Stenham Quarter 1 2013 Report

A Favourable Environment for Risk-Taking

April 2013




1. Market Movements

Equity Indices	Q1 2013 Change %	Fixed Income Markets	Q1 2013 Change %	Currencies vs. USD	Q1 2013 Change %	Commodities	Q1 2013 Change %
MSCI World (Local)	+9.22	Global Bonds	-2.80	GBP	-6.45	Gold	-4.57
S&P 500 (USD)	+10.03	Investment Grade	-0.54	EUR	-2.86	Oil (Brent Index)	-1.00
DJ Euro STOXX (EUR)	-0.45	High Yield	+2.94	JPY	-8.03	DJUBS	-1.15

2. Review of the 1st Quarter of 2013

2013 began with a strong rally across all risk asset classes as a last minute deal averted the worst of the fiscal cliff, supported by strong economic data both from the US and China. Rather than the worst-case scenario of a 4-5% impact on US GDP, the agreement on the fiscal cliff looks closer to 1-1.5% and estimates for US growth continue at c.2% for 2013. Whilst not matching January's strength, risk assets continued to perform well during the quarter, spurred by strong economic data from the US and the anticipation of huge fiscal and monetary stimulus from Japan. As the quarter drew on, clear divergence was present, certainly in equity markets, with US and Japanese markets outperforming others, in particular emerging markets.

The agreement reached over the fiscal cliff saw the Bush tax cuts permanently extended for incomes under US$ 400k and unemployment benefits extended for a further year. Estimates of the impact on the US economy are of c.-1.5% on GDP, in line with initial forecasts and away from the draconian and recession creating contraction of close to 5% if no deal had been reached. Some decisions have been pushed out for the Sequester which began on 1 March; these debates will most likely attract headlines but the overall impact on the economy will be minimal (less than 0.5% GDP). US fiscal policy has been addressed though not resolved and the debate about the size of US spending and deficit is likely to continue for years to come.

Policy Developments in Japan

Later in the quarter the most significant policy developments came from Japan, where markets again experienced dramatic moves. The JPY weakened, JGBs strengthened and stock markets rallied on the back of statements by the new BoJ governor Kuroda and Prime Minister Abe promising exceptional policies to address the 20 years of stagnation the country has experienced. The moves, in anticipation of the change in policy, have been huge; the JPY has weakened over 20% in the last 6 months and the Nikkei has risen over 50% (albeit still 65% below its 1989 peak). Leading up to his appointment as governor, Kuroda's rhetoric was strong, vowing "If I were appointed governor… I would do everything possible to get out of deflation" and "(the BoJ) is not doing enough in terms of the size of its asset purchases or the range of assets being bought". The first actions by Kuroda did not disappoint as he announced a massive program of quantitative easing; the BoJ will buy JPY 7.5trn of government bonds a month (estimates were closer to JPY 5trn), doubling the monetary base by the end of 2014 and designed to achieve an inflation target of

2% within 2 years. We have moved from anticipation of policy to actual policy and the question will be when investors start expecting to see actual results rather than policies which promise results.

