

'As we face into the New Year, the issue of liquidity in European sovereign debt markets dominates all other concerns.' **Page 5**

# MarketWatch

## January 2012

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*The European financial crisis continues to dominate the financial markets' landscape. The last EU Summit meeting, held in early December, was the fifteenth such meeting since the crisis began a couple of years ago. However, we seem to be further away than ever from reaching a satisfactory solution to the problems of Europe.*

*The need to restore liquidity to sovereign debt markets must be at the heart of any solution. Greece and Ireland were forced out of the public bond markets in 2010 and Portugal followed suit early last year. All three are now dependent on funding programmes from the International Monetary Fund ('IMF') and the European Union ('EU') to meet their day-to-day obligations but these three countries combined account for only 6% of Euro zone GDP and their financing needs can be catered for within the existing support funds of the EU and IMF.*

*Once larger issuers such as Italy and Spain (and even France and Germany) find it difficult to access funds in public bond markets, the risks to the system are greatly magnified. These countries need to raise hundreds of billions of Euro over the next few months just to refinance their maturing obligations. Unless they can do so*

*in the public markets, we are running the risk of sovereign default and all the consequences that would bring for the global economy and global financial system.*

*Already there are clear negative feedback loops from the crisis to the real economy and most forecasters expect the Euro zone to slide into recession again in 2012.*

*It has also raised the fear of the break up of the Euro itself in the minds of many. We think that is very unlikely. We do not believe there is any way of breaking up the currency union without having a very serious impact on the global banking system and it is difficult to see how a major global depression could be avoided in such circumstances.*

*Ultimately we do not believe policy makers will allow this happen, but, until they give a clear indication of their determination to support the system, financial markets are likely to remain under strain. In the meantime we recommend that portfolios remain underweight risk assets and be as flexible and liquid as possible.*

*Robbie Kelleher  
Head of Global Investment Strategy*

# On the brink

## Global recovery runs out of steam

It may seem strange now but this time last year many analysts were relatively optimistic about prospects for the global economy and global financial markets. The post-Lehman Brothers recovery which began in the middle of 2009 had gathered pace in 2010 and we now know that global GDP expanded by more than 5% in that year. At the same time global corporate profits had bounced by more than 40% and some equity markets had almost doubled in value from their lows of March 2009 but even at these higher levels, valuations in equity markets did not seem particularly demanding.

The 2009/2010 global economic recovery was mainly driven by a very substantial and globally coordinated policy response to the financial stress that emerged after the fall of Lehman Brothers in September 2008. Interest rates were reduced to very low levels, budget deficits were allowed to widen, Central Banks provided massive liquidity support to money markets and Governments injected significant capital into banking systems.

It was hoped that 2011 would be the year where the private sector took on the stimulatory baton from the public sector. That would require consumers to start spending again and companies to increase their capital investment programmes, but,

as the year unfolded, it became clear that the response from the private sector was less than was hoped for. By the third quarter of last year, the year-on-year growth rates had slowed to around 1.5% in the Euro zone and the US and only 0.5% in the UK. It now appears likely that both the UK and the Euro zone are on the brink of recession again and forecasts for 2012 are being reduced.

The failure by the private sector to respond as hoped, to some extent reflected the impact of the massive accumulation of debt that had taken place over a long number of years. Consumers, in particular, seem more intent on paying down debt than increasing spending. The balance sheets of the corporate sector are in a much healthier state than those of consumers, but they are unwilling to increase productive capacity unless they are confident that the increased demand will materialise.

## Financial crisis in Europe elevates global risks

At the same time of course, the financial crisis in Europe continued to escalate and numerous initiatives by European leaders failed to convince markets that a durable solution had been found. Both Greece and Ireland had been forced out of the public bond markets in 2010 and entered

funding programmes jointly sponsored by the International Monetary Fund ('IMF') and the European Union ('EU'). Portugal followed the same path in February of last year.

These three countries are small and, combined, account for only 6% of Euro zone GDP. In themselves, therefore, their financing needs were unlikely to be a major threat to the European financial system. They could be readily accommodated from the various rescue facilities that had been put in place by the EU and the IMF.

However, the threat to the system if bond market pressures spread to larger economies, such as Italy (17% of Euro zone GDP) and Spain (12% of GDP), would be much more serious. Those pressures did indeed emerge in the summer months. By August, 10-year bond yields in both Spain and Italy rose above 6% and perilously close to the 7% level at which the three smaller countries were forced into funding programmes. There have been several EU Summits and policy initiatives since then to try and assuage markets but they have all singularly failed and tensions in European sovereign bond markets remain acute. Indeed the pressures have gone beyond the periphery and into some of the core countries such as France and the Netherlands. Even Germany itself has had difficulty in

completing a number of bond auctions.

### **Liquidity needs to be restored to European sovereign debt markets**

Investors remain unconvinced that debt-to-GDP ratios in many countries can be stabilised and then reduced unless there is an improvement in prospects for economic growth. Therein lies the dilemma. There are now negative feedback loops into the economy from falling confidence associated with the continuation of the crisis itself, as well as from the direct impact of ever-growing austerity measures being imposed on many Governments. In such circumstances there is a requirement for a sizeable and credible 'backstop' that would assure investors the risks of sovereign default had been taken off the table.

