Stenham Quarter 4 2011 Report

Investable Trends Emerging

January 2012




1. Market Movements

Equity Indices	Q4 2011 Change %	Fixed Income Markets	Q4 2011 Change %	Currencies vs USD	Q4 2011 Change %	Commodities	Q4 2011 Change %
MSCI World (LC)	+7.11	Global Bonds	+0.68	GBP	-0.89	Gold	-3.71
S&P 500 (USD)	+11.15	Investment Grade	+1.09	EUR	-3.64	Oil	+9.57
DJ Euro STOXX (EUR)	+6.28	High Yield	+6.42	JPY	+0.22	DJUBS	+0.34

2. Review of the 4th Quarter of 2011

2011 turned out to be a difficult year. At first glance, the final return outcomes for the year look like reasonably investable trends yet the manner in which these occurred presented considerable challenges to many of the hedge fund managers with whom we invest.

The well documented liquidity and solvency crisis in Europe, slowing global growth, widespread evidence of rising inflation, particularly in the East and continuing low interest rates all forced a feverish quest for yield and safety. As a result, equity indices in all major World markets fell (the MSCI World Equity Index fell 7.6% in local currency terms), while fixed income indices rose in all areas apart from those European countries where the recent years of budgetary profligacy were finally called into question. Overall, the Citigroup World Global Bond Index gained 5.7% and the Citi High Yield Index rose 5.5%, while the yield on 10 year US Treasuries declined to below 2%. The S&P/Goldman Sachs Commodity Index gained 2% for the year overall but there was a wide range of component returns: gold gained a further 10.1% for the year, while copper declined 22.7% and oil advanced around 10% in US Dollar terms.

The US S&P 500 Index ended 2011 at virtually the same level as it started, but on 35 days, approximately every seventh trading day, the S&P closed with a gain or loss of more than 2%! Volatility at these levels has not been seen since 2008. These moves were caused in part by the huge amount of politically induced static that played a much more influential part than usual in the outcome for financial markets than in most years.

The initial speed of a solution for Ireland was not repeated for Greece as the full extent of the refinancing issues faced by many Euro members was revealed. As an economy, Greece does not matter on a World scale, but the precedent of providing a solution for Greece has widespread implications for the rest of the EU. As investors appreciated the size of the unfolding problem and the immediacy of the need for a solution, there was considerable concern at the hesitancy of European politicians to provide a credible plan. However, the Euro did not weaken during the first half of the year as US politicians forced their own agenda by threatening not to raise the US Government's borrowing cap (required to finance its spending deficit). To the incredulity of investors, for a few weeks in July, the US looked like it could be forced into a position of technical default.

With both the Euro and the US Dollar facing considerable immediate issues, investors sought solace in the Yen, the Swiss Franc and certain other fringe currencies. Financial markets gyrated between periods of hope and despondency. None more so than in the immediate aftermath of the Japanese earthquake, where it seemed that natural disaster was conspiring with political hesitation to halt global economic growth.

Many of the managers we talk to articulated their inability to recall a period when political influence was so prevalent in financial markets as during 2011. As a result, exposure levels were reduced by many managers across all strategies within our portfolios. Fixed income markets were the primary beneficiary as investors bid up any instrument that offered a yield and a better probability of the return of capital than certain European Governments. Investor concern in these latter countries' ability to repay was further undermined as the initial austerity packages, necessary to begin to turn the tide of ever-rising Government debt levels, were met by resistance from the populous who vented their disappointment that the spending party was coming to an end, to be replaced by severe spending cuts, with widespread civil protest. In addition to these issues in the Developed World, parts of the Developing World saw protest leading to major regime change – the so called "Arab Spring". All in all, it was an eventful year on the political front.

In the final third of the year, the US Dollar strengthened as the US debt cap was raised decisively while European solutions appeared half hearted. Germany's resistance to take the action that many commentators called for: unlimited support from the ECB, allowed concern to grow (and forced some political change here too). At its third attempt, the Eurozone is now been taken more seriously by financial markets but the lack of commitment saw the dollar strengthen progressively from September through to the year end. The provision of unlimited US Dollar finance by the ECB (the LTRO - a form of Quantitative Easing) will provide a much needed means by which banks can heal their bad-debt and liquidity constrained balance sheets.

