



What a difference a quarter makes !

The second quarter has seen a spectacular recovery in most risky asset markets and a sell off in the government sector. Global equity markets have recovered about 30 % from their lows of the beginning of March, and with this recovery we have seen a dramatic issuance in new equity issuance as listed companies race to replenish balance sheets. Interestingly at the same time the level of insider selling is now running at the highest level since June 2007, two months before credit markets froze, in fact insiders have been net sellers for the last 14 weeks in a row according to data compiled by Insiderscore.com.

The pull between insiders selling stock and companies raising fresh capital is echoed in a number of other tug of wars taking place at the moment. The deflation versus inflation argument that the bond market is trying to figure out, the Chinese consumer to save the world versus US consumer and even the big government versus small government that is playing out on different sides of the Atlantic. One of my favourite charts is the one that superimposes the 1929 Stock Market on the 2009 Stock Market, suggesting that we are reliving in a bizarre way the ups and downs of the post 1929 crash (see Figure 1).

Chartists and technical analysts are having a field day at the moment, citing both the recent break in the S&P 500 200 day moving average (see Figure 3), as a positive sign for future market direction, with the up tick in the VIX indicator of volatility (see Figure 2) out of a declining channel as a negative sign. These coupled with convergence of 50 and 200 day moving averages as well as a myriad of other indicators seems to be giving out quite divergent information. Which way should we turn, and who should we trust?

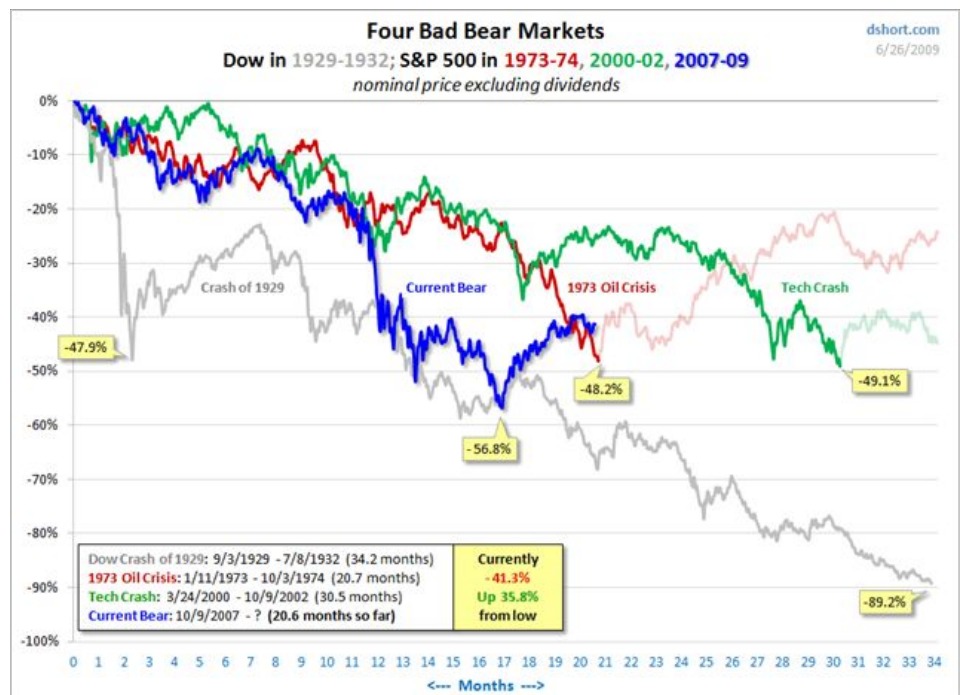


Figure 1. Four Bad Bear Markets

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Frustratingly of course there is no magic solution, no silver bullet indicator that distils everything we need to know into a simple "buy or sell" signal. We have spent much of the last month trawling through the numbers, sifting the tea leaves so to speak (an increasingly difficult task due to the widespread use of teabags), and have arrived at the following conclusions.



Figure 2. The VIX Index since 02 January 2009

We think that government bond markets remain an accident waiting to happen and are worried that the corporate markets that trade on a spread over these Gilt and Treasury markets are in a state of denial over the probable levels of defaults that we will witness over the next 18 months. We understand however that the debate over inflation or deflation is still alive and that the premature talk of a rapid V shaped recovery, as predicted by recent stock market movements is as much a product of government wishful thinking as it is a result of better than expected corporate data, more likely not as bad as feared data.

All of our discussions over the last month with Managers of Hedge Funds suggests that many of these managers have also been surprised by the ferocity of the equity market rally, and that most have not really participated, and if they have it has been more a result of the market dragging them in rather than their conviction. This is no great surprise as many had negative performance and lost assets in 2008, and have a bias towards capital preservation rather than risk augmentation. We think that this market activity and narrow participation probably sets the equity markets up for a pretty severe correction, and perhaps even another leg lower as the earnings and macro data deteriorate. However we also acknowledge that not everything has rallied and that the divergence of returns across sectors is as wide as it has been for a long while.

How to invest then in the current climate?

