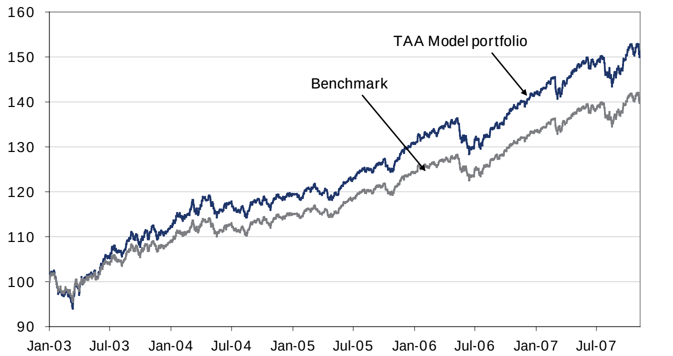
Tactical Asset Allocation

Danske Capital • 9 Nov. 2007

Historical Performance

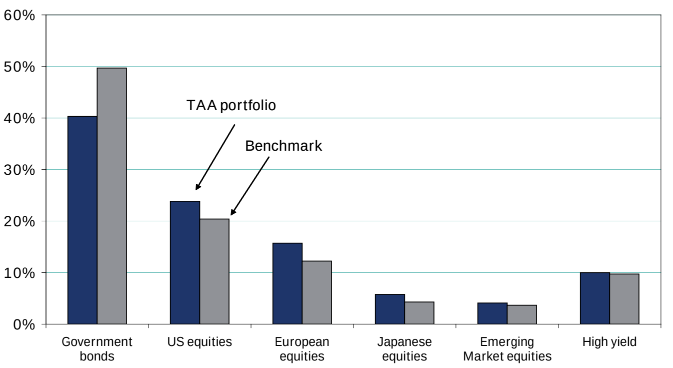
TAA Performance



Information Ratio: 1.4

Current recommendation

Model portfolio November 2007



Note: Benchmark is rebalanced at the beginning of each year

Performance results:

Portfolio return 2007 (ytd):	5.6 percentage points
Performance 2007 (ytd):	0.9 percentage points

This is the toughest decision this year – we can no longer justify recommending a 3 percent overweight in GEM. We have therefore decided to reallocate the 3 percentage points to global equities.

Are EM equities overvalued? In absolute terms, our answer to that question is no. However, in relative terms, they are getting there! Importantly, we think most of the fundamental story has now been priced in and further upside from here will most likely involve increasing levels of exuberance. Consequently, we find ourselves in a situation where we can no longer recommend putting new money into GEM at the current point in time, unless the investment time horizon is longer than usual and, crucially, risk tolerance is high.

EM (on the face of it) seems to have decoupled completely, in terms of economic growth as well as in terms of equity market performance. The latter, especially, is causing us a severe headache. The broad EM equities are starting to look stretched on a number of metrics (a few of which are shown in this publication). To us there are two important points. The first is valuation and the second is market sentiment. EM equities no longer trade at a discount to developed equities (in fact they trade at a premium on a number of factors). Is that a problem? No – we think it is fully justified by the superior growth outlook and the structural changes across EM economies.

It does mean, however, that the fundamental story is priced in which leads us to the next point – market sentiment. EM is the only market that displays euphoric characteristics, with total ytd return in excess of 40 percent, including a massive rally since mid-August. Key to the above considerations, however, is the fact that there are important regional differences within GEM, with Asia showing tentative signs of being outright overvalued (China, of course, already is), while Eastern Europe and, to a lesser extent, Latin America, still appear reasonably attractive.

Where does that leave us – with a serious challenge! We are still fundamentally positive on the EM growth outlook, but by recommending an overweight of 3 percentage points to GEM, 50 percent of which is Asia, we are exposing ourselves to various types of risk that we do not think we fully understand – one particular point in mind would be Chinese politics, another would be the liquidity story and the last is commodities. Internally, we bought Eastern European equities and GEM Small Cap, when we in-

creased our weightings in September (options we do not yet have in our recommended model portfolio). We are sticking to those positions, due to reasons outlined above as well as the defensive character of the GEM Small Cap product.

However, we cannot recommend buying broad GEM at this point. But, crucially, we continue to believe that developed market equities offer significant value.

We are fundamentally positive on EM, and all the quantitative work we have done on EM suggests that the stage is set for a further rally. We think it unlikely that EM will correct without a serious global equity correction (which we do not expect), and finally, the broad liquidity story in Asia, which remains one of massive wealth creation and nowhere to put it, can run a very long way. However, markets are stretched so we opt for a more cautious stance.

