IPREO

Flow of Funds Sector Report

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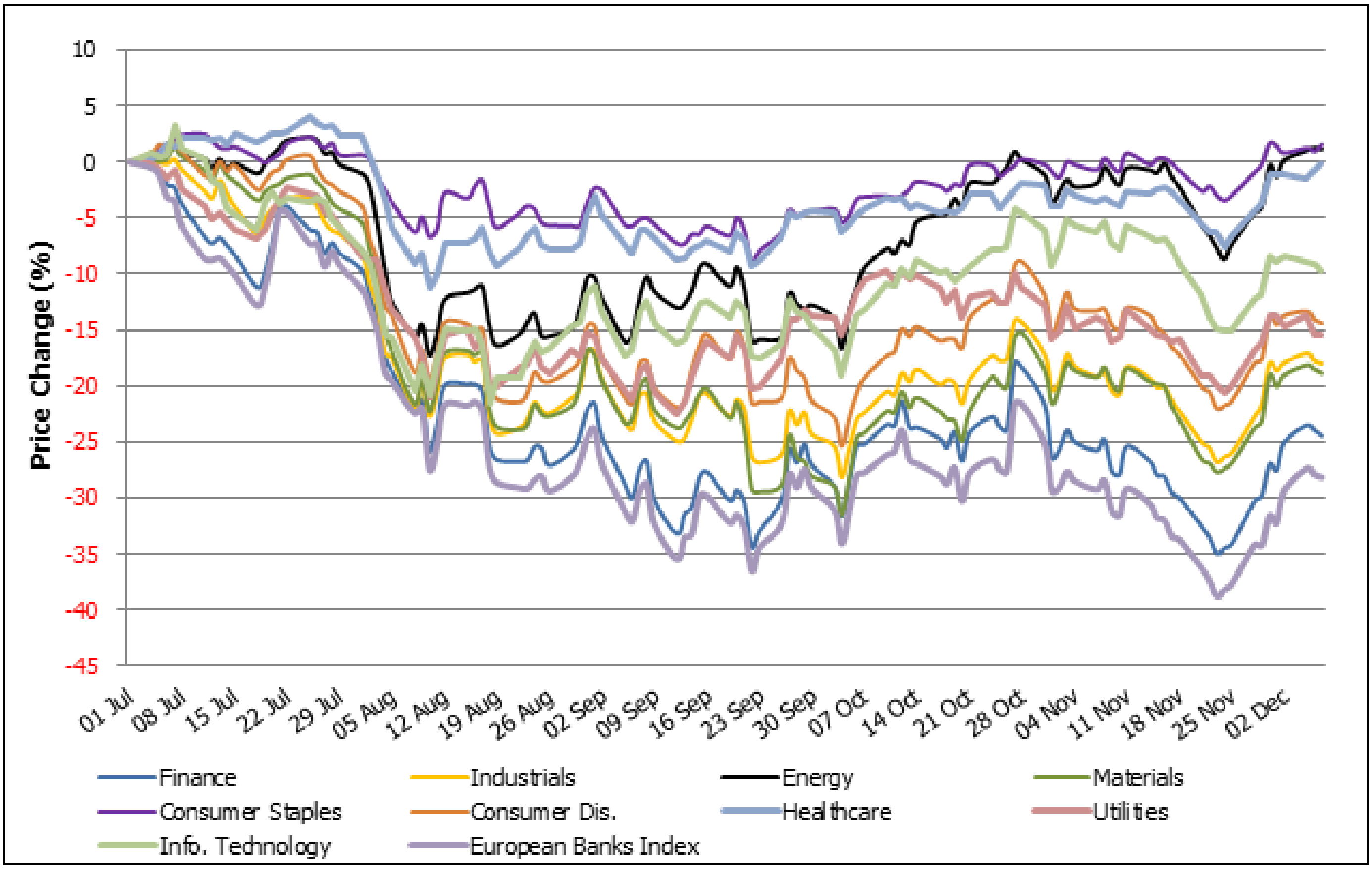
Financials