3. Outlook

The key problem for investors is coming to terms with the difference between political and financial market agendas. Financial markets like clarity and swift resolution. Politicians tend to have multiple agendas with compromises only forced through when the alternative seems too grim to bear. There are multiple examples of this playing out in the EU as Germany extracts conditions for its support for the "periphery" and Greece looks to avoid default in March 2012. However, overall, we see a clearer picture than a year ago.

There is widespread evidence in the US of improving economic trends (GDP growth is turning out to be higher than expected, job creation better than predicted, money supply is rising again and there is even evidence of an improving housing market). In China, inflationary concerns have subsided as the rate of inflation falls back (the Nov CPI was 4.2% compared to the July peak of 6.5%) and the lower rate of economic growth (4Q11 GDP estimated at +8.9%) has been welcomed as it was swiftly followed by the first signs of easing of monetary conditions by the Chinese banks. Intriguingly, the latest Chinese Five Year Plan now stresses economic growth as the primary objective whereas the previous version was much more concerned with suppressing inflation. So far, the landing in China looks to be “soft”.

Even in Europe, the outlook has improved with German rhetoric that it wants to hold the Euro together at last being accompanied by a response from the ECB. The fine words of 2011 are now being backed by actions. The full extent of the various austerity programs have not yet been fully reflected in EU GDP figures and the scale of the refinancing problem should not be under-estimated: European Sovereigns have to refinance €835bn this year, with €225bn falling due in the 1Q12! The rates at which countries like Spain and Italy have recently raised money are unsustainable, though they provide the most amazing “round trip” return for those able to borrow from the ECB. Markets are testing politicians’ resolve but they took the investment rating downgrades of a number of EU countries in their stride, suggesting that there is a feeling of improved predictability of outcomes.

In the corporate sphere, reported earnings are at record highs as the immediate reaction to the events of 2008, have substantially boosted productivity and margins in the light of robust demand, such that corporate balance sheets remain strong. The pull-back in equity prices during 2011 have occurred against corporate earnings’ reports that have, in general, surprised on the upside, such that equity valuations are now much better than they were a year ago. With historically high earnings yields and with continuing low interest rates providing very few compelling alternatives, equity valuations look attractive.

By contrast, fixed income instruments look to offer a much higher risk profile. With the exception of the European periphery, yields ground tighter throughout 2011. Initially, the upward sloping yield curve was encouraged by Governments because of the healing effects provided to bank balance sheets. However, the current degree of steepness in certain curves is untenable and the levels of negative real returns in sovereign debts that are deemed as risk free are also unsustainable. We fear that the required adjustments have huge implications for the capital values of a directionally long fixed income book. We therefore believe that investors are much better off in the fixed income and credit area with exposure to relative value strategies.

4. Strategy Allocations

The largest allocations in our Multi-strategy portfolios remain Global Macro and Equity Long/Short, followed by 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: 32%

We believe that the Global Macro strategy offers the best opportunity to capitalise on the outlook we foresee and that our macro book is well hedged in itself. Many of our Global Macro managers have been in our portfolios for years and have produced consistent returns over this period of investment. Although they also battled with the levels of volatility last year we do expect them to get back on track as fundamental trends re-emerge in the year ahead.

Equity Long/Short: 32%

We believe that Equity Long/Short strategies act as a good hedge to the inflationary impetus from the widespread Quantitative Easing in the West as well as providing exposure to a cheap asset class (both in absolute terms and relative to bonds) which has the inherent characteristics of providing good upside momentum. Most of our Equity managers are fundamental stock pickers who should produce reasonable returns if tail risk scenarios do not resurface. We believe that the flows into equities could be considerable if, and when, the recent risk aversion towards fixed income reverses.

Event Driven: 22%; Relative Value: 12%

The balance of the multi-strategy exposure is in Relative Value, Portfolio Hedges and Event Driven strategies. We continue to believe that there is extensive fundamental support for Event Driven strategies in terms of slowing top line growth, encouraging industry consolidation, strong corporate balance sheets and cheap finance (available to a select few), which despite being masked by the political issues that dominated 2011, should come to the fore in 2012.

5. Summary

We believe that 2012 looks more certain than 2011 turned out to be and hence expect a much better return outcome this year. We believe that the managers we have selected have the necessary skills to generate positive returns, while providing an acceptable liquidity profile. We remain confident that our processes, due diligence and long track record will continue to hold us in good stead for the year ahead.

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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