

LABHA
INVESTMENT ADVISORS SA

Strategy 2013

Seeking Positive Real Returns –

A follow up from last year

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Strategy Overview

As we began 2012 we observed that, “as we expected, investors had been buying defensive stocks with high dividend yields even though they were not too optimistic about the future of equities in general. These defensive stocks looked fully valued and in our opinion the more cyclical names offered better value though they were much more volatile.”

In the sell-off in May 2012 we therefore accumulated the more cyclical stocks with good dividend yields in Europe as they were pricing in a high level of pessimism even considering all the issues both economic and political at the time. In August 2012 we emphasised this position again and elaborated on it in our Bloomberg TV interview. In October 2012 we advised increasing emerging market exposure as well as commodity equities and other industrials which would benefit from the stabilisation and recovery in China which we were expecting (Fig.1a&b). We also expressed this view on Bloomberg TV.

At the end of December 2012 all of these shares had performed far better than the market over the period of recommendation and as a result our client portfolios, though taking less risk than the markets, achieved a better than benchmark return.

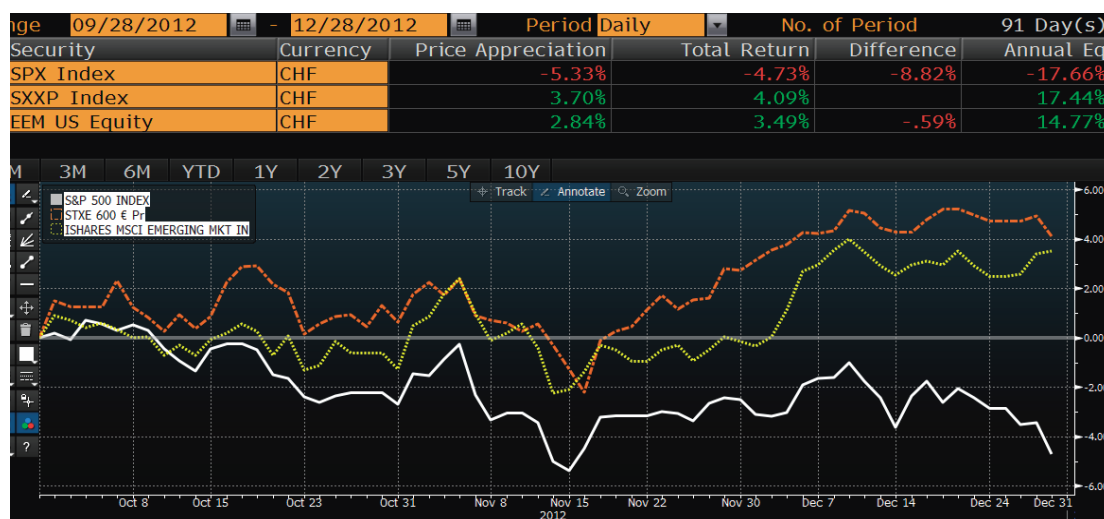


Fig. 1a: US, European and Emerging Market equity performance Q4 2012 (CHF)

