VIEWS FROM THE DESK (VFTD) October 2012

## Heads I win, tails you lose

The story goes that Brian Clough, a famous English football manager, owned a two-headed coin that he used when his team tossed for the first choice of changing rooms at Wembley stadium ahead of cup finals. He would always choose the 'home' facilities – otherwise known as the lucky changing rooms – and invariably go on to win the match.

The football fans among you will have to forgive a degree of poetic license in recounting this story, but many investors over this last quarter will have felt they have been in possession of a two-headed coin. The price of risk assets has risen on good news days and also climbed higher on bad news days – a truly win/win environment for those with cash invested in markets. It is clear this wave of optimism has been driven by the 'do whatever it takes' rhetoric, and the subsequent policy follow-through, delivered by the European Central Bank (ECB) and the US Federal Reserve (the Fed). Improving data surrounding the US housing market and a raft of solid, if unspectacular, earnings numbers has provided further impetus to rising prices, with valuations – outside of core developed-country government bonds – generally supportive too.

Primary analysis of the recent actions by the ECB and the Fed reveal very different motives. The former has acted to preserve the entire monetary union and the latter has a stated goal to reduce the stubbornly high levels of unemployment. Indeed, with over 30 million people unemployed across the Eurozone and the US, both central banks will want to see their actions address this very tragic and damaging issue for society.

These latest policy moves have generated an impassioned debate as to whether further QE is good or bad and what the short vs. long term effects will be on economies and markets. The central bankers themselves contend that the additional liquidity will lower borrowing costs, encourage investment and lead to economic growth and the creation of new jobs. Others make the contrarian argument that there is no such thing as a free lunch and the manipulation of the price of money will end badly – although the various scenarios they foresee vary from depression to hyperinflation.

Secondary analysis of these policy actions is an important part of our investment process and key to shaping our portfolio asset allocation We are reminded that Albert Einstein reportedly called compound interest 'the most powerful force in the universe' – a force which many US savers in their mid to late 20's will remain unfamiliar with given Ben Bernanke's stated commitment to hold near zero interest rates through to mid-2015. Thrift is considered a personal and societal good in that it allows savers to be self-sufficient in future years, it supports older generations now and provides capital to finance economic growth. Household savings rates are therefore very important, but it is clear the Fed is discouraging thrift and encouraging the risk averse to take risks. This objective is gaining further traction in an environment of negative real interest rates – an environment where inflation is higher than returns available from savings accounts and money market funds. Will the Fed be successful in encouraging the flow of long-term savings into more speculative investments? Time will tell but, in the interim, it is clear the authorities want asset prices to inflate, particularly equities and real estate and would appear to have had some success with respect to this goal (reference table below).

Total Return Performance by Major Global Financial Assets (Source: Deutsche Bank 1st October 2012)

| Asset | Currency | Instrument | Q3 2012 | YTD 2012 |
|---|---|---|---|---|
| Equity | EUR | DJ Stoxx 600 | 7.5% | 13.6% |
| | GBP | FTSE 100 | 4.2% | 6.8% |
| | USD | S&P 500 | 6.4% | 16.4% |
| | EUR | Greece Athex | 22.2% | 11.8% |
| | EUR | IBEX 35 | 9.2% | -7.6% |
| EM equity | CNY | Shanghai Composite | -5.5% | -2.7% |
| | BRL | Bovespa | 8.9% | 4.3% |
| Credit | EUR | Corporate | 4.3% | 10.3% |
| | EUR | High Yield | 6.3% | 18.0% |
| | USD | High Yield | 4.3% | 11.7% |
| Governments | EUR | Bunds | 1.3% | 3.3% |
| | GBP | Gilts | 1.2% | 3.4% |
| | USD | Treasury | 0.6% | 2.3% |
| EM Bonds | USD | EM Bond USD All | 6.3% | 13.7% |
| Commodity | USD | Copper | 7.7% | 9.4% |
| | | Brent WTI | 14.9% | 7.8% |
| | | Silver | 25.7% | 24.0% |
| | | Gold | 10.9% | 13.3% |
| FX | N/A | EUR/USD | 1.5% | -0.8% |
| | | GBP/USD | 2.9% | 4.0% |