Having just returned from New York, it is clear to us that the subprime crisis is far from over and will cause much volatility in the foreseeable future. We stick to our call of a worst-case scenario economic loss related to subprime/ Alt A of USD200bn. However, it is also crystal clear from our range of meetings and, more importantly the spate of speeches, comments and statements from the Fed that monetary policy makers in the US are trying to be ahead of the curve and performing risk management with a capital R. They want to ensure that a seriously negative (though low probability) outcome does not materialise.

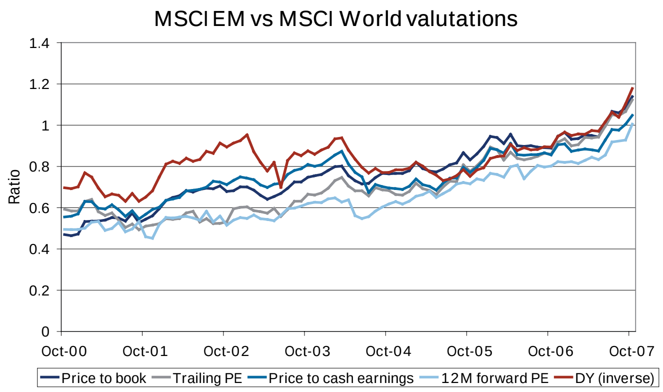
We think it will take serious stress in markets to make the Fed ease again and thus call for the Fed to be on hold at 4.5 percent well into 2008. However, our track record in predicting market hysteria has been very poor recently and further disturbance from here will put extreme pressure on the Fed given their decision to go neutral in October.

Latest strategy changes:

09/11/07	Emerging Market equities downweighted 3%, global equities upweighted accordingly. Overall equity overweight unchanged
13/09/07:	Emerging Market equities upweighted 3%, bonds downweighted accordingly.
08/06/07:	Equities downweighted 5%, bonds upweighted accordingly. Global equities downweighted from 8% to 4%, European equities downweighted from 2 to 1%. Overall, equity over-weight 5%
25/04/07:	Global equities downweighted 2% to 8% overweight, bonds upweighted accordingly, European equity 2% overweight retained, overall equity overweight 10%
01/01/07:	Equities upweighted 2%, bonds downweighted accordingly
22/08/06:	European equities upweighted 2%, bonds downweighted accordingly
07/06/06:	Japan, Emerging Markets downweighted to neutral, USA upweighted to neutral
01/01/06:	Equities overweight increased to 8% at the expense of bonds
06/12/05:	Cash downweighted to neutral 0%, bonds upweighted accordingly Europe downweighted to neutral, US upweighted accordingly to -5%
20/10/05:	Japan overweighted to +3%, USA downweighted to -7%

Quantitative indicators for Tactical Asset Allocation

Asset classes	Equities/Bonds	High Yield/Equities	High Yield/Bonds
Valuation (+/- 2)	buy(+2) Yield gap	sell(-2) High Yield gap	neutral (0) Credit Spread
Trigger 1 (+/- 1)	neutral (0) Risk appetite	sell (-1) Slope of the yield curve	sell (-1) Slope of the yield curve
Trigger 2 (+/- 1)	neutral (0) Production	neutral(0) Capacity Utilisation	buy (+1) Real Interest Rate
Trigger 3 (+/- 1)	neutral (0) Volatility	neutral [0) Volatility	buy (+1) Investments
Total Score (+/- 5)	+2 buy	-3 sell	+1 buy

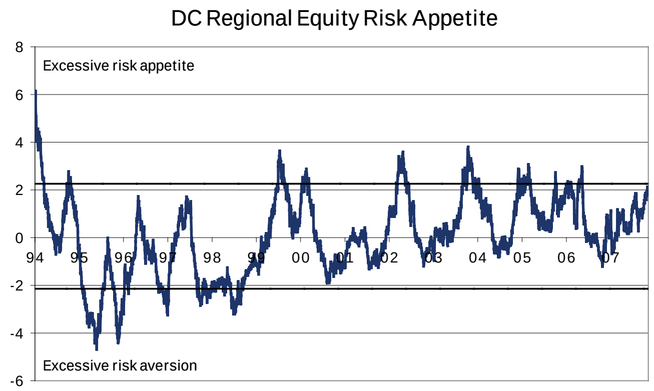


Emerging Markets – the new safe haven?

When we increased our weightings at the beginning of September, we argued that the broad EM equities should trade at a premium to developed market equities. We were not expecting this to materialise so soon.

As can be seen from the chart to the left, EM performance for the past two months has resulted in EM trading at par or higher than developed markets on a range of factors.

