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VIEWPOINT

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Newsflash

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Under normal circumstances November 2008 would be described as an extremely volatile month with regards to market movement, with most asset classes in negative territory. Compared to October, however, returns turned out to be slightly subdued with only property and commodities registering declines in excess of 10%. Bonds, led by US Government paper, and gold bucked the trend as a further flight to safety pushed yields across the curve lower, and the price of bullion went up. During the turmoil of the past year there have not been many places to hide, with all assets, apart from government backed paper in developed countries, being in negative territory.

To illustrate the extreme market conditions that followed the loss of investor confidence in September, it is interesting to look at the Dow Jones Industrial Index. It ended November on -35% for the year to date. If markets remain flat in December this will be the third worst year ever. Figure 1 shows the returns for this index since 1901, and it is clear that the events unfolding during 2008 have been unprecedented since the Great Depression in the 1930s. There are probably not many lawmakers in Washington that would publicly declare that it was a good decision to let Lehman Brothers go bankrupt.

Turning our attention to the more immediate history equity markets continued the October roller coaster ride into November, but managed to end the month with single digit percentage losses.

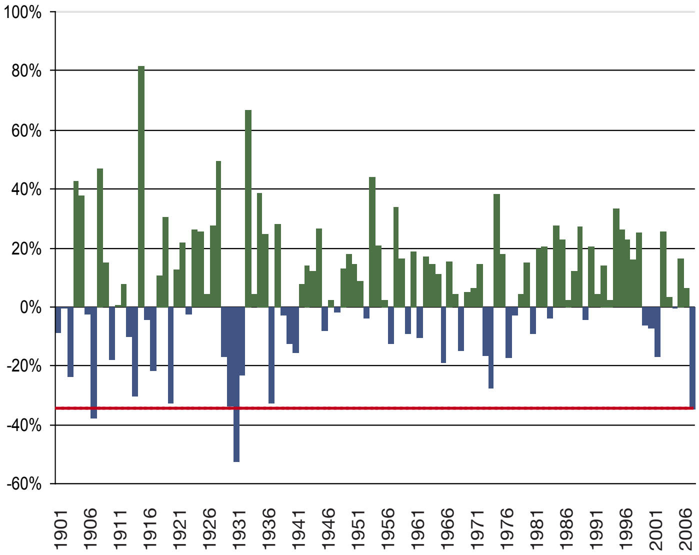

Fig 1: Dow Jones Industrial Index.
Source: Bloomberg

In the United States, Europe and emerging markets equity indices gave up around 7% for the month, taking the S&P 500's move to -38% for the year to date, European (ex-UK) equity markets down 42.5% over the same period and emerging markets down 56.7%. The FTSE 100 held up a bit better, and was down only 1.7% for the month (-32.4% year to date). This was partly undone by a weak Sterling which would have reduced UK valuations to investors reporting in US Dollars or Yen. Global equity markets as a whole gave up a little over 6% in the month, taking the performance for the year to -42.2%.

Bonds, and more specifically US government bonds, rallied towards the end of November with the US paper up 5.5% for the month. The yield on the 30 year US Government bond is now less than 3%, which is not far away from the US long term inflation average of 2.7% (measured over the last 15 years). Incidentally, average US inflation is also 2.7% for the last 87 years, but the inflation basket has changed significantly over this time. For the year to date US Government Bonds would have returned just over 10%, with European Government bonds adding 3.8% for the month taking the year to date returns up to 8.2%. In Japan bonds added 0.3% to push the eleven month return to 1.9%, and global bonds returned 3.6% pushing the year to date returns into positive territory (0.7%).

Other areas in the fixed interest market, that traditionally hold up well during times of equity market woes, have turned out to not be the safe haven many investors have banked on. Bank loans and high yield credit have continued to disappoint, with both asset classes providing equity like returns for the month. These two fixed interest plays were hit hard after the collapse of Lehmans. Inflation linked bonds in the US have also become attractive after deleveraging drove valuations down into undervalued territory.