Q3 2011

Market Performance & News

Equity Market Performance



European Financials hit their lowest point of 2011 in November. The iShares Euro Stoxx Banks hit a low point of €8.70 in 2008 during the Lehman crisis when meltdown was a possibility. In late November 2011 it was priced at €8.80 and is now at €10.52. That revival depends on a successful outcome at the European summit on 9th December. The problem is that banking liquidity has been damaged to the point where a global recession is a strong probability (with emerging market economies being hit by reduced lending and/or reduced demand) and a European recession a near-certainty.

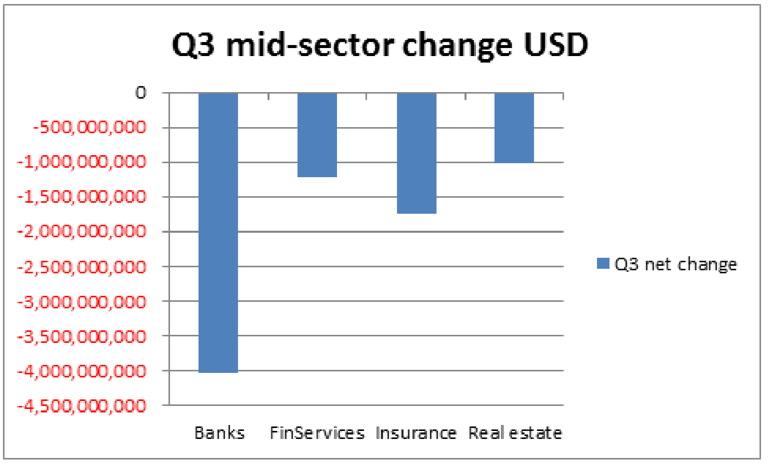
While consumer staples, healthcare and energy are back at their 1st July levels financials are 25% off and banks are 28% off.

DIVESTMENT OF FINANCIALS IN CONTEXT

WEU as a whole has simply seen exponential divestment quarter on quarter with $7 billion sold in Q1, $14 billion in Q2 and $22 billion in Q3. In Q3 financials made up $7.28 billion or 33% of that total so the sector remains the biggest single (and a disproportionate) drag on European equities – no surprises there.

Ipreo survey data cast results into relief. **Natixis Asset Management**, **Harris Associates, La Banque Postale Asset Management**, **JP Morgan Asset Management (UK)** and **Lombard Odier Darier Hensch** are the prime examples of institutions which were major sellers of financials stocks in Q3 but buyers of WEU equities outside of financials. Major buyers of financials were dominated by index investors (**BlackRock Asset Management (Deutschland)**, **Lyxor Asset Management,** and **SSGA**), reflecting inflows into passive strategies and ETFs in particular. The iShares Dax (DE) fund alone has seen inflows of $10 billion in the past 12 months. **Amundi Asset Management** unlike Natixis was buying both WEU in general and WEU financials.

Within the sector banks are the weakest component by a long way but they are bringing down the rest of the sector with them: reduced demand has seen swathes of retail and office properties seeing reduced demand so real estate is brought down.



