



LABHA
INVESTMENT ADVISORS SA

Indexing Versus Active Management

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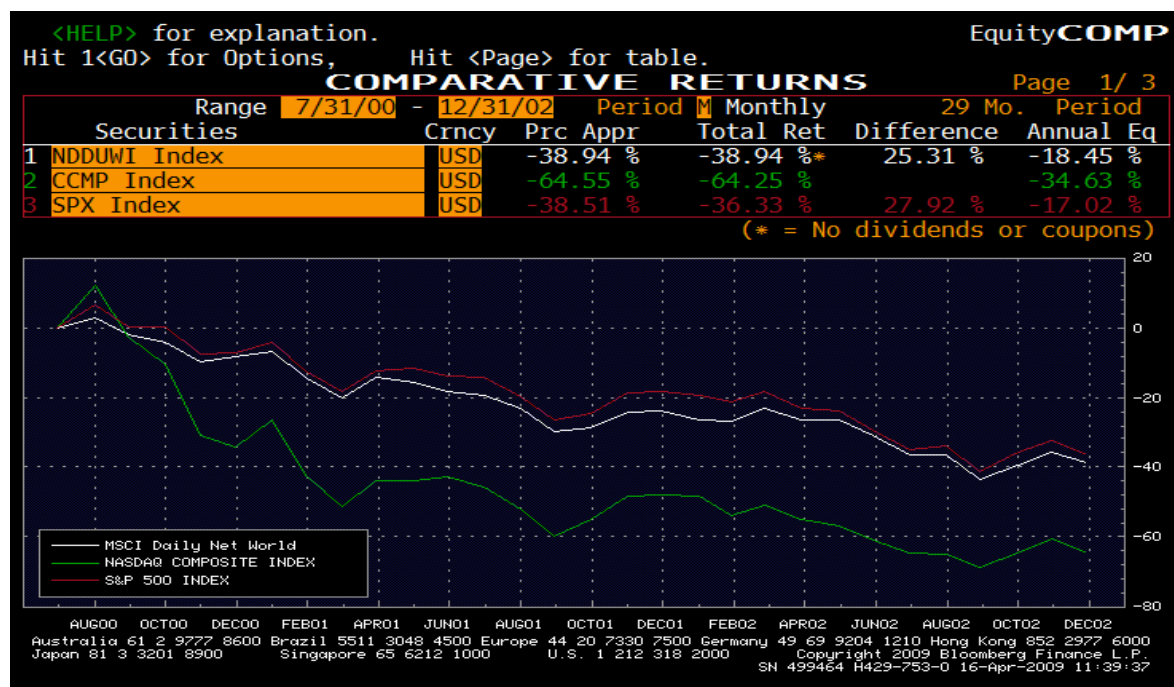
Volumes have been written about the awful equity market returns over the past 10 years and about the growing preference of investors for ETFs (Exchange Traded Funds) investing in broad indices as opposed to having active managers investing their money. Therefore it is worth looking at these two points in greater detail using actual data from the past 10 years.

Equity performance over the past 10 years

Looking at equity performance over the past ten years and concluding that equities are no more the asset class they used to be is a simple conclusion to draw. However, those investors with good active management of their portfolios did not buy and hold equities for the whole period but rebalanced their exposures to the various asset classes regularly. The way successful investors have invested for years is to avoid asset classes, regions, sectors and individual securities that look expensive and buy those that look cheap fundamentally.

Yes the full 10 year period performance of a buy and hold equity portfolio was terrible. However, as developed equity markets were expensive buy any measure in 2000, a marked reduction in equity holdings would have been a reasonable position to take.

