

# PanVIEW



Evercore Pan-Asset's Global Asset Allocation and Investment Review

3rd QUARTER 2008

## Asset Allocation Overview John Redwood

As we feared, markets have fallen further as the banking crisis has developed. The falls have dragged down all the main world markets. Individual days have seen collapses when share prices have fallen as much as 10% in a single day. It is symptomatic of a world financial system in crisis. Heavily-gearred funds are having to cut their positions. Banks are trying to sort out their books in the wake of the move of Lehman into Administration. Retail and institutional investors decide from time to time to reduce their risks by selling more shares or redeeming funds.

The Paulson Plan seems a long time ago. We were sceptical that it would save the financial world when it was launched. Its impact was blunted by the understandable arguments in Congress. Delays in setting up the fund and spending the money then led to revisions in thinking.

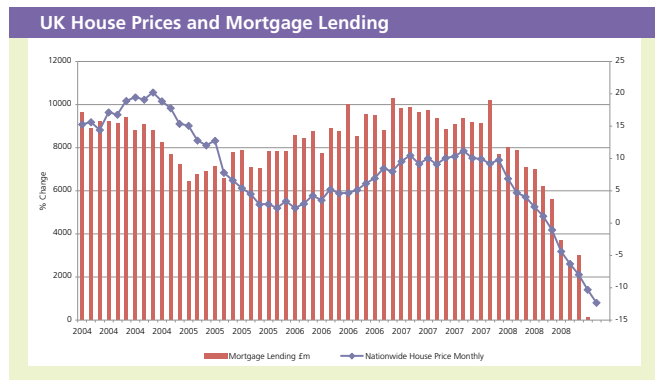
Even the Brown Plan seems a long time ago. The UK trumped the US by offering \$850 billion to the US's \$700 billion of banking support. The Prime Minister then succeeded in persuading the Continental Europeans to put up further substantial sums for their banks. These measures led to a brilliant one-day stockmarket rally, and some glacial improvement in the interbank market, but nothing major on the scale required so far.

Optimists say that nonetheless the announcements by US, UK and Euroland represent the bottom of the banking crisis. There is no need for people to worry now about their deposits in major banks, as they have explicit or implicit government support. Banks should gradually learn to trust each other again as they take comfort

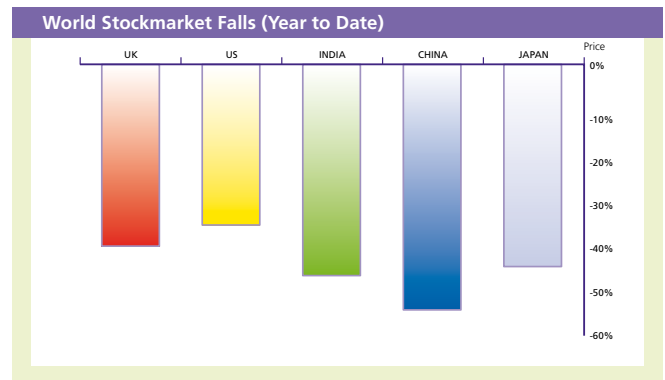
from the public support. Pessimists say the banking system is so damaged it will take a long time for enough banking confidence to return to reach acceptable levels of lending. Meanwhile government creditworthiness has been reduced by governments taking on such large liabilities and spending so much borrowed money on bank support. Transferring risky assets from the private sector to the public through the nationalisation of Freddie and Fannie, AIG, Northern Rock, Bradford and Bingley and RBS does not solve the problem. It merely gives it to someone else to work through and the taxpayer has to pay the bills.

Markets are now spooked by the impact all this will have on the real economy. We are pessimistic about the UK. The country has large twin deficits, being over-borrowed in both the government and private sectors. It has been very dependent on financial services and banking in the credit expansion years. These will now be hit hard. We advise people to have much less in UK assets than has been customary in UK funds. This winter will see rising unemployment, big reductions in property, car and other discretionary spending, and many stories about company distress. The weakness of goods and services markets will cut company cashflow, at exactly the time the banks will try to cut facilities, and push up banking fees and charges.