GEOGRAPHIC CHANGE – REGION OF INVESTOR

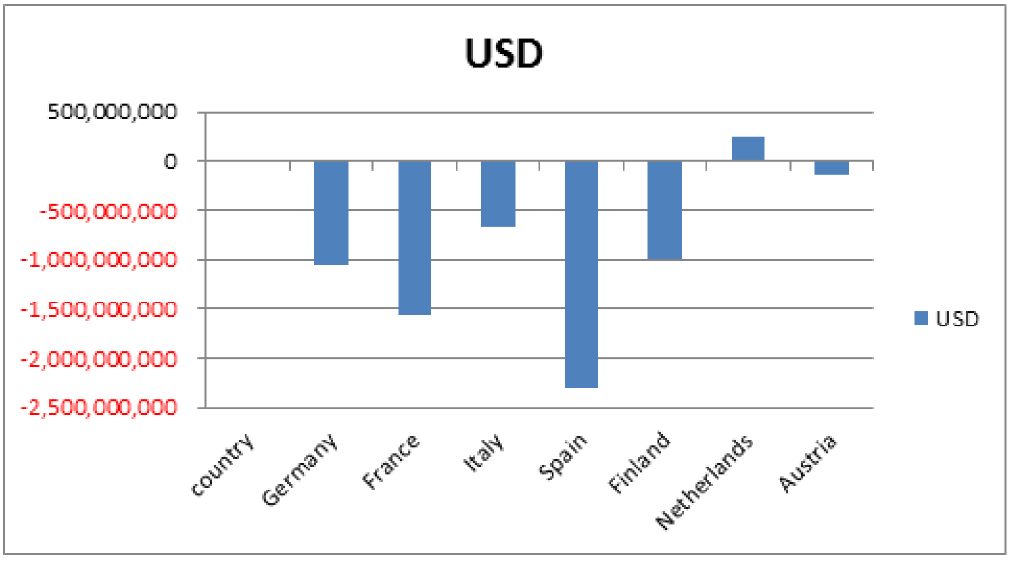
North America was the biggest seller of European financials in Q3 with net divestment of $2.99 billion followed by UK (-$2.01 billion) and Western European investors (-$1.68 billion). For WEU stocks as a whole, domestic (western European) investors were net buyers but in financials they followed everyone else in net selling, except for Scandinavian investors (bought $582 million). The American sellers were headed, as so often, by **Capital World** & **Capital Research** who along with UK growth investor **BlackRock Investment Management** were the top 3 sellers of financials. The Capital Group along with **Franklin Mutual**, **Fidelity International Ltd (UK)** and **DWS Investments** were also all top sellers of Western Europe as a whole, their financials sells representing only 22 to 26% of their total European sales. This is in stark contrast to **BlackRock** and **Northern Cross** for whom financials made up 80% and 68% of their total WEU divestment.

Top 10 buyers bought $4.23 billion where top 10 sellers sold $7.39 billion but buyers there were headed by the biggest owner of the sector, **Norges Bank Investment Management** which added 9% to its portfolio with net buys of $1.30 billion. The big incomers into the sector were **Templeton Global Advisors**, **Janus Capital Management**, **Fischer Francis Trees & Watts**, **William Blair & Company** and **Pyramis Global Advisors** which all increased their portfolios by over 30% meaning that 7 out of the top 10 investors were North American (they just got out-bought by Capital Group).

Investment Overview

GEOGRAPHIC CHANGE – BY ISSUER MARKET

Earlier in the year the dogma was that periphery would suffer while core markets would remain intact if not strengthened. As the exposure of Europe's banks (above all French banks) to Greek sovereign & commercial debt was revealed, that argument failed to be replaced by a north-south distinction (Germany, Austria, the Netherlands and Scandinavia would thrive).



Neither argument holds weight as of Q3 2011.

CHANGE BY INVESTMENT STYLE

WEU stocks as a whole were sold by all investment styles without exception with GARP and Alternative investors being the biggest sellers in percentage terms, followed by growth and value investors selling at the same rate. For financials the same held true except that growth investors outsold value investors.

Top Holders, Buyers & Sellers

BIGGEST HOLDERS, BUYERS & SELLERS – FIRMS

Q3 saw a lot of investment companies reduce their equity exposure dramatically in response to the sharp July/August price drops. As John Redwood of Evercore Pan Asset said last week, "we had half our assets in cash and we're wondering why we didn't have the rest there". Investors moved out of European financials and eurozone equities in general into bonds and cash.

