

Asset Allocation Strategy

26 November 2009

Investment Committee

Asset Allocation summary

The table summarizes investment decisions on Asset Allocation and loan currencies made by JGAM.

Asset Allocation	
Fixed Income	N
Equities	U->N*
Alternatives	O->N*
Cash	O->N*

Loan mix	Low Risk	Medium Risk
CHF	50%	0%
USD	50%	100%

Note: N = Neutral, O = Overweight, U = Underweight.

* The movement into neutral positions are technical, as we have decided to broaden the range around the neutral benchmark positions.

Economics and financial markets

Nothing much has changed in the past month. The picture is still the same:

- The global economy is slowly recovering (L-shape in most places)
- Policymakers are still stimulating the economies
- Inflation is non-existing
- Emerging Markets are ahead in the business cycle as they are not handicapped by de-leveraging consumers
- China is doing well thanks to world record stimuli (12% of GDP) and an artificially weak currency
- Euro and gold have become the non-dollar-assets to be in as the dollar continue to downtrend
- Companies are doing well due to cost cutting, question is if top-line revenues can improve in an environment of slow growth recovery?

As the “cake of growth” is small, the game has turned into a who-gets-the-biggest-piece, and this game is mostly determined by currency plays. As long as the US dollar is in a downtrend and the Chinese renminbi is pegged to the dollar, Europe suffers a competitive loss as the euro becomes stronger. This movement is very much what drives the relative performance between stock markets in the US, China, other Emerging Markets and Europe at present. Europe is getting the smallest piece of the “growth cake”.

The risk is that the dollar-trend will turn and the whole picture will then change. Therefore, it is important to understand what’s behind the weakening dollar.

Long-term the dollar is under pressure from a:

- Current account deficit
- Reduced status as reserve currency

Short-term there are also forces in place weakening the dollar:

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- Unfavorable interest-rate differences
- Dollar used for carry-trade
- We are in a “risk on” scenario

Let’s look into the dollar-depreciating factors and examine what the risks are that the picture could change.

For many years the US has run a current account deficit mirroring a negative savings rate. A country running a current account deficit does not earn enough foreign currencies on exports to pay for its imports and therefore has to “import” foreign capital, i.e. borrow abroad. This traffic creates a demand for foreign currencies and hence a downward pressure on the dollar. In the long run a depreciating dollar will improve the US’ competitiveness and reduce the imbalance between exports and imports. What could change this situation that has been going on for years? As long as the global economy lacks growth the US cannot export itself out of the crisis. Therefore, in the present situation a continuing depreciation of the dollar is the only solution to an improvement of the US current account deficit.

Traditionally, the US dollar has been - and still is - used as reserve currency. It’s only natural as the US economy is by far the world largest and many goods and services are traded in dollar. Also, the current account deficit that the US has had for many years has caused an accumulation of dollar-claims in other countries. For example the Central Bank of China holds a dollar reserve of 2,500bn USD. This is more than the G20-countries have used so far on fiscal policy stimuli since the financial crisis took off. With its currency reserve China could easily buy the total British stock market or the French and German ditto together. However, China has signaled that they have accumulated enough dollar reserves and would like to diversify more into other currencies, e.g. the euro. Other countries with large currency reserves have indicated the same. Hence, a traffic has started away from the dollar reserves into other currencies, especially the euro. It’s a slow development as no dollar-loaded country is interested in seeing the dollar plunge, which would happen if a larger part of dollar reserves were suddenly to be swapped into other currencies.

At present the interest rate gap between the US and other countries is unfavorable for the dollar. The US interest rate is very low as policymakers are trying to kick-start the economy. Lately FED’s chairman Ben Bernanke said that *“low rates of resource utilization, subdued inflation trends and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period”*. The signal is clear, FED is not going to raise interest rates before there are clear signs that the economy is improving and can continue to do so without help from the central bank. As other countries (especially in Europe and China) have not been - and will continue not to be - as aggressive as the US on monetary stimuli, an interest rate gap unfavorable to the dollar will persist. The risk that this situation will change is limited.

