Standard Life Investments

GARS Update

GARS was built for times like this - August 2011

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Most investors realise financial markets have been turbulent but many would also be surprised to learn just how volatile they have been in recent days. The US equity market, represented by the S&P 500 Index of largest stocks, recently exhibited the third largest weekly fall in the past 50 years! Many major global stock markets recently showed daily moves of 3-5%, and intra-day movements were even larger. Under this surface, many individual stocks were down 35-40% in just 7-10 days without there being any new company-specific news. This contrasts with the market falls in 2008 that were pre-dated by a slew of corporate profit warnings in the month before and many more after the event.

For many people the most frightening thing about markets at the moment is the fact that they are so binary. There appear to be only two prevailing market conditions, namely the current full-scale panic or the indiscriminate buying of risky assets. This poses two critical questions for investors:

1. Why have things become so black and white?
2. Is it still possible to achieve genuine diversification?

Feast or famine

The 'risk-on', 'risk-off' nature of markets is a function of a number of factors but at the root is the fact that economic growth is very fragile. This has not been a surprise to us. From late 2008 we have expressed the view that sharp reductions in interest rates, the absorption of banking losses by the public sector and the huge credit creation programme in China would be sufficient to cause a weak economic recovery. At the time we were quoted as saying that a floor had been put under the global economy, but not a trampoline. Our caution was driven by recognition that the much talked about need to deleverage Western economies had not really happened; there had simply been a transfer of borrowing from the private to the public sector. This placed much of the uncertainty relating to the ultimate scale of losses into the 'stronger hands' of governments.

Our view was that this increase in government debt would ultimately pressure them in the direction of fiscal responsibility, which would in turn limit the possible speed of economic growth. A low growth world with governments hampered in their ability to smooth over soft patches, whatever the cause, is a volatile world, and never very far from the fear of recession. In addition, there has been an increase in regulatory pressure on banks. This has had the effect of restricting their activities, so many have had to draw back from proprietary trading. This results in less risk-taking capital available in the global financial system to absorb trades driven by short-term newsflow.

This is why, on the short timeframes over which most people make investment decisions, markets have become feast or famine. Consequently, it becomes difficult to avoid being drawn into micro decisions as to the 'risk-on', 'risk-off' characteristics of the coming month or quarter.

Is it still possible to achieve genuine diversification in today's market climate?

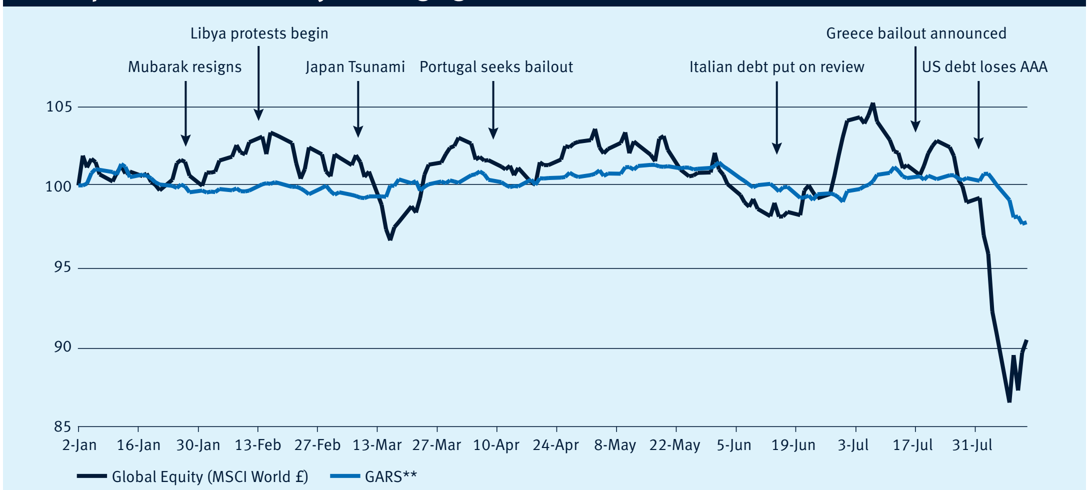
We believe it is, but only by taking longer-term views is it possible to rise above the short-term binary nature of markets and achieve genuine diversification.

Within our Global Absolute Return Strategies Fund (GARS), we have prospered in recent years from taking long range views. We are comfortable with the fact that many of our positions, on a quarter-by-quarter basis, will perhaps tend to go in opposite directions. For example, owning both high-yielding corporate bonds and Australian government bonds recently has rarely been simultaneously rewarding on any one day, week, or even quarter. However, on a multi-year view we have been well rewarded for both these positions as the market has come to appreciate the value of assets with reliable yield in a low interest rate world, and the wisdom of lending to solvent governments or corporate entities with strong balance sheets.

We genuinely believe that GARS was built for times like this and we do see some real opportunities to extract well-balanced performance from the current market conditions. Some of our themes are very familiar and have already been in the portfolio for some considerable time. For example, given serious concerns about a recession that we think unlikely to happen, and with the US central bank indicating that they will not raise rates for at least two years, the environment for credit could not get much better and so we like high-yield bonds in the US and globally.

We also like European financial sector credit because rehabilitation of the banking sector is crucial to restoring financial order. We combine these risk positions with interest rate positions in fiscally prudent countries such as Sweden, Australia and even Mexico. We made good use of the crisis to introduce a new position where we sold the Swiss franc and bought the Norwegian krona as the former was exhibiting all the symptoms of an overbought safety first position.

Stable performance in a very challenging 2011



Source: Standard Life Investments, 12 August 2011
**Return data relates to the pooled UK Institutional GARS portfolio

These are the reasons GARS has behaved less violently than equity markets recently, retaining its balanced risk characteristics as it did in 2008. We believe swings in market sentiment are likely to continue, causing more unrest for investors. By contrast, GARS offers a more assured path, continuing to demonstrate that by taking a longer-term view and seeking genuine diversification, it is possible to combine long-term returns with shorter-term stability.

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