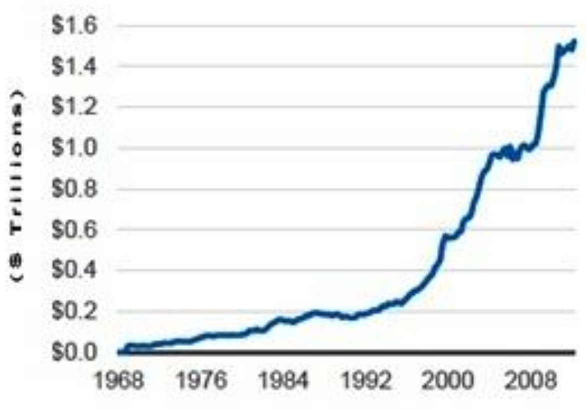
Strengthening US Economy

Whilst Japan began embarking upon huge monetary and fiscal stimulus, in the US there was renewed debate around the impact of quantitative easing and the timing of its exit. Members of the FOMC have become increasingly vocal over the costs of continuing with such an aggressive program but equally many members, including through Chairman Bernanke in his testimony to the Senate Banking Committee, have sought to allay concerns that they would exit if it put the economy under pressure. If nothing else, it does appear that many members of the FOMC are increasingly analysing the costs/benefits of QE and the balance between the two is beginning to shift. That said, it is clear that the Fed will seek to minimise disruption on any exit. The commitment to keep interest rates at close to zero until unemployment reaches 6.5% seems unquestioned and most observers see this keeping benchmark rates at close to zero until mid-2015 at the earliest.

The US economy continues to show relative strength. GDP for Q4 2012 disappointed coming in at -0.1% (subsequently revised to +0.4%) though investors generally discounted this as one-off impacts of a reduction in government spending and inventories. PMIs continue to indicate future economic growth and other measures such as house prices and employment growth contribute to a strengthening US consumer. That said, not all of the data has been positive; in particular March's payrolls were a disappointment. Economic growth is slower than in previous recoveries and some data misses may be inevitable. However, the longer-term trend of relative strength and the benefits of lower energy prices from the shale gas revolution and improving consumer finances seem set to continue.

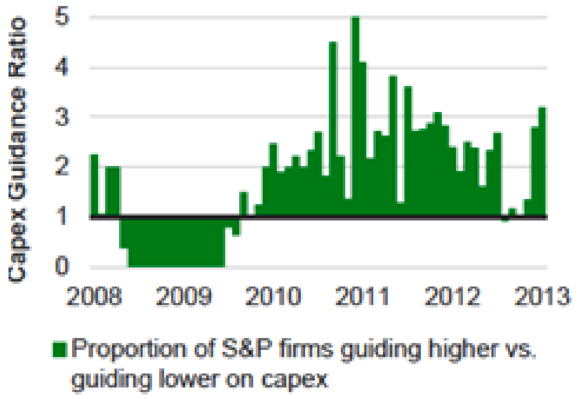
We saw increased corporate activity most visibly through the large LBOs of Dell and Heinz. Global M&A remains somewhat contained with US$ 507bn of announced deals (source: Bloomberg). Corporates remain in relatively good shape with high cash balances. If they begin deploying these cash balances through M&A or organic investment then this could provide further upside to the economy. Encouragingly, there are signs that this could be starting to occur with companies raising guidance on capital expenditure.

