The Red House

Current concerns in Bond Markets

- **The Eurozone crisis**

The Greek debt crisis has dominated the financial pages in the last week. Some commentators are describing it as a 'Lehman' moment, the suggestion being that if Greece defaults on its sovereign debt this will start a domino effect amongst other Eurozone countries. 'PIGS' is the collective acronym for the usual suspects of Portugal, Ireland, Greece, and Spain. A 2008 doomsday scenario is then developed from this picture with bond values falling as the rating agencies downgrade the credit value of sovereign debt and investors demand higher yields.

TRH doesn't believe in predicting markets, let alone market crises, but it would be unusual for a market crash to occur when everyone is aware of the problem. Crashes occur suddenly and catch the unwary investor, market recoveries start quickly and many again miss out on the upturn. The FT's Lex column of 18th of June made the point that 'The Hellenic Republic's travails have been analysed ad nauseam for two years now. Europe is as prepared for a Greek default as it will ever be.'(1)

The news over the weekend was that a restructuring of Greek debt had been agreed, supported primarily by the IMF and the strong German economy. But who knows whether this will be enough? Will Greece eventually be forced to default? What will be the knock-on effects? We will leave such predictions to the imagination of the media.

Our reading of the history of market returns has consistently demonstrated that it is extremely difficult to improve a portfolio's long-term performance by taking short-term tactical timing decisions. A portfolio's long-term return is primarily explained by its asset allocation. We therefore keep a very close eye on every client portfolio to ensure that the split between the various equity asset classes and bonds remains within accepted tolerances.

- **Bond exposure in TRH portfolios**

TRH believes that growth in a portfolio is primarily driven by equity assets. Equities exhibit higher risk characteristics than bonds or cash and are therefore expected to provide higher returns. However equity investment brings volatility; we use fixed interest bonds in our portfolios to dampen this volatility. The higher risk a portfolio carries, the lower the exposure to bonds. TRH 4 is split 60/40 equities/bonds whereas the high-risk TRH6 portfolio is 100% equities.

We use the Dimensional Global Short Dated Bond Fund to capture the portfolio's required exposure to low volatile, fixed interest bonds. We continually monitor the holdings of this fund. Earlier this month Matt Kiddle and I met David Plecha, Dimensional's Head of Fixed Interest, for an update. In the current febrile bond market clients may find the following data on the TRH bond holdings reassuring.(2)

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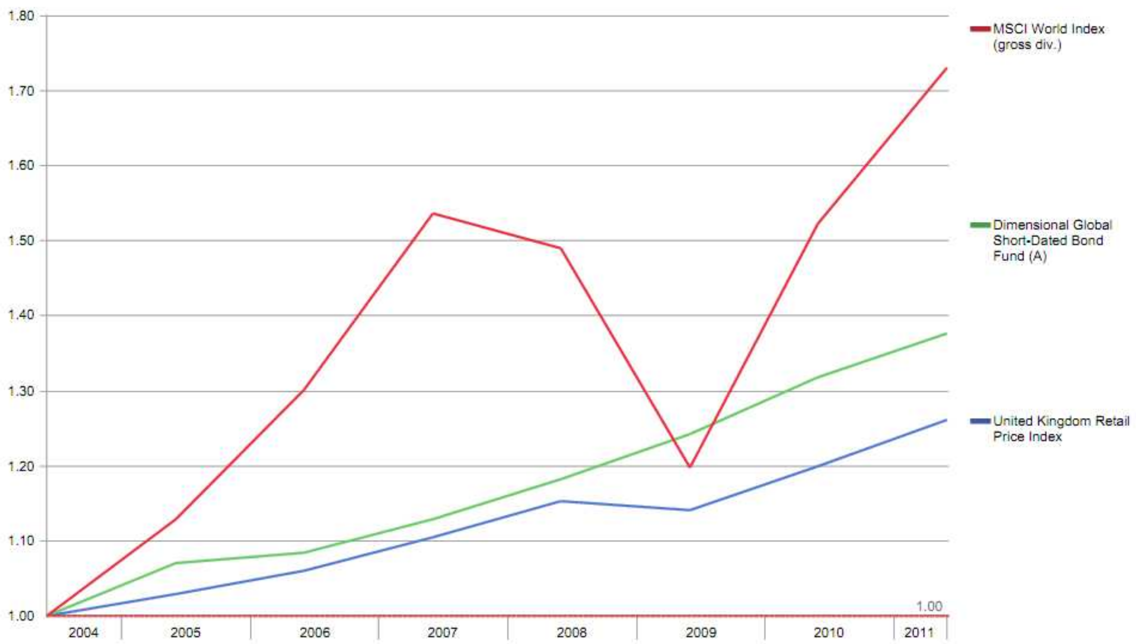
As at 31 March 2011:-

- The fund held 94 issues with an average maturity of 4.10 years. 59 holdings were AAA rated, the balance were AA rated.
- 58 government bonds were held but no Greek, Portuguese, Irish or Italian issues and only one Spanish corporate bond (Santander).
- No one holding can exceed 3% of the fund.
- All non sterling holdings are hedged back to sterling to eliminate currency risk.
- The fund commenced on 14 January 2004 and on 17 June 2011 was valued at £658.09 million.
- Since launch it has returned 4.45% per annum (31st of May 2011) and has not had a negative return in any year to date. The best year's return was in 2008 at 6.6% (just when we needed it!), and the worst year was 2006 at 2.77%.
- There have only been five negative quarterly returns since inception.

The chart below compares the performance of the bond fund since inception and demonstrates its low volatility against the major world equity markets as shown by the MSCI World index. This shows how the fund delivers the desired dampening effect to our portfolios. The comparison with the UK RPI also shows how it has kept pace with inflation.(3)



I hope clients find this information useful. Whilst we cannot predict how the current sovereign debt crisis in the PIGS will pan out, we do believe our fixed income strategy provides the best method of delivering low volatile, secure returns within our portfolios. The prices of our bond holdings may well be affected by market sentiment. However it is our belief that the high-quality and short durations of the bonds provide the appropriate 'balancing' risk characteristics we require for client's investments.

Please do give Ruth, Matt or me a call if you have any comments or questions on this note or would like to discuss any aspect on your portfolio.

Gareth Marr

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21st June 2011

Sources: (1) Financial Times 18/06/11 Lex column. (2) Presentation by David Plecha, Head of Fixed Interest Dimensional Fund Advisers 07/06/11. (3) Dimensional returns programme 20/06/11.