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# Trends

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## Keeping Loss Potential in Check

**Dossier** Risk-Oriented Investment Concepts Offer Distinct Advantages During Market Corrections

**Column** Gold – The End of an Era?

**Equity Global** Eight Surprises Which Could Drive Luxury Goods Shares in 2013

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Fences and walls mark boundaries. For risk-oriented investment concepts, limits are set in order to restrict potential losses during correction phases.

# Editorial

**Robert Parker**
Head Strategic Advisory Group,
Member of the Global Investment
Committee

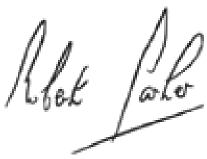
## Dear Reader

Traditional benchmark-based investment approaches do not prove successful in every market environment. This has been demonstrated during the past five years by repeated sharp corrections. Portfolio risk and therefore the potential for losses during phases with persistently high selling pressure can thus rise significantly without the share of risky assets having been increased. This effect can lead to many a sleepless night.

In this issue of Trends, we discuss two investment approaches which aim to curb the potential for losses during stress phases: the already established capital protection concept and the as yet less well known volatility limit concept. We also look at the question of whether gold is set to lose its shine following the latest fall in price. And as usual, we also report on markets and trends.

We hope this edition makes for enjoyable and thought-provoking reading, and provides you with some investment ideas.

Yours sincerely



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# Asset Allocation
# The Rotation Continues

Patrick Bucher, Investment Strategy

**The global economy is continuing on its path to recovery. Despite disruptions such as the complex fiscal situation in the US and the elections in Italy, pleasing, yet unspectacular growth is being recorded. Although the current momentum will not suffice to produce rapid progress in bringing down the high unemployment figures, the sluggish growth rate guarantees the continuation of the strongly expansive central bank policy. The rotation out of zero-interest investments into real assets is likely to continue for the time being.**

Leading indicators such as purchasing manager indices have recently recovered further and even point to a slight acceleration in global economic growth during the second half of 2013. The US weathered the tax hikes at the start of the year remarkably well. Meanwhile, the risk of inflation in the developed economies remains very limited provided there are no unpredictable oil price shocks. There is thus nothing standing in the way of a continuation of the extremely loose monetary policy. The Bank of Japan has even increased the extent of the expansion. The European Central Bank is now lagging behind in the competition for the loosest monetary policy, but would itself have to respond should the euro strengthen significantly.

Driven by these monetary fireworks, the equity markets have also reached new highs. Even though this development, considering the precarious situation of certain dimensions of the economy, appears suspicious to some commentators, with some even talking of manipulation through central bank interventions. We do not believe that the upside potential on the equity markets has been exhausted.

## More risk continues to pay off

This also applies to most cases when comparing risky assets to so-called risk-free investments. The rotation into risk is likely most advanced within fixed-income investments. Here the spreads for corporate bonds are once again in line with the long-term average. Opportunities for returns have therefore been somewhat exhausted. Nevertheless, we continue to prefer corporate bonds to government bonds. Given the rather dubious quality of government bonds at present, we see no reason why the spreads should fall below the long-term average values. When talking about emerging market bonds, we can go a step further, as here the spreads are actually below the long-term average. Nevertheless, the improvement in the relative fiscal situation of the emerging markets is too strong for this to give rise to concern.

In contrast to bonds, the rotation into risk is not yet as advanced as for equities. Considered alone, there are indeed already certain valuation ratios which make equities no longer appear so attractive. However, all benchmarks which measure the relative value of equities compared to bonds continue to point towards a valuation gap relative to the highs achieved in the past decades. This speaks in favor of further upside potential, even without any increases in corporate earnings. This multiple expansion is very likely the most underestimated force on the equity markets at present.

The low interest rate environment is likely to have a similar impact on the real estate market. When central banks talk about overheating here, they are warning about the consequences of their own actions. It is unlikely that the increase in prices is over. In the meantime, however, a regionally differentiated positioning is advisable for investors, with the US and Germany having significant advantages over Switzerland.

**Globally-oriented model portfolio for Swiss pension funds***

| | CHF | EUR | GBP | USD, CAD | JPY | Em. Markets, Commodities | Total |
|---|---|---|---|---|---|---|---|
| **Liquidity** | **14.6%** | **0.1%** | **0.9%** ▲ | **0.0%** | **0.0%** | **0.0%** | **15.6%** ▲ |
| | 9.8% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 9.8% |
| **Bonds** | **47.3%** | **1.3%** | **0.0%** ▼ | **0.0%** ▼ | **3.8%** ▲ | | **52.4%** |
| | 53.2% | 3.0% | 1.0% | 2.0% | 1.0% | | 60.2% |
| **Equities** | **9.0%** ▼ | **7.9%** ▲ | **1.3%** | **6.7%** | **2.0%** | **5.2%** ▼ | **32.0%** ▼ |
| | 10.0% | 4.0% | 2.0% | 8.0% | 2.0% | 4.0% | 30.0% |
| **Total** | **70.9%** ▼ | **9.3%** ▲ | **2.2%** ▼ | **6.7%** ▼ | **5.8%** ▲ | **5.2%** ▼ | **100.0%** |
| | 73.0% | 7.0% | 3.0% | 10.0% | 3.0% | 4.0% | 100.0% |

Bold: tactical positioning. Normal type: long-term strategy/benchmark. Arrows show change compared with last issue of Trends, 02|03.13. Source: Credit Suisse.
* This is an indicative asset allocation, which may change over time.
Historical performance indications and financial market scenarios are no guarantee for current of future performance.

# Asset Allocation
## Outlook

| | 08.03.2013 | Estimate 12 months | Expected return in local currency (%) | Expected return in CHF (%) |
|---|---|---|---|---|
| **Equity market** | | | | |
| USA (S&P 500) | 1,551 | 1,620 | 4.4 | 4.3 |
| Germany (DAX) | 7,986 | 8,300 | 3.9 | 9.3 |
| Netherlands (AEX) | 352 | 370 | 5.0 | 10.4 |
| UK (FTSE 100) | 6,484 | 6,800 | 4.9 | 4.1 |
| France (CAC 40) | 3,834 | 4,000 | 4.3 | 9.8 |
| Italy (MIBTEL) | 16,204 | 18,000 | 11.1 | 16.9 |
| Spain (IBEX 35) | 8,628 | 9,000 | 4.3 | 9.7 |
| Switzerland (SMI) | 7,745 | 7,900 | 2.0 | 2.0 |
| Japan (TOPIX) | 1,021 | 1,050 | 2.9 | 1.7 |
| **Capital market (10-year government bonds)** | | | | |
| USD | 2.05 | 1.90 | 3.3 | 3.1 |
| CAD | 1.94 | 2.30 | –1.0 | 0.7 |
| AUD | 3.58 | 3.70 | 2.7 | –1.8 |
| JPY | 0.66 | 1.00 | –2.3 | –3.4 |
| EUR | 1.50 | 1.90 | –1.8 | 3.3 |
| GBP | 2.01 | 2.40 | –1.1 | –1.8 |
| CHF | 0.76 | 1.20 | –2.9 | –2.9 |
| **Money market (3 month LIBOR)** | | | | |
| USD | 0.28 | 0.40 | 0.3 | 0.2 |
| CAD | 1.19 | 1.20 | 1.2 | 2.9 |
| AUD | 3.17 | 2.60 | 3.0 | –1.6 |
| JPY | 0.16 | 0.20 | 0.2 | –1.0 |
| EUR | 0.13 | 0.20 | 0.2 | 5.4 |
| GBP | 0.51 | 0.60 | 0.5 | –0.2 |
| CHF | 0.02 | 0.10 | 0.1 | 0.1 |
| **Currencies against CHF** | | | | |
| USD | 0.95 | 0.95 | – | –0.2 |
| CAD | 0.92 | 0.94 | – | 1.7 |
| AUD | 0.97 | 0.93 | – | –4.4 |
| JPY | 0.99 | 0.98 | – | –1.1 |
| EUR | 1.24 | 1.30 | – | 5.2 |
| GBP | 1.42 | 1.41 | – | –0.7 |
| **Gold** | | | | |
| USD/oz | 1,579 | 1,600 | 1.3 | 1.2 |

Performance indications do not consider commissions levied at subscription or redemption.
Estimated performance indications and financial market scenarios are no guarantee for current or future performance.

Source: Credit Suisse.

# Macro Global

# Monetary Expansion to Remain Growth-Supportive

Thomas Herrmann, Global Economic Research

## ! Did you know that …

… inflation is expected to remain low for the foreseeable future?

… default by a major eurozone country or even euro break-up seems to remain extremely unlikely?

… in the US, despite tax increases at the beginning of the year, retail sales momentum has remained strong?

… emerging Asia is still leading the global "growth hierarchy" and also remains stronger than other emerging regions?

