

Oh yes I can!

Happy New Year!

As 2009 fades away, I guess many people are glad to see the back of the 21st century's first decade. Indeed, stock market investors – most of whom are more than likely poorer than when they began to invest 10 years ago – are probably wondering why they even bothered at all. Those who believed the mantra of investing their savings every month as the way to make long term gains are probably reaching for the small print of their savings contracts. In fact, the whole financial and savings industry is – quite deservedly – under the microscope at the moment.

Looking into that microscope myself, as both an investor and a tax-payer, what troubles me is how little proactive change is taking place in the banking industry. If banks do not evolve, the marketplace will change the environment for them. For example, private family-owned banking firms in the United Kingdom have been inundated with customers transferring their assets and their business away from uncontrolled government-rescued banking behemoths. Mind you, this was to be expected: if you are a depositor, there is much to be said for entrusting your money to a partner-owned bank that does not have an investment banking arm. And I find it rather ironic that, whilst the banking sector fiercely tries to preserve the status quo, a new breed of risk-taking investment bank-like institutions is quietly, but resolutely, emerging. Today, large private equity and hedge fund firms are buying bank licenses and applying to run retail banking networks, while others are adding investment banking to the spectrum of their activities. It would not surprise me if, over the next several years, we saw a trend towards the creation of new banks, with distinct difference in the types of business and services these new organizations set out to provide. This would be a very healthy move away from the insane consolidation that has taken place over the last 10 years.

Indeed, structural change is necessary. As the cost of rescuing the financial system soared over the past two years, I have been amazed by the political class' reluctance to deal with key structural issues. For example, I have long believed that investment banks – the old fashioned merchant banks of yesteryear – should be risk seekers, because their purpose is to maximize return on capital, for themselves and their clients. And as the risk takers are partners betting their own capital, they should be compensated accordingly, win or lose. Investment banks should be allowed to disappear or get purchased if they fail, and to handsomely reward risk if they succeed. On the other hand, retail and commercial banks should be low-risk, conservative and reliable. We – the tax-payers – should be prepared to support these institutions, if necessary. But such support should never even be contemplated for investment banks.

At last, change could be on the way. Mr. Obama and many – but not all – in his administration are intent on redressing the imbalance of power between Main Street and Wall Street or between Washington D.C. and New York. With the formidable Paul Volcker looking over his shoulder, Mr. Obama just announced that the banking industry does indeed need to be reorganized, possibly with a return of the segregation between investment banking and commercial banking. We all hope the authors of any financial reform grasp the system's intricacy and inter-linkage as well as Mr. Volcker and it appears he has convinced Mr. Obama that risk is an integral part of financial markets. Risk-taking should be allowed and even encouraged, but such risk-taking should be the exclusive domain of risk-takers: investment banks, hedge funds and the like. That is exactly what Mr. Obama stated when he introduced what he called the "Volcker Rule": "Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers." The President said, "If financial firms want to

trade for profit, that's something they're free to do. Indeed, doing so — responsibly — is a good thing for the markets and the economy. But these firms should not be allowed to run these hedge funds and private equities funds while running a bank backed by the American people."

Finally! It seems to me that splitting the financial industry along these — admittedly simplistic — lines would solve many problems associated with the banking sector, such as the "too big too fail" question, a popular theme throughout the current crisis, or the sensitive and populist issue of bonuses. Yes, the Volcker rule could induce a massive reduction of the liquidity of equity and bond markets, as well as a significant pick-up in volatility. Some banks reacted to the proposals by saying that they will simply relocate their trading activities to a more accommodating jurisdiction! Just two of the many examples highlighting the complexity of inter related global financial markets. But if the financial game is really changing, the survivors will be those who adapted first, while those fighting to preserve a discredited status quo will fade into deserved oblivion.

Change can only occur with political will. My hope is that the American President — often long on rhetoric but short on achievement — has the ability and the courage to push ahead with these much-needed reforms.

Markets

Finally, some surprise seems to have returned to markets! The dollar, having been the only short in town for several months, is rallying. Commodity markets had a tricky December as precious metals retreated, although no one is suggesting that the risk of a meltdown has receded. Chinese growth jumped to a whopping +10.7 % in the last quarter, a figure which may or may not be correct. But global markets took

fright when Chinese authorities used it to justify a series of measures controlling credit creation to cool a red-hot domestic real estate market. If you factor the additional — and unknown — impact of the eventual end to QE around the world, the mid-term elections in the U.S., a general election in the U.K. and major concerns over the creditworthiness of a number of Eurozone countries (read Greece), you have plenty of reasons to be less complacent in 2010.

In fact, looking at these increased levels of uncertainty, I think investment portfolio construction should revolve around two related precepts: capital preservation and a long volatility stance. This is not the result of Nobel prize-winning mathematics, but rather of many years of hard-earned experience at the coal face of investing, laced with a healthy dose of common sense. Common sense does not mean we are perma-bear investors, far from it. We are as positive in our outlook on life as the next investor. However, our outlook is shaped by the experience and observation that markets can and will surprise. Forecasting expected returns is generally about as effective as sifting tea leaves in a black pot. Therefore, our current portfolio approach to effectively preserve capital is to combine a fixed income-like return/risk profile with high levels of optionality to benefit from probable increases in market volatility. This process should provide an excellent antidote to the risks involved in investing in current markets, by creating an all-weather portfolio that is not a hostage to forecasted return expectations in each asset class.

Please call us to find out more and feel free to share your comments and suggestions. In the meantime, all of us at Eurofin Capital wish you and those dear to you, a very healthy and prosperous 2010.

James M.M. Edwards
Chief Investment Officer

To find out more about Eurofin Capital, please contact us:

Eurofin Capital S.A.
rue Muzy 8
1201 Geneva
Switzerland
Tel: +41 22 707 4220
info@eurofincapital.com

www.eurofincapital.com