



PERSPECTIVES

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Local Asset Management

Local Growth Drivers Have Remained Strong Despite Inflation Concerns



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Local Asset Management

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Global Fixed Income Investing

Given the continued growth in the U.S., spread widening in recent months suggests to us that credit markets globally are possibly being too pessimistic about economic prospects in the U.S. and around the world.

Strategic Income Investing

By leveraging our in-house research resources, focusing on longer-term fundamentals and assessing both credit and interest rate risks, we have been finding what we believe are attractive investment opportunities as we position our multi-sector fixed income portfolios

Mutual Series

We have been finding value in companies that are domiciled and traded in Europe but are not significantly European in their footprint.

In 2011, India's central bank, the Reserve Bank of India (RBI), embarked on an aggressive monetary tightening policy to rein in persistently high inflation. The most recent hikes in interest rates in October left the repo and reverse repo interest rates at 8.5% and 7.5%, respectively. However, inflation has recently been hovering around 9%, and while this is lower than levels seen in the first half of 2010, we believe it needs to go down to much lower levels.¹ Therefore, we do not expect the RBI to have a very dovish stance until inflation reaches manageable levels.

Some investors have worried about the impact of rising interest rates on economically sensitive sectors such as infrastructure, auto and financials. Indeed, these stocks saw significant volatility during 2011, especially in recent months. While rising interest rates may have been one variable affecting these industries, we think it may not have been the most important, and other factors may have also exerted an influence. For example, in our view the infrastructure sector was affected by a slowdown in higher-quality projects due to factors such as uncertainty about policy. We believe the auto industry was affected not only by slowing demand but also by several other issues, such as competitive intensity. And in the case of financials, we saw increased uncertainty as the industry entered uncharted territory because of recent deregulation for savings banks' interest rates.

Looking to 2012, we believe domestic issues in India, such as growth, reforms and fiscal stability, may gain importance over global issues. Low growth in many global economies may not necessarily have a large impact on the Indian economy because the country's external trade, as a percentage of total gross domestic product (GDP), is not

very high. Instead, we believe the focus for India is going to be more on issues such as getting growth back on track, clearing bottlenecks in the infrastructure sector, implementing various policy reforms and instituting fiscal stability.

In our view, the country's improving demographics are likely to play a role in driving domestic growth. During the past decade, the Indian economy saw accelerating growth because of an expansion in the middle-class population. Today, about 20% of India's population belongs to the middle class, and this figure is projected to increase by about 12% per year until 2025.² As the middle class population increases, we are likely to see increasing consumption. From 2010 to 2020, about 500 million people are projected to join the world's working-age population, of which India is expected to contribute more than 25%.³ In our view, as more people enter India's workforce, the country's domestic savings rate, which is now more than 30%, is likely to increase and further fuel growth.⁴ As a result, we believe India's growth has been driven by a combination of increased consumption and investment in the economy, in terms of infrastructure and manufacturing capacities. We expect these factors to continue to drive growth over the next 10 years, and the trend could even accelerate.

Meanwhile, we have seen a qualitative shift in the Indian stock market—it has become more efficient and, in our opinion, has achieved a better allocation of capital than it has in the last five to six years. We have also been seeing a qualitative improvement in governance and transparency, and we would like to see further improvement in these areas in the months and years to come.

1. Source: Reserve Bank of India, November 2011.
2. Source: DB Research, 15 February 2010.
3. Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2010 Revision.
4. Source: The World Bank.

Global Fixed Income Investing

Credit Markets May Have Been Too Pessimistic



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Beyond the noise generated by the European sovereign debt crisis and the seemingly unending debate about reducing the U.S. federal fiscal deficit, we believe macroeconomic fundamentals are evolving just as they might be expected to in the wake of the financial crisis of 2008-2009. It is useful to remember that the U.S. grew at an (admittedly not spectacular) annualized rate of 1.8% in the third quarter of 2011.⁵ Given this continued growth in the U.S., spread widening in recent months suggests to us that credit markets globally are possibly being too pessimistic about economic prospects in the U.S. and around the world.