Global business surveys have continued to improve over the past few months and the debate over "currency wars" suggests that as long as policies are targeted toward "domestic" goals and do not involve outright currency intervention, international opposition is limited. The distinction between domestic goals and currency manipulation is, of course, largely semantic. However, in our view, the benefits of the global expansionary setting continue to exceed the costs. Inflation in particular still seems unlikely to become a major issue in most countries. Additionally, given mostly moderate or even weak credit growth, as is the case in Europe, the fear that a renewed credit-fuelled boom will turn into yet another bust also seems unfounded for now.

**Global easing bias persists**
With growth moderate, unemployment in advanced economies elevated and inflation low for the foreseeable future, monetary policy is thus likely to remain very expansionary. Key decision makers at the Federal Reserve (the Fed) appear to remain strongly committed to expansionary policy and a continuation of asset purchases. Despite an overall positive outlook, the Fed looks likely to continue asset purchases at the recent pace (USD 85 billion monthly) this year, as the unemployment rate is likely to fall only gradually. The Bank of Japan (and possibly the Bank of England) is also likely to increase asset purchases. If all this leads to significantly more euro appreciation, the European Central Bank (ECB) may also ease more. But with short-term money market rates close to zero, a cut in the official lending rate would still have only a limited impact, although it might have a signaling effect in currency markets. To have a bigger impact, the ECB would need to try to move market interest rates, and thus the relevant funding conditions, in the most affected economies with stronger language or by renewed asset purchases.

**Europe still weak**
We remain of the view that a return to the extreme eurozone fears of last year is unlikely. Of course, events like the Italian elections, which resulted in political uncertainty, can briefly raise associated concerns but default by a major eurozone country or even a euro break-up remain extremely unlikely. Market pricing is likely to reflect this over time with peripheral yields still likely to drop, the euro to

strengthen and safe haven assets under more pressure. That said, austerity and high unemployment limit eurozone growth and we continue to expect stagnation this year with only a gradual improvement in quarterly growth rates and Germany still outperforming.

**US indicators remain solid despite fiscal headwinds**

In view of the significant tax increases at the start of the year, US economic data point to remarkable resilience. Car sales growth and also retail sales growth momentum have remained strong. In addition to significant tax increases at the start of the year, automatic spending cuts have become effective and there remains some uncertainty regarding the impact of both on economic activity. More importantly, however, business surveys remain solid overall and point to stronger order intake and employment prospects. While the unemployment rate could actually rise again as labor force participation picks-up, the latest nonfarm payroll release was significantly above expectations (+236,000, corresponding to the strongest increase since 2006). In addition, the latest consumer sentiment readings also increased.

**Emerging market improvement continues**

Judging from both the momentum in industrial production and trade, emerging Asia is still leading the global “growth hierarchy” and also remains stronger than other emerging regions. In China, expansionary credit conditions remain in place despite some recent regulatory efforts to limit mortgage growth. Latin American business surveys have also improved, and Brazil looks likely to accept further currency strengthening to limit inflation. Brazil has also moved towards a tightening bias, which might lead to rate hikes over the next months. In contrast, Mexico cut rates by 50 basis points in March, but we expect it to be a one-off as inflation could remain above the central bank's target. Eastern European business surveys are also showing some improvement, but the region is likely to remain the laggard among emerging markets.

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Given mostly moderate or even weak credit growth, the fear that a renewed credit-fuelled boom will turn into yet another bust seems unfounded for now.

# Fixed Income

## Back to Normality?

Dominik Scheck, Asset Management Fixed Income

**While fixed income markets continue to be affected by the European debt crisis and ongoing fiscal negotiations in the US, economic growth and monetary policy expectations seem to be playing a more central role lately. While a cyclical upturn is becoming more likely in the industrialized counties, despite recent disappointing economic data, most developing countries are still struggling to find a sustainable path of recovery.**

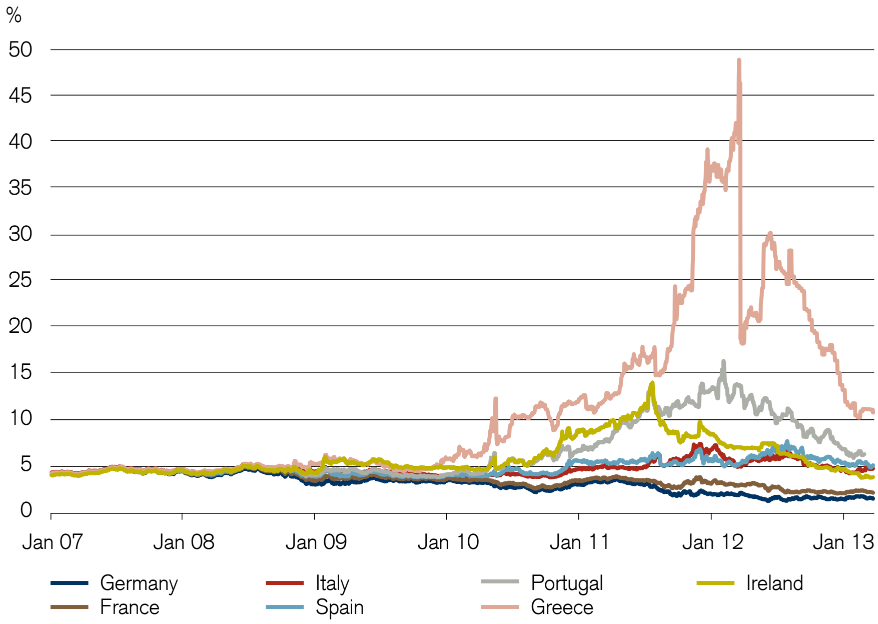
**Central banks are therefore keeping their low interest rate regime in place. However, recent statements from the Federal Open Market Committee (FOMC) regarding the risks of continued quantitative easing and the shrinking balance sheet of the European Central Bank (ECB) – due to the repayment of long-term refinancing operations (LTRO) – have highlighted the importance of changes in monetary policy for asset class performance. This is especially true as flows and returns have been distorted by the low interest rate environment and central bank balance sheet expansion over the previous years.**

### Recent developments

In an environment of improving investor sentiment due to declining political tail risks, riskier fixed income markets started the year with a resilient performance, whereby high yield showed a very solid performance. In contrast, core government markets suffered from rising yields. However, interest rates moved lower as political uncertainty flared up in connection with Italian elections. The difficulty to form an effective, stable and longer-lasting government has increased the risk for economic recovery in Italy and also poses a contagion risk for other peripheral markets. However, the widening of sovereign risk premiums – in relation to the tightening since July 2012 – was relatively muted, as the verbal commitment of the ECB and the option of open market interventions kept a lid on sovereign spreads.

Credit spread tightening came to a halt in the first months of the year as negative data, especially from Europe, and the discussions about quantitative easing policy changes weighed on performance. Additionally, a more equity friendly environment with increasing merger and acqui-

**Spread tightening of peripheral government bonds has come to a halt recently**




Eurozone 10-year government bond yields

Source: Datastream, Credit Suisse/IDC. Last data point: 18.03.2013.

sition activity and leveraged buyouts has increased single issuer and sector risk.

The fundamental economic and political situation in many European countries also remains fragile and the discontentment of voters suffering from high unemployment and the adverse effects of austerity programs is spreading further.

**Central banks expected to remain accommodative**

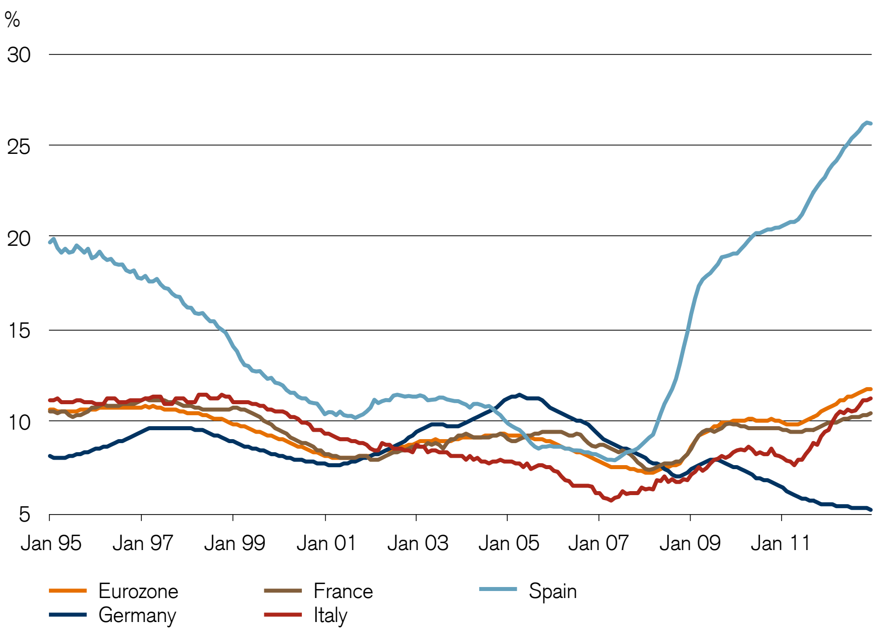
Despite poor economic and financial conditions, some positive signs have emerged in the Eurozone. At the end of February 2013, and hence prior to maturity, roughly EUR 150 billion of the first EUR 489 billion LTRO tranche was repaid. In addition, EUR 61 billion of the second LTRO tranche of a total of EUR 529 billion was repaid. At the same time, the slow retreat of imbalances in the intra-eurozone payments system TARGET2 continued. Still, the ECB is caught between countries with substantially different economic positions. After a decline in GDP in Q4 2012, Germany is expected to resume growth. On the other hand, Spain, Portugal and, in particular, Greece need to cope with rising unemployment rates and falling economic output.