Source Bloomberg

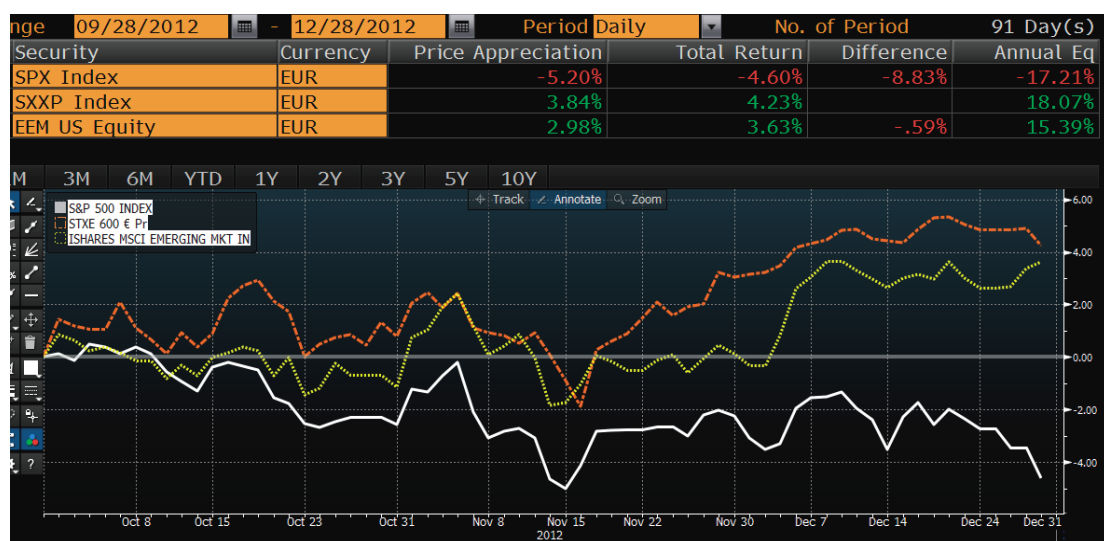


Fig. 1b: US, European and Emerging Market equity performance Q4 2012 (EUR)

Source Bloomberg

At the start of 2012 we also cautioned that “cash as a percentage of most investor and fund portfolios was still high and even though the overweight position in bonds had moderated, they still dominated

most investor's portfolios—"We believe that investors sense very clearly that if they seek positive real returns, (returns after deducting inflation) they should be reducing their bond exposure in favour of equity holdings in good quality companies." However they were reluctant to do so. In May 2012 those invested heavily in bonds were profiting from a yield drop and falling equity markets. However by the end of December the picture had reversed itself completely and 2012 was an above average year for equities and a below average one for bonds. In fact all those who bought bonds mid 2012 were suffering a loss by year end. (Fig.2). The only exception being bonds of the peripheral European nations which had suffered severely in the first half of the year and recovered strongly on Mr. Draghi's declaration of support. The bonds of countries like Greece and Spain were exhibiting volatility similar to that of equities and were backed by much more questionable balanced sheets than many cyclical companies in Europe. Therefore, to us it made more sense to buy equities with solid balanced sheets and good dividend yields in beaten up cyclical sectors than to buy Greek or Spanish bonds.



Fig. 2: Global equity performance versus global bond performance for 2012 (CHF)

Source Bloomberg

We also mentioned in our last report that "We are aware that the multitude of economic signals, political indecision, power play and sensationalistic headlines create a very convoluted picture of the investment world. Hence, it is even more important to remain agile and have a disciplined investment approach – but it will be necessary to accept more volatility, especially in the short term, to gain in the medium term. Short term market movements are increasingly dictated by computer trading or sudden liquidation needs of large funds which increases market correlation, i.e., no place to hide, or falling Gold prices even in insecure times with money printing on-going."

We believe that the tolerance for short term volatility in order to achieve medium term real returns will be required in 2013 as well. We expect equities to continue to outperform bonds and commodities to strengthen at least during the first half of the year. We expect gold to attempt a break of its previous high of USD 1'900 achieved in September 2011 and the emerging markets and Europe to perform better than the United States. However, we are expecting setbacks and periods of increased volatility along the way. The details of our strategy are put forward in the remainder of this document.

Cash

As we outlined at the start of last year we believe that "central banks will probably wait for sure and persisting signs of inflation before raising rates enough to produce positive real returns on cash. "Their priority at the moment is economic growth and employment. Though there are some signs of growth in the US and emerging markets, Europe continues to be major source of concern, with recession threatening most of the continent.

Countries	CPI YoY	Unemployment SA	Central Bank Rate	Nominal GDP QoQ
Australia	3.5% 09/11	5.3% 11/11	4.25% 12/11	1.6% 09/11
Belgium	3.49% 12/11	6.60% 10/11	1.00% 01/12	0.4% 09/11
Canada	2.9% 11/11	7.40% 11/11	1.000% 12/11	1.142% 09/11
China	4.2% 11/11	--	6.56% 12/11	--
Germany	2.1% 12/11	6.8% 12/11	1.00% 01/12	1.1% 09/11
France	2.5% 11/11	9.80% 10/11	1.00% 01/12	0.7% 09/11
United Kingdom	4.8% 11/11	8.3% 10/11	0.500% 01/12	1.0% 09/11
Italy	3.3% 11/11	8.50% 10/11	1.00% 01/12	0.2% 09/11
Japan	-0.5% 11/11	4.5% 11/11	0.100% 12/11	1.2% 09/11
Netherlands	2.6% 11/11	5.80% 11/11	1.00% 01/12	-4.9% 09/11
Sweden	2.80% 11/11	6.70% 11/11	1.75% 12/11	1.6% 09/11
Singapore	5.7% 11/11	2.0% 09/11	0.03% 01/12	2.3% 09/11
United States	3.4% 11/11	8.6% 11/11	0.250% 12/11	4.4% 09/11
Switzerland	-0.5% 11/11	3.0% 11/11	0.00% 01/12	0.1% 09/11
India	9.39% 10/11	--	7.50% 01/12	--

Fig. 3a: Comparison of Inflation (CPI) to Bank Interest Rates end 2011

Source Bloomberg

We published the chart above at the start of last year (Fig. 3a) and have now added the same view 12 months later (Fig. 3b). What can be observed is that in most countries inflation is lower one year later and this coupled with higher unemployment and lower growth levels has resulted in even lower interest rates than 2011.