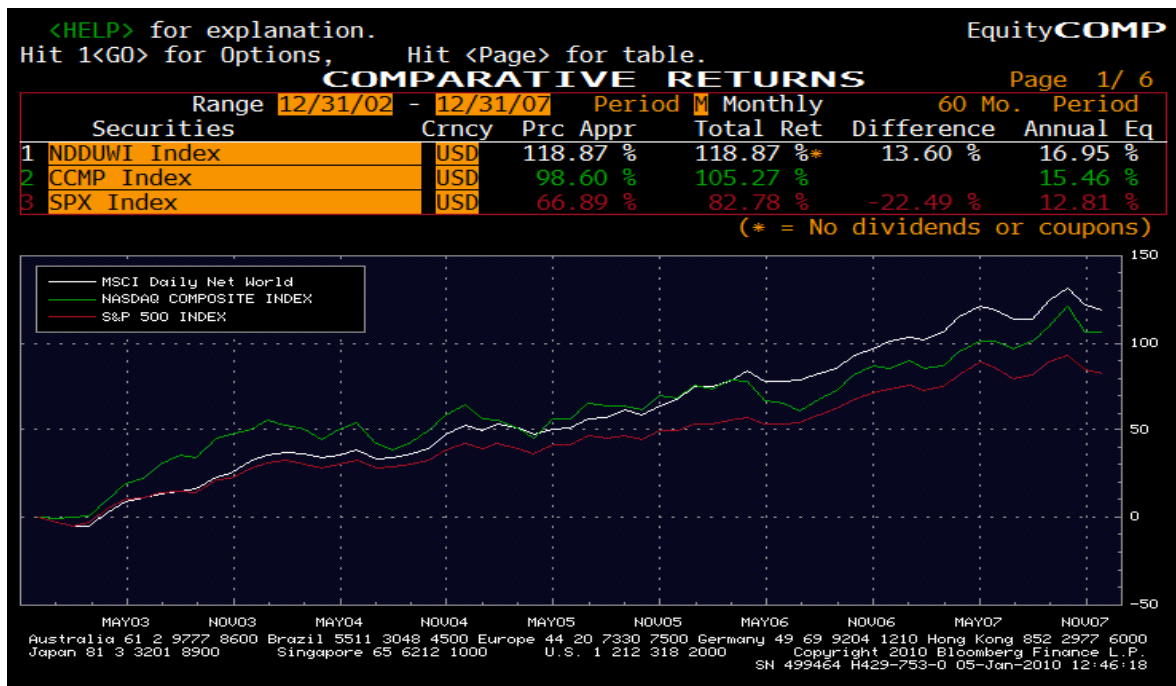
Though LABHA was not founded till 2005, the advice given to clients at the time was to reduce Equity exposure to at least one level lower than usual. i.e. for those who have 75% equities to 50% and for those who have 50% in equities to 30%. Also within this equity exposure rotation was advised from the TMT (Telecom, Media and Technology) sectors into the energy, utilities, consumer staples and healthcare sectors.



MSCI WORLD, NASDAQ and S&P 500 in USD Jul.2000 - Dec. 2002

Source Bloomberg

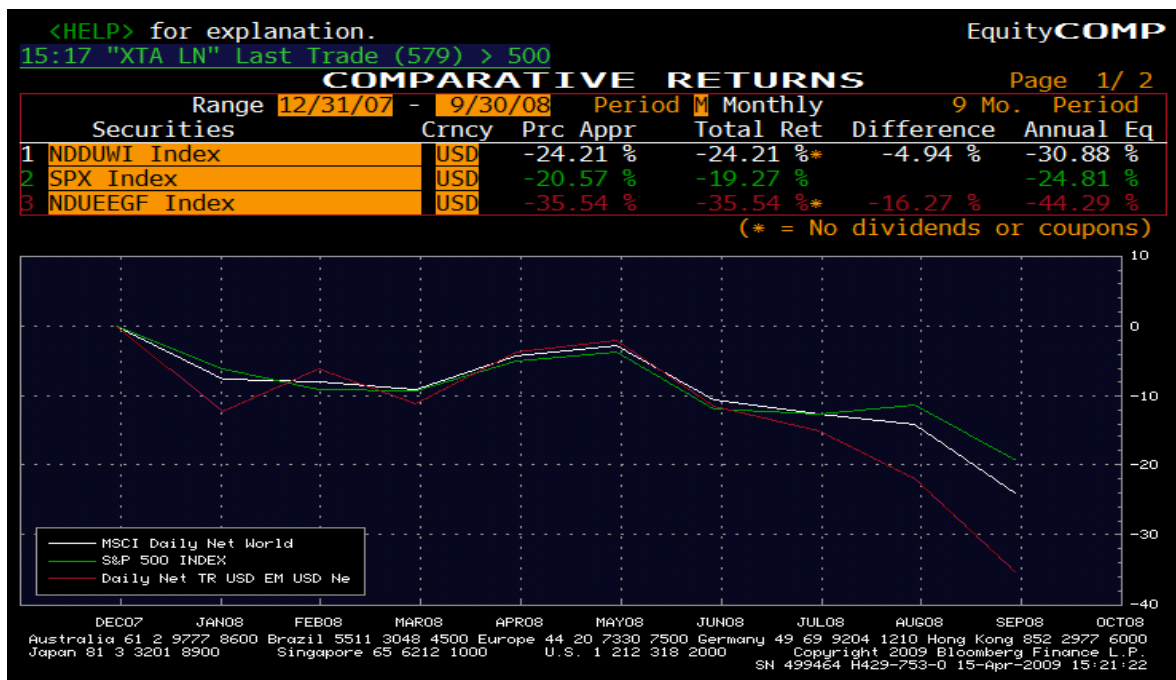
Clients following this advice did very well and achieved a positive performance for 2000 and 2001 that was higher than that of a pure bond or pure cash portfolio. The performance in 2002, the only negative year was much less negative than that of the equity markets but below that of a pure bond or cash portfolio. Equity weighting was then gradually increased starting at the end of 2002. Not exactly at the bottom of that bear market but close enough.



