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VIEWPOINT

Newsflash

A new month and the 71st issue of Viewpoint from PPi.

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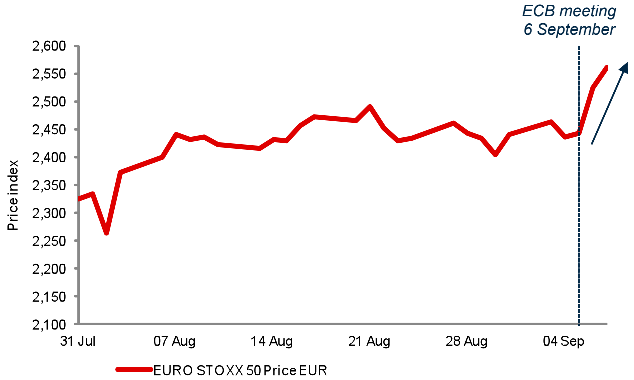
Not for the first time during the past couple of years, one day and one key central bank address served to erase much of the previous 30 days' news from investors' minds. European shares rose by over 2% following European Central Bank (ECB) President Mario Draghi's announcement that the Bank stood ready to purchase government bonds in unlimited quantities.

Figure 1: European equities spike post Draghi's address



Following Draghi's speech, 'OMT' – which stands for Outright Monetary Transactions – now forms part of the market's lexicon, as the ECB unveiled its new facility for purchasing government bonds. The ECB will purchase debt with a remaining time to maturity of between one and three years, and without subordinating existing holders.

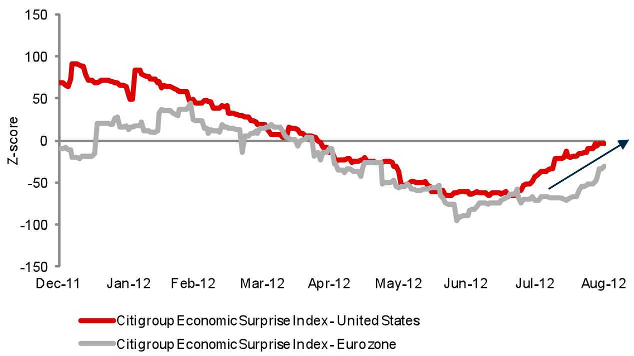
The Federal Reserve responded in September by launching its third round of large-scale asset purchases (quantitative easing), at an initial rate of USD 40 billion per month.

The US central bank also announced its decision to extend 'Operation Twist' – its portfolio rebalancing programme aimed at reducing longer term interest rates – through the remainder of 2012.

Equities continued to rally during August, in anticipation of further intervention from policymakers on both sides of the Atlantic, alongside tentative signs of an improvement in the underlying economic data. In the US, economic releases generally exceeded expectations last month, with positive news from the labour market, the housing market and manufacturers. The data momentum was rounded off by an upward revision to second quarter gross domestic product (GDP), which was raised from the preliminary estimate of 1.5% to 1.7%.

In Europe, output continues to contract, although data has begun to move back in line with market expectations.

Figure 2: Citigroup Economic Surprise indices. The surprise indices aggregate the magnitude of deviations between actual economic releases and analysts' forecast levels

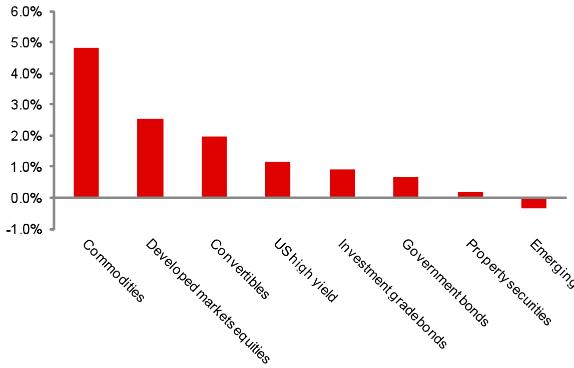


Source: Lipper Hindsight / Bloomberg. Returns in US dollars unless otherwise stated. August 2012.

Eurozone GDP contracted by 0.2% in the second quarter, although Germany's economy continued to grow (+0.3%) whilst France avoided dipping into negative territory with a reading of flat. Europe's largest debtors saw their output contract meaningfully, however, as tough austerity programmes weighed on growth. Across the Channel in the UK, second quarter GDP was revised up to -0.5% from an initial estimate of -0.7%, whilst unemployment fell to 8%.

