

Black Swan Capital – May 2008 Newsletter

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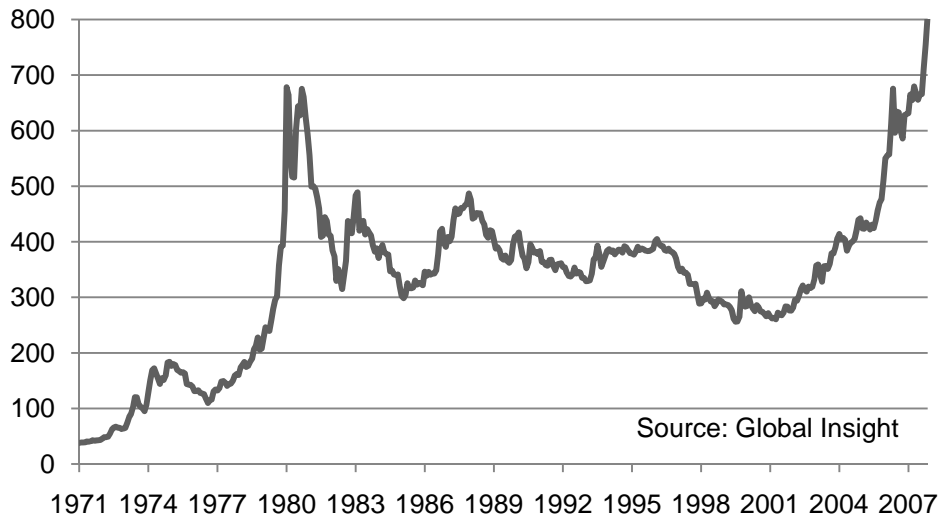
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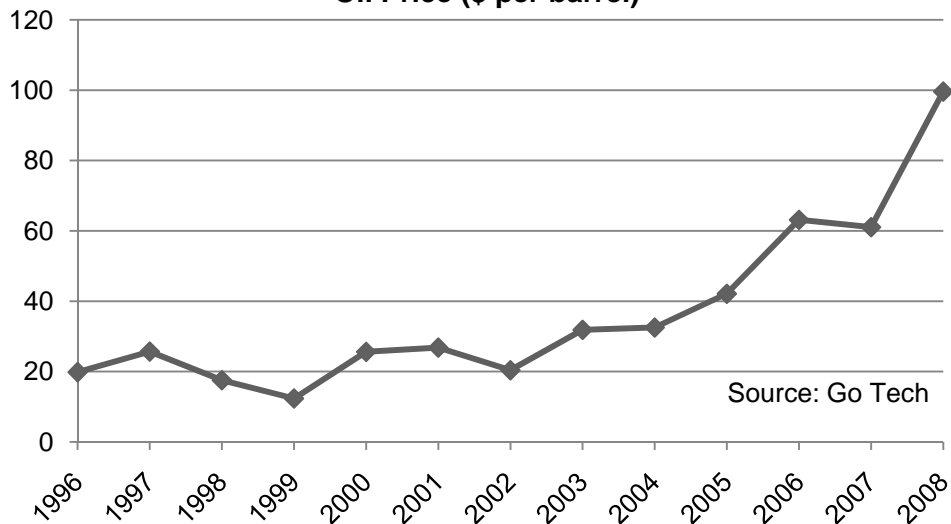
An update on our macroeconomic views

Not a great deal of particular significance has happened since we last wrote in January. There have been no sudden changes of direction, market reversals, alien invasions (or American invasions, no new ones anyway), ecological disasters, or massive population wide mood swings – there’s just been plenty more of the same gloom and doom, plenty more confirmation of what we already suspected was happening, which is that the global economy is slowing down (and being propped up by the likes of China and other chunky emerging markets), the US and the US\$ are in decline (hands up who still thinks the current US\$ weakness is just temporary... you crazy people), the UK property market has stalled, lenders are not lending, inflation is looming in the face of economic stagnation, and gold is soaring (but still less than half way to its previous inflation adjusted peak from the early 1980s).

