Stenham Quarter 3 2011 Report

Compelling Conditions for Global Macro

October 2011




1. Market Movements

Equity Indices	Q3 2011 Change %	Fixed Income Markets	Q3 2011 Change %	Currencies vs USD	Q3 2011 Change %	Commodities	Q3 2011 Change %
MSCI World (LC)	-15.26	Global Bonds	+3.99	GBP	-2.61	Gold	+8.24
S&P 500 (USD)	-14.33	Investment Grade	+3.93	EUR	-7.31	Oil	-5.41
DJ Euro STOXX (EUR)	-23.48	High Yield	+5.55	JPY	-4.25	DJUBS	-11.34

2. Review of the 3rd Quarter of 2011

The third quarter of 2011 was characterised by growing concerns that while European politicians were arguing about the best way to resolve the multiple issues facing the Euro, there was growing evidence of mounting inflation and slowing GDP growth in a number of key global markets. While the Euro dominated headlines, there was disappointing GDP data from the US, where reported 2Q11 figures were well below consensus and prior figures for 1Q11 and for 2010 were also revised downward. In addition, slowing Chinese growth figures were accompanied by the persistence of inflation above 6%. There was a growing fear that much lower global economic growth and persistent inflationary pressures would add to the widespread austerity resulting in the withdrawal of funds from risk assets by investors.

Global equities and, in particular, European equities, endured a torrid third quarter as the prospect of a Greek default and its consequences for the wider Eurozone led to sharp market declines. There was also evidence of a slowdown in European economic growth and widespread civil unrest at the mounting austerity programs in a number of European countries. The rising yield of many European Governments' debt and the cost of insuring against default by these countries (via CDS) showed a growing conviction that the European problem will not be confined to Greece, Spain, Portugal and Ireland. The PIGS became the PIIGS with the addition of Italy as rising yield on Government debt, currently over 6% at the 10 year level, indicated growing investor concern that the Euro's issues were not just at the periphery. The issues are technically very difficult to solve (as the Euro was set up without provision for a country's departure) and the political will lacks unison.

Debate raged as to the adequacy of the European bailout fund which is now regarded, at €440 billion, as too small for the potential scale of the problems, yet the Germans in particular seem reluctant (for now) to allow the European Central Bank (ECB) to act as guarantor. In addition, the underlying macro-economic picture in Europe weakened with the French manufacturing Purchasing Manager Index (PMI) showing a contraction for two consecutive months (August and September) and German PMI, whilst still expansionary, showing its weakest level since September 2009. Outside Germany, other EU GDP growth figures tended to disappoint and showed a slowing trend. There was much talk of the EU sliding into recession.

In the US, the Federal Reserve announcement that they saw “significant downside risks to the economic outlook” was accompanied by Operation Twist, a program of bond-buying which will involve the purchase of around US$ 400 billion of long-dated Treasuries financed by the selling of a similar amount of bonds with three or fewer years to maturity. There are two implications of this new initiative: it shows an understanding by policy makers that the US balance sheet is incapable of supporting limitless Quantitative Easing (QE) and it prioritises the wider economic benefits of lower medium-term borrowing costs over the healing effect that a steep yield curve has had for the banks.

Overall, the MSCI World Equity Index fell 15% during the quarter but Continental European markets fell around 25%. In Asia, the combined fear that the slowing outlook for growth in both the US and Europe would have adverse consequences for Asian markets as well as reports of higher levels of inflation across the region led Asian equity markets to decline between 10% (Japan) and 21% (Hong Kong).

In fixed income markets, the search for secure yield drove Treasury prices higher and yields lower, while a similar trend was evident amongst higher quality corporate credits with the Citigroup Investment Grade Index rising 3.9% in the quarter. In contrast, more risky fixed income instruments went in the opposite direction with the US High Yield Index falling 5.6% and the US Leveraged Loan Index declining 3.8% during the quarter. The US dollar rose against most currencies except the Yen, oil prices declined and the Gold price reached an all-time high.

3. Stenham Fund Performance

Against this background, the Stenham funds’ returns in 3Q11 improved from the first half of the year and we believe that our relative performance has been much better than our competitors.

The principle reason for this has been the improved contribution from our Macro managers and the relatively high allocation to Global Macro across our Multi-strategy portfolio. From a pro-cyclical stance during the first half of the year, most Macro managers turned bearish of equities, commodities, the Euro and high yielding debt while taking long positions in the Dollar, Gold and Treasuries during 3Q11. The strong absolute and relative performance of the macro book in 3Q11 of +3.4% compares with the HFRX Macro Index return of -0.85%. This strong return flowed into the Multi-strategy portfolios to largely neutralize the negative impact of the sharp pullback across equity markets, bringing the overall 3Q11 returns to around -0.6%.

