

Portfolio Management Report Q4 2011

Our investment strategy in the 4th quarter 2011

Positioning versus our benchmark (MSCI World) or neutral stock / bond allocation

European stocks	underweight
US stocks	neutral
Japanese stocks	underweight
Emerging Markets stocks	overweight
European bonds	underweight
US bonds	neutral

Exchange rate forecasts (quarter-end)

	2012 Q1	2012 Q2
USD/EUR	1.30	1.35
GBP/EUR	0.85	0.87
JPY/EUR	105.00	110.00

At a glance

- The outlook for the euro zone has clouded further, with a recession considered likely. Countries with sound fundamentals, such as Germany, should be able to decouple from this trend to some extent and get away with nothing worse than a stagnating economy.
- The US should close the year on solid growth. Our outlook for the coming year is clouded, however, due to the expiry of tax breaks. Nonetheless, current data warrant a little more optimism than for the euro zone: we believe that, over the full year, growth may well run at 2 percent.
- In an exceptionally speedy reaction, the European Central Bank (ECB) lowered its policy rate to 1 percent. In addition, the ECB announced further measures designed to take pressure off the financial sector and the financial markets. After the steps taken, the ECB is now expected to wait for their effects to unfold and to make adjustments if necessary. The US central bank (Fed) will continue to be guided by labour market performance. While recent data have been quite solid, further action may be called for should the situation deteriorate once again.

Review of 4th quarter 2011

The battle against the debt crisis continues

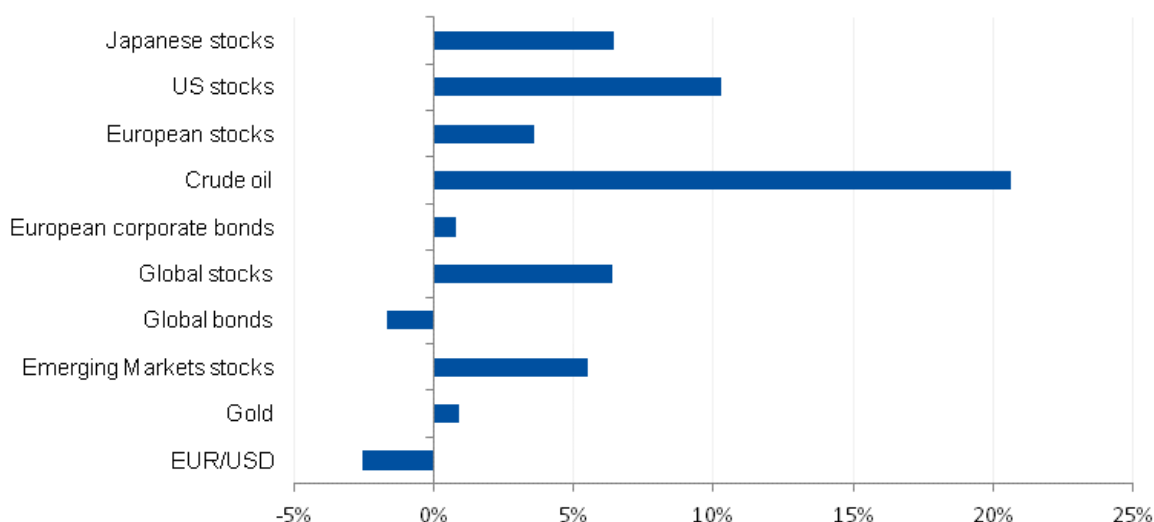
Even though the financial markets have stabilised a little in the course of the fourth quarter, it is unlikely that this will suffice for ending the year on a positive note. The problems that remain unresolved are still too massive and the outlook on the coming year appears too uncertain. The impatience with which a resolution of the debt problem is being awaited is in stark contrast with the slow progress being made in developing solutions, even though policies are now moving in the right direction. These will be discussed in more detail in the chapter on fixed income.

The calls for more proactive intervention are addressed primarily at the ECB, even though this institution did in fact make a quite substantial contribution towards the resolution of the problem in the fourth quarter. Beside the two rate cuts from 1.5 percent to 1 percent, this contribution included, most importantly, supporting measures designed to prop up the banks and the economy as a whole. In this regard, the ECB has proved quite creative. On 21 December, the ECB conducted a 36-month tender procedure with an early repayment option after one year. In addition, the reserve ratio was reduced from 2 percent to 1 percent. This move alone resulted in an additional EUR 100 billion in funding becoming available to commercial banks. In addition, the criteria governing the eligibility of collateral were relaxed once again and access facilitated for the banks. The problem of tight USD funding was tackled as well. The ECB's additional USD funding offer met with lively demand. In the 3-month tender conducted in early December, almost USD 51 billion were allotted, which was significantly more than in previous tender operations. Given these measures, it would be inappropriate to accuse the ECB of failing to act.