Gold Price (\$ per ounce)



Oil Price (\$ per barrel)



Yes, the world economy is definitely slowing down, in spite of the fact that the two charts above are heading north. Neither the US recession nor the UK housing slump are surprising – they are just inevitable way points along the greater economic cycle. In many ways the cyclical nature of the global economy is a good thing, as it operates as a natural selection mechanism on business. In the growth phase of the cycle, new companies spring up to offer new services and products, injecting new ideas and fresh blood into society; but when the music stops, only the strong or flexible or clever or unleveraged survive. A recession, in this sense, is like a cull, which removes the old, injured and flawed from the herd, and clears the way for the strong and beautiful to thrive.

But what never ceases to amaze us here is the relative shortness of the economic cycle. Logic suggests that it would be at least a human generation long, perhaps even a human working life time long – as surely the same mistakes will only be made once by the same group of people. Apparently not – we seem to be back where we were just a few years ago. Perhaps this length of time should be known as a ‘gold fish bowl year’ – the length of time that it takes for human society to forget that you can’t spend more than you earn.

The Americans and the British, who are second and first most indebted nations on the planet in per capita terms (yes, we did get that the right way around; sadly the British are more in debt than the Americans) should have Charles Dickens’s Micawber principle drilled into them at school: "Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

However, this cycle has gone too far even by recent standards, thanks to a compounding combination of excess borrowing by consumers, excess leverage by investors and businesses, and reckless risk taking by banks who should know better but instead think, ‘what the hell, the government will bail us out!’.

It’s easy to point the finger of blame at the US subprime mortgage debacle, but the reality is that this was just the weakest link. The way things were going, something had to give – someone had to be the first to trip over the coffee table and vomit on the carpet at the decade long easy credit party. So, now that we’re in this mess, two questions spring to mind –

What happens next?

And what should we do?

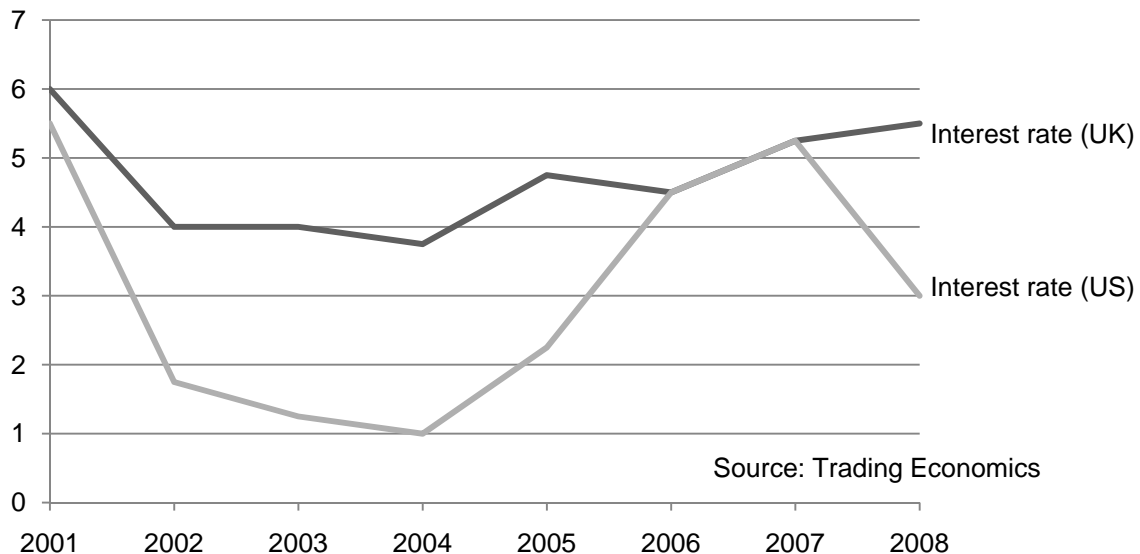
What happens next: First, realize that the globalised economy is an extremely complex system, similar to the weather in that you can explain it to a degree, but not accurately predict it. For that reason, everything that follows comes with the caveat ‘we think’ or ‘in our opinion’. Any economist or financial analyst who tells you what’s going to happen next will almost certainly be wrong; his forecast is only one possibility in a range of possibilities that may follow from the current set of circumstances and conditions. An enlightened guess, at best. Not even the full range of possibilities may be known; there is always the possibility of an ‘unknown unknown’.