The European Central Bank ('ECB') is the only European institution that has the resources and the balance sheet large enough to provide such a backstop. It has bought over €200 billion of sovereign bonds through its Securities Markets Programme ('SMP') but much more is needed. It had been hoped that a major initiative would follow the last EU Summit in early December, if the Heads of State agreed to a regime of strict fiscal rules and much more stringent fiscal governance. The new Head of the ECB, Mario Draghi, appeared to suggest this in a speech in

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# “ As we face into the New Year, the issue of liquidity in European sovereign debt markets dominates all other concerns. ”

advance of the Summit but those hopes were firmly dashed by his comments at the press conference that followed the December meeting of the Governing Council, even though EU leaders had delivered the required fiscal commitments at their Summit.

As we face into the New Year, the issue of liquidity in European sovereign debt markets dominates all other concerns. There are several hundreds of billions of Euro of European sovereign debt maturing in the coming months. Unless it can be refinanced through normal market channels, we are facing the bleak prospect of sovereign default and associated pressures on the European and global financial systems.

We think it is unlikely that the authorities would stand by and permit widespread default if it came to that but, until they give some clear signals that they are prepared to support markets in this way, the sense of ‘crisis’ will persist and the negative feedback loops into the real economy will increase.

## **Does all this mean the Euro will break up?**

We do not believe it will. A break up of the Euro would require the restoration of national currencies for those countries which departed the currency union. There are no other practical alternatives, the

process of restoring national currencies would take months to implement and would create massive legal and logistical issues. The implications and dislocation to the global financial system would be very considerable and it is difficult to see how a major global economic depression could be avoided.

The risks are so great that policy makers are likely to provide the liquidity necessary to avoid such an outcome. However, unless the decisions are much more decisive than what we have had so far, the most likely outcome is a ‘muddle through’ one. That will severely curtail economic growth across the world and will probably result in negative growth in both the Euro zone and the UK.

## **What are the investment implications?**

Of the major asset classes, equities were the clear underperformer in 2011, hardly surprising in retrospect given the deteriorating performance of the global economy and the continued escalation of the European debt crisis. Global equities, on average, fell more than 8% in the year with many of the main European markets faring considerably worse. The DAX lost almost 15% and the CAC fell by 17%. Corporate profits held up better than might have been expected given the economic background. As a result, valuations in most equity markets have

fallen well below their long-term averages. Price/earnings ratios ('P/E') in most of the major European markets are in single digits and are now, effectively, pricing in a significant fall in corporate profits in 2012. Valuations under other headings such as price/book and dividend yields also look cheap relative to their historic norms.

However, we doubt that cheap valuations, on their own, will be sufficient to facilitate a recovery in equity markets as long as the threat to the global economy and global financial system from the European debt crisis remains so serious. If all we get is 'muddle through' from European policy makers over the next few months, equity markets are likely to remain under pressure.

These developments in public equity markets obviously impact on private equity as well. In November, KKR and a trio of co-investors announced the \$7.2 billion acquisition of Tulsa, Oklahoma-based oil and gas exploration company, Samson. The deal represented one of the largest private equity-backed acquisitions of 2011 and an exceptional deal for the fourth quarter, where many new acquisitions were put on hold by increasingly tepid financial markets. The fallout from the ongoing Euro zone debt crisis made it difficult to finance even modest acquisitions. Unsurprisingly, there were few, if any, exits. Even where private

companies could find a willing buyer, the valuations that could be achieved, compared with those achievable earlier in 2011, put all but the forced sellers off. The technology sector again stood out, with private companies such as Groupon and Zynga coming to the public markets. The media was also abuzz with stories of Facebook considering an initial public offering in 2012.

We have highlighted on many occasions that the only valuation that truly matters for a private equity-backed company is the one that is achieved when it is ultimately sold. However, for the private equity firms who own or part-own these companies, mark-to-market rules apply. Quarterly valuations must be adjusted to reflect equivalent public equity valuations and, as a result, unsurprisingly many valuations were written down in the fourth quarter. For the moment, the positive news is that there has been, almost without exception, no significant fall off in business performance for the underlying companies. However, all of the private equity firms we invest with on our clients' behalf are concerned about the negative impact of a more prolonged crisis in the Euro zone.

In contrast, investors in most Government bond markets fared well in 2011. The total return on both US Treasuries and German Bunds was in

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high single digits, as was the return on UK gilts for comparable maturities. This reflected the fall in benchmark yields in those markets as global growth slowed, expectations of interest rate increases were reduced and investors sought safe havens away from the troubled debt markets in peripheral Europe.

But yields in these markets are now at historically low levels. Two-year yields, for example, are barely positive while 10-year yields are close to 2%. We see little value in Government bonds at these levels. We could see yields rise if the European debt crisis abates and global prospects improve or, indeed, if markets focus on the debt and deficit ratios of the UK and US which are a good deal higher than in some of the more troubled European markets (Spain, for example).

Thus, until we can see more clarity on a resolution for the European debt crisis, we recommend an underweight position in equities in portfolios but would match that with an overweight position in cash rather than Government bonds.