The US and, specifically, the Federal Reserve Bank (Fed) are demanding more resolute action to combat the crisis. However, when such pressure is applied from outside, its reasonableness must be questioned: the Fed did indeed take action earlier in response to its own economic cycle, which has been running ahead of Euroland's. Considering that the monetary policy transmission mechanism in the US (which describes how monetary policy decisions impact the economy in general and the price level in particular) is disrupted even more profoundly than in the euro zone, even more aggressive action would in fact be warranted in the US. Moreover, the level of US debt is higher than aggregate euro zone debt. Over the past few months at least, monetary and fiscal measures (tax concessions) produced results in the shape of good economic data. However, there is still no plan for fiscal consolidation. By contrast, a number of euro zone countries are already issuing much clearer signals.

There is still a lot that needs to be done here and there, and it is not to be expected that a solution will be found overnight. The steps taken are leading in the right direction, however.

Performance by asset class in the 4th quarter 2011 in EUR (as of 16 December 2011)



Source: Bloomberg

Outlook – Positioning

US: looking forward with slight optimism

In the fourth quarter, the economic environment looked significantly more positive in the US than it did in the euro zone. Although indicators still fail to signal strong growth – with no change being expected over the coming quarters – there has been a reversal in many of the leading economic indicators, suggesting that growth rates will remain in positive territory. One key representative of this category is the ISM index, which has recovered from its August low and has meanwhile risen to 52.7 points. What is particularly encouraging in this context is the fact that the new orders sub-component has climbed to 56.7 points, which signals continuing growth in the industrial sector in the months to come.

Further positive signals come from the labour market, where more than 100,000 new private-sector jobs were created during the past months. Unemployment is down from 9 percent to 8.6 percent, which – at first glance – is a strong signal. A closer look at this development reveals that it is due in part to a reduction of the potential workforce. This may indicate that imbalances persist, that jobs are hard to find and that many have stopped looking for work. The number of the so-called "discouraged jobseekers" is slightly up again to almost 1.1 million. This means that the underlying problems continue to exist despite some signs of improvement.

Nonetheless, fourth quarter growth should come in robust and may well exceed the 2-percent rate recorded in the third quarter. One key driver might once again be the US consumer, who should currently be feeling slight relief due to lower crude prices, which is a welcome effect in the Christmas shopping season.

Despite the positive signals from the US economy, the outlook remains cloudy as a large part of current momentum appears to be attributable to corporate tax concessions: investment expenditure incurred by 31 December 2011, for example, may be written off by as much as 100 percent in the first year. It may be assumed that many businesses have taken advantage of this option. The move has been widely criticised, with critics arguing that investment momentum will consequently be lacking next year and growth rates are therefore expected to

fall significantly. But if investment activity increases due to this and other stimulus measures, the resulting production, supplies, etc. will in many cases take place only next year. Therefore, momentum should continue to remain strong and ensure positive growth. We share the views of numerous analysts who predict sluggish growth for 2012, but we do not believe that the economy will actually slump at the beginning of the year.

For the Fed, such a scenario would lead to lengthy debates. The Fed is faced with a predominantly low-growth environment. The increase in payrolls is reasonably satisfactory but not large enough to reduce the jobless rate. Last but not least, above-target inflation may cause the one or the other dove to consider "quantitative easing III" or other measures.

Europe: signs are pointing to recession

To outside observers, the euro zone may not always have presented a pretty picture over the past few months. Many countries were/are forced to confront the debt problem proactively. But since omelettes cannot be made without breaking eggs, such measures do not always proceed completely smoothly. As a preliminary result of debates held so far, awareness of the problem has been raised and, on this basis, austerity plans have been presented. Ambitious fiscal consolidation packages have meanwhile been announced not only by the well-known countries of the periphery, but also by Italy and Spain. Even Austria, which had caught less of the limelight in the past, has now recognised the signs of the time and is trying to put together a package that is acceptable to both coalition parties.

The idea of cutting spending in a downturn, i.e. procyclically, may appear highly questionable to economists. On the other hand, one should not only think in terms of conventional theory but also bear in mind that there is no alternative to austerity in view of widening risk premiums and the prospect of further widening in the future, which will reduce fiscal leeway in the years ahead. In the short run, the impacts on the economy may be negative. In the medium and long term, however, these measures will lay the fiscal groundwork on which policy-makers will be able to actively pursue economic policies instead of just reacting.