Countries	CPI YoY		Unemployment SA		Central Bank Rate		Nominal GDP QoQ	
	Value	Date	Value	Date	Value	Date	Value	Date
Australia	2.0%	09/12	5.2%	11/12	3.00%	12/12	0.2%	09/12
Belgium	2.23%	12/12	7.40%	11/12	0.75%	01/13	0.5%	09/12
Canada	0.8%	11/12	7.10%	12/12	1.000%	01/13	0.738%	09/12
China	2.5%	12/12	--	--	6.00%	01/13	--	--
Germany	2.1%	12/12	6.9%	12/12	0.75%	01/13	0.3%	09/12
France	1.3%	12/12	10.50%	11/12	0.75%	01/13	0.5%	09/12
United Kingdom	2.7%	11/12	7.8%	10/12	0.500%	01/13	1.7%	09/12
Italy	2.4%	12/12	11.10%	11/12	0.75%	01/13	0.1%	09/12
Japan	-0.2%	11/12	4.1%	11/12	0.100%	01/13	-0.9%	09/12
Netherlands	2.9%	12/12	7.00%	11/12	0.75%	01/13	-6.3%	09/12
Sweden	-0.10%	11/12	7.50%	11/12	1.00%	12/12	0.5%	09/12
Singapore	3.6%	11/12	1.9%	09/12	0.03%	01/13	-1.0%	09/12
United States	1.8%	11/12	7.8%	12/12	0.250%	01/13	5.9%	09/12
Switzerland	-0.4%	12/12	3.0%	12/12	0.00%	01/13	0.6%	09/12
India	9.55%	11/12	--	--	7.00%	01/13	--	--

Fig. 3b: Comparison of Inflation (CPI) to Bank Interest Rates end 2012

Source Bloomberg

The interest paid on cash is below the rate of inflation in most countries resulting in an erosion of purchasing power (i.e. real returns are negative). In 2012 cash produced about 1.5% negative real returns if we use official numbers. We raised clients' cash holdings in the first quarter of 2012 when markets were too optimistic in our opinion and gradually reduced it again in the second quarter when extreme pessimism was taking hold in Europe and the Emerging Markets. We believe that these rebalancing moves add value but holding onto excessive cash positions as a permanent asset allocation decision will not produce favourable results over the medium term.

Currencies

In 2012 we have seen once again that when fear rules the market investors gravitate to the US Dollar as was the case in the second quarter of 2012. This move was rapidly unwound when Mr. Draghi made his announcement in September that he would offer unlimited support to the Euro and the fiscal cliff in the United States started to be a concern for investors. We believe such moves depending on where the concern is concentrated from quarter to quarter will be the norm this year as well.

After dropping 8% mid-year the Euro managed to end 2012 flat against the dollar. In our opinion the Swiss Franc will gradually weaken as the European situation stabilises and the global economic situation shows signs of improvement. This move has already shown some momentum in the second week of January and should develop as the year progresses even though volatility will prevail. The Swiss National bank will probably be the last central bank to raise interest rates as there is a trend towards deflation caused by the strength of the Swiss Franc.

Commodity supported currencies like the Australian Dollar, Canadian Dollar and Norwegian Kroner will probably continue to experience bouts of volatility as they did last year but should develop favourably especially during the first half of this year. After the major correction in emerging market currencies in 2011, 2012 was a more stable year and we believe that 2013 could be a better year for emerging market currencies. The Japanese Yen has weakened considerably in the past quarter as a result of political and central bank posturing and we expect this trend to continue with some consolidation expected in the short term.

