EIS Asset Management

EIS ASSET MANAGEMENT – INVESTMENT STRATEGIES FOR VOLATILE MARKETS

The end of the credit crunch?

Co-ordinated response may unlock markets

The global financial system may be on the brink of recovery from the credit crunch, following a coordinated policy response from world leaders. The two biggest issues plaguing markets have been liquidity and counterparty risk. Measures outlined in recent days and weeks address these challenges.

Governments are using a range of policy tools

These measures include the $700 billion US Troubled Asset Relief Plan (TARP); the interest rate cut by central banks in north America, Europe and Asia; part nationalization of key financial institutions, such as AIG and Royal Bank of Scotland. The history of recent financial crises in Sweden and the US suggests that swift implementation of policies such as these can restore stability to financial markets and prevent a deep and protracted recession. In particular, the Resolution Trust Corporation, which helped resolve the US Savings & Loans crisis of the late 1980s, offers useful lessons.

World leaders will keep trying until they succeed

Over and above the specifics of individual measures is the clear commitment by world leaders to end the credit crisis. G7 finance ministers outlined a five-point plan on October 11th, which included a commitment to take "all necessary steps to unfreeze credit and money markets". They also promised "urgent and exceptional action" to restore confidence. Given the unprecedented nature of the current financial crisis, it is difficult to predict precisely which policy tools will ultimately prove effective. And of course with all solutions, swift implementation is needed. Crucially, world leaders have promised to continue trying new solutions – and spend ever more taxpayer money – until they find a formula that works.

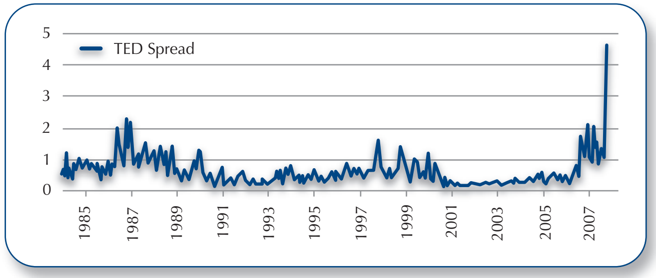
Key indicators to watch

Recent turmoil in financial markets has made many traditional economic indicators redundant in assessing the health of the global economy. Data on GDP, employment and inflation are lagging indicators. Today, key statistics in money and derivatives markets are more useful guides to future trends in conventional assets such as stocks and bonds, and the real economy. We believe TED spreads, Credit Default Swaps and the Vix will be among the first signals that the worst of the credit crunch is over, and the recovery is beginning.

1. TED Spreads

The TED spread is the difference between the interest rate on interbank loans and short term US government debt. (The acronym is formed from T-Bill and ED, the ticker symbol for the Eurodollar futures contract). Historically, the TED spread has tended to trade between 10 and 40 basis points, but has widened dramatically during the credit crunch, touching 465 basis points on October 10th.

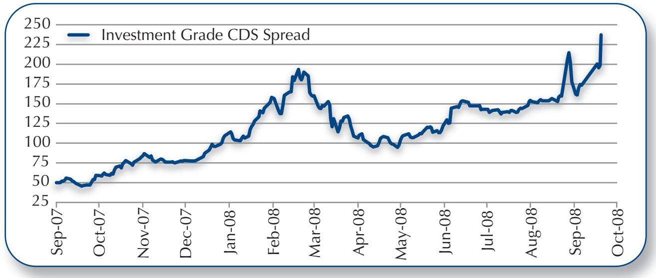
The TED spread is a key indicator of risk appetite among banks. We are watching for the moment when the widening trend stops, and the TED spread begins to narrow. This point of inflection could signal the beginning of the end of the credit crisis.



2. Credit Default Swaps

Credit default swaps are derivative contracts based on bonds or other large-scale borrowings. Some lenders use them to hedge against default by borrowers, while others use them to bet on a company's ability to pay its debt. Spreads on these securities have widened significantly during the credit crunch: investors are betting that the risk of default is on the rise. This is true of CDS instruments linked to many companies, such as Morgan Stanley or General Electric, and of broader CDS indexes such as Europe's benchmark Markit iTraxx Crossover index.

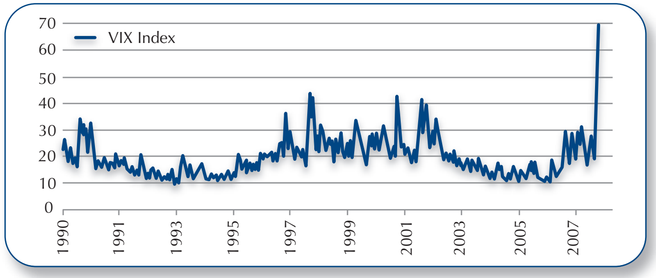
As with the TED spread, we will be watching for spreads in the CDS market to reverse their trend of widening, and begin to narrow. We believe this will provide an early indicator that the worst of the credit is over.



