Manager Insight

Our managers' views on the European debt crisis

August 2011

It has been a very eventful year for the markets already. After contending with the Arab Spring and the Japanese tragedy earlier in the year, investors are now faced with the European debt crisis resurfacing, and the downgrade of US debt by S&P. Markets have taken a significant hit in recent weeks with increased uncertainty and volatility.

Economies are slowing down across the globe and concerns over Chinese inflation and growth are also weighing on investors' minds. It is also looking increasingly likely that the weakening US economic numbers cannot be put down to industrial supply-chain disruptions caused by the Japanese tragedy alone. Markets are increasingly getting more difficult to navigate in, especially when you consider the uncertainty surrounding the potential actions (the nature, timing and magnitude of them) taken by governments and central banks to stem the tide. Although the Q2 US earnings numbers came in much better than expected, they were swamped by mixed results elsewhere and the aforementioned macro concerns. We asked some of our managers to give their perspectives on what is transpiring in the markets and how it could potentially affect their investment strategy.

Faisal Rahman, CFA, Portfolio Manager, Russell OpenWorld

RARE

Fund: OpenWorld Global Listed Infrastructure
Manager: Rare Infrastructure Limited

Manager insight: During the recent downturn, our utility shareholdings have performed as expected with small declines and the transport (ports, toll roads, airports) names have reacted more severely. Listed infrastructure has performed well during this dislocation and based on history should perform better in the preceding months.

Although the portfolio is fairly balanced between utilities and transports at this time, we have been reviewing it to determine if we should reweight any stocks with similar returns but lower risk profile. We have adjusted the portfolio at the edges to reflect this reweighting and we are testing the portfolio companies for a bear case economic scenario. If our view on the economic outlook changes we may increase our exposure to utility companies whose investment characteristics offer a more defensive positioning. All companies in the portfolio have strong predictable cash flows, sound balance sheets and good financing or refinancing prospects in a world where global growth is likely to be lower. We continue to strongly believe listed infrastructure will perform better than general equities in the current market conditions.

Fund: OpenWorld Global High Dividend
Manager: Thornburg Investment Management

Manager insight: Clearly the financial related stocks are selling off and in some cases providing opportunity as the entire sector is vulnerable. With the Fed coming out and stating that they will maintain their existing interest rate policy at least until March 2013, we see an opportunity in REITS. Some REITS are providing double digit yields and this was partly due to worries about a rising interest rate environment. With this scenario less likely, the short term and medium term outlook for yields seems much more compelling.

Some of the consistent earner names have held up which makes them more expensive on a relative basis and a potential source of cash to fund better risk/ reward opportunities. Consistent earners are your 'steady eddy' stocks such as the McDonalds and Coca Cola of this world. In general, we have been opportunistic and added to names like Ares and Hopewell. Finally, we are looking for the portfolio to hold up in this downward market given its defensive bias, which it has done so far.

Fund: OpenWorld Europe Focus Equity
Manager: Hermes Sourcecap Ltd

Manager insight: We made a number of changes to the portfolios earlier in the year in anticipation of a slowdown in the global economy. We have been negative on the outlook for banks for some time now, a view which has not changed. Essentially, we are seeing a crisis in confidence in the ability of politicians to cope with the fiscal burdens that most countries have built-up in the good times and post the financial crisis. Dithering and lack of leadership in the US and Europe has created a mood of extreme anxiety on the long-term growth prospects for western economies that has combined with a general trend amongst plan sponsors towards de-risking. We have always believed that trend rates of economic growth in the developed world will be severely constrained by the weight of debt that they carry so it is only the speed and ferocity of the adjustment to this view by the consensus that has surprised us.

The silver lining, if there is one, in this rout is that European equities are now pricing in a lot of fear and represent good long term value. Commodity prices have fallen relieving some pressure on corporate profit margins and household income and the ECB, at least, has the scope to cut rates. We do not see a V-shaped recovery in the market as politicians still have to devise a plan, but at least we are discounting some extreme fears in prices currently. We had already made the defensive shifts e.g. selling Julius Baer, Ageas, BASF and buying Roche, as well as trimming other cyclical stocks in July. In this sort of environment it is dangerous to make too many changes as being reactive can be counter-productive. We are looking for attractive ideas amongst the rumble but we do not anticipate making any significant thematic changes to the portfolio as many of the challenges for the global economy are structural in nature.

