Investment Solutions for Investors with Low Appetite for Volatility

The banking crisis and property crash have provided an extraordinary lesson for Irish investors on some of the most important aspects of investment portfolio theory, particularly with regard to concepts such as counterparty exposure, asset class, sector, currency and geographic diversification and liquidity. Even since the dramatic destruction of wealth visited on Irish investors since 2007, professional advisors and pension fund managers continue to market supposedly "diversified" portfolios with as much as 70% exposed to specific asset classes such as equities or long dated Sovereign Bonds. Irish Managed pension fund surveys point to equity allocations in excess of 75% despite historically high correlations between different stockmarkets. Private client stockbrokers, bloodied from their ill-fated foray into private equity funds and syndicated property deals, have moved back to advising almost solely on shares and Sovereign Bonds but again with little in the way of a structured or robust approach to risk management.

Bank depositors through the turmoil of the last three years have also come to a better understanding of the concept of counterparty risk. At the height of the crisis surrounding the Irish Banks and the Irish Sovereign in late 2010 and 2011, risks varied from a major default by the Irish banks on their deposits, the ability of the state to honour its guarantee of bank liabilities including deposits, to a redenomination of deposits from Euros into a heavily devalued new Irish currency. Subsequent IT problems at Ulster Bank have reinforced the view that bank deposits like any other investment face their own specific set of risks and should be approached on the basis of reconciling the level of return with the level of risk and never being over-exposed to any one counterparty or risk no matter how secure these appear.

The objective of this paper is to outline an alternative approach to investing "safe-haven" funds in a way that minimises risk of loss of buying power either through investment loss, counterparty default or inflation erosion.

An Appropriate Benchmark for Safe-Haven Funds – German Bonds or Irish Deposits?

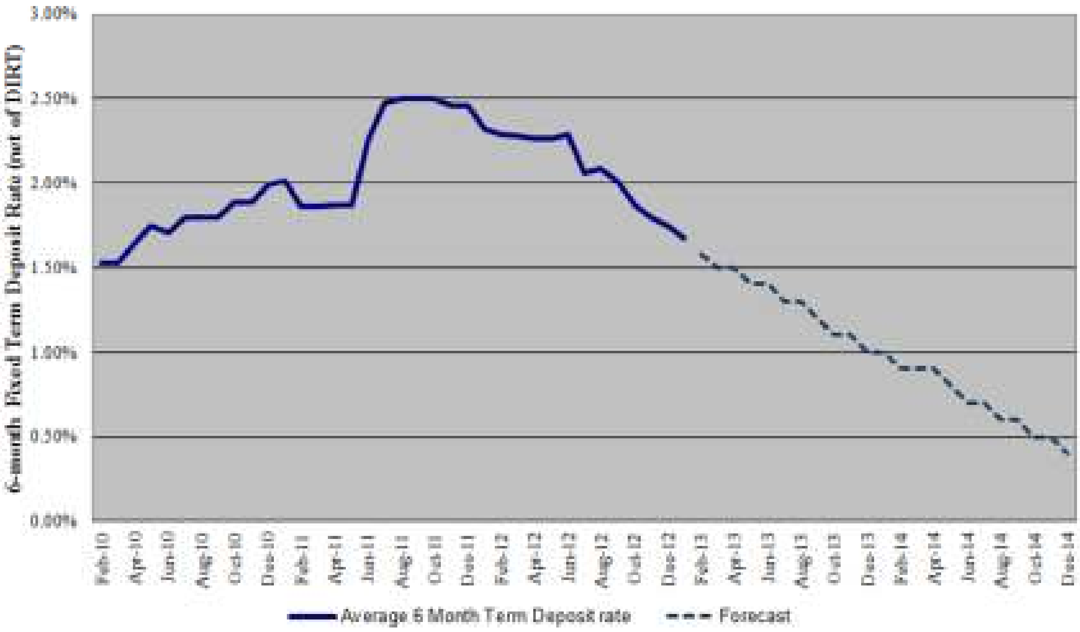
A major consideration in approaching the construction of a "low-risk" investment strategy is agreeing an acceptable level of return. Short dated German Treasuries are generally viewed as the benchmark risk-free asset for Euro based investors. Despite this status these assets currently afford not only the protection of the German taxpayer, but also a guaranteed loss over the term of the investment due to the negative yields priced into the bonds when trading costs are allowed for. A benchmark level of return of minus 0.25 -0.5% hardly seems attractive regardless of how conservative you might be in terms of investment risk appetite.