Chart 1: Corporate Cash Balances



Source: Deutsche Bank

Chart 2: Companies Now Guiding Higher on Expected Cap-Ex

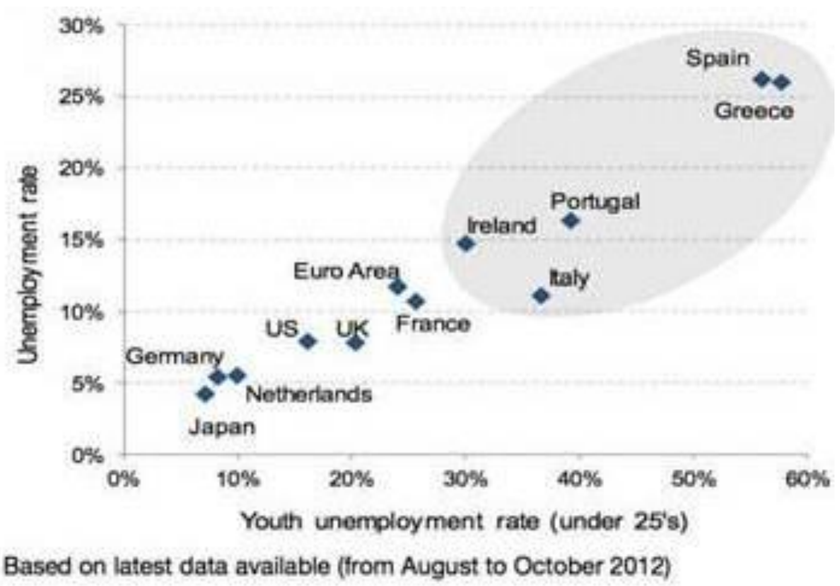


Source: Deutsche Bank

Europe Hits the Headlines Again

Europe again hit the headlines for the wrong reasons. The economic data announced was worse than expected and there was renewed political uncertainty coming from inconclusive Italian elections and the bail-out of Cyprus which led to bank depositors taking a haircut for the first time since the Eurozone crisis began. Q4 2012 GDP came in at -0.4% for the Eurozone. Not only did this extend the technical recession but was the worst GDP growth figure since Q1 2009. Unemployment is high, rising and a particular issue for young adults.

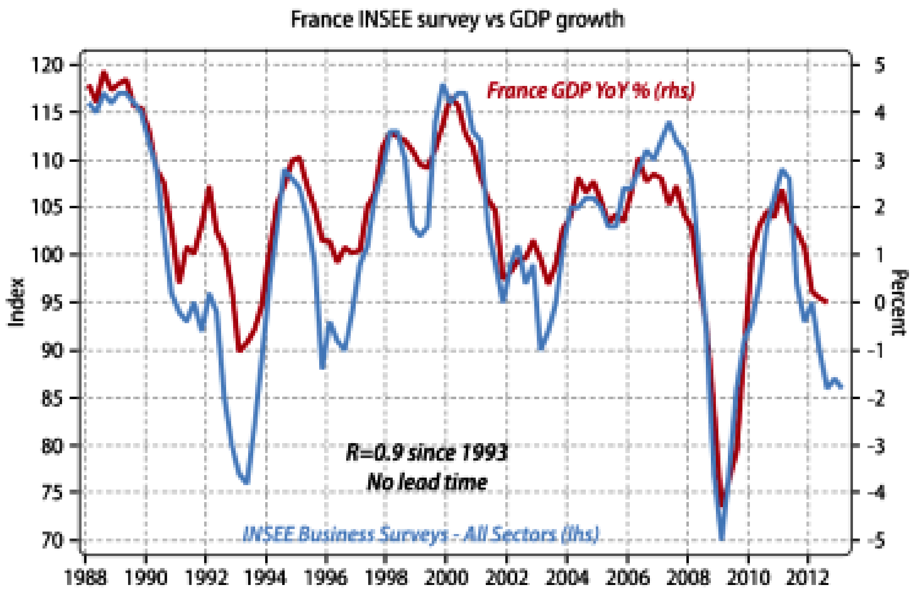
Chart 3: Unemployment in Advanced Countries



Source: Goldman Sachs

PMIs continue to point to economic contraction and whilst the hope at the start of the quarter was that that data, if weak, would be improving, this does not seem to have happened. German data continued to be fairly robust but else-where the situation remains bleak. Of particular note, France's weakness continues and the divergence with Germany is becoming stark. Given forward looking indicators, opinion is increasing that France will enter a recession; it is unclear what the consequences of this are but the weakness in France could lead to a lessening of the austerity applied in Europe.

Chart 4: French Business Climate Sharply Worsening



Source: GaveKal

Political uncertainty again came to the fore. The Italian elections in some ways resulted in the worst outcome. Whilst anti-establishment/Euro/austerity parties did not win a majority, there was no obvious coalition to be formed and as a result no obvious functioning government. In many ways Italy has been left in political limbo. How this plays out in terms of new government, the shape and policies of that government and timing is unclear.