Second, realize that your UK centric view is just that: UK centric. There are large parts of the world that are, economically, doing just great! That’s part of the problem, because some of those countries have been lending to the west on a vast scale thereby inflating the credit bubble in the first place. But they’re also part of the solution, because possibly for the first time ever – unless there really is an absolute meltdown and a return to cave dwelling in the US – the rest of the world should not be so badly affected by this US recession as it would have been in the past. The Chinese and Saudis helped pump up the

bubble with air, and now the Sovereign Wealth Funds are helping to replace the air with badly needed capital to shore up battered balance sheets.

In spite of what's going on at home in the UK, we are confident that the US will take action to avoid a serious meltdown. They have both monetary and fiscal policy tools at their disposal, and they're not afraid to use them. Expect further Fed rate cuts and increasing government spending. Our view is that they will prioritize balanced trade and employment over currency strength and status. Perversely, it may be the large US bond accumulators such as China and Saudi who end up putting a brake on the US recovery by not allowing the currency devaluation to proceed as quickly as required by refusing to dump (we meant 'strategically reallocate') their US\$ stock.

Historical Interest Rates (%) (UK & US)

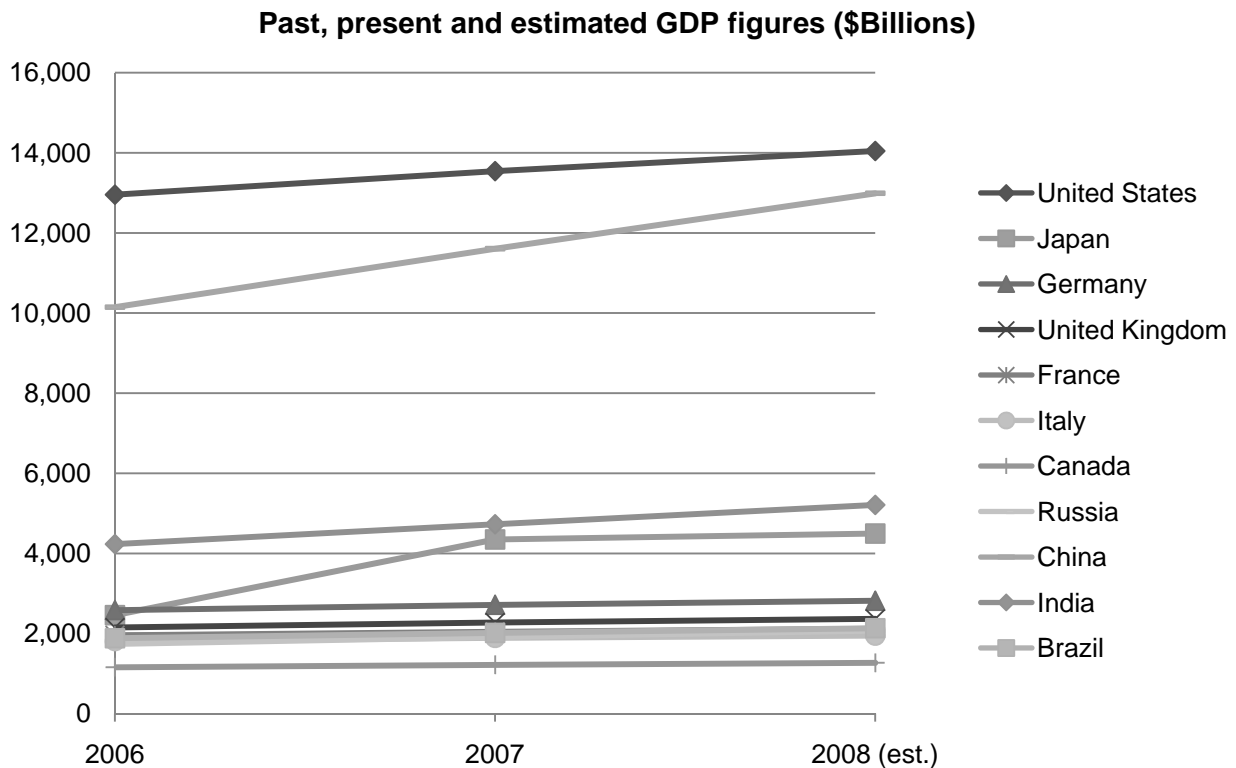


We are also confident that there are huge piles of cash available for investment – it's just that those huge piles of cash are in Middle and Far Eastern Sovereign Wealth Funds, which takes a bit of getting used to. As US assets get cheaper and cheaper, this cash will be deployed, and the US economy will climb out of its dive. What a tangled web.