Bonds

At the start of 2012 we were expecting a difficult year for debt markets and this is what we have seen unfold. We wrote "In order to bail out the private households and the banks, the US, British and several governments in the Eurozone took on debt that exceeded their usual limits. Therefore, investors looking for decent yields have been much more prone to lend to solvent & underleveraged companies than to overleveraged sovereigns. As a result many multinational companies in the US and Europe have been able to borrow from the markets at extremely advantageous rates. However, now that yields on corporate debt have fallen dramatically as spreads tightened, most bonds look rather expensive at current levels." We had increased our exposure to emerging market debt at the end of 2011 as their interest rate hiking cycle seemed to be reaching its end and their currencies had weakened considerably. This position has been very favourable in 2012. We now believe that these bonds do not look as compelling anymore, so would advise holding them but not adding to positions.

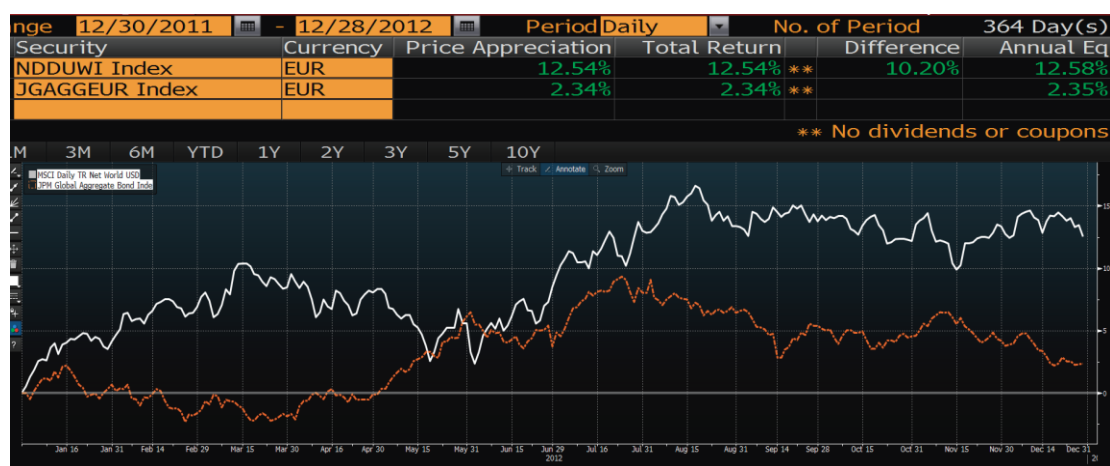


Fig. 4: Global equity performance versus global bond performance for 2012 (EUR)

Source Bloomberg

As we can observe in Fig.4 bonds did as well as equities till the middle of the year and then dropped off quite rapidly. We expect this trend though volatile to continue in 2013.

It is important to note that even though the FED extended QE3, the 10 and 30 year yields rose the next day. When rates are as low as they are and when so many extraordinary measures have already been taken to keep them low, the danger that sudden upward moves can result in substantial losses for bondholders is ever present. We had bought corporate bonds in 2009 and 2010 with average durations of about six years. The duration of these portfolios is about three and a half years now and we intend to keep it that way.

Equities

Longer term the QE globally should cause hidden inflation as assets rise in price. As bonds are not a claim on the profitability of assets or their increase in value they do not benefit from this trend. Bonds

give the holder the priority to be paid before shareholders and in times of extreme crisis this is a very important aspect. During a crisis and at the start of a recovery it therefore makes sense to hold a large portion of portfolios in corporate bonds as they offer more security, provide a steady cash flow and benefit from capital gains as interest rates fall. At that stage “companies are working for their bond holders”. Equities are a claim on the profitability of a company and the value of its assets. Therefore as company’s balance sheets and profitability improve and the threat of inflation starts to rise, it becomes more attractive for investors to hold equities than bonds. At this stage companies are in better shape and are able to roll forward debts at extremely low interest rates and fix these rates for longer periods. They can use this debt to invest and achieve returns which will benefit the equity holders. The bondholders do not participate in this increase in profitability. In fact they are the enabler but not the beneficiary. As inflation starts to rise the bond holder will suffer through a drop in the value of the bond but the equity holder benefits as long as inflation does not get out of control. This is because they have a claim on the increase in asset value of a company as well as its profitability and the asset values rise with inflation but the value of the debt is eroded. At that stage “companies are working for their equity holders”.