Cyprus was the latest Eurozone country to require a bail-out. Similar to Greece (though hopefully less long-running), Cyprus is a small economy and in itself largely irrelevant to the broader Eurozone economy; in Jim O'Neill's (Chairman of Goldman Sachs Asset Management) oft-quoted statistics, China creates an economy the size of Greece every 12 ½ weeks and one the size of Cyprus every week. However, the principles applied to the bail-out could have far-reaching consequences. Of most importance was the fact that bank depositors would suffer losses. Whilst the initial suggestion that depositors under the sovereign guaranteed amount of EUR100k would suffer losses has since been rescinded, the fact that this was proposed may have consequences in other countries should they again experience solvency concerns. This was reinforced by comments from Jeroen Disselbloem, Chairman of the Eurogroup Finance Ministers, that the Cypriot restructuring should be seen as a template for the rest of Europe, though officials later looked to downplay these comments, stressing that Cyprus was an isolated incidence given its large non-resident deposit base. Will Spanish/Italian/Portuguese depositors keep savings at their national banks if they feel there is even a slight chance of experiencing losses? Redenomination risk has led to deposit flight from these countries at times of stress and the potential for losses on bank deposits will, in all likelihood, exacerbate this effect. Nor would it be a transfer from the weaker to the stronger banks as all depositors were impacted in Cyprus.

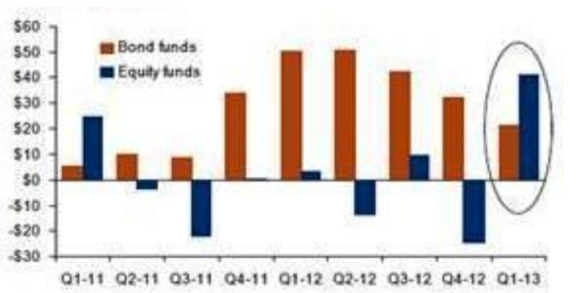
One encouraging sign is that in the midst of this disappointing economic data and political uncertainty, spreads in government debt of the peripheral countries did not show any significant rise; it appears Draghi's vow to do whatever it takes to save the Euro through OMT helped prevent these spreading to a more wide-spread risk aversion event.

China may Struggle to Achieve Growth

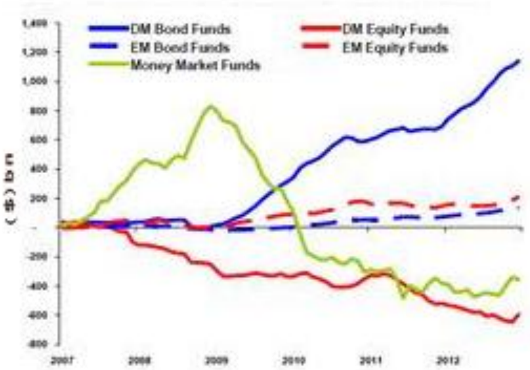
China's new leadership re-affirmed its estimate of annual growth at 7.5% GDP though did caution that this may be difficult to achieve. Economic data was mixed during the quarter, starting positively with HSBC's flash PMIs beating expectations and trade data stronger than forecast. However, as the quarter drew on, data softened with PMIs declining and industrial production and retail sales falling short of expectations. New measures were also introduced to mitigate potential bubbles in real estate.

We stated in our Q4 2012 report that we saw equities as attractively priced relative to many fixed income instruments and there were many sell-side reports talking of a potential great rotation by investors from fixed income into equities. This has not occurred. Equities have seen an increase in flows, but this has largely been from cash / money market funds. Credit continues to see inflows and certainly large outflows have not materialised. We expect marginal allocators to favour equities over fixed income but whether the great rotation occurs remains to be seen.

Chart 5: Strong Equity Fund Inflows Relative to Bond Inflows in Q1



Source: DB, JPM



Source: Citi Research and EPFR

3. Outlook

Our outlook has not changed materially from last quarter. We continue to anticipate that the US will perform strongly. Consumers are in better shape than they have been and corporates have shown a marginal increase to deploy their large cash balances; should this increase it could provide a significant tail-wind to economic growth. In the age of immediate newsfeeds and information, longer-term themes and trends can sometimes receive less attention than deserved. The US energy revolution is an example and the long-term impact of cheaper energy could be dramatic.

