

November 2010

Generating returns despite unattractive valuations

The return of risk appetite since the financial crisis has driven up asset prices to a point where none of the major asset classes look attractively valued from a fundamental perspective. With this backdrop in mind, this article looks at some of the ways Insight's Multi-Asset team are looking to generate positive returns for clients.

Markets since the collapse of Lehman Brothers

The collapse of Lehman Brothers in September 2008 will long be remembered as one of the most extreme financial events of modern times. Global asset markets suffered badly across the board in aftermath of the event, with correlations breaking down and even traditional safe havens such as gilts and gold initially falling more than 10%. Higher-risk assets such as corporate bonds, equities and

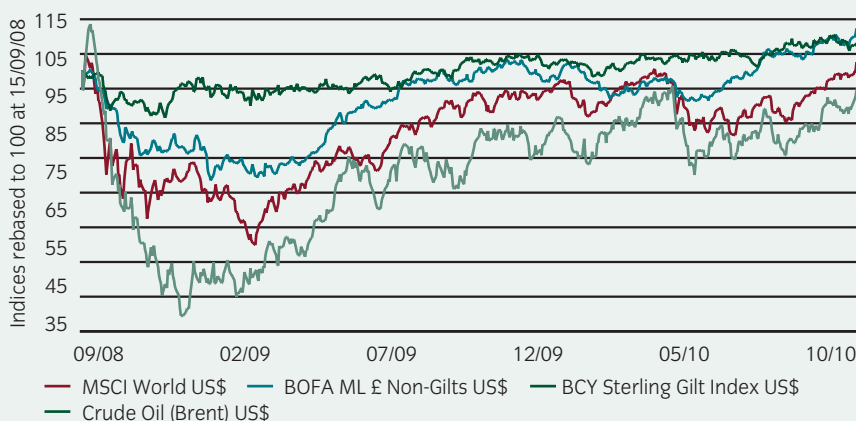
commodities suffered far greater losses. Yet most risk assets have now recovered their post-Lehman losses, implying that crisis conditions are no longer factored into valuations. While the benefits of diversification were clearly reduced as correlations rose in extreme conditions, investors in multi-asset portfolios have still seen reduced drawdown and lower volatility than those in traditional long-only equity funds. The pace of market returns has slowed down considerably in 2010, however, as growth rates in the developed world have eased.

Assessing the current outlook

Although it is usual to see some slowdown in the pace of growth and risk performance following the initial stage of an economic recovery, there are reasons to be more cautious about the scope for further positive progress in this cycle. Whereas the consumer typically leads economies out of recession, this is unlikely to be the case this time around. Increased taxation, government spending cuts and high levels of household debt are likely to have a material impact on consumers' ability and desire to spend.

Furthermore, developed world governments also have very high levels of debt, having absorbed much of the fallout from corporate balance sheets, meaning there is little room for policy error and increased downside risks to recovery. We feel that risk asset valuations are not cheap enough to reflect this difficult backdrop, and as such believe it is inappropriate to be running large directional positions in credit, equities and commodities. However, whilst we feel that absolute valuations of most asset classes are not

Chart 1: Performance of risk assets since collapse of Lehman Brothers



Source: Datastream

➤ A BNY MELLON COMPANYSM

More insight. Not more of the same.

Insight
INVESTMENT

offering exceptional value, we strongly believe that opportunities exist within asset classes in a relative sense. We therefore currently have a preference for investments in a range of actively managed strategies, which look to generate a positive return without reliance on continued upwards progress in overall market direction.

Strategies to generate returns

We are looking to deliver positive returns at present in four main ways: by isolating equity exposure, considering long-term themes, investing in total return funds and making opportunistic trades.

Isolated equity

In many cases we look to isolate the expected 'alpha', or outperformance potential, when implementing equity-based investment ideas. The benefit of taking this approach is that it means we can tap into the outperformance of top fund managers without taking on market directional risk. This requires the use of derivatives to remove unwanted market or other factor risks from the selected investment to focus our exposure. A recent example of this has been buying the Blackrock UK Special

Situations fund but selling an equal quantity of FTSE 100 futures. The Fund has consistently outperformed the broader market this year, meaning the position has generated a steady return for our clients which wasn't subjected to the sharp falls in equity markets in the second quarter of the year.