We have just completed our Quarterly Investment Committee and the results are a pretty good guide for an absolute return investor who is not constrained by asset class. Below we add a bit more flesh to the bone in terms of some of the ideas that we think make sense in the current environment.

Remain Underweight In Equities

Whilst our suggestion at the March quarterly meeting had been to increase the allocation to equity markets, we remain unconvinced over the strength and foundations of the rally, and as such want to remain underinvested in global equity markets. To the extent that it is possible, and also bearing in mind our expectation that volatility will increase from these levels we believe that option strategies such as selling calls and using the premium to fund a series of puts has attractive pay off characteristics. We are not entirely convinced of the BRIC decoupling argument and having looked at the levels of valuations in most of these markets are not looking to add positions.

Remain Underweight in Bonds

This view is entirely in keeping with the call from Q2. Bond yields have been driven to exceptionally low levels, and they are unsustainable in the face of the huge financing needs from pretty well every government on the planet. Curves are too steep and will bear flatten and credit spreads are expected to come under real pressure as both the crowding out by government issuance and default rates scares investors. Specifically bear flattening trades in Government bonds via futures.



Figure 3. S&P 500 50 Day and 200 Day Moving Average

Remain Overweight Hedge Funds

Fund selection apart we think that the safest place to park capital at the moment is in the Hedge Fund space. Absolute return mandates are best placed for capital preservation and more dynamic capital deployment, and the fact that hedge fund managers are deploying their own capital with their investors gives us additional comfort. For a more detailed discussion on the specific strategies that we favour please call to discuss, but we have this quarter increased our allocation in the Equity Hedged manager space. Our reasoning for this move is simple. Earlier we discussed the huge dispersion of returns across and within the equity markets. Our collective experience as

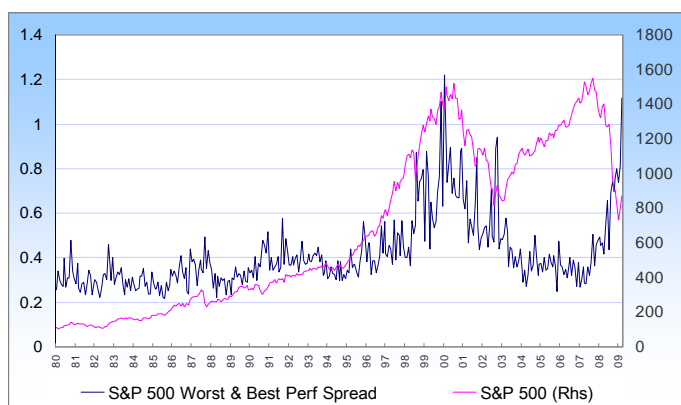


Figure 4. S&P 500 Worst and Best Performance Spread

investors reminds us that these periods of broad dispersion are the most profitable, in particular when we measure expected returns for a given measure of risk. Fewer crowded trades, less risk of private equity bidding for companies that managers want to short, and less competition from prop desks. (see chart that measures S&P 500 dispersion versus performance, Figure 4).

Remain Underweight Private Equity

Ironically we think that the current environment should be the ideal hunting ground for traditional PE companies, not the leveraged firms that held sway for the previous 4 years, but those firms that can go in and manage a business. The overhang of all these over-leveraged deals is having an impact not just on the performance of the vintage 05/06/07 Funds but also on the leveraged loan market (it is not open for new issuance) and the management of the PE Firms. Yes, you can buy secondary pieces of PE funds at significant discounts at the moment, but this reflects both the fact that investors want to get out, BUT also the fact that many of the deals were done at the wrong price. As a result we think the best way for investors to use PE at the moment is to look for new firms that are

launching, with experienced and able managers who will be able to concentrate on generating value rather than in trying to salvage their business.

Remain Overweight Commodities

A number of reasons to be in the commodity markets at the moment, and also a number of ways to invest. Primary reasons to be in the market are the store of value that real assets have, their inflation hedge characteristics and the key factor that the bubble in the asset class burst last year, lead by oil falling from \$147, all the way back down. Coupled with the change in macro circumstances, any increase in global growth will be felt via the pulse of the commodity markets, and importantly there are few trading restrictions.

Directional bets are a great way to reflect a growth or inflation view if felt strongly enough, but our preference is in fact to allocate capital to managers who have demonstrated capabilities in niche markets and strategies. We have packaged this via a Fund and have no problems with blowing our own trumpet so to speak in terms of our track record!

Finally, Real Estate

Is it mainstream or alternative as an asset class? Who cares! We are beginning to get quite excited about the prospects for investors, in both the residential as well as the commercial sectors. We do not believe that we have any added value in most of the emerging market real estate markets, but see significant value in the UK, USA and European mainstream markets, and one of the drivers of this value is that we think the exit into recovery will offer tremendous opportunity for cash rich investors and those who are able to offer attractive financing arrangements. The second and possibly more fundamental reason is that we believe that we will continue to see a speeding up in the process of capital leaving the oil and commodity rich markets which offer few investment opportunities and no diversification, towards the deeper, richer western markets that are essentially commodity importers. Expect this trend to continue and take a 5 year view on the cheap level of these assets and the attractive yield, growth and undervalued FX opportunities that they represent.

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