3. The Vix Volatility Index

Vix is the ticker symbol for the Chicago Board of Trade Volatility Index. It's an indicator of trading volatility on US stock markets (the Vix is based on options on the S&P 500). Typically, it trades in range between 20 and 30. Any number below that indicates unusually calm stock markets, while any number above that indicates unusually erratic trading. On October 10th, the Vix climbed to a record level of 75. Before October of this year, it had never been above 50 in its 18-year history.

We are watching for the Vix to reverse this trend. When we reach that point of inflection, and the Vix falls back towards its historic average of 22, we believe a semblance of normality may be returning to the market.



Overview

- The co-ordinated global policy response to the credit crunch may mark the beginning of the end of the financial crisis.
- Sharp falls in the price of equities, corporate bonds and real estate present opportunities in developed and emerging markets.
- Watch the key sensitive market indicators for clear guidance of a market turning point.
- The sell-off in Middle East & North Africa stocks seems excessive. Current valuations represent significant buying opportunities.

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Asset allocation

We believe recent stress in financial markets presents opportunities to acquire assets at attractive valuations. This is true across assets classes, and across geographies. In this document we highlight the thinking behind our asset allocation at this time.

Opportunity

Developed markets	Emerging markets	Middle East & North Africa
Equities trade at lowest valuations since 1982	Equity valuations at the lowest level in recent history	Price/earnings ratios in single digits
Investment grade bonds yielding near double digits	Earnings growth remains positive, albeit at a slower pace	Yields are rising on Islamic bonds (sukuk)
Real Estate Investment Trusts trade below NAV	Decelerating inflation may prompt interest rate cuts	Earnings growth remains strong, as governments reinvest oil surpluses, fuelling GDP growth

At-a-glance EIS Asset Allocation October 2008

	Developed Markets	Emerging Markets	Middle East & North Africa
Equities	over	over	over
Corporate bonds	over	over	over
Government bonds	under	over	n/a
Real Estate	equal	over	over
Cash & Equivalents	under	under	under
Hedge Funds	neutral	under	n/a

Note: Of course, our asset allocation strategy is far more nuanced than the weightings in this table. It is intended simply to give an overview of broad investment themes

Global asset allocation

Global equities are inexpensive

The aggressive sell-off in global stocks has driven valuations down to historically low levels. The trailing price/earnings ratio of the MSCI World Index is now 11 – the lowest since 1982. The average trailing P/E ratio for emerging markets is 9, against a historical average of 16. Even if corporate profits were to decline by 10 - 20%, the market would still remain attractively priced.

Corporate bond yields are high

Yields on investment grade US corporate bonds are approaching 9 percent – more than 700 basis points above the Fed Funds target rate. Yields on high-yield corporate bonds are in the high teens. With corporate balance sheets looking healthy (with the possible exception of the financial sector) and default rates low by historical standards, we believe these are attractive. By contrast, a “flight to quality” by many investors has driven up the price of government debt. Yields on these assets are consequently negligible, making them unattractive.

US housing market may be bottoming out

The rate of decline in US house prices is leveling out, suggesting that we may be close to the bottom of the market. Prices have fallen by 20 percent since the peak in summer 2006, according the Case/Shiller survey, representing an attractive entry point. Real Estate Investment Trusts (REITS) also offer attractive valuations with many are trading at a discount to Net Asset Value.

Hedge funds are struggling under new regulations

Regulators in the United States and many other markets have passed emergency measures prohibiting short selling of financial stocks. This is having a negative impact on many hedge funds, which deploy long-short strategies. For this reason we are cautious about investing in hedge funds. We do have some exposure to hedge funds, but our investments are generally in funds with conservative strategies.

Prospects for the Middle East & North Africa

A range of factors drove MENA shares lower

To understand the opportunities and risks of investing in MENA assets, it’s first important to understand the factors behind the sharp drop in share prices throughout 2008. The Saudi Tadawul index had fallen 48 percent by mid-October, the main Dubai index had dropped 49 percent, while the regional benchmark MSCI Arabian Markets index was 38 percent lower. Factors driving these declines include:

- Oil fell from a peak of $145 a barrel to below $80
- Foreign investors sold shares following redemptions from emerging market funds
- Margin calls forced some investors to sell shares
- Broker reports forecast a decline in Dubai real estate prices
- Investigations into fraud and embezzlement at some UAE firms
- Liquidity tightness as the credit crunch spread to the region

Valuations now look attractive

Many shares in the Middle East & North Africa now look cheap, following steep declines in regional benchmarks. Prices may fall even further before they recover, but for long-term investors looking build a portfolio of regional equities, current valuations mark an attractive entry point. At EIS, the Fund Manager has taken this opportunity to raise equity exposure of the MENA Opportunities fund above neutral, from 60 percent to 65 percent.

Regional sukuk offer attractive yields

Islamic bonds, or sukuk, have also reached attractive levels. Many are now yielding about 400 basis points above their benchmark rate (EIBOR), which itself is some 300 basis points above the Fed Funds rate. Given that many sukuk are issued by state-backed companies, particularly in the UAE, they have an implicit government guarantee – a fact reflected in strong ratings by international agencies.