HOLDERS

Data for WEU as a whole shows 4 index firms among the top 10 holders (**BlackRock Fund Advisers US**, **Vanguard**, **Lyxor** and **BlackRock Deutschland**) none of which are top 10 holders of European financials. Similarly 6 out of top 10 holders of WEU as a whole are North American; only 2 North American firms (**Capital Research Global Investors** and **FMR**) are in top holders of WEU financials which is more locally owned, by 3 French institutions (**Axa**, **Natixis** and **Amundi**), one Austrian (**Wiener Staedtische Versicherung**) 2 Scandinavian (**Swedbank Robur** and **Alecta**) and one Dutch (pension fund **APG**) meaning that ownership is more widely spread geographically and among other institution types (insurances, SWFs, pension funds).

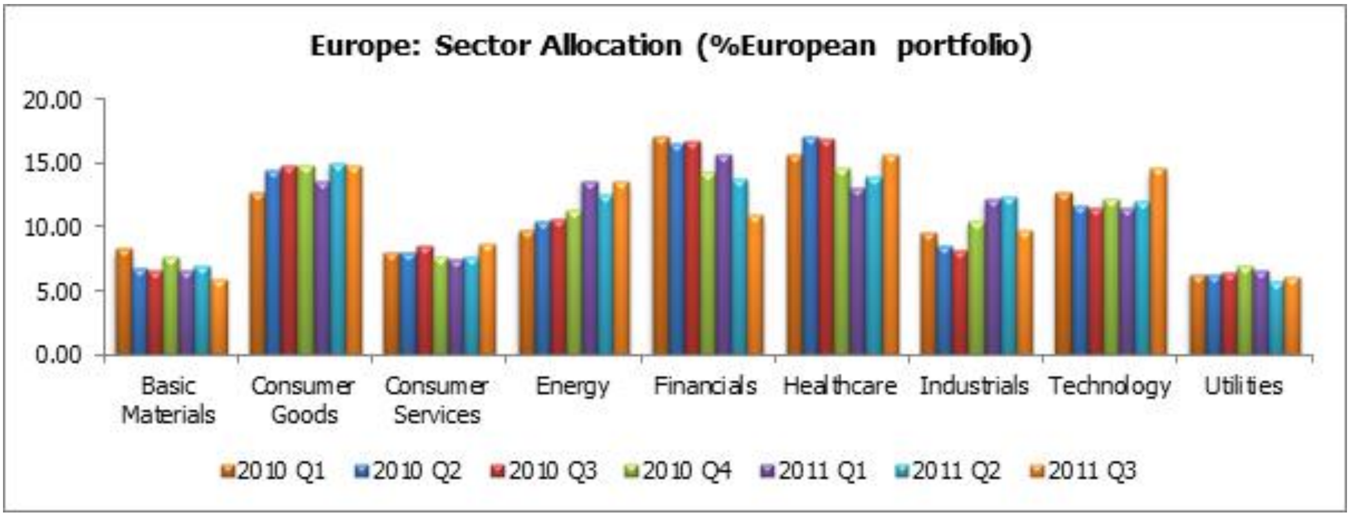
BUYERS

Norges Bank Investment Management is top holder of the sector and top buyer. Crucially it bought $1.308 billion in financials in Q3 against a net buy of only $169 million in all other sectors. This result is confirmed in Ipreo survey results which show Norges Bank buying both WEU and financials in both Q3 and Q4 (and in Q4 going on to buy much more in financials than in other sectors). The only other major (over $1 billion) investor was **Templeton Global Advisors** of Nassau. They were largely static in Q3 in Ipreo survey data but we have seen the buying they did publicly in WEU financials in Q3 continuing in Q4. On a smaller scale it is interesting to see momentum investors – acting in general ahead of the pack – **Janus Capital Management** and **William Blair & Co**, both aggressive growth investors, among the top 10 buyers , along with deep value investors Dodge & Cox. At the end of Q3 managers of the Dodge & Cox International Stock Fund said : "Despite higher levels of liquidity and capital, we note that valuations of the banking and insurance industries are similar to where they were in the financial crisis [of 2008]. After considerable analysis, we believe that the Fund's Financials holdings are much healthier now, with improved liquidity, less reliance on wholesale funding, stronger capital ratios, and higher reserves for loan losses." They accept the strong possibility of a recession but suggest that, with the MSCI EAFE trading at 9.4 times estimated forward earnings and a dividend yield of 3.9%, even if the pace of earnings growth moderates and proves those estimated earnings slightly too rosy, the resultant valuations would still be very appealing."

