



LABHA
INVESTMENT ADVISORS SA

Strategy 2012

Seeking Positive Real Returns

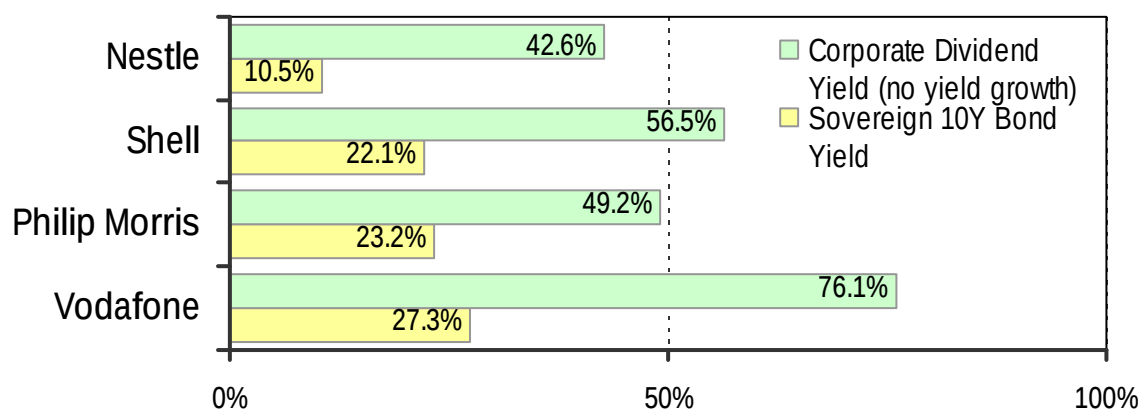
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Strategy Overview

At the start of 2011 we wrote, "Most Investors have been reluctant to invest in equities for the past two years and have preferred bonds. In many cases high quality companies with solid cash flows are paying dividends which produce a yield 50-100% higher than that of their 3-5 year bonds. We believe that this situation will tempt investors back into the equity markets, starting with the more defensive sectors and stocks with good and relatively secure dividend yields."

We had put together a chart showing a comparison between sovereign bond yields (in yellow) and corporate dividend yields, accumulated over the next 10 years (in green). We assume no dividend growth and constant share price. What we observed is that corporate dividend yields would most likely outperform sovereign bond yields in the future. Or in other words, these share prices would have to fall at least 30% and stay there for 10 years for the return on these shares to equal that of the respective bonds.



As we begin 2012 we observe that, as we expected, investors have been buying these stocks even though they are not too optimistic about the future of equities in general. For example, the 12 month return on Unilever was 17%, Royal Dutch 17.5% and Roche 24%, while the average European market was down 15% during the same 12 month period. In the US, Coca Cola returned 10.5%, Procter & Gamble 7% and Johnson & Johnson 8% even though the US markets were flat for the year. This compares with a 2% return on bonds in Europe and 9% in the US.

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 and as a result have started with the more defensive names. These defensive stocks now look fully valued and in our opinion the more cyclical names offer better value though they are much more volatile. Cash as a percentage of most investor and fund portfolios is still high and even though the overweight position in bonds has moderated, bonds still dominate most investor's portfolios.

Additionally, with the very high debt burden of western economies, the solution that looks probable in Europe and has been practiced for a long time in the US already is to deflate the debt by increasing the money supply. So far, the effects on inflation are not as pronounced as one might have expected. This is mainly due to the fact that even though we see a vast increase of money supply by central banks, the transactional volume of money (velocity of money) has decreased. Banks do not pass on the money handed out by the central banks in the form of private or small enterprise credit. For example, large amounts that the banks borrowed from the ECB were immediately deposited back at the ECB to bolster

the bank's capital reserves even though they were borrowing at 1% and earning just 0.25%. Furthermore, Banks have reduced credit facilities to the market and each other and are reluctant to buy sovereign debt. Additionally, due to the ongoing mistrust of the people in their government's ability to handle the financial crisis many private citizens and companies are spending and investing very cautiously if at all. Hence, one does not yet observe the rapid increase of inflation which one might expect to see due to loose money policy. But should these large volumes of money that have been pumped into the markets and are sitting idle become hot, i.e., come into circulation, the governments will not be able to raise interest rates fast enough to combat inflation without stifling the economy. As a result we would expect to see much higher levels of inflation than anticipated over the medium to long term. With this scenario in mind, it would be advisable to allocate increasing portions of portfolios to assets that would be expected to produce real returns such as equities and precious metals and reduce allocation to cash and debt.