As the economic outlook remains muted for the time being and the refinancing situation for consumers and companies in the periphery remains difficult, we expect the ECB to keep or lower policy rates, especially as its balance sheet is shrinking, an appreciation of the euro is unwelcome, and inflation came down further to the spot the ECB defines as its upper limit (+2%).

In the US, economic data point to remarkable resilience despite fiscal tightening having some dampening effect on growth. We expect the Federal Reserve (the Fed) to keep policy rates at current low levels, especially should the recovery in the labor market only remain gradual and inflation expectations remain well anchored. However, recent FOMC minutes emphasized the potential cost and risk of quantitative easing, including inflationary risks, irrational market behavior, capital loss risk for the Fed, and the functioning of financial markets. Therefore, several participants of the committee stated that the further path of quantitative easing should be evaluated on an ongoing basis, even without a substantial improvement in the labor market. We do not expect a change in the quantitative easing program in the first half of 2013. However, the risk for changing guidance has increased and could lead to volatility in credit markets.

In Switzerland, we do not expect the Swiss National Bank (SNB) to reduce their foreign currency reserves through outright sales for the time being without a sustainable and strong depreciation of the Swiss franc. However, in case of a continued economic improvement in Europe, the SNB would have various other instruments in order to bring interest rates at a higher level – e.g. repo transactions or foreign exchange swaps. In the view of the SNB, a normalization of interest rates would clearly be welcomed with regard to their view of an overheated housing market.

**Surging unemployment rates in peripheral European countries**

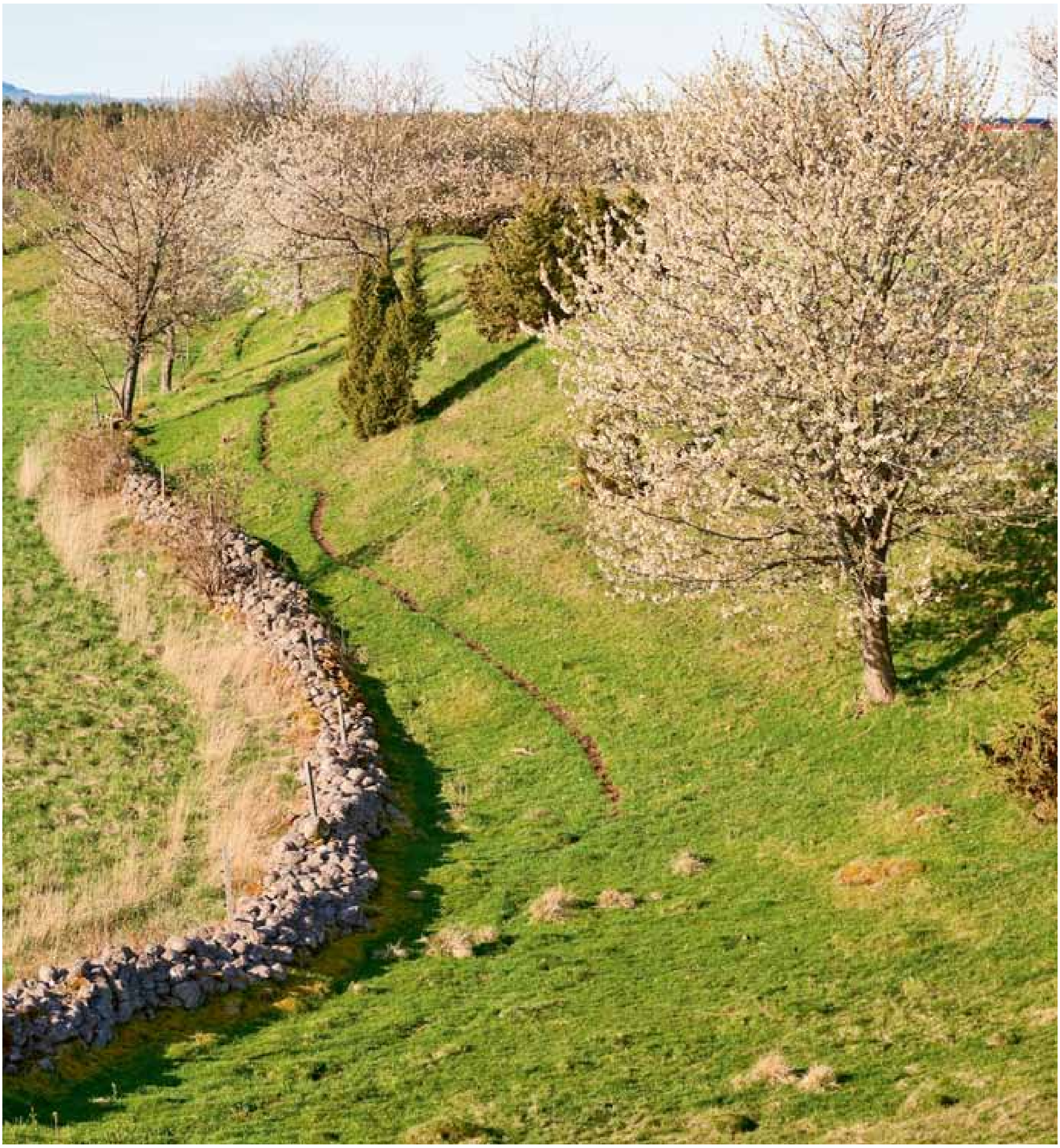



Eurozone unemployment rates (seasonally adjusted)

Source: Datastream, Credit Suisse/IDC. Last data point: 31.12.2012.

**Outlook**

We expect that the political situation in Europe as well as the tax break and debt ceiling discussion in the US will add volatility to fixed income markets in the coming months. However, expectations about the pace of economic growth and central bank policy should become a more dominant factor for interest rate and credit market performance. While the US economy seems to be more resilient as the overall state of consumer balance sheets has improved, the ongoing risk in Europe should not be underestimated, and we currently see no strong upward pressure for higher interest rates in the short term. However, the risk for higher rates in the medium term has increased in our view, especially should discussions about central bank exit strategies intensify. We expect spread markets to remain supported by stable corporate fundamentals, the demand-supply mismatch, and the low yield environment. However, setbacks are probable, especially as valuations have become stretched in various segments of the market. Therefore, diversification is becoming more important, especially in view of an increasingly more equity-friendly environment, as merger and acquisition and leveraged buyout activity is likely to increase. Overall, we prefer corporate over government debt and recommend diversify in non-core fixed income asset classes like high-yield, emerging market debt, convertible bonds and inflation-linked bonds.



# Column

# Gold – The End of an Era?

Tobias Merath, Head Commodity Research

**The gold market has seen pronounced price moves recently. After a period of sideways trading, the gold price sold off in February, falling from above USD 1,700 to around USD 1,550 at times. On the way down, the price broke below key technical support levels and investment interest in the yellow metal has declined noticeably. However, this recent price decline has to be seen in a longer-term context.**

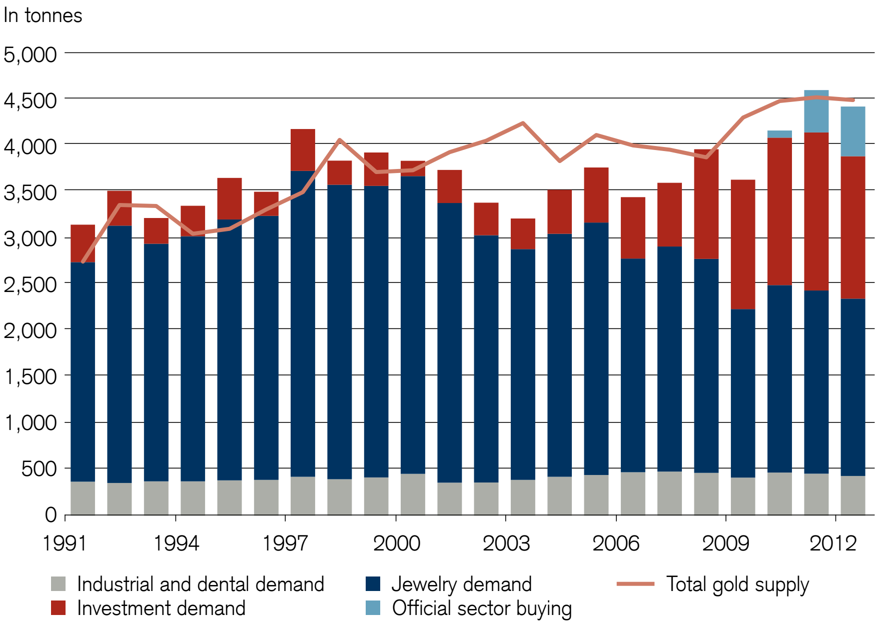
After having reached a new all-time high above USD 1,950 in August 2011, the gold price has seen a correction. Since then, i.e. for the last 18 months or so, the market has traded sideways in a rather wide USD 1,500 to 1,800 range. In this context, the correction in February is not a surprising development. On the contrary – the market is still trading within the familiar range. The key question is whether this period of sideways trading has now been in place long enough to call an end to the long-term uptrend of gold prices that has been in place since 2001. In our view, the evidence is mounting that this might indeed be the case.