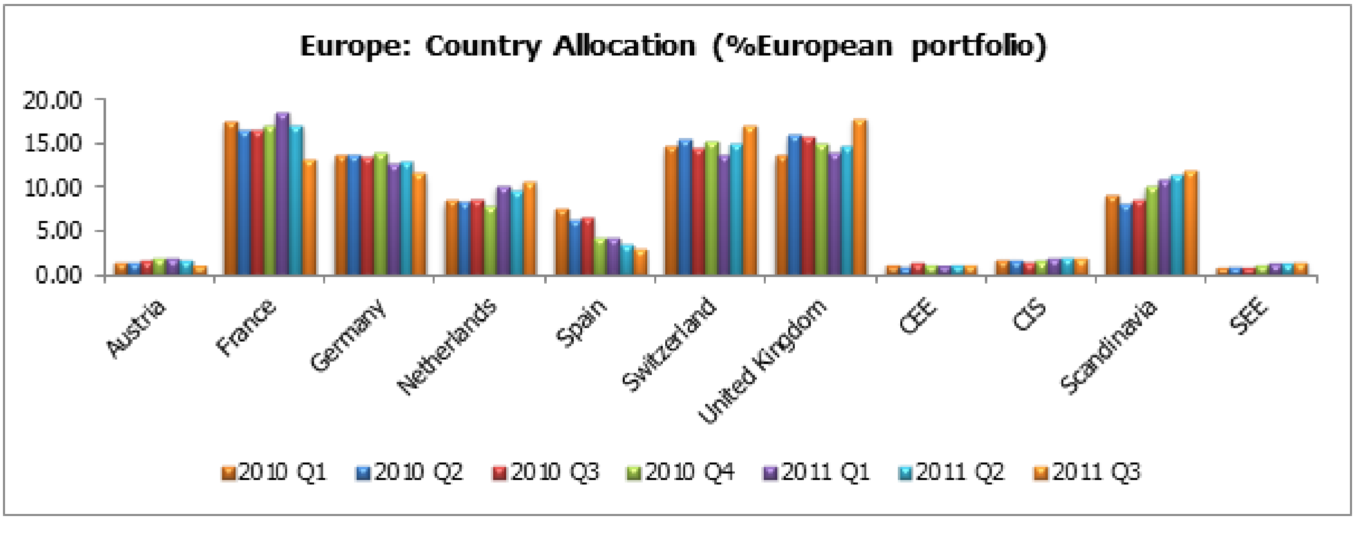
Top Holders, Buyers & Sellers

SELLERS

As in WEU as a whole, and as for so much of 2011, Capital Group companies **Capital World** and **Capital Research** headed the sellers, selling $1.658 and $1.273 billion respectively. In both cases financials made up 27% of their total divestment of WEU stocks – slightly higher than benchmark, but not much. And as seen below (FUND FOCUS) they had plenty of non-eurozone financials to dispose of before they reach eurozone stocks. For **Northern Cross**, Financials made up 66% not 27% of their WEU sales.



The graph charts the decline in **Capital World's** allocation to financials within its European portfolios since Q1 2010, falling from over 20% to around 12%. (Interestingly their exposure to "defensive" sectors healthcare and technology has not grown in that period; the increase are seen in Consumer Goods and Energy.) For **Capital Research** the fall is slightly less dramatic, from 18% to 12%. Of as much interest is the graphed shift in country allocation (in this case for Capital Research not Capital World):



This shows the flight out of Spain, a major sale of France in Q3 2011, trimming Germany and finding some safety in Netherlands, Scandinavia and UK.

