Barclays Wealth Global Research & Investments

COMPASS

January 2012

Focus on the Long Term
Strategic Asset Allocation: Update and Adjustment
Consumer Vital Signs
Government Bonds: The Economy Matters Most
Companies are in Good Health – and Look Inexpensive
It's Always Darkest Right Before the Dawn

BARCLAYS WEALTH

Contents

Focus on the Long Term 2

Strategic Asset Allocation: Update and Adjustment 3

Data Update 3
Longer-Term Trends in Returns and Risk 4
Stocks Should Have a Better-Than-Average Half Decade 5
High-Grade Bonds Will Likely Struggle........ 6
EM Stocks: Relatively High Risk – Relatively Even Higher Returns 7
'Risk-Free' Interest Rates Likely to Remain Low for the Next Five Years 7
Asset Allocation Changes........ 8

Consumer Vital Signs 10

Consumer Share and National Output: Share and Size are Related........ 10
The American Consumer 11
A Potential Headwind 12
The European Consumer 12
The Chinese Consumer 12
Going Forward 13

Government Bonds: The Economy Matters Most 14

A Sovereign Debt Crisis and a Bull Market in Bonds........ 14
Why Bond Prices Rose Alongside Debt Worries 16
…And Why Prices and Debt Worries Might Now Subside Together........ 18
Two Long-Term Certainties: Debt and Taxes........ 18
Investment Strategy 19

Companies are in Good Health – and Look Inexpensive 20

A Corporate Health Check 20
Tax Temptation? 21
Are Companies Priced for Good Health?........ 22
The Equity Risk Fable........ 23

It's Always Darkest Right Before the Dawn 26

The Volatility of Equity Markets........ 26
Unexpected Turning Points........ 26
The Best and the Worst of Times........ 28
(Not) Timing is Everything........ 29

Aaron S. Gurwitz
Chief Investment Officer

Focus on the Long Term

Dear clients and colleagues:

After a year filled with dramatic, market-moving developments – the Arab Spring, the Tohoku earthquake and tsunami, the downgrade of US Treasury obligations, and the ongoing Eurozone sovereign debt crisis – it's easy to become obsessed with the latest headlines. However, doing so can be harmful to your financial health.

Of course we need to be aware of and try to understand current events. But in our view, successful investing requires perspective, discipline and stability. The aspect of investment activity that deserves the most attention is strategic asset allocation (SAA). Your SAA should reflect the structure of financial markets, as well as your particular financial situation, your financial personality, and your *long-term* expectations regarding investment performance and risk.

This first issue of *Compass* for 2012 is primarily devoted to our strategic three to five year outlook. We begin the thought process with an assessment of the financial condition of three major economic entities – businesses, households, and governments – from a global perspective. Over the next three to five years the first of these will likely remain in good shape, the second should be able at least to hold its own, and the third will more likely be an impediment to economic activity and investment returns than a net contributor.

Our evolving longer-term expectations have led us to recommend some changes in our standing strategic asset allocation recommendations. A section of this *Compass* is devoted to the strategic shifts we are recommending and our reasons for doing so. Our advice reflects our assessment of the outlook. Unless the global economy performs worse than we expect it to, it will be difficult for government bonds to eke out positive returns. In contrast, we expect investments linked to the performance of the global private sector, such as equities and high-yield bonds, will provide unusually high risk-adjusted returns.

Sincerely yours,

Aaron S. Gurwitz
Chief Investment Officer

Strategic Asset Allocation: Update and Adjustment

Aaron Gurwitz
+1 212 526 9255
aaron.gurwitz@barclayswealth.com

- Strategic Asset Allocations should be adjusted occasionally in light of updated data and evolving long-term financial market expectations.
- We expect equities, especially emerging market equities, to deliver unusually high excess returns on average over the next five years.
- We recommend a strategic shift out of high-grade bonds into investments that provide exposure to the performance of private businesses.

By its nature an investor's SAA should change very slowly over time, although temporary tactical over- and under-weight positions in individual asset classes may occasionally be advisable.

An investor should, however, update and revise the strategic weights assigned to the nine asset classes from time to time in light of either major changes in his or her financial situation or substantial shifts in long-term trends affecting financial markets.

Accordingly, it will be our practice to update, review, and, if advisable, revise our standing SAA every one to two years.

An appropriate strategic asset allocation (SAA), defined as the percentage mix of asset classes that one plans to hold on average over time and that best suits one's financial situation and financial personality, is the cornerstone of the Barclays Wealth Investment Philosophy. In a White Paper we published last year, *Asset Allocation at Barclays Wealth*[1], we explained why we believe most investors should build an investment portfolio that includes nine specific asset classes and set out the methodology we used to determine the percentage mixes for various degrees of risk tolerance.

It's now been about 18 months since we introduced our nine asset class framework and initial SAA. Much has changed in the global economy and financial markets since then, and we believe the time has come for SAA adjustments[2]. This article describes the changes we are making and explains why we think they are appropriate.

Our SAA thought process begins with the 'market portfolio', an estimate of the amount of all investable financial assets outstanding in the world, sorted into our nine asset classes and translated into a common currency. If all investors had the same financial situation and the same degree of risk tolerance, and if market prices always accurately reflected expected returns and risks for each asset, then every investor would hold a share of this market portfolio. However, it is a fundamental premise of our investment philosophy that none of these conditions hold. So we start with the market portfolio and adjust our recommendations to reflect our clients' varying degrees of risk aversion. Then we take into account our considered expectations about multi-year trends in relative asset class returns and risks that are not, in our view, reflected in current market prices.

Our review of SAA, therefore, involves two broad activities. First, we update our data on asset class capitalization and relative asset class risks. Second, we reconsider our long-term expectations regarding relative asset class returns and risks.

Data Update

The data we use falls into two categories: asset class capitalization and asset class risks and correlations. Changes in these data have affected our recommendations.

First, we have expanded the definition of the High Yield and Emerging Market (EM) Bonds asset class. Previously we defined this asset class as including speculative-grade

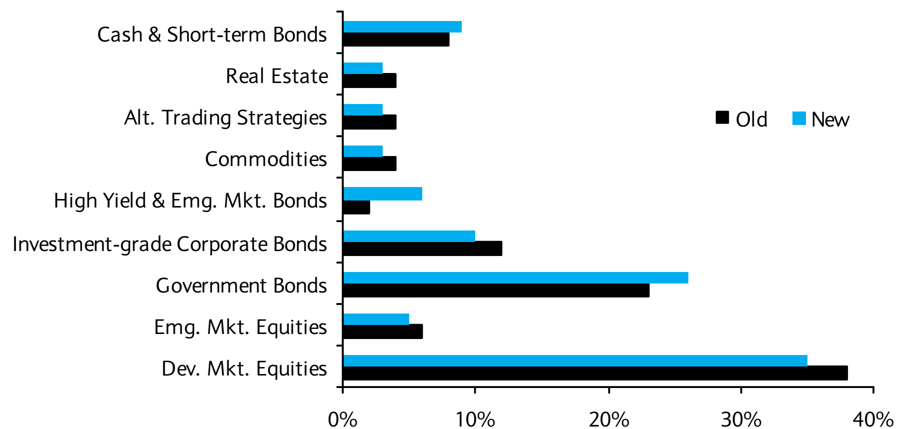
[1] *http://corp.barclayswealth.net/prodres/res/americas/Documents/Asset%20Allocation%20White%20Paper_US_130810.pdf* and *http://corp.barclayswealth.net/prodres/res/americas/Documents/Mathematical_Appendix_250810.pdf* or your Barclays Wealth Investment Representative can provide it.
[2] The changes discussed will be effective February 1, 2012.

corporate bonds and obligations of EM governments denominated in major currencies (US dollar, euro, yen, or British pounds). A third component, EM bonds denominated in local currencies, has become increasingly important in terms of both market capitalization and potential contribution to portfolio risk-adjusted returns. Adding this additional market sector increases the aggregate market capitalization of the relatively small High Yield and EM Bonds asset class substantially, by close to 70%.

Second, because recovery in developed economies has been weak, government tax revenues have continued to grow more slowly than government spending. As a result developed economy governments have continued to issue large volumes of bonds. At the same time, public companies have felt little need to raise additional capital in either the equity or bond markets. As a consequence the relative size of the government bond asset class has increased noticeably over the past two years.

Figure 1 represents the changes in the market portfolio proportions over the past 18 months.

Figure1: Market Capitalization Portfolios



Source: Barclays Wealth, Research, Economics, and Strategy

The other avenue by which updated data might affect our asset allocation recommendations would be some major increase or decrease in asset class return, risk or correlation. The only noteworthy change we've seen in this regard is a continuing increase in the correlation between returns on commodities and the performance of the other relatively risky asset classes. This development in the data has not been pronounced enough to affect our asset allocations.

Longer-Term Trends in Returns and Risk

As we think about our SAA recommendations we focus on trends in asset class returns and risks that are likely to play out over the next three to five years. This is in contrast to the thought process that guides our tactical asset allocation recommendations, which focuses on the coming three to 18 months. When we were developing the SAAs we recommended starting in the middle of last year, we had two principle views regarding the subsequent three to five years. First we expected that (longer-term) government bonds would generate lower returns than cash and short-term bonds. In other words, we expected yields on high-grade bonds to rise over time. Second, we expected EM equities would generate higher returns per unit of risk than developed market stocks. The first of these expectations has not played out over the past 18 months. As the global economic

recovery continued to disappoint and as the continuing sovereign debt crisis in Europe drove investors to 'safe havens,' yields on high-grade, longer-term governments bonds have continued to decline and/or remain quite low. EM equities have generated better returns per unit of risk than developed equities, although neither of these asset classes has performed particularly well over the past 18 months.

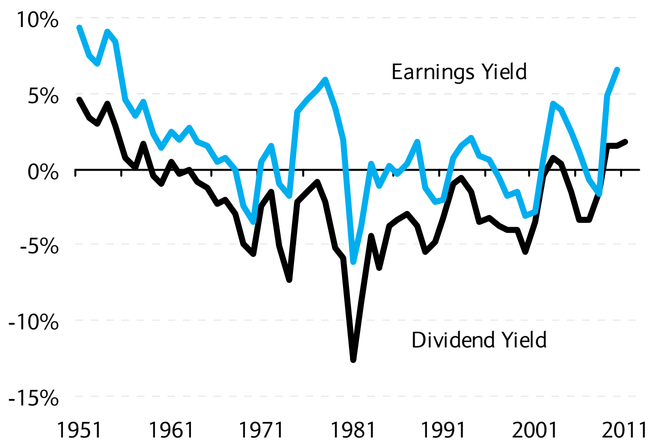
As explained below we continue to expect yields on high-grade, longer-term government bonds to trend upward (perhaps sharply) and for EM equities to outperform developed market stocks on a risk-adjusted basis. We have, however, formulated a new view regarding asset class returns over the next three to five years that may turn out to be more important than the other two views. Specifically, we expect developed market equities to generate unusually high *excess* returns (i.e., returns over and above the yield on cash and short-term bonds) on average over the next five years.

Stocks Should Have a Better-Than-Average Half Decade

We are 'long-term bullish' on equities for a number of reasons. For one thing, as discussed by my colleague, Kevin Gardiner, in his article "Companies are in Good Health – and Look Inexpensive," developed world public companies have had great success translating modest sales and revenue growth into strong earnings growth. To some extent this reflects advances in the efficiency of corporate management, but we suspect high unemployment and the resulting weak labor markets have also kept unit labor costs low and will likely to continue doing so. We are also impressed by the soundness of the balance sheets of non-financial corporate businesses in developed economies.

