



## Newsflash

A new month and the twenty ninth issue of Viewpoint from FP.

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Unless you encountered the same fate as Rip van Winkle and fell into a twenty year sleep (see our Focus section), like most professional investors you probably gave a sigh of relief to see the end of 2008. Many equity, property, credit, commodity and hedge funds indices recorded their largest declines since inception, and money market returns and government bond yields are at historical lows. Credit flow has been stifled, with market confidence being all but ruined over the last 12 months. Looking back at the different markets' performances 2008 was indeed an extraordinary (and in some ways an unprecedented) year.

In December all but one of the major equity indices provided some respite to investors in registering positive returns, albeit on the back of a long slide down during the year. In the United States the S&P 500 was up by 1%, and across the Atlantic the FTSE100 increased by 3.7%. European equities were slightly down (-0.3%) and in Japan the Nikkei 225 rose by 3%. Emerging market equities had somewhat more of a pronounced rally in returning 7.8% in the last month of what has been a very difficult year in the equity markets. For the year to date US equities are down over 37%, the United Kingdom nearly 30%, Japanese and Continental European Equities over 40% and in spite of its late rally emerging markets lost a little more than half of its value by shedding 53.3% for the year.

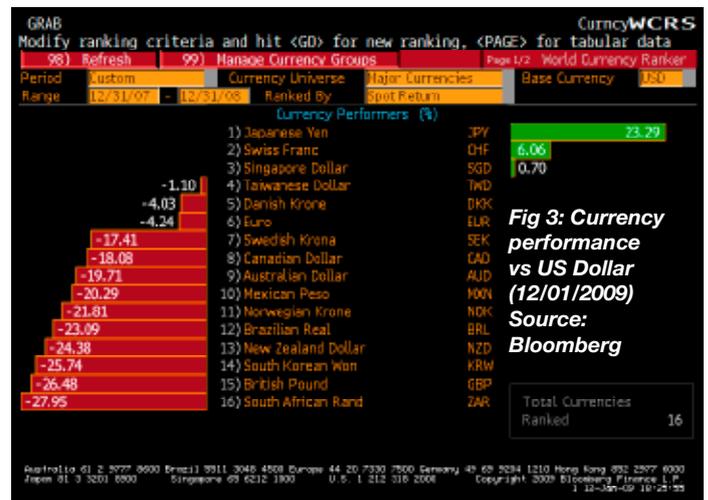
The asset class that in hindsight proved to be the safe haven for the year was bonds, and more specifically government

bonds. In the United States bonds were up 14.5% for the year, with 9.4% of the return being added in November and December. In local currency terms European bonds gained 9.4% for the year, Japanese bonds were up by 3.6% and globally bonds strengthened by 6.3% (in USD) in December to return 7.1% for the year.

United States investment grade, non-government bonds (as measured by the Barcap US Aggregate Total Return Index, previously named Lehmans) were up just over 5% for the year, compared to a 14.5% total return for US Treasuries. This shows that US government assets were preferred over even investment grade corporate debt when the flight to safety took place in the last two months of the year. The yield on the 10 year US Government Bond is now at a level last seen in 1953 (which is as far back as the Federal Reserve records on their website go). This limits the further upside that one may expect from this asset class, whereas the risk on the downside is probably more pronounced than before.

Investment grade and high yield bonds, which have also had a tough time in 2008 due to the market pricing for the ever increasing default risk and expected decrease in recovery rates, started to turn for the better at the end of December. In our Focus section we show how the spread of these yields over government paper yields has started to decline in the last couple of weeks.

Following in equity's footsteps property came back in December after a year that many property investors would rather forget. US real estate investment trusts (REITs) moved up 15.2% in the month to bring the end of year growth to -38%. Other regions' property also posted small gains in December (with year to date figures in brackets); United Kingdom up 0.7% (-46.1%), Europe up 5.4% (-41.9%) and Asia up 4.8% (-52.5%). The outlook for 2009 remains fairly bleak however as the availability of credit – an integral ingredient for property growth – is still stifled and will probably remain so for at least the first half of the year.



In December most currencies strengthened against the dollar, but this was not enough to erode the gains that the greenback has made in 2008. During the month both the euro (9.5%) and the Yen (5.1%) gained against the US Dollar, with the Pound Sterling losing another 6.3%. For 2009 it would be very difficult to predict the currency of choice as most currencies are probably in equally bad shape.