MSCI WORLD, NASDAQ and S&P 500 in USD Dec.2002 - Dec. 2007

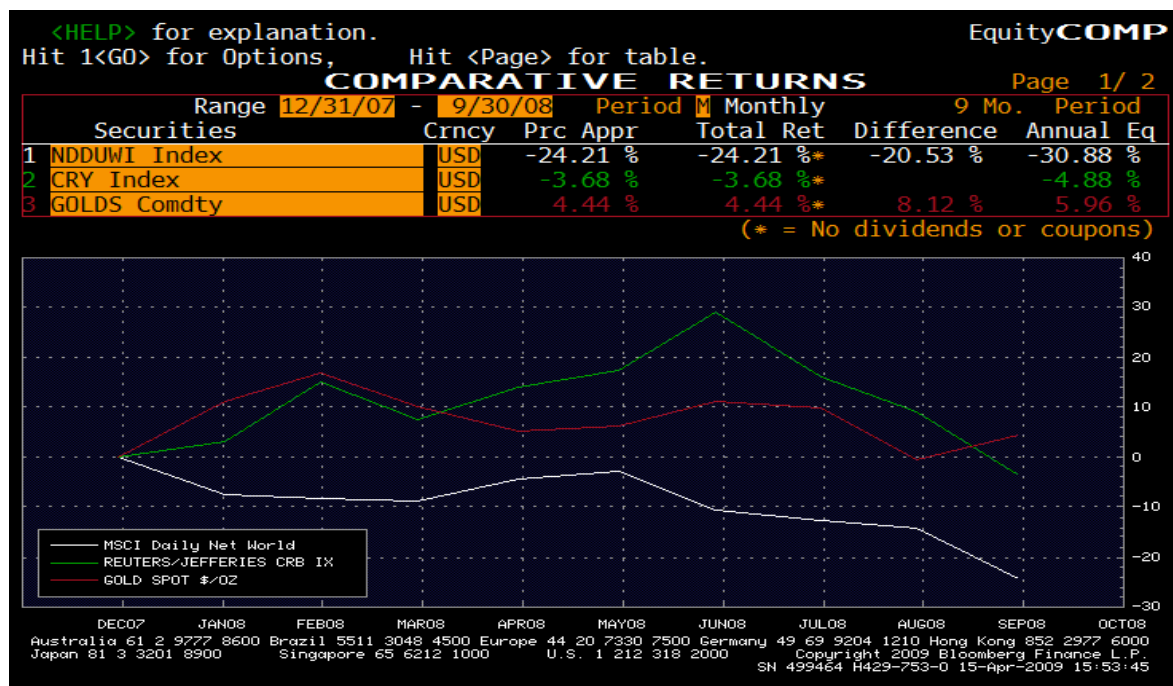
Source Bloomberg

The advice given in 2007 was also similar. The reduction advised was less as equity markets were not over-priced as they were in 2000. From 75% to 60% and from 50% to 38%. For conservative clients the equity exposure was reduced to under 15%. We also increased exposure to government and high quality bonds simultaneously. Advice within the equity exposure was to substantially underweight the financial and consumer discretionary sectors and to regularly rebalance weighting in other sectors. We also advised underweighting Europe and the Emerging markets which had outperformed substantially in the rally of the past 4 years. Equity exposure was reduced further in the first half of 2008 as the markets rallied strongly in the middle of the year.