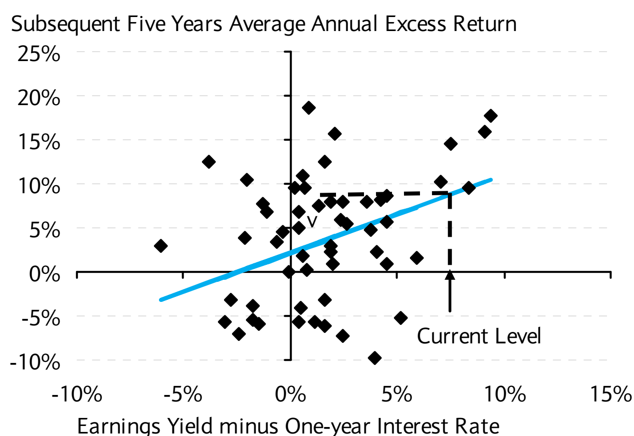
None of this would be relevant if equity valuations were not attractive. By our reckoning they are very much so, particularly from a longer-term perspective. Reliable indicators of whether stocks are cheap, and therefore likely to perform well in the future, relate equity prices to the level of interest rates. Figure 2 tracks two such measures, the differentials, or spreads, between the dividend and earnings yields on the S&P 500 US equity index over the level of one-year interest rates. By both measures the yield on stocks is quite high relative to one-year interest rates by the standards of the past 60 years. Figure 3 shows why these yield spread statistics are relevant for strategic asset allocation; the

Figure 2: S&P 500 Dividend and Earnings Yield Over One-Year Interest Rates



Source: Prof. Robert Shiller, *http://www.econ.yale.edu/~shiller/data.htm*

Figure 3: Earnings Yield over Interest Rates vs. Subsequent Five-Year Total Returns



Source: Prof. Robert Shiller, *http://www.econ.yale.edu/~shiller/data.htm*

yield spread over one-year interest rates is one of the more reliable indicators of average S&P 500 excess total returns during the subsequent five years. If we simply extrapolate from the current earnings yield spread of about 7% along the regression line (the average relationship between the variables on the two axes of Figure 3) we might expect an average annual excess return on US equities of nearly 10% over the next five years. That would be attributing too much reliability into the statistical relationship; the wide scatter of markers in the figure indicates there are many things other than this measure of valuation that determine future equity returns. This analysis, along with our observations about corporate earnings performance and sound financial condition, does however provide justification for a long-term bullish view on stocks.

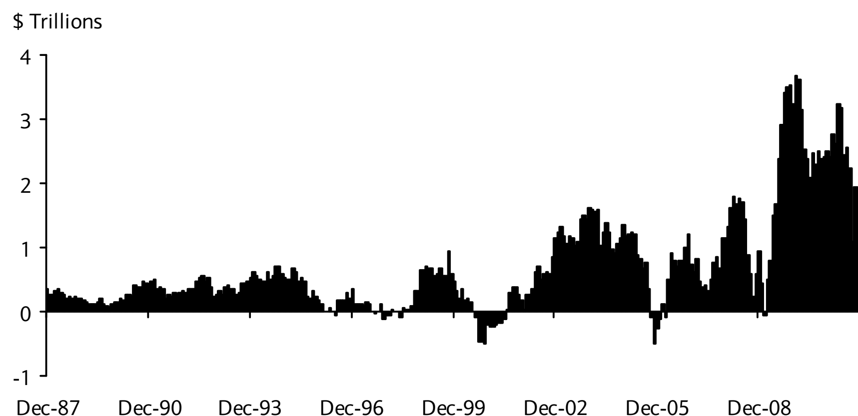
High-Grade Bonds Will Likely Struggle

As noted, we still expect government bond yields to rise on average over the next five years, and for EM equities to outperform developed market stocks on a risk-adjusted basis.

With respect to government bonds, as discussed by Fadi Zaher in his article “Government Bonds : The Economy Matters Most,” our expectation is not just based on the fact that, for many maturities in many markets, bond yields are so close to the lower bound of 0% that there is no way they can fall much further. If economic growth remains weak, if inflation continues to decline, and if investors continue seeking the safety of this low-risk asset class, interest rates could remain low for a long time and even decline more. But at some point during the next five years it’s likely that growth will accelerate, inflation will start to rise a bit, and investors will start seeking better returns than high-grade bonds can offer.

When these things happen there’s a good chance rates will rise and bond prices will decline quickly and significantly. For one thing, the volume of outstanding government bonds has risen rapidly and is likely to continue doing so for a while longer (Figure 4). To be sure, some governments, especially in Europe, have embarked on programs of fiscal austerity, which may reduce their level of new borrowing over time. But the two largest borrowers in the government bond market, Japan and the US, have yet to initiate any serious degree of fiscal contraction. So the volume of government bonds outstanding is unlikely to contract, or even grow more slowly, over the next five years. Furthermore, the average quality of the government bond market has deteriorated. None of the three largest borrowers in this market, Japan, US, and Italy, is rated triple-A by any of the three rating agencies.

Figure 4: Change in Par Value of Government Bonds Outstanding over Previous 12 Months



Source: Barclays Capital

Even though we are pessimistic about government (and investment-grade corporate) bond returns over the next five years, we still believe it is important to have an allocation to these asset classes in a well designed portfolio. We could, of course, be wrong about our expectation that economic conditions in the developed economies will improve over the next three to five years. And if we are wrong, then high-grade, longer-term bonds will play an important role in a portfolio by rising in value at a time when stock prices are going down. Our long-term bearishness on high-grade bonds is a reason for a strategic underweight on this asset class, not a reason for avoiding it.

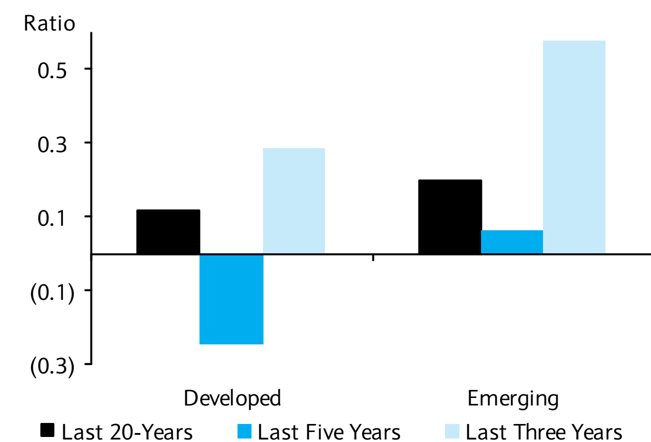
Emerging Market Stocks: Relatively High Risk – Relatively Even Higher Returns

Our final current strategic view is that EM equities will continue to produce superior risk-adjusted returns, consistent with the historical pattern illustrated in Figure 5. We expect this to continue because the large EM economies will likely continue to generate the lions' share of economic growth, and EM companies will benefit from this. Further, the equity markets of many of the largest emerging economies are becoming more mature, more liquid, more transparent, more open, and more attractive to a wide range of investors. All of these trends are likely to generate returns on local equities that more than generously compensate investors in those markets for the higher volatility they're likely to experience.

'Risk-Free' Interest Rates Likely to Remain Low for the Next Five Years

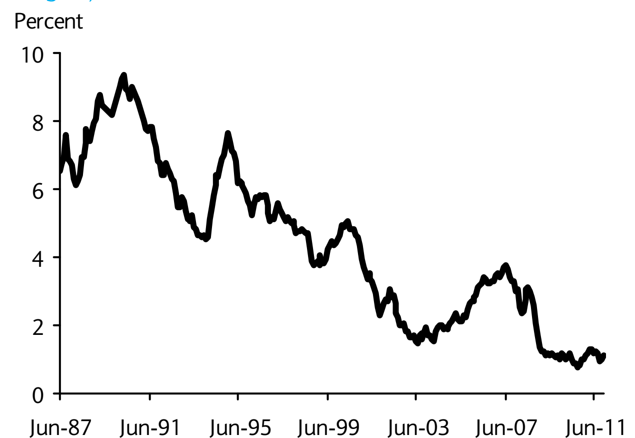
Our expectations regarding the yield on our lowest risk asset class, our 'risk-free' asset, Cash and Short-term Bonds, does not affect our asset allocation recommendations. The proportions of portfolios we recommend be allocated to the nine asset classes reflect our assumptions and expectations regarding *relative excess returns*, where the 'excess return' is the amount by which the return on eight of the asset classes exceeds that on Cash and Short-term Bonds. However, for financial planning purposes, investors need guidance as to what *absolute* returns they should expect on average over time, along with a clear indication of the degree of uncertainty about what this average return might be over time. The expected absolute return on any given portfolio is the weighted average of the expected excess returns plus the expected average yield on Cash and Short-term Bonds.

Figure 5: Excess Returns Per Unit of Risk (Sharpe Ratios)



Source: Factset

Figure 6: Yield on Global 1-3 Year Treasuries (Currency Hedged)



Source: Barclays Capital

Economic theory leads us to expect that over time the so called risk-free interest rate will be roughly equal to the average real growth rate of the economy, which in turn is determined by the growth of the labor force and improvements in productivity. Last year we assumed the risk-free rate would average around 4% over long periods of time. Further consideration of demographic and productivity trends in the developed economies led us to conclude that 3% is probably a better long-run estimate. That is the number that we recommend investors use when doing very long-term financial planning.

Over the next five years, however, we expect the average yield on cash and short-term bonds to be even lower. After almost 30 years of declines, the yield on the Barclays 1-3 Year Currency Hedged Government Bond Index, the benchmark for our 'risk-free' asset class, is only about 1% today (Figure 6). We do not expect this will rise to 3% quickly.

Nominal yields on short-term high-grade bonds are controlled by central bank monetary policy. Today, with unemployment extremely high and inflation likely to trend lower in the near term, it is unlikely that developed country central banks will raise interest rates any time soon. The US Federal Reserve has already announced its intent to keep interest rates low until mid-2013. So while it may be reasonable to expect that the risk-free rate will average 3% over long periods of time, we recommend investors base their near term absolute return expectations for the next five years on an average 2% risk-free rate.

Asset Allocation Changes

We have updated our data on asset class market capitalizations and risks and translated our expectations about asset class returns into quantitative assumptions. These data and assumptions are the inputs to the quantitative model described in the Mathematical Appendix to our White Paper[3] on asset allocation. Our work with that model led us to recommend the changes in our middle of the road SAA presented in the Figure 7 below. The changes for the full range of risk level portfolios appears at the end of this section.

Figure 7: Previous and New Market Capitalizations and Strategic Asset Allocations

	Previous Mkt. Cap. Share	Old SAA	Previous Strategic Over-weight	New Mkt. Cap	New SAA	New Strategic Over-weight	SAA Change
Developed Markets Equities	38%	36%	-2%	35%	38%	3%	2%
Emerging Markets Equities	6%	8%	2%	5%	10%	5%	2%
Developed Government Bonds	23%	11%	-12%	26%	9%	-17%	-2%
Investment Grade Bonds	12%	6%	-6%	10%	4%	-6%	-2%
High Yield & Emerging Markets Bonds	2%	6%	4%	6%	8%	2%	2%
Commodities	4%	6%	2%	3%	5%	2%	-1%
Alternative Trading Strategies	4%	13%	9%	3%	14%	11%	1%
Real Estate	4%	4%	0%	3%	4%	1%	0%
Cash & Short-term Bonds	8%	10%	2%	9%	8%	-1%	-2%

Source: Barclays Wealth Research Economics and Strategy

[3] *http://corp.barclayswealth.net/prodres/res/americas/Documents/Asset%20Allocation%20White%20Paper_US_130810.pdf* and *http://corp.barclayswealth.net/prodres/res/americas/Documents/Mathematical_Appendix_250810.pdf*

In summary, our main recommendations for the next three to five years are:

1. **Allocate more to Developed and EM Equities.** This reflects our expectation that the excess return on equities will be unusually high on average over the next three to five years because of the good financial health and strong earnings performance of public companies and because stocks look undervalued.