### **Safe haven assets**

As noted above, we believe the likelihood of a break up of the Euro and the associated pressures on the global banking system are very low. Hence, we regard risks to deposits in systemically important banks as being similarly low.

Nevertheless, there is a growing constituency of investors who seek insurance against this outcome, even if they deem the probability of such an outcome as being very low. We believe short-term German Bunds offer the best protection against such an outcome. The attractions include the strength of the German credit risk and possible exchange rate protection if Germany and some surrounding countries were to leave the Euro. The instrument is also highly liquid and we believe client portfolios should retain as much flexibility as possible in the current environment.

Some would recommend non-Euro assets be bought as a hedge against a Euro break up. While such assets may provide some protection in such an event, they do introduce serious exchange risk in the event of a European resolution being agreed and that, after all, we believe is by far the most likely scenario. The recent 20% appreciation of the Euro against Swiss Franc, after the intervention in the markets by Swiss National Bank (‘SNB’), was a timely reminder of the scale of such risks ■

*Robbie Kelleher  
Paul Giblin  
Oliver Sinnott*

# Ireland: Europe now the main issue

**This time last year you might have said 'Ireland was Europe's main problem'. Now it is probably appropriate to say 'Europe is Ireland's main problem'.**

Towards the end of 2010, Irish policy makers finally bowed to the inevitable and admitted that funding in public bond markets was no longer a viable option going forward. They applied to the International Monetary Fund ('IMF') and the European Union ('EU') for access to the European Financial Stability Facility ('EFSF'). The third party to the so called Troika was the European Central Bank ('ECB'). The ECB did not make monies available directly to the Irish Government but was already a major source of funding to the Irish banking system and was obviously anxious to be part of the group that would oversee any arrangement.

Eventually a funding package of €85 billion was arranged, of which €17.5 billion was to come from domestic resources: cash reserves and the National Pension Reserve Fund ('NPRF'). The availability of the funding was clearly based on meeting closely defined targets for reducing the Government deficit and for substantially recapitalising the Irish banking system. Of the €80 billion, €30 billion was earmarked for capitalising the banks and the remainder

to fund Exchequer needs going forward. Representatives from the Troika were to visit Ireland on a quarterly basis to assess whether the targets in the plan were on track.

More than 12 months on, progress, from an Irish point of view, has been satisfactory. We have comfortably passed all the quarterly inspections and the fiscal targets for 2011 have been broadly met. The banks were recapitalised in July at a cost well short of the original estimate of €30 billion. The total capital requirements came to €24 billion but more than €6 billion was raised from private sources through a combination of liability management on subordinated bond holders and private sector involvement in a Bank of Ireland rights issue. Moreover, the Troika agreed that the portion of the €30 billion that was not used for bank capitalisation could be added to the €50 billion that was already earmarked for Exchequer funding. On this basis Ireland has sufficient funding in place to meet its financing needs until the end of 2013, provided, of course, that it meets the targets set in the deficit reduction schedule.

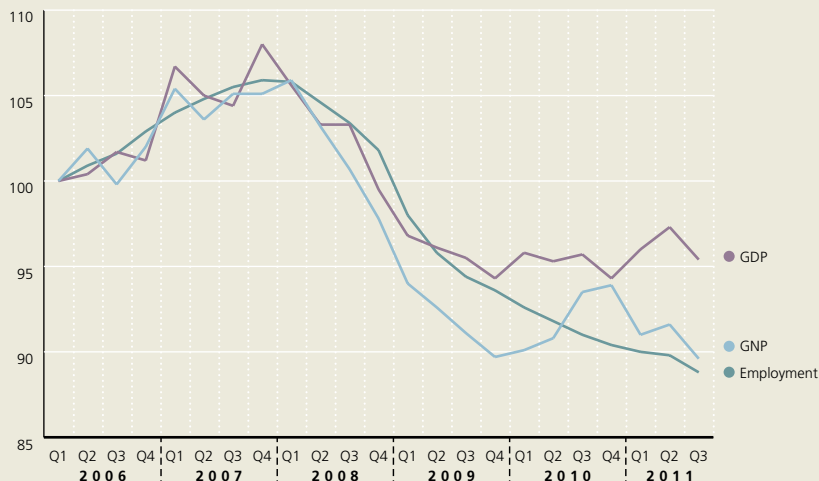
Budget 2012 was the next step in the adjustment process. Some €3.8 billion was taken out of the

“ Whatever measures of activity one uses, it is clear Ireland is now very much a two-speed economy. ”

economy, €2.2 billion through expenditure reductions and €1.6 billion from revenue raising measures. That brings the total adjustment since 2008 to €24.4 billion, the equivalent of almost 20% of forecast GNP for 2012. A further €8.7 billion of adjustments are planned for the next three years before the deficit reaches its target of less than 3% of GDP in 2015. At that stage the total adjustments will have amounted to almost 25% of this year's GNP. Very few modern economies have achieved fiscal adjustments of this magnitude.

