
Asset Allocation: Planning for the unexpected

Highlights:

- **Energy and gold sector provide hedge against geopolitical and natural disaster risks**
 - **Falling valuations in Japan have led to opportunity, with positions added across the multi manager range**
 - **Long term drivers remain supportive for oil even after resolution to Middle East crisis**
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Investors are currently faced with an increasing number of concerns that have the potential to significantly impact on future returns, recent additions to this list being the disaster in Japan and the uprisings in the Middle East and North Africa (MENA) region. According to the co-founders and co-fund managers of Legal & General's Multi Manager business, Tim Gardner and Alan Thein, this is likely to make for continued volatility in 2011 although they still feel that equities can make further progress over the year rather than undergo a prolonged fall as was witnessed after the collapse of Lehman Brothers.

Tim stated that the recent natural disaster in Japan is first and foremost a terrible human tragedy but in many ways it is easier for managers to deal with such unexpected events as opposed to wider market or financial crises. He explained that historically markets tend to bounce back more quickly from natural disasters as there is greater clarity over the impact on economic growth and the associated costs. Governments throw money at the situation to aid recovery, restructure and rebuild. With financial disasters there are many more uncertainties – for example the lack of transparency of bank balance sheets – and the path to recovery is more obscure and longer, he said. With the financial system global in nature this means that problems within one part of the world can quickly spread to the rest of its constituents whereas the impact of a natural disaster is typically more localised.

Tim said, **“There was a much bigger fallout from the Asian financial crisis in 1997 than from the Kobe earthquake in Japan in 1995.”**

Although the events in Japan are still quite fresh and it has undoubtedly caused disruption to global markets, Alan and Tim have upped their Japan weightings following the earthquake. Companies in the region were already considered to be on reasonably attractive valuations and the sharp market falls after the earthquake made them even more attractively valued, Tim commented. Immediately prior to the earthquake Tim and Alan had negligible weightings to Japan while as of 28 March their funds featured between 2-4%. Acknowledging there remain risks to the Japan market, Alan and Tim continue to prefer managers such as Morant Wright, whose highly-experienced team place considerable emphasis on finding cheaply-valued companies with strong balance sheets.

As to the ongoing Middle East and North African uprisings, again it is a difficult situation for managers to plan for and asset allocate in advance. Like natural disasters these events are unpredictable but Tim said managers could to some extent judge whether or not sufficient risk premium is built into asset prices and take action accordingly. This is one reason why Alan and Tim had already begun upping their energy exposure in the fourth quarter of 2010 ahead of the political upheavals in North Africa. Although this move was in large part due to their view that energy equities were undervalued relative to other areas of the stock market and to the price of oil, they recognised at the time that the geopolitical risk premium factored into the latter looked low.

“In this day and age there are a lot of geopolitical risks around the world that will flare up on occasion. In Q4, we didn't feel the price of oil reflected that sufficiently and that the rise off the lows after the credit crisis had been predominantly driven by the rebound in global economic activity and the quantitative easing measures employed”, said Tim.

The call turned out to be correct and the duo increased weightings further following the Egyptian crisis. For example, as of 28 March the Legal & General Multi Manager Growth Trust held around 9% in the Guinness Global Energy Fund. Alan and Tim favour this fund as manager Tim Guinness takes a high conviction approach, leveraging off his in depth knowledge of the energy market, both in terms of companies and the macro drivers. The fund is also small enough in size that it can be nimble in times of uncertainty, Tim said.

Legal & General Investments

Fund: Legal & General Multi Manager funds

Managers: Tim Gardner and Alan Thein

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“No one can predict with any great degree of certainty how the situation in the MENA region will unfold but energy can hold its ground better than many other sectors of the market. Although energy stocks have performed well of late, having a high position right now still makes sense, as valuations are broadly undemanding and it is difficult to see how the market will stop worrying from a geopolitical perspective. This is not something that is going to be resolved over night – it is too widespread for that and even if there is a quick end to the turmoil in Libya, which is far from certain by any means, the market is going to remain worried about the likes of Bahrain, Saudi Arabia, Iran, Syria and Yemen. An escalation in events that causes increased uncertainty about Saudi Arabia oil supply could have serious consequences for the price of oil.”

Gold is also a hedge against global uncertainties and this is another area Alan and Tim increased exposure to last year and again in recent weeks. The Legal & General Growth, Balanced and Income multi manager portfolios have between 5-7% in the asset class, with the managers favouring exposure via gold equities.

“It is the safe haven asset that people often turn to whether it’s a result of Middle East uprisings, natural disasters or ongoing sovereign debt worries in Europe”, commented Tim.

Alan and Tim may have increased their gold and energy weightings in light of recent situations but the pair also point out these are not short term bets taken in response to recent global events. They believe there are strong long term drivers in place for both asset classes. For example, the allocation to gold in part reflects the continued debasement of paper currencies, a hedge against future inflation (albeit not a threat in the immediate term) and increasing demand from central banks (e.g. China, India).

Tim said **“Our view today is similar to the start of the year before all of this began. We still see more value in equities than in bonds. However, we do think the market is in for another volatile year and the key approach in such an environment is to be pragmatic and to have some hedges in place.”**

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