And finally, we're still seeing strong economic activity in the big emerging markets and most of South East Asia – they're a lot less dependent on the US than they were a few years ago. Growth in this part of the world combined with inflation and devaluation in the US is likely to drive further growth in commodity prices. Yes, oil is expensive in relative nominal terms, but for the first time in human history the world is now consuming oil at a rate of over 1,000 barrels per second, and China's dependency on foreign imported oil has now reached 50% of its total requirement, which itself is growing by the equivalent of the entire UK energy requirement each year. Inflation in China is officially running at around 7%, although food prices increased approximately 18% during 2007. The US\$ is weakening. And the Gulf states are making noises about breaking their pegs to the US\$ (translation: stop propping it up). Of course the price of oil is going to keep going up!

Country	GDP (\$Billion)		
	2006	2007	2008 (est.)
Canada	1,157	1,217	1,267
Russia	1,739	1,909	2,068
Italy	1,809	1,888	1,947
Brazil	1,881	2,014	2,132
France	1,953	2,040	2,117
United Kingdom	2,148	2,271	2,364
Japan	2,456	4,346	4,495
Germany	2,583	2,714	2,816
India	4,232	4,727	5,210
China	10,147	11,606	12,989
United States	12,955	13,543	14,046

Source: International Monetary Fund (April 2008)



The same forces are at work on the price of gold: restricted supply, increasing demand, priced in a weakening currency. Of course it's going to keep going up! In fact, since our January newsletter, which opened with the words, 'Buy Gold', the price of gold has risen from around US\$800 per ounce to well over US\$900.

So, what to do? Answer: Nothing. Hang on in there, keep your head down, and watch out for black swans. If your investment time horizon is really short then you shouldn't be in anything other than cash anyway. If it is, and you're not, then go to cash now, because while we think that now may be a good time to be buying, we can't be certain that this time next year won't be an even better time to be buying. Volatility can be a killer in the short term. All we know for sure is that the storm will pass – we're just not sure when.

Actually that highlights one of our golden tenets of investment: Forget market timing, it's a mug's game. Go for steady, regular contributions over many years, and concentrate on asset allocation and portfolio construction rather than market timing and stock picking. Focus on the long term.

Let us now move on to our 'core portfolio', which is nothing less than an expression of the sum of our knowledge, experience, fears, greed, hopes and dreams. Well, we like it anyway, and it keeps us off the streets.

The core portfolio (and our very interesting investment process)

CTP's objective in managing your money is to boost value by optimizing performance through strategic asset allocation, portfolio construction, ongoing management, and regular review.

The difference between good and bad investment performance can mean the difference between retiring at 55 and 65. It's that simple. Even small improvements in performance compounded over many years can have a significant impact on fund value. For example, £1,000 invested each month for 25 years with an underlying growth rate of 5% net will result in a fund worth £586,000; increase the net performance by just 2% and the fund will be worth £783,000 – that's over a third more value for just 2% extra performance!

So what if the extra performance costs you a bit more!? Do you really care if your advisers and fund managers are rewarded for making you money!? Far too many people, lead by advisers and managers hiding behind pathetic performance track records, focus on cost rather than performance. Obviously cost competitiveness is important, but focusing on cost to the exclusion of all else usually proves to be false economy. "Look after the pennies and the pounds will look after themselves"... Tosh and twaddle! Look after the pounds! Focus on the pounds!

At CTP we aim to help you drive this extra performance out of your pension funds and other investments. We've put a huge amount of time, effort, resource, technology, and expertise (the majority of financial advisers are unqualified in this area, and won't pay for the technology required to do the job properly) into building an asset allocation model, and fund selection and portfolio construction processes. Over the last few years we've helped our clients achieve growth on their investments that they've never experienced before. One of our clients recently said -

"The fund selections that you made for me (8 months ago) are excellent, thanks. The value of my (funds) has grown from £76k at the start of the year to £110k now with only £10k of extra contributions..."