A further consequence of the action taken by the central banks is the rise in commodity prices we expect to see. It is somewhat ironic the wealth effect which the Fed is trying to engender and the hoped-for rise in consumer spending that should come with it, will undoubtedly be curtailed by a fall in real incomes as inflation is driven higher by a rise in the cost of basic materials. The Fed is clearly trying to generate inflation which many would consider the last gasp for a central bank dealing with a debt crisis. Based on the implicit medium-term unemployment rate target – in the range of 7% to 7.5% - and assumptions around economic growth rates, Goldman Sachs estimate near-zero interest rates could stay until mid-2016 and the QE3 spend may total as much as $2 trillion. This is an enormous number which will most likely result in a dollar de-basement over time and inevitably be inflationary.

## Asset allocation implications

So what does this mean for investors? We have long held the words of the economist John Maynard Keynes in our minds when he warned:

'*by a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens*'.

At Affinity, we recognise that this “financial repression” is a real and increasing risk for families looking to protect their wealth and as a consequence, the maintenance of the purchasing power of our clients' assets is an overriding priority - and challenge – over the medium to long term. Consequently both our Real Return and Growth mandates have CPI-linked investment performance objectives and our portfolio construction and on-going management routines are anchored to achieving these goals.

We believe market participants are generally underestimating the risk of future long-term inflation and on this basis buying inflation protection is relatively cheap. We have been achieving this through index-linked fixed income exposures within portfolios, as well as allocations to Emerging Market local currency debt, where strengthening currencies will help cushion the effect of a weaker US dollar, euro and sterling.

Whilst we carry exposures to gold in the Real Return and Growth mandates, we have been reviewing how we want to gain exposure to a broader complex of commodities and expect to allocate a portion of the cash we currently hold during the final quarter of 2012.

In terms of recent trades we have introduced a further two strategic bond funds to our fixed income allocations, both run by a managers with long established track records and dynamic, high conviction styles ideally suited to the current environment. Within our current suite of strategic bond fund managers we have taken comfort from the move by some to reduce their exposure to high yield debt. Whilst valuations are far from stretched, spreads have narrowed a long way over a short period of time and some profit-taking has been justified.

Finally, as the quarter ends we are allocating cash to global technology equities. Compelling valuations, strong top line sales growth and a secular tailwind of growing global demand provides an ideal backdrop for investors to deploy capital to a sector with a high probability of beating inflation over the long term.

## Conclusions

1. Looking ahead, and at the risk of repeating past commentaries, we expect continued volatility as global economic fundamentals are not currently very inspiring. As we go to press, the latest numbers highlight declines in US household employment, real wages, industrial production and core retail sales. In Asia, China's industrial sector is faltering with profits in recession having contracted 2.7% this year and in Japan, the government has downgraded the assessment of its economy. In Europe, Italy has just sharply cut its economic growth forecast and France's PMI data is at a 41-month low.

2. As a counter to this soft macroeconomic landscape, liquidity injections continue to be constructive for risk assets. As mentioned earlier, valuations are not at all extreme. High yield debt and US equities may be flashing amber, but Emerging Market and European equities are cheap. .

3. Whilst we do not profess to possessing the investment equivalent of a two headed coin, we continue to believe that a diversified, multi asset class investment strategy is, the most appropriate approach to building wealth and preserving purchasing power for those investors with a sufficiently long investment time horizon.

## Performance of model strategies

| Strategy | September 2012 % Performance | YTD 2012 % Performance |
|---|---|---|
| Income | 0.83 | 7.53 |
| Real Return | 1.46 | 7.76 |
| Growth | 1.84 | 7.50 |

Composite performance numbers are currently being calculated and will be provided on request.

The performance detailed above is for illustrative purposes only and reflects the returns across Affinity Private Wealth's Income, Real Return and Growth model strategies, net of 0.95% management fees.

This does not constitute investment advice and past performance should not be viewed as an indicator of future performance.