2. **Reduce exposure to government bonds.** At some point in the near future we expect investors to begin demanding higher yields to induce them to hold a rapidly increasing volume of bonds of deteriorating credit quality.

3. **Increase allocation to High Yield and EM Bonds.** The corporate High Yield component of this asset class should perform relatively well over the next five years for the same reasons we think equities will do well; businesses should make a lot of money in the economic environment we see evolving over the next few years. Further, we've added another substantial component to this asset class in the form of EM local currency bonds. Investors who do not have any or sufficient exposure to this market sector in their current portfolios should add some.

Our SAAs are based on the current market portfolio and our expectations for asset class returns and risks over the next five years. In revising the SAAs we are not recommending any immediate changes; we believe the current tactical asset allocation, which differs from both previous SAAs and the new ones, is the optimal mix of assets for investors to hold today. Our purpose now is to provide guidance on what the 'centre of gravity' of an investor's portfolio should be as it evolves tactically over the next three to five years.

One final point: our new SAAs look modestly riskier than our old ones. (Figure 8 notes the SAA changes for all five core risk profiles.) This is intentional. On average over the next three to five years we expect the largest, most important, and most interesting risk asset classes, developed and EM equities, to perform unusually well both absolutely and relative to interest rates. This will, in our view, make the future a more rewarding environment for risk taking than has been the recent past.

Figure 8: SAA Revisions by Risk Level

Asset Class	Developed Markets Equities	Emerging Markets Equities	Developed Government Bonds	Investment Grade Bonds	High Yield and Emerging Markets Bonds	Commodities	Alternative Trading Strategies	Real Estate	Cash & Short-maturity Bonds
Risk Level 1 (Conservative)									
Current	15%	3%	10%	6%	3%	3%	8%	5%	47%
Updated	16%	4%	10%	3%	4%	2%	11%	7%	43%
Difference	1%	1%	0%	-3%	1%	-1%	3%	2%	-4%
Risk Level 2 (Moderately Conservative)									
Current	27%	6%	13%	7%	5%	5%	13%	5%	19%
Updated	29%	7%	13%	4%	7%	4%	16%	5%	15%
Difference	2%	1%	0%	-3%	2%	-1%	3%	0%	-4%
Risk Level 3 (Moderate)									
Current	36%	8%	11%	6%	6%	6%	13%	4%	10%
Updated	38%	10%	9%	4%	8%	5%	14%	4%	8%
Difference	2%	2%	-2%	-2%	2%	-1%	1%	0%	-2%
Risk Level 4 (Moderately Aggressive)									
Current	43%	10%	8%	4%	7%	6%	12%	4%	6%
Updated	45%	13%	6%	3%	8%	6%	11%	3%	5%
Difference	2%	3%	-2%	-1%	1%	0%	-1%	-1%	-1%
Risk Level 5 (Aggressive)									
Current	48%	12%	6%	3%	7%	6%	11%	3%	4%
Updated	51%	17%	4%	2%	6%	6%	8%	2%	4%
Difference	3%	5%	-2%	-1%	-1%	0%	-3%	-1%	0%

Source: Barclays Wealth Research, Economics and Strategy

Consumer Vital Signs

Hans Olsen, CFA
+1 212 526 4695
hans.olsen@barclayswealth.com

In many respects, the consumer has carried the weight of the global economy on it shoulders for some time. After being buffeted by the extreme volatility of 2011, can we expect the global consumer to continue to power on?

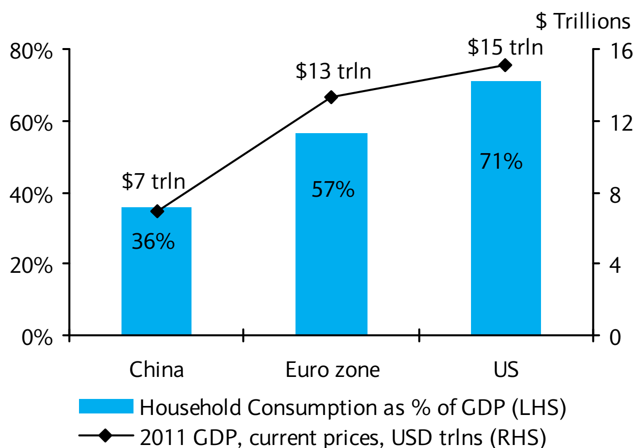
Consumer Share and National Output: Share and Size are Related

The consumer is a key driver of a country's economic growth. The level of involvement and influence the consumer has varies from country to country, but nevertheless remains a significant contributor in the calculus of a nation's economic output.

The correlation between the consumer share of a national output and the size of a country's GDP is clear (Figure 1). The United States economy is the world's largest with the consumer accounting for roughly 71% of the country's output. The Eurozone is the second largest economy with its consumer accounting for 57% of collective output. China, the third largest economy, has a consumer share of GDP that stands at roughly 36%.

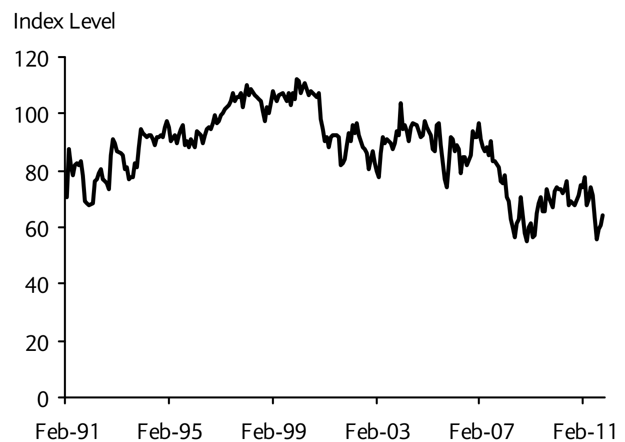
Physicians have long been trained to listen to their patients to determine their health. Central to this is the use of a stethoscope to listen to the patient's heart. This 'auscultation' provides critical insight into the body's engine of activity. Given the importance of the consumer to national output, an examination of consumer health will provide a potentially profitable insight into the economic activity we might expect in 2012, and by extension what corporate profitability might be derived from this activity.

Figure 1: Consumer Share of GDP



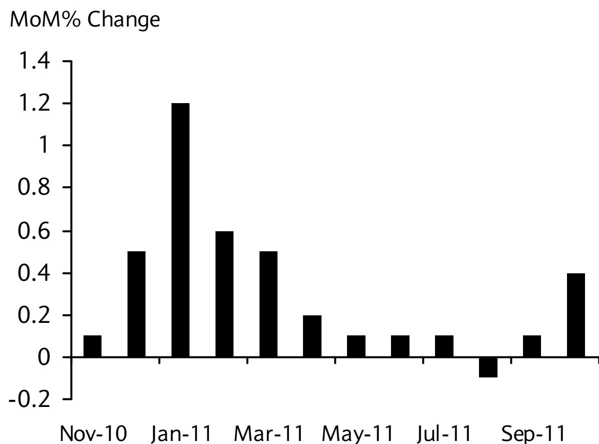
Sources: McKinsey Global Institute, Eurostat, IMF, Factset

Figure 2: Consumer Confidence – University of Michigan Consumer Sentiment



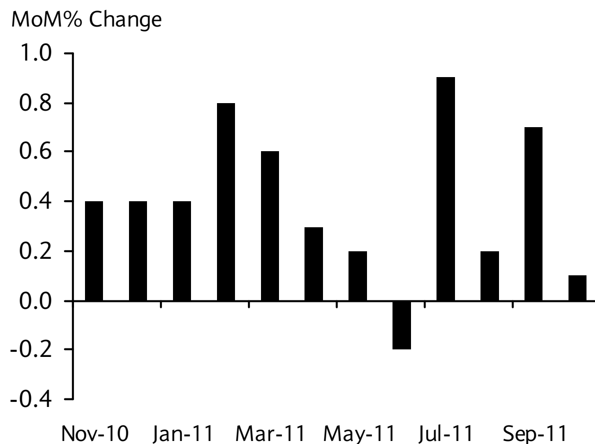
Source: Bloomberg

Figure 3: US Personal Income



Source: Bloomberg

Figure 4: US Personal Consumption Expenditures



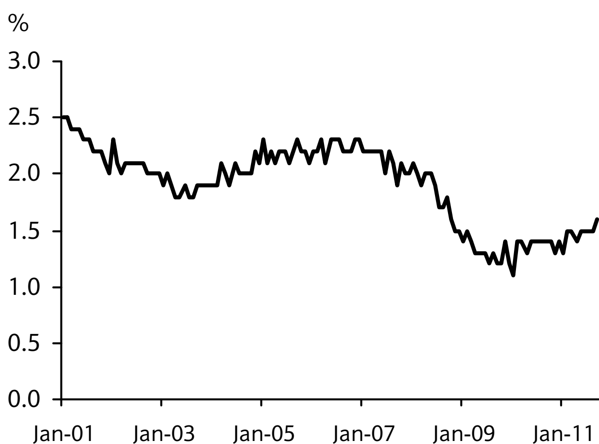
Source: Bloomberg

The American Consumer

Almost two and a half years after one of the deepest recessions in the country's history, the consumer is slowly regaining composure. Consumer confidence was battered in 2011 by a series of unfortunate events. However, sentiment is slowly improving as indicated by the University of Michigan Consumer Sentiment Survey (Figure 2).

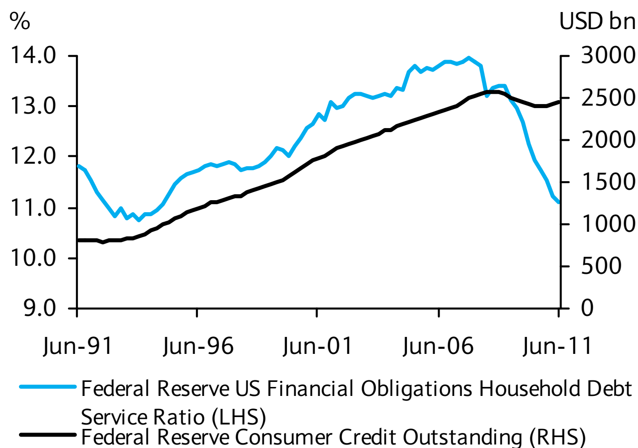
The improved sentiment is helped by rising personal income which drives rising consumption (Figures 3 and 4). Retail sales figures confirm this trend, as they have increased every month since last May. Unemployment remains intransigent, averaging 9.43% since the official end of the recession in June 2009. In November this rate declined below 9% for the first time since March. More encouraging news on the employment front comes from a counterintuitive measure: the Quits Rate. This rate, published by the Bureau of Labor Statistics, is on the rise (Figure 5). People tend to quit their jobs if they think they can get another job or have a job to go to, which portends well for labor mobility as well as the potential health of the labor market.