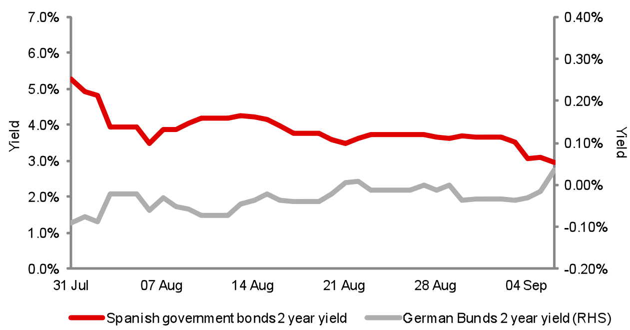
Recapping market moves last month, higher risk/ return assets generally responded positively to the prospect of further intervention from central banks, with equities, credit and commodities all posting gains during August. Safe haven government bonds saw their yields rise modestly, whereas peripheral European government bond yields fell.

Figure 3: Asset class returns August 2012
US dollar terms



Germany's cost of borrowing money for a period of two years has risen by circa 13 basis points (0.13%) since the end of July, whilst equivalent Italian and Spanish yields have fallen by 174 and 232 basis points respectively. With a modified duration of two years, the normalisation of German two year government bond yields towards their ten year average (2.3%), would result in losses for current holders of 4.5% on a total return basis. Purchasing bonds at these levels indicates that investors are still more concerned about the return of their money as opposed to the return on their money.

Figure 4: Path of German Bund yields versus Spanish government bonds



Source: Momentum Global Investment Management – August 2012

Equities in the US, the UK and Europe all rose by around 2% over the month in local currency terms, but it was peripheral Europe that once again enjoyed the best of the gains. Commodity markets were led by precious metals, with gold rising by 4.8%, as the prospect of further monetary stimulus encouraged investors to opt for a physical asset (gold) over fiat currencies. Perhaps the biggest surprise was the rise in the oil price, taking Brent crude to USD 115 compared with USD 90 at the end of June. The latest moves appear to have been caused by fears over future supply emanating from the Middle East.

In contrast, emerging market equities were subdued, with China in particular continuing to weaken. Forward looking indicators continue to trend down, alongside muted credit growth and disappointing data for both exports (+1.0%) and imports (+4.7%). The market now recognises that a significant slowdown is occurring in China; the issue is whether it will prove to be cyclical – with growth returning to the 8-10% level – or structural, marking a shift down towards 6%.

Higher risk/ return assets have enjoyed three strong months after bottoming in early June. Since that time global equities have added over 16.0%, and are now back in line with their level at the start of May 2011. We expect continuing volatility in markets in the months ahead, with periods of risk seeking behaviour punctuated by risk aversion. Underpinning equity markets, however, are attractive and in some cases compelling valuations, making equity purchases during periods of weakness a potentially attractive proposition for long term investors.

Source: Momentum Global Investment Management – August 2012

Asset Class Performances

Asset Class/Region	Index	Currency	To 31 August 2012 Month	Year to date
Developed Markets Equities				
United States	S&P 500 NR	USD	2.2%	13.0%
United Kingdom	FTSE All Share TR	GBP	2.2%	7.0%
Continental Europe	MSCI Europe ex UK NR	EUR	2.6%	11.4%
Japan	Topix TR	JPY	-0.6%	1.7%
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	USD	0.2%	13.2%
Global	MSCI World NR	USD	2.5%	10.0%
Emerging Market Equities				
Emerging Europe	MSCI EM Europe NR	USD	2.5%	11.5%
Emerging Asia	MSCI EM Asia NR	USD	-0.7%	6.3%
Emerging Latin America	MSCI EM Latin America NR	USD	-0.5%	0.3%
BRICs	MSCI BRIC NR	USD	-0.9%	0.9%
Global Emerging Market	MSCI EM (Emerging Markets) NR	USD	-0.3%	5.6%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-0.1%	2.6%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-0.4%	5.9%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.2%	7.9%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.2%	10.6%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-0.2%	3.8%
UK Corporate (Investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	0.8%	10.0%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.7%	6.1%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.0%	9.4%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	2.6%	17.0%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	-0.2%	1.6%
Australian Government	JP Morgan Australia GBI TR	AUD	0.4%	5.7%
Global Government Bonds	JP Morgan Global GBI	USD	0.7%	2.1%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.9%	3.2%
Global Convertible Bonds	UBS Global Convertible Bond	USD	2.0%	8.0%
Emerging Market Bonds	JP Morgan EMBI +	USD	1.0%	12.7%