One key argument is that there are structural changes taking place in the gold market – particularly on the demand side. In the year 2000, global gold demand stood at just above 3,800 tons, of which 84% came from the jewelry sector. In 2012, global gold demand was about 4,400 tons and the share of jewelry demand was as low as 43%. So today, jewelry demand is a much less important driver for gold prices than it was in the early 2000's. We think the main driver today is investment demand. In 2000, investment demand accounted for about 4% of total gold consumption. In 2012, this share was at 35%. So over the last years, investment demand has gradually replaced jewelry demand. This is important as investors look at different factors than jewelers when deciding whether or not to buy gold. For instance, jewelry demand is very price sensitive and tends to decline when prices increase. Investors on the other hand might even be attracted by rising prices.

The reasons behind this shift from a jewelry market toward an investment market are twofold. First, the introduction of new investment vehicles such as physically- backed exchange-traded funds or structured derivatives have made the gold market more accessible – both for institutional and private investors. Second, the long-term decline in real interest rates that we have seen over the last decade made gold increasingly attractive for investors. An investment in gold pays neither interest nor dividends. As a result, interest rates correspond to the opportunity costs to hold gold. By investing in gold an investor foregoes interest rate payments that he could earn by investing elsewhere. As interest rates declined, opportunity costs to hold gold declined as well, attracting more investors to the market. In our view, this was the main trigger for the uptrend of gold over the last ten years.

Therefore, in order to assess the prospects for gold prices from here on, we have to look primarily at the behavior of investors. And here we think things are changing. After several years of decline, interest rates seem to have found a bottom. As long as interest rates were falling, gold became more attractive every year. Interest rates are still very low, but since they are unlikely to fall much further the environment for gold has stopped improving. As a result, it is unlikely that investment demand will accelerate much more. There is also the argument of relative performance. Over the last ten years, gold prices increased at an average rate of more than 18% p.a., outperforming inflation and stocks. As a result, gold looks expensive compared to other assets – at least when looking at historical relationships. Last but not least, after trading sideways for more than one year now, the technical chart looks increasingly difficult, and this too is limiting investment interest.

**Demand structure of the gold market**




Source: GFMS, Credit Suisse/IDC, as at December 31, 2012.

Historical performance indications and financial market scenarios are no guarantee for current or future performance.

In our view, the environment for gold has changed over the last months. Investment interest is likely to remain positive, but unlikely to accelerate much further. In this context, we think the upside potential for gold is limited. We expect prices to trade sideways over the next twelve months.

# Keeping Loss Potential in Check

## Risk-Oriented Investment Concepts Offer Distinct Advantages During Market Corrections

René Küffer, Global Head iMACS, and Thomas Isenschmid, Head Client Portfolio Managers iMACS

Excerpt from the White Paper "Risk-oriented investment strategies – investment concept with volatility limit"

**Experience over the past five years has shown that a classical investment approach linked to a benchmark is not ideal in every market environment. For instance, during periods of elevated uncertainty and sustained selling pressure on the securities markets, portfolio risk, and thus loss potential, can increase sharply without the asset allocation having been actively changed.**

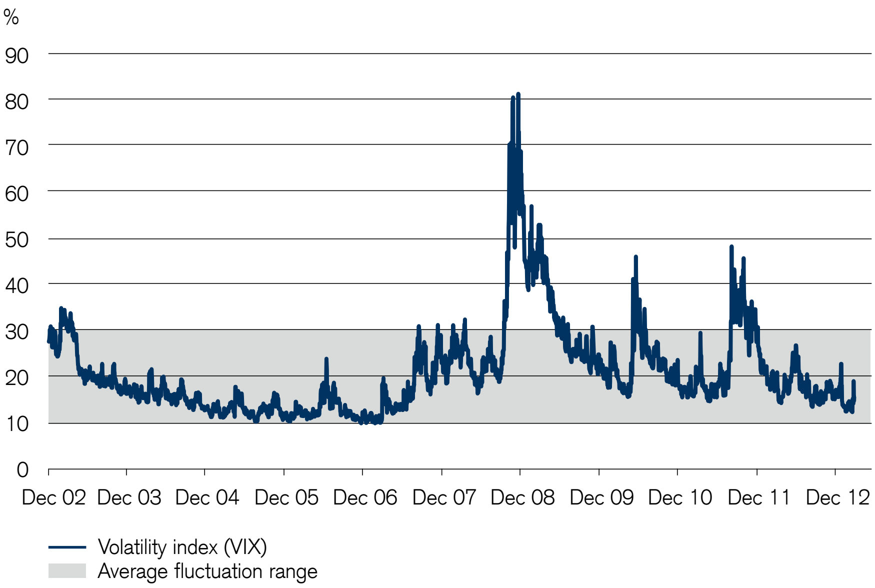
**In order to avoid such stress phases, an active asset management strategy focused on limiting losses can present a very effective alternative. Two solution approaches present themselves here: the capital protection concept and the comparatively lesser known investment concept that employs a volatility limit. Whereas the first approach sets a floor that the portfolio's maximum loss in value cannot exceed, the second approach sets a ceiling for the portfolio's maximum volatility.**

**Unpleasant correction phases**

A "normal" market environment is characterized by a generally tolerable return fluctuation range (i.e. return volatility) accompanied by relatively low correlations between individual investment segments. Under such market conditions, balanced portfolio diversification is an efficient investment approach. Amid steady return prospects, a sensible combination of individual asset categories and asset classes reduces overall portfolio risk.

But if elevated uncertainty and sustained selling pressure prevail on the markets, portfolio risk can jump sharply without the allocation of riskier assets such as stocks

**Evolution of S&P 500 stock index volatility**




Source: Credit Suisse. For illustrative purposes only. Last data point: 28.02.2013.

Historical performance indications and financial market scenarios are no guarantee for current or future performance.

or foreign-currency-denominated bonds having been raised. This is illustrated, for example, by the return fluctuations and thus volatilities recorded during the periods from mid-2008 to mid-2009, from May to June 2010 and from August to September 2011, which hit readings far above the historical average in some cases.

The above chart tracks the evolution of the weekly volatility of the S&P 500 stock index. Although the volatility normally ranges between 10% and 30%, it broke out of that range during the aforementioned stress periods, by a significant amount in some cases. During those stress periods, the S&P 500 stock index was susceptible to much stronger fluctuations than it is in a normal market environment. The probability of suffering a substantial loss in value on a broadly diversified portfolio thus increased considerably without the allocation of risky assets having been added to.

**New conditions on the financial markets require new investment concepts**

Although the financial and debt crisis appears to be under control, it has by no means been resolved yet and is likely to continue to subject the markets to repeated stress tests in the years ahead. So this raises the question of whether there are investment approaches that can control and reduce portfolio losses, particularly during stress periods.

Asset management involves various investment concepts. For example, it is possible to draw a distinction between the following approaches:

- the classical benchmark-oriented concept;
- risk-oriented concepts.

The benchmark-oriented concept reduces overall portfolio risk through balanced diversification. The expected market trend is taken into account by overweighting or underweighting individual asset categories and asset classes in accordance with the Investment Committee's market and investment views. The goal is to outperform the market by employing tactical decisions. Ultimately, though, the portfolio largely remains subjected to market fluctuations.

Risk-oriented concepts enable the portfolio to profit from rising markets, but at the same time provide a certain degree of protection against substantial losses in value. So compared to the benchmark-oriented concept, risk-oriented concepts offer a highly attractive additional dimension for investors who have above-average sensitivity to risk or losses.