The Organization for Economic Cooperation and Development in late November forecast that Europe was likely to suffer, at worst, a mild recession in the final quarter of 2011 and the first quarter of 2012 and that the U.S. would continue to grow at a real annualized rate of 2.0% to 2.5% in the same period. Given this moderate growth and given that quantitative easing initiatives by central banks (essentially involving bond purchases through newly minted money) may help spur inflation, we believe current benchmark government bond yields in countries such as the U.S. may be too low. The “real” yield—the difference between 10-year U.S. Treasury yields and the inflation rate—went as low as -1.92% in September (its lowest since at least 1992)⁶ and still stood at zero at the beginning of December. In other words, investors have been willing to lend the U.S. government money for 10 years with the expectation of being paid zero interest in inflation-adjusted returns.

By contrast, we regard debt sold by industrial companies in Europe and the U.S. as attractive, especially as spreads (the extra yield investors demand for company bonds worldwide instead of similar-maturity government debt) had widened to 277 basis points by end-November, according to the Bank of America Merrill Lynch Global Broad Market Corporate Index. And yet 70% of

Standard & Poor’s 500® Index companies beat analysts’ consensus forecasts for third-quarter earnings, according to data compiled by Bloomberg, while the default rate on noninvestment-grade debt was well below the longer-term average. We believe the possibility of continued growth of the U.S. economy should be positive for corporate bonds even if profit growth slows.

Although slowing, China’s growth could be in excess of 8% next year, and the country, along with most Asian nations, has fiscal scope to potentially cushion its economy from any further escalation in Europe’s debt crisis, according to a World Bank report in late November.⁷ We believe the rest of Asia should likewise be able to withstand the blows from any slump in demand for its exports or pull-back in credit by European banks. We, therefore, continue to believe that local and foreign currency-denominated debt issued by some emerging Asian countries, including the likes of Indonesia, offers value for global bond investors given the region’s strong fiscal positions and economies. Federal and state debt in Australia also looks attractive to us, and, despite an interest rate cut by the Reserve Bank of Australia at the beginning of December, we think the Australian dollar offers scope to potentially push higher once the fear of a hard landing in China recedes.

While we expect the euro to survive, eurozone leaders need to present a credible plan that allows them get ahead of the market on the sovereign debt crisis. The Brussels summit in early December represented another attempt to do just that, but it remained unclear to us at the time of this writing whether the markets were willing to accept at face value the stated commitments to deeper fiscal integration and much closer supervision of national budgets. We have been avoiding debt issued by the European Financial Stability Facility, the eurozone’s bailout fund, just as we have remained cautious about eurozone government debt for some time.

5. Source: U.S. Bureau of Economic Analysis, 22 December 2011.

6. Sources: U.S. Bureau of Labor Statistics; U.S. Federal Reserve, January 1980 through November 2011.

7. Source: The World Bank, EAP Half-Yearly Update, November 2011.

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Strategic Income Investing

Pursuing Income in a Low-Yield Environment



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In the current environment of generally low fixed income yields, one of the questions we get asked is where to look for the best risk-adjusted fixed income opportunities that can generate income.

When speaking about risk in the context of fixed income investing, there are two basic types: credit and interest rate. Of the two, many investors tend to focus on credit risk, or the risk of not getting their coupons paid and/or their principal back. However, when longer-term interest rates rise, the price for government bonds will generally move lower (and the longer the maturity of a bond, typically the greater the downward price move). Considering the historically low rates currently being offered in many of the developed-market government bond markets (such as those of Japan, the U.S., Germany and Canada), investors are not getting paid very high yields to invest in these countries' bonds. While inflationary pressures are expected by many to remain subdued over the near term, the potential longer-term impact of government debt funding needs from these countries, combined with very low current yields, does not make these fixed income sectors very compelling longer-term investments, in our view.