Long-term thematic exposure

By taking a long term view, we are looking to profit from structural themes within our diversified portfolios and have a focus on areas such as Asia, agriculture and environmental markets. While past performance is no guarantee of future performance, history has shown that structural trends in markets can continue for far longer than investors expect. Taking Asia as an example, we feel that the transfer of wealth from the West to the East is still in its early stages, meaning diversified investments in the region represent an attractive proposition for European investors. Chart 2 shows how Asian markets have consistently outperformed UK markets in recent years, despite the considerable stresses on exports during the global recession. While consumers in the West look to pay down debts and rebuild savings levels, Asian consumers are likely to want to run down their high savings levels to boost their standards of

living. This should result in continued stronger growth in Asia than in developed countries as domestic demand in Asia increases and countries increasingly export goods to other parts of their region. Asian assets look well placed to continue to outperform as a result, and are represented in our portfolios. We are also able to isolate any thematic exposure if we are worried about the possibility of a setback in broader global equity markets.

Total return funds

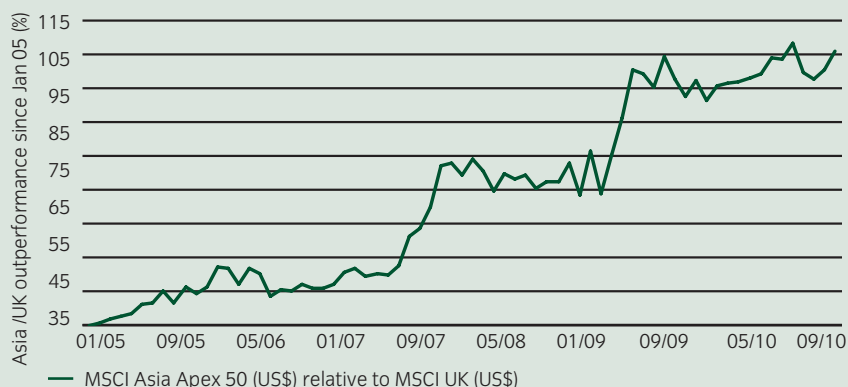
We have exposure in our multi-asset portfolios to absolute or total return funds, which are those which look to produce positive returns regardless of the prevailing market conditions. These can take a variety of forms and have been an important component given the turbulent market conditions of the past few years. They include currency funds, market neutral and long/short equity funds, absolute return bond funds, as well as multi-strategy funds. Currency funds are relative return products by definition as currencies can only be valued relative to another currency. Market neutral equity funds look to generate returns from stock picking without market direction exposure by hedging every long position with a short position of equal size, and absolute return bond funds tend to have the ability to move large allocations to cash in times of financial stress to protect capital.

Multi-strategy absolute return offerings, such as our own in-house Absolute Insight Fund, spread capital across a range of the aforementioned strategies, providing greater diversification for clients to smooth out periods of poor performance in individual strategies.

Opportunistic positions

If we believe there is a particular opportunity in a market, we have the

Chart 2: Asia has been a consistent outperformer



.Source: Datastream.

capacity to place opportunistic trades in our Funds. This is typically where we place relative trades, offsetting a long position with a short position of equal size. These tend to be shorter-term in nature than many of our core holdings and aim to profit from valuation anomalies. We would look to close out the position once the valuation discrepancy has been recognised by the market and subsequently reduced, thereby capturing a positive return for the Fund without necessarily taking exposure to underlying market direction.

With many markets now having recovered their losses since the collapse of Lehman Brothers in September 2008, the big question is now whether there is scope for further upwards progress. In our view, the fragile position of developed economies means that a continued strong recovery is less likely than in previous cycles, with serious downside risks to growth going forward. As such we are investing in a range of strategies which have the ability to perform in all market conditions and should help protect client capital should economic conditions start to deteriorate.

For further information please contact:

Wholesale Business Development

brokersupport@bnymellon.com
0500 66 00 00

Client Relationship Management

cddirect@insightinvestment.com
020 7321 1499

Consultant Relationship Management

consultantrelations@
insightinvestment.com
020 7321 1209

Institutional Business Development

business.development@
insightinvestment.com
020 7321 1547

European Business Development

europe@insightinvestment.com
+ 44 (0)20 7321 1928

www.insightinvestment.com

Telephone calls may be recorded.
Call charges may vary by provider.

Past performance is not a guide to future performance. The value of investments and any income from them will fluctuate (this may partly be due to exchange rate changes) and investors may not get back the amount invested.

This document is only directed at investors resident in jurisdictions where our funds are registered. It is not an offer or invitation to persons outside of those jurisdictions. Insight Investment reserves the right to reject any applications from outside of such jurisdictions. Issued by Insight Investment Funds Management Limited. Registered office 160 Queen Victoria Street, London EC4V 4LA. Registered in England and Wales. Registered number 1835691. Authorised and regulated by the Financial Services Authority. FSA Firm reference number 122259.

➤ A BNY MELLON COMPANYSM

www.insightinvestment.com

Insight
INVESTMENT

07860-11-10