View from PIM

“Always Look on the Bright Side of Life”

Tom Becket, Chief Investment Officer

January 2012

- 2011 was a difficult year for investors
- Structural issues will drag on the economy in 2012
- There remains the chance of a cyclical slowdown
- Sustainability and dependability are key to our strategy
- Markets in 2012 could well resemble 2011

The start of a new year always brings resolutions that are unlikely to be maintained much further than mid-January. Rather than shunning alcohol or turning ultra-healthy, the PSigma Investment Team is delighted to reveal that our collective resolution (which we will endeavour to keep), is to focus as much on the positives as the negatives, in financial markets and the economy in 2012.

It was very easy in 2011 to be swept up in the wave of negative news flow and doomsday prophecies; 2012 is a “new dawn, it’s a new day” and we’re “feeling good”. For now, therefore, we are willing to put aside the fact that the developed world is saddled with a debt burden that will ultimately prove impossible to pay back. We are also trying to see through the economic slowdown that has presided through Europe, the UK and the Emerging Market nations towards the end of last year. With no shortage of hopeful optimism, we are forcing ourselves to forget that most politicians appear clueless when it comes to the financial issues that presently plague the world. However, whilst trying to sail on an optimistic tack, we remember the words of Voltaire who wrote; “Optimism is the mania through which those who are in hell convince themselves that everything will be alright”. For now, markets seem willing to believe that “everything will be alright”. Patient investors have been rewarded with a buoyant end to the year (due to the annual “Santa Rally” forecast in our last newsletter) and a strong start to financial markets in the nascent days of 2012. **With a positive mindset we are asking whether the moves higher can last longer than the New Year’s Eve hangover? Possibly, rather than probably, would be our view.**

Despite my sarcastic introduction, there are grounds for encouragement. In particular, we should not forget that the starting point for 2012 is that the global economy is growing. Led by the US and some Emerging Market economies, the global engine is purring rather than roaring, but **unless confidence dissipates totally in the early part of this year, we do not envisage the re-emergence of a global recession**. A recession is likely in Europe and very possible in the UK, however, elsewhere growth should persist. **Confirmation that a global recession has been avoided should help support asset markets in the year ahead,** as has been the case over the last few weeks. Whilst we can be thankful for growth, we also have to constantly acknowledge that the global economy is far from booming and the environment in which we now live is very fragile. The debt issues that stalked investors and markets in 2011 have yet to be dismissed or even, in some cases, addressed at all. The US is a classic example of the latter point and we watch with caution the poisonous rhetoric that will flow as we build up to November’s Presidential election. We still believe that the economic trajectory for the next few years is very hard to predict, as governments, banks and consumers are forced to pay down the debt mountain that has built up in the last two decades. **So whilst asset class returns could be positive in 2012, we feel that our medium term view of sub-average returns from risky assets remains likely**.

It is hard to be too bearish though about potential returns over the next five years. It is our core view that many asset valuations are sufficiently attractive to allow forecasts to be fulfilled for positive returns this year. **Equity valuations, particularly those of the very largest companies, are reasonable and certainly allow room for positive returns, as long as investor confidence is not buffeted too hard by the gales that will blow on both sides of the Atlantic**. There are definitely risks to equity investment; not least the potential for earnings to come in below the current projections of analysts. **We are, therefore, continuing to focus on those companies and investments where we can see sustainable profit growth and dependability of business models.** Indeed, sustainability and dependability are key buzzwords for investment strategy in 2012, as we expect the overall investment environment to remain volatile and (sadly) unpredictable. **However, we strongly believe that volatility can breed opportunity**.

Whilst many investors in the UK are obsessed with the performance of the FTSE 100, which was down “only” 6% in 2011, it is worth noting that 2011 was a dire year for many other global equity markets, with the MSCI World index ending 2011 down nearly 10%. Markets in Europe, Asia, Japan and Latin America were hammered down between 15-25%, leaving many of them now looking very cheap. **We prefer the long term growth story in Emerging Market economies and the recovery potential of the abhorred Japan. However,** we acknowledge that if the green light flashes for equities this year, then it might well be a case of a “rising tide floating all boats”.

