

Investment Newsletter

October 2011

equilibrium
asset management

Blame the ratings agencies!

It's ironic to think that whilst there has been so much going on recently, there has actually been very little to report on until now!

It's been some time since we issued our last bulletin, as we felt we've said most of what we can say without repeating ourselves.

Markets continue to either fall on fear of a Eurozone implosion, or rally on the slightest hope of a solution. Fear and rumour continues to drive markets as the facts remain largely unchanged.

The FTSE 100 has established a clear resistance level at 5,000. As it falls close to this level, it tends to spring back as people view this as a buying opportunity.

We have some concerns that if this level is significantly breached markets could continue to fall as panic really sets in. However, it was somewhat reassuring that even though the market recently closed at 4,944 just three days later it was 7% higher.

We were hoping for a relative market low point for the strike date of our defined returns plans. As the saying goes, "you should be careful what you wish for" which couldn't be truer, as the day before the start date of the Barclays product, the FTSE had fallen to a low point when markets dipped as low as 4,868.

In some ways, it is a shame that the next day markets recovered and so the "strike price" of this product was actually 5,291. Although we've not been able to buy in at what we hope is the very bottom, the fact that it did recover so quickly was reassuring, and we still believe we've bought in at attractive levels across the board.

The strike dates and prices for all three plans are shown below:

Product	Strike Date	Strike Level	Potential Return (Simple)
Barclays	6 October 2011	5,291	12.75% pa
HSBC	10 October 2011	5,399	11.25% pa
Credit Suisse	13 October 2011	5,403	11.05% pa

As long as the index is higher on any of the following six anniversary dates, we will benefit from the potential return of each product outlined as above.

Many of our clients are asking why we didn't buy more? There are two reasons for this. Firstly, there is a risk that the bank may become insolvent and secondly, because we believe that the market will do significantly better.

The investment banks will also be hoping that markets recover. They will be investing the capital in the hope of a return significantly higher than the rates they are offering us. This is what investment banks do, they gamble with other people's money.

A flurry of news

Having not received any 'real' news for weeks, we now have twelve UK banks being downgraded such as RBS and Lloyds. In addition, Italy and Spain have now had their ratings cut too.

It was the rating agencies that allowed this crisis to happen by rating junk as AAA! They continue to cause chaos by the ill timed and sometimes inappropriate ratings they come up with. We believe that we need just one independent, not-for-profit, worldwide rating agency funded by the governments. However with too much self interest, that is never going to happen.

We have seen the launch of QE2 in the UK or at least an extension to the original program of quantitative easing with an additional £75bn. The ECB has also provided €40bn for asset purchases and is now providing funding for European banks for up to thirteen months – the longest duration banks have ever been able to borrow from the ECB. This gives them a great deal of leeway to carry on their businesses without worrying about their funding.

In addition, the swift and decisive way in which France and Belgium have dealt with the potential crisis at the troubled bank Dexia, has given some reassurance that authorities will not let banks get into trouble.



Cumulatively we hope these actions will provide enough confidence for markets to recover.

They have given us enough comfort to buy back into the Invesco Perpetual Tactical Bond fund which we sold in August. This fund holds a large chunk of bank bonds which now have very high yields and so potentially attractive returns, provided the banks don't default.

From the date we sold on 22nd August to the day we bought it back on 7th October, the fund fell by 7.37%. It has since gained 3.77% (as at 18 October).

We believe that this fund has the potential to rebound significantly and having missed a large amount of the falls, we want to benefit from this potential recovery.

Volatile Valuations

We expect markets to swing violently along with your valuations. We know how worrying this can be and we thank you for your patience and understanding.

We are confident that with the actions we are continuing to take, your portfolios will not just recover, but will actually profit from the volatility as markets recover.

We do not anticipate a long recovery and believe it is possible that in the next three months they could recover to circa 6,000.

The publication of our sixth monthly investment review is currently underway and will be with you shortly. This will explain in detail all the actions we have taken and how we believe you will be better off in the long run.

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General Economic Overview

Global economic growth is likely to remain muted. On balance we believe it will remain positive but the chance of recession has grown. As a result, interest rates are likely to remain 0.50% for the next two years and at low levels for years to come.

European sovereign debt issues will continue to concern markets, but we believe we will avoid a second credit crunch. Inflation may die back in the short term but we remain worried about it in the long term.

Asset class key

+ positive	+5 strongly positive
- negative	-5 strongly negative
= neutral (normal behaviour)	

Equity Markets	Outlook
Based on valuations such as price/earnings ratios and dividend yield, many equities show good value. We were neutral in July when the FTSE 100 was around 6,000. Despite lower growth prospects and given the extent of market falls, we have moved to a +4 score. A resolution of the Eurozone issues may lead to a strong recovery.	+4
Fixed Interest Government gilts have rallied due to risk aversion in other asset classes, whilst high yield and bank bonds have fallen back. 10 year gilts now yield around 2.2%, a record low, and well below inflation. We expect below average returns from fixed interest in general, but some pockets of riskier debt look great value after market overreaction to the current crisis.	-4
Commercial Property Whilst the rental yield on commercial property remains attractive, this is diluted by high levels of cash in property funds. Capital growth is dependent on economic growth which is likely to be poor.	-5
Residential Property We believe prices are likely to remain flat over 18 months.	-5
Cash With interest rates remaining at record lows, returns on cash could remain below average for some time. However, there is a short term safe haven appeal.	-5

Balanced Asset Allocation

For a typical balanced portfolio we are overweight equity and cash and underweight the other asset classes. Based on our above scores we'd expect a Balanced Asset Allocation (excluding client cash) to return approximately 7.5% on average pa rather than the normal 8%pa over the medium to the long term.

A neutral score (=) means we expect the asset class to move in line with our long term assumptions: 10% pa for equity, 7% for property, 6% for fixed interest, 5% for residential property, and 3% for cash. A +5 score means we think the asset class could outperform by 50% or more. A -5% means we think it could underperform by 50%. A negative score does not necessarily mean we think the asset class will fall.

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.