Fund: OpenWorld India Focus Equity
Manager: Quantum Advisors Private Limited

Manager insight: The price of Indian assets will be set by foreign money flows, but the value of Indian asset will be determined by what happens in India's domestic economy. The current volatility is a concern and if a Lehman like event were to happen it would not surprise us if the Indian stock market went into a free fall and foreign investors sold Indian shares. However, we would not want to take our eyes away from the real growth of the Indian economy and the earnings power of Indian companies. It will be the real earnings power of a company and the real growth in the economy that will determine the underlying long term value of a business. The question we ask ourselves is whether India can ride out this volatility and its consequences. We think India can, as it did successfully in the

aftershocks of the Lehman bankruptcy.

Having said that, a global slowdown leading to lower commodity prices should be positive for many Indian companies. Declining oil prices will be particularly positive for them. This would lead to lower inflationary pressures and reduce the risk to Indian GDP growth. From a portfolio perspective, we may increase weights in companies that would benefit from declining oil and commodity prices. We are also adding to companies whose stock price have been impacted by negative sentiments due to higher interest rates but whose valuations and business fundamentals look good from a longer term perspective. As always, we will continue to be alert to company level issues and accordingly adjust the portfolio.

Fund: OpenWorld Global Dynamic Bond

Manager: Strategic Fixed income LLC

Manager insight: With the downgrade of the U.S. by S&P one would think this would be negative for the U.S. dollar. In a vacuum it would be. However with the enormous sell-off in risk assets the USD has become a safe haven currency. The USD has actually strengthened a little on a trade-weighted basis since last Friday. The Japanese yen and the Swiss franc have also benefitted by their flight to quality status. However real and threatened intervention in both currencies has had us reduce our long Swiss and short Euro exposures. We have also trimmed almost all our exposure to commodity type currencies (CAD, AUD, NZD, and Non-Japan Asia). We went into last weekend with very little exposure to these markets. On balance our foreign currency exposure relative to the index is close to flat. At some point when the risk markets settle down we will look to underweight the USD.

Going into last weekend we had duration across most major market sectors which were in excess of the benchmark index. We have maintained those positions and increased them somewhat. The flight to quality and the Fed statement about keeping rates low until June of 2013 has helped most markets. The only problem for us has been the ECB buying of Spain and Italian paper which has pushed those markets higher. We are underweight there but we have long positions in other European markets to help compensate.

In the near term the direction of the currency and bond markets will be highly dependent on the behavior of the stock markets. In the medium term the damage which has be done to risk assets will not be unwound quickly and will thus depress global growth further. Inflationary fears were overstated and are likely to turn into deflationary fears at some point. This should be good for bonds. The low level of U.S. interest rates at some point will serve to depress the USD. We are not sure Europe will be the beneficiary because of the peripheral problems but Non-Japan Asia, AUD, CAD, and LATAM currencies may be promising if equity markets stabilize.

KEMPEN CAPITAL MANAGEMENT

Fund: OpenWorld Euro Credit

Manager: Kempen Capital Management

Manager insight: We are in a serious confidence crisis. This crisis is pointed at the policymakers who have been unable to – at least up until now - to halt this panic. Without coordinated and forceful action of these policymakers, it will be very hard to restore confidence. Our Strategists are of the opinion that the chances of a renewed recession are slim. However a recession could form on further escalation of the Euro crisis, evolving into a total "freeze" of the European banking system.

In terms of our policy within the portfolio, we were lightly positioned in terms of beta (between 0.97 and 1.03). Last week we moved to an actual small underweight with a overall beta of 0.97. We were able to fine tune positions by a couple of small sells, even in the first days of minimal liquidity. We have been and still are underweight in the peripheral countries and for now will hold on to that position. The current situation puts pressure on our central scenario with heightened probability of changes for better or for worse. Therefore we will remain rather close to home in terms of overall beta.

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