Meanwhile, some indicators suggested the Irish economy has performed reasonably well during the first half of 2011. Gross Domestic Product ('GDP') expanded by 3.2% in the first six months of last year. Using this measure, that was quicker than any other Euro zone economy over the period. However, given the large impact which the multi-national sector in Ireland has on the Irish National Accounts, Gross National Product ('GNP') is a better indicator of the economic well-being of the country. GNP declined by 2% over the six months. In any event, some of the

FIGURE 1: Irish GDP, GNP and Employment: (Q1 2006 = 100)



Source: Central Statistics Office

first half gains in GDP were reversed again in Q3.

Moreover, recent trends in economy-wide employment have been disappointing. Employment in the second quarter of the year fell by just 4,000, having declined by an average of more than 25,000 per quarter over the previous three years. That raised hopes that the fall in employment was close to being over. However, the pace of decline accelerated again in Q3, with a quarterly fall of more than 20,000.

Whatever measures of activity one uses, it is clear Ireland is now very much a two-speed economy. Having recovered by 6% in volume terms in 2010, exports grew by a further 4% in the first nine months of the year. In contrast domestic demand, both consumer and investment spending, continue to decline as real

incomes are further squeezed, business confidence is fragile and bank finance is difficult to obtain.

Thus, if the Irish economy is to meet the growth targets set in its fiscal plans, a strongly growing export sector is key. That, in turn, can only be achieved if the global economy itself continues to grow. Europe, in particular, is an important destination for Irish exports. Hence, forecasts of a return to recession for the European economy in 2012 make this task all the more difficult and the associated dislocation caused in the banking system makes the funding of the domestic economy even more difficult.

More than ever Ireland needs Europe to get its act together ■

*Robbie Kelleher*

# NAMA's performance to date

**The National Asset Management Agency ('NAMA') was one of the central planks of the Fianna Fáil/ Green/Progressive Democrats Government's plan to deal with the integrated problems of the banking crisis and the property crash.**

It is almost three years since the concept was first introduced and two years since the first loans were purchased. In that time €72.3 billion of debt has been purchased from the Participating Banks ('the PBs') for a total consideration of €30.5 billion<sup>1</sup>. The table below gives an approximate breakdown of these figures by PB.

## So, how is NAMA performing?

### Backdrop and original objectives

Together with the bank guarantee scheme and other actions, NAMA was designed to try to circumvent the raw market forces unleashed by the collapse of Lehman Brothers ('Lehman') and the global financial crisis by wrapping the banks in a

protective state embrace until such time as the market regained its equilibrium. Serious issues in the financial world and parts of the global economy which started to become apparent in 2007 culminated in the collapse of Lehman in September 2008 and tipped the world economy into recession. The Irish banks, beginning with Anglo Irish Bank (now Irish Bank Resolution Corporation Limited ('IBRC')), came under immediate and severe pressure from both stock and funding markets due to their size and their known exposure to the Irish property market (exposure to property assets helped trigger the eventual collapse of Lehman). Significant steps needed to be taken to avoid a collapse of the banking sector and these measures would ultimately include the bank guarantee scheme, equity injections, the gradual nationalisation of most of the Irish banking sector and NAMA.

NAMA, as initially envisaged, had three broad objectives (not in any particular order of importance):

	AIB € bn	Anglo € bn	BoI € bn	EBS € bn	INBS € bn	Totals € bn
<b>Gross loans</b>	18.5	34.0	9.4	0.8	8.5	71.2
<b>Acquisition price</b>	8.5	13.0	5.4	0.3	3.0	30.2
<b>Discount (%)</b>	54.0	62.0	43.0	63.0	65.0	58.0

Source: NAMA & Davy

- 1 To take a large portfolio of loans out of the PBs and to manage these assets with the objective of making a return for the state.

*The targeted loans related primarily to development assets and assets connected to developers with large amounts of development-related debt. By achieving this objective, NAMA could manage the loans or enforce their security and take physical possession of the assets covered by that security. Where this security included personal guarantees, NAMA could potentially take possession of assets outside the scope of the loans in question.*

- 2 To influence the recovery in the Irish property market by taking such a large position in the market.

*This would be achieved by:*

- i not dumping assets on the market at the outset in an attempt to recover value quickly<sup>2</sup>; and*
- ii adopting a strategy that would help revive the Irish property market.*

*As the name suggests, NAMA was designed as an asset management agency and was given the powers that a large property owner could use to its advantage in managing such a large portfolio of assets.*

- 3 To purchase a significant portfolio of illiquid loans from the PBs to put them in a position where they could start lending in volume again as quickly as possible.

*The projected timeline for repayment of the €30.5 billion is as follows<sup>3</sup>:*

<b>By Year</b>	<b>€ billion</b>	<b>% repaid</b>
<b>2013</b>	7.50	24.60
<b>2015</b>	12.20	40.00
<b>2017</b>	24.40	80.00
<b>2018</b>	27.45	90.00
<b>2019</b>	30.50	100.00

Source: NAMA & Davy

2 This was one of the fears of leaving all of the loans with the PBs – that at some point, in an attempt to recover whatever value could be recovered quickly, they would dump properties onto the market in an attempt to get out ahead of the other banks.