Figure 5: US Quits Rate



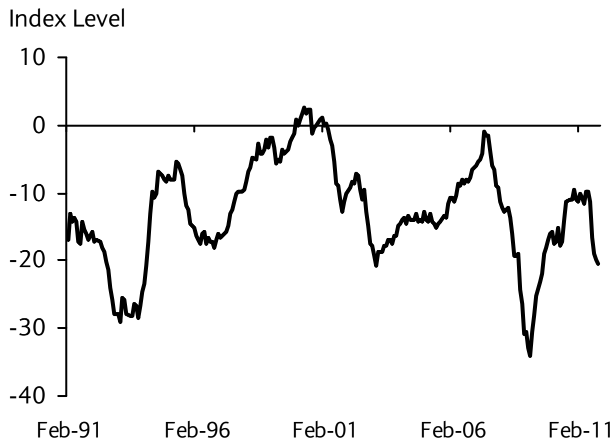
Source: Bloomberg

Figure 6: Consumer Debt and Debt Service



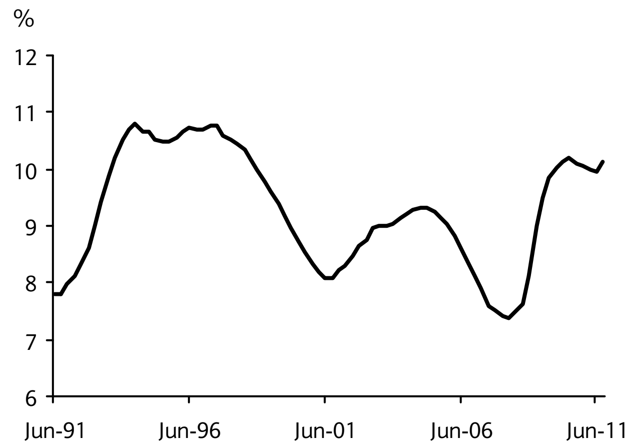
Source: Bloomberg

Figure 7: Eurozone Consumer Sentiment



Source: Bloomberg

Figure 8: Eurozone Unemployment Rate



Source: Bloomberg

A Potential Headwind

Coming off a debt binge of epic proportions, the US consumer is in need of balance sheet repair, and this process takes time. While servicing the existing debt has become much easier courtesy of historically low interest rates, aggregate levels of consumer debt have declined only modestly since the end of the recession (Figure 6).

We remain optimistic that the encouraging consumer trends will continue into 2012, supporting GDP growth as well as corporate profitability. While it will take time for US consumers to find their financial balance once again as finances are put right, the signs are pointing to a continued recovery in this important region.

The European Consumer

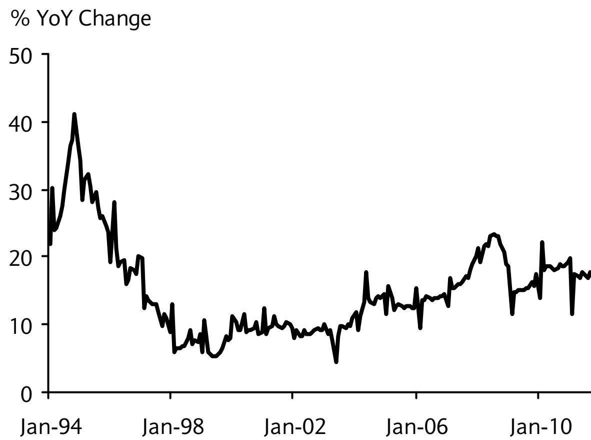
Problems in the Eurozone have finally taken their toll on the region's consumer (Figures 7 and 8). Viewed through the lens of sentiment, the consumer looks peakish as recent readings appear in free fall. Unemployment in the monetary bloc remains stubbornly high at 10.3%. Retail sales, another measure of consumer health, have declined on a year-on-year basis in seven of the last nine months. Combine these consumer readings with the business sector, and the recessionary conditions are clear. Unfortunately, quick fixes and durable resolutions to the fiscal and structural problems plaguing the continent will remain elusive. Expect little help from the Eurozone consumer in lifting global GDP.

The Chinese Consumer

In many respects, the future belongs to the Chinese consumer. At 36% of GDP, the consumer's share of the economy is the lowest of the large economies. With the saving rate at 25% of disposable income, the Chinese consumer has plenty of room to expand his share of national output. According to work by the consultancy, McKinsey & Company, household savings in China are high for the following reasons:

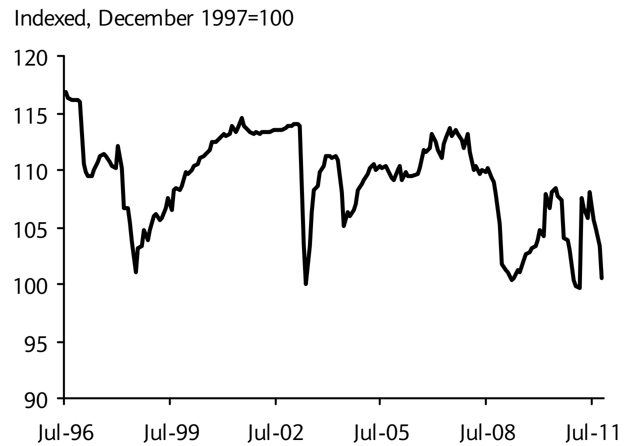
- Lack of consumer goods in smaller cities and rural areas
- Lack of consumer credit
- Limited social safety net

Figure 9: Chinese Retail Sales



Source: Nation Bureau of Statistics of China, Datastream

Figure 10: Chinese Consumer Confidence



Source: Bloomberg

These deficiencies can be reckoned with as the Chinese modernize their society and rebalance their economy from one that is export-driven to one that is more consumption-based. In fact Chinese retail sales have held up well with year-on-year growth averaging roughly 17% during the first 10 months of 2011 despite fears of a slowdown in growth (Figure 9).

Chinese wages are expected to continue their impressive growth (they tripled) of the past 10 years. As is the case with other economies, as the middle class grows so does consumption. According to McKinsey, the Chinese middle class is set to rise from 43% of the population to 76% by 2025.

While Chinese consumer confidence has been robust by western standards, it has weakened recently as concerns about inflation and growth dented sentiment (Figure 10). Overall, marginal growth in global GDP will come from the emerging world as countries such as China evolve the consumption-production equation to the needs and aspirations of their populations.

Going Forward

With consumers in two of the three large trading blocs in healthy or improving shape, the outlook for global growth looks reasonable for 2012. According to the Conference Board, global growth is set to rise 3.2% this year. Developed economies will grow 1.3% while developing economies will grow 5.1%. Supported and hindered by their respective consumers, economies will go in large part where the consumer points. This is one of the reasons why we have maintained our exposure to developing economies and reduced our exposure to developed markets – favoring those economies with a healthier consumer at the expense of those with a weaker consumer.

Government Bonds – The Economy Matters Most

Kevin Gardiner
+44 (0)20 3555 8412
kevin.gardiner@barclayswealth.com

Fadi Zaher
+44 (0)20 3134 8949
fadi.zaher@barclayswealth.com

The sovereign debt crisis may not be the main threat to the market value of government bonds held in investor portfolios. In a 'muddle through' scenario for euro area and US fiscal policy, it may be a combination of the US business cycle and rich valuations that causes bond investors most concern in the year ahead. Like President Clinton's adviser said, "It's the economy, stupid."

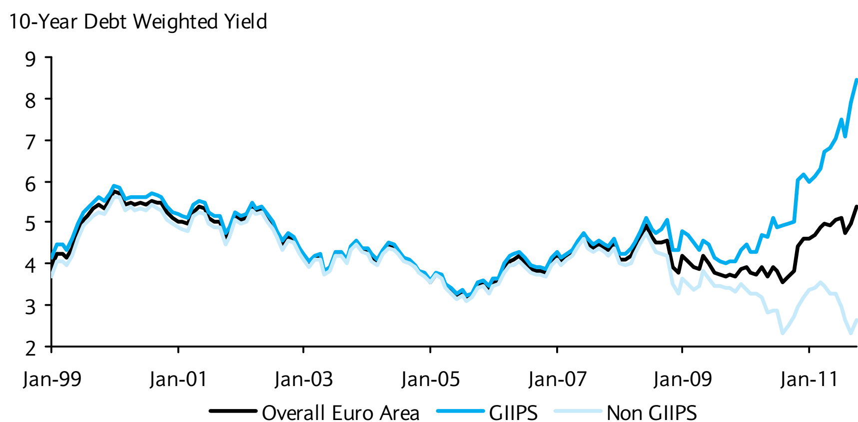
A Sovereign Debt Crisis and a Bull Market in Bonds

2011 will go down in the history books as the year of the sovereign debt crisis. On both sides of the Atlantic, fears about government creditworthiness rocked the markets and dominated the media to a much greater extent than in 2010.

The past year in the euro area saw peripheral spreads widen sharply; a third country take explicit support from the IMF; and investors worried that write-downs on government bonds would imperil the banking system and trigger a re-run of 2008. A string of EU summits reached inconclusive conclusions as the long-term solution of fiscal integration remained politically out of reach, and many commentators penned lengthy – and in many cases, somewhat smug – obituaries for the euro. Meanwhile S&P recently placed the entire euro area on credit watch. In the US, political gridlock led all three major rating agencies to place US sovereign debt on negative outlook for the first time, and some professional politicians publicly fostered the notion that a government default might be tenable. A supercommittee met, but failed to leap tall buildings, leaving the federal government facing spending sequestration from 2013.

A debt-weighted composite bond yield for the euro area as a whole has risen, by 80bps, and is roughly 100bps above its lifetime average (Figure 1). However, peripheral and core

Figure 1: Euro Area Debt-Weighted 10-Year Yields

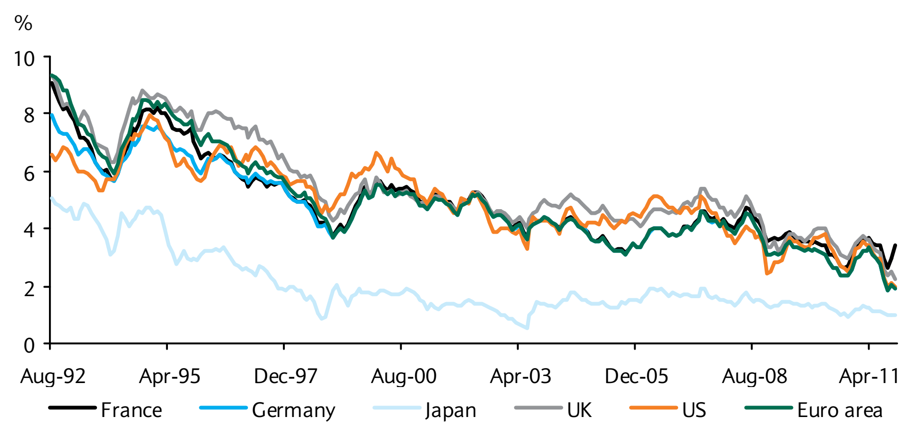


Source: Bloomberg, Barclays Wealth Strategy

markets have moved in opposite directions: at the time of writing, the single most important government bond market in the euro area, that for German bunds, has seen yields at the 10-year maturity fall in 2011 by 90bps. The euro's trade-weighted exchange rate is broadly flat on the year. Meanwhile, the US 10-year Treasury note yield is down by 130bps.

Bunds, Treasuries and UK gilt yields in fact touched the lowest levels on record during the year (Figure 2). Globally, government bond yields are down 50bps in 2011. No developed country has yet formally defaulted on its obligations (though Greece is of course close). In other words: the year of the sovereign debt crisis saw a bull market for sovereign debt.