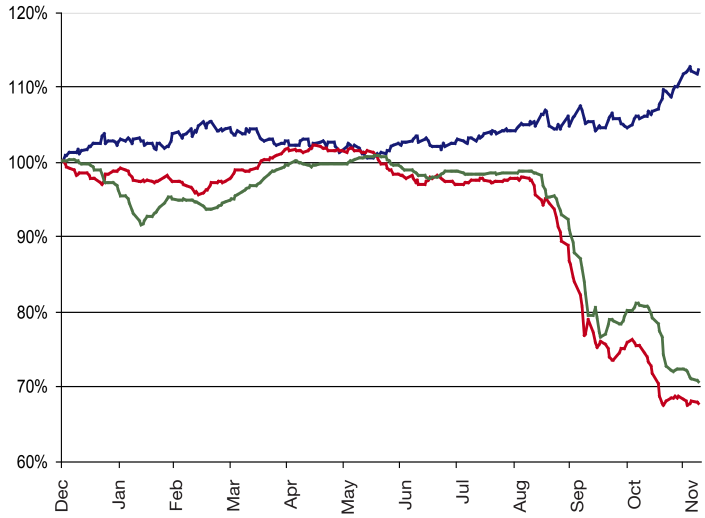

Fig 2: Government Bonds vs. High Yield and Bank loans.
Source: Bloomberg

Property continued on much the same course as the rest of the year, with US REITs shedding 22%, UK property down nearly 16% and European assets down just short of 11%. Asian properties held up well for the month losing only 3.7%. Analysing the year to date performance it transpires that Asian properties were hit earlier in the year, with US property values starting a steep decline in October and November. For the year to date property indices across most geographical regions have lost around half of their value (% change in brackets); US REITs (-46.2%), UK real estate (46.8%), European property (-44.9%) and Asia (-54.7%) all suffering from the stifled credit markets and global recession fears.

Source: Bloomberg, Lipper Hindsight, RMB Asset Management. November 2008.

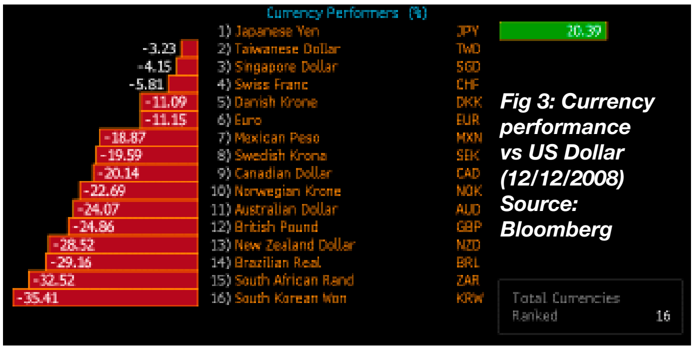

Fig 3: Currency performance vs US Dollar (12/12/2008) Source: Bloomberg

Volatility in the currency markets subsided somewhat from its October levels, the main theme still being Yen strength and with the US Dollar also holding up well. Aggressive interest rate cuts by the Bank of England caused further declines in the Pound Sterling against most major currencies (down 5% against the US Dollar and more than 8% against the Yen). The euro held its ground against the greenback (0.1% for the month).

At the end of November the Yen proved to be the strongest currency for the past year, up 17% against the dollar, around 40% against the euro and more than 50% against Pound Sterling.

Commodities, save the traditional safe haven of gold, had a very tough year and gave up a lot of the gains made in 2007 and the first half of 2008. The price of crude oil is at levels last seen in December 2006, and many metal prices have also returned to its pre-2007 territory. Gold gained 11.2% during November (after a sharp decline in October), taking it to -2.8% for the year. The rallies in gold and US government paper in the last month further illustrate the flight to safety that we have seen through much of September and October.

Source: Bloomberg, Lipper Hindsight, RMB Asset Management. November 2008.

Asset Class Performances

Asset Class Performance (%)	November 2008	2008 YTD
US Equities $	-7.3	-38.1
UK Equities £	-1.7	-32.4
Cont. European Equities €	-7.1	-42.5
Japanese Equities Yen	-3.7	-42.4
Global Equities $	-6.4	-42.2
Global Emerging Markets Equities $	-7.5	-56.7
US Bonds $	5.5	10.7
European Bonds €	3.8	8.2
Japanese Bonds Yen	0.3	1.9
Global Bonds $	3.6	0.7
US REITs (property) $	-22.4	-46.2
FTSE Real Estate £	-15.9	-46.8
FTSE EPRA Real Estate EU ex UK €	-10.9	-44.9
FTSE EPRA Real Estate Asia $	-3.7	-54.7
Euro vs. US Dollar	0.1	-13.2
Sterling vs. US Dollar	-5.0	-22.9
Yen vs. US Dollar	3.3	17.3
Rand vs. US Dollar	-2.1	-32.1
Commodities $	-11.1	-36.9
Agricultural Commodities $	-4.2	-33.5
Oil $	-17.0	-44.1
Gold $	11.2	-2.8

Source: Bloomberg, Lipper, Citigroup, November 2008.

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FOCUS: Who moved my correlation?

In the late nineties Spencer Johnson, MD, published a book of two mice and two men looking for cheese in a maze. "Who Moved My Cheese" became an international bestseller, as many readers wanted some assistance in figuring out how to deal with change in business and in life.

The extraordinary events that unravelled in the last eighteen months, and more specifically the second half of this year, may have lead many investment managers to the point where they also wondered what has happened to long established principals in capital markets. One of the basic foundations of modern portfolio theory is the value that diversification can add to your portfolio. The old adage that you should not put all your eggs in one basket has never been more true than now, as many shareholders in Bear Sterns, Lehmans, AIG and General Motors can attest. What few market analysts expected was that so many baskets of eggs would drop to the ground at the same time. Correlations between asset classes are at historical highs, and have lead to many investment professionals asking "who moved my correlation?".