Opinions on Japan differ and are bifurcated. Optimists believe that the new program will be successful in generating much needed inflation; that devaluation of the currency will stimulate the export sector; and that this in turn will stimulate the economy. Pessimists see the enormity of the programme as reflecting the enormity of the challenge facing policy makers and that the well-known problems of a huge government debt burden, worsening demographic and the concomitant impact this will have through a declining savings rate on the ability of the government to sustain its debt burden, will prove insurmountable. Japan has so far escaped strong censorship for the vast JPY weakening from other major countries (G20 came out with a very moderate statement), but competitor export economies (e.g. Korea) may look to also weaken should they lose market share.

Europe's economy continues to disappoint. Credit remains constrained (banks de-lever in stark contrast with the US) and governments pursue austerity. In the absence of a major policy shift we struggle to see significant economic growth within continental Europe. Q1 also reminded us that the Eurozone crisis is far from over and the initial suggestion that all bank depositors should experience losses as part of the Cyprus bail-out at the very least shows the continued potential for policy error.

4. Strategies

Discretionary and Systematic Global Macro

Discretionary managers entered Q1 2013 with renewed optimism on the back of strong performance at the end of 2012. Japan continued to be the dominant trade and theme in manager's portfolios. Following on from the election victory of Abe in Japan at the end of 2012 and the expected early retirement of Shirawaka at the BoJ, global macro managers sensed real changes afoot in Japan. Their feeling was further strengthened in Q1 2013 by the news that Abe would nominate Kuroda to replace Shirawaka. Global macro managers were quick to further ramp up long Nikkei and short Yen positions which drove much of the strong performance in the quarter. Global macro funds continued to outperform commodity focused funds as commodity markets experienced a difficult period. In addition to the aforementioned Japan trades, other trades that worked during the quarter were short Euro FX positioning in February and March; short Sterling positions in January; and owning fixed income front-ends in Europe during February, as front-ends rallied on renewed Eurozone concerns on the back of the Cyprus bailout. Managers also had constructive views on US equities, particularly the financial sector.

Risk levels for discretionary managers were at a reasonably high level during the quarter, and significantly higher than the lows of the past 12-18 months. However, managers continue to retain a tactical approach to trading and started reducing risk towards the end of the quarter on profit-taking. In terms of outlook, discretionary managers believe the upcoming quarter could be more challenging and remain wary of increased talk of the Fed tapering QE, effects of Sequestration on US economic data, continued economic fragility in the Eurozone and slower than expected growth in emerging markets. Funds have shown a preference to continue deploying risk in the Japan theme, while paring back risk across other regions and asset classes.

Commodity managers had a more challenging quarter with commodity markets lagging as potential fears of a supply glut in commodity markets and renewed talk that the Federal Reserve may scale back stimulus sooner rather than later, proved a headwind. Precious metals, PGMs and gold mining related equities were hit particularly hard in the quarter over concerns about China's growth and increased supply after years of capacity expansion programmes.

Systematic managers had a strong quarter with both quantitative market neutral strategies and trend following strategies posting positive performance. Increased stock dispersion in equity markets aided market neutral managers, while the trend-following strategies were able to catch the rally in equities and specific foreign exchange moves. Long fixed income positions detracted from performance in January, but helped funds generate performance in February and March.

Equity Long/Short

There was a relatively large amount of dispersion in the performances from our equity long/short managers in Q1 2013. This dispersion was primarily driven by geographic location with managers invested in developed market equities outperforming those invested in emerging market equities. It was an interesting feature of the quarter that developed markets, most notably in the US and Japan, were up strongly whilst emerging markets, on the whole, fell. There were various reasonable theories offered as to why this performance phenomenon happened, but no completely concrete explanations.

We had a significant outperformer during the quarter with a US-focused manager that returned +15.8%. This manager operates a fundamental value based equity long/short philosophy with a bias towards the energy and consumer sectors. They posted their outstanding performance as a result of some exceptional gains from a number of their larger long positions, most of which they have held in their portfolio for relatively long periods.