3 NAMA 2010 Annual Results Presentation 28th July 2011, slide 13.

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# “ The deepening of the Euro crisis has further dampened economic recovery in Ireland and the Euro zone. ”

## Other significant events since 2009

In evaluating the performance of NAMA since its inception, a number of significant events which have taken place in the interim cannot be ignored. These events have erected additional hurdles in the way of the projected roll out of NAMA's strategy. In no particular order, the following events are important:

- 1 The rate of growth, both in Ireland and globally, has been more subdued than anticipated. One of the key philosophies behind the bank guarantee scheme was that as long as the banks could be protected from raw market forces for a period of time, growth would return to the economy and it would return to equilibrium somewhere close to the heights achieved in 2007. However, for a variety reasons, growth in both the Irish and global economies has been lower than anticipated, with a knock-on effect on both general sentiment and recovery in asset prices. This, in turn, has affected the recovery of the banks and the return of investors to the Irish property market.
- 2 More subdued growth plus a loss of bond market confidence forced Ireland into a bailout by the IMF/EU/ECB. Despite the precarious position of the economy and the significant amount that the Irish state had to raise in the public markets, the bailout came as a shock. The deal itself called for significant additional austerity measures with the potential to further dampen the economic recovery. It also introduced a general uncertainty which affected both consumers and investors. A number of property deals which had been publicised in the period before the bailout failed to complete after it, due to a change in sentiment from the buyers, their funders or both.
- 3 The deepening of the Euro crisis has further dampened economic recovery in Ireland and the Euro zone. As the crisis has deepened, appetite for risk assets has reduced and Euro zone bond yields have come under more pressure, thereby increasing pressure on the banking system as its significant holdings of sovereign debt have reduced in value. As a result, the inter-bank market has been adversely affected, meaning banks are very nervous about funding other banks, creating additional pressure on banks – a serious negative feedback loop.

While none of these events appear to have a direct impact on property markets, they have:

- › significantly reduced the appetite for risk assets, including property investment, as investors wish to stay in cash or liquid investments considered safe;
- › dampened economic activity, which has impacted property markets in different ways. As consumer spending contracts, retail revenues fall and increased pressure is being put on retail rents. As the economic outlook deteriorates, companies and businesses postpone leasing decisions or demand lower rents. These factors have an indirect but reasonably immediate effect on the property market;
- › contributed to the fall of the Fianna Fáil/Green/Progressive Democrats coalition Government as a result of the bailout and the successful election of the Fine Gael/Labour Government. The new Programme for Government stated that new regulations would be introduced to unilaterally ban upward-only rent reviews in existing leases<sup>4</sup>.

The resulting uncertainty surrounding future rental flows from these leases was a direct contributing factor in the virtual standstill in investment activity during 2011. Thankfully, the Government has abandoned the proposed changes and allowed landlords and tenants to deal with this issue directly themselves<sup>5</sup>; and

- › further reduced the ability of banks to fund investment. In Ireland this has been clear for some time. However, the impact of the deepening Euro zone crisis has brought reminders of the seizing up of the bank finance system in the period prior to the collapse of Lehman. We are seeing that some German and French banks (i.e. core European banks) need significant capital injections to remain solvent. Banks in those positions are not lending to fund new investment<sup>6</sup>.

<sup>4</sup> See *Programme for Government 2011*, page 9.

<sup>5</sup> *NAMA has introduced a procedure to allow tenants appeal directly to them where they control the loan and effectively the property. NAMA does not promise a reduction but will work to agree a solution that is in the best interests of the borrower/the property. In reality, this has been happening for some time between many landlords and tenants.*

<sup>6</sup> *As an example Commerzbank, Eurohypo (both part of the same group) and other banks have suspended lending to new property investments over the last few weeks.*

## “ The formation of NAMA has not yet succeeded in its objective to encourage banks to lend more money... ”

**So with this backdrop, how is NAMA progressing in meeting its initial objectives?**

### **OBJECTIVE 1: To take control of a large portfolio of loans from the PBs and manage them with the objective of making a profit**

Over a period of approximately 18 months from December 2009, NAMA went from a standing start to legally owning loans with a face value of €72.3 billion. This process had necessitated significant legal and technical due diligence and the recruitment of 150 staff during this period<sup>7</sup>. In addition, during this period NAMA had started demanding business plans from the larger borrowers and had started negotiations into agreeing medium-term plans with some of these borrowers. To execute this volume of work in that time period was a significant achievement.

NAMA has also made some progress in selling assets. At the end of October 2011, NAMA had approved sales of assets totalling €6.2 billion, although it has not yet disclosed the value of the sales actually achieved. To date it has concentrated its attention on foreign assets (representing 80% of the approved sales figure) and has achieved<sup>8</sup> some high profile sales in London in particular. It is speculated that some of these sales have achieved significantly more in value than NAMA had paid for them. This is obviously a further achievement.

In addition, we are aware of discussions NAMA has had with borrowers in relation to a number of large loans secured by development sites in various European countries. To date NAMA has taken a pragmatic view, is giving time for planning and other value-enhancing works to be carried out and has approved additional loans of €950 million to fund improvements to assets under its control<sup>9</sup>. This would suggest NAMA is prepared to wait for an improvement in the economy to extract itself from these loans as it expects to make a better return by doing so.