MSCI WORLD, S&P 500 and Emerging Market Index in USD Jan.1999 - Dec. 2007

Source Bloomberg



MSCI WORLD, Commodities and Gold Index in USD Jan.1999 - Dec. 2007

Source Bloomberg

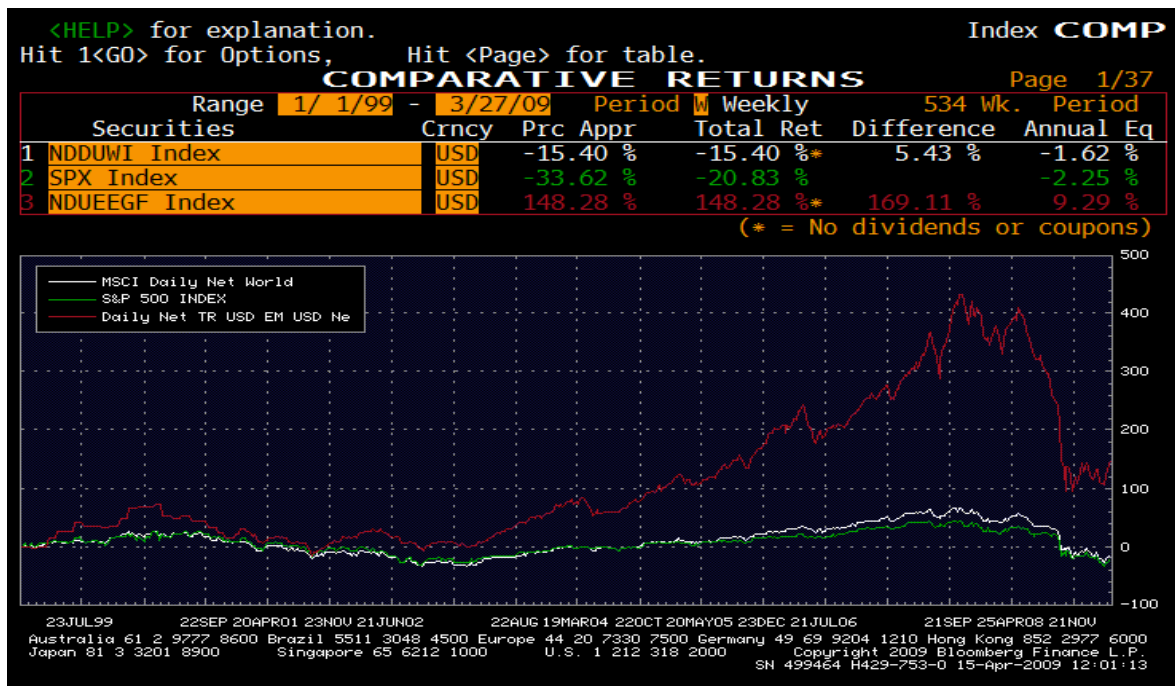
In the last quarter of 2008 we advised increasing Emerging market and commodity exposure while maintaining the underweighting in financials and consumer discretionary. In early 2009 we recommended reducing exposure to government bonds as they looked far too expensive relative to other asset classes. Therefore by avoiding stocks, bonds, emerging markets or commodities when they looked overstretched based on fundamentals and buying them when they looked cheap a capable active manager is able to produce a superior performance over a period of 10 years which makes a buy and hold approach to investing in stocks irrelevant. There may be periods of one or two years where this approach under performs either a pure stock or pure bond approach due to timing issues but these differences are overcome over a five or ten year period.

The above argument ofcourse is mainly a discussion on the asset allocation of the portfolio. So what about the equity exposure of the portfolio?

Why not just buy an ETF based on the MSCI World Index to cover equity exposure instead of an actively managed fund?