Aside from geographic location, sector exposures were also an important differentiator for the quarter. Interestingly the two best performing sectors were healthcare and consumer staples, both defensive sectors. The MSCI World Healthcare Index was up +13.4%, while the MSCI Consumer Staples Index was up

+12%. It is fairly unusual to have defensive sectors leading a strong rally in the markets. The explanation for this seems to be that investors rotating out of bonds are still cautious about taking large amounts of equity risk. They are therefore looking to allocate to the most defensive, "bond-like" stocks first. Both healthcare and consumer staples fit this bill with low cyclicality in earnings and high dividend yields. Stenham is optimistic about opportunities in this sector and launched a specialist healthcare focused fund on 1 January 2013; this delivered a return of +7.3% for the quarter.

Going into Q2 most managers in the portfolio have retained their bullish stances towards equities. Average net exposures amongst the managers are still near the highest levels that they have been over the past 6 years at around +60%. Managers have recognised that economic data has softened somewhat over the course of the quarter. Equally, however, softening data makes it more likely that global central banks will continue to support markets through the provision of liquidity. From a valuation perspective equities also trade at historically unprecedented levels of attractiveness relative to credit. Lastly, stock-to-stock correlations have fallen to their lowest levels in 7 years which allows for a far better opportunity set from bottom-up fundamental stock picking.

Event Driven

The quarter began with the sizeable LBO of Dell which created much speculation as to whether we would see a wave of LBOs. Heinz was even larger than Dell though the wave of LBO deals did not occur. Deal activity started strongly but petered out to some extent with announced deals totalling US$ 507bn (source: Bloomberg). We continue to feel that the micro dynamics augurs well for an increase in activity; the cost of credit declines and the difference between dividend yields and credit yields remains high creating an increasing incentive to pursue M&A. The event driven allocation performed well, driven by positive events on select M&A positions as well as some softer catalyst positions as certain companies looked to address their capital structure and also engage in debt buy-backs and special dividends.

Relative Value

Credit spreads and yields tightened during the quarter. There was a sharp move post the US fiscal cliff but even after this, spreads steadily ground tighter. Structured credit continued to receive a strong bid, including CMBS which had lagged other structured credit in prior months. The CDX HY Index spreads tightened 56bps and the CDX IG 3bps (figures for on-the-run 5yr indices).

Our Relative Value portfolio produced positive returns. Our funds remain cautiously positioned but our credit long/short managers managed to trade moves in credit markets opportunistically as well as one manager benefiting from the out-performance of equity over credit. Our multi-strategy credit funds benefited across strategies, particularly from structured credit (non-agency RMBS and CMBS) and post re-org equities.

Our managers remain conservatively positioned with what they see as limited further upside from credit beta given yields remain near all-time lows across many indices. They are hedged and are focused on exploiting mispricings between individual assets and markets; outright directionality is relatively low. We believe much of the beta trade in credit has come to an end but alpha generation is possible in some of the more complex markets and securities. The asymmetry offered from shorting credit also offers a potential source of uncorrelated returns. Stenham launched a credit focused fund in January which has returned 3.4% in Q1 2013.

5. Summary

We see the environment for investing as materially different from 12-24 months ago. The risks we see today compared with then are:

- US sequester: US fiscal cliff
- Slow/negative Eurozone growth: break-up of the Eurozone
- Chinese economy slowing: Chinese hard-landing
- Japanese policy inducing heightened inflation: Japanese stagnation
- Ever-present geo-political risk

These risks are much reduced and concomitantly we see systemic risk as much reduced. To be clear, we are not saying that investment risk is gone, but, with the decline of many systemic risks, we believe that the environment favours taking more risk. We continue to see markets as more investible, with one example being lower correlation levels within individual stocks.

We continue to focus our portfolios on more fundamentally driven strategies such as equity long/short, event driven and some credit related areas with the global macro allocation serving as a non-correlated source of returns. We have completed the transition and concentration of our portfolios that we discussed at the end of last year; this has had a positive impact on performance in Q1 2013 which we expect to continue.

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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