Conversely, we think the "risk-on, risk-off" volatility we have experienced across the global financial markets in 2011 has created opportunities by somewhat indiscriminately driving price performance for various sectors of the fixed income markets. For example, we regard the fundamentals for the corporate credit sectors (high yield, investment grade and leveraged bank loans) as having been fairly strong and supportive recently. Third-quarter corporate earnings were generally above expectations, corporate liquidity is high, and the default rate continues to remain near cyclical lows. Despite these supportive fundamentals, security prices in the credit markets have largely moved up and down this year based on headlines from the eurozone and the U.S., as well as from moves in global equity markets. As a result, we believe

valuations across the corporate credit markets provide attractive compensation and yields relative to our assessment of credit risks, so we have sought to take advantage of these dislocations to add selective exposure to credit. We have particularly focused on high-yield corporates in the latter half of 2011, given the more significant underperformance of that sector relative to others.

The non-U.S. dollar-denominated government bond sector has been another area that has been negatively affected by swings in market sentiment over the past year. We think the fundamentals for many of the countries and underlying currencies that we have invested in are still very supportive, particularly as we look at the comparative growth rates for certain Asian countries relative to the U.S., eurozone and Japan.

Another approach that may help to mitigate the longer-term potential for rate increases is to purchase floating-rate instruments. Floating-rate leveraged bank loans, for instance, adjust their interest rates over time (tied to short-term rates). Consequently, if interest rates were to rise, these loans would not tend to see pressure on their prices, and could possibly benefit over time as short-term rate increases could lead to additional income distributions on these loans. Similar to high-yield corporates, bank loans are sensitive to economic growth, and fundamentals have been supportive for this asset class as recent default rates have been low and corporate earnings growth positive.

Overall, headline news has certainly added to the daily volatility across financial markets, and income opportunities in certain government bond markets have been more limited. However, by leveraging our in-house research resources, focusing on longer-term fundamentals and assessing both credit and interest rate risks, we have been finding what we believe are attractive investment opportunities as we position our multi-sector fixed income portfolios.

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Mutual Series

European Equities: Seeking Value in the Midst of the European Debt Crisis



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Any comment on the European sovereign debt crisis seems to have a short shelf life these days as observers' focus shifts to the next summit or major development. Unfortunately, the sense of urgency among European politicians for addressing the issues does not seem to match the financial markets' much shorter time horizon. As a result, the markets have been putting pressure on politicians to find a viable solution as time may be running out to prevent a major catastrophe. In our view, the European equity markets are unlikely to recover until there is a comprehensive resolution, but for now politicians seem to be hopping from one summit to another.

Regarding the impact of the sovereign debt crisis on equity markets, shares of European banks have generally been receiving the brunt of recent shock waves. As the largest holders of the region's sovereign debt, European banks stand as the major channel of contagion. They are faced with the dual challenge of having to write down their exposure to southern Europe's sovereign debt and the need to increase their capital ratios. In view of these pressures, particularly the risk of significant equity dilution, the Mutual Series team has been highly cautious about the region's banking sector.

Additionally, even though shares of banks may have experienced the sharpest

selloffs throughout the crisis, investors have been generally indiscriminate and sold off shares of European companies in just about every sector.

We have been finding value in companies that are domiciled and traded in Europe but are not significantly European in their footprint—for example, large, multi-national companies that derive a significant portion of their profits from markets outside of Europe that are anticipating a relatively higher rate of gross domestic product growth in the coming year. These exporters have also been benefiting from an added competitive advantage derived from the decline of the euro against other global currencies. More than ever, we continue to focus on large companies with solid balance sheets that are not fully reliant on banks to finance their operations.

Presently, we have been finding opportunities among consumer staples companies in the tobacco, food and beverages industries that pay attractive dividends—something we welcome as a sign of good corporate health in this current environment.

Overall, we have continued to favor well-diversified portfolios, with risk spread among a large number of investments, and we have tended to hold cash, which can be helpful in managing risk during difficult market scenarios.

All investments involve risk.

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