The chart below compares the performances of the MSCI World, S&P 500 and Emerging Market Indices from January 1999 to March 2009. Investors have been told for years that if they invest in equities with a medium to long term horizon i.e 5 to 10 years they would be very pleased with the performance as compared to holding bonds or cash. However, the chart below shows that the average yearly return of the S&P 500 over the past 10 years was -2.25% and the MSCI World Index though slightly better was - 1.62%. These are the two numbers that are being quoted most often in the Media. The third number is getting less attention i.e. the Emerging Market performance over the past ten years which averaged an excellent 9.29% per year.

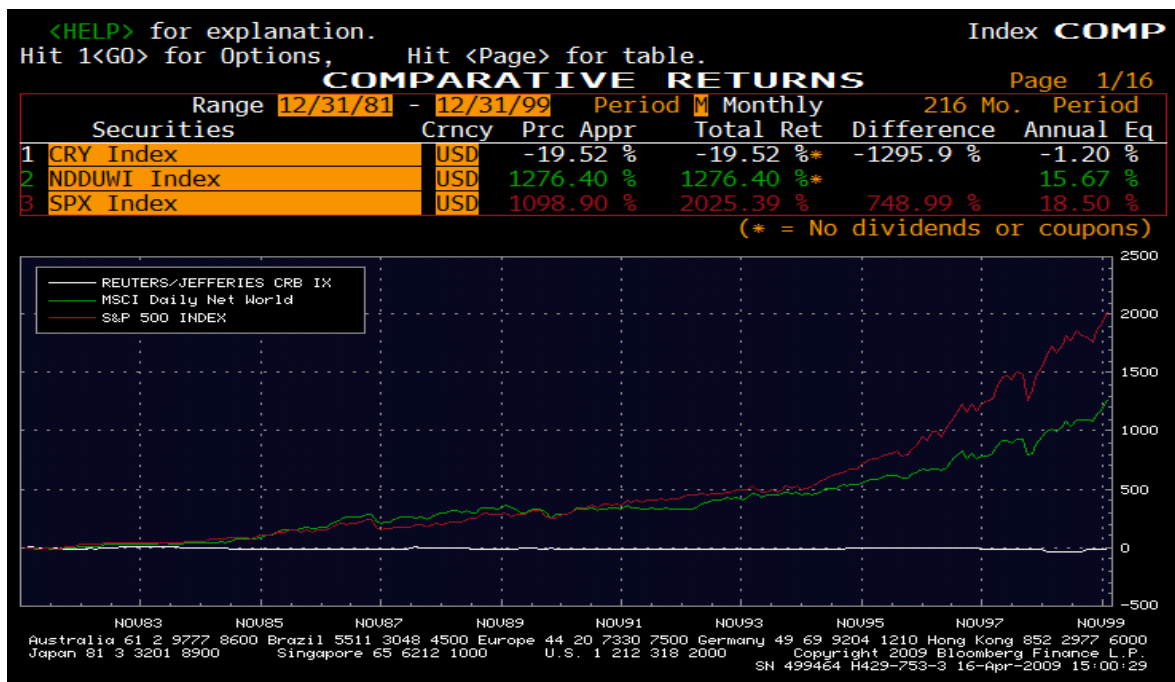
In 1999 it was clear that the Asian markets were very cheap when compared fundamentally with developed markets. They had been severely punished as a consequence of the Asian Crisis the year earlier and were just starting to find their feet. Therefore making an allocation of 10% to emerging markets with about 8% in Asia including India and China and a percentage each in Russia and Brazil would be have been a reasonable diversification. As can be seen from the graph below the S&P 500 was the best performing index from 1981 to 1999, the emerging markets lagged and commodities were the worst performers during the period.