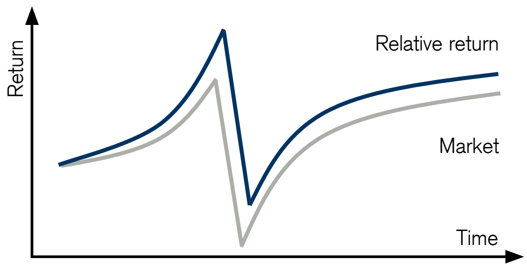
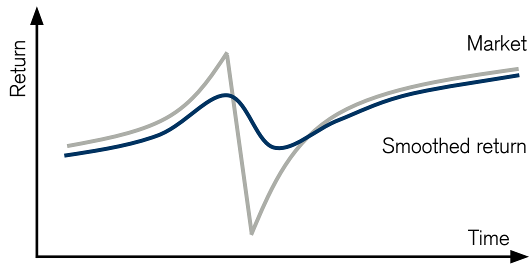
**Overview of risk-oriented concepts**

To curb portfolio risk during stress phases, the investor sets a limit that the overall portfolio is not allowed to exceed. The limit can be set in two ways:

- determination of a value loss floor for the overall portfolio (absolute loss limitation);
- determination of a ceiling for portfolio volatility (relative loss limitation).

Like the benchmark-oriented concept, risk-oriented investment concepts start off with active portfolio management. Using market expectations and investment views as a basis, the aim is to seize market opportunities in order to maximize

### Benchmark- and risk-oriented investment concepts

| | Benchmark-oriented | Risk-oriented |
|---|---|---|
| **Diagram of performance over market cycle** |  |  |
| **Investment focus** | Aimed at a predefined target return | Aimed at avoiding or reducing losses |
| **Investment goal** | Outperformance of a designated benchmark | – Limitation of loss potential in the event of substantial market corrections<br>– Maximization of investment return in a normal market environment |
| **Investment style** | Active portfolio management based on the market expectations and investment views | – Active portfolio management based on the market expectations and investment views<br>– The loss limit is monitored and adhered to by reducing investment risk if the portfolio approaches the loss or volatility limit |

Source: Credit Suisse. For illustrative purposes only.

the return on investment. This means that with due regard paid to the investment strategy geared to the investor's risk profile, riskier assets can definitely be included in the portfolio and can even be assigned a substantial weighting. Additionally, though, the loss limit set by the investor – regardless of whether an absolute or relative loss limitation – has to be taken into consideration at the portfolio level. It takes on central importance when the financial markets correct sharply (if an absolute loss limitation has to be adhered to) or when volatility on the markets climbs to an above-average level (if a portfolio volatility cap has to be complied with). If the portfolio value or portfolio volatility approaches this barrier, the portfolio manager is compelled to reduce risk in order to adhere to the limit. If the markets relax and the portfolio value or portfolio volatility returns to a comfortable distance from the set limit, risk positions can gradually be built back up again in order to capture market opportunities. Since the markets first have to calm down before exposure to riskier assets can be ratcheted up again, the investor "misses out" on the first stage of the recovery following the trend reversal. On the other hand, the investor's losses were effectively contained during the preceding correction phase.

If the loss limit is defined as a value loss floor for the portfolio, this is actually an investment concept with capital protection. If the desire is to keep portfolio volatility under control, this has to do with a volatility-limiting concept. Both approaches are outlined below.

**Capital protection (or floor) concept**
The aim of this concept is to generate a positive absolute return and at the same time to ensure capital protection, with the

investor accepting limited loss risk. To protect capital, the investor sets a bottom boundary or floor that defines the maximum allowed loss in the portfolio's value (absolute loss limitation). The floor is geared to the investor's risk profile and can be adjusted as needed. It is usually raised as the portfolio's value increases.

The portfolio manager safeguards adherence to the floor while taking into account a wide array of risks such as credit, issuer and liquidity risk, for example (as well as equity risk, if this asset category is taken into consideration at all given its comparatively high volatility). If the value of the portfolio approaches the floor, risk must be gradually scaled back. Since the leeway for a loss in value is normally relatively small (i.e. the floor is set just a few percentage points below the initial portfolio value), the floor is treated as the main parameter guiding the management of the portfolio in any market environment. Apart from that, the management of the portfolio is based on a well-structured investment process, just like the benchmark-oriented solution. In order to not endanger the floor, the portfolio assets are invested primarily in highly liquid investment instruments under a very professional risk management regime.

A related approach is the absolute return concept. It likewise strives to earn a positive absolute return while providing capital protection, but has zero tolerance for potential losses. In other words, it sets the loss floor at the level of the initial portfolio value.

**Volatility-limiting concept**
This investment concept aims to participate as much as possible in rising market opportunities and to significantly cushion

losses (but not to prevent them entirely) in the event of severe market corrections. This is done by putting a limit on portfolio volatility. When the markets are wracked by nervousness and correspondingly wide price fluctuations and portfolio volatility nears the predefined limit, riskier assets have to be cut back in favor of lower-risk investments. This lowers portfolio volatility and reduces vulnerability to big losses in value. The objective of the volatility-oriented concept is relative rather than absolute loss limitation.

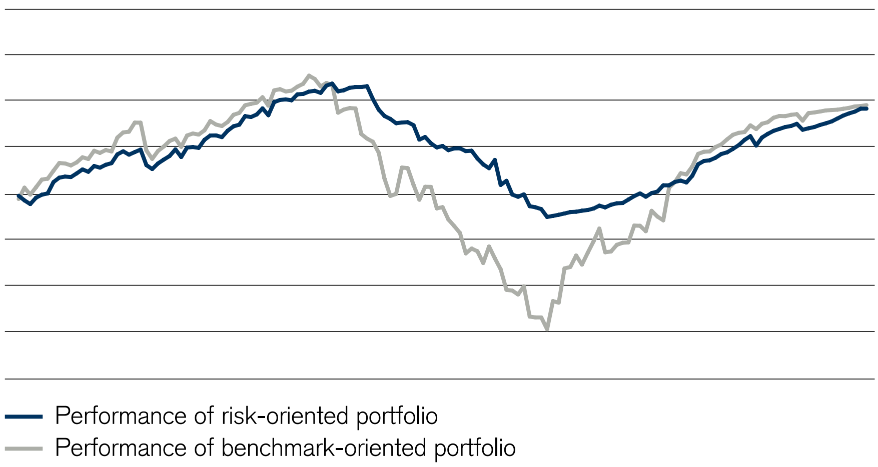
In a nervous market environment, the volatility limit thus takes over the function of being the main control parameter for managing the portfolio. Since volatility is usually lower in sideways drifting or rising markets, under normal market conditions the composition and thus the performance of the portfolio is determined primarily by the prevailing investment views. This is also where the big advantage lies compared to the capital protection concept: under favorable market conditions, the investor can participate fully in the uptrend within the predefined volatility limit while during correction phases, a safety net is activated once a predetermined threshold has been reached.

The primary objective of this investment approach is to smooth out portfolio volatility across the normal and stress phases of a market cycle. Daily portfolio volatility serves as the main parameter for the asset allocation. Short-term volatility is weighted more heavily to factor in the present market situation. Instead of a classical benchmark, the reference measure is a portfolio volatility limit predefined by the investor that may not be exceeded in any phase regardless of the market trend.

### Advantages of the risk-oriented solutions

In contrast to the benchmark-oriented investment approach, which focuses on a return target and uses a target tracking error to determine the desired deviation from the benchmark, the risk-oriented concepts put loss limitation in the foreground. During stress phases with elevated psychological pressure, the volatility-limiting concept enables investors to resort to rules that they instated in calmer times.

**Reduction of risk during stress phases** (illustrative example)




During protracted stress phases, part of the negative performance can be averted using a volatility-oriented approach. However, participation in rising prices is delayed during recovery phases.

Source: Credit Suisse. For illustrative purposes only.

The risk-oriented concepts are not risk-free, as investors ultimately remain invested in the financial markets. These concepts instead aim to curb losses. From a longer-term investment perspective, they offer an additional attractive aspect: If investors suffer less substantial losses during market phases with sharp corrections, they do not need to take as many risks in a more favorable environment in order to compensate for these losses. Risk-oriented solutions thus limit losses during difficult periods, while reducing performance pressure in good times.

Compared to the capital protection concept, the portfolio for the volatility-limiting concept is much more aggressively positioned during favorable market phases, which – just like the benchmark-oriented investment approach – enables investors to profit from market opportunities within the scope of their personal investment profiles. The volatility-limiting concept thus combines the benefits of benchmark- and risk-oriented investment concepts and it is in future likely to be met with increasing interest from both institutional and private investors.

The volatility-limiting concept is presented in detail in our recently published White Paper "Risk-oriented investment strategies – investment concept with volatility limit". If you are interested in this topic, you can order the White Paper. Contact details can be found on pages 30 and 31 of this publication.

# Equity Global

## Eight Surprises Which Could Drive Luxury Goods Shares in 2013

Juan Manuel Mendoza, Head Equities Asia, Asset Management Core Investments

**The luxury goods industry is unquestionably in a secular uptrend. The main driver for sustained high growth is the rapidly increasing purchasing power in emerging countries, especially in Asia. Eight surprises could spur luxury goods stocks this year.**[1]

The biggest surprise in 2012 was that Chinese consumers overtook European and US shoppers and became the world's largest buyers of luxury goods, despite many macroeconomic concerns. They now account for 25% of global luxury goods sales through purchases at home and overseas (see chart 1). While China's domestic retail sales were weaker last year, offshore sales by Chinese tourists were unprecedentedly strong. In fact, it is estimated that roughly two thirds of the purchases occurred outside Mainland China, given the higher import duty and weaker European currencies favoring Chinese tourists to shop in the US and Europe. Typically, a luxury lady's handbag costs 40% less in Paris than in Beijing. This shift towards an increasing proportion of Asian consumers is ongoing and is happening for most luxury goods brands.

