



LABHA
INVESTMENT ADVISORS SA

Strategy 2011

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Strategy Overview

We believe that just as the past decade was good for bonds and very unfavourable for equities, the next decade will be the reverse. The one asset class that has done well in the past ten years and will probably continue to do so is Commodities. Cash will probably produce negative real returns due to inflation being ahead of nominal interest rates.

Most Investors have been reluctant to invest in equities for the past two years and have preferred bonds. Recently due to the rapid increase in yields globally and the resulting negative performance of bonds, equities are attracting some attention. We are of the opinion that this trend will continue to gather momentum over the next year. 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.

Cash

Though cash was king in 2008 and the early part of 2009, it has produced a negative real return in 2010 in most of the developed world (Fig. 1). The fragile economic recovery and the shock of the financial crisis 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. As inflation is calculated by a rather complicated formula which does not usually reflect our experience of it in real life, we are of the opinion that most people will feel the need to invest their cash to receive better real returns over the coming years. Their resistance to investing should be systematically broken down by the realisation that they are loosing purchasing power by holding on to excessive levels of cash.

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

Source: Bloomberg

Currencies

In our opinion, the US dollar will devalue over the next decade as the inevitable reduction of US dominance globally 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. The British Pound has also fallen substantially from its highs due to the effects of overleveraging and the financial crisis fall out but we are not yet fundamentally convinced of this currency either.

The Euro has had an extremely weak 2010 but we believe that it is now undervalued versus most of the major currencies. The Swiss Franc should trade in a range of plus or minus 10% from these levels, rallying as fear takes hold and retracing when risk appetite increases. We realise that this is an extremely wide range but as can be seen from the recent past currency movements of 10% and even 20% are not at all uncommon in the space of one quarter or less (Fig. 2). The Swiss Franc is looking fundamentally overvalued and is worrying both the Swiss National Bank and especially Swiss exporters. We therefore believe that as soon as any signs of stability are seen in the Eurozone debt situation and the US economy shows signs of sustainable growth at a reasonable pace, the Swiss Franc will weaken substantially. The Swiss National bank will probably be the last central bank to raise interest rates as inflation is very low and their primary concern is the strength of the Swiss Franc. The Swiss Franc is benefiting from fear at the moment but we have seen situations like these reversing very rapidly.

Commodity supported currencies like the AUD, CAD & NOK continue to be key beneficiaries from the crisis and the growing need for commodities globally. 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. Australia has already raised interest rates and the economy actually escaped recession this time. However, even though they have strengthened substantially over the past two years, these currencies are not immune to the general volatility in the forex markets.

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.



Fig. 2: The Movement of the US Dollar Versus the Swiss Franc Q2/2010 (+10% then -10%)

Source - Bloomberg

Bonds

At the start of 2010 we were expecting a difficult year for all sovereign debt and this is what we have seen unfold in Europe and more recently in the US. 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 the Eurozone some sovereign debt might outperform but should still underperform corporate debt in general.

Companies were very overleveraged in the dotcom crisis and most of them learnt from the experience. The one glaring exception was the finance industry. The private sector leveraged up in the past decade while most companies deleveraged. Then 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 & under-leveraged 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 these 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.

Therefore bonds, especially investment grade bonds look expensive at the moment and investors must be very selective with bond purchases in 2011. We remain underweight this asset class.

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 (Fig. 3) shows the performance of global equities in Euro (white) versus global bonds in Euro (green) from Early 2003 till Christmas 2010. 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 equities have outperformed bonds since the previous recession.

Fig. 3



Fig. 3: MSCI World Equity Index (white) versus JPMorgan Global Bond Index (green)

Source - Bloomberg

Equities

1.1 Regions

In our opinion emerging markets may be due some consolidation now and will remain very volatile over the next decade. 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 in the next 10 years than were allocated in the past 10 years.

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 and certain subsectors of industrials related to alternative energy and commodities.

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 recently announced substantial increases in capital expenditure aimed at increasing exploration and production, the additional commodity supply from these investments will not be seen for at least 5 years. We therefore believe that supply will continue to lag demand, sometimes substantially over the next decade and that commodities will continue to be a very strongly performing but markedly volatile asset class.

Conclusion

As we enter 2011 we have had a volatile year for all asset classes in 2010. LABHA's clients have had a successful year and we think that 2011 will be a year of positive returns though mixed with substantial and recurring volatility. Equity markets have gone from very undervalued in March 2009 to fair or in some cases overvalued. Therefore, though we still believe that equity markets could produce a positive result for 2011 we think it is time to reduce risk and book some profits. We have done this and maintain a slightly overweight exposure to equities, with a tilt towards the more defensive and higher yielding sectors. We are temporarily less positive on bonds and remain substantially underweight this asset class.

To summarise, we are overweight equities, though less so than in the middle of 2010. Our bond exposure remains underweight and we have temporarily raised cash levels. The commodity exposure has been maintained in client portfolios but has shifted over the course of the last year from base metals to agricultural commodities.

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