MSCI WORLD, S&P 500 and Emerging Market Index in USD Jan.1999 - Mar. 2009

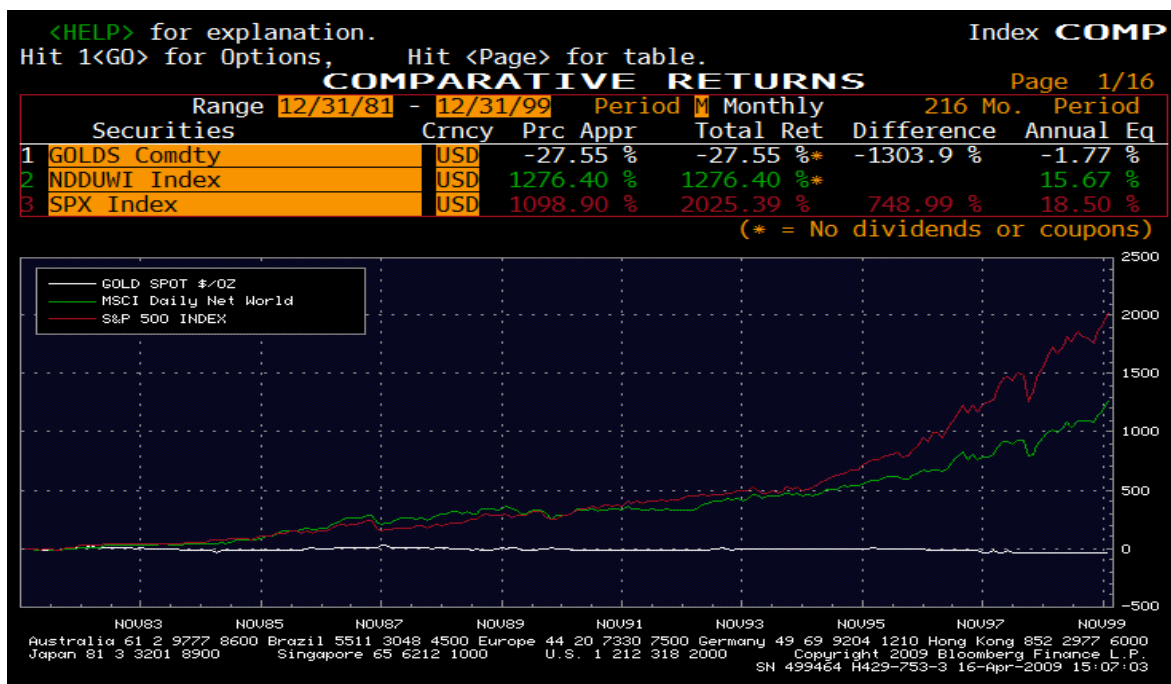
Source Bloomberg

Therefore let us add the Element of Commodities/Commodity related stocks and Gold to the equation. Commodities had experienced 17 terrible years from 1982 to 1999 and prices had dropped severely leading to a lack of investment in supply from 1990 onward. There were already signs that use of commodities per capita was growing in Asia and increase in supply would be very difficult considering the lack of investment in exploration and production over the previous 10 years. This made a 5-10% investment in commodity related stocks a viable investment at very depressed prices historically. (The performance of commodities from 1981-1999 can be seen in the graph above). Gold had also fallen from its highs in the 80s due to a sharp drop in inflation and a rise in the value of the US dollar as well as the increasing emphasis on intellectual property over real assets. Therefore Gold was also a diversification worth considering at this point. The relative performance of Gold can be seen in the graph below.