Winners & Losers

BIGGEST WINNERS & LOSERS – STOCKS

From a country perspective there was no automatic core-periphery distinction. Spain was most sold country (-$2,307 million) but it was followed by France (-$1,566 million), Germany (-$1,052 million) and Finland (-$1,001 million, entirely down to massive sales of insurer Sampo Oyj) before reaching Italy (-$667 million). Greece and Portugal were flat or slightly positive.

Spanish banks took the biggest hit with BBVA losing $1,655 million of net investment and Banco Santander $712 million headed by **Capital Research** funds selling over 200 million shares of Santander in September 2011 and 1,275,589 shares in BBVA. Italians **UniCredit** (-$368 million) , **Intesa SanPaolo** (-$254 million) and **Mediobanca** (-$155 million) were also among the most sold though **UBI Banca** was the second most bought bank in Europe after deutsche Bank (+$124 million).

No French bank fared well on the back of Eurozone exposure, specifically Greek then Italian. **Societe Generale** was the most sold at -$439 million followed by **BNP Paribas** at -$272 million. **Credit Agricole** and **Natixis** were relatively unscathed at -$22 million.

German banks were generally bought (**Deutsche Bank** up $469 million) with the exception of **Commerzbank** (-$169 million) where questions have been raised about its capital ratios. Germany's net sale of over $1,000 million was largely down to massive sales of Deutsche Boerse (-$1,824 million) by US institutions including **Franklin Mutual Advisers** (sold over 1.8 million shares as of 30th September), **TIAA-CREF**, **MacKay Shields** and **MFS Investment Management**, and **Union Invest Privatfonds** of Germany.

UBS AG of Switzerland was lightly sold while **Credit Suisse** was heavily bought (+$569 million, after German insurer **Allianz SE** the most heavily bought financials stock in Q3.

BIGGEST WINNERS & LOSERS – FIRMS

Firms have seen massive reductions in their equities under management ("EUM") owing to

- Sharply reduced equity values
- Sharply reduced equity allocations (in Q3 2011 many major global firms in the US and in the UK cut equity exposure below 50% for the first time in living memory)
- Redemptions and loss of mandates.

The net effect may mean that a firm has made no stock-specific decision but simply slashed the amount it has to invest in a given (picked) stock. Biggest losers YTD include **AllianceBernstein** whose publicy stated equity assets were36% down against a peer group average decline of 12% (and 27% down in Q3 alone): **Carmignac Gestion**, the high flyer of 2009 and 2010 (its public EUM rose from $5.7 billion in 2008 to $37.6 billion in 2010) which has lost 29% : hedge fund **Paulson & Co** down 27% on the back of redemptions and loss of value : **Janus Capital Management** down 26% : and **Fidelity International Ltd** of the UK, down 23%.

Winners – firms whose equity assets have fallen by less than the peer group average of 12% YTD, or even actually risen – include real estate specialist **Cohen & Steers**, up 15% YTD, **Van Eck Associates**, **Harris Associates**, index investor **BlackRock Asset Management Deutschland** , and **Thornburg Investment Management.**

In Q3 specifically the sharpest falls, suggesting major reallocations out of equities, were seen by **Axa Investment Managers** (down 41%) , **DWS Investment** (down 29%), **Lyxor Asset Management**, **Allianz Global Investors (Germany)** and **Natixis**, whose stated EUMs all fell by over 25%.

