LABHA
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Investing in Volatile Markets

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One general observation about the average investors' time frame is that it has shrunk considerably over the past 10 years. This may be a result of two extreme drops in equity markets, one in 2000-2002 caused by the bursting of the dotcom bubble and the other in 2007-2009 caused by the bursting of the housing bubble. The resulting equity performance over the ten years spanning 1999-2009 was negative in the US, Europe and at the global level (Chart 1).

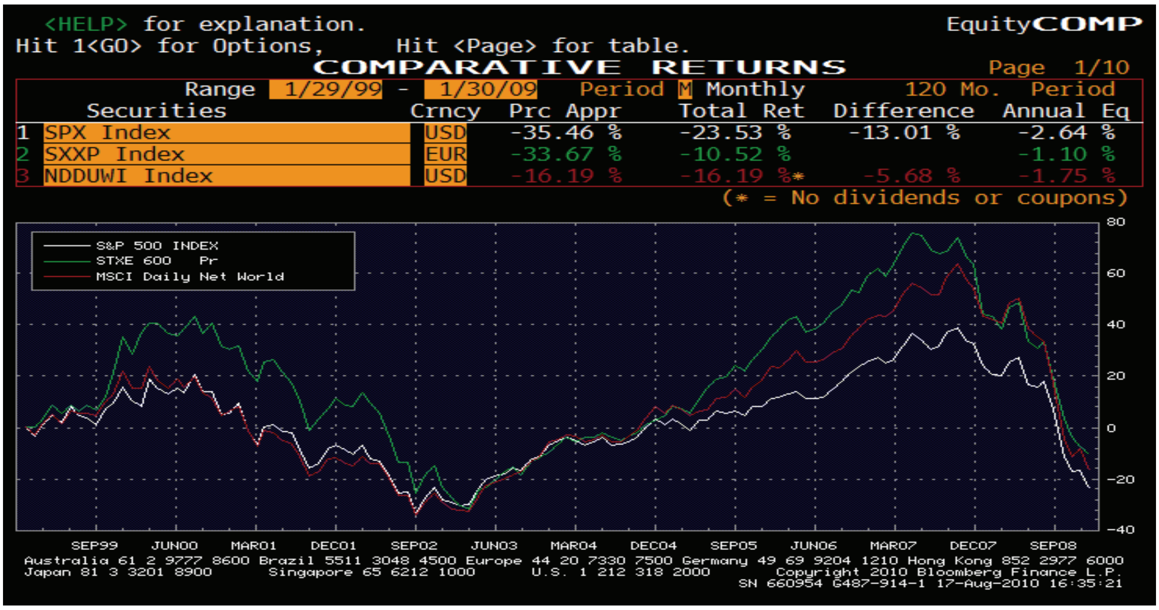

Chart 1: Performance of the US, European and Global Equity Markets 1999-2009 Source Bloomberg

This was not what investors were expecting. Based on historical data, they had counted on equities to outperform cash and bonds substantially over a period of ten years. In the 10 years from 1989-1999 equities had returned 12-19 % per year depending on which region one had invested in and bonds had returned just 9% (Chart 2). This outperformance by equities had been observed in several other decades leading up to 2000 as well.

However from 1999 to 2009 equities returned -2% to -3% per annum compared to 5.64% for global bonds (Chart 3).

In fact over a period of 20 years from 1989-2009 it had made little difference whether one had invested in equities or bonds as both had returned about the same. However, the lower volatility of bonds was a lot more comfortable for most investors.

The large number of "Baby Boomers" retiring now and over the next twenty years look back at these numbers and come to the conclusion that in order to preserve their capital and achieve reasonable returns, bonds are much more preferable to stocks. Therefore many of them are either liquidating their equity positions or not increasing their allocation to equities.