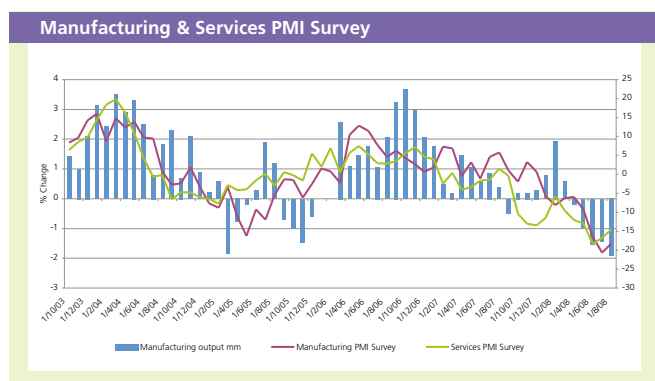
India and China will continue to grow faster than the West. The US was first into the downturn and, of the Western economies, will probably be first out. We still like cash as an asset class. We are looking for opportunities to buy Asian and American equities on black days.



Source: Thomson Reuters



Source: Thomson Reuters



Source: Thomson Reuters



**John Redwood** held senior investment roles at Robert Fleming and NM Rothschild in the 1970s and 1980s. Since, he has been a Pension trustee, Investment Committee member for an Oxford College, Chairman of an investment company and a non-executive Director of a hedge fund and an Investment Trust. An early advocate of tracker funds, he has written extensively on economics and investment.