Despite the constraints detailed above, some small progress has been made in relation to starting the process of recovering its Irish loan book. A small number of high profile assets (this process was always going to start with good quality assets)

<sup>7</sup> NAMA 2010 Results Presentation 28th July 2011, slide 3.

<sup>8</sup> Source: NAMA press release dated 9th December 2011 quoting a speech by Brendan McDonagh to a Davy investor conference in London.

<sup>9</sup> Source: Above-referenced press release.

were brought to the market during the last three months, including office buildings at Warrington Place and Riverside II and the Morrison Hotel.

- › *We understand that Warrington Place is under offer to a UK institution for a yield in the region of 7.5%. This would be a strong result given that the building is probably over-rented, but this reflects the fact that it is newly built and let to a semi-state organisation.*
- › *We also understand that progress has been made with the sale of the Morrison Hotel and a small number of offers relatively close to the guide price may be forthcoming.*

If these deals close they would represent a good end to 2011. With the confirmation in Budget 2012 that the Government's rent review proposals have been shelved, 2012 should be a more positive year for the investment market in Ireland and NAMA's divestment strategy.

However, it is still much too early to judge NAMA's performance under this heading. We would expect strong results to be achieved from the strong prime assets. The recovery from more difficult assets, particularly partly-developed projects outside of Dublin and the other key urban areas, will be much more difficult and will require some very innovative solutions. Due to the early stage of this process, we have not seen how the more difficult assets will be managed. We will be observing this with interest over the next few years.

### **OBJECTIVE 2: To positively influence the recovery in the Irish property market**

NAMA certainly cannot be accused of flooding the market with assets and thereby suppressing asset values. To date it has taken a very measured approach to pushing assets onto the market. This has been the only sensible approach given the issues that have arisen during the last couple of years.

The constraints outlined above have also limited the effectiveness of any proposals NAMA could have made over the last two years as there were few, if any, buyers in the market.

In terms of the positive actions, NAMA has taken some small steps:

- › It was vocal in its opposition to the rent review proposals and may have been instrumental in getting the Government to publicly call an end to the proposals.
- › NAMA has also proposed that it would make finance available for transactions involving assets it controls. Under these proposals, NAMA would act as the funding bank, offering commercial terms in order to facilitate the sale of assets. However, NAMA is in effect a debt recovery agency and not a full service bank with a long-term future. This will make borrowing from NAMA a less attractive option.
- › These proposals have included suggestions that NAMA would provide development finance in limited circumstances. Again, until we see what these proposals look like in real transactions, it is difficult to gauge how effective they will be.

We will need to see NAMA become more creative in how it deals with its more difficult assets before we can assess how successful the agency will be under this objective. Market conditions have not been conducive to NAMA bringing any innovative solutions to the market and we would hope that, if market conditions do improve over the next couple of years, we will see many of these.

### **OBJECTIVE 3: To free up PBs' balance sheets to allow them to start lending again**

The formation of NAMA has been one of a number of policy initiatives undertaken to resolve the banking crisis and to encourage Irish banks to lend again. These policy initiatives have included:

- › The formation of NAMA and the purchase of €72.3 billion of loans for consideration of €30.5 billion with the attendant provisioning by the banks and capital injections as necessary. This was achieved in an 18-month period from the start of 2009.
- › The early nationalisation of both Anglo Irish Bank and Irish Nationwide. The initial objective was to stabilise the banks and get them back to lending as soon as

possible. As time has passed, the objective has changed and these banks are now merged and are in wind-down.

- › The Prudential Capital Assessment Review ('PCAR') process of early 2011 during which Blackrock and other consultants stress tested the books of the banks to assess the rate of bad debts and the capital required to return the banks' Tier 1 Capital ratio to 9%. This resulted in a list of actions for the banks to perform to achieve these levels and included significant capital injections from the Irish state and, in the case of Bank of Ireland, private sources.

However, the actions taken, including those outlined above, have not yet resulted in the banks returning to active lending. The reasons for this include:

- › The banks retain large loan books secured on property assets that are relatively illiquid and include books of mortgage loans that are not performing well and on which the outlook is very uncertain. It had been hoped that economic growth would help to solve these issues but anaemic growth is not helping.
- › The banks have also been instructed, under the terms of the bailout, to deleverage in order to reduce the overall size of the banking system to a more sustainable level and repay some of the capital injected. This process is not compatible with a strategy to increase lending volumes.
- › Banks are funded from a variety of sources including short-term loans from other banks. One result of the worsening Euro zone crisis is banks are lending less and less to each other. As this inter-bank funding becomes scarce, it becomes more expensive, thereby increasing the cost of funds to the banks. Banks simply cannot increase lending volumes in conditions where their funding is so uncertain.
- › The banking crisis and the current uncertain economic outlook has made lending teams, and in particular credit committees, much more conservative regarding the loans they will consider and the terms of the loans they will be prepared to make.

The formation of NAMA has not yet succeeded in its objective to encourage banks to lend more money by freeing up their balance sheets. However, this is due to a number of factors, many of which could not be foreseen at the inception of NAMA in early 2009.