The low US interest rate and the weakening dollar has made the greenback become a popular carry trade currency. Investors take on a loan in dollar and invest the proceed in other currencies. This traffic amplify the weakening trend of the dollar. The risk is that a sudden appreciation of the dollar will force carry traders to cover short positions in dollar, amplifying a dollar appreciation. When its status as a carry trade currency ended, the yen made a significant jump up. This is maybe the most risky scenario for an investment strategy based on a continuing dollar depreciation.

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Finally, at present we are in a “risk on” situation. Investors are taking on more and more risky investments as economies are improving and financial markets are returning to more normal volatility levels. Therefore, investors are moving out of dollar bonds and into more risky securities. If for whatever reason (e.g. geopolitical tension between USA/ Israel and Iran or debt problems in Dubai, Greece or Ireland) we should return to a “risk off” scenario, it’s very likely that investors will seek safe heaven again in US Treasuries, causing a demand for dollars.

All in all, many forces – long as well as short term – point in the direction of a continuing dollar depreciation. There are risks that the dollar could move the other way, but we think these risk scenarios are less likely to mature. Therefore, we continue to base JGAM’s investment strategy on a weakening dollar.

Asset allocation

Foreign exchange

- We keep an **underweight** position in **USD** as we still expect the USD to be in a long-term downtrend against other major currencies.

Fixed income

- We keep a **neutral** position on fixed income.
- We continue to favor high-quality corporate bonds and Emerging Market bonds because of attractive yield spreads.

Equities

- We move to a **neutral** position, as we have broadened the band around the benchmark we define as a neutral position.

Alternatives

- We move to a **neutral** position (in gold), as we have broadened the band around the benchmark we define as a neutral position.

Cash

- We move to a **neutral** position, as we have broadened the band around the benchmark we define as a neutral position.

Loan mix

- In the leveraged **low risk** portfolios we keep a funding of **50% CHF** and **50% USD**.
- In the leveraged **medium risk** portfolios we keep a funding of **100% USD**.

Gearing level

- We stay with leverage **below maximum levels**.

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Analysis and investment approach

JGAM make macroeconomic research and financial analysis on various types of securities. These analyses form the basis for JGAM's decision on Asset Allocation, i.e. the tactical weighting of security types (bonds, equities etc.) in the portfolios JGAM offer: Low Risk, Medium Risk, High Risk and Speculative.

JGAM does not make analysis on specific securities. In stead JGAM uses analysis from external sources to decide what specific securities to invest in.

JGAM follow a top-down approach when deciding how to invest. First, the economic and financial trends are examined. Second, JGAM's asset allocation is determined including currency exposure, the composition of loan mix in leveraged portfolios and level of gearing. Third, we select specific securities within the asset classes.

Tactical weights in JGAM portfolios are equal to market determined dynamic weights unless JGAM decide to change the asset allocation or positions in specific securities.

JGAM's analysis, recommendations and investment decisions are presented in the following reports:

- Asset Allocation Strategy
- Foreign Exchange Strategy
- Fixed Income Portfolio
- Equity Portfolio
- Alternatives Portfolio

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Bond investment involves risk. Many factors, including the country’s credit quality, willingness to pay, liquidity, social conditions and economic developments may affect the price of a bond. Indirect factors may also affect the price of a bond, for instance global economic factors, global risk tolerance and geopolitical risks.

Equity investments are associated with risk. Movements in the equity market, the sector and/or news flow, etc. regarding the company may affect the price of the equity. In connection with an ADR or similar papers, the foreign exchange risk exists relative to the currency in which the underlying equity trades.

Alternative investments (including commodity investments) involve risk. Movements in the credit market, the sector and/or the news flow, etc. regarding the issuer may affect the price of an alternative investment.

Leveraged investments are very risky, exposed to all the above mentioned factors as well as a fall in the value of collaterals combined with an increase in the value of the loan currencies. Leveraged investments are only recommended for investors with a suitable risk profile.

All of the above mentioned risk factors should not be regarded as exhaustive.