## Current Asset Allocations - For Sterling Based Portfolios

Asset Class for Sterling Investors	Status of Asset Class	Relative Yield Analysis			Fundamentals		Current Valuation versus Long Run Average	Price Momentum			Recommended Portfolio Weighting Versus Natural Weighting	
		Current Yield %	Estimated Supporting Growth Rate %	Required 3 Year Capital Gain to Return Inflation + 5% %	5 Years	1 Year		Moving Average 200 Day	Bollinger 20 Day	Signal	Strategic (5 Years)	Tactical (1 Year)
<b>Government, Corporate and Inflation-Linked Bonds</b>												
UK Government Bonds	Tactical	4.4	0.0	17.1	●	●	●	●	●	●	Underweight	Neutral
US Government Bonds	Tactical	3.6	0.0	19.6	●	●	●	●	●	●	Underweight	Neutral
European Government Bonds	Tactical	3.9	0.0	18.6	●	●	●	●	●	●	Neutral	Overweight
£ Corporate Bonds	Tactical	7.1	0.0	8.3	●	●	●	●	●	●	Underweight	Neutral
US Dollar Corporate Bonds	Tactical	7.0	0.0	8.8	●	●	●	●	●	●	Underweight	Neutral
Euro Corporate Bonds	Tactical	5.4	0.0	13.7	●	●	●	●	●	●	Underweight	Neutral
UK I-L Govt Bonds (Inflation 3%)	Strategic	4.4	3.0	17.0	●	●	●	●	●	●	Neutral	Neutral
US I-Linked Govt Bonds (Inflation 2%)	Tactical	3.9	2.0	18.7	●	●	●	●	●	●	Neutral	Neutral
European I-L Govt Bonds (Inflation 2%)	Tactical	3.9	2.0	18.8	●	●	●	●	●	●	Neutral	Neutral
<b>Equities</b>												
UK Equities	Strategic	4.5	3.0	16.7	●	●	●	●	●	●	Underweight	Underweight
US Equities	Strategic	2.5	4.0	23.5	●	●	●	●	●	●	Overweight	Overweight
Europe(ex-UK) Equities	Strategic	4.6	3.0	16.4	●	●	●	●	●	●	Underweight	Neutral
Japanese Equities	Strategic	2.2	3.0	24.6	●	●	●	●	●	●	Underweight	Neutral
Far East (ex-Japan) Equities	Strategic	3.9	5.0	18.8	●	●	●	●	●	●	Overweight	Neutral
Chinese Equities	Strategic	2.4	8.0	23.9	●	●	●	●	●	●	Overweight	Neutral
Indian Equities	Strategic	1.3	7.0	27.7	●	●	●	●	●	●	Overweight	Neutral
Global Emerging Markets Equities	Strategic	3.3	7.0	20.8	●	●	●	●	●	●	Overweight	Neutral
Global Equities	Strategic	3.2	5.0	21.1	●	●	●	●	●	●	Overweight	Neutral
<b>Listed Property</b>												
UK Property	Strategic	3.6	2.0	19.9	●	●	●	●	●	●	Neutral	Underweight
US Property	Tactical	9.1	3.0	2.2	●	●	●	●	●	●	Neutral	Neutral
European Property	Tactical	4.1	2.0	18.2	●	●	●	●	●	●	Underweight	Underweight
Far East Property	Tactical	5.3	5.0	14.1	●	●	●	●	●	●	Overweight	Neutral
Global Property	Strategic	7.0	5.0	8.8	●	●	●	●	●	●	Neutral	Underweight
<b>Listed Private Equity</b>												
Global	Strategic	3.8	5.0	19.1	●	●	●	●	●	●	Overweight	Underweight
<b>Listed Hedge Funds of Funds</b>												
Multi Strategy	Strategic	0.0	0.0	32.4	n/a	n/a	n/a	n/a	n/a	n/a	Neutral	Neutral
<b>Listed Commodities</b>												
Gold	Tactical	0.0	5.0	32.4	-	-	n/a	-	-	-		
Multiple Precious Metals	Tactical	0.0	5.0	32.4	-	-	n/a	-	-	-		
Oil	Strategic	3.8	5.0	19.3	-	-	n/a	-	-	-		
Multiple Energy	Strategic	3.8	5.0	19.3	-	-	n/a	●	●	●	Overweight	Underweight
Multiple Industrial Metals	Strategic	0.0	5.0	32.4	-	-	n/a	-	-	-		
Agricultural Commodities	Strategic	3.8	5.0	19.3	-	-	n/a	-	-	-		
All Commodities	Strategic	3.8	5.0	19.3	●	●	n/a	●	●	●	Overweight	Underweight
All Commodities (Ex Energy)	Strategic	3.8	5.0	19.3	●	●	n/a	●	●	●	Overweight	Underweight
<b>Other Alternatives</b>												
Timber	Tactical	0.0	5.0	32.4	-	-	n/a	-	-	-		
Water	Tactical	1.9		25.7	-	-	n/a	-	-	-		
Clean Energy	Tactical	0.0		32.4	-	-	n/a	-	-	-		
Global Infrastructure	Tactical	2.7		22.8	-	-	n/a	-	-	-		
<b>Cash as Asset Class</b>												
Sterling Cash	Strategic	6.1	0.0	n/a	n/a	n/a	n/a	n/a	n/a	n/a	Underweight	Overweight
<b>Cash versus Sterling</b>												
US Dollar	Tactical	4.1	1.0	18.1	●	●	n/a	●	●	●	Overweight	Neutral
Euro	Tactical	5.1	1.0	14.7	●	●	n/a	●	●	●	Neutral	Neutral
Yen	Tactical	1.0	3.0	28.8	●	●	n/a	●	●	●	Overweight	Overweight
Reference: One Year Sterling Cash		6.5										
Reference: UK Inflation				4.8								

If you would like to know more about our global asset allocation process please contact Christopher Aldous on 020 7398 5842 or by email at: christopher.aldous@pan-asset.co.uk



Guy Davies will be joining us as Head of Charities at the end of October 2008. He has until recently been in a similar post at Barclays Wealth. After a commission in the Army he began his career in investment management at Barclays Private Bank in 1994, followed by roles as private client and charities Director at UBS Warburg, Lazard and Barings. He is a Trustee and Investment Committee member of the Army Benevolent Fund and Army Central Fund.

# Market and Investment Overview

Christopher Aldous

The Credit Crunch has put pressure on the theory of decoupling between East and West. Far East markets have suffered as much, if not more, than Western ones so far this year. Nevertheless, we believe some great investment opportunities will emerge in the Pacific region once the dust has settled on the Western financial sector and the world begins to benefit from lower interest rates and increased availability of credit.

However, the financial crisis may not yet be over, particularly in the structured credit markets, which still have potential to further harm the global financial system. This risk alone is enough to make us hold back from trickling investment out from the cash positions we built up earlier in the year back into US and Asian markets. In the case of Asia, some of the falls have been extreme in 2008 with Japan down 45%, China down by 54% and India down 47%. Whilst these three economies will undoubtedly feel the effect of a general reduction in world activity, we do not expect their longer-term recovery to be held back by the burden of consumer and government debt which we believe will delay the UK, US and parts of Europe. For the time being, though, we will continue to hold high cash levels and look for clear signs that the worst of the financial sector shocks are behind us.