We are aware that the multitude of economic signals, political indecision and power play and not least the press looking for ever more 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 ongoing. We are of the opinion that in order to attain good returns over the medium term, the ability to tolerate some volatility in the short term is essential.

Cash

The fragile economic recovery and the shock of the financial and sovereign debt crises are bound to cause hesitancy on the part of central banks to raise interest rates going forward. The central banks will probably wait for sure and persisting signs of inflation before raising rates enough to produce positive real returns on cash. We published the chart below at the start of last year and have now added the same view 12 months later.

Countries	CPI YoY	Unemployment SA	Central Bank Rate	Nominal GDP QoQ
Australia	2.8% 09/10	5.2% 11/10	4.75% 12/10	1.2% 09/10
Belgium	3.10% 12/10	8.50% 10/10	1.00% 12/10	0.9% 09/10
Canada	2.0% 11/10	7.60% 11/10	1.000% 12/10	0.70% 09/10
China	5.1% 11/10	--	5.81% 12/10	--
Germany	1.7% 12/10	7.5% 11/10	1.00% 12/10	1.0% 09/10
France	1.6% 11/10	9.80% 10/10	1.00% 12/10	0.8% 09/10
United Kingdom	3.3% 11/10	7.90% 10/10	0.500% 12/10	0.9% 09/10
Italy	1.7% 11/10	8.60% 10/10	1.00% 12/10	1.0% 09/10
Japan	0.1% 11/10	5.1% 11/10	0.100% 12/10	0.6% 09/10
Netherlands	1.6% 11/10	5.20% 11/10	1.00% 12/10	-4.2% 09/10
Sweden	1.80% 11/10	7.10% 11/10	1.25% 12/10	2.1% 09/10
Singapore	3.8% 11/10	2.1% 09/10	0.01% 12/10	0.2% 03/10
United States	1.1% 11/10	9.8% 11/10	0.250% 12/10	4.6% 09/10
Switzerland	0.2% 11/10	3.6% 11/10	0.25% 12/10	1.4% 09/10
India	9.70% 10/10	--	5.25% 12/10	--
Eurozone	1.9% 11/10	10.10% 10/10	1.00% 12/10	--

Fig. 1: Comparison of Inflation (CPI) to Bank Interest Rates 2010

Source - Bloomberg

What can be observed is that in most countries inflation is higher one year later despite the European crisis and fears of recession. The exceptions are India and China (which have been raising rates to combat inflation), and Switzerland and Japan (very strong currencies reduced the cost of imported goods - this is a temporary effect).

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	--
Eurozone	3.0% 11/11	10.30% 10/11	1.00% 01/12	--

Fig. 2: Comparison of Inflation (CPI) to Bank Interest Rates 2011

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 2011 Cash outperformed only in the third quarter and underperformed in all the three remaining quarters of the year. We raised cash holdings in the second quarter of 2011 but gradually reduced them again in the third quarter. 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 our opinion, the US dollar will devalue over the next decade as the inevitable reduction of US dominance unfolds and the pressure of their debt burden takes its toll. This however, does not rule out several strong rallies in the US dollar in the short term. It is still the world's reserve currency and this status will persist for some time. In 2011 we have seen once again that when fear rules the market investors gravitate to the US Dollar as was the case in the fourth quarter of 2011.