The bottom line is this: Driving more performance out of an investment is a far more economical means of increasing value than just putting more money in or trying to cut costs. Here's how we do it.

The failure of the financial services industry (except us) to adequately look after your money

The difference in performance levels between an average portfolio of investments and a well structured, diversified and managed portfolio can be many, many percentage points. At CTP we frequently come across cases where people have significant sums of money languishing in half forgotten pension funds or other investment vehicles. These funds are suffering from neglect. More often than not they are invested in one-size-fits-all funds that might be cheap, but certainly do not perform. This reflects badly on advisers and managers who use the cheapness of the funds they are recommending to divert attention away from the performance that they are not delivering.

Sadly, far too many managers of your money - whether we're talking about your advisers and administrators or the underlying fund managers into whose hands your advisers and administrators have put your money – fail to perform by any measure. Some of the reasons for this are –

- Advisers and managers rely on their big brand names: A large employer, or worse a lazy adviser, may put your money with one of the 'big names' into one or more of their 'big funds', just because they have the brand name and it's an easy option. Investors generally do put faith in a brand they know and trust – or their employer or adviser does on their behalf. Brand may inadvertently become a more important factor in the manager selection process than performance.
- Advisers and managers often put too much emphasis on charges and fees, and will look for cheaper funds and structures regardless of performance. However, it is very easy to demonstrate that investors who put their money into actively managed, diversified portfolios of funds usually end up with significantly more value, regardless of the impact of higher charges and fees.
- It's difficult to stay at the top of the performance tables. Continuous monitoring is required to keep track of how the various funds and fund managers are doing. Most advisers do not regularly review their clients' portfolios (because they don't know how, and they earn their commission upfront and don't care after that). This is like pointing a car in the general direction of the destination at the start of the journey, and then not bothering to steer.
- Investors are often very undemanding! Investors seem reluctant to switch advisers or fund managers, in spite of the fact that their funds are neglected and lack of performance is detracting from the potential value of the investments. It's your money. Take charge! At the very least, a portfolio of investments should be reviewed and rebalanced if necessary to account for changes in fund performance, risk characteristics, over and underweight positions, changes in macroeconomic factors, and changes in personal circumstances which may impact on financial targets and risk tolerances. Think about that old preserved pension scheme languishing in some unknown fund administered by your three-jobs-ago ex-employer. Have they rebalanced your portfolio for you recently?
- Buying high, selling low: Er, yes, it should be the other way around, if you want to make any money. However, investors often pile into funds that have recently performed well *simply because they have recently performed well* – managers advertise and market on the back of strong performance, and lazy advisers take the easy option of placing their clients' funds there, without looking under the bonnet to determine whether it was achieved through luck or at great risk, or

trying to ascertain if that performance is sustainable on an ongoing basis. No one wants to back a lame duck – but the long term winning strategy is to back the tortoise, not the hare.

All of this represents a general mass failure of the financial services industry to service its customers. The essential conclusion of this is that bad advisers and managers should be fired immediately, and professional advisers and managers appointed to run your money, extract greater performance from your investments, and make a positive proactive contribution to building your wealth.

The alternative

We will help you to put your funds to work in a well structured, diversified and actively managed portfolio of funds in tax efficient investment vehicles. Our model portfolio is constructed on the basis of thorough analytical research and back testing using institutional calibre software and tools. Even if it costs more, which is usually does, the extra cost can be easily and quickly overcome by the potentially superior performance that can be achieved.