Commodities, MSCI World and S&P 500 Index in USD Jan.1982 - Dec. 1999

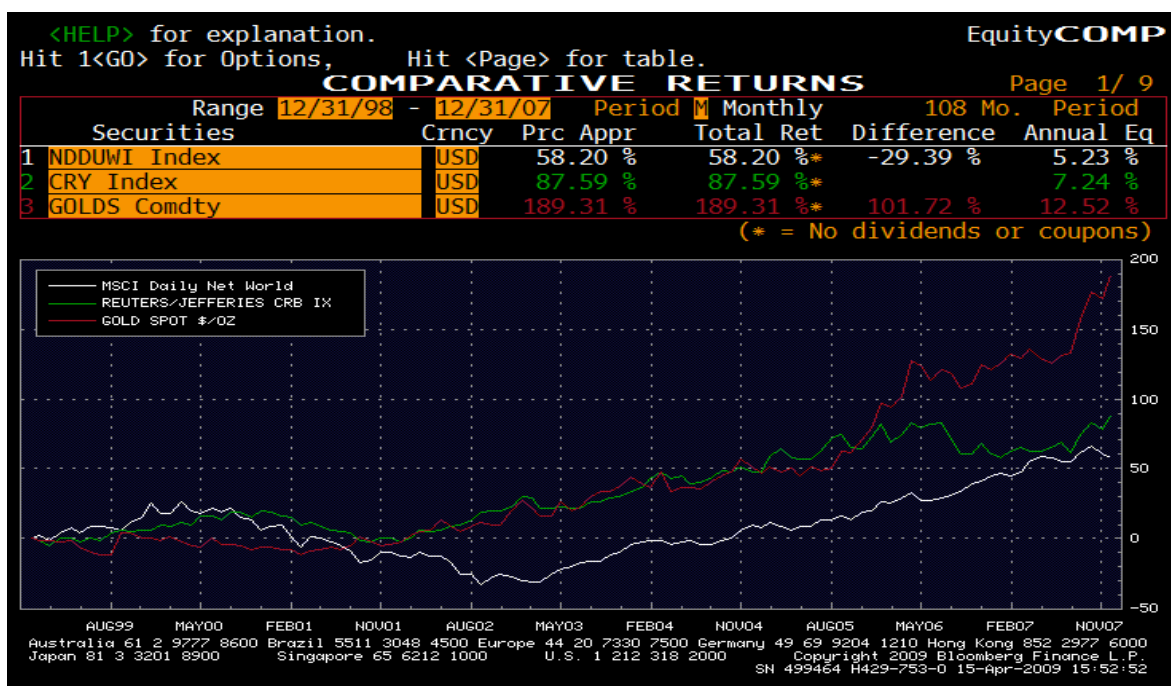
Source Bloomberg



GOLD, MSCI WORLD and S&P 500 Index in USD Jan.1982 - Dec. 1999

Source Bloomberg

It is important to note that though we analysed the situation correctly in the above cases we did not take disproportionate risks and allocate 25-50% of the portfolio to these sectors. An allocation of 10-15%% struck the correct risk/return balance in our opinion. There is enough scope to increase positions if market movements confirm an opinion or reduce them without much damage if something different arises. In our opinion this is the essence of good portfolio management. Balancing risk and return without being too aggressive or too conservative in order to provide consistently superior risk adjusted returns to clients.



MSCI WORLD, Commodities and GOLD Index in USD Jan.1999 - Dec. 2007

Source Bloomberg

Increasing or decreasing weights of sectors and regions has added substantially to performance over the years. In a ETF, regional and sector allocation change after weights change in the index so that an investor is in ef-

fect buying into areas that have done well and selling those that haven't. Superior risk adjusted performance is achieved buy buying or selling ahead of changes in the index and this is not possible with an ETF.

In 1999 the Technology sector had reached over 20% of the World equity index in weight. Today the weight is just 11%. An ETF would have adjusted the weighting after it was adjusted in the Index. We adjusted the weighting in Advance. In 2007 Financials were over 25% of the Global index now they are 19% again the ETF followed while we led. These adjustments can mean a 3-5% better equity performance in years when substantial changes like the ones mentioned above take place.

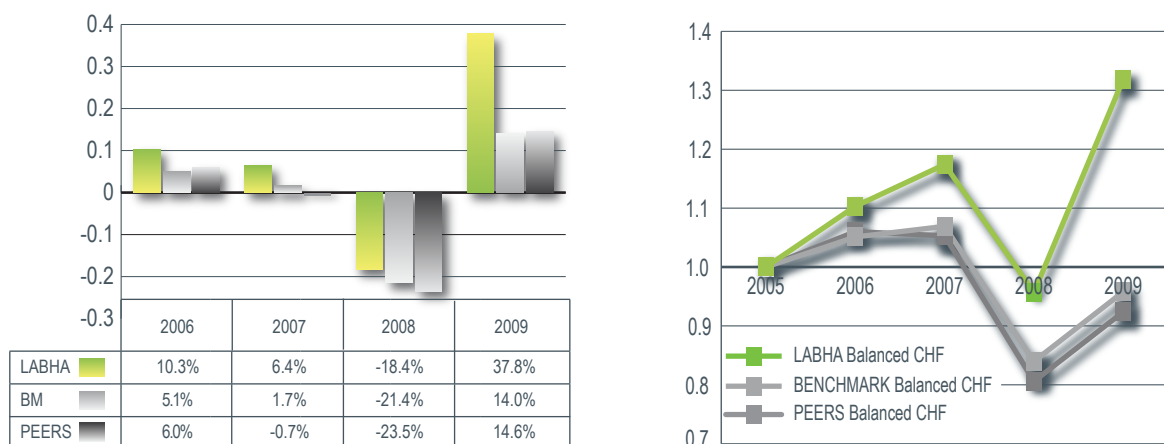
At the regional level the weighting of Japan has declined drastically since the 80s and that of the US and Europe has been in gradual decline while emerging markets increase in weighting. Again ETFs can only follow this trend and will never be ahead of it.