The Euro has had a weak 2011 but we believe that it is now undervalued versus most of the major currencies. The rally in Swiss Franc was halted due to the action of the Swiss National Bank and in our opinion the Swiss Franc will gradually weaken as the European situation stabilises and the global economic situation shows signs of improvement. The Swiss Franc is still fundamentally overvalued and is worrying both the Swiss National Bank and especially Swiss exporters. 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 continue to be beneficiaries from the growing need for commodities in the emerging markets. Banks in these countries did suffer in the crisis but there were no major disasters or bail outs, and employment has continued to be supported by the commodities they produce. However, these currencies are not immune to the general volatility in the foreign exchange markets.

At the start of 2011 we wrote "The emerging market currencies, though well supported by growth, have issues of liquidity, transparency and therefore are prone to excessive volatility. Although they will probably strengthen over the coming decade, we believe that the path will be interrupted with considerable volatility and these currencies are not liquid enough to allocate substantial parts of a portfolio to." The chart below demonstrates what we were referring to; most emerging markets currencies were down substantially in 2011. After this correction we believe that some emerging market currencies look attractive though further volatility cannot be ruled out.



Fig. 3: The Performance of Emerging Market currencies versus the US Dollar in 2011

Source - Bloomberg

Bonds

At the start of 2011 we were expecting a difficult year for all sovereign debt and this is what we have seen unfold in Europe. We wrote "In the Eurozone some sovereign debt might outperform but should still underperform corporate debt in general." This is exactly what has taken place. We did not hold any sovereign bonds for clients but opted for corporate bonds instead. The corporate bonds have performed very well but are now looking expensive. We are of the opinion that US government bonds will experience a difficult decade due to the outfall of the current crisis and the debt burdens the US faces.

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.

The emerging markets offer a very diverse picture with extremes in attractiveness and viability. Therefore these markets are best addressed through a well managed emerging markets bond fund.

Most investors looked at their portfolios in March 2009 and saw that bonds had performed very well for them and equities had lost them money over a ten year period. As we now know that was a good point to increase equity exposures in portfolios. At the time we were encouraging all clients to do so and the result has been very favourable. The chart below (4) shows the performance of global equities in Euro (white) versus global bonds in Euro (green) from end 2002 till end 2011. We can observe that depending on when one looked at the chart different conclusions could be drawn with regard to the performance of equities versus bonds. However despite the financial crisis global equities have outperformed global bonds since the previous recession, i.e. over a nine year period (fig 3).

In our opinion rebalancing asset allocation regularly adds more value instead of trying to time the market perfectly.



Fig. 4: MSCI World Equity Index (green) versus JPMorgan Global Bond Index (white)

Source - Bloomberg

Equities

1.1 Regions

In our opinion emerging markets will remain very volatile. However, their share of global GDP is set to increase substantially and that of the G7 set to head in the opposite direction by default. We therefore believe that larger portions of equity portfolios should be allocated to these equity markets whenever dips provide the opportunity. We have established positions in the emerging markets and intend to build on them. Foreigners returned to being net buyers of Asian Equities in December and there is a large net short position among hedge funds which could lead to a short covering rally.

Asian equities are trading at about 10 P/E which is a 21% discount to the 10 year mean. China and Korea are trading at 8 P/E and P/B 1.6. Earnings estimates are conservative and since October 2011, earnings revisions have actual turned positive. Stock markets usually anticipate earnings improvements by several months. Compensation for risk bearing is at a record high. This deviation level is as high as that of the 2003 market bottom and was exceeded only for 5 weeks in Q4 2008. Inflation in China is now at 4% and allows the govt to ease considerably. Besides the 50 bp cut in reserve requirement ratio, the SHIBOR has declined 130bps and rates for small and medium enterprises have fallen dramatically. December new loans are expected to exceed both October and November levels. Loan quality and Capital efficiency are also improving from a low level.

The Q4 improvement in US economic data has not yet been 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.

