Manager Insight

Impact of higher oil prices on investment strategy
March 2011

Even before the Japan tragedy struck, the ongoing conflict in the Middle-East was leading to some angst amongst investors. Oil prices rose as a direct result of the crisis, with Brent up by over 20% in the six weeks leading up to the Japan disaster. Although the oil price has come down marginally since (on expectation of lower Japanese demand in the short term), they remain elevated. Higher and persistent oil prices can certainly contribute to derailing any global economic recovery. Some areas in the market are more impacted than others, and pricing power is key in an environment where companies are dealing with persistently rising input costs. Given the important role the region plays in the global energy markets, developments therein must not be taken lightly. This would be especially pertinent if the crisis were to spread to other oil producing and exporting countries such as Algeria and in particular, Saudi Arabia.

We asked some of our underlying managers to give their perspective on the high oil prices, and how they could potentially affect their investment strategy.

Faisal Rahman, CFA, Portfolio Manager, Russell OpenWorld

Fund: OpenWorld India Focus Equity
Manager: Quantum Advisors Private Limited

Manager insight: High and sustained oil prices may effect Indian equities as investors would worry about increasing inflation and interest rates. As Indian stock prices are very dependant on foreign flows - especially in the short term - a slowdown in these flows due to the stated fears could be near term negative for equities. Furthermore, India consumes about 140m tons of petro products; and crude oil imports are close to 130m tons. Out of a trade deficit of close to USD 120bn (about 7% of GDP), oil/petroleum imports account for USD 100bn. These deficits may have an adverse impact on inflation and interest rates if oil is persistently at or above USD 100.

The rise in inflation and interest rates will not result in any change in our portfolio strategy. We will continue to search for value and invest when we find value. Pharmaceuticals and consumer staples will be less impacted by rising interest rates and inflation, and we have exposure to these sectors. Some stocks in the portfolio may face some head winds due to rising interest rates. This could mainly be due to slow down in consumption and not to leveraged balance sheet. Therefore rising interest rates is not necessarily a huge risk at stock specific levels.

Hermes Sourcecap

Fund: OpenWorld Europe Focus Equity
Manager: Hermes Sourcecap Ltd

Manager insight: We have put much emphasis on finding companies with pricing power in our investment process. Therefore, companies we own, are either direct beneficiaries of raw material cost increases (such as miners) or companies we think are able to pass through price increases. As we entered 2011 to get outperformance, it is as much

about omission of stocks as it is about ownership. The recent surge in commodity prices has clearly raised the prospect of earnings risk. We have seen a number of companies warning about input cost pressures. *Britvic* is a recent example, having increased raw material cost inflation guidance to 9%-11% from 5%-6% previously. With oil over $100, one needs to be wary of energy intensive companies. The transportation stocks and cement companies come to mind.

We have been positioned at the sharp end of the industrial cycle, i.e. exposed to those areas that are causing the inflation. We remain overweight in the oil & gas space, but have made a conscious decision to stay away from the majors, whose leverage to crude oil price increases is reduced by their low-margin downstream businesses. Instead, we prefer large upstream players, which have sufficiently diversified asset portfolios to reduce political and asset risk, and oil service companies who will be in a stronger position to increase prices with a higher oil price.

Looking at the wider implications for the economy, real incomes get squeezed which threatens consumer demand, hence we must monitor the discretionary consumer space carefully. Fortunately, it is something we have been acutely aware of for some time, so hopefully we are in a position to weather it well. The fund has done well in the last 6 weeks, a time when oil has surged some 30%.

Fund: OpenWorld Commodities Long Neutral
Manager: Mount Lucas Management LP

Manager insight: It was the war in the Middle East that led to a surge in oil prices, a global recession and sharp fall for risk assets back in 1990-1991. Countless other times, however, unstable dynamics in the Middle East elicited temporary jumps for oil prices and volatile but temporary swings for risk assets.

As we contemplate a new Egypt, a bloody revolution in Libya and protests in Bahrain, we cannot dismiss the possibility of an oil spike-induced calamity for risk assets, emerging a consequence of disruption of Saudi Arabian output. That said, it is our judgment that the much more likely outcome involves a dismissal of the Qaddafi regime, a defusing of Bahraini protests and no disruption of Saudi oil production. Should this more likely outcome - a cooling off in the Middle East - eventuate, risk asset markets will refocus on the very positive fundamental developments that have been in full view over the last several months. The markets, in such circumstances, will benefit from news that USA real growth has accelerated, that core inflation pressures remain subdued and that profits are growing strongly.