Regions

The US FED has announced an extension of QE3 (Quantitative Easing 3) until unemployment drops to 6.5% and as long as inflation stays below 2.5%. Mr. Bernanke stated that the FED would target a further USD 1 Trillion in asset purchases in 2013. This is equivalent to a third of its balance sheet. The BOE, BOJ and ECB are expected to expand their balance sheets as well. It appears that as fiscal discipline is being pushed through due to budget deficits in Europe and the US, central bankers are being forced to keep monetary policy loose so as to avoid stifling the very fragile growth in these regions. This provides a favourable backdrop for relatively good equity performance.

We expect 2013 to be a good year for equities just as 2012 was. Growth in the US and Europe, though not as strong as wished for, will probably turn out to be better than expected, crises will most likely be averted and companies should continue to post solid results. The latest US GDP figures showed a negative development on the head line number but the underlying figures paint a more positive picture. The economic growth is being fuelled to a large extent by business investment and a much smaller reliance on government spending. The very strong durable goods orders earlier this week underline this trend. This is a positive change and is an indication that business confidence is recovering despite all the fiscal cliff discussions. Till very recently businesses were holding back on investment and GDP growth was heavily reliant on government spending. That was an unsustainable path and the change should be welcomed by investors.

China has shown signs of economic growth with controlled inflation and this will indirectly benefit the rest of Asia as well as Brazil through their trade ties and commodity demand. We were expecting a Chinese recovery as discussed in our reports in October last year and had positioned portfolios accordingly. We are happy with the results thus far and intend to maintain this position and possibly build on it.

For 2013 we expect that the US equity market to underperform the European and the emerging markets. We established this relative position in the middle of 2012 and are pleased with the way it has worked out. The reason we took this position in the second half of 2012 was that the more positive US GDP and employment numbers versus the negative headline numbers and the European debt crisis caused a substantial gap in the performance and valuation of the regional equity markets. Therefore it was more likely that high expectations were priced into the US markets and there was room for disappointment, whereas European expectations were very subdued and would react quite strongly to even minor positive surprises. Even though the gap has narrowed considerably over the past quarter we believe that there is still some potential for European outperformance left. However, we must keep an eye on the fact that US manufacturing has become more competitive due to stagnant or falling wages in the US versus rapidly rising wages in Asia. Additionally, access to low cost energy due to the natural gas price in the US being two thirds cheaper than in Europe or Japan increases US competitiveness globally as well as increasing energy independence and these factors could turn the

trend in their favour.

We must also carefully monitor the twin dangers of protectionism and currency wars. As economies go through a difficult patch, there is a tendency toward increasing trade barriers in order to support local industry and employment. Though these decisions seem advantageous in the short term the negative impact in the medium to long term can far outweigh the short term gains. It has taken several decades to reduce trade barriers and open up global trade and these changes were desired by all parties involved. Now if some decide that they wish to alter course due to short term disadvantages, it will be extremely difficult to revert when doing so is seen as an advantage. The recent moves in the Euro and the Japanese Yen are being watched carefully by global investors. Germany as a leading global exporter has profited since the financial crisis from the weakening Euro. During the same period the Japanese exporters have suffered due to the strengthening Yen. This is especially relevant when comparing their auto industries. The recent strength in the Euro and weakness in the Japanese Yen if it is sustained will work in favour of the Japanese auto industry and be a significant setback for their German counterparts. These recent currency moves have therefore caused quite a stir and heated discussions in Germany as the Japanese seem determined to stay the course. It is important to note that the recent moves are simply a moderation of a trend which was very pronounced and worked against the Japanese exporters since the financial crisis. Therefore, there should not be too much objection to current levels. However, if the Yen weakens considerably from this point forward, there is a real danger that currency wars ensue in order to retain global competitiveness. This will once again increase volatility in equity markets and alter relative regional performance.