Our Equity Long/Short managers reduced their gross and net exposures, thereby reducing their beta to the equity markets. Only the Event Driven allocation was disappointing, an area where we have been increasing our exposure in the Multi-strategy portfolios on the basis that lower economic growth and high corporate cash levels yielding little, tend to lead to higher levels of corporate activity. It seems that the increased level of uncertainty in financial markets has overwhelmed these incentives and a number of the corporate transactions that have taken place, have had specific issues while a number of hedging strategies have not provide the anticipated protection. The size of this allocation is under review.

4. Outlook

The series of compromises reached recently within the EU to restructure Greek debt with private investors being coerced to take a 50% write-off, a plan to leverage the European Financial Stability Facility and suggestion of further EU bank re-capitalisation, at least showed some determination to grasp the seriousness of the situation. However, the lack of detail suggests to us that this will not be the last plan for the Euro as it does not address the crux of the EU issue: that overall levels of EU sovereign debt is already too high to be repaid, while the current welfare safety net looks set to push these figures much higher. The politicians' nerve to make the right policy decisions will be repeatedly tested at the ballot box. Of equal concern, is the combined impact of the required Greek debt write-offs and the need for additional capital that will inevitably further shrink EU bank balance sheets. Not all Debtor nations can restructure their balance sheets at the same time, against a background of such low economic growth. Much higher levels of growth are required to make a material impact on debt levels.

While a Euro disaster appears to have been adverted (for now) by the EU announcement and the size of the Greek haircut being demanded shows a reasonable reflection of the economic reality. The surprise decision by the Greek Prime Minister to hold a referendum, later reversed, suggests that political nerves in Europe are very frail. Equity markets in particular responded positively but the outlook for liquidity in the EU has clearly deteriorated. The surprise and then reversal of the Greek PM's position on a referendum showed that political risk remains high and policy is subject to change. We do not believe that we have heard the last of a solution for the medium-term stability of the Euro.

5. Strategy Allocations

The largest allocations in our Multi-strategy portfolios remain Global Macro followed by Equity Long/Short, Event Driven, Relative Value and finally tail hedges. Very few changes were made to the portfolio from a strategy point of view during the quarter.

Discretionary and Systematic Global Macro: 33%

Macro managers had a much better 3Q11 than earlier in the year as they found clear investment trends with less interference from Government and Central Banks. We continue to believe our Macro managers remain well placed to understand the complexities of these global dynamics and structure their portfolios accordingly. We feel that both their absolute and relative performance delivered in the quarter provides evidence of this. The uncertainty around the Euro, widespread evidence of slowing global GDP and rising inflation all provide opportunity for a continuation of this improved performance.

Equity Long/Short: 34%

Equity Long/Short managers struggled as the background trend has been so unfavourable. The slowness of European politicians to come to terms with the severity of the Euro's problem and the structural difficulties of sorting it out weighted heavily on equity markets. The response seen across equity markets in October shows that whenever there is reason for hope, investors are willing and quick to commit to equities. Particularly so as Government bonds present such poor medium-term prospects.

Event Driven: 19%

All the evidence continues to point towards banks being unwilling to take risk and lend to only the very safest of covenants. This looks unlikely to change anytime soon, thereby continuing to provide a favourable background for companies to engage in corporate activity. Cash to invest is an increasingly valuable resource and despite evidence of inflation, no Central Bank has the nerve to raise interest rates while GDP growth is so weak. While the turbulence across financial markets in 3Q11 has not led to a positive outcome for Event Driven strategies, both those selected for our portfolios and for the strategy overall, we do not think the outlook has changed and still believe that the strategy will generate positive returns going forward.

6. Summary

3Q11 GDP growth figures from the US surprised on the upside but some commentators have suggested that this is not fundamental, but rather a bounce back from the severe supply restrictions of earlier in the year caused by the Japanese Tsunami. Even if the US figure is genuine the quantum remains much lower than US trend GDP growth in the past.

The most encouraging feature of 3Q11 was the fact that the trends became more investable than they had been earlier in the year and this provides an ideal canvas for good quality hedge fund managers.

Thank you for your ongoing confidence in Stenham. Please contact us if you would like to hear more about our strategies or funds. Further information can also be found on our website:
www.stenhamassetmanagement.com

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