As we search for other positive stories to accompany our valuation argument, we can be comforted that the default position of most global central bankers, if not all of them, is to help cure the banks of their many ailments by flooding the world with cheap money. With this move, they are desperately hoping that this liquidity wave will drive asset markets higher. **At this point in time many financial markets are being either covertly, or openly, distorted through the manipulating hand of central bankers and politicians**. Whilst the "rigging" of markets can boost short term confidence, it could also impact upon the trust that investors have in the investments they have made for the long term. Certainly one of the trends that we have seen over the last few years is a general distrust from investors towards equities, following three crises in just over a decade and unprecedented levels of volatility. Headlines that filled the Christmas editions of various Newspapers screaming "Trillions wiped off global equity markets in 2011" are hardly likely to be shoring up the brittle confidence of bruised investors. **Such scepticism might in fact prove to be healthy for patient investors, were faith to be rebuilt in the waning "cult of equity", resulting in a re-rating of equities**.

Central bankers' maintenance of very low interest rates is likely to drive savers out of bank accounts and low-yielding government bonds, particularly if inflation continues to erode the savings of prudent citizens. This could well create a boom in riskier investments and the "Hunt for Yield" remains a key theme of our portfolios in 2012. This has been a reason why there has been a recent improvement in the residential property markets of the US and UK, as investors give up on bank accounts and seek yields in "buy to let" properties.

Corporate credit was a solid performer in our portfolios in 2011 and we expect the performance differential between government bonds and corporate credit to narrow in the year ahead. **If conditions stabilise, we can envisage returns of around 8% from certain corporate credit markets, as the yields on offer should entice other investors to the asset class**. We will be focussing a lot of attention on credit markets in the months ahead, aiming to try and exploit the excellent opportunities on offer here.

Looking back to 2011, it was an incredibly challenging year for investors. Whilst 2008 was a dreadful year for asset markets, 2011 was a never-ending roller-coaster of extreme volatility; with deep troughs of fear, punctuated by false euphoric rises. **Broadly, the difficulty of last year was its unpredictability. One would have struggled, as we digested 2010's turkey, to have imagined such a treacherous course through the year**. If one uses Gold as a graphic example, the yellow metal traded from $1,200 all the way up to nearly $2,000, before crashing to $1,500, whilst at the same time having many days when the price fell or rose by nearly 4%. Gold was not alone and many other assets and currencies exhibited similar volatility. 2011 was as difficult an investment environment to operate in as we can remember. On the balance of probabilities, surely 2012 has to be easier, or are we now being too optimistic?

As well as pointless resolutions, each New Year also brings wild forecasts from the many sages in the investment industry. Notably, many of these are again either extremely bullish or bearish. Very few people are suggesting that the year just started could in fact mimic 2011. **That volatile and almost sideways move would be our central case, with small overall positive returns likely. Our forecasts could, of course, be wrong both to the upside, in the event of a powerful recovery, or to the downside, were a new recession to eventuate**. The greatest positive surprise could come from a continuation of the recent improvement in the US, the avoidance of a lengthy recession in Europe and confirmation that a "soft-landing" has been engineered in the Chinese economy. If all three occur simultaneously (which is possible), then 2012 could be a cracking year for investment returns. Without wanting to finish our optimistic opening shot of the year on a down note, the downside risk to the economy and financial markets is a lack of conviction that European governments will be able to "roll over" the 450bn Euros worth of debt maturing in the coming three months, without causing further turbulence to the fragile European financial system. This and many other questions remain, but for now we are looking "on the bright side of life" and will try to maintain our resolution, at least until February.

We wish you all the very best of luck for the year ahead.
Happy New Year.

Thomas Becket
Chief Investment Officer
6th January 2011