Figure 1. Yields on German 2 Year Sovereign Bonds Have Fallen to Close to Zero

Source: Bloomberg

Irish investors have traditionally used bank deposits as their benchmark for investment returns. Recently, however, it has been difficult to call any exposure to Irish banks "risk-free" and the relatively high level of deposit rates offered by Irish institutions have reflected this. As the conditions facing the Irish banks improve, and they have in our view improved, their appropriateness as a benchmark may also return. However, this improvement is being accompanied by a corresponding fall in the interest rates offered to investors. Assuming the risks associated with the Irish banks continue to reduce, the outlook for deposit rates is for a rapid migration towards the ECB reference rate of 0.75% or lower. The imperative for the banks of rebuilding capital ratios and profitability will likely keep rates significantly below the prevailing level of inflation for some years.

Figure 2: Irish Fixed Term Deposit Interest Rates Reducing as Bank Funding Stress Eases



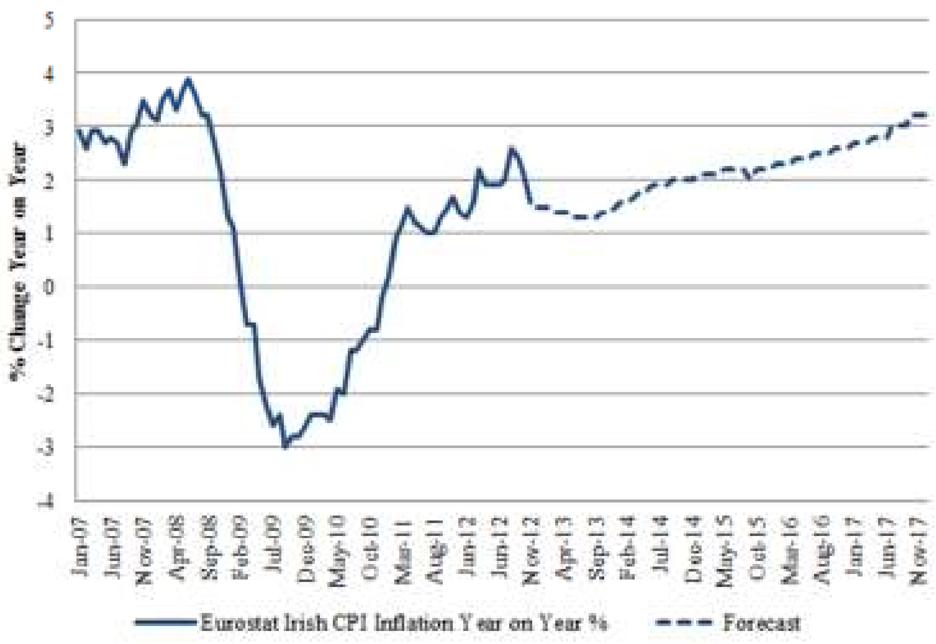
An Alternative Approach – Diversified Portfolio Approach to Safe-Haven Investing

Bearing in mind that one stop risk free approaches such as a short dated German Bond or a bank deposit offer a negative return when account is taken for inflation while at the same time presenting a concentration of risk, an alternative approach is warranted. **The following are the steps we believe should be taken in constructing a low-volatility safe haven portfolio where preservation of buying power is the first priority.**

Step 1: Identify the "risk free" rate of return.

