invest in Japanese equities has yielded a disappointing nominal return of 2.5% per annum in yen terms. In dollars, however, the decision has added a far more respectable 9.8% per annum.

Source: Bloomberg, April 2012

Chart 2: The relative experience of the Nikkei225 index in local currency and US dollar terms

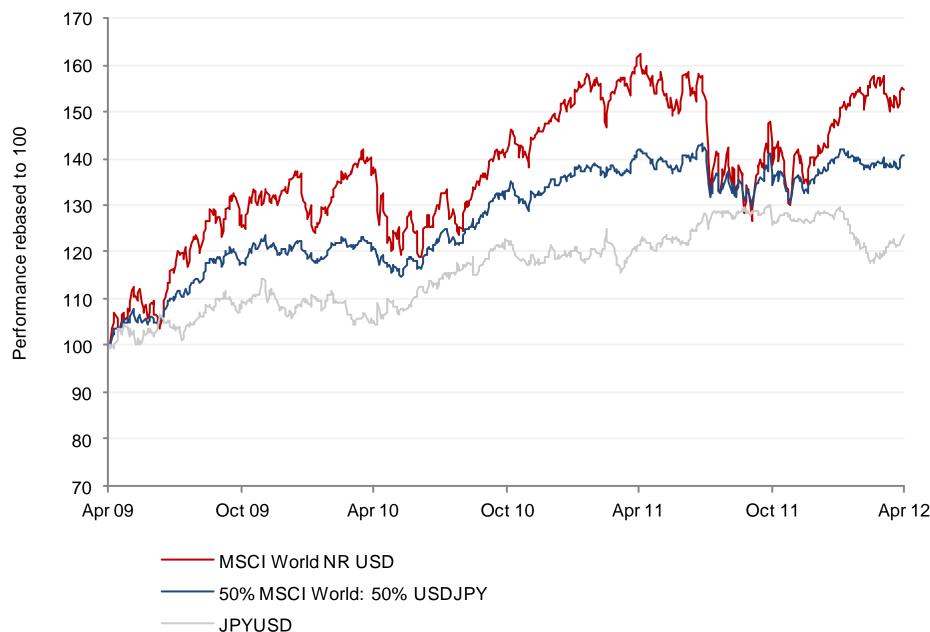


Despite the muted performance of Japanese companies over the past three years, the strong yen means that a dollar-based investor nonetheless enjoys a respectable return. In this instance, whilst the asset allocation choice was a poor one, the currency choice was a good one.

Currencies should not be considered a residual component of the portfolio construction process. As with any asset, their risk and return characteristics provide opportunities in the context of a blended portfolio. Chart 3 plots three hypothetical portfolios: a 100% allocation to global equities, unhedged in US dollars; a 100% position in the yen, which is converted at the beginning of the period and then left to sit as cash rather than in any interest bearing account; and finally an equal weighted blend of equities and currency. Here the currency decision provides the benefits of an uncorrelated diversifier. The addition of the foreign currency exposure, even following a simple equal weighted split, enhances the portfolios risk-adjusted returns.