The yen ended the year as the strongest major currency, followed by the Swiss Franc and the Singapore Dollar which had a minor gain on its US counterpart for the year. For the year the euro lost just over 4% against the US Dollar, with most other major currencies losing in the region of 20% or more against the greenback. The Pound Sterling was extremely weak and, together with the South African Rand retreated by around 27% against the US Dollar in 2009.

In the beginning of 2008 many market commentators were still referring to a commodity super cycle, but those views have since changed following diminishing global demand for commodities, most of the developed world in recession and not a sign of inflation – at least for the next couple of years. Metal prices collapsed from historical highs and we have not seen any meaningful recovery yet. The exception is gold which ended the year up by 3% after adding 6% in December. The price of a barrel of Brent Crude oil has also more than halved,

recording most of its decline in the last quarter when it fell 59.7% compared to where it started the year.

All in all 2008 was a grim year for most investors. One would however do well to learn from the mistakes that we dearly paid for over the last eighteen months and to use those lessons to

inform our judgments during the year that lies ahead. A prudent investor will utilise his risk budget to add positions to a portfolio in a measured way without trying to reverse losses in the same short period in which they happened. Patience, backed by the application of sound investment principles that have been tested through many cycles, will surely be rewarded in 2009.

## Asset Class Performances

Asset Class Performance (%)	December 2008	2008 YTD
US Equities \$	1.0	-37.4
UK Equities £	3.7	-29.9
Cont. European Equities €	-0.3	-42.7
Japanese Equities Yen	3.0	-40.6
Global Equities \$	3.3	-40.3
Global Emerging Markets Equities \$	7.8	-53.3
US Bonds \$	3.5	14.5
European Bonds €	1.1	9.4
Japanese Bonds Yen	1.7	3.6
Global Bonds \$	6.3	7.1
US REITs (property) \$	15.2	-38.0
FTSE EPRA Real Estate UK £	0.7	-46.1
FTSE EPRA Real Estate EU ex UK €	5.4	-41.9
FTSE EPRA Real Estate Asia \$	4.8	-52.5
Euro vs. US Dollar	9.5	-4.2
Sterling vs. US Dollar	-6.3	-26.5
Yen vs. US Dollar	5.1	23.3
Rand vs. US Dollar	8.9	-27.9
Commodities \$	-7.1	-41.4
Agricultural Commodities \$	4.7	-30.4
Oil \$	-25.5	-58.4
Gold \$	6.0	3.0

Source: Bloomberg, Lipper, Citigroup, December 2008

## FOCUS

In case you are not familiar with the Washington Irving short story Rip van Winkle (published in 1819) here's a summary of the plot. The story is set in the years before and after the American Revolutionary War. Rip Van Winkle, a villager of Dutch descent, lives in a nice village at the foot of New York's Catskill Mountains. An amiable man whose home and farm suffer from his lazy neglect, he is loved by all but his wife. One autumn day he escapes his nagging wife by wandering up the mountains. After encountering strangely dressed men, rumoured to be the ghosts of Henry Hudson's crew, who are playing nine-pins, and after drinking some of their liquor, he settles down under a shady tree and falls asleep. He wakes up twenty years later and returns to his village. He finds out that his wife has died and his close friends have died in a war or gone somewhere else. He immediately gets into trouble when he hails himself a loyal subject of King George III, not knowing that in the meantime the American Revolution has taken place. An old local recognizes him, however, and Rip's now grown daughter eventually puts him up. As Rip resumes his habit of idleness in the village, and his tale is solemnly believed by the old Dutch settlers, certain hen-pecked husbands especially wish they shared Rip's luck.

How many investors and investment managers in the crash of 1987 wished they shared the same luck? But imagine waking up in 2007 after twenty year's of blissful sleep to a year like we had in 2008! Suddenly the world has changed and new terms like CDOs, sub-prime loans, credit crunch, structured products and deleveraging are used when investors talk about the market crash. A number of investment banks have come and gone, with many of the 1987 players only existing in name but different in structure. The rise and stumble (if not fall) of hedge funds has taken place, and interest rates are nearing zero. The Democrats are in power in the United States Congress and Presidency (another American Revolution?) and Europe is for all intents and purposes one economic entity. So much has changed while our imaginary investor was asleep, and yet so much has stayed the same. The events

that unfolded, more specifically in the last eighteen months, have set the scene for the return to asset classes that our Rip van Winkle investment professional would have used twenty years ago when constructing a well diversified multi-asset portfolio: equity, bonds and cash.

In times of extreme security valuations (like we are experiencing at present) a risk budget is probably best spent on the volatility associated with conventional asset classes, without adding the risk that leverage brings. Following the extreme levels of forced selling that we have seen towards the end of 2008 many asset classes are trading at very attractive discounts to fair value, which offers the shrewd investor a number of opportunities to patiently start to recover some of the losses experienced in the last year.