Asset allocation

This is the most important stage of the process. The asset allocation of a portfolio of investments has more impact on the long term performance than individual fund or stock selection (in fact, it has been calculated that as much as 92% of performance can be attributed to asset allocation alone). It is also the stage at which diversification can have most benefit, as different asset classes are usually less correlated with each other than individual funds within a sector or asset class are. The main asset classes that we consider are –

- Equities
- Commodities
- Fixed interest
- Property
- Cash

The main application of our core portfolio is for pension funds or other tax efficient investment vehicles such as ISAs and offshore bonds. These are almost invariably only a relatively small part of a client's overall balance sheet, which usually includes separate items of property and cash. It is also a simple fact that the majority of CTP's clients are in the 30 to 45 age bracket, and therefore they are in the accumulation phase of their financial lives rather than the income drawdown phase; the implication is that capital growth is more important to them than income generation and capital preservation. Therefore, for our purposes and unless specified by a client according to their particular requirements or preferences, we do not include cash or property or fixed interest in our core portfolio. We focus on equities and commodities for growth, inflation proofing, and diversification. And as time horizons are generally long, and the portfolios that we are constructing are a relatively small part of the overall picture, there is a bias toward overseas investment in actively managed growth funds.

Commodities are, by definition, an 'international' asset class, whereas equities are usually specific to a region. Investing outside one's home territory creates relative risks through currency exposure and asset price volatility. A useful metaphor is standing in a carriage on a train and witnessing the apparent stability of your carriage relative to the next carriage along, which appears to buck and jump around at every bump in the track. Investing internationally allows for a much greater degree of diversification within a portfolio – diversifying into other areas, as well as diversifying away from an over-concentration of

investment in your own region, which is a risk in itself – as well as creating the opportunity to benefit from higher growth areas of the world. Therefore, we break the equities element of the asset allocation into -

- Local
- International
- Emerging

'Local' ultimately refers to the country where it is envisaged that the investment will eventually be encashed and spent; the UK for most of our clients. The majority of our clients have plenty (if not too much) exposure to the UK via their main homes and employer pension schemes.

We exclude UK equities from our core portfolio to enhance overall client balance sheet diversification. We break down the international element into the following sub-regions -

- North America (i.e. USA)
- Europe
- Asia

And we break down the emerging markets into –

- Global
- Latin America
- New Europe
- China

Let us consider a typical client example: A 40 year old male planning for retirement at age 55. Even if he has a fairly conservative attitude to risk, he has a long time horizon, so he can afford to take some more risk; the higher trend growth rate of a diversified portfolio of actively managed and individually risky funds should overcome the increased volatility over the longer term. We would recommend the following portfolio –

- 30% commodities
- 70% equities

Within the equities allocation, the regional allocation is as follows –

- 20% Europe
- 20% Asia ex Japan
- 10% China
- 20% other emerging markets

Note that the US and Japan are missing from the regional allocation. This is based on our firm view currently that the US is in decline, and Japan has some major structural problems that it is struggling to deal with. We are aware that excluding two of the world's greatest economies goes against the grain as far as diversification is concerned – but if we strongly believe that this is truly the case, why would we back these regions with your money?! We may well bring a US and/or Japanese allocation back into the portfolio when we believe they've reached a turning point, but that time is not now.

Fund selection and portfolio construction

The next stage is actual fund selection and portfolio construction. It is important to have access to as large a universe of funds as possible, and a flexible trading platform to operate from so that portfolio adjustments and fund switches can be implemented quickly and efficiently when required. For that reason, CTP works extensively with Skandia and Selestia, because they have the largest range of funds and access to the most third party specialist fund managers of any wrapper providers in the market, as well as offering technologically superior trading platforms. Within the available fund universe we select funds within each sector according to the following criteria -

- Minimum 3 years track record
- Top quartile performance for last 3 years (and 5 years, if required to narrow field)
- Top quartile 'information ratio' relative to sector benchmark for last 3 years

The reason we require a minimum 3 year track record is that we want to have sufficient data to make credible comparisons between different funds within a sector. A newly established fund is not necessarily inferior – in fact, some brand new funds offer some very interesting and, in our opinion, potentially very rewarding strategies. However, that is just our opinion, and unless a client specifically wants to make such an investment alongside their core portfolio, we restrict our selection of core funds to ones where there is track record and data available to rank funds relative to their peers.