Sectors

Due to the underlying fundamentals regarding bonds and equities outlined above, as a crisis subsides, more and more investors are forced into equities as bonds underperform. Initially there is a lot of resistance to this move and bonds still seem to be a better alternative but gradually this resistance is worn down. The first equities that investors feel comfortable holding are the defensive stocks like, Nestle, Novartis, Unilever, Johnson&Johnson, Procter and Gamble, Coke etc. which have steadier cash flows and pay good dividends. We saw these stocks performing very well for the first eight months of 2012. When the potential in these areas is realised and these stock prices have appreciated to the extent that they look expensive, there is a tendency to be willing to take on more risk in the cyclical sectors. This is especially the case when the crisis seems more under control, growth seems to be improving and central banks continue to be supportive. We have seen this happen in the last quarter of 2012 and believe that this pattern will continue in 2013 with some setbacks. The Q4 improvement in US economic data has not yet been fully reflected in bond yields. If the 10 year yield rises just 0.5% from 1.9% at the moment, it could prompt a big move into growth sensitive stocks. Sectors we favour are basic materials, oil and gas, technology and some industrials. The latest GDP figures out of the US show that Business spending has risen sharply and this should have a positive impact on the business related technology stocks. There has been a lot of talk about the death of the PC market which has been a headwind for all PC makers as well as Intel and Microsoft. Intel with a price to earnings multiple of 10 and a dividend yield of 4.25% looks attractive to us. The company has taken steps to reduce its dependence on the PC market and to increase focus on the tablet and smartphone segments. Its manufacturing capabilities and technology leaps will likely put a lot of pressure on the competition. We believe that at current levels a lot of the bad news of the past is priced in and even slightly better news can produce a rally in the stock due to its fundamental value and the fact that its 4.25% dividend yield looks very secure and is more than twice as high as the ten year treasury yield. Microsoft is trading at similar multiples and a lower dividend yield of 3.35%. There was disappointment related to the reception of Windows 8 last year and this along with the headlines about PCs dragged the stock down. We believe that enterprise demand will remain and that Windows 8 will be better received in 2013 due to the availability of more hardware using this platform. Simultaneously, the Microsoft Office upgrade cycle as well as the games division will produce the solid cash flows that will enable more share buy backs or an increase in dividends. Both companies fulfil key fundamentals that investors look for in uncertain times and we believe that they will start to perform better as the year progresses. In the meantime the dividend yields make waiting less painful.

Commodities

Prices of basic materials are very dependent on China which is the biggest incremental user of most commodities. For example, after reaching a low of USD 86 in September last year due to destocking cycle in China and a year of below par growth, Iron ore prices have shot up to USD 158, i.e. +80% in just four months. This move is largely based on the better PMI data out of China over the past quarter and a restocking spree by Chinese steel mills while supplies remain tight due to seasonal adjustments. It appears that just as prices overshot in September they are overshooting now as well just in the opposite direction. The price should stabilise around USD 130 which would be good news for Vale of Brazil as well as BHP and Rio Tinto of Australia. We have seen large price movements exceeding 25% in both directions in commodities during average years and moves exceeding 50% in 2008, 2009 and once again in 2012/13. We believe these moves are set to continue.

In our opinion, agricultural products will be even more volatile and as in the past buying seed, fertilizer and grain processing storage and distribution stocks is a better approach than direct commodity exposure which is futures based and prone to high rolling costs. Last year Syngenta (+33%) was a big winner for our clients and this year we find the fertilizer stocks like Potash more interesting.

		Tonnes	% of reserves			Tonnes	% of reserves
1	United States	8,133.5	77%	21	Austria	280.0	57%
2	Germany	3,395.5	74%	22	Belgium	227.5	41%
3	IMF	2,814.0	-	23	Philippines	193.4	13%
4	Italy	2,451.8	73%	24	Algeria	173.6	5%
5	France	2,435.4	73%	25	Thailand	152.4	5%
6	China	1,054.1	2%	26	Singapore	127.4	3%
7	Switzerland	1,040.1	12%	27	Sweden	125.7	14%
8	Russia	934.5	10%	28	South Africa	125.0	14%
9	Japan	765.2	3%	29	Mexico	125.0	4%
10	Netherlands	612.5	61%	30	Libya	116.6	6%
11	India	557.7	11%	31	BIS	116.0	-
12	ECB	502.1	34%	32	Greece	111.8	83%
13	Taiwan	423.6	6%	33	Kazakhstan	104.0	20%
14	Portugal	382.5	91%	34	Romania	103.7	12%
15	Venezuela	362.0	74%	35	Poland	102.9	6%
16	Saudi Arabia	322.9	3%	36	Australia	79.9	10%
17	United Kingdom	310.3	17%	37	Kuwait	79.0	14%
18	Turkey	302.4	15%	38	Egypt	75.6	26%
19	Lebanon	286.8	31%	39	Indonesia	73.1	4%
20	Spain	281.6	31%	40	Korea	70.4	1%

Top 40 reported official gold holdings (September 2012)

Source IMF, World Gold Council

Gold has been part of our client portfolios from the time we started LABHA. However, we booked some profits in September 2011 and have since bought back what we had sold at levels about 15% lower. We believe that any further fall in the price should be used to add to positions. From the table above we see that even though the US and many European countries hold a large part of their reserves in gold, this is not the case for most emerging markets including China. The private individuals in India have for decades been major purchasers of gold, the Indian government on the other hand has only 11% of its reserves in gold despite its large purchase in 2010. In past decades the developed nations held large and increasing reserves. In the past decade the emerging markets, especially China have been increasing reserves and looking for a way to diversify away from the increasing number of fundamentally weak currencies. This offers substantial support to gold prices.

