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The volatility continues



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This note provides a brief update on the recent volatility and an outline on what we are doing to manage this risk in your portfolios.

Market

Last week saw global equity markets fall 8% as fears rise over the global economy. The S&P downgrade of US government debt over the weekend, while not a great surprise, provides another reason for investor angst. Over night the S&P500 was down 6.5%, gold was up to a new record high and US Treasuries – the trigger of this outbreak of fear – rose in price again (10 year yields down to 2.32%)! This note aims to provide some perspective amidst what is a painful time for investors. We also outline how we are positioning portfolios and the key issues we are focusing on.

What does the recent downgrade mean? The reality is the US debt situation hasn't changed because S&P changed its credit rating. The debt is still big and it still needs addressing – this is bad news, but it is not new information. For example, yields on US Treasuries actually fell during July despite the embarrassing handling of the debt ceiling. Investors have yet to find a 'safer haven', so for now US Treasuries continue to play that role.

As we have said for a while, the developed world faces a prolonged

period of adjustment in which debt levels must be brought down. This will constrain growth. There are also plenty of reasons to expect volatility on the journey to a better balanced world – fears concerning European sovereign debt and a Chinese hard landing being two of the most obvious that will cause spikes in agitation levels from time to time. It is worth remembering that these risks are why equities are priced to provide a return premium (usually) compared to less risky assets.

MLC portfolio positioning

What are we doing to navigate this difficult environment?

- It is first worth noting that the best time to position portfolios is in advance of this kind of volatility – not during and not after. This is why we recommend clients place most of their fiduciary focus on defining the strategic asset allocation that best reflects their risk tolerance.
- From a strategic overlay perspective, we continue to recommend an overweight to foreign currency (unhedged global shares) as a way to reduce risk. The 9% fall in the A\$ over the last week highlights how this can cushion the downside for our clients' portfolios in 'risk-off' markets.
- In our longer maturity debt portfolios, we are consciously underweight sovereign bonds, as the return to risk looks

Making sense of a volatile world

asymmetrically unfavourable given the low yields in the US, Europe and Japan. As yields have fallen further in recent weeks, this has detracted from returns, but being paid 2.34% pa nominal to lend to the US government for 10 years still doesn't strike us as a great proposition.

- We continue to seek reliable sources of diversification. Cash and bonds have worked well in the last 6 weeks as traditional portfolio diversifiers to equities. The strategies within our Low Correlation Real Return strategy have also continued to perform well.
- For many clients, we continue to recommend an allocation to inflation-linked bonds within the debt strategy. This is particularly relevant as there is a big incentive for policymakers to aim for elevated inflation to reduce the real value of their sovereign debt. This can never be publicly admitted, but it looks like arguably the least painful exit strategy for the developed world.
- Within our debt strategies our exposure to peripheral European debt is very low and the credit quality is AA on average.
- Within global shares, we remain comfortable with our strategic decision to allow managers to

invest in both developed and emerging market companies. There are many companies, only some of which are based in developed markets, which will benefit from exposure to growth opportunities in markets and economies which are largely free from the public sector and consumer debt which hobble "western" economies.

On the last point, it is worth noting that whilst public balance sheets remain under pressure in many developed markets, corporate balance sheets and cash-flows are very robust. The majority of US companies in the S&P 500 again exceeded consensus earnings expectations in the second quarter. Efficiency improvements continue for many companies with productivity gains running at over 1.5% pa, which is greater than the average of the last 8 years. This is showing in strong capital spending growth of 17% annualised as corporates use technology to enhance efficiency. In the US alone corporates hold over \$1.5 trillion dollars of cash.

At times of uncertainty in markets, valuations between high and low growth companies converge, and this has historically been an appealing time to access better quality opportunities to invest for strong medium term returns.

We expect a growing divergence in valuations between winners and losers over time.

As an example, stocks in MLC's Global Equity portfolio have an average gearing level of 26% versus a benchmark level of 45%. The portfolio also has exhibited stronger earnings and cash-flow generation than the market. These quality/defensive characteristics have helped the strategy outperform in 13 out of the last 14 down months since the strategy was restructured in February 2009. The portfolio has beaten the benchmark by 1.9% pa over this period. While there are no certainties, these types of characteristics should support performance over the medium term.

There are clearly uncertainties, but these kind of dramatic market sell offs also cause prices to disconnect from fundamentals. They also create the potential for a sharp rally in risk assets. This will provide opportunities at a stock level for our managers and at a strategic overlay level for MLC. We are aiming to analyse these risks and opportunities in a disciplined and objective manner... and will update you as our thinking evolves.

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