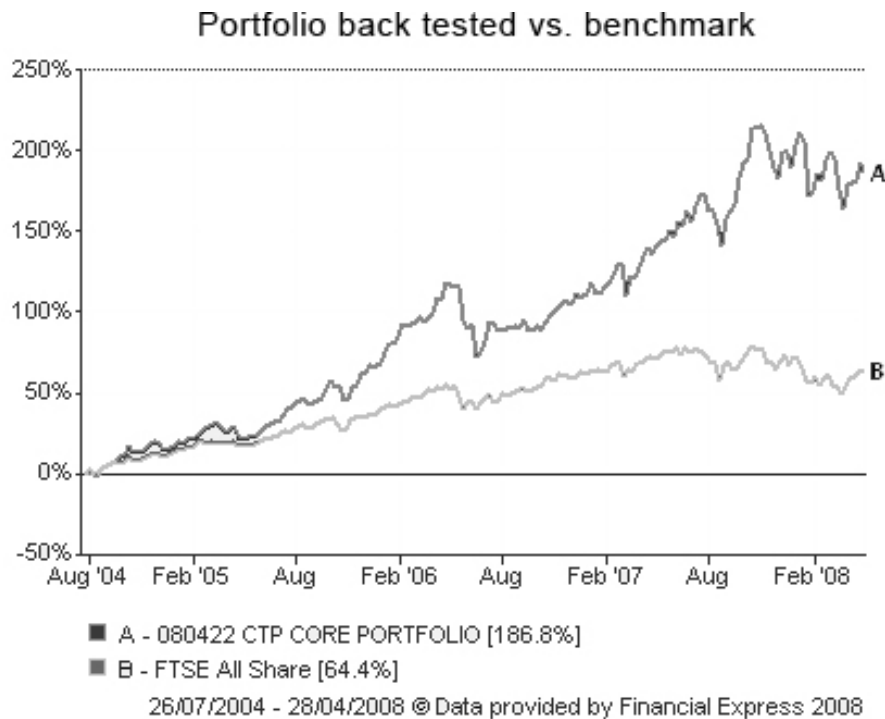
We require consistent top quartile performance. We acknowledge that past performance should not be used as a guide to the future, unless it is considered in the context of other factors. We use past performance simply to narrow the field – we rule out the funds that have done badly, and we take no further interest in those funds. Then, focusing on the remaining funds, we look at the 'information ratio' (IR).

There are many statistical measures of risk adjusted performance, and it is our view that this is the best one for our particular purposes. The IR measures the performance over benchmark relative to risk over benchmark; in plain English, that means we are separating out fund manager performance from underlying market performance, and considering the level of risk that was taken to produce that performance. For example, we're not interested in the fund manager who made a fortune, but took disproportionately high levels of risk to achieve it; we're much happier with the consistent 'tortoise' fund manager who takes some risk and delivers regular, proportionate outperformance against his benchmark.

So, while we're using performance statistics to narrow the field, we're looking at risk relative performance to make the final selection. Using this methodology, we have selected the following funds within the various sectors to come up with our core portfolio –

- 15% Merrill Lynch Gold & General
- 15% JPM Natural Resources
- 20% Baring Europe Select
- 20% Fidelity South East Asia
- 5% Gartmore China Opportunities
- 5% Invesco Perpetual HK & China
- 10% Axa Framlington Emerging Markets
- 5% Invesco Perpetual Latin America
- 5% JPM New Europe

This is how our portfolio has performed versus the FTSE All Share over the last few years –



Not bad! Of course it's easy for us to pick a portfolio now that looks good on a historic basis – but as many of you know reading this newsletter, this portfolio contains funds that we have been recommending for several years. However, in the interests of fair play, we will only start keeping score from now. Each quarter we'll publish our portfolio performance in the newsletter, and also explain any portfolio adjustments. We invite your views and comments on our approach – many of you are financial services professionals yourselves, so what do you think?

We will assume a £1,000 per month regular contribution starting on 28th April 2008 and keep track from there.

CTP 'alternatives' portfolio

For those of you with a more adventurous spirit, or just a larger portfolio that can accommodate further diversification, we put forward 'alternative' investment opportunities. We've decided to start keeping track by putting together a portfolio made up of our favourite alternative investments. We expect that the performance figures will be very choppy, at least to begin with, for the simple reason that many (but not all) of the alternative investment opportunities that we put forward are unlisted or illiquid or structured products, and therefore regular 'marking to market' is just not possible. But here we go...