Source: Momentum Global Investment Management / Lipper Hindsight. August 2012

			To 31 August 2012	
Asset Class/Region	**Index**	**Currency**	**Month**	**Year to date**
Property				
US Property Securities	MSCI US REIT TR	**USD**	-0.2%	16.3%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	**GBP**	1.1%	21.5%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	**EUR**	-0.9%	16.6%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	**AUD**	0.0%	23.0%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	**USD**	-0.3%	24.8%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	**USD**	0.2%	19.7%
Currencies				
Euro		**USD**	2.3%	-2.9%
UK Pound Sterling		**USD**	1.4%	2.2%
Japanese Yen		**USD**	-0.3%	-1.7%
Australian Dollar		**USD**	-1.8%	0.8%
South African Rand		**USD**	-2.5%	-4.2%
Commodities				
Commodities	RICI TR	**USD**	4.8%	5.2%
Agricultural Commodities	RICI Agriculture TR	**USD**	1.2%	11.0%
Oil	ICE Crude Oil CR	**USD**	6.4%	5.1%
Gold	Gold index	**USD**	4.8%	5.1%
Hedge Funds	HFRX Global Hedge Fund	**USD**	0.5%	2.3%
Interest Rates			**Current rate**	**Change at meeting**
United States	13 September 2012	**USD**	0.25%	-
United Kingdom	6 September 2012	**GBP**	0.50%	-
Eurozone	6 September 2012	**EUR**	0.75%	-
Japan	8 August 2012	**JPY**	0.10%	-
Australia	4 September 2012	**AUD**	3.50%	-
South Africa	19 July 2012	**ZAR**	5.005	-0.50%

Source: Momentum Global Investment Management / Lipper Hindsight. August 2012

Focus: Have Convertible bonds answered for 2008?

Introduction

Convertible bonds ("Convertibles") were expected to offer more risk-averse investors a way of participating in equity market growth. They were sold with a theoretical 'price floor' – like a bond – that was supposed to cap potential losses in the event that equities declined. This feature appeared to work: between 1994 and 2007 Convertibles captured almost three quarters of the upside of the equity markets and only half of the downside . Then in 2008, prices hit the floor and kept on falling. This month's Focus considers whether Convertibles have done enough in the years following the financial crisis to answer for the events of 2008 and whether they continue to justify a place in investors' portfolios.

What are Convertible bonds?

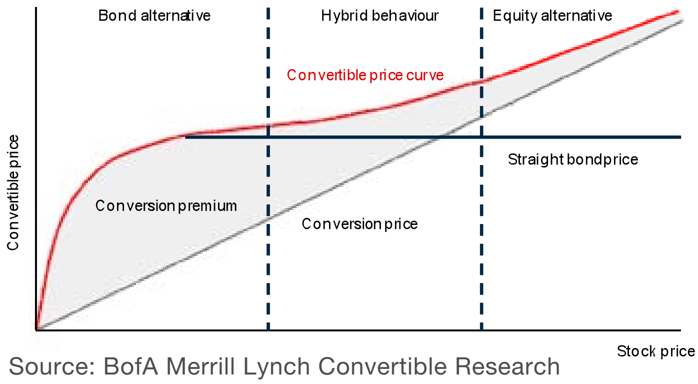
Convertibles are a 'hybrid' security. That is, they contain features of both traditional bonds and equities. The first Convertible is said to have been issued by railroad executive J.J. Hill in 1881 . Today, the market for Convertibles is worth approximately USD 200 billion . The term 'Convertible' is applied to a wide range of instruments, all of which have the same common feature that they can be converted into ordinary stock. A Convertible bond, then, consists of a straight bond with an equity warrant attached; if the stock price exceeds a certain level, the Convertible holder may choose to convert the bond into equity. In some cases, the issuer may also have the right to convert the bond into equity, if certain conditions are met.

Valuing Convertibles

Valuing Convertibles involves breaking them down into their component parts; namely a straight bond and an equity call option. Bond prices are driven principally by interest rates, inflation and changes to the issuers credit quality, whilst option prices are foremost a function of the company's share price and volatility.