Fund: OpenWorld Global Listed Infrastructure
Manager: Rare Infrastructure Limited

Manager insight: Our view is that the recovery in developed markets (particularly US and Europe) remains on track. The main risk to this thesis is whether the current political upheavals in the Middle East and North Africa remain isolated to that region. The key indicator for the crisis is the price of oil. A spike in energy prices could derail the recovery underway in developed markets, for example, some US commentators have suggested that an oil price of $130+ for more than two weeks could result in a 1% decrease in GDP.

RARE's portfolio currently contains little exposure to oil (at the margin, fuel prices impact traffic on toll roads and result in higher airline ticket prices, which in turn reduces the number of passengers passing through airports), however, a broader slowdown in the recovery would obviously impact all equities. We currently have ~50% of the portfolio exposed to the more defensive utility names, which we expect to outperform in that scenario.

Fund: OpenWorld US Credit
Manager: Logan Circle Partners

Manager insight: We believe that oil is just another component of increased input costs that we are focused on for issuers in our universe. We have been discussing higher commodity prices across the board and are focused on which issuers are exposed at the cost level (to the negative) and which issuers are benefiting selling into the elevated metals/agriculture/energy environment. We have experienced 6 straight quarters of expanding margins domestically and are now seeing operating margins nearly 200bps higher than historic levels. We think this could partially revert towards the mean, given most of our issuers have varying levels of exposure to the global commodity inflation on the raw material side, combined with slower growth trends on the revenue side. For us, this could signify peak earnings margins are behind us, but given recent growth trends we would argue we don't see a huge retrace on the profit/free cash flow side. This coupled with solid balance sheets leads us to remain focused on (bondholder unfriendly) corporate actions (dividend hikes, share buybacks, m&a) than earnings concerns thus far.

From the bank/consumer credit front, our concern is the eventual impact on the consumer of higher oil and food prices. We have seen steady improvements in charge-off and delinquency data, but continued high unemployment. At some point, persistent high unemployment coupled with increased energy and food consumption costs could lead to decreasing asset quality at banks. That said, given the strength in fundamentals and improved capitalization of domestic financial issuers, we feel currently this is more an equity story than credit story.

A large and sustained spike in oil prices ($125 or more for a long period of time) would cause us to re-evaluate our fundamental and macroeconomic assumptions, however that is not currently our base-case.

KEMPEN CAPITAL MANAGEMENT

Fund: **OpenWorld Euro Credit**
Manager: **Kempen Capital Management**

Manager insight: The increase in oil prices is a threat for global economic growth, especially when the rise in oil prices is caused by supply disruptions instead of strong growth in demand. Consensus is that oil prices above $150 a barrel could reduce economic growth by 1% to 2%. Sectors that are seen to be most sensitive to rising oil prices include the auto (input costs of steel are higher), media and transportation (both have high correlation to economic growth) sectors. Other sectors that are most likely to suffer are the airlines (higher fuel prices, limited hedging with relatively short duration and lower passenger rates due to the lower economic growth), and the building material sector, due to their high energy consumption. There are, however, also sectors that can benefit from this. The most obvious one is the energy sector that directly profits if oil prices rise. Also, some utilities might profit from higher oil prices especially if their energy generation mix is more skewed to alternative energy sources. Banks might not be influenced by a direct link with the oil price. However if we would experience a high oil price for a longer period that would effect banks in several ways: 1) lower economic growth would result in higher credit losses; 2) lower economic growth could make problems worse for the peripheral countries in Europe with a contagion to the banking sector.

Overall, we think rising oil prices are a negative for the credit markets. We see a continuing rise in oil prices caused by the unrest and protests in the Middle East or other supply disruptions as a serious threat for the global economy. We have therefore reduced the overall beta in the portfolio to a slightly underweight level (excluding ABS). We have reduced our weight in the more cyclical corporates, and we reduced our positioning in subordinated financials to underweight. In addition we focus on long positions in market leaders with strong brands and strong pricing power, like for instance in the consumer sector companies like Pernod, Anheuser Busch and PPR, and on companies active in the oil sector.

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