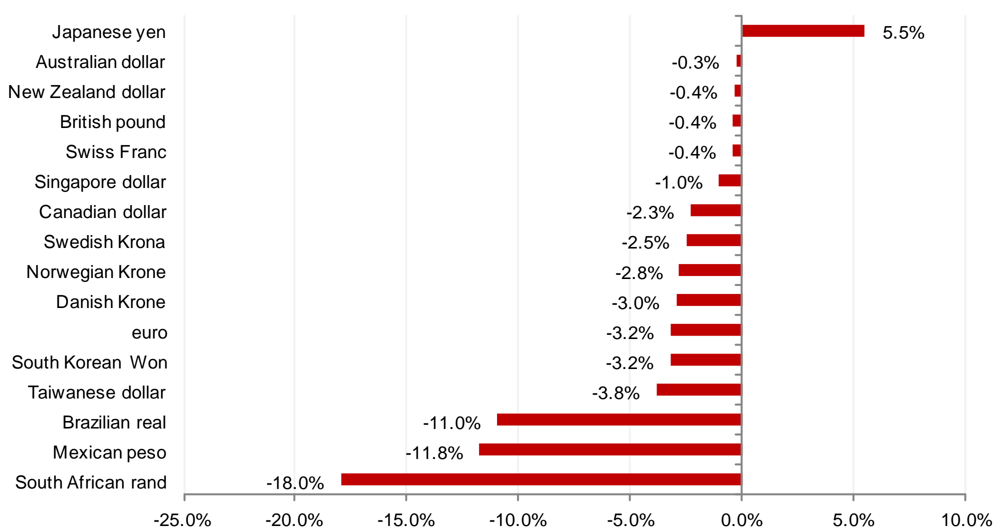
Source: Bloomberg, April 2012

Chart 3: Currency as a diversifier within global portfolios



Looking back at 2011, and in respect of a US investor, the strongest currency from the basket of major global currencies was the Japanese yen, which appreciated by approximately 5.5% versus the dollar over the course of the year. Other currencies generally lost ground, with the Brazilian real, Mexican peso and South African rand all declining by more than 10%, as investors sought protection in the dollar and US treasuries.

Chart 4: 2011 currency returns versus the US dollar



Source: Bloomberg, April 2012

Given its predominance in international trade, the dollar is typically chosen as the base currency for global portfolios. When the dollar strengthens therefore, the value of foreign-denominated assets declines and the portfolio suffers as a result. When the dollar weakens, this effect is reversed. Hence a US dollar investor holding yen denominated assets will have received a tailwind in 2011, whilst South African mining stocks will have needed to return at least 22.0% in local currency terms in order to add any value to our dollar-based portfolio.

Across Momentum Global Investment Management, managers seek to identify undervalued assets trading at a discount to their 'true' or 'intrinsic' value, whilst incorporating a margin of safety to gild the opportunity. Currencies present a unique set of challenges for value driven investors such as ourselves for several reasons:

- Despite the existence of intuitive parity conditions that should help investors to arrive at a fair value for currencies, the application is complicated by technical factors. Purchasing Power Parity (PPP), for example, says that goods should trade at a common price when translated into different currencies, in order to avoid an arbitrage opportunity where investors buy fungible goods cheaply in one location and sell them for a higher price in another location to realise a risk-free profit. Deviations from the PPP implied level of exchange rates, however, are common and show a high level of persistence.

- Currency pairs show a tendency to revert over time, due to the reciprocal nature of the relationship between currencies and the real level of activity in an economy. As one currency appreciates, driven by demand for attractive local assets for example, the competitiveness of that country's export sector declines, in time leading to a reduction in activity. The opposite effect can be observed if we focus our attention on the other side of the currency pair.

- Currencies are heavily influenced by local dynamics. This is evident currently in Europe, where the euro has come under pressure from money managers scrambling to get their assets out of the region.

How then can we begin to overcome these problems? Firstly, it is important to select an appropriate base currency for the portfolio, in order to match an investor's returns to their liabilities. To illustrate this point, consider the case of an investor who is based in the US, has no plans to leave the US either now or in the future, and has all their liabilities denominated in US dollars. Ignoring for a moment their tolerance for risk and the combination of assets to be used in the portfolio, a portfolio with a US dollar base currency would be the most suitable for this investor. In terms of the relative allocation between the US dollar and international currencies, a two thirds:one third split between the US dollar and international currencies provides an appropriate starting place. The investor is insulated in two thirds of the portfolio from currency movements, whilst at the same time gaining exposure to a basket of foreign currencies that can be expected to add diversification. It is prudent to construct a portfolio with a bias towards the US dollar in this way, in order to produce a return in dollar terms, for which the portfolio is ultimately designed. In the case of a truly globally focused investor who has no ties to any of the leading global economies, it is prudent to adopt a diversified approach to currency, with typically one third in US dollars, one third in pan European currencies and one third in pan Asian currencies.