Exaggerating this trend further are large numbers of investors/speculators who in the face of negligible returns on cash are searching for yield in the "relative safety" of bonds and are still very reluctant to invest in equities for longer than a few weeks or days. This psychology of fear is resulting in price movements in equities, bonds and commodities which are sudden and exaggerated. Asset classes, currencies and individual stocks tend to be in favour or out of favour and have large numbers of investors moving toward or away from them depending on the short term expectation of price movements. This mass movement and momentum chasing has caused several major moves in both directions in each asset class and most major currencies since the financial crisis started to unfold.

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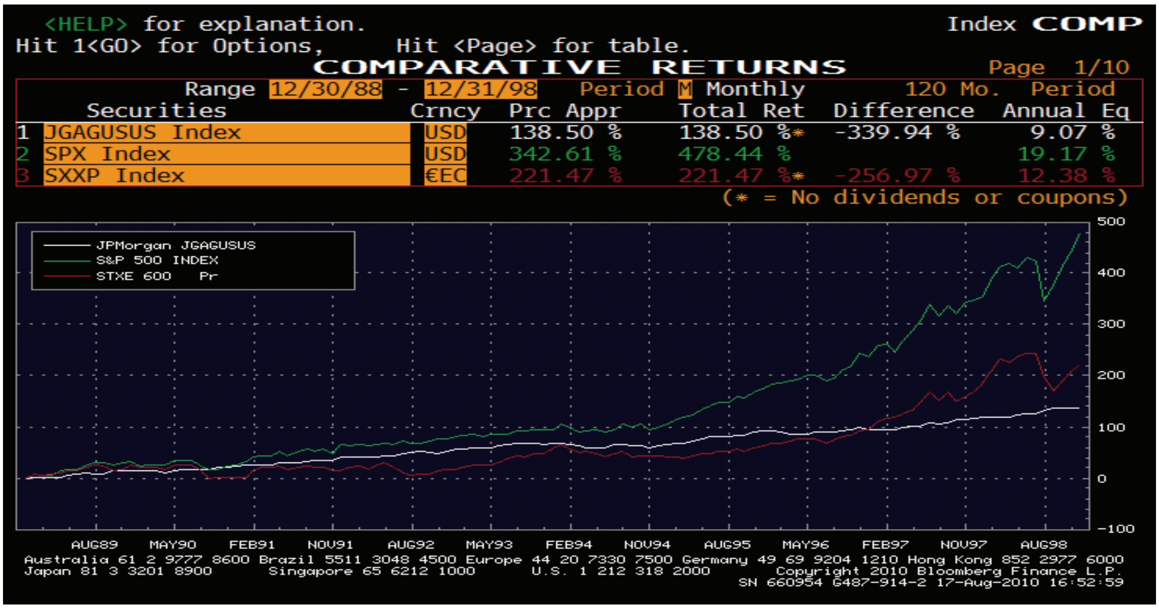

Chart 2: Performance of the Global Bond Index, US and European Equity Markets 1989-1998 Source Bloomberg