**Government Bonds** - The monetary authorities are showing an uncertain approach, alternating between tightening for fear of inflation and loosening for fear of recession. We think that the ECB and even the Bank of England will in due course have to cut rates further in response to the obvious weakness of the banking sector and growing influence of the credit crunch on real activity but only after they are convinced that inflation is falling substantially. Inflation-linked stocks are no longer looking expensive, especially in the US, as a result of sharply lower inflation expectations. Although inflation risks seem low at the moment, holding them can be viewed as a longer-term insurance policy. Despite their yield advantage, corporate bonds are still best avoided by risk-averse investors until the credit crunch shows more signs of easing since banks and other financial sector borrowers account for a major part of the corporate bond market. Risks to this view are more on the side of stronger returns from government bonds now that commodity prices have eased and the economic slowdown has resulted in sharply reduced inflation expectations. At some point, the high level of US, UK and Italian government borrowing may become an issue, especially for longer duration bonds.

**Equities** - General outlook supportive on valuation grounds. Credit crunch worries, slower profits growth, less takeover bid support and poor sentiment will all hinder recovery from the current weakness but good buying opportunities are starting to appear. Once the credit crunch eases, we anticipate that equities will be the major asset class that performs best as we suspect that investors will remain wary of property for some time and cautious about government bonds given their low yields. It is more important than ever to invest globally – the UK faces some difficult local problems in the

next couple of years. The risks to this view are more on the side of weaker equity markets in the short term as company profits news deteriorates. Geographically, we prefer the US, China and India. The commodity bubble has now burst providing some support for equity recovery, but they will only make sustained progress when monetary authorities are able to ease conditions further.

**Property** - General outlook in the UK is poor on valuation and sentiment grounds with valuations adjusting sharply downwards. There is likely to be a substantial overhang of space in the City for some time, adversely affecting rents and values. The residential market is falling after a period of low volume with people waiting on events. However, listed UK Real Estate Investment Trusts are already discounting much having experienced big falls and at some point buying opportunities will emerge. Similar arguments apply internationally where REITs have also been much weaker than physical property. Risks to this view are more on the side of even weaker property prices as economic slowdown results in forced disposals and weaker tenant demand.

**Hedge Funds** - The credit crunch has highlighted the risks in choosing individual hedge funds. There have been a number of sudden and spectacular failures, some amongst hitherto very successful funds with moderate perceived risk. Heavy redemptions may force many other funds to close over the coming months. There are funds of hedge funds which have protected assets in the downturn and which have provided a decent real rate of return over most time periods. It has been disappointing to see so many hedge funds fall over the first nine months of 2008, albeit by less than stockmarkets, when they were meant to be uncorrelated. The temporary ban on short selling may hit more successful hedge funds badly and more regulation is also likely in the future.

**Private Equity** - General outlook deteriorating for operational, financial and sentiment reasons. Risks to this view are more on the side of weaker private equity returns if slowing growth unmasks unsustainable loadings of debt. The credit crunch means far less gearing in private equity deals, lower returns and poorer exit prices. It is still too early to buy into private equity.

**Commodities** - General outlook becoming less supportive as global growth slows. The long-term story still holds but some prices are still high and we look for a further correction. It is now emerging how much speculative money went into oil and metals over the last year and how quickly it was withdrawn.

**Cash** - Dollar exchange rate is steadier in the short term and more attractive than sterling which is still over-valued and likely to move lower still against all major currencies in both the short and long term. In due course, Euro and sterling interest rates will come down and short dollar interest rates are already low. US rates may also further fall further. The dollar has improved sharply but is still more attractive than sterling although it yields less. Yen is the most attractive of the major currencies of the developed world.



**Christopher Aldous** has been involved in wealth management since joining Cazenove in 1981. He has since been a Director of Barclays de Zoete Wedd, an Executive Director of UBS and a Managing Director of Robertson Stephens, the US technology investment bank. He co-founded Absolute Fund Management in 2001, where he managed a fund of hedge funds and was Chief Executive Officer until 2007.