While no asset can truly be described as "risk free", conventional investment theory generally benchmarks returns against an agreed low risk asset, usually a highly rated Government bond or cash instrument. For Eurozone investors this has generally come to mean AAA rated German Government bonds, which for investors with a 2-3 year investment horizon, implies an expected annual return of 0 – 0.2%. We believe, however, that in implementing an investment strategy which seeks to protect the buying power of accumulated wealth first and foremost, the risk free level of return should be subject to a minimum of the expected rate of inflation over the anticipated investment horizon.

Figure 3. Irish HICP Inflation Recent History and Forecast



Source: Eurostat and Wellesley I&P

Irish Consumer Price Inflation for 2012 averaged about 2% which exceeded forecasts due to the impact of increases in the pricing of Government services and higher food and oil prices. Expectations for 2013 are for a slightly lower rate of price increases (1.3%)[1], however, this is based on the effect of higher oil and food prices rolling off in 2013 and does not allow for the continued high inflation in the prices of government services and indirect taxation. Over the medium term, given the level of monetary expansion being undertaken by all of the major Central Banks, we would envisage an increase in inflation rates driven partly by higher commodity prices. Irish consumer price inflation is likely to be further underpinned by relatively strong underlying demographics and some degree of rebound from the recession.

It is also worth noting that the relevant inflation rate varies by demographic. A young worker just out of full time education and benefitting from lower housing costs faces a very different environment to a recent retiree

[1] Central Bank Quarterly Bulletin Q3 2012

who is more likely to be exposed to the significant inflation in state healthcare costs, property taxes and energy costs. Looking over a 5 year horizon, we believe an average inflation rate of 2.5% is realistic with rates moving higher over time. This is we believe an appropriate net investment return target for low-risk investors.

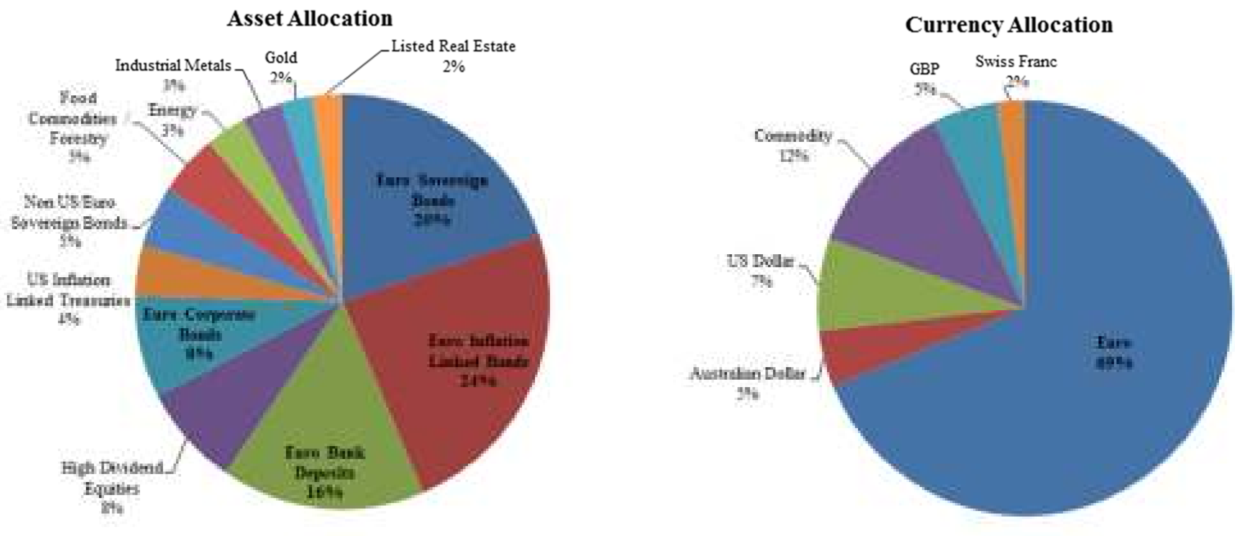
Step 2: Identify a blend of assets that will provide the target low risk return while minimising investment volatility.