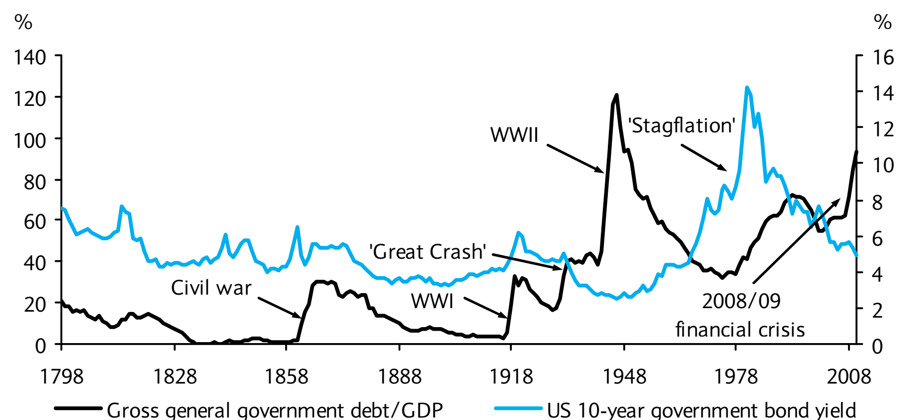
Figure 2: 10-Year Government Bond Yields



Source: Ecowin, Barclays Wealth Strategy

Historically, the US debt-to-GDP ratio has been at or above current levels in the past, and without triggering significant increases in yields then either (Figure 3). In 1946 the debt-to-GDP ratio was around 120% and the 10-year government bond yield around 2.5%. Other developed counties share similar experiences: the link between indebtedness and market performance is much looser than is often realized.

Figure 3: US Government Debt and Long-Term Interest Rates



Source: IMF, measuringworth.com

Why Bond Prices Rose Alongside Debt Worries…

Private investors reliant on the news media may find this a little surprising. However, the state of government finances is just one of the many factors that drive government bond yields: the economic climate, and investors' collective risk appetite, are important too – often more so.

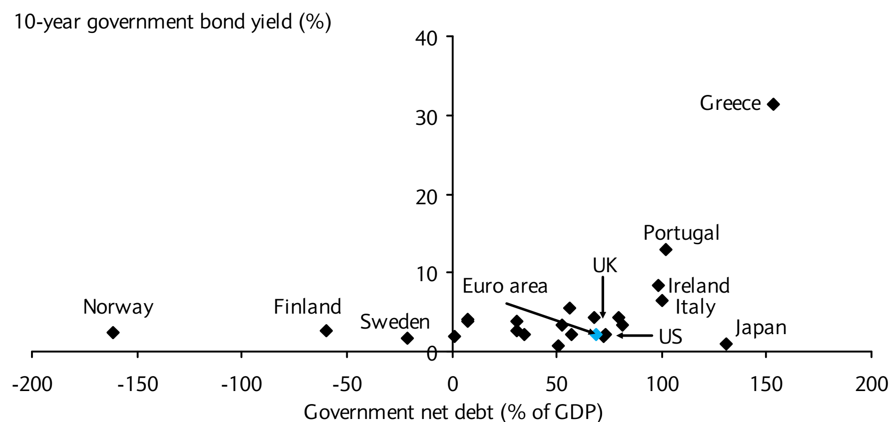
Figure 4 uses cross-sectional data for 24 developed countries/regions to make the same point, namely that the relationship between government bond yields and the level of government debt is perhaps not quite as pronounced as it's often assumed to be.

An upward slope fitted to the scatter points would be sharply influenced by a small group of countries – which on closer inspection turns out to be (in descending order of indebtedness) Greece, Portugal, Ireland and Italy.

In the body of the scatter plot, it is possible to find governments with similar debt levels but very different yields (Spain, Germany and Switzerland would be examples), and others with similar yields but very different debt levels (Canada, Germany and the US).

Even the outliers seem to trace a vertical line rather than a slope – that is, the difference in their yields seems marked by comparison with the difference in their debt levels.

Figure 4: Developed Economies General Government Net Debt and 10-Year Government Bond Yields



Source: IMF, Ecowin

Admittedly, the chart shows nominal yields only. But the marginal buyer of bonds is often a (currency-hedged) international investor, and with this in mind it is not clear which inflation rate if any should be used to translate these yields into real terms.

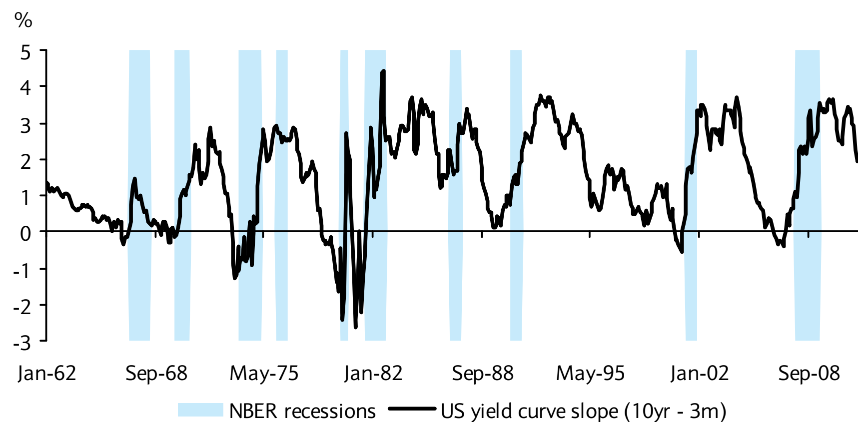
For example, the fact that German inflation is high relative to German yields may not matter to an investor based in Japan, for whom those nominal German yields look attractive relative to local Japanese inflation. That said, the modest ongoing deflation in Japan helps explain why Japanese bonds are able to yield just 1% in the face of one of the largest debt/GDP ratios in the developed world: the Japanese bond market itself is mostly held by local investors.

There are several reasons why bond yields on the one hand and debt levels (or creditworthiness as assessed by the rating agencies) on the other are not linked as smoothly as we might expect. As noted, one of these is the extent of local ownership (which in practice is linked to the existence of sustained balance of payments deficits). Much more important, though, as we indicated at the start of this section, are the local and global business cycles, and the general state of risk aversion, or investor confidence.

Government deficits are often large, and government debt rises quickly, when economies are weak. Mounting unemployment, and falling tax receipts, have a potent and fast effect on government finances. But economies usually weaken because the private sector decides to save more – to correct earlier imbalances, and/or because it fears for the future. And as they weaken, short-term interest rates and corporate profits fall.

As a result, there can be more funds available to buy bonds just as competing investments look less attractive. Historically, this effect tends to be more important than deteriorating government finances: bonds perform well ahead of recessions (Figure 5).[4] In 2011, economic data in both the US and Europe have disappointed for much of the year, and fears of a double dip recession have been a recurring theme, boosting bonds' tactical appeal.

Figure 5: US Government Bond Yield Slope



Source: Ecowin, NBER

Independently, if investors in aggregate are particularly nervous, they may well feel that even a downgraded government bond market is still preferable to risk assets. With nerves still raw from 2008/9, and the euro-area banking system seemingly fragile, risk appetite in 2011 has been slim.

In this context, S&P's US downgrade hit equity markets, not bonds, as investors reasoned that even a downgraded Treasury was still safer than a stock exposed to the uncertainty and retrenchment that would follow S&P's action.

[4] We tested for a statistical relation between yield curves and economic environment using macro-econometric models, but this relation has also been tested in previous literature – e.g. Estrella, A. and G., Hardouvelis (1991), *"The Term Structure as a Predictor of Real Economic Activity", Journal of Finance 46 (2), p. 555 - 576;* Zaher (2007), *"Evaluating factor forecasts for the UK: The role of asset prices," International Journal of Forecasting, Elsevier, vol. 23(4), p. 679-693*

… And Why Prices and Debt Worries Might Now Subside Together

A lasting solution to the euro area's problems requires much greater fiscal (and likely political) integration. This cannot happen overnight, as we've often noted here in *Compass*, but instead will proceed in a piecemeal, faltering fashion over many years.

However, we do think the member governments will make it clear they intend heading in this direction. This, together with the austerity packages already announced in the peripheral countries and ongoing support from the ECB (and if necessary the IMF), will slowly soothe investors' worst fears about sovereign creditworthiness.

If so, in the current climate it would likely serve also to reassure investors that their worst fears about the banking system and the euro area economy have been overdone. The impact of this on risk appetite could be extremely positive – particularly if, as recent data is beginning to suggest, the global economy is not quite as fragile in late 2011 as seemed likely a couple of months back.

In the US the budgetary stalemate does not seem likely to be resolved soon. However, it's the US where the economic data have been surprising positively. Our colleagues at Barclays Capital estimate that the economy has been growing at more than 3% in real terms in the fourth quarter, which would make it the fastest quarter of the year.

As a result, risk appetite may start to revive, and saving ratios fall – and with 10-year US Treasury yields at barely 2% in nominal terms to begin with, the stage could be set for a marked rebound in yields, even as rising taxes and falling unemployment bring the government deficit down. Government bonds are the most expensive of the nine asset classes that Barclays Wealth's Investment Philosophy suggests should be included in long-term, strategic portfolios, and in the muddle-through scenario, valuations will slowly become more important.

Two Long-Term Certainties: Debt and Taxes

The keys to the long-term sustainability of government balance sheets are the credibility of fiscal policy and economic growth. In the short term these objectives can be in conflict, as higher taxes and lower public spending bite into aggregate demand. But in practice, as noted earlier, the private sector often pushes its savings ratio up first, allowing it to absorb some of the fiscal retrenchment when it comes. The monetary climate too, can often offer support, for example real interest rates across the G7 and BRIC countries are currently negative.

These are not just academic observations: the UK economy famously (and embarrassingly for the 364 economists who signed a critical letter to the *Times*) grew out of a tough budget in difficult economic circumstances in 1981, partly for these reasons.

Longer term, governments in democracies usually preside over growth rather than deliver it. The key drivers of prosperity, as we noted in October's *Compass*, are the availability of land, labor and capital, and the way in which we make use of them (our collective entrepreneurialism, or productivity), not financial balance sheets. Governments can try to influence these things, but there are no guarantees of success. Some countries are clearly better endowed than others.

Market failures such as externalities (climate change, perhaps) and public goods (defense, for example) mean there will always be a role for government to play in even the most liberal of democracies. This in turn means government debt will likely always be with us. The ability to tax and borrow at favorable rates over very long time periods, not to mention government's monopoly over the provision of organized violence, gives fiscal policy its ultimate credibility. It would be inefficient for governments not to take advantage of this. The idea that public debt in aggregate will one day be repaid is as extreme in its way as the idea that the state should control everything.

Government borrowing can of course become unsustainable: if on reasonable assumptions and time horizons it looks as if the interest burden is set to rise faster than the tax base. No major government is currently faced with this situation. In particular the idea that Italy becomes insolvent the instant that the government bond yield hits 7% is surely mistaken.

Investment Strategy

As we discussed, the local and global business cycles, and the general state of risk aversion and investor confidence are the key drivers of the direction and level of yields.

With the US economy seemingly on a firmer footing, fears about a global recession have faded. This means that US Treasuries are vulnerable, and could set the stage for a sell-off in other developed government bond markets. But government bonds still offer a degree of portfolio insurance in uncertain periods, despite their inflated valuations, and most portfolios should maintain an ongoing holding in them.

There are two ways investors can maintain exposure to government bonds while at the same time reducing the risk posed by a sell-off.

A do-it-yourself approach that offers a degree of portfolio insurance and predictable income is a 'buy and hold' strategy focused on short-duration bonds (less than 5-year) to reduce reinvestment risk. Tactically, this strategy can be implemented by investing equally on the different tenors of the short-end of the yield curve. We favor the US and core euro area as key strategic markets.

