

## IPS View: O Protection, Where Art Thou?

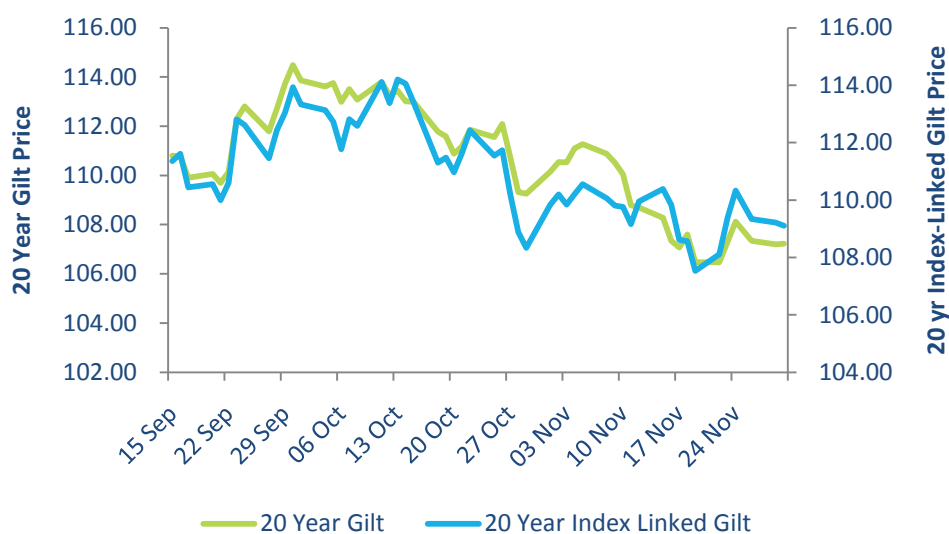
One theme we have been thinking about for 2011 is how to successfully “protect” client assets in a general sell-off. This year’s Eurozone crises illustrate the problem well. Both May and November saw a smaller European country run into trouble and need assistance. Both months also saw a corresponding sell-off in equity markets and risk assets in general. As we explain below, the crisis this time round has been worse (if you are Irish) but better (if you are an equity investor). The interesting thing is that so-called “protection” that worked in May has not really helped in November. We think this is an important development as we expect this theme to continue in 2011.

First, though, we note that from a European perspective the crisis has arguably been worse in November than May. The real worry for markets is not the next domino (Portugal) but the two after that (Spain and Italy). Credit default swaps on Spain (which insure against a Spanish default) peaked at 365bps in November. This compares to a high of 275bps in May. More worryingly, Irish default swaps similarly peaked at 273bps in May. This means that markets think Spain today is a bigger risk than Ireland was five months before it received its bailout!

In spite of this, equity market reaction has been more muted. The FTSE 100 fell -5.9% peak to trough in November compared to a -11.0% fall in May. What do we note from this? First, if credit markets are gloomy and equity markets more optimistic, we tend to lean with the credit people (remember 2007?). As we have been saying for a while now, we think the problems in the Eurozone will keep rumbling on and we are prepared for these periodic crises to continue and, ultimately, for at least one of the problem countries to default.

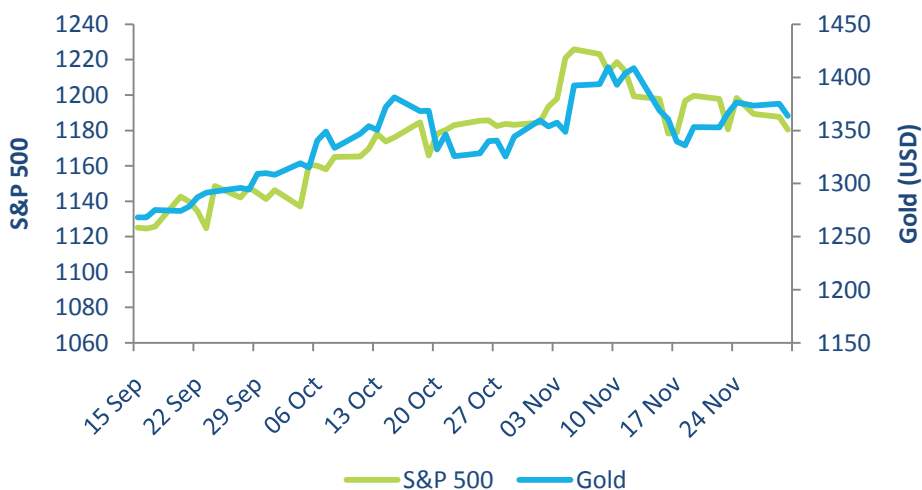
Our main conclusion, though, is that protecting portfolios is much harder right now. The two graphs below illustrate this point. First we show how the 20 year gilt has performed since mid-September. OK, so growth and inflation prospects have generally been looking up so it is perhaps not surprising that gilts have sold off. Take a look, though, at the performance of the 20 year index-linked gilt which we have also plotted. The 20 year index-linked gilt has sold off in *exactly the same way*. Index-linked gilts have not provided any more protection than traditional bonds even in a rising rate/inflation expectations environment.

**Chart 1: Longer dated Index-linked gilts have not been a safe haven...**



The second chart shows gold and the S&P 500, again since mid-September. We understand the argument that gold is effectively a reserve currency for those that no longer want to hold the dollar. Look, however, at the correlation between gold and the benchmark dollar risk asset, the S&P 500. Note also the sell-off in both assets when the Irish situation intensified. This does not look like an ideal safe haven to us.

**Chart 2: Gold and equities are looking more correlated...**



What, then, to do? Our regular readers will know that we have long been saying that Eurozone troubles will continue and bonds may not be the safe-haven people hope for. We were therefore relatively well positioned for the sell-off and our client portfolios were up in October and November. There is, of course, no easy solution here but we remain committed to our approach of genuine diversification and a significant allocation to trading strategies that will profit in volatile markets. We expect 2011 to look a lot like 2010 and we trust that this approach will continue to serve us well.