Returns profile

Figure 1: The Convertible price curve



Source: BofA Merrill Lynch Convertible Research

Wouldn't it be nice if investors could own the stock market when it was going up, but be sat on the sidelines when it sold off? 'Timing' the market in this way requires a great amount of skill, and many investors have been caught out by being too early or too late. Convertibles, however, can help reduce the need for market timing. By combining a bond with an equity option, the middle section of the Convertible price schedule (headed 'hybrid behaviour' in Figure 1) is curved. As stock prices rise, Convertibles increasingly behave like equities; when prices decline, Convertibles come to look more like straight bonds.

The Greek letter delta is used to describe the sensitivity of a Convertible's price to changes in the underlying stock price. A delta of one would mean that the Convertible was moving in lockstep with the underlying share. This can be the case when the straight bond price is very low in comparison to the share price; in this instance the Convertible behaves like an 'equity alternative'. On the other hand, a Convertible whose share price is significantly below the conversion price would have a delta of close to zero, and would behave like a 'bond alternative'. As one moves from left to right in the middle section of the Convertible price schedule, delta increases. This is what gives Convertibles their unique returns profile; namely, variable sensitivity to the stock and bond markets.

Price floor

Whilst a company's bonds do not always move independently of its share price (see the far left hand portion of the Convertible price curve in Figure 1: here the sharply falling share price also implies a worsening outlook for the company's creditors) the straight bond price is generally lowly correlated to the company's equity, creating a 'floor' for the Convertible's price. In the event that a company's equity disappoints, the owner of the Convertible still continues to hold a straight bond. This means that the Convertible should never trade at a discount to company debt of the same seniority.

Equally, Convertibles that are immediately exercisable generally do not trade with a 'conversion price' that is less than the underlying share price. The conversion price is an implied share price, found by dividing the price of the Convertible by the number of ordinary shares for which it can be exchanged. If this price relationship did not hold (i.e. the conversion price fell below the share price) an investor could purchase the Convertible, exercise the option to exchange the bond for ordinary stock, and sell this stock at the prevailing market price to realise a riskless (arbitrage) profit.

Instead, buyers pay a premium for the conversion right. A $100 Convertible, exchangeable for five ordinary shares currently trading at $18 a share, is priced at a premium of $2 per share (paying $100 for 5 shares values those shares at $20 each, which is $2 above the prevailing market price of $18). This represents a premium of around 11% (the $2 premium as a percentage of the market price of $18 per share).

Uses

Thanks to their interesting returns profile, Convertibles are used for a wide variety of reasons by investors. Some of the more popular uses include:

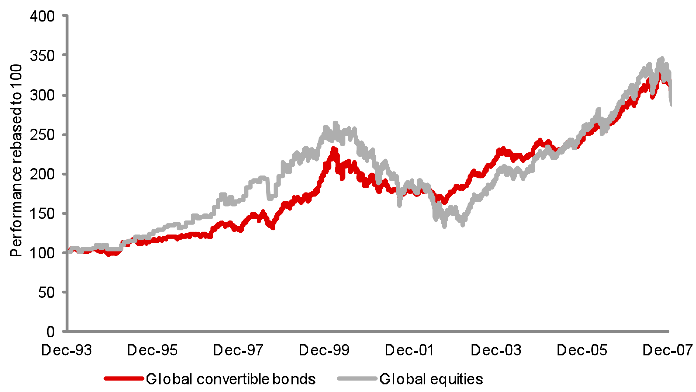
- As a defensive way of accessing equity market growth.
- As a low yield, high growth 'kicker' in fixed income portfolios. The yield on Convertibles is typically less than that of straight bonds ranked pari passu, due to the Convertible's having an embedded equity call option. The payment of a lower coupon is one of the main reasons companies choose to issue Convertibles.
- As a means of accessing low dividend paying companies for those investors who require a yield from their investments.
- As part of an arbitrage strategy, to exploit instances of mispricing versus the underlying equity. Hedge funds traditionally employed significant amounts of leverage in order to make money from these sorts of trades.

Performance

Convertibles aim to participate in rising equity markets, whilst protecting investors' capital when markets sell off. The positive relationship between delta and share prices should mean that Convertibles behave more like equities on the upside, and more like bonds on the downside, removing the need for market timing. In other words, as equities decline, the portfolio automatically becomes less sensitive to the market.