Not only has the Chinese government been adding to its gold holdings, from the bar chart below (Fig. 5) it is clear that Chinese consumption is fast catching up with that of India. Therefore we believe that gold though it does not produce any cash flows and has costs related to its storage will benefit from capital gains especially when the alternative for many people is holding cash which returns next to nothing. If investors view gold as an alternative to equities or other asset classes the decision may be less clear. However, we believe that most people buy gold as an alternative to holding cash in various currencies and that this tendency will persist with the present monetary policy backdrop. Gold also has started to look favourable when compared with bonds. At current interest levels the opportunity cost of holding gold instead of bonds is low and if interest rates rise bond prices will suffer whereas gold prices should rally.

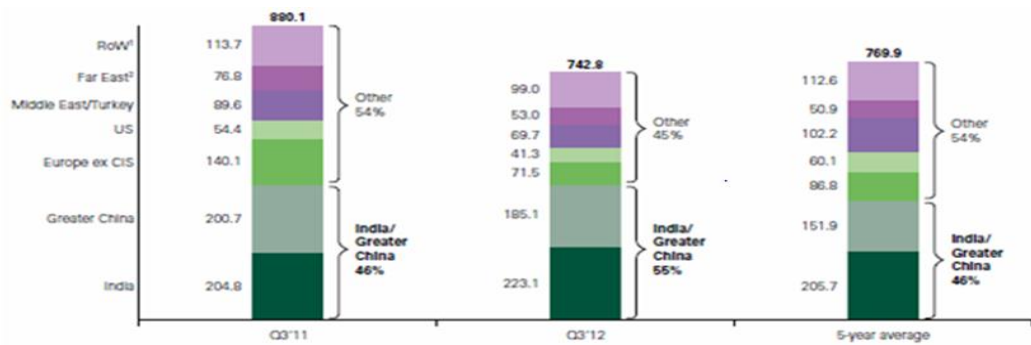


Fig. 5: Consumer demand for gold by region: Q3 2011, Q3 2012 and 5yr. average

Source: World Gold Council

Conclusion

To summarise, for 2013, we are recommend a neutral position in equities while underweighting the US and overweighting Europe and the emerging markets. Our bond exposure remains underweight. We have rebuilt the gold positions sold in September 2011 and intend to add to positions on any further weakness. Our tactical stance may differ from the strategy outlined above from time to time as we rebalance portfolios in response to market volatility.

At the start of 2012 we wrote “In our opinion, just as the US, Japan and the UK have resorted to quantitative easing to solve their debt problems, Europe will eventually be left with little choice than to follow suit. The result of such a move would in our opinion result over the medium to long term in higher inflation than expected as mentioned above. Therefore, as outlined in the asset allocation discussions earlier, we would recommend building positions in equities of companies with solid balance sheets and good cash flows as well as precious metals. As real returns (nominal interest-inflation) are negative now and would fall even further in the scenario outlined above, the search for real returns would lead us to allocate larger portions of client portfolios to these two asset classes.” We continue to follow this strategy for the medium term.