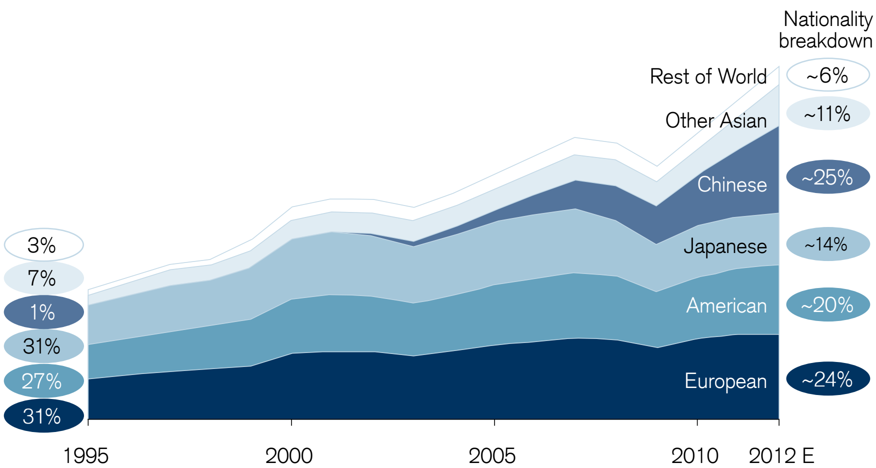
Turning to 2013, sales in Asia have also started trending upwards, a trend that started during the Christmas season for many of the leading luxury brands. Retail sales data for January and February of this year has also turned out to be much better than expected, both in Mainland China and Hong Kong, particularly in the high-end segment. Thanks to this Asian-led recovery, we now expect the luxury goods industry to grow sales by 12% and earnings by 17% in the current year.

For the "Year of the Snake", we have identified eight surprises which might benefit luxury goods companies and provide upside potential for investing in the sector.

**Surprise number 1: Strong momentum for ultra-luxury brands**

We have observed consistently positive news in the ultra-high end luxury segment. Sitting at the top of the pyramid, we believe this segment will outperform globally in 2013. In other words, brands priced at the very high end like Chanel, Bottega Veneta, Hermès or Patek Philippe, are expected to enjoy higher demand than luxury goods priced at the mid–range. This will be the case not only in the brands' home countries but, more interestingly, also in emerging markets and the US. In fact, luxury goods consumers in the US are becoming more sophisticated and are ready to trade up across all product categories. For instance, there have been waiting lists for months for selected Chanel handbags and dresses at luxury department stores like Saks in Fifth Avenue, New York. Brunello Cucinelli, famous for

**Chart 1: Development of luxury goods market by consumer nationality**




Source: 2012 China Luxury Market Study, Bain & Co., as of December 31, 2012.

Historical performance indications and financial market scenarios are no guarantee for current or future performance.

[1] The figures and estimates in the text are based on information provided by individual companies in the luxury goods industry, research papers by sector specialists and own analyses and estimates.

its cashmere sweaters, is growing very fast in the US given the lack of ultra-high-end apparel brands in the country's department stores.

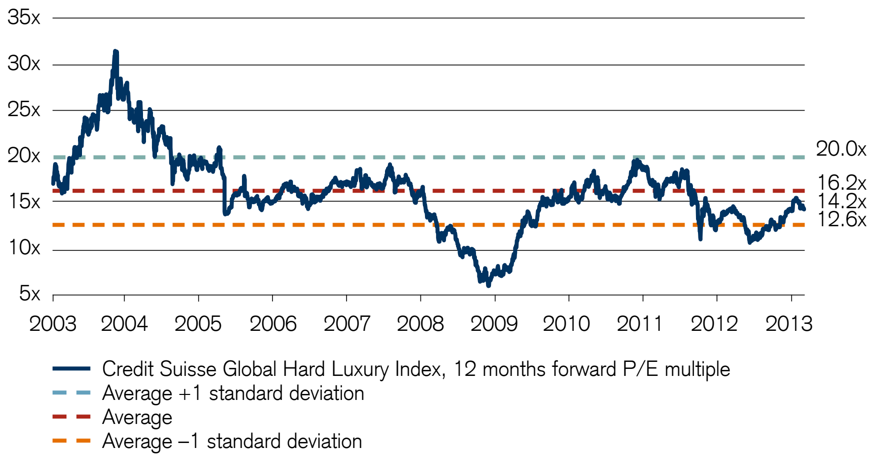
**Surprise number 2: More "fast fashion" at the expense of craftsmanship**
Flash collections will increase across the board of luxury brands. The industry looks at brands like Prada which is able to bring products from a design sketch to new collection in stores within a lead time of only five to six weeks. Prada's progressive industrial business model allows the company to react much faster than its peers to changing consumer tastes, thereby attracting store traffic and, likewise, maintaining a best-in-class sales momentum. Therefore, competitors like Burberry are now moving in the same direction, with the aim of reducing production lead time and injecting limited edition products and fresh designs on a much more regular basis. The implication of this "industrialization move" is that, on the one hand, we can expect luxury goods companies to be more innovative in terms of their offering. On the other hand, they are likely to make more use of outsourcing manufacturing capabilities in countries outside Europe. Outsourcing to Chinese or other low cost manufacturing partners is an ongoing process for luxury brands. Today, China is already manufacturing about 30% of the global luxury handbags and small leather goods, and Chinese manufacturers have been growing at 25% p.a. in the last five years.

**Surprise number 3: The rise of Americas' luxury consumption**
One should not underestimate the US market, as continuing strength in major cities like New York and Miami can be observed. Investors should keep in mind that there are 442 US dollar billionaires in the country, almost four times that of China. Same store sales in US luxury department stores increased 11.6% last January. Flagship stores of leading European brands in the major US cities have also been growing at double digits recently. This stronger demand has been driven by a stronger domestic luxury consumer base as well as an increase in tourists from emerging markets. For instance, stores located in popular tourist areas frequently visited by Brazilian tourists are booming. Some high-end brands in Miami are enjoying same-store sales growth between 30% and 80%. Miami is definitely best positioned to be the gateway for Brazilian tourists.

**Surprise number 4: Asian-led luxury watches and jewelry sales recovery**
Swiss luxury watch producers and Chinese luxury watch distributors as well as Chinese listed jewelry companies have been gradually re-rated recently, indicating that hard luxury brands – i.e. watches and jewelry – might outperform in 2013. Indeed, Hong Kong watches and jew-

elry sales have returned to double-digit growth after several months of sluggish numbers. During the Chinese New Year, watches and jewelry sales jumped 38% in Mainland China, and were particularly strong in the high-end segment. Hong Kong and Chinese luxury jewelry brands are expected to gradually recover and to post high double digit same-store sales growth in the current year. The Credit Suisse Global Hard Luxury price/earnings (P/E) index (see chart 2) is trading at a multiple year low, reflecting the sluggish growth and low investor confidence of last year. We expect this to gradually change.

**Chart 2: Historically low valuation of hard luxury brands**




Source: Credit Suisse, as of February 27, 2013.

Historical performance indications and financial market scenarios are no guarantee for current or future performance.

**Surprise number 5: Return of IPO and M&A activity in the luxury goods industry**

After a quiet 2012, this year we expect to see a clear acceleration of initial public offerings (IPOs) for distinctive global luxury brands. Many well-known and large luxury brands, especially in Italy, are still owned by founders, families or private equity investors. Most of the mid-sized luxury brands might have to raise capital to finance the expensive store expansion into emerging markets. Given the improved market conditions, we also expect some private equity investors to look for an exit in the coming months. Most leading brands have sizeable cash holdings. There is a visible trend to deploy cash for acquisitions of strong established brands as well as new Asian brands offering the potential to expand globally. Many Chinese luxury brands have emerged in the last years (see chart 3) and could be a target of European luxury groups. For instance, the French luxury giant PPR (Gucci Group) is continuing to divest its non-core assets and develop their luxury brands portfolio. PPR, similar to LVMH, is creating a global platform for leading and younger luxury brands across the globe. It recently added a Chinese luxury jewelry brand called Qeelin to their brand portfolio.

**Quote by François-Henri Pinault:**

"The world number one jewelry brand is already Chinese. Creating a luxury brand is not only about branding but is about its heritage and experience. I believe that we will see very significant Chinese brands but I believe it will be in categories other than apparel."

Source: François-Henri Pinault, Chariman and CEO, PPR, March 2013, Thailand Tatler Magazine 02/2013.