Put simply the objective is to construct a portfolio that is extremely robust in terms of counterparty risk and volatility and which can deliver a return after costs and tax of at least 2.5%.

The first principle in minimising the risk and ensuring the safety of the strategy in preserving capital is to ensure diversification across every conceivable risk exposure. Counterparty, sector, asset class, currency and interest rate exposures are all capped with lower volatility and short duration Euro assets allowed a higher limit so that these can form the secure core of the strategy.

Step 3: The level of interest / dividend yield applying to each component is applied to the portfolio and weightings adjusted until the net yield of the portfolio reaches the relevant return level, in this case 2.5%. Specific investment views and opportunities are also overlaid on the strategy but remain subject to the overall diversification of the portfolio being maintained and the core allocation to low volatility assets not being compromised. Non-interest / dividend bearing investments are only included where they provide a direct correlation with expected inflation movements (e.g. oil, food commodities, metals, etc.)

Figure 4: Sample Asset Allocation of a low-volatility well diversified portfolio



Step 4: Stress Testing

The resulting portfolio should be comprehensively stress-tested using both historical precedences and potential future events regardless of how extreme these may seem. The risks faced by an investment portfolio change constantly and so along with reviewing the portfolio's exposure to a given list of threats, the list of risks themselves should be closely monitored and updated. Medium term threats that we currently use for testing portfolio robustness include: impact of a 40% fall in global stockmarkets, 5% increase in base interest rates; oil price increasing to $200 per barrel; Major Eurozone Sovereign default, Geo-political deterioration in China, etc. Any significant risk exposures identified should be addressed by reducing relevant positions or increasing offsetting exposures.

Step 5: Liquidity and Active Management

Liquidity or ability to access funds or rebalance the portfolio at short notice remains, in our opinion, an important factor in terms of reducing investment risk. In general we would be of the view that there needs to be a very strong financial reason to sacrifice the ability to access funds on demand and where possible the investment portfolio strategy outlined above should be executed using listed, tradable assets, held directly in the name of the client and which can be sold at short notice without penalties or exit restrictions. Where fixed term investments such as government or corporate bonds are included as part of the portfolio these should be of benchmark issue size, which basically means that there is a readily available liquid market for these securities if they are to be sold before the final maturity date.

Flexibility and nimbleness in terms of adjusting the portfolio to reflect changes in market risks and to take advantage of specific short term opportunities also differentiates this approach from what is effectively a "buy and hold" approach adopted by the traditional Irish fund management industry. Rapid and significant adjustments to asset allocation can significantly reduce the volatility of investment portfolios as well as allowing funds to take advantage of short term trading opportunities.

Conclusions

Investors seeking first and foremost to protect their wealth have traditionally looked to bank deposits and highly rated Government bonds as the sole basis for investment. Negligible returns on these assets and the dramatic downgrading of the credit quality of both deposit taking banks and most Sovereigns require a change to this approach. We advocate a portfolio approach based on the following key principles:

1. **Returns should be based on the anticipated rate of inflation to protect the buying power of accumulated wealth;**
2. **A portfolio should be constructed from the lowest volatility assets upwards until the targeted level of return is achieved based on income yields on the various assets;**
3. **Investments should be diversified across every conceivable heading with defined limits according to the volatility of each sector / asset class;**
4. **Investments should be regularly "stress-tested" as investment risks change and portfolios adjusted for these.**
5. **Safe-haven investment portfolios should be liquid, easily traded or accessed and proactively adjusted and rebalanced to reflect the changing tradeoff between risk and return.**

Wellesley Investments & Pension Ltd.

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