Foreign currency exposure can be hedged at little expense, given the liquidity of foreign exchange markets. The decision to hedge out this exposure may be prudent for more risk averse investors. Where investors are willing (and able) to bear the currency risk, the portfolio manager should adhere to the same principles that guide any investment decision: namely, they should seek diversification and attractively priced assets trading with a margin of safety. Clearly it would not be prudent to move a global portfolio to 100% euros or sterling just because the view on the currency was favourable, in the same way as putting 100% of a portfolio's assets into a single stock would go against the basic tenets of prudent investing.

Source: Momentum Global Investment Management, April 2012

Within a well diversified basket of currencies, there is the opportunity to express tactical views. Emerging market currencies are a case in point: whilst these nations appear to enjoy a structural tailwind as funds flow from debtor nations to creditors, investors should be mindful of other considerations: For example, (i) There tends to be more inflation in emerging markets, which should put downward pressure on currencies; (ii) Countries in emerging markets have tended to pursue a cycle of depreciation/devaluation versus China, in order to maintain their export competitiveness.

Source: Momentum Global Investment Management, April 2012

Manager meetings

Manager	Long Only		
	Asset Class	**Date**	**Location**
Foyston, Gordon & Payne	Global / GEM	03-Apr-12	London (Conf Call)
Threadneedle	UK	03-Apr-12	London
M&G	Inflation	03-Apr-12	London
Tradewinds (Nuveen)	GEM	04-Apr-12	London
Tradewinds	GEM	04-Apr-12	London (Conf Call)
Artisan	Global	04-Apr-12	London (Conf Call)
BNY Mellon Standish	Fixed Income	04-Apr-11	London
Natixis Loomis Sayles	Fixed Income	04-Apr-11	London
Natixis Loomis Sayles	Fixed Income	04-Apr-11	London
Frontier Capital	US Small Cap	05-Apr-12	London
Vulcan	Global / US	05-Apr-12	London (Conf Call)
Wellington	Fixed Income	05-Apr-11	London
Eaton Vance	Fixed Income	05-Apr-11	London
FFTW	Fixed Income	06-Apr-11	London
FX Concepts	Currency	06-Apr-11	London
Hathersage	Currency	06-Apr-11	London
Lazard	Fixed Income	07-Apr-11	London
Axa	Fixed Income	07-Apr-11	London
Muzinich	Fixed Income	08-Apr-11	London
Morgan Stanley	Global	12-Apr-12	London (Conf Call)
Sky Investment Council	Global	12-Apr-12	London (Conf Call)
Driehaus	GEM	13-Apr-12	London (Conf Call)
Sparinvest	GEM	17-Apr-12	London
Tiburon	Japan	17-Apr-12	London
Pzena	Global	18-Apr-12	London
Mondrian	GEM	20-Apr-12	London
M&G	Fixed Income	21-Apr-11	London
Komodo	Indonesia	26-Apr-12	London
Somerset	GEM	26-Apr-12	London (lunch)
Matthews	Asia ex Japan	26-Apr-12	London
Franlkin Templeton	Global	30-Apr-12	London
Burgundy	GEM	30-Apr-12	Toronto
Sky Investment Council	Global	30-Apr-12	Toronto

	Hedge Fund		
Manager	Asset Class	Date	Location
	CTA	05-Apr-12	London
	Equity Long / Short	05-Apr-12	London
	Event	05-Apr-12	London
	Equity Long / Short	11-Apr-12	London
	CITA	11-Apr-12	London
	Credit	13-Apr-12	London
	CTA	16-Apr-12	London
	Volatility	19-Apr-12	London
	Event	24-Apr-12	London
	Equity	24-Apr-12	London
	Event	24-Apr-12	London
	Equity	24-Apr-12	London
	Equity	24-Apr-12	London
	Equity	24-Apr-12	London
	Commodities	24-Apr-12	London
	Credit	24-Apr-12	London
	Converts	25-Apr-12	London
	Credit	25-Apr-12	London
	Distress	24-Apr-12	London

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Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

Momentum Global Investment Management Limited (Company Registration No. 3733094) and has its registered office at 20 Gracechurch Street, London, EC3V 0BG.

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