### Conclusion

At this stage it is difficult to pass judgement on the success or otherwise of NAMA. Those of us who deal with NAMA are critical of its bureaucracy and the time taken to make decisions. However, these complaints are now common within the regular banking system and NAMA is working to resolve these issues.

On the important question of whether NAMA will make a profit, we are too early in the process to make a detailed assessment. The early asset sales have been successful but they were sales of prime assets and were the 'easy wins'. How NAMA deals with the more

difficult assets of poorer quality will be more interesting.

On NAMA's impact on the market, bigger issues have so far had a more direct impact. As these issues are resolved, we will need to see some innovative solutions considering the saturated markets evident in areas such as the hotel sector and residential developments outside of the three or four leading urban areas.

NAMA has not been successful in putting the banks into a position where they could return to lending in volume. However, it has done what it set out to achieve by purchasing a large portfolio of loans from the PBs. This was not sufficient to return the banks to lending and subsequent events have exacerbated this situation ■

*Robin Potter Cogan*



**WARNING:** Please refer to the Important Information on Page 27.

# Absolute return funds: are they absolute nonsense?

**Absolute Return ('AR') funds are currently the fund 'du jour' and there has been a lot written about them in the press of late. Some have dismissed them as nothing more than a marketing ploy while others present them as the solution to investors' need for more stable returns. With these conflicting opinions circulating, it can be difficult to separate fact from fiction.**

So what is an AR fund? In essence it is a fund that aims to make a real return (i.e. greater than zero) year-in, year-out regardless of whether the market moves up (2004–2007), down (2008–2009) or sideways (2010–2011)<sup>1</sup>, with the best of the bunch beating the banker, the taxman and inflation.

Sounds pretty good to us and to investors around the world, resulting in a

dramatic increase in the number of funds launching under the banner of 'absolute return'. Since January 2009, the European AR market has grown by 80%, reaching €140 billion in assets under management by March of this year<sup>2</sup>. However, these burgeoning sales have brought with them the concern that investors may not fully understand the nature and risks of their newly acquired AR investment. As with any investment, investors need to do their homework and consider their decision carefully before investing in AR funds.

Below are some of the most common statements we hear in relation to AR funds. In the rest of the article we will try to address them and determine whether AR funds are absolute nonsense, absolutely great or somewhere in between.

*"Absolute returns - great, that means I have a guaranteed return."*

**FALSE**

*Absolute return is an investment aim not a performance guarantee. This is the most important piece of information investors need to know about AR funds. Just like a student may aim to achieve an A in next week's science exam, this does not guarantee that he or she will. Similarly, AR funds aim to generate positive returns*

<sup>1</sup> Source: Bloomberg

<sup>2</sup> Source: FitchRatings, Sector update, 'European Absolute Return Funds: A Snapshot', July 2011

*but there is no guarantee that this will actually be achieved. Some regulators, such as the UK's Financial Services Authority ('FSA'), have a big issue with this point. It fears that investors may be buying these funds because they misunderstand the AR funds' objectives, believing labels like 'real return' or 'absolute' mean their initial investments are either protected or guaranteed to grow. To be clear, these funds are not guaranteed and they can lose you money. Investors also need to consider the time frame over which the AR fund intends to deliver their targeted 'positive return' - is it over a twelve-month period or a rolling five-year period for example? There is, unfortunately, no standardised agreement as to how long this time period should be. Investors need to consider whether the target return is achievable in the expected time frame and if it suits their personal financial objectives. If they are unsure, they should ask for help from their professional advisor.*

*"All AR funds have the same aim, so they must all follow the same investment strategy."*

**FALSE**

*Again, this is not true. There is no commonly agreed definition as to what constitutes an AR fund so the investment strategy will vary from fund to fund. Some funds will invest solely in bonds to produce their AR returns, some only in equities, the majority of managers in this space invest in a mixture of asset classes (these are called multi-asset funds) and an increasing number of funds use more advanced techniques such as the use of derivatives. It is unfortunate that so many different funds with very little in common are all categorised together because of a term used in their name and it is understandable that this may create the potential for misplaced expectations with investors. The main reason why there is not a clear definition is that it would have to be broad enough to encompass the wide universe of funds that share the AR objective and specific enough to ensure comparability. Investors need to ensure they look under the bonnet of these funds*

*to better understand how these fund managers' investment strategies actually work. Unfortunately, you will not find that by looking at the label. Investors should read carefully any documents relating to an AR fund they are considering investing in and enlist the help of their financial advisors to help them gain some clarity on how the fund operates and the risks involved.*

*"AR funds have no merit."*

**FALSE**

*Given what we have reviewed so far, the question must arise: do AR funds actually have any value? The answer is yes, they certainly do for some investors, as an allocation within a diversified portfolio of assets but not as a replacement for all other investments. No one investment strategy can be all things to all people. There are certain market conditions, such as falling or volatile markets, where absolute return funds can offer the best return. This is because, in general (and I use the word general very loosely), AR funds exhibit low levels of correlation with overall equity market movements, so if there is a big fall in equity markets AR funds may avoid this decline or at least fall less than equity markets. However, in periods of strong growth (such as 2004–2007<sup>3</sup>), AR funds may perform positively but underperform these same equity markets. Investors may be disappointed by AR funds if they assume that they will outperform in down markets and in up markets.*