For 2012 we believe that the US may continue to outperform Europe and the emerging markets in the first half of the year. However, we expect Europe and especially the emerging markets to perform better over the year as a whole. The German and Swiss markets were hit disproportionately last year as they are the most liquid markets and had no short selling restrictions. In the rally of the past months these two Indices have outperformed strongly. We see a lot of value in the large cap multinationals in both Indices and have been adding to them in the slumps of October and November last year.

1.2 Sectors

The financial sector in the west looks set to lose its dominance in index weights. The consumer discretionary sector, though less affected, appears also to be heading in this direction. We therefore continue to stay underweight both these sectors and instead concentrate on those which we believe will rise in weighting in the various indices. Sectors we favour are basic materials, oil and gas, technology, consumer staples and certain subsectors of industrials related to alternative energy and commodities.

US capital utilisation has increased from 65% to 75% over the past 2 years. The level before the drop in 2008 was 80%. The US has not had a Capex cycle since 2003-2007 which implies increasing obsolescence. IT spending makes up the largest single component of total US Capex i.e. 31%. Inventory to sales ratio at wholesalers remains extremely low. All of this provides a very favourable back drop for the outperformance of technology and industrials stocks if growth in the US continues the trend of the recent quarter.

For 2012 the energy, materials, technology and industrial stocks will probably remain very volatile but positions should be built on dips as we believe that there is a lot of value in these companies. Last year when investors were buying into the above mentioned sectors, we chose to increase positions in the consumer staples and healthcare names with solid balance sheets and dividend yields. After the excellent performance in these two sectors we are less inclined to add to positions. However, we would advise increasing exposure on dips.

Commodities

In general there has been underinvestment over the past two decades in exploration and production for most commodities as returns were low and often negative. Just as investment was starting to accelerate from 2006 onwards, the financial crisis hit and caused a delay in a lot of projects due to lack of financing. Additionally, the sharp drop in demand for most commodities in 2008 caused many miners to adjust their investment time frames and decrease their levels of debt in order to prepare for any future shocks. Even though, several mining and oil companies have increased in capital expenditure over the past two years aimed at increasing exploration and production, the additional commodity supply from these investments will not be seen for at least 3 years. We therefore believe that supply will continue to lag demand, sometimes substantially and that commodities will continue to be a strongly performing but markedly volatile asset class.

Prices are very dependant on China which is the biggest incremental user of most commodities. We have seen large price movements exceeding 25% in both directions in commodities during average years and moves exceeding 50% in 2008 and 2009. Recently China had reduced imports over the second half of 2011 and run down inventories as prices had risen considerably during the first half of 2011. After a drop in the copper price which exceeded 25%, China has started to increase the import of copper and iron ore and this has resulted in a stabilisation in prices.

Gold has been part of our client portfolios from the time we started LABHA. However, we booked some profits in September this year 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.



Fig. 5: Gold (Yellow), Oil (orange) Copper (White) over the past 12 months.

Source – Bloomberg

We sold our agricultural commodity exposure with a 60% gain last year and have not bought back positions yet. We prefer to gain exposure to the agricultural sector through seed producers, fertilizer manufacturers and machine builders.

Conclusion

To summarise, we are underweight equities, though less so than in the middle of 2011. Our bond exposure remains underweight and we have temporarily raised cash levels. We have rebuilt the gold positions sold in September and intend to add to positions on any further weakness.

Some economists and market commentators are of the opinion that the Eurozone and therefore the Euro will not survive in their current form. Investors are concerned about this issue and especially since such events are often sudden and leave little chance for investors to protect their assets from the out-fall. The way we have positioned client portfolios is to concentrate on German and Swiss Bonds and equities. If a sudden break up of the Euro should occur, we believe that this position should provide a good foundation in client portfolios. German equities and bonds would then be quoted in a national currency which would be stronger than most in Europe and should provide a buffer to the loss of value in equities and bonds if such an event should occur. It would not be possible to completely avoid the negative effects of such an event. However, by avoiding assets in the regions with weaker economies and currencies we believe that we have positioned client's portfolios for good stability.