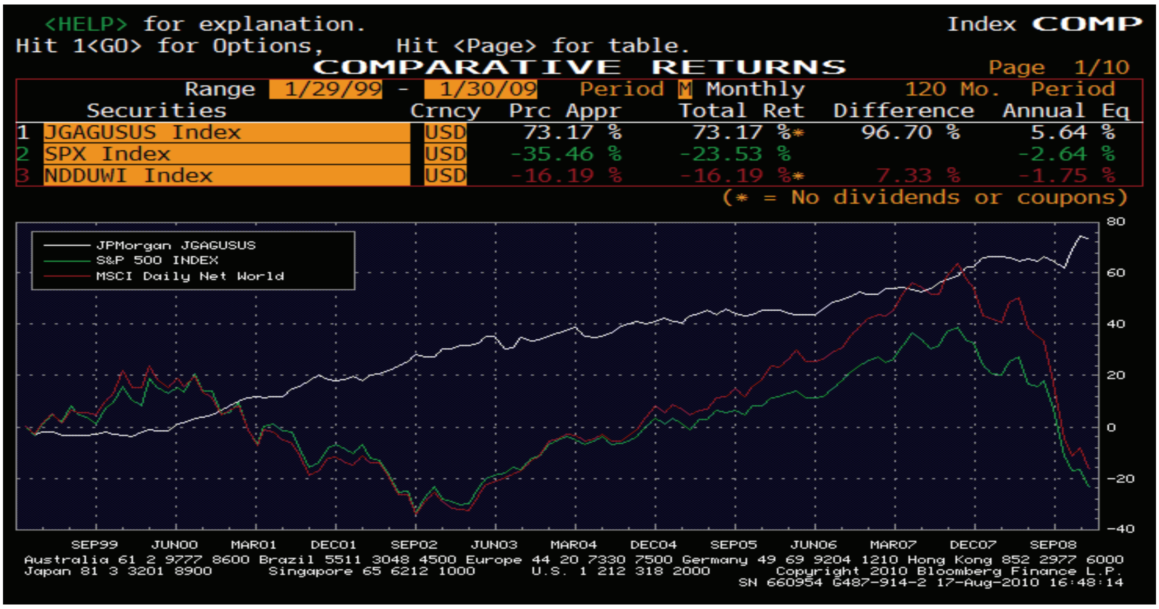

Chart 3: Performance of the Global Bond Index, US and Global Equity Markets 1999-2009 Source Bloomberg

As most investors do not feel that they have profited from taking a long-term view on their investments, they have started to focus on the extremely short-term and are judging the performance of their fund managers and investment advisors based on quarterly, monthly and in some cases weekly performance!! This is an extreme situation which is causing performance chasing by portfolio managers. This performance chasing in the short-term is further exaggerating the magnitude of moves in each direction.

Additionally, there has been a huge increase in the number of hedge funds. Many of these funds take long/short positions and apply leverage to them. When a panic in markets causes large numbers of investors to withdraw their money from such funds the effect on individual stocks is often dramatic. The best stocks (which hedge funds are long) need to be sold and the worst (which they are short) need to be bought back in order for them to have enough liquidity to pay back their investors. As a result of so many of them executing the same transactions at the same time the market price of individual stocks is thrown completely out of ranges which could be justified by any fundamental analysis. This was the case in the last few months of 2008.

All of this change in behaviour on the part of investors and their asset managers resulted in the following extreme moves over the past couple of years.

1) In the early part of 2008 as the dollar weakened, the prices of commodities rose at rates never seen before. As soon as one group of investors pushed the prices higher, the herd behaviour kicked in and pushed oil and soya bean prices up 50% in one quarter (Chart 4)!

Chart 4: Performance of the Soybeans, the commodities Index and Oil Jan.-June 2008 Source Bloomberg

Chart 5: Performance of the Soybeans, the commodities Index and Oil June 08-March 09 Source Bloomberg

2) One quarter later however, the picture was dramatically reversed (Chart 5)! This collapse in commodity prices lasted well into 2009. Then, after oil had fallen from USD147 to USD 32, the market was predicting USD 10 as the oil price. Just a few months earlier at USD 147 the market had been calling for USD 200 oil.

3) There are several examples of such movements over the past two years, including in equity markets (Chart 6), currencies and the and even Gold (Chart 7).

Chart 6: S&P 500, EUROSTOXX 600 & Emerging market equity Indices July 08-Dec. 09 Source Bloomberg

The most amazing factor in the graphs above is that all these movements took place in a period of less than one year!