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Factors driving MENA returns

Economic fundamentals are strong

While some negative issues remain, we believe the economic and demographic fundamentals in the region are strong. Furthermore, we believe corporate balance sheets are on the whole robust, and that earnings growth of 20 percent in 2008 and 2009 is realistic. Against this backdrop, valuations appear attractive: the average price/earnings ratio of regional listed companies is in single digits, even based on conservative projections for 2009 earnings.

Oil prices are high by historic standards

Oil may have fallen from close to $150 a barrel to below $80, but that is still high by historical standards. The break-even point for most Gulf government budgets is about $50 a barrel. Furthermore, many governments have built up significant sovereign wealth over the past few years as a result of high oil prices. For these reasons, Gulf governments will continue to pay for significant public spending programmes that are key engines of growth.

Governments will support the financial system

We further believe that Gulf governments will use this oil wealth to relieve tightness in regional credit markets. Regional banks have begun to feel the effects of the credit crunch. For example, the spread between the three month UAE interbank rate (EIBOR) and the Central Bank base rate climbed above 300 basis points in October. This followed a period of rapid expansion in bank lending (c. 40% y-oy), outpacing growth in deposits, with the aggregate loan/deposit ratio of UAE banks reaching 107% at the end of June 2008. UAE banks had increasingly relied on the international wholesale debt market for funding, but that source has all but dried up.

Gulf governments take active steps

In late September, the UAE Central Bank responded with a Dhs50 billion programme to inject liquidity into the financial system, and pledged to take further action if necessary. In October, the UAE government guaranteed all bank deposits, and interbank lending. In addition a further Dhs70 billion will be pumped into the system in various forms to aid liquidity. The Qatar Investment Authority said it would take stakes of up to 20 percent in domestic banks, while the Kuwait government directed its sovereign wealth fund to take a range of measures, including doubling deposits with domestic banks.

Economic growth will fuel population growth

Economic growth will continue to fuel population growth through immigration. While many of those arriving are low-skilled, low paid workers, an increasing number are middle and upper income workers: engineers, doctors, bankers, teachers etc. This population growth has driven the construction booms taking place in cities such as Dubai, Abu Dhabi and Doha, and in parts of Saudi Arabia.

Supply bottlenecks will keep real estate in balance

Some broker reports have predicted an oversupply of housing in Dubai from 2009, and are therefore predicting declines in house prices of up to 20 percent. This has prompted fears among some investors that “the bubble is about to burst”. Our view is that population growth, coupled with bottlenecks in the completion of new homes, should keep supply and demand in relative balance. Indeed, residential real estate prices have roughly quadrupled since 2003; the market could absorb some moderation in prices, which could prove beneficial in easing inflation.

Opportunities for Growth

MENA companies trading at forward p/e ratio of 9

We have stress-tested our valuation models to take account of the possible impact of the credit crunch on economic and corporate activity within the region. Even adopting a conservative approach, we see a price/earnings ratio of about 9, based on 2009 earnings. Dividend yields in high single digits are commonplace, with a number of companies actively considering buyback programmes, which could further boost shareholder value.

Emaar Properties trades at heavy discount to NAV

For example, Emaar Properties is trading at a heavy discount to the Reported Net Asset Value. Based in Dubai, Emaar is the region’s largest publicly traded real estate developer. The reported net asset value as of mid-2008 implies a share price of 17 dirhams. Emaar shares closed on October 12th at 5.1 dirhams.

Arabtec valuation appears attractive

Shares of Arabtec, a construction company based in Dubai, have lost more than half their value in three months. From a peak of close to 20 dirhams in summer, they closed below 7 dirhams on October 12th. Arabtec is a market leading contractor with a good track record of delivery and a strong order book. We believe it has been oversold, as a combination of panic selling, fund redemptions and margin calls led investors to discard shares in good companies. Even after using a very conservative assumption of discounting the order book by a third, we still get a P/E for 2009 of 6.5m which is extremely cheap compared to the market.

Etisalat sell-off looks unjustified

Etisalat is another good company that has been dragged down in the recent wave of selling. Shares of the UAE telecom operator have dropped by more than a third since peaking in April, despite its robust balance sheet, dominant domestic position and overseas expansion. Etisalat is now great value, trading at a 2009 p/e ratio of 10.

Increased demand for income yielding funds

Given the extreme stress in the equities markets we have seen a lot of demand for stable income yielding funds. Our Emirates Real Estate Fund, as an example, has delivered 39 consecutive months of positive return since inception (Year to date +12.97%). Similarly the Close Freehold Income Trust fund provides a steady income stream with no correlation to commercial or residential property prices. Over the past 10 years this fund has provided positive return months in excess of 95% of the time.

Conclusion

Asset markets around the world have been battered by a remarkable series of negative events over the past year. The Middle East & North Africa has been no exception. While the sell-off in some of assets has been justified, many good assets have been oversold.

We believe the co-ordinated policy response from world leaders will ultimately succeed in returning stability to global markets. As such, today’s prices represent attractive valuations at which to acquire fundamentally sound assets that will benefit from the recovery.

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