We believe that over the next 10 years several major movements will take place at the regional and sector level and only active management will be able to address this change in advance while ETFs follow.

How has the actively managed portfolio using all of the principles outlined above performed?

Since LABHA was founded in 2005, let us look at the performance of balanced portfolios managed by us from 2006 to 2009. This is a period of 4 years including two very volatile and turbulent ones.

Our clients have benefited from a consistent out performance in their portfolios over the past four years. The table below indicates the yearly performance achieved by the Swiss Franc Balanced portfolios (50% Equity, 50% Bonds) managed by us. We have produced a better performance than the Benchmark (50% MSCI World Equity Index in CHF, 50% J.P. Morgan Global Aggregate Bond Index) and our peers in each of the past four years.



The performance depicted above is the average of performance achieved for CHF balanced portfolios managed by LABHA. Past performance is not necessarily a guide to future expectations. Benchmark: 50% MSCI World Equity in CHF (Net) und 50% J.P. Morgan Global Aggregate Bond Index in CHF. Peers: Balanced Strategy Funds quoted in CHF (Data source: Bloomberg).

In the Graph on the right the cumulative performance of Swiss Franc Balanced Portfolios managed by us is indicated. We have a better performance now than even at the market highs of 2007. This is not the case with the benchmark or our peers which have a negative cumulative performance since 2005.

All of our performance in all portfolios from conservative to equity has been achieved without leverage or being net short. The average Beta of the equity portion of all portfolios is 1.

2006: We were of the opinion that financial stocks had become expensive and that banks were more leveraged than they had ever been. We therefore underweighted the sector in all portfolios. We were a bit early with this decision which reduced our outperformance in 2006. Outperformance was helped by the overweighting of the energy and commodity sectors. At the regional level we over weighted the emerging markets. We were neutral on bonds and held very little cash during this period. Gold was also a permanent position in our portfolios.

2007: We felt that the emerging markets had rallied too strongly in a very short period of time and were looking expensive. We therefore decided to drastically reduce our exposure to them in October 2007. We reduced general equity exposure in balanced accounts to 35%.

2008: In June 2008 we halved our exposure to the energy and commodity sectors resulting in an equity exposure under 30%. We slightly increased exposure to government and high quality bonds during this period. We performed well up to September 2008 but re-established our exposure to emerging markets and commodities a week too early in October. This was the week when indices dropped 25% and emerging markets even more. We therefore ended the year with a less optimal performance than we would have liked.

2009: In March we raised our equity exposure to 50%, by adding substantially to our holdings in energy, commodity and technology stocks. We remained underweight the financial and consumer discretionary sectors. At the regional level we increased exposure to emerging markets and Japan. We sold most government bonds and neutralised overall bond exposure with this move. In the second quarter of 2009 we further increased equity holdings to 60% by increasing our exposure to the industrial and agricultural sectors. This asset, sector and regional allocation has proven to be very successful as can be seen from the performance of 37.8%

Of course all of this is a matter of taking positions making the necessary observations and rebalancing accordingly. The exact timing is something that one usually manages only on occasion through pure luck. However, we have found that by making fundamentally sound decisions, initialising a position and increasing or decreasing it when our theories are confirmed or proven incorrect has been the best way of outperforming consistently over a period of three to ten years. Over the short term 1-2 years volatility and other short term noise can be too much to overcome but in the medium to long term structural changes will persist.

Gillian Hollenstein

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