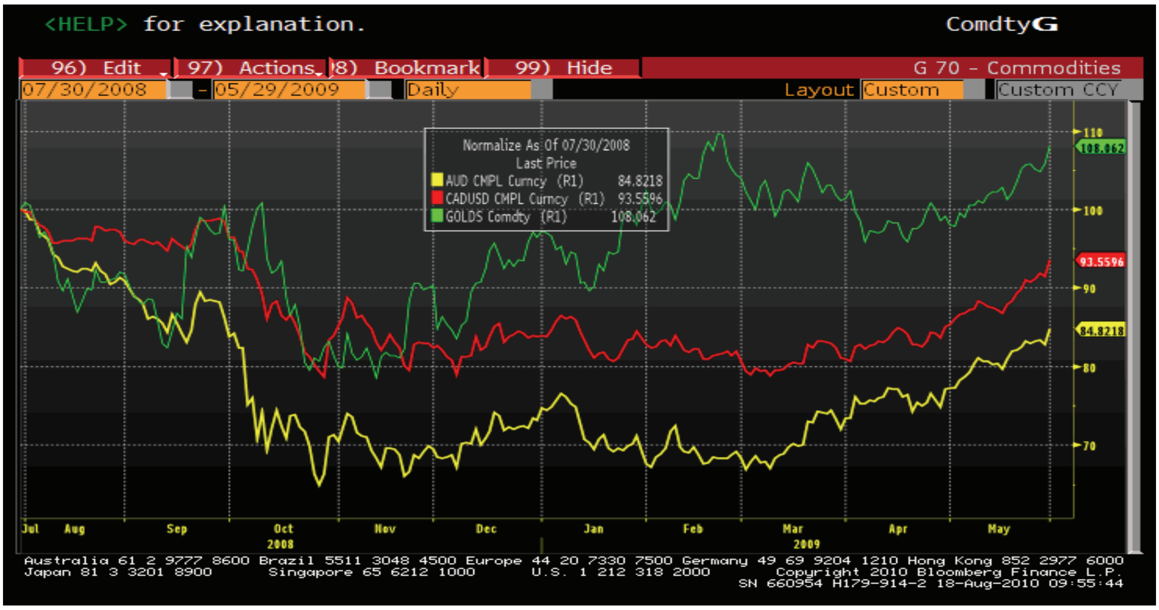

Chart 7: AUD vs USD, CAD vs USD and Gold July 08-May 09 Source Bloomberg

Yes, one could argue that this was a very unusual period in economic and financial terms. However, the magnitude of these moves and counter moves is still astonishing especially as they do not appear to be fundamentally driven but liquidity driven. We are expecting this trend to continue, though not in these dimensions. We believe that future frequent 10-20% moves, though substantial, will be subdued compared to the 25-50% moves seen in the charts above.

Central banks in "developed" nations are keeping interest rates at all time lows for extended periods. They are also pumping liquidity into markets through security purchases etc. All of this is in an effort to stimulate investment in the real economy and consumption. However, these low interest rates are resulting in investors/speculators hunting for yield. These market participants who still have the events of 2008 and 2009 fresh in their minds are looking for confirmation that all is well before investing. As a result, many of them missed the entire equity market rally from March 2009 till December 2009. Then when they felt they had enough confirmation that the market was "safe", they started to buy equities in the first quarter of 2010. However those who waited till Q1 2010 to invest in equities have a 10% negative performance in 2010.

Equities had gone from being very cheap in March 2009 to being fairly priced in April 2010. However, in March 2009 there were few buyers in the market. In April 2010 buyers started to rotate out of bonds and into equities and optimism reigned. Now after a 10-15% correction in the leading equity indices, fear reigns once more and the only place market participants are willing to put their money is bonds (Chart 8). The market logic seems to be that the last time bond yields shrunk so much was in Q3 and Q4 2008 and the result was equity markets dropping off a cliff.

While we certainly cannot rule out a drop in equity markets we need to examine the likelihood of such an event as well as the circumstances surrounding equity markets in Q3 2010.

In Q3 and Q4 2008 there was a fear of economic collapse, run on the banks and a mistrust of even large corporations with good balance sheets making it impossible for them to borrow money. Therefore, money fled to government bonds as the only safe haven with and implicit guarantee of capital return.