Our first three investments for this quarter's newsletter are as follows –

€100,000 into the Dalmatia Developments (II) Ltd private equity property development project

Well, okay, we have to admit, this is effectively one of our own; DD(II) is the second in a series of Croatian property development investment opportunities to come off the Emerging Market Property production line. For the benefit of our newer clients, the Emerging Market Property business was spun off from CTP a couple of years ago, but the two companies are still closely associated.

However, in spite of that link, DD(II) stacks up in its own right. The first project is well under way now, and the equity investors (some of whom are CTP clients) who funded that project to the tune of €3.3m this time last year are looking forward to a very healthy return on their investment in around June 2009. Have a look at the web site for the property that the project is developing: www.kavanjin.com

DD(II) builds on the experience and success of that first project. They're aiming to raise €6.3m to fund the land purchase and get the project rolling. It's expected to take about two and a half years from land purchase to liquidation and exit. The investment is structured as part loan, part equity. The loan element is required for around 14 months and will pay 15% interest. The equity element is required for the duration of the project, and returns are conservatively forecast at 23.8% per year compound, which equates to almost 70% return in absolute terms.

However, the investment is unlisted, illiquid, geared, and generally should be treated as risky and not for the faint hearted. Only experienced or professional investors need apply.

£50,000 into the Meteor Galaxy Commodities 5 geared protected commodities fund

We like this one very much. Quite a number of our clients have been very happy with their investment in the JPM Natural Resources fund over the last three or four years. And so they should be, because it's gone through the roof!

We believe commodities prices are still on the way up, but the higher they go, the less certain we can be. The top is somewhere up there... This clever little structured product from Meteor Asset Management allows you to get exposure to commodities (albeit a different mix than the JPM fund) with both upside gearing *and* downside protection. This means that our JPM Natural Resources investors have been able to switch to Meteor (transaction costs involved, obviously, so we only contacted investors with large enough positions to make the trade worth considering), lock in their commodities gains achieved so far, still get any future upside, and put in a floor at the current level. We like that a lot.

The only restriction is that this is a structured product rather than a listed fund, so you're in for the full 5-year duration, and if you need out in the mean time, you could lose out badly depending on market conditions.

But if you believe that inflation is going to be a major issue over the next few years, and if you think that the US is going to pull through eventually, and that China and the other chunky emerging markets are going to carry on steaming ahead, we think this is a good bet.

£50,000 into a basket of Hong Kong listed property developers with large Chinese land banks

We're thinking outside the box with this one. A few years ago we put a number of our clients into direct property investment in Shanghai, and even arranged mortgages for them with the local Chinese banks. Ground breaking stuff, at the time. And then the Chinese regulations changed, and foreign investors were pretty much locked out. We've been looking for a way back in ever since. We think we've found it.

There are a number of Chinese property developers listed on Hong Kong stock exchange. The very fact that they are listed there rather than solely in mainland China is highly reassuring – surely an indicator of a higher than average Chinese standard of corporate governance and financial control.

We have selected a handful of these companies which have substantial land banks in mainland China, in the belief that this will create a proxy exposure to the mainland Chinese property market. They're listed in Hong Kong, liquid, you can buy and sell them through a stock broker, and they're developing property in China. That ticks all the boxes for us.

With literally hundreds of millions of Chinese moving out of the countryside and into towns and cities, there is an enormous amount of development work going on. Plus the population is expected to grow by the equivalent of a whole USA in the next generation. These are big numbers – they'll all need a roof over their heads.

We'll build up our alternatives portfolio over time, marking to market where possible, marking to cost where not. We're not going to go overboard – we'll just add one or two investments each quarter at the very most, investing a fairly nominal amount (or the product minimum) of fantasy money. Let's see how it goes!

All of the investments we back can be accessed directly or via a SIPP (Self Invested Personal Pension).

General financial review

We hope that this news letter has been, at the very least, an interesting read. Even better, we hope that it has provoked some thought that might lead to some business for us and to an improvement in your financial circumstances!

If you would like to discuss any of the investment strategies in this newsletter, or if you would like to arrange a general financial review, please do not hesitate to contact us.

To contact Black Swan Capital about any of the issues raised in this newsletter, or to arrange a free, no obligations financial review, please call us on **+44 (0)844 888 0575** or send an e-mail to **enquiries@blackswancapital.uk.com**

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