An alternative approach is to use an actively managed fund. Such funds, based around a global or regional bond index, and able to use the manager's discretionary skill to take advantage of developments in the different business cycles across the developed world, can enhance the returns available from that index. These funds also provide return and risk characteristics loosely linked to the targeted index (e.g. the Barclays Capital Global Treasury Index), but are capable of outperforming it.

Companies are in Good Health – and Look Inexpensive

Kevin Gardiner
+44 (0)20 3555 8412
kevin.gardiner@barclayswealth.com

Will Hobbs
+44 (0)20 3555 8415
william.hobbs@barclayswealth.com

Right now companies seem to be in better financial shape than governments. If the global economy continues to grow in 2012, and governments leave them alone, we think their profitability and balance sheets will remain solid. However, this does not seem to be reflected in current stock market valuations.

A Corporate Health Check

It is debatable who behaved most recklessly during 'The Great Moderation' that ended abruptly in 2008 – lenders, sub-prime borrowers or governments? However, there should be widespread agreement on who behaved least recklessly: the bulk of the corporate sector, that is, non-financial companies.

Companies are not always such financial paragons. The cycle that culminated in the technology boom and bust in 2000 saw some very reckless borrowing and M&A activity that subsequently hit the corporate sector hard in 2001-2. Perhaps because they learned from that experience, the cycle that began in 2003 was characterized by financial restraint on the part of mainstream business.

During that cycle, the return on equity (RoE, a measure of profitability) averaged 13% on a trough-to-peak basis across developed markets, compared to a long-term trend of 12% (and that long-term trend was generated over a more inflationary period). This profitability was generated without recourse to rising leverage, with operating margins being the more important driver, a useful reminder that you can enjoy pricing power even at moderate levels of general inflation.

Profitability was of course hit hard by 'The Great Recession' that followed the collapse of Lehman Brothers and subsequent freezing of the global money supply. Financial companies were not the only ones to see large write-downs in assets, and operating margins were squeezed by the severe drop in economic activity.

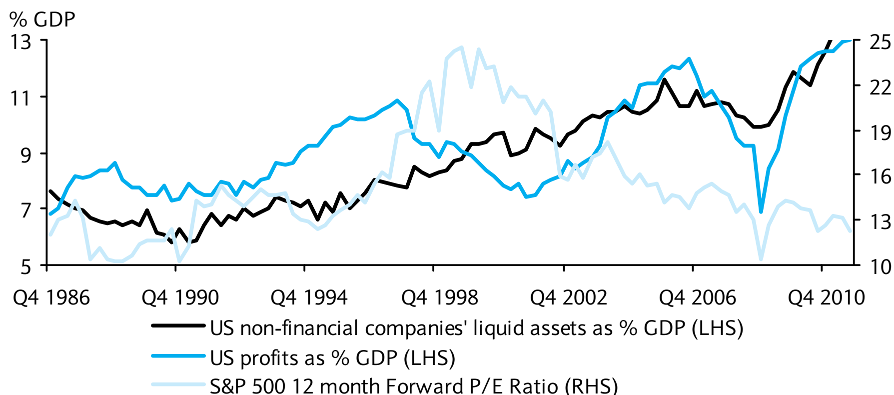
However, companies were quick to respond to the downturn in late 2008 by cutting costs, and they've been relatively slow to re-hire. As a result, operating margins have rebounded strongly, which has meant that a little top-line growth has gone a long way, particularly in the US.

European companies have obviously faced a more difficult operating environment, but for the developed world as a whole, RoE is firmly back into double digits. It seems unlikely to fall materially (if at all) in 2012, even if we allow for analysts to be around 10% too optimistic in their aggregate earnings projections (the 'R' in 'RoE'). Meanwhile, leverage has fallen, even (or especially) in the financial sector.

Tax Temptation?

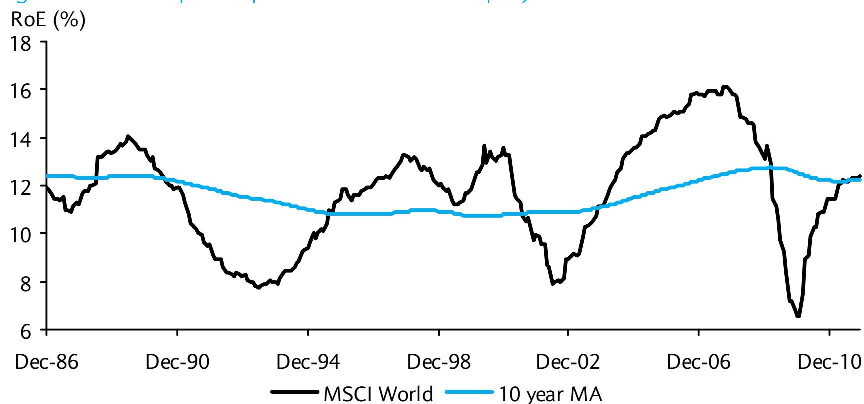
High profitability, cash generation, and large amounts of cash on many corporate balance sheets will provide a tempting source of extra tax revenue for hard-pressed governments. Windfall taxes have already been levied on many banks, and resources groups (oil and mining companies) are also easy targets. On balance, however, we think politicians will mostly resist this temptation, not least because capital spending and employment would likely be hit alongside shareholder returns.

Figure 1: Aggregate Profits and Corporate Cash in US National Accounts



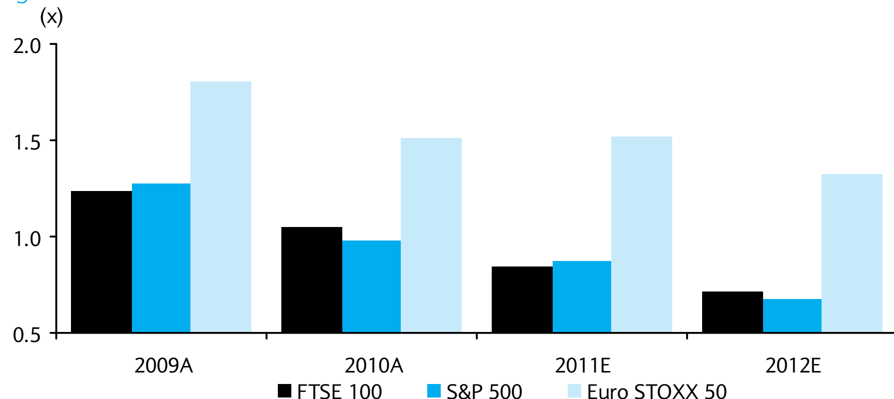
Source: Datastream, Barclays Wealth Strategy

Figure 2: Developed Equities – Return on Equity and 10-Year Trend



Source: MSCI, Barclays Wealth Strategy

Figure 3: Net Debt/EBITDA since 2009



Note: Data built using bottom up consensus expectations. Source: FactSet, Barclays Wealth Strategy

Are Companies Priced for Good Health?

Stock markets have been volatile for much of 2011, impacted by the sovereign debt crisis and renewed worries about a US ‘double dip’. As we write, the MSCI developed world index is down by roughly 10% in local currencies year to date, having been up 6% back in mid-February.

During the past year, profits have continued to edge higher, with a modest fall in the euro area being offset elsewhere, particularly in the US, where profits have again beaten analyst expectations (for a straight 11 quarters since they bottomed in late 2008).

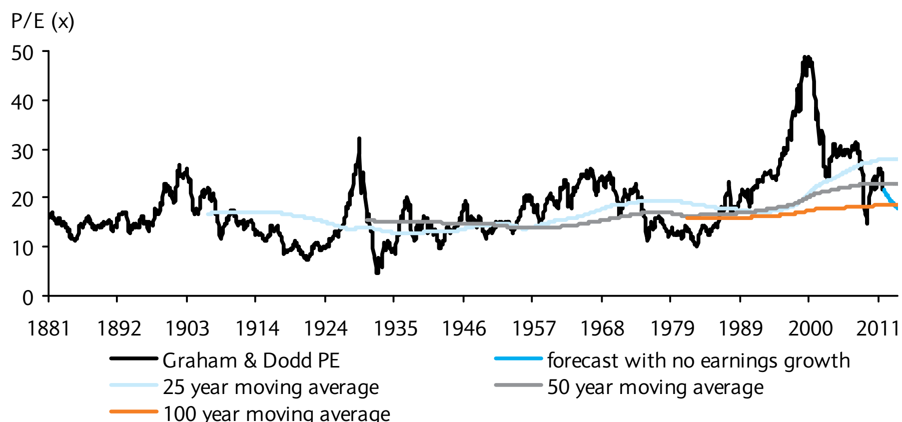
As a result, trailing price-to-earnings (PE) ratios have fallen markedly. More importantly, forward ratios based on analysts’ collective estimates of profits in the 12 months ahead have also fallen, and for the developed bloc as a whole stand currently at around 11, roughly one and a half standard deviations below their 10-year average. At this level, analysts could be collectively 25% too optimistic about those projected earnings and the ratio would still be no higher than usual.

Of course profits could disappoint by even more than this. But unless the economic outlook significantly worsens – that is, unless our ‘muddle through’ scenario is wrong – a dramatic shortfall looks unlikely. If it were to happen, most likely perhaps because euro area bank write-downs are bigger than expected and drive a wedge between GDP growth and quoted sector profits, it might be followed by a pronounced rebound in 2013 and beyond: a large and sustained fall in profits requires a significantly worse economic outlook than we currently think likely.

Balance sheet-based ratios tell a similar story. The ratio of stock prices to companies’ book value (shareholder funds), at 1.6, is almost 30% (also one and a half standard deviations) below its 10-year average.

Some valuation metrics paint a more negative picture. Most visibly, because it features frequently in the financial broadsheets, a very long-term analysis of a ‘cyclically-adjusted price earnings ratio’, or CAPE, suggests that stocks may even be expensive. For example, the US CAPE stands some way above its 100-year moving average.

Figure 4: A US Cyclically-Adjusted Price Earnings (CAPE) Ratio



Source: Robert Shiller, Barclays Wealth Strategy team

However, as we have noted often in earlier editions of Compass, we think this metric needs to be treated with care. For one thing, today's accounting conventions are simply not comparable with those that prevailed a long time ago. There wasn't widespread agreement on these things until after the Great Depression, and earnings statements from earlier periods are almost certainly too lenient – that is, they likely overstate earnings, and understate PE ratios.

Another difficulty is that the composition of the stock market and the wider investment context has changed dramatically. What practical insight can the PE ratio for a small basket of mostly frontier investments in the late 19th century offer now? It makes little sense to attach this to an index of 500 liquid stocks diversified across 10 broad sectors and benefiting from instant and costless newsflow.

Lastly, proponents of the CAPE forget that even the 10-year moving averages they favor as a way of smoothing out cyclical fluctuations in profits can still be influenced by base effects. As poor earnings data from 2002 drops out of the calculation, the moving average will rebound, and even if there is no further earnings growth in 2012 the CAPE is poised to fall markedly into 2013.

The Equity Risk Fable

Another measure often encountered in a long-term context is 'Tobin's Q' – the ratio of the current market value of companies' assets to their book value cost. It's also questionable in our view. In this case the available historical data is highly unsound, and the metric is arguably flawed to begin with because it makes little allowance for non-tangible assets, a major omission given that the service sector amounts for the bulk of most modern economies.

Meanwhile, another group of valuation measures tell a materially more positive story than PE and PB ratios considered in isolation. Other valuation measures are based on the notion that any investment can be valued by taking its projected future cashflow and translating it into a present value equivalent using an appropriate discount rate. They vary from full-blown dividend discount models, driven by long-term profitability and growth rates as well as by the risk-adjusted discount rate, to more inexpensive proxies such as the gap between equity yields and government bond yields. What they all have in common is that they make equities look cheaper because interest rates at present are so unusually low.