Efficient market hypothesis is based on the assumption that one can add additional assets to a portfolio and in doing so expect either a higher return, at the same level of risk, or the same return, at a lower level of risk. The benefits of diversification becomes clear when one constructs a portfolio consisting of asset classes that have a low or negative correlation to other asset classes in the portfolio. This will lead to different return profiles over time to reduce portfolio risk, and make more efficient use of the risk that an investor is willing to take.

Traditionally bonds, equities, property, high yield bonds, bank loans and hedge funds have all exhibited sufficiently different return profiles (and therefore low correlation) to each other so that each of these assets could successfully be combined in an efficient, well diversified portfolio. Losses in one asset class are normally cushioned by a rally in another (negative correlation), or long term stable returns in a third (correlation close to zero). The table below shows the correlations between a number of asset classes during the period January 1999 to June 2007:

Correlation matrix - 1999 to mid 2007

	US Equity	US Bonds	US High Yield	US Property	US Loans	Hedge funds
US Equity	1.00	-0.28	0.29	0.51	0.18	0.37
US Bonds	-0.28	1.00	0.05	0.12	-0.16	0.10
US High Yield	0.29	0.05	1.00	0.32	0.38	0.39
US Property	0.51	0.12	0.32	1.00	0.40	0.45
US Loans	0.18	-0.16	0.38	0.40	1.00	0.36
Hedge funds	0.37	0.10	0.39	0.45	0.36	1.00

The table illustrates that all of these asset classes have sufficiently low correlation to be added to a well diversified investment portfolio. The period under review contained a bull as well as a bear market in equities, and it is interesting to see whether these correlations also hold true during periods of volatility in equity markets.

The Dow Jones Industrial Index had three consecutive years of negative performance from 2000 to 2002, and the next table overleaf shows the influence on correlations:

Correlation matrix - 2000 to 2002

	US Equity	US Bonds	US High Yield	US Property	US Loans	Hedge funds
US Equity	1.00	-0.46	0.12	0.50	0.04	0.22
US Bonds	-0.46	1.00	-0.13	-0.13	-0.26	-0.03
US High Yield	0.12	-0.13	1.00	0.11	0.24	0.33
US Property	0.50	-0.13	0.11	1.00	0.42	0.16
US Loans	0.04	-0.26	0.24	0.42	1.00	0.37
Hedge funds	0.22	-0.03	0.33	0.16	0.37	1.00

Source: Bloomberg, Lipper Hindsight, RMB Asset Management. November 2008.

During this period of relatively poor equity performance well diversified portfolios held up fairly well as asset classes continued to exhibit low correlation to each other. During the last eighteen months however this has not been the case. Apart from government bonds all other classes have proved to be in the same 'basket of eggs', as high yield bonds, property, bank loans and hedge funds followed equity markets south and government bonds rallied. The last table demonstrates the correlations amongst asset classes during the last eighteen months, when even hedge funds have proved to have relatively higher correlations to falling equity markets than has been the case before.

wonder what this means for portfolio construction in 2009 and beyond. We do not think that the change in correlations heralds the dawn of a new era, but rather that it is a function of distressed selling of liquid assets in order to provide liquidity to panic stricken investors. The challenge in the next year will lie in the addition of risk to portfolios (assuming that most of the risk has been removed), and doing so in the most efficient way. Many of the asset classes that have disappointed in the last year are sure to provide better returns to investors. Investors will be faced with a choice of assets which are all expected to provide some respite, but the question will be at which risk premium this will come. High yield bonds, bank loans, convertible bonds, investment grade bonds and equities all look attractive from a valuation point of

Correlation matrix - mid 2007 to Nov 2008

	US Equity	US Bonds	US High Yield	US Property	US Loans	Hedge funds
US Equity	1.00	-0.28	0.83	0.94	0.88	0.60
US Bonds	-0.28	1.00	-0.49	-0.27	-0.36	0.06
US High Yield	0.83	-0.49	1.00	0.86	0.93	0.59
US Property	0.94	-0.27	0.86	1.00	0.88	0.58
US Loans	0.88	-0.36	0.93	0.88	1.00	0.61
Hedge funds	0.60	0.06	0.59	0.58	0.61	1.00

Notable changes from the long term trend in correlations are between equities, high yield bonds and bank loans. The long term correlation between equities and high yield bonds is 0.29, but this went up to 0.83 over the 18 month period. In a similar vain the correlation between equities and bank loans increased from a very low 0.18 to 0.88 during this time of turmoil.

It is clear that some of the principles on which portfolio construction is based have been compromised, and one may

view, but are sure to provide different return profiles in the next twelve months. The successful investor will analyse the risk / return rewards of each asset class, and add appropriate levels of risk to portfolios. Portfolios need to be carefully positioned to capture risk rewards when market confidence starts to return, most of the deleveraging has taken place, and some dry powder is released from their low yielding cash reserves. 2009 will hold great opportunities for the (calculated) brave, and is sure to separate the mice from the men!

Source: Bloomberg and Lipper Hindsight, September 2008

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