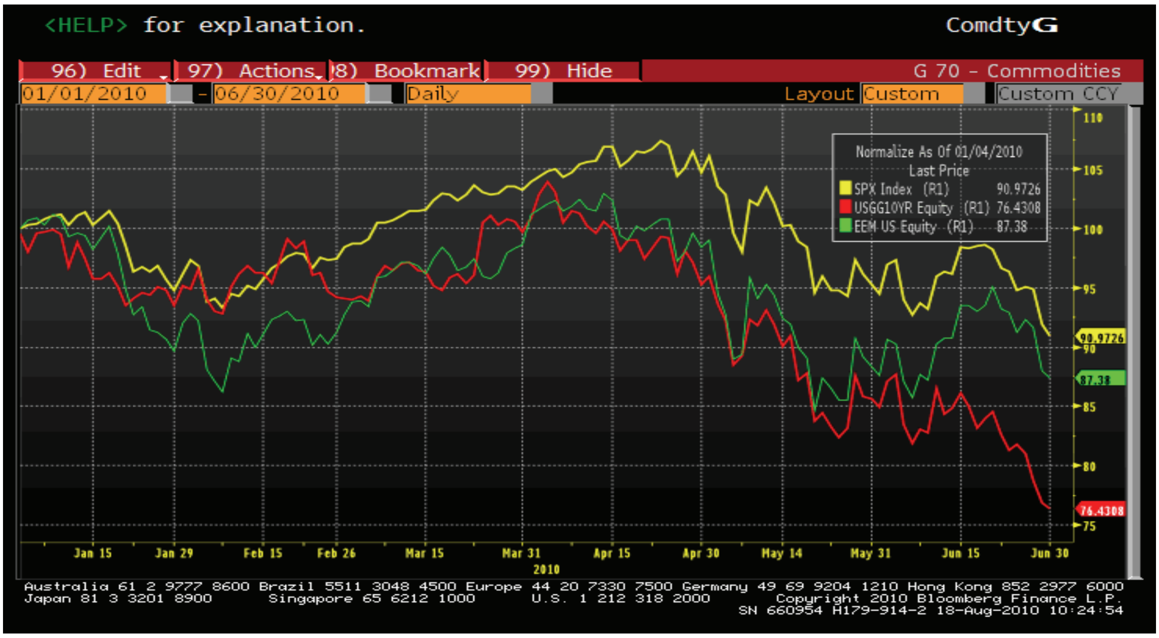

Chart 8: S&P 500, US 10yr. Treasury rate & Emerging market equities Jan. 10-June 10 Source Bloomberg

Today, the economic picture though not as strong as hoped is a lot more stable. However, now it is the governments which have over extended balance sheets. Large corporations with solid balance sheets are finding it very easy to borrow and at historically low rates.

Therefore, if the market is worried about the sovereign debt of Greece, Spain, Ireland and Portugal why is it investing in German government bonds? Yes, the German economy is doing exceptionally well, but if any of the above mentioned countries is in danger of defaulting, the guarantor of last resort is Germany and this will have an impact on their bonds as a result. Therefore, flow of capital into German government bonds does not seem rational, especially at current historically low yields.

The same applies to US treasuries. Several US states are in a critical financial situation and will have to be bailed out by the Federal government if the situation worsens. The US treasury is already in a very tight position and is concerned about the reduction in treasury purchases by China. If China reduces its purchases of Treasuries, yields will have to rise in order to compensate alternative investors for perceived risk. Therefore, the flow of money towards US treasuries at these levels does not seem rational either.

Of course if the threat of default does arise, the equity markets will probably fall more than bond markets in the short term as the "risk off" trade will prevail. But again, we believe this will be short lived if it occurs.

We believe that the more likely scenario is that we do not see a default threatening financial markets. We expect lower economic activity than markets would like resulting in low interest rates prevailing for longer. In this scenario the large multinational corporations with solid balance sheets have an ideal environment in which to borrow. They have been issuing large amounts of debt and taking advantage of current market conditions. As a result companies like Mc Donald's can borrow for 10 years at 3.5% interest! This is an ideal situation for a company which has international growth opportunities.