The fabled 'equity risk premium' (ERP) is a component of this sort of valuation tool. This is the amount of extra return that investors require to compensate them for the additional risk – ownership risk – that equities carry. When added to the 'riskless' interest rate – usually a long-term government bond yield – it comprises the discount rate needed for that present value calculation. Unfortunately, it can only be estimated indirectly, and needless to say there are as many ways of doing this as there are analysts in the market (if not more).

By far the most common approach when estimating the ERP is simply to equate it with the excess returns delivered by stocks historically (see for example, 'Triumph of the Optimists', LBS 2002, for a well-known illustration of this approach). Unfortunately, while this is the easiest way of calculating ERP, it's also potentially misleading.

The ex post returns on equities can diverge quite considerably from the ex ante excess return needed to compensate for risk. This is because in practice investors do not have the perfect foresight attributed to them by the finance textbooks.

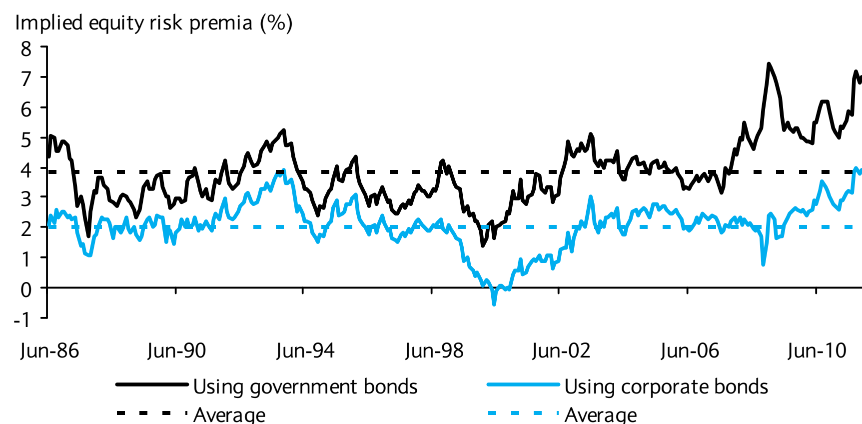
For example, and most visibly, in the last 15 years US equities have actually underperformed 10-year US Treasuries, by 16% in total (or 1.2% per annum). Does this apparently negative risk premium mean that stocks are less risky than bonds? Of course not. If investors could forecast their returns with some confidence, then they wouldn't be taking equity 'risk' at all.

The key measurement point is that ex post returns are unavoidably dependent on the time period used for analysis – and there is much more variation even between estimates spanning several decades than we might wish.

The solution is to estimate a genuinely forward-looking proxy for the risk premium. But because this requires an estimate of future long-term growth in dividends (or earnings), it also requires some subjectivity regarding how best to proxy such growth.

The results of using a forward-looking approach based loosely on recent trend growth in nominal GDP are shown in the chart below. It suggests that the amount of risk currently priced-in to the US equity market is perhaps three standard deviations higher than the 25-year average – a reading that is two standard deviations cheaper than would be suggested by considering, over the same period, a simple trailing PE on its own.

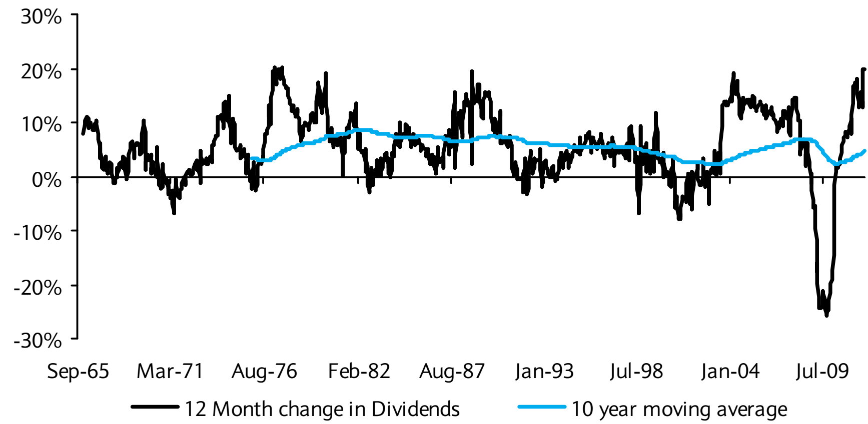
Figure 5: Estimated Forward-Looking Equity Risk Premia for the US



Source: Datastream, Barclays Wealth Strategy

Such an approach assumes that equities have not gone 'ex growth'. This shouldn't really be a contentious assumption: the following chart shows that after suffering the sharpest fall in living memory in 2008/9, US dividend growth has rebounded sufficiently to start pulling the trend rate of growth back up towards the levels typically built-in to long-term dividend discount models.

Figure 6: Dividend Growth and Trend (% Y-o-y)



Source: S&P, Datastream, Barclays Wealth Strategy

Of course for institutional investors to start using these interest rate-based valuations the current crisis needs to fade. Presently, the extreme valuations of equities relative to government bonds is a consequence of the investment climate, not a driver of it. In recent years investors have been selling stocks to buy bonds because they are scared, and the resultant valuations are a reflection of that. Only when the risks of euro collapse and of a double dip in the US have more visibly receded will those valuations start to be an input to investment decisions again, not an output of them. This will take some time, even in our central 'muddle through' scenario.

It's Always Darkest Right Before the Dawn

Emily Haisley, PhD
+44 (0)20 3555 8057
emily.haisley@barclayswealth.com

Investors are understandably hesitant about investing in risky assets right now, and are instead focused on the risk of economic conditions deteriorating even further. However, it's not just about the risk of being in the market. Investors also need to think about the risk of being out. The turning points that accompany rallies tend to occur when economic indicators still look bleak. Prior to sustained recovery, false starts and stops wear investor patience thin but contain some of the best performing days. This can make slight timing mistakes disproportionately costly.

The Volatility of Equity Markets

The inherent volatility of equity markets has both positive and negative implications for investors. On the positive side, greater risk means greater long-run returns. Over time equities outperform less risky assets, compensating equity investors for the uncertainty they endure. On the negative side, dramatic price movements coupled with market mistiming can undermine years of disciplined investing.

Research on the 'investor behavior penalty' shows the cost of market mistiming: the average return investors receive from equity funds is lower than the return they would have received with a simple buy and hold strategy. A Cass Business School study commissioned by Barclays Wealth estimates the investor behavior penalty for the average investor at 1.2% per year. This is a conservative estimate relative to other research findings. For example, estimates for the S&P 500 tend to be in the 3% to 7% range. The penalty becomes more pronounced for more volatile funds, implying that we can expect it to increase during uncertain times such as these.

Why does the average investor pay a penalty when attempting to time equity markets? Emotional trading is part of the problem. We make decisions that feel emotionally comfortable at the time, but lead us to exactly the opposite of the simplest and soundest investment advice: buy low and sell high. Our intuitive emotional reactions tempt us to buy equities when economic conditions are booming. When economic conditions look bleak, as they have since last August, our emotions urge us to run for the hills. For those who have stayed invested the market turmoil has taken a toll, depleting reserves of commitment and emotional resilience. The risk here is that selling out of equities now can undo years of investment by selling at a low point and missing a rally.

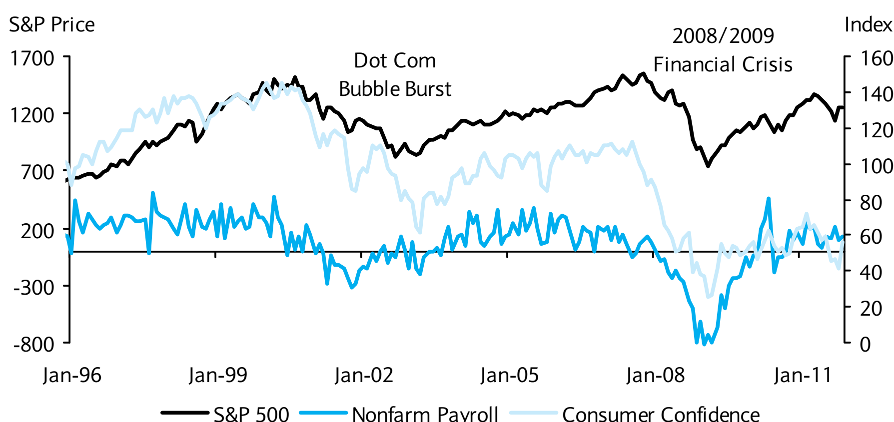
Unexpected Turning Points

The trouble is, rallies are impossible to time with any accuracy because they usually occur with little or no warning, when economic indicators still look daunting and our emotional resolve to stay invested is at its lowest. An economic analyst looking at

indicators today would not make particularly rosy predictions. However, the exact same thing could be said right before two large rallies we have seen in recent history: the recoveries after the dot com bubble burst and the 2008/2009 financial crisis.

Figures 1 and 2 overlay US economic indicators with the performance of the S&P 500. Consider the economic outlook during the turning point that preceded the recovery from the internet bubble burst in late 2002 to early 2003. Consumer confidence was lower than it had been in almost a decade. Labor market statistics, reflected by nonfarm payrolls, were depressed and volatile. Only ISM indices of business activity showed modest signs of improvement compared to the lows of 2001.

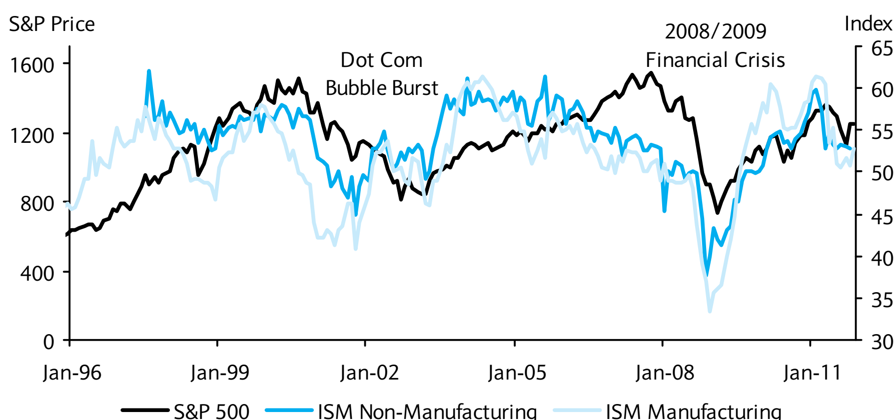
Figure 1: US Stock Market Performance and Indicators of Consumer Sentiment and Employment



Source: Barclays Wealth, Datastream, Institute for Supply Management

The indicators were even bleaker right before the credit crisis recovery in early 2009. Indicators of consumer sentiment, labor market statistics, and business activity were all at all time lows.

Figure 2: US Stock Market Performance and ISM Business Activity Indicators



Source: Barclays Wealth, Datastream, Institute for Supply Management

The lesson from these examples is that even when economic conditions look dismal and forecasts are grim there is still the possibility of recovery. The moment recovery starts is likely to be while things still appear rather dark and gloomy. Much of the current economic malaise comes from political uncertainty, which could abruptly resolve, provoking a quick rally. The challenge is enduring the slow processes of political posturing, conflicts and negotiations experienced during the US debt ceiling crisis and now with the Eurozone crisis. The more turmoil we observe, the more the emotional toll rises and the more difficult it becomes to stick with risky investments. However, as time passes, the greater the chance of a rally.