Back to our headline: are absolute return funds absolute nonsense? Absolutely not. They can fulfill many roles for suitable investors. Firstly, stock market volatility has increased sharply since 2008 and investors now have an increased appetite for downside protection and returns that are less dependent on market

direction. This may increase the appeal of absolute return strategies both as a means of managing portfolio volatility and actively profiting from periods of market downturn. Secondly, investors' appetite for income/yield has not abated and, given the current low interest rate environment that we find ourselves in,

“ Diversification is key and investors must ensure that AR funds are only one part of their overall allocation to risk assets. ”

investors are looking further than the traditional bond markets for this income. However, AR funds do vary dramatically by style and approach, and few individual

investors have a thorough understanding of exactly how these funds operate and the risks associated with them.

**Therefore, two things are key:**

1. Extensive due diligence remains essential in order to differentiate between strategies, target returns, time frames and investment risks. An analysis of the experience and skill of the fund's management team should also be conducted. The due diligence process should include reading all fund documents and seeking advice from your financial advisor. This process may be lengthy but is the best way for investors to ensure they have a good understanding of what they are investing in.
2. Diversification is key and investors must ensure that AR funds are only one part of their overall allocation to risk assets. This will help investors to build an 'all-weather' portfolio which can hopefully deal with whatever the markets throw at it and, importantly, match the investor's long-term financial objectives.

*Ciara Connolly*

# The importance of putting a financial plan in place

**As we look towards 2012, there are a number of key challenges ahead. We remain in a difficult and uncertain economic environment with a number of financial and currency risks which need to be managed and mitigated. In addition to managing risk, individuals also need to manage the level of tax payable on their assets given the increases to tax payable on investments and the reduction in tax reliefs available which were set out in Budget 2012.**

Having worked with individuals over the last number of years through various economic cycles, we firmly believe that

a financial plan is key to developing the most effective investment strategy for our clients and to ensure their objectives can be met in these uncertain times. Putting a financial plan in place can help you manage your savings and investments, develop a strategic approach to determine what your financial objectives are and enable you to implement a solution to meet them.

Individuals have different objectives and different personal circumstances, so every plan should be unique. However, irrespective of this, an effective financial plan should incorporate the key features which have been summarised below:

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## **Clearly Defined and Prioritised Objectives**

You have your own financial objectives: some short-term, some longer term and some that are more critical than others. Like most people, you may tend to view your objectives in terms of consumption, i.e. what you can buy using income. By quantifying your consumption needs/goals in terms of capital amounts, you can establish a clear savings and investment target to help you achieve your objectives.

As an initial step, these objectives should be identified and prioritised in order to establish a plan which is suitable for you. This will ensure that you structure your assets and invest in a manner dictated by what you are seeking to achieve.

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**Consolidated Approach to your Affairs**

You may have many different sources of capital and savings. However, these sources should not act in isolation in achieving your investment goals. An effective financial plan should take account of all your assets and the contribution these play in achieving your objectives.

Taking a consolidated view enables you to effectively manage your pension, personal and/or corporate assets in a structured and consistent manner.

**Structure your Existing and Future Assets in the Most Effective Way**

In an environment where taxes are increasing, helping to minimise tax has become just as important as maximising returns and managing risk on your assets. So your plan should be structured to help:

- ▶ maximise any available tax reliefs that are available to you, and
- ▶ minimise tax on investment income and gains.

**Put You Back in Control**

It is our responsibility, as advisers, to:

- ▶ assess your current financial circumstances,
- ▶ make you aware of your options, and
- ▶ provide information to enable you to determine the most appropriate approach for you.

By engaging in this process, you put yourself in a better position to determine your future financial well-being and security.

**Why should you undertake the financial planning process?**

A successful financial plan identifies a set of key actions designed to achieve the goals that have been established as part of the process. Following the

“ A successful financial plan identifies a set of key actions designed to achieve the goals that have been established ”

implementation of these actions, it is important to review your plan regularly and adjust it as necessary to ensure you remain on track to achieve your objectives.

As a result of engaging in the financial planning process, you:

- ▶ **will have a greater understanding of your financial objectives;**
- ▶ **will have greater clarity and control over how your assets are invested;**
- ▶ **will have a clearer picture of how your assets are working to meet your objectives;**
- ▶ **are enabled to implement an efficient and coordinated strategy across assets classes and across asset managers; and**
- ▶ **are enabled to diversify risk in the most appropriate manner.**

If you are uncertain about any of the following, engaging in a financial planning process may be worthwhile:

- 1 Have you clearly defined and prioritised what you need your assets to do/provide in terms of lifestyle goals?**
- 2 Do you have a strategic plan for your investments which is aligned with your objectives?**
- 3 Have you reviewed your tax position with your tax advisor? Have you constructed your saving and investment portfolios in the most tax efficient manner?**

At Davy, we have a team of planning specialists who will work with you to review and develop your financial strategy ■

*Sandra Rockett*



**Davy is not a tax or legal advisor. It is important that you seek independent professional advice prior to making any decisions which have tax, legal or other financial implications.**

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