Next to high–end jewelry, other luxury categories are emerging in China and could become a target for the European luxury giants, namely spirits. This product category includes, for example, a high-end liquor called Kweichow Moutai. A 30-year old bottle of this Southwestern Chinese luxury liquor can cost up to USD 3,500.

**Surprise number 6: Unprecedented luxury goods spending by men**

Led by Asian men's luxury goods consumption, the men's category of most leading luxury brands is recording double digit growth. In fact, some brands are specifically launching dedicated men's stores, especially in Asia. Dunhill is continuing to open concept stores for men after opening in Shanghai. Bottega Veneta recently opened its second men's store in Shanghai. The industry estimates the market potential for men's bags and accessories in the Asia-Pacific region alone to be as high as USD 8 to 10 billion and growing as fast as the women's market. Already today, China is an atypical luxury

**Chart 3: Number of luxury brands by origin and category**

| | Mainland China | Hong Kong | France | UK | Switzer-land | USA | Japan | Italy | Germany | Spain |
|---|---|---|---|---|---|---|---|---|---|---|
| Clothes | **12** | 9 | **37** | 7 | 2 | 8 | 4 | **18** | 2 | 1 |
| Bags | 9 | 5 | **31** | **10** | 5 | **11** | 2 | **21** | 5 | 1 |
| Footwear | **13** | 6 | **22** | **10** | 2 | **10** | 2 | **27** | 5 | 1 |
| Watches | 7 | 3 | 6 | 4 | **69** | 3 | 1 | 2 | 5 | 0 |
| Jewelry | **13** | **21** | **25** | 8 | 9 | 7 | 1 | **11** | 3 | 1 |
| Cosmetics/Perfumes | 7 | 6 | **62** | 5 | 2 | 7 | 4 | 3 | 2 | 1 |
| Alcohol | **33** | 2 | **33** | **10** | 3 | 6 | 0 | 5 | 3 | 3 |
| Automobile | 8 | 1 | 4 | 7 | 1 | **14** | 4 | 4 | **57** | 0 |
| SPA/Beauty Treatment | **19** | **11** | **23** | 6 | 5 | 6 | **20** | 2 | 3 | 2 |
| Hotel/Resort | **15** | **10** | **15** | 8 | **16** | **15** | 7 | 6 | 2 | 3 |
| Restaurant | **33** | 8 | **27** | 6 | 3 | 5 | 3 | **11** | 2 | 2 |

□ 0-9 brands ■ 10-29 brands ■ 30 or more brands

Source: KPMG, Global Reach of China Luxury, as of January 2013.

market as men account for more than 55% of the total luxury market, well above the global average of 40%. More recently, sales of men's apparel at British luxury brand Burberry were up more than 50% and sales for men's accessories such as bags and smaller leather goods items were up 40%.

**Surprise number 7: South East Asia is outperforming China**

Today, the South East Asia luxury market is growing at a similar pace to the Chinese market. It is a quarter of the size of the Chinese market and is making a significant contribution to the global luxury goods spending. Luxury malls in cities like Bangkok and Manila are growing at 25% a year with several new luxury developments emerging over the next three years. The Indonesian onshore luxury market has doubled in size since 2007 to USD 1 billion currently. More importantly, if you include the offshore spending of Indonesians in Singapore, the number is even more promising. The "Singonesia" luxury goods market should reach around USD 8 billion by 2015, representing the lion share of the luxury market in South East Asia.

**Surprise number 8: Valuation will not matter in the recovery phase**

Valuations based on P/E ratios in the luxury goods industry vary significantly, depending on product category and geographical breakdown of sales, but luxury goods companies typically trade at a premium to the overall equity market given superior sales and earnings growth as well as high margin and strong balance sheet metrics. The Credit Suisse Global Soft Luxury Index (including producers of leather goods, clothes, etc.) is currently trading at a 12 month forward P/E ratio of 18.3x, whereas the Credit Suisse Global Hard Luxury Index is trading at a historically low multiple of 14.2x. But with the better than expected sales momentum during Christmas and positive data on recent Chinese New Year trading, full year earnings across the sector are likely to be higher than current average estimates, resulting in lower P/E multiples. As already mentioned, we expect 12% sales growth and 17% earnings growth for the luxury goods industry as a whole this year. Rising earnings is not of a surprise to us given that we are in a strong recovery phase.

Please find an overview of selected leading luxury goods companies on the following page.

**Selected leading luxury goods companies** (by sales)

| Company | Country | Sector | 2012 | | | |
|---|---|---|---|---|---|---|
| | | | Sales in EUR mn | % of sales to emerging markets[1] | Operating profit in EUR mn | Operating margin in % |
| LVMH | France | Multi luxury brands | 28,103 | 46% | 5,921 | 21.1% |
| Richemont | Switzerland | Jewelry/Watches | 10,193 | 45% | 2,417 | 23.7% |
| PPR | France | Multi luxury brands | 9,736 | 43% | 1,792 | 18.4% |
| Chow Tai Fook | Hong Kong, China | Jewelry/Watches | 6,037 | 100% | 778 | 12.9% |
| Coach | USA | Leather goods | 3,921 | 30% | 1,191 | 30.4% |
| Rolex | Switzerland | Watches | 3,838 | 45% | 1,151 | 30.0% |
| Hermès | France | Leather goods | 3,460 | 45% | 1,086 | 31.4% |
| Prada | Italy | Leather goods | 3,301 | 55% | 892 | 27.0% |
| Chanel | France | Leather goods | 3,250 | 55% | 943 | 29.0% |
| Tiffany | USA | Jewelry | 2,802 | 20% | 515 | 18.4% |
| Burberry | UK | Apparel | 2,293 | 40% | 446 | 19.5% |
| Armani | Italy | Apparel | 2,070 | 35% | 323 | 15.6% |
| Patek Philippe | Switzerland | Watches | 1,950 | 45% | 624 | 32.0% |
| Zegna | Italy | Apparel | 1,251 | 44% | 140 | 11.2% |
| Dolce & Gabbana | Italy | Apparel | 1,133 | 35% | 237 | 20.9% |

[1] including offshore purchase

Source: Company data, Credit Suisse estimates, as of December 31, 2012.

# Real Estate
# Exciting Construction Projects Overseas

Ulrich Braun, Head Real Estate Strategies and Advisory

**Internationally-oriented real estate investment products invest in a wide range of existing properties. In addition, they also consider promising construction projects in attractive urban locations.**

International real estate investments are today an essential component of a broadly diversified asset allocation. This investment segment is thus now equally as important as equity and bond investments: international diversification is viewed as an investment norm. The synchronous global recession over the past few years attracted negative headlines for many international real estate markets. Quick profits are indeed unlikely in the current environment. Longer-term investors should, however, take advantage of the opportunities emerging in some of the transparent and liquid real estate markets. The best-suited properties to do so are those with long-term rental agreements and tenants with a strong credit rating, excellently positioned shopping centers (in Europe in downtown areas where possible) with good main tenants, and real estate used for new forms of housing such as retirement homes. The latter offer a high level of domestic comfort in combination with care services. They are less susceptible to economic developments and can benefit from the trend towards a higher life expectancy.

**Investment in prominent construction projects**

When making international real estate investments, asset management typically invests a large portion of the investment portfolio in existing properties. In addition, however, the portfolio is also supplemented by construction projects in attractive and urban locations. At the moment, there is a focus in particular on major cities in Chile, Canada and Australia. Sustainability is also an important factor in the construction of projects in an international environment. Wherever possible, certification in accordance with locally or internationally established sustainability labels is sought. We provide a brief presentation of three exciting and promising projects overseas below.

- **Office and retail building in Santiago, Chile**
  The final touches are currently being put to the new building situated at Apoquindo 5400 in the Las Condes district of Santiago. The high-quality property including seven floors below ground, the ground floor and 21 upper floors has been constructed in accordance with the requirements of the LEED gold standard. In total, some 20,700 square meters of rentable office space, 1,300 square meters of retail space and 690 parking spaces will be created. The property will be ready for use in Spring 2013.

- **Old Stock Exchange in Vancouver, Canada**
  The Old Stock Exchange was built in 1929 in an Art Deco style and was the headquarters of Canada's third-largest stock exchange. The building is today used by around 50 tenants as office space. It is located at an important traffic hub in the Vancouver financial district, in close proximity to the waterfront. An extension project, which will incorporate the Old Stock Exchange, is currently being planned. The construction work is scheduled to begin in Summer 2013, with the new building being expected to be completed in 2016.

- **Office building in the CBD of Brisbane, Australia**
  A 15-story office building scheduled to be completed in May 2013 is currently under construction in the central business district (CBD) in Brisbane. The property is located in the city's downtown area and is rented to the Australian Taxation Office (ATO) on a long-term basis. It has a 15-year rental agreement as single tenant for all of the available office space. The property is being constructed by a local project developer under a general contractor agreement. The building will meet high sustainability standards and upon completion will be awarded the 5 Star Green Star label, while the 5 Star NABERS label is also being targeted. The floors below ground will include around 500 square meters of storage space, a parking garage for 50 cars and a modern bike garage, which will be made accessible via its own lift and will have the capacity to house at least 150 bikes.