Large multinationals are trading at price to earnings and price to cash flow multiples which are low and many of them have dividend yields which are higher than the yields on government bonds or even their own bonds. Therefore, if we step back from the short term and think about the next 3-5 years what is likely to happen?

The process of deleveraging of government and private balance sheets should continue. Inflation should return gradually at first and then gain some momentum. This will put upward pressure on yield curves and be a headwind for bond performance. Economic growth should remain subdued in the developed world but still remain positive. The "emerging market" economies should grow at a healthy pace even if this is much lower than the rates seen in 2007 and the end of 2009.

What does this mean for a multinational corporation in the "developed" world with either a technology or brand which is sought after in the "emerging" world?

These companies have been able to issue 10 year debt at historically low interest rates. They have healthy balance sheets and excellent cash flows, have increased productivity and reduced costs in the past two years and are operating at high levels of efficiency. Even before the financial crisis hit, they were facing very lukewarm growth in the "developed" world and looking for growth in the "emerging" world. This has not changed. However, their circumstances have improved and so have their valuations. They are able to borrow at interest rates 2-3% cheaper than they could in 2007 and are facing less competition when it comes to acquiring smaller high growth companies or good distribution channels in the "emerging" or "developed" worlds. They are also able to hire talent cheaper and the same level of capital expenditure is going a much longer way. These are excellent conditions for them to expand their businesses and increase their cash flows. These cash flows should then result in share buy backs, dividend increases or increases in their share price.

However, investors are reluctant to buy the shares of these companies. They are buying their bonds instead. What can the investor hope to receive from the bonds of these companies over the next 5 years?

The return of their capital and about 3.5% of interest per annum, if they are lucky, and there can be no appreciation of their capital from all of the above mentioned factors. <u>In fact they are lending at low rates to the equity investors of these companies and receiving little in return</u>.

As we are in Switzerland, let us take Novartis as an example. Five year Swiss government bonds yield 1%. Novartis bonds expiring in 2015 offer a yield of 1.16% at present. On the other hand its dividend yield is 4% and its stock is trading at 11 times earnings and free cash flow. These multiples are far lower than historic levels. Novartis is a pharmaceutical company and though there are some concerns about regulatory and pipeline issues for pharmaceutical companies, we believe these are more than sufficiently discounted in the stock price. To us this appears to be a good entry point for investors wishing to gain exposure to a company which is not exposed to cyclical volatility, has a strong balance sheet and excellent cash flows. If the stock price does not move up at all over the next five years, investors should still receive the 4% dividend as compared to the 1.16% on the bonds. It is possible that the stock falls more than 4% from current levels and this makes it less attractive than the bond. However, we believe that if this happens it will be a temporary setback and that this makes the stock an even more compelling investment at that point.

Novartis is just one example of stocks we find attractive at current levels. We believe that investors will be buying these stocks at higher levels in a few months time when they feel more confident.

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We can find examples of radical movements across most sectors and many individual stocks over the past couple of years. In the majority of these cases the trend change was sudden and dramatic. We understand that investors are concerned about the fall out of the financial crisis and how it will affect the value of their assets. However, though many things have changed, one thing remains constant - markets are priced to compensate investors for perceived risk. The higher the perceived risk the lower the current price and the higher the potential profit if the real risk turns out to be lower than expected. Therefore, in order to improve future returns, an investor must examine the perceived risk in each asset class and security and decide whether too much or too little risk is being discounted in the current price.

We have successfully applied this approach to investing and continue to do so. It is this approach that prompted us to buy equities in the last quarter of 2008 and first quarter of 2009. We had no way of knowing for sure if markets would rise or fall the next day. Instead, we analysed the situation and used a disciplined approach to building up positions. We believe in this approach to investing in volatile markets and continue to apply these principles in order to increase future returns for our investors.

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