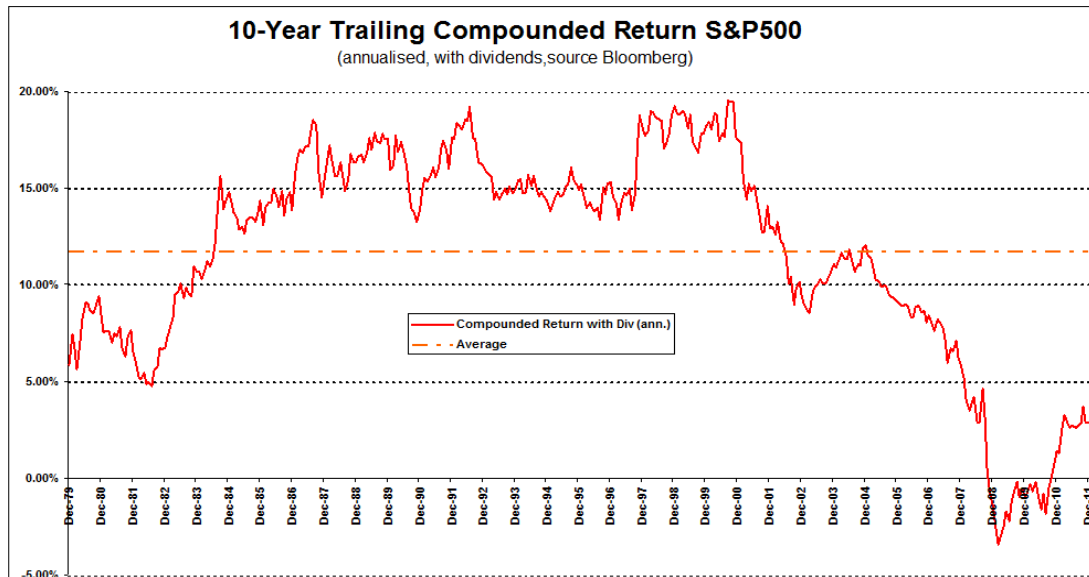


Fig. 6a: 10 year trailing annualised returns – S&P 500 from 1979-2011.

Source Bloomberg

The graphs above and below (Fig. 6a&b) show the annualised 10 year returns on the S&P 500. What we can observe is that the ten year annualised return on equities was at its lowest in March 2009 and was negative but has since turned positive and is rising.

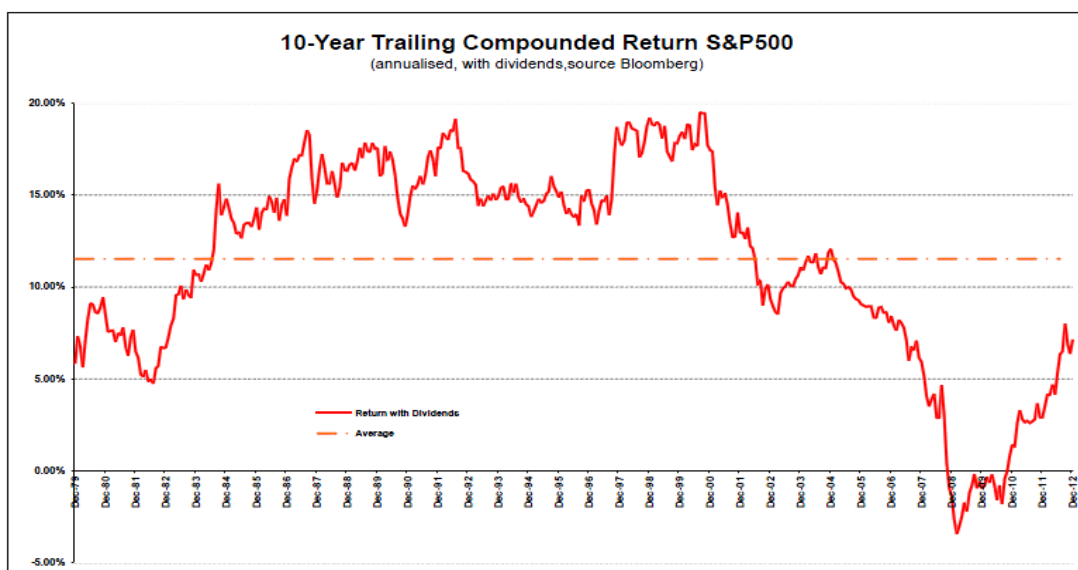


Fig. 6b: 10 year trailing annualised returns – S&P 500 from 1979-2012.

Source Bloomberg

The average is still well below what has been observed historically and while we are aware of the volatility which has accompanied these moves and do not expect a smooth curve moving ever upward, the tendency seems to be positive and the trend appears to have established itself.

In 2012 we bought equities between May and July when a lot of negative news was being priced in. After the strong rally in the past 3-4 months we are holding back on purchases and have even booked some profits. In our opinion sentiment has turned too complacent after reaching levels of panic just a couple of quarters ago. Small disappointments at current levels could lead to widespread profit taking at current levels. Therefore even though our strategic view is towards more equity allocation, our tactical position for the short term is more cautious. We are pleased that our clients have recognised the importance of this tactical discipline and the positive result of such actions. We believe that once again in 2013 rebalancing will be required regularly in order to optimise returns at moderate levels of risk.

Gillian Hollenstein

Important Disclosures

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