If you would like to know more about our portfolio construction process using index-tracking Exchange Traded Funds or gain an up-to-date view about investment trends and opportunities please visit our website:  
[www.pan-asset.co.uk](http://www.pan-asset.co.uk)

## Evercore Our new Partner

In July **Pan-Asset** entered into a partnership in asset management with Evercore Partners, a leading US-listed investment banking boutique and investment firm. Evercore acquired a 50% interest in Pan-Asset and injected substantial development capital as well as making further sums available for long-term growth. The firm has been re-named Evercore Pan-Asset Capital Management Limited and Evercore Partners will have the option to acquire full control eventually. Established in 1996, Evercore Partner's advisory business counsels its clients on mergers, acquisitions, divestitures, restructurings and other strategic transactions. Evercore also has a successful investment management business in the US and Mexico.

This transaction provides Evercore Pan-Asset with an extremely strong balance sheet and allows it to take full advantage of the major growth opportunity for its innovative investment management process. For Evercore, this is its first move into investment management in Europe and an important step towards its strategic goal of building its international investment management business.

## Are Exchange Traded Funds secure in volatile markets?

Evercore Pan-Asset does not recommend Exchange Traded Notes (ETNs) and Exchange Traded Commodities (ETCs). Tracking precious metals or commodity indices presents particular problems. The underlying index components cannot easily be physically bought or sold in small lots to replicate the index, so the sponsors of ETNs and ETCs have come up with different solutions. Often these take the form of a note issued by a counterparty undertaking to match the return of the index. In normal markets this works well. In markets where the stability of every counterparty, however reliable, is questioned, the risk of default on the note undermines confidence in the product. Nevertheless, although the market in some ETCs and ETNs was temporarily disrupted, the counterparties did not fail, guarantees have been strengthened and the market in these products has now become more orderly.

A swap is then used to ensure that there is no difference between the performance of the assets and the index. The swap counterparty is normally the ETF's sponsor and if the ETF is UCITS III compliant, the swap can be up to a maximum of 10% of the assets but will generally be much less. The risk of default on the swap is quite low; the biggest sponsors of synthetic replication ETFs in the UK are Deutsche Bank and Societe Generale, both well-supported banks. Finally, an ETF's capital value can fall in line with the index, but it is normally an independent legal entity with formal corporate governance so there is little risk of failure of the structure.

We do, however, recommend Exchange Traded Funds (ETFs). We prefer ETFs which either use all their money to buy all the shares in the index, which is the full replication system of tracking, or use optimisation to buy most of the index components where it may not be practicable to buy all of them. Neither of these approaches carries counterparty risk, but the latter can have a small risk of higher tracking error. We also invest in ETFs which use a small amount of their money to get closer to index tracking through a 'swap'. This process is a synthetic replication and these ETFs hold underlying assets which are not necessarily components of the

Liquidity is assured as ETFs are listed on the stock market. The market makers quote competitive buying and selling prices throughout the dealing day and since ETFs are open-ended funds there is a creation and redemption process between the market makers and the ETF sponsor that prevent their prices diverging significantly from the underlying fund asset value. The transparency of ETFs and the fact that the holdings within ETFs are liquid exchange traded investments means that any discrepancies that might emerge are quickly arbitrated away. Of course, ETFs can only be as liquid as the underlying listed assets in the index they are tracking but they remain a versatile, well-diversified, low-cost way to invest in equities, bonds and alternatives, provided proper advice is sought and they are chosen with care.

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## About Evercore Pan-Asset

We are an independent firm providing an asset allocation advisory service to pensions, charities and private wealth. This can be part of an integrated investment management service or as a stand-alone consulting service. We use Exchange Traded Funds extensively to implement our asset allocation views. Apart from our PanCONSULT service we offer six contrasting investment strategies, each of which can be tailored to the needs of the individual client.

- PanBALANCED
- PanCASHPLUS
- PanGROWTH
- PanPACIFICSHIFT
- PanOPPORTUNITIES
- PanALTERNATIVES

Evercore Pan-Asset Capital Management Limited is authorised and regulated by the Financial Services Authority