FUND FOCUS

Capital World's **American Funds Europacific Funds** sold $2.426 billion in Financials in Q3 but it cannot be said that Eurozone was singled out. Asia saw biggest net sales (-$857 million) then Europe outside the Eurozone (-$608 million) then Eurozone (-$608 million). It was net negative in every global region, only near neutral in Canada. Of its total sales of $2.426 billion, banks made up 60%. Iggest bank sales were **Agricultural Bank of China** and **UBS AG**; eurozone banks **UniCredit**, **Erste Group** and **BNP Paribas** came in further down the list along with Turkiye Garanti Bankasi. While selling one quarter of its stake in **BNP Paribas** it increased its larger holding in **Societe Generale** by 10%; its biggest European buy was a buy-in of $154 million in **ING** of the Netherlands. (It has sold down from a peak position of 6.8 million shares in BNP since March 2011 to 4.07 million but the position is worth watching – in Q1 they bought 1.8 million shares.) In the past 18 months the funds has increased its Asian financials exposure from 35 to 44% (of total financials), reduced European from 50 tp 39%, doubled North American from 6 to 12% and reduced South American from 8 to 5%.

Henderson Global Financials Fund managed by Emily Adderson shows the trend : in May banks made up 57% of its portfolio, now 46%, with **Deutsche Bank**, **ING Group** and even **Banque Cantonale Vaudoise** all now dropped out of the top 10 which they occupied then. Exposure to Financials services has doubled from 8 to 16%, as has exposure to Life, Non-Life Insirance and Real Estate. Interestingly BNP Paribas is a big buy, now #1 holding in the fund. "We continue to believe that at current valuations, and with risk premiums elevated above normal levels, there is significant upside in financials… We believe that as the focus shifts from macro issues towards company specific positives that are surfacing, the catalyst for the risk premium to reduce will be found eventually leading financials to outperform."

Jupiter Financial Opportunities Fund went in a similar direction by exercising its ingenuity in a) finding financials which are not banks b) finding banks with no eurozone exposure and then by retaining a healthy proportion of its portfolio in cash.

Investment Trends

INVESTMENT TRENDS – Q4

In Q3 Ipreo saw net divestment in WEU of $3.004 billion. Of that divestment financials made up $1.204 billion – so as per public data financials made up over 33% of the net sales. In Q4 we have to date logged net sales worth $8.634 billion for WEU as a whole i.e. nearly 3 times the total for Q3 in only 2 months so the picture for Q4 as a whole is bleak. Of that financials make up $2.113 billion or 24%. In Q4 we can see some major new sellers who were either buying WEU financials in Q3 or selling then at a much lower rate : in the first group **Lyxor Asset Management**, **Fidelity Management & Research**, **Fidelity International Ltd (UK)**, **BlackRock Asset Management (UK)**, **BNP Asset Management** and **UBS Global asset Management (Switzerland)**.

In addition we can see a number of Sovereign Wealth Funds selling, headed by **China Investment Corporation (CIC)** who were the #1 seller of European financials in Q4. The **Saudi Arabian Monetary Agency (SAMA)** was also a seller.

As per the result (net outflow of over $ billion) sellers obviously exceed buyers (top buys were one quarter the size of top sells) but there are buyers and in the context of our start point – a notional bottoming out (dependent on a eurozone solution – otherwise all bets are off) - they are worth focusing on. They are not dominated by the index investors listed above who were so prominent in Q3, meaning that we are looking predominantly at firms with active investment strategies.

Consistent investors (buyers in Eurozone financials on Q3 and Q4) are headed by **Norges Bank Investment Management**, **Amundi Asset Management** , **Swiss Re (Investment Management)**, and **Liverpool Victoria Asset Management**. Converts (sellers or neutral in Q3, buyers in Q4) are headed by **Janus Capital Management** and **Capital Research Global Investors** , suggesting that the 3rd largest seller of financials in Q3 (per public data) has now recognised value in the sector. (It goes without saying that the quarter is not yet over and a great deal can happen before next week let alone next month.)

END NOTE

As Jupiter's Guy de Blonay pointed out this month, the issues are no longer local : "*the acute problems in Europe have made investors reluctant to buy into the current market weakness, regardless of the fact that some quality businesses are trading at very low values. A short, sharp economic downturn and fall in profits is now being forecast for 2012. However, the depth of the downturn will depend on the outcome of Europe's current deadlock, whether China has a soft or hard economic landing and whether the US economy manages to avoid a double-dip recession.*"

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