# Alternative Investments
# Current Positioning in Hedge Fund Strategies

Damaris Reiser, Alternative Investments Advisory

**In this article we would like to outline our views and the resulting strategy for the first half of 2013. As such, we would like to elaborate on the opportunities and challenges that different hedge fund strategies may face in the coming months, and derive our own hedge fund strategy allocation.**

### Brief review of the main trends in 2012

Equities: Ultimately, 2012 was a good year for risky assets, despite the MSCI World's mid-year correction and going back to flat after a positive start into the year. Subsequently, the markets accepted that central banks' easing would mitigate tail risk, particularly when the European Central Bank followed its accommodative course.

Bonds: Performance in G7 government bonds was range-bound in the second half of 2012, with only modest performance. Central banks' quantitative easing strategies continued to drive inflows into the higher-yielding segments of the market. In credit, for example, investors' appetite for yield prompted a record year for high yield: volumes totaled USD 384 billion globally in 2012, officially breaking the record for the largest year in terms of new issue volume, and yields fell towards all-time lows of below 6%. Emerging market bonds, in turn, delivered above-average returns.

### Opportunities and headwinds within the different hedge fund strategies

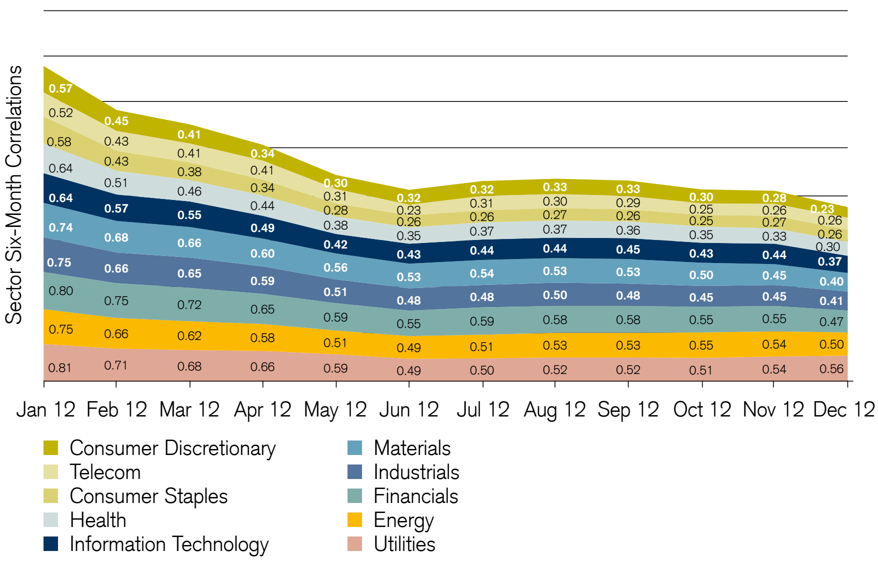
#### Fundamental strategies

Long/Short strategies: In equities, monetary policy effects (notably risk asset rotations) and the economic upturn, in combination with reasonable equity valuations, make a strong case for equity exposure. We would take advantage of a potential increase in volatility in connection with the US fiscal and debt management debates, or euro troubles, to further build up our equity allocation. However, we believe that directionality will be less relevant in 2013 than stock differentiation. Interstock correlations have dropped to lower levels, which may generate stock picking and long-short spread opportunities for fundamental strategies.

This means that we are constructive on managers who target more stock-specific and idiosyncratic opportunities rather than looking to trade books aggressively solely based on macroeconomic views. Also, we prefer managers with a variable net exposure mandate, able to adapt to changing directionality in the markets.

Event Driven strategies: As companies continue to hold large cash balances, company boards face increasing pressure to put money to work, which could be supportive of corporate events. Furthermore, record-breaking high-yield issuance has created many pre-emptive

**Lower correlations may generate stock-picking opportunities in fundamental strategies**




S&P 500 sector intra-stock correlations in 2012

Source: Credit Suisse HOLT, as at December 31, 2012.

Historical performance indications and financial market scenarios are no guarantee for current or future performance.

re-capitalization, liability management and other catalyst-driven opportunities (e.g., in the financial sector). We believe it is still early with regard to a large-scale distressed European opportunity set; however, European banks, which had been reluctant to sell holdings at a loss, have recently started implementing large selling programs, creating opportunities for well positioned specialists.

**Tactical strategies**
Markets are moving away from systemic risk and starting to punish fiscally weak "false safe havens" (such as UK fixed income). As such, it is a better environment for discretionary traders as themes move in the direction of policy makers. That's why we favor tactical macro managers with a higher emphasis on policy actions and multi-asset capability aiming to capture market volatility and intermediate moves.

Regarding commodities, we see short-term spiking potential on weather and geopolitical volatility. In managed futures, trend following programs may still find the policy driven environment challenging. That's why, in our tactical strategies, we focus on diversified global macro strategies and just take tactical positions in CTA and commodity programs capturing short-term opportunities.

**Relative Value strategies**
We are broadly neutral on Relative Value strategies. We continue to favor nimble managers combining wider investment mandates with disciplined risk management as many specialist-oriented, structural opportunities present a less compelling risk/return profile today than they did a year ago. Still, we expect reasonable opportunities for the sub-strategy "structured credits". This is due to the fact that the housing sector is rebounding. As a result, credit sensitive RMBS (residential mortgage-backed securities) should strengthen as loss assumptions are adjusted accordingly. We also see opportunities in agency RMBS: the US Federal Reserve's most recent quantitative easing (QE3) has exerted significant upward pressure on prices which creates exploitable distortions in the marketplace. Therefore, we favor non-agency and agency RMBS based strategies in particular.

**Resulting strategic allocation**
Considering all these different market considerations, we believe that there are two main factors which may lead to increased potential opportunities for hedge fund strategies: Firstly, the inter-stock correlations which are at low levels and generate stock picking opportunities in fundamental strategies. Secondly, in contrast to recent behavior, these are macro managers' investment views in synchronization with policy biases, which could lead to the opportunity of capturing market moves by macro fundamental positions. This is also supported by the fact that shrinking investment bank proprietary businesses has led to increased market inefficiencies and less competition.

The combined result of these factors is a barbell top-down portfolio approach, which means a mix of fundamental strategies (based on clean balance sheets, low default rate, high free cash flow, etc.) with trading strategies aiming to capture market volatility and intermediate moves.

### Summary: First Half 2013 Investment Outlook

| Sector | Strategy | Sub-Strategy | Outlook 2H 2012 | Outlook 1H 2013 | Recommended Allocation Change 2H 2012 – 1H 2013 |
|---|---|---|---|---|---|
| **Fundamental** | **Equity Long/Short** | Equity Long/Short – Opportunistic | + | + + | Increase ↑↑ |
| | | Equity Long/Short – Low Net | + + | + | |
| | | Equity Long/Short – Stock Picker | + | + | |
| | | Equity Long/Short – Macro | = | = | |
| | | Equity Long/Short – Trading | + + | – | |
| | | Equity Long/Short – Activist | – – | = | |
| | **Event Driven** | Event Driven – M&A | = | = | Neutral ↔ |
| | | Event Driven – Distressed/Credit | = | = | |
| | | Event Driven – Multi-Process | = | + | |
| | | Event Driven – Special Situations | – – | + | |
| **Tactical Trading** | **Global Macro** | Global Macro – Diversified | – | + | Neutral ↔ |
| | | Global Macro – Quant | – | = | |
| | | Global Macro – EM Focus | + | + + | |
| | | Global Macro – Currency | + + | + | |
| | **CTA** | Trend Following – Short Term | – | – | Moderate Decrease ↓ |
| | | Trend Following – Diversified | = | = | |
| | | Systematic Multi-Strategy | – | + | |
| | | Non-Trend/Mean Reversion | + | + | |
| | **Commodities** | Commodities | = | = | Moderate Decrease ↓ |
| **Relative Value** | **Corporates/Multi-Strategy** | Multi-Strategy | + | + | Moderate Decrease ↓ |
| | | Equity Volatility Arbitrage | = | = | |
| | | Multi Asset Class Volatility | + | = | |
| | | Long Volatility Bias | – – | + | |
| | | Quant Equities | + | = | |
| | | Structured Credit – Credit | + + | + | |
| | | Corp Credit – Directional/LB | = | – | |
| | | Corp Credit – Low Net/Tactical | – | = | |
| | | Convertible Arbitrage | + | = | |
| | **Fixed Income** | FI Multi-Sector | + + | = | Moderate Decrease ↓ |
| | | FI Arbitrage | = | = | |
| | | Structured Credit – Prepay | + | = | |

++ Positive   + Moderately Positive   = Neutral   – Moderately Negative   – – Negative

Source: Credit Suisse/AFS Group.

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