Apart from political uncertainty, fundamental conditions have exacerbated further as well. Entrepreneurs, especially in the industrial sector, are sceptical about the situation in the coming year. In the euro zone, new orders are already on the decline, pointing to weaker production activity in the months ahead.

This is likely to apply to the average euro zone country while Germany is expected to outperform. While sentiment in our neighbouring country is far from rosy, current data point at least to some stabilisation. We do not wish to rule out some periods of declining economic activity, but Germany's annual growth rate should be noticeably higher than in the peripheral states.

What is unusually high in this economic environment is the inflation rate. With economic growth running at barely above zero percent, prices should in fact not be rising at a rate of 3 percent p.a.. Monetary policy has nonetheless been loosened, which leads us to conclude that the ECB regards other problems as more urgent. If growth slows down in the coming year as expected, inflation rates should decelerate as well, though. It is therefore quite legitimate to give priority to other trouble spots.

Japan: growth weakens after solid 3rd quarter performance

The latest figures reported from Japan have been extremely strong. In the third quarter 2011, growth turned positive for the first time this year. After rising vigorously from July to September, economic performance is expected to weaken again in the final quarter of 2011, due above all to the global slowing of economic activity. While Japan's direct exports account for

only a minor share of GDP, indirect dependence on upstream production is significantly higher.

A positive contribution to Japan's economic performance might come from the extra budget approved by Prime Minister Noda to fund reconstruction after the earthquake. The development of household demand, on the other hand, is likely to stall again after the expiry of a wide range of stimulus measures.

Asia: strategies designed to stimulate economic activity

Growth forecasts for 2012 signal weakening in the Asian region as well. Nonetheless, economic growth in Asia is estimated to run at around 7 percent and in China at more than 8 percent.

The decline in growth is attributable above all to lower exports to the US and to Europe. Next year, China may possibly record zero growth in exports. In its latest meeting, the Chinese government presented steps to boost export growth as well as to stimulate the entire economy. Exports to emerging markets are to be increased: special export bases are to help exporters in developing and marketing products and services in emerging markets. Of similar importance are exports of small Asian countries to China, for whom China is the prime export market. Intra-Asian trade currently accounts for 55 percent of exports.

Even though the current decline in inflation might suggest that monetary policy could be loosened, this is a measure that is set aside for specific purposes. In China, the minimum reserve requirement was lowered already in November. The stimulus packages of the years 2008/2009 and the system of shadow financing have pushed debt up significantly in recent years. A further relaxation of monetary policy along with a significant rise in wages driven by the shortage of labour in the cities would trigger another sharp rise in inflation. The central government is therefore trying to stimulate consumption through fiscal measures rather than loosening monetary policy to stimulate the economy. If growth slumps more steeply than planned, the Chinese government will, however, not hesitate to take the necessary measures.

Stock markets: global uncertainty and volatility

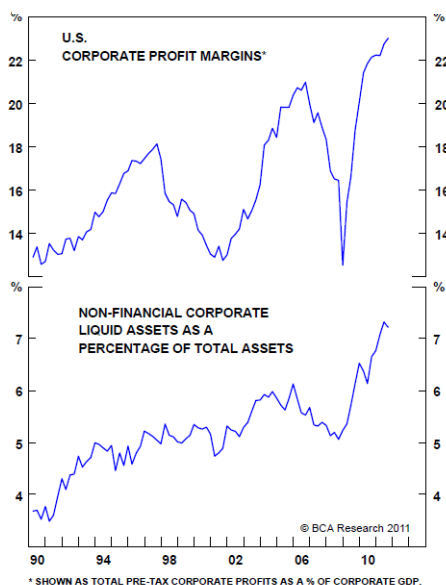
Slower economic growth or even recession in parts of the European Union combined with tough austerity policies and credit tightening by the banks is the scenario that investors will be faced with in 2012. This economic scenario is overshadowed by the euro crisis. The measures taken to rescue the euro zone are being widely criticised by political leaders and economists world-wide. On the other hand, the all but total loss of confidence that a solution will be found may also be good news: now, any credible approach to a solution will be regarded as a positive surprise.

Investors have to ask themselves whether current valuations al-

ready price in the gloomy economic outlook. Over the past three months, global earnings estimates for 2012 have been cut by almost 6 percent. For the coming year, analysts still expect earnings growth rates of around 10 percent in both the US and in Europe. In view of the austerity programmes announced by governments, the question is whether earnings estimates may not be too high after all.