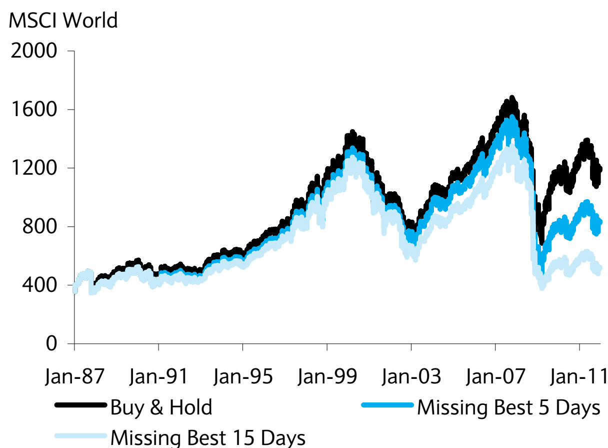
Though cash feels secure, it leaves you both vulnerable to the possibility of foregone upside and the near certainty of decreased value in real terms over time. By investing in 'safe haven' assets such as Treasuries or gold you are actually taking a strong implicit bet on economic conditions getting worse. If things get better, safe haven investments will tend to decline in value, making them quite the opposite of 'safe'.

The Best and the Worst of Times

Another potential culprit for the investor behavior penalty is a basic property of equity markets: volatility is concentrated in periods after abrupt market declines. This means investors can sacrifice a great deal of return if they are out of the market at the wrong time. Missing just the best five days of performance of the MSCI World Index over the last 25 years reduces the average yearly return dramatically from 9.4% to 5.3% (see Figure 3). Missing the best 15 days drops the yearly return down to 1.8%. Note this is just a handful of days out of approximately 6,500 trading days.

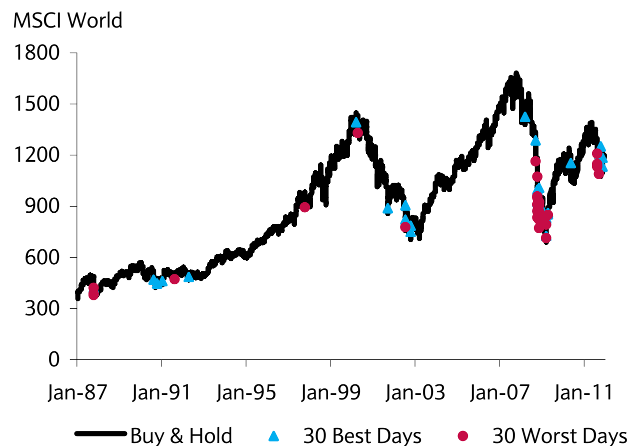
Missing the worst days of performance dramatically improves returns to a similar degree that missing the best hurts performance, leading to the conclusion that sitting out during down markets is a riskless strategy. However, we know on balance that we can expect the good to outweigh the bad – that is why equities have a positive expected return. Secondly, the rarity of the exceptionally good and exceptionally bad days makes

Figure 3: The Cost of Missing Just a Few Days of Exceptional Performance



Source: Barclays Wealth, Datastream

Figure 4: The Best and the Worst Days of Stock Market Performance



Source: Barclays Wealth, Datastream

predicting them essentially impossible to accomplish with consistency. If we accept that short-term market movements are difficult to predict and that we lose out in the long run sitting out of the market, particularly when equities are relatively cheap, then taking chances timing an exit from the market begins to look risky.

The high cost of missing just a few of the best days of stock market performance is not simply the product of an atypical time period or the selection of a particular index. The results are robust across variations in both time periods and indices. The returns of the less volatile bond markets are harder to shake, so ironically the dangers associated with mistiming are lower for assets we feel more comfortable buying and holding.

Though the days of exceptional performance are quite rare, our chances of missing them are enhanced because they occur exactly when we feel it's best to minimize risk exposure, i.e. when economic indicators are bleak and markets have been falling. Figure 4 depicts the 30 best and worst days of MSCI World performance over the same 25 year period. As you would expect, the worst 30 days of performance are concentrated during market lows. The surprising observation is that the best days tend to fall in these troughs as well.

(Not) Timing is Everything

Missing rallies, both short-lived and sustained can have a high cost. It's important to keep in mind that they tend to occur during periods of pessimism. They are surprisingly easy to miss because short-lived false starts account for most of the best performing days and sustained recoveries come without warning.

This reinforces the mundane wisdom of maintaining a risk exposure in line with your risk tolerance as opposed to gambling on a potentially unlucky market exit. This is not to say we advocate doing nothing. Now is an excellent time to review and rebalance[5] your portfolio to ensure you are not underweight equities relative to your ideal medium to long-term asset allocation. In particular, many portfolios that were correctly invested may now be underweight risky assets, simply because of the market movements – rebalancing back to the original allocation is a simple way to buy low, and sell high. Another option clients may favor is switching to more defensive stocks that tend to perform well in down markets.

Staying invested is not easy advice to take, particularly in the uncertain economic times we're currently experiencing. It requires emotional fortitude and tenacity. The drastic swings in performance and false starts can test anyone's patience and the consistent stream of bleak economic news focuses investors on the risk of further losses ahead. Refraining from attempting to time the market is one of the most echoed prescriptions for a good reason – it can be extremely challenging to enact successfully.

[5] Rebalancing does not guarantee an investor's goals and objectives will be met.

Global Investment Strategy Team

Risk tolerance | Composure | Market engagement | Perceived financial expertise | Delegation | Belief in skill

AARON GURWITZ, PhD Chief Investment Officer
aaron.gurwitz@barclayswealth.com 1 212 526 9255

US

DANIEL EGAN Head of Behavioral Finance, Americas
daniel.egan@barclayswealth.com 1 212 526 0549

ELIZABETH FELL Fixed Income
elizabeth.fell@barclayswealth.com 1 212 526 2589

HANS OLSEN Head of Americas Investment Strategy
hans.olsen@barclayswealth.com 1 212 526 4695

DINAH WALKER Macro
dinah.walker@barclayswealth.com 1 212 526 3426

UK

FRANCESCO CAPPONI Macro
francesco.capponi@barclayswealth.com 44 (0)20 3555 8401

GREG DAVIES, PhD Head of Behavioural and Quantitative Finance
greg.davies2@barclayswealth.com 44 (0)20 3555 8395

JIM DAVIES Equity
jim.davies@barclayswealth.com 44 (0)20 3555 8397

KEVIN GARDINER Head of EMEA Investment Strategy
kevin.gardiner@barclayswealth.com 44 (0)20 3555 8412

RYAN GREGORY Macro
yan.gregory@barclayswealth.com 44 (0)20 3555 8403

EMILY HAISLEY, PhD Behavioural Finance
emily.haisley@barclayswealth.com 44 (0)20 3555 8057

KYLIE HIGGINS Equity
kylie.higgins@barclayswealth.com 44 (0)20 3555 8413

WILLIAM HOBBS Equity
william.hobbs@barclayswealth.com 44 (0)20 3555 8415

TANYA JOYCE Commodities
tanya.joyce@barclayswealth.com 44 (0)20 3555 8405

PETR KRPATA FX
petr.krpata@barclayswealth.com 44 (0)20 3555 8398

AMIE STOW Fixed Income
amie.stow@barclayswealth.com 44 (0)20 3134 2692

CHRISTIAN THEIS Macro
christian.theis@barclayswealth.com 44 (0)20 3555 8409

FADI ZAHER, PhD Fixed Income
fadi.zaher@barclayswealth.com 44 (0)20 3134 8949

SINGAPORE

PETER BROOKS Head of Behavioural Finance, Asia
peter.brooks@barclaysasia.com 65 6308 2167

KUNSHAN CAI Equity
kunshan.cai@barclaysasia.com 65 6308 2985

EDDY LOH Equity
eddy.loh@barclaysasia.com 65 6308 3178

XINYI LU Macro
xinyi.lu@barclaysasia.com 65 6308 3114

BENJAMIN YEO Head of Asia Investment Strategy
benjamin.yeo@barclaysasia.com 65 6308 3599

Risk Tolerance

This is an expression of the long-term trade-off between risk and return in your portfolio. Higher risk tolerance indicates a higher risk, higher return portfolio.

Composure

The composure scale measures how emotionally engaged you tend to be with the investment journey.

Market Engagement

This measures the degree to which you are inclined to avoid or engage in financial markets. It shows whether you have a mental hurdle to investing.

Perceived financial expertise

This dimension assesses how familiar and informed you feel you are with current financial circumstances, and how confident you feel in your financial knowledge and decision making.

Delegation

The delegation scale assesses how much you believe you can benefit from delegating day-to-day portfolio management decisions to someone.

Belief in skill

This scale is used to determine how much you believe it is worth paying for an investment professional's potential to achieve above-market returns.

The value of the investments which may be stated in this document, and the income from them, may fall as well as rise. Past performance of investments is no guide to future performance. You may not get back the amount of capital you invest. Any income projections and yields are estimated and are included for indication only.

Barclays Wealth does not guarantee favorable investment outcomes. Nor does it provide any guarantee against investment losses

This publication is for information and discussion purposes only. Discussions herein do not take into account the specific investment objectives, financial situation or particular needs of any particular person, and the products, services and concepts described may not be suitable for all investors. If you are interested in investing in any product or service described herein, please consult a financial professional. **Investing in securities involves risk. This publication does not disclose all risks that may be associated with a particular investment described herein. Past performance is no guarantee of future results**.

This publication shall not constitute an underwriting commitment, an offer of financing, an offer to sell, or the solicitation of an offer to buy any products or services described herein. Barclays Bank PLC (including its affiliates worldwide, together herein "Barclays") accepts no liability whatsoever for any consequential losses arising from the misuse of this document or reliance on the information contained herein. Summaries of particular products and transactions described herein are indicative and may be amended, superseded or replaced by subsequent summaries. The final terms and conditions of any particular product and/or transaction described herein shall be set out in full in the applicable offering document(s) or binding transaction document(s).

Certain products or services described herein may not be available in all jurisdictions. You should not take notice of this publication if you know that your access would contravene applicable local, national or international laws. The contents of this publication have not been reviewed or approved by any regulatory authority.

Barclays does not guarantee the accuracy or completeness of any information value of any investment may fluctuate as a result of market changes.

Barclays and/or the individuals associated therewith (in various capacities) may already have or intend to: (i) seek investment banking or other business relationships for which they already receive or will receive compensation from the companies that are referenced herein ("Researched Companies"), such as underwriting, advising, and lending – as such, it is possible that Barclays and its affiliates may have managed or co-managed a public offering of securities for any issuer mentioned in this publication within the last three years; (ii) have an interest in the Researched Companies by making a market or dealing as principal in securities issued by Researched Companies or in options or other derivatives based thereon, or otherwise hold personal interests in the Research Companies; (iii) appoint employees or associates as directors or officers of the Researched Companies; (iv) act upon the contents of this publication prior to your having received it; and (v) effect transactions which are not consistent with the recommendations given herein.

In the United States, Barclays may act as both broker dealer and investment adviser. There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties. Please make sure you understand these differences before making any investment decision.

Barclays does not provide tax advice, and you should consult a tax professional prior to making any investment decision. Pursuant to Treasury guidelines, any tax related commentary contained in this publication (or any attachment) does not constitute a formal opinion. Accordingly, any tax related commentary contained herein (or any attachment) is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding penalties that may be asserted by the Internal Revenue Service. (Circular 230 Notice).

For additional information on any product or service described in this document, please contact your Barclays Wealth Investment Representative.

Printed December 2011
US0003