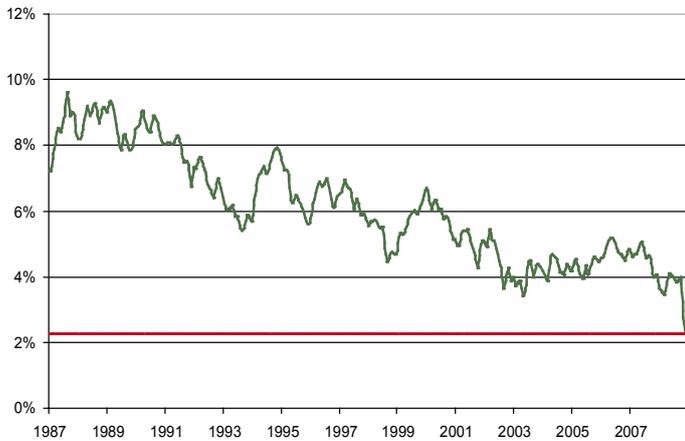
In our focus section we provide our views on a range of fixed interest asset classes that investors may consider for inclusion in their portfolios during 2009.

### Cash

Across the globe monetary policymakers are reducing if not slashing interest rates in order to create liquidity in debt markets again, and to try and resuscitate the world economy that has slipped into recession. In absolute terms cash kept in major currencies will yield not much more than zero while rates are so low. We would therefore look to other fixed interest investments to steadily add a couple of percentage points to a portfolio instead of leaving the money in cash where it is not working for its investors. We would be cognisant of the downside risk associated with riskier fixed interest assets but believe that sensible investments would add to performance without adding unnecessary risk to portfolios.

### Government bonds

Government bonds, especially in the United States, have seen a phenomenal run over the last twenty years, with only two years of negative total return. Over this period the annualised

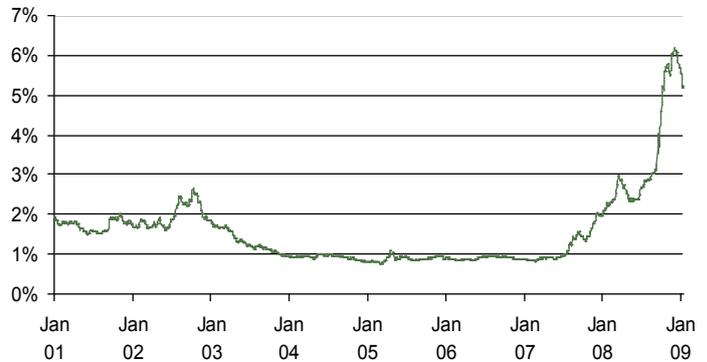


return was 7.5% per annum, with a 14.5% return over the last year. This has however been on the back of an ever decreasing yield over the last twenty years, which may have reached a turning point (given no further systemic shocks to the world's financial markets). The graph shows the yield on the US 10 year Treasury since 1987, and supports our view that government bonds, and more specifically US Treasuries, may have seen the most of its gains. Interestingly enough another one percent decline in yield (however unlikely that may be) would only lead to about a 9% increase in the value of the 10 year Treasury notes. On the longer end of the yield curve there may be more gains down the line, but the upside is somewhat more limited than in 2008. In order to fund its planned USD1 trillion deficit the US government will have to borrow a lot of money in the next couple of years, and with many Asian countries (including China) considering spending their cash reserves on home soil rather than investing in US Government debt yields are bound to increase again over time.

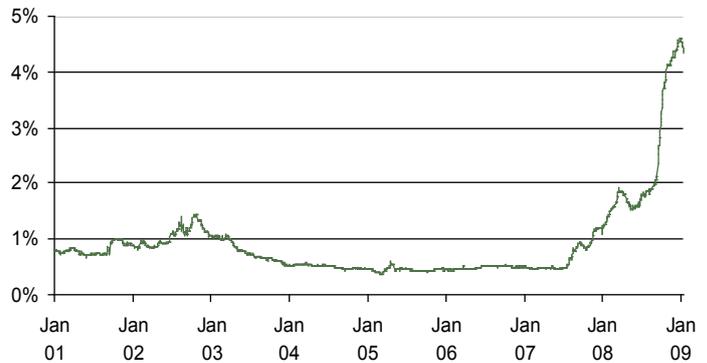
### Investment grade corporate bonds

Spreads between government paper and investment grade corporate bonds have widened significantly over the last eighteen months, to levels not experienced for a very long time. The market has priced in defaults at historically high (around 6% per annum) and recovery rates at historically low levels, which may prove to be overly bearish. If the expected default levels are realised the world's economy is in a much