"Next year's elections in the U.S. and abroad could, in and of themselves, warrant a re-rating of equities, as could a creative solution to the European debt crisis, lower energy prices, or a myriad of other unforeseen developments that inspire greater confidence that the earnings already achieved are unlikely to vanish. In the same way that the mind is willing but the flesh is weak, the earnings are there but the confidence is not."
Strategas Research Partners

Healthy US corporate balance sheets



Even if it appears trivial to point once again to companies' strong balance sheets and high cash holdings, these micro factors still warrant due attention. In view of subdued unit labour costs and low interest rates, especially US companies should again report sound earnings growth in 2012. The forecasts for the US were cut by only 0.7 percent last month, which is consistent with the real economy surprises in the US, which tend to be on the positive side.

Analysts' estimates for the current year had likewise been repeatedly criticised for being overly optimistic. Nonetheless, actual corporate earnings came in as expected or even higher. In the third quarter 2011, US companies reported earnings growth of almost 17 percent versus the same quarter of the previous year.

In terms of general asset allocation our position is neutral. Especially during difficult market phases and at times of high uncertainty, broadly based positions and disciplined decision-making are of key importance. The prices of investment-grade sovereign bonds are currently not exactly attractive and investors are holding high levels of cash. This raises the probability that some of these funds will flow again into the stock market. While stocks offer upside potential, the risks remain high due to the current fiscal environment. Against this backdrop, the coveted safe haven may best be found in a broadly diversified portfolio.

"We do not expect a breakthrough in the short term and the tug-of-war environment should persist until the ECB becomes more proactive. However, as long as investors are convinced that Europe can avoid a systemic event, U.S. equities should experience an one off upward rerating sometime in the next year. We believe that the ECB will continue to try to set up a firewall to prevent a systemic failure and this is why we take a cautiously optimistic view on stocks."
BCA Research

We keep preferring non-cyclical high-dividend stocks and are globally strongly underweighted in the financial sector. Asia keeps developing very dynamically. We do not share fears of a hard landing. In view of the improved global environment we now see better support for Asian stocks and have increased our exposure at the expense of US stocks. Our US position is thus again neutral. We maintain our significant underweighting of Japan and the European markets. Our largest overweight is now in Asia and, as before, in emerging markets, above all in Eastern Europe.

Fixed income: continuing caution is advisable

The fourth quarter 2011 was marked by concerns about the future of the euro zone. At two summits, a variety of strategies were proposed to resolve the debt crisis. Our views on these are mixed, but at least not entirely negative.

What the financial markets are calling for is clear: a "big bang" – a Community bond and/or a massive asset purchasing programme by the ECB. As regards the first option – bonds that are jointly issued and guaranteed – it is above all Germany that is unwilling to take the plunge. The second option, i.e. massive purchasing of peripheral countries' bonds by the ECB, is in conflict with the treaties defining the remit of ECB activities, according to President Draghi's current views (and, most importantly, Bundesbank President Weidmann's).

In early December, a way out of the dilemma had apparently emerged already: ECB President Draghi indicated that the ECB might play a significantly more active role if the rules of the Stability Pact were tightened. When the heads of state or government finally agreed on a new Stability Pact (without the UK), it turned out that Draghi's comments before the European Parliament may have been over-interpreted. The bond market, in any case, reacted with disappointment when the ECB failed to take major action. But still: the results of the second summit constitute progress. They underline the absolute commitment of all euro states to the single currency and pave the way towards closer fiscal union. An automatic debt-reduction mechanism that cannot simply be circumvented by rotten compromise is a key prerequisite for restoring confidence.

Another positive development in the fourth quarter was the formation of new governments in both Greece and Italy, whose willingness and ability to implement substantial austerity measures are believed to be greater than their predecessors'. In Ireland, Portugal and Spain, austerity packages were carried out resolutely, if with varying success.

However, to prevent our assessment from appearing excessively upbeat: with the "new Stability Pact", the devil is in the fine print, since not only is its implementation unclear but the evaluation procedure must yet be defined. One thing is certain, however: even if the governments get their deficits under control and the new Stability Pact delivers on its promises, it will probably take too long to produce results and we will need one of the "big bangs" mentioned above nonetheless. While the governments' consolidation policies will have a slowing effect on the overall economy, the tighter capital adequacy requirements for banks will have a negative impact on lending. A credit crunch among European banks might hit in particular emerging markets, dashing all hopes for growth drivers coming from there. The ECB is trying to counteract this by cutting rates and lowering the reserve ratio. However, in view of high redemptions of (government-guaranteed) bank bonds and a certain fear of state ownership, the banks prefer shrinking their balance sheets rather than extending new loans.

Where our exposure is concerned, we remain cautious yet constructive. Strongly underweighting peripheral states is still the order of the day in our opinion. The focus should nonetheless be on an assessment of return and risk. We have identified opportunities in secured bonds and corporate bonds while being careful not to underestimate the impacts of the debt crisis.

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