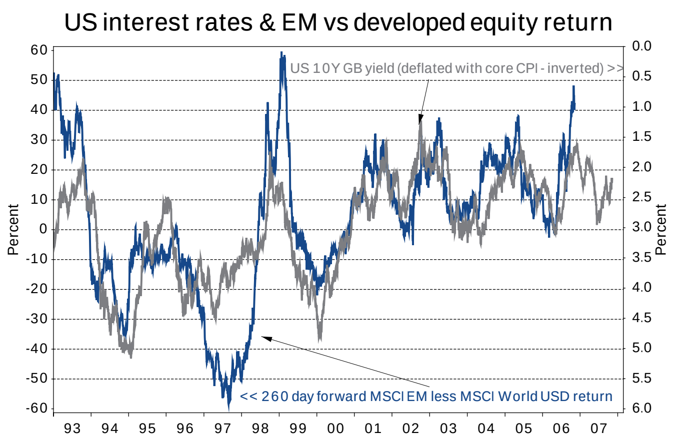
When judged solely on a forward PE basis, EM equities trade at par. That PE however, is built on a higher expected growth rate than for developed markets, implying that a lot has been priced in.



Our risk appetite index is composed of five different sub-indices, one of which is shown to the left, covering a range of different asset classes. The chart compares the130-day risk-adjusted return for GEM vs US.

Of the five sub-indices this one is the only index that shows any sign of exuberance (sentiment in credit markets, on the other hand, once again look depressed).

This does not mean that EM cannot move higher. But it does mean that there will be a long way to drop, in case of a significant scare to global markets.



There are, nevertheless, many good reasons for the phenomenal performance of EM equities. On the macro side, EM has clearly changed for the better, with improved internal and external balances and signs of increasing strength in domestic demand.

From an investor's point of view, EM is now much more of a dedicated allocation than it was just 5 and 10 years ago, which should mean less volatility in times of global stress. Furthermore, right now, in times of subprime worries, EM seems to offer a safe haven.

Finally, our quantitative work suggests that lower global interest rates always benefit EM as shown to the left. However as the chart illustrates, EM seems to have moved a bit too far and we thus recommend investors to be very cautious about putting money into GEM at this point in time.

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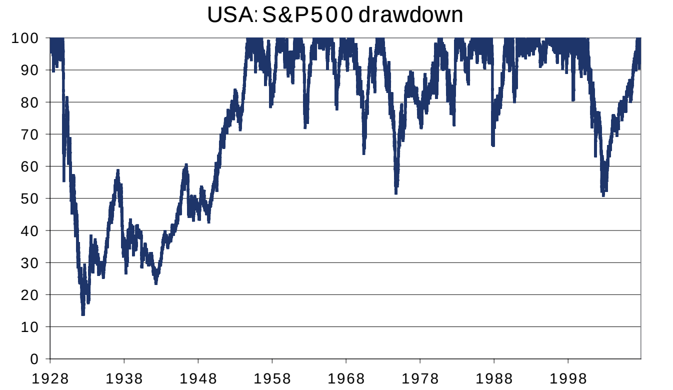
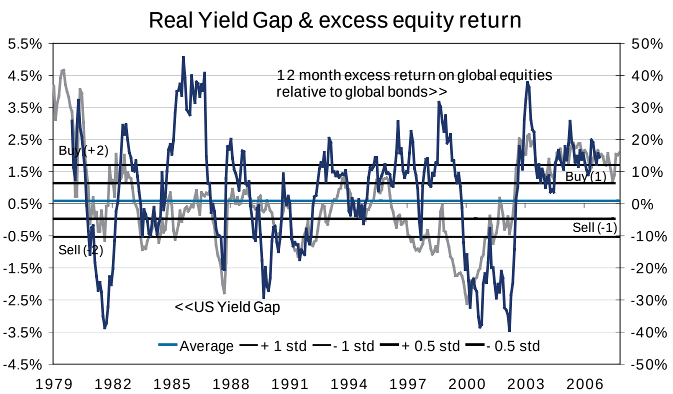


In times such as now where the world (at least the financial one) seems to be falling apart, it helps to take a step back.

One thing to bear in mind is illustrated in the chart to the left. Although days and weeks like the current ones may seem painful, it is nowhere near what we witnessed just a few years ago.

The bursting of the dotcom bubble was one of the largest equity meltdowns in the US in the 20th century. And we have just now recouped most of the value destroyed in the aftermath of the excesses of the New Economy Era. The obvious question to ask is therefore if the credit excesses that we are facing now will prove to be just as painful to the equity investor?



Regular readers will know that we are relatively optimistic about the effects from subprime on the US economy. That optimism of course extends to US as well as global equities.

One reason is the attractive valuations in both absolute and relative terms. Our Yield Gap is once again in extreme buy territory. That signal, however, is built on the consensus forward EPS expectations of continued growth. Where would we be if earnings disappoint? Simple, if earnings in 12 months' time were to fall 15 percent below the level realised so far in the year to the 3rd quarter, the Yield Gap would sit at its long term average. That should limit the downside while also leaving plenty of room to surprise on the upside.