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 much 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.

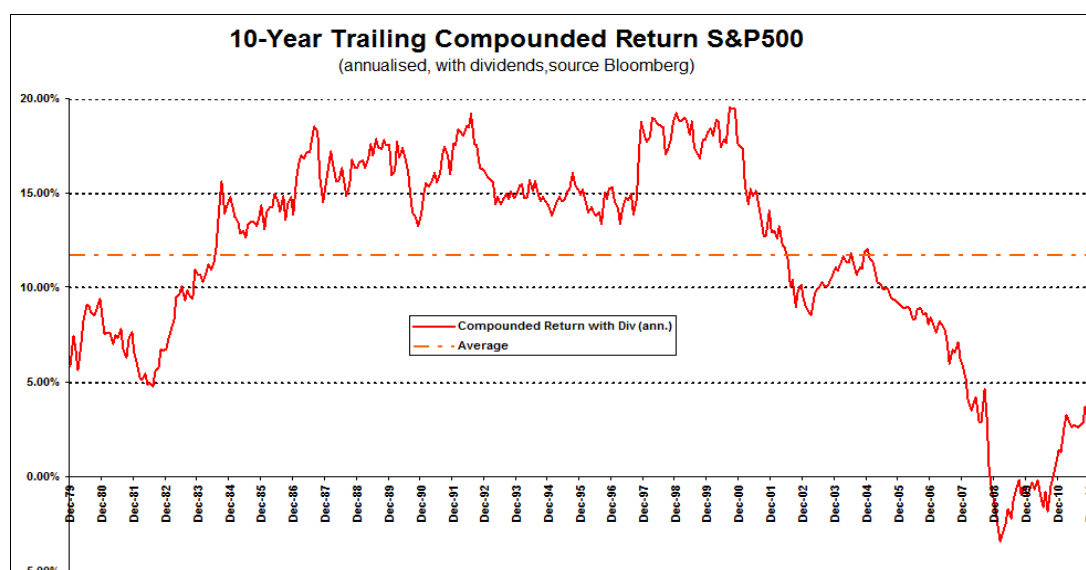


Fig. 6: 10 year trailing annualised returns – S&P 500 from 1979-2011.

Source – Bloomberg

The graph above (fig. 6) shows the annualised 10 year returns on the S&P 500 and we studied similar graphs for the Dax and other indices though not as far back. 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. The level reached in 2009 was lower than at any time in the history available i.e. since 1835. Similar levels were reached in 1844, 1937 and 1974¹. In each case the following decade proved to be a good one for equities with annualised returns exceeding 15%.

Over the past decades studies have shown that equity markets usually do better when earnings are lower than the previous year or quarter but not falling off a cliff as market participants start to anticipate earnings improvement and positive surprises are usually frequent. Markets do not perform so well when

¹ Source: Stifel Nicolaus

current earnings are excellent as most of it is already priced in and the likelihood of disappointment is high. Therefore, just as we have done in the past, we continue to follow the discipline of adding to positions when we feel that markets offer good value, investors are too pessimistic and therefore the potential for positive surprises are high. We tend to book profits when markets have rallied substantially and investors are getting complacent.

We believe that the first couple of quarters of 2012 will probably remain very volatile as positive news on the economic front in the US and emerging markets is negated with Eurozone debt crisis issues. In 2011 we were able to protect our clients from the worst of the crisis and have produced a much better result than most of our competitors. We achieved this result by rebalancing portfolios regularly. We booked profits when the markets looked like they were ignoring risks and bought back positions when we felt fear had taken the upper hand. We applied this discipline across asset classes, regions and sectors and believe that regular rebalancing will be necessary in 2012 as well. Though this has been good for our client portfolios, the fact that we buy when most are panicking and sell when most are euphoric is not always easy for clients to accept on the day that these actions are taken.

However, we are pleased that our clients have recognised the importance of this discipline and the positive result of such actions can be seen in the consistently superior performance of their portfolios.

Gillian Hollenstein

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