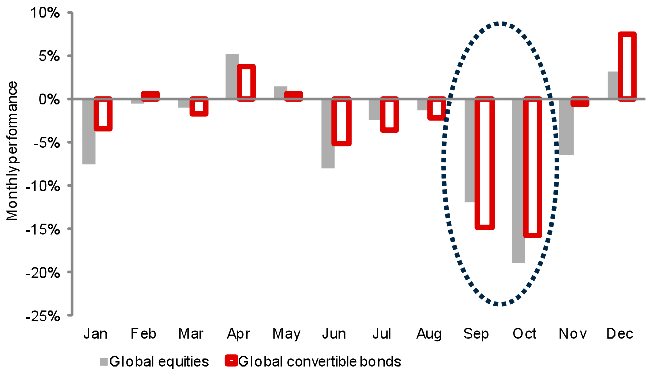
Figure 2 shows that between 1994 and 2007, Convertibles broadly achieved this aim. They delivered a meaningful amount of the upside of equities, but with considerably less downside. On the basis of simple risk-adjusted returns, Convertibles appeared attractive relative to equities.

Figure2: Convertibles long-term performance versus equities since 1994



Then, in 2008, Convertibles faltered.

Figure 3: Monthly performance of Convertibles versus equities in 2008



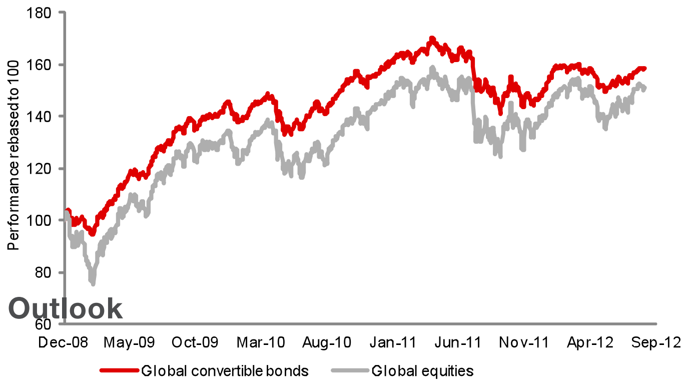
The asset class was favoured by many hedge fund managers, who were able to use Convertibles' sensitivity to both credit and equity risk to hedge out one or other exposures. Convertible arbitrage managers were able to exploit small differences between the price of companies' common shares and the conversion price of the same companies' Convertibles, which arose due to market inefficiencies. In a separate strategy, volatility traders used Convertibles to bet on the direction of future implied volatility on a market-neutral basis. By owning the Convertible and simultaneously short selling the underlying stock, these strategies were able to isolate the effect of volatility on the price of the Convertible's embedded option. Both of these arbitrage strategies required the use of significant amounts of leverage in order to be profitable, leading to Convertibles being over-owned by highly exposed investors.

Convertibles were caught in a technical crosswind in 2008, as hedge funds dumped the asset class in an attempt to unwind their leveraged trades, pushing prices through their theoretical floor. Short selling restrictions imposed in the wake of the financial crisis subsequently curtailed demand for the asset class, as Convertible arbitrage managers found themselves unable to implement their strategy.

Beyond the financial crisis

Since 2008, the make-up of investors in the Convertibles market has shifted in favour of traditional, long-only funds. This, arguably, should help to reduce the chances of the kind of technical-led sell off witnessed during 2008. The asset class has enjoyed a tailwind from lower supply, with company's using the low interest rate environment to issue straight debt, without the embedded equity option. Performance has also picked up since 2009, with Convertibles capturing over 70% of the upside of equities and only half of the downside. So far this year the asset class has captured 68% of the stock market upside and 58% of the downside.

Figure 4: Convertibles short-term performance versus equities since 2009



Outlook

Have Convertibles done enough to answer for 2008? They have done well, but the jury is still out. Clearly Convertibles were not the only asset class to fail to live up to investors' expectations at that time, but the acid test of their downside protection credentials will only come during the next major bear market.

Convertibles continue to play a role in constructing multi-asset portfolios, due to the fact that they are not perfectly correlated to stocks or bonds, a feature which can help to remove the fluctuations that come from owning either asset class in isolation. Holding uncorrelated investments within a multi-asset portfolio can help to improve investors' outcomes, by reducing volatility and periods of negative returns. Convertibles remain a core component of many investors' portfolios, due to their attractive risk and return characteristics and their imperfect correlation to traditional asset classes.

The key to Convertibles' success is their variable sensitivity to the equity markets, as captured by delta. Convertibles move up with the stock market, but offer downside protection when equities sell off. As with any investment decision, however, it is important to pay the right price in order to maximise this hybrid behaviour. In this regard, active managers seek out the most attractively priced issues from around the world, in order to access the growth potential of stock markets with lower downside risk.

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