CAZENOVE
CAPITAL MANAGEMENT

Cazenove Pan Europe Fund

Fund commentary –December 2011

Market Review

We were right to be wary of placing too much faith in Europe's political leaders and markets fell into a slough of despond in November. The UK and European equity markets set a record of 10 days of consecutive falls as investors gave up hope of finding a market-friendly solution to Europe's intractable debt problems, even after Greece, Italy and Spain attempted to prove that they are committed to remaining in the euro and reforming their economies. Spain proved that democracy can deliver a pro-reform government, whereas Italy is attempting to prove that a technocratic government can deliver again (as in 1992) where democracy has failed. Who knows with Greece, but unfortunately the markets have not given them a chance, with government bond yields rising to unsustainable levels in all three countries. After ten down days it was perhaps inevitable that the markets rallied. Hedge funds often close for Christmas at the end of November, and that was always likely to cause a squeeze in crowded short positions. European equity is one such short trade, so the rally into the month end was sharp. There was also a clear signal of how desperate investors have become: 1 year German government bond yields turned negative this month. This is a sure sign of fear. Maybe that was the trigger for central banks to coordinate cheap dollar liquidity for the highly stressed banking system. Whatever the cause, the effect was a continuation of the short squeeze in markets. Whether the rally can continue is up to the politicians. At least they know the pressure is on them to deliver something substantive this time.

The broad trends of the hard economic data reported continued the same pattern as recent months. US expansion continues to be solid, with encouraging signs of the smaller businesses joining in finally. Eurozone recession is becoming a more consensual view for the first half of 2012 as survey data continue to trend down, although the rate of decline is stabilising in most countries, and Germany continues to suggest modest growth is possible as the IFO defied consensus and rose a tad in November. Chinese growth is slower than people think, with the latest official PMI survey dipping into contraction territory, which merely confirms the HSBC version which dropped below 50 back in July. This confirmation of contraction, allied to concerns of eurozone recession, prompted the Chinese to signal the end of monetary tightening as we expected. They reduced the Reserve Requirement Ratio by 50bps to release $60billion of lending potential into the economy. Back in the UK the economy is forecast to grow just above stall speed according to the consensus. Hmmm, we'll see if the dollar block can just drag us up enough to offset the Eurozone woes.

Fund Review

Performance was distorted downwards in the same way it was boosted last month by the fact that the fund did not price on the last day of October. The fund was boosted by 2.5% in October (i.e. underlying performance was 0.7% behind the index), but negatively hit by 4.5% in November (i.e. underlying performance was 0.3% ahead of the index). Over the last two months we are therefore around 0.4% behind the index, which is not a big surprise given our moves to balance the fund out after the falls over the summer. The main positives were stock selection in travel/leisure as Bwin rallied sharply on hopes of a US partnership. Defensives did well, especially Vodafone, Babcock and Bayer. Our worst performers included Galp which saw a disappointing price for its Brazilian assets take 15% off the stock. Eiffage in France suffered from being highly geared and seeing downgrades to the local construction outlook. Geared financials were the remaining losers, such as Resolution, Intesa and Axa.

Fund Strategy

We have taken account of the likely policy response from the ECB to a “fiscal compact” between the main countries of the Eurozone by adding again to riskier stocks in the portfolio. We have moved back into BNP and added to Axa and Allianz again to make the fund 1% overweight financials, and taking non-life insurance to the most overweighted sector in the fund at 4.5% overweight. Banks remain our biggest underweight thanks to the problem of bad debts arising at the corporate level as we enter recession, and are clearly facing a major funding problem going into the New Year. It would appear that politicians intend to keep markets happy with a new revised treaty to enshrine fiscal rigour into law. However, the French have insisted on leaving it possible for a qualified majority of 85% to overrule those laws if necessary. This is not the Germanic discipline the ECB would like to see, but in a quid pro quo they have at least prevented a total seizure of the system by allowing banks to repo a much wider range of collateral of up to 3 years duration at the discount window. The recession that Europe faces may not therefore be as deep as it otherwise would have been, so we have added a little more cyclicality too, with mining now moving to an overweight as China begins to loosen policy. We have added Xstrata to an enlarged holding of Anglo American and Rio Tinto. We expect to reduce our consensual oil sector overweight in compensation after recent outperformance, leaving us neutral commodities.

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Swiss paying agent: Neue Privat Bank AG, Limmatquai 122, CH- 8022 Zürich

Cazenove Capital Management Limited, 12 Moorgate, London EC2R 6DA. Telephone +44 (0)20 3479 1000.
www.cazenovecapital.com/investmentfunds

Registered Office 12 Moorgate London EC2R 6DA.