

Schroders Private Banking Investment Strategy

Past the worst



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Is it a good idea to buy the bonds of a country that is printing money to buy the bonds that it issues? Are we at the start of a new equity bull market? These are the key questions facing investors following the implementation of quantitative easing (a form of printing money) in a number of countries that triggered a strong recovery in equity markets.

The world is in recession, banks are reluctant to lend as they look to rebuild their balance sheets, unemployment is rising and companies are operating below capacity as inventories of unsold goods build up. This is a very deflationary cocktail.

Government bonds are the best investment to profit from deflation. The announcement of quantitative easing pushed prices of **government bonds** up and yields down. We have taken some profits. Deflationary pressures are expected to keep yields low, but a turn in economic data and aggressive policy actions mean that the longer term outlook has begun to swing in favour of inflation further out. **Corporate bonds** offer better value. Credit analysis is vital as defaults will rise dramatically.

Recent data points to a moderation in the pace of economic slowdown. The better tone to economic data is likely to continue into the summer as the inventory cycle turns upward

and households enjoy the cash flow benefits of looser fiscal and monetary policy.

The key difference between this cycle and all others in the post war period is the need for balance sheets to be repaired. This is a process that will take years and lowers the long-term growth potential of many economies. However, the upturn in forward-looking indicators means it is no longer appropriate for portfolios to be positioned exclusively for capital preservation.

We are adding to risk assets in portfolios, favouring corporate bonds, emerging market debt and selective equities. Sentiment hit record lows on a number of measures in the middle of March. The crisis can be dated back to 2007, starting with the concerns about sub-prime mortgages in February and spreading to broader credit markets in July. Two years of negative news has left the majority of investors too defensively positioned.

For **equities**, the fall in earnings to date is the worst since the Great Depression and we have not yet hit the bottom. The need to reduce the level of debt in many areas will weigh on long-term growth. We do not believe that we are at the start of a multi-year bull market. However, sharp falls have created selective value, even assuming the worst. We favour managers with sufficient flexibility to profit from opportunities in what is definitely not a normal economic cycle.

We have bought **Emerging Market Debt**. While these economies will suffer due to the slowing exports to the developed world, their banking sectors are generally healthy. They have not seen the increase in consumer debt that will remain a drag on growth in many developed economies. Many of these economies have suffered substantial crises in the last generation, which means that the institutional framework for dealing with the current downturn is in place. In



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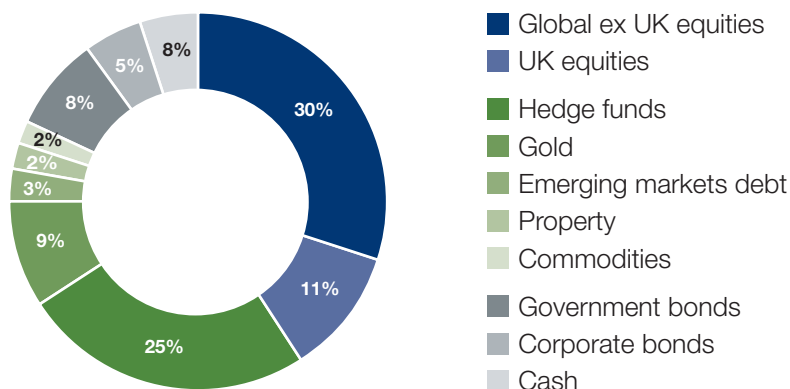
addition, a number of currencies have weakened more than justified by their fundamentals and now offer value.

We have added to **gold** holdings in portfolios. We expect the price to trend up over the medium term as the printing of money by a number of central banks encourages more investors to keep a portion of their wealth in bullion. Governments and central banks are implementing relatively experimental policies in order to avoid widespread deflation and get the global economy back onto a growth path. Gold offers insurance against the risk that these policies ultimately undermine the value of the currencies of these countries.

The withdrawal of capital from the **hedge fund** industry in 2008 means there will be less competition for surviving managers. Not only are there fewer funds but also there is significantly less capital with their other key competitor, the proprietary desks of investment banks. This is expected to translate into better returns. We are positive on macro funds. They are able to profit from volatility across a broad range of markets. They have proved adept at profiting in this difficult environment for risk assets and therefore offer good diversification in the current environment. We see value in the listed hedge fund sector, with many stocks trading at substantial discounts to underlying asset value.

In conclusion, the strong rebound in markets does not signal an end to our economic woes. However, individual securities and markets fell to prices that priced in Armageddon. With some signs of stabilisation, we are adding to positions where valuations are compelling even if economic recovery is some way off.

Asset allocation for balanced mandate



Source: Schroders, as at 30 April 2009.

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