BarCap US Agg Corporate Avg OAS



BarCap EuroAgg Corporate Avera

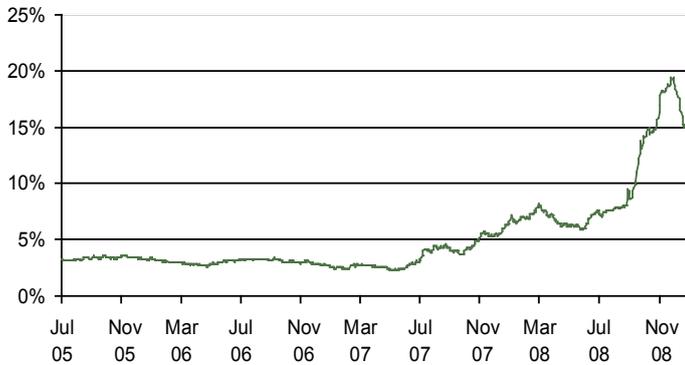


worse shape than what is priced in the equity market which will obviously have a knock-on effect on equity valuations. From our point of view investment grade corporate bonds provide good value without taking excessive risk. Bondholders' superior position to equity holders in companies' capital structure is a further advantage. The graphs show how the yield on investment grade bonds have peaked and then started to decline towards the end of December and into early 2009, in both the US and Europe.

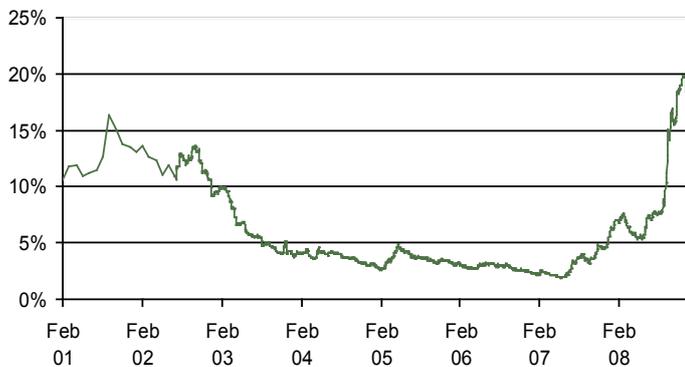
### High yield corporate bonds

The same argument that supports our view on corporate bonds also holds for high yield bonds. Default rates priced in at the moment are in the region of between 50% and 65% over a five year term, which seems somewhat excessive. United States high yield bonds (also known as junk bonds) are currently yielding 15% over US Treasuries, which will

BarCap US High Yield 2% Issuer



BarCap European HY 3% Issuer C

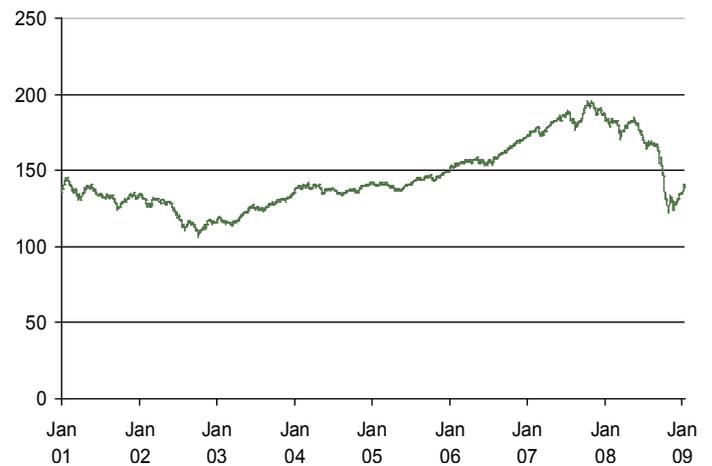


be a very attractive return if spreads stabilise without even returning to anything similar to normalised levels. Higher yield bonds are inherently riskier than investment grade bonds, resulting in a higher expected return.

## Convertible bonds

Call option on the underlying equity, have been used extensively in the convertible arbitrage hedge fund space. Forced deleveraging towards the second half of 2008 has sent market values due south, and good investment opportunities

UBS Global Focused Convertible Bond Index



have become available in this asset class. The advantage that convertible bonds have over their pure bond or pure equity counterparts is that these provide some downside protection in the form of the bond yield when equities decline and bonds rally, and provide some participation in the upswing when equity markets rally and bond yields move higher.

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