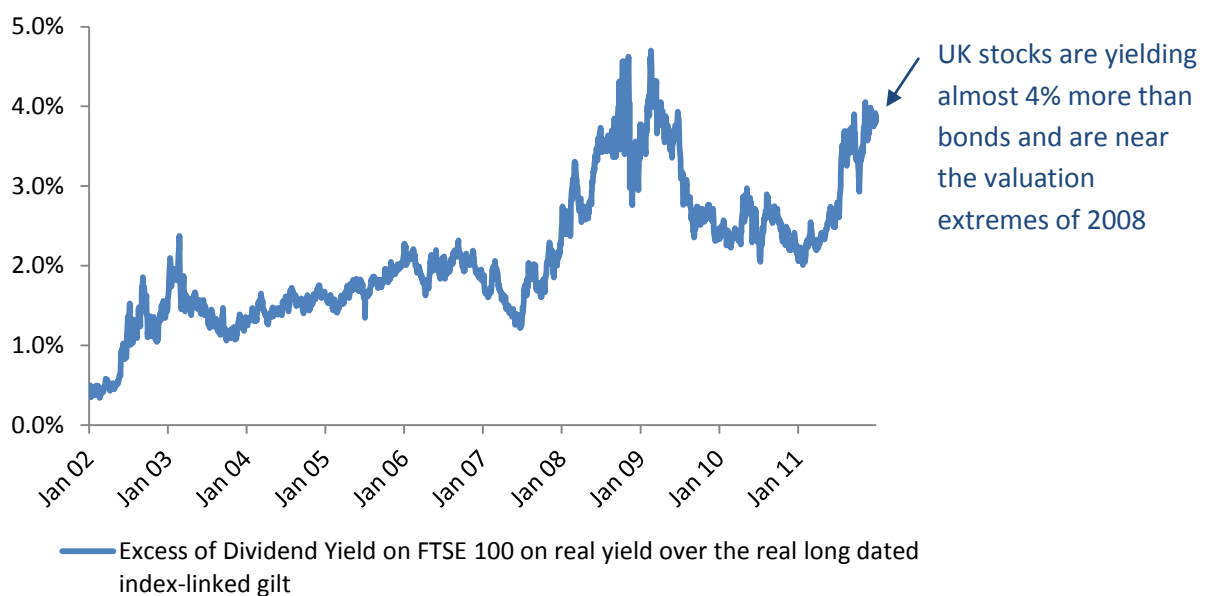


## IPS View: Our strategy for 2012

At IPS we continue to believe a diversified, multi-asset approach remains a key way to generate attractive, risk-adjusted returns for investors. As part of this approach we do, of course, look at the traditional asset classes of equities and bonds. This IPS view sets out our thoughts on each and outlines our strategy to make money for our clients in 2012.

For government bonds, the answer is simple: avoid. Lending money to the UK government for 10 years at 2% when inflation is running at 4.8% is simply not a good use of our clients' money, no matter how well the asset class has performed in the past. Lending money to the Germans at 1.9% feels even worse, particularly when they are most likely to have to pick up the bill for the excesses of their Eurozone neighbours.

For equities, the investment decision is much harder. There are unquestionably certain regions and sectors that are trading cheaply relative to their historic averages. We illustrate this with two charts. The first shows the dividend yield on equities (the FTSE 100) compared to the real yield on 10 year government bonds. In simple terms, the dividend yield on equities is 3.9% higher than the real yield on gilts. This is near all time highs and argues that even more conservative, income focused investors should be looking more closely at equities today. Interestingly, the real yield on the 10 year index-linked gilt is actually *negative* at -0.65%. If you buy this gilt you are *guaranteed* to have a -6.3% loss in real, inflation adjusted terms at maturity. It is an illustration of just how risk-averse some parts of the market are that investors would rather lock into this loss than own the (admittedly riskier) positive income stream that equities provide.



Source: Bloomberg

The second chart shows that the fallout from 2011 has created sectors that trade very cheaply compared to their long term averages. Energy and mining companies are one example. Another is emerging markets. To illustrate this, we show below the p/e ratio for China's Hang Seng index since 1996. Note current levels are in line with previous crisis lows for the region (including the Asian financial crisis in 1998 and the SARS health scare). When the market has traded this cheaply in the past it has typically preceded a period of 20% plus returns for the brave. The question is, of course, is now the time to be brave?



Source: Bloomberg

For Asian equities, we believe the key will be timing the ending of the slowdown in China. There have been encouraging signs on inflation recently but it is still we believe too early to sound the all clear. For broader risk markets we are looking to more certainty over the outcome of the Eurozone crisis. It is hard to be too keen on risky assets when Europe sits on the edge of another Lehman-style collapse. European leaders are effectively doing the minimum needed at any point in time to avoid outright catastrophe. It would be wrong, though, to think that they are making no progress. The ECB has guaranteed the solvency of the banking system for the next three years. The fiscal pact announced in December is a necessary step along the road to jointly guaranteed Eurobonds. However, it may well be that they need a sense of crisis to drive the next stages of reform through. If so, this cannot be good news for equities for the first half of this year.

Unlike 2008, though, we are reluctant to be completely out of equities especially when the longer term value case is so strong. Our general strategy is therefore:

- Maintain some exposure to equities with good long run value story but run lower than normal levels because of the high uncertainty over the outcome in Europe. It may be that the actions of the ECB have put enough liquidity into the system to keep the sovereign bond markets trading at respectable levels. In this environment, the US and emerging markets may generate attractive returns therefore, we need to have some exposure to them to make sure we profit from this scenario.

- That said, we are maintaining relatively high (around 25%) cash levels. Announcement by central banks, rating agencies and politicians can change the outlook overnight. We need to be ready to act quickly to take advantage of any opportunities that arise – especially after a sharp sell-off in equity markets.
- We are keeping our gold exposure as a protection against central banks simply printing money to make problems go away.
- We are also keeping our exposure to trading strategies and macro funds that have a proven ability to make money when financial crises hit. We should be able to make money with these funds even if the market turns down once again.
- For our Euro and sterling based clients we are keeping some US dollar exposure as we believe the dollar will inevitably rise in times of crisis. Our US dollar clients are broadly currency neutral.
- Finally, we added to our US high yield corporate credit position following the sharp sell-off in that market in August last year. We were attracted by the 8% yields available and by our belief that the US was not about to fall into renewed recession. Steady but below par growth is, we believe, a good one for corporate credit – especially relative to equities. This has proved to be a profitable investment and we continue to like it for our clients.

Putting this all together, we believe we have enough attractive investments today for clients to profit from a rally. We also feel we have enough cash and defensive assets to be ready for any further problems in the Eurozone. It's likely that at some time this year we feel it will be the right time to be brave. We are ready and waiting but, for us, the time has not yet come.

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