



Barclays Wealth Global Research & Investments

COMPASS

February 2012

Another Year of Living Dangerously?
Alternative Trading Strategies: Using Market Unrest to Your Advantage
Real Estate: Stability at Last
Commodities: The Future's Bright but Further Volatility is Likely
Living in the Past

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Aaron S. Gurwitz
Chief Investment Officer

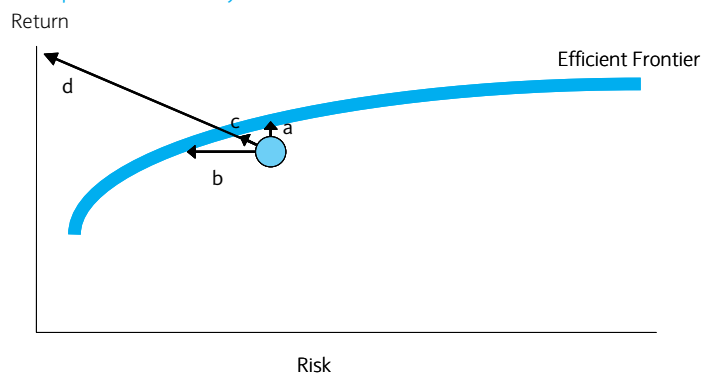
Introduction

Dear clients and colleagues:

This edition of *Compass* is devoted to updates on our outlook for our three strategic alternative asset classes: commodities, alternative trading strategies, and real estate.

We encourage investors to expand their investment horizon beyond stocks and bonds because we believe that, at any given level of risk, a more *diversified*¹ portfolio can generate a higher return on average over time. The goal of diversification is to move an investment portfolio closer to the ‘efficient frontier’. The efficient frontier represents an estimate of the highest return an investor can expect to achieve on average over time at any given level of risk. The line in the diagram below is wide because we never know exactly where the efficient frontier is. The circle represents the combination of expected return and risk one could expect from a hypothetical undiversified portfolio. As marked on the diagram, the reason for diversifying beyond the traditional asset classes is the opportunity to a) enhance future returns *modestly* without increasing risk, b) decrease risk *modestly* without sacrificing future average returns, or c) some combination of the two.

Perception vs. Reality of Diversification



Since late 2008 I’ve been hearing advocates of concentrated investment strategies arguing that diversification “didn’t work” during the crisis. It is true, of course, that stocks, most bonds, commodities, hedge funds, and real estate all declined in value during the worst of the crisis. But saying that diversification didn’t work ignores two facts. First, long-term, high-quality, liquid government bonds went up in value, and by a lot during the worst of the crisis. Investors who had none of these were insufficiently diversified. Second, most asset classes declined in value during the crisis, but some did much worse than others, and some recovered more quickly and by more as markets stabilized. So diversified investors lost money in the crisis, but wound up better off after the dust settled than they would have if they’d held a narrower variety of investments.

Diversification across nine asset classes may make for a better, more efficient portfolio and we suggest investors consider alternatives for that reason. But it does not do more than that (d).

Sincerely yours,
Aaron S. Gurwitz
Chief Investment Officer

¹ Diversification does not protect against loss.

Another Year of Living Dangerously?

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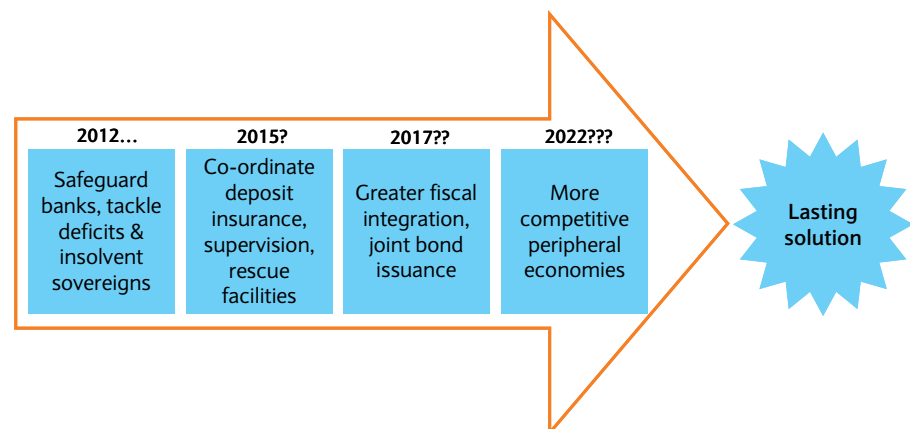
Despite the stock markets' New Year party, the two big dangers that dogged investment markets in 2011 haven't suddenly disappeared. The euro crisis and uncertainties about global growth are both still very much with us. But there have been positive developments under each heading, and much bad news was priced into markets in late 2011. A renewed bout of volatility this year would not be a surprise, but in our 'muddle through' scenario we expect selected risk assets – stocks and high-yield bonds – to deliver materially better risk-adjusted returns in 2012 than cash or core government bonds.

Euro Crisis: ECB Lends a Big Hand

A lasting solution to the tensions afflicting the single currency project is not at hand, nor will it be any time soon. But this doesn't mean investors need to stay on the edge of their seats. If euro area politicians show they are travelling credibly in the right long-term direction, we think the ECB (and to a lesser extent the IMF) will continue to act as backstop to the banking system in particular. Its actions to date in this respect have probably been more potent than is generally appreciated.

The long-term fix requires much greater fiscal and political integration, and economic reform for the underperforming peripheral European countries – most obviously, Greece and Portugal, but also Spain and Italy (Ireland is in a different category, and could outperform again within a year or two). However, with no single politician in charge of the euro integration project, and with northern electorates deeply resentful about supposedly 'bailing-out' the periphery, progress in this direction has to be slow. A plausible timeline is illustrated below (Figure 1).

Figure 1: A stylized timeline for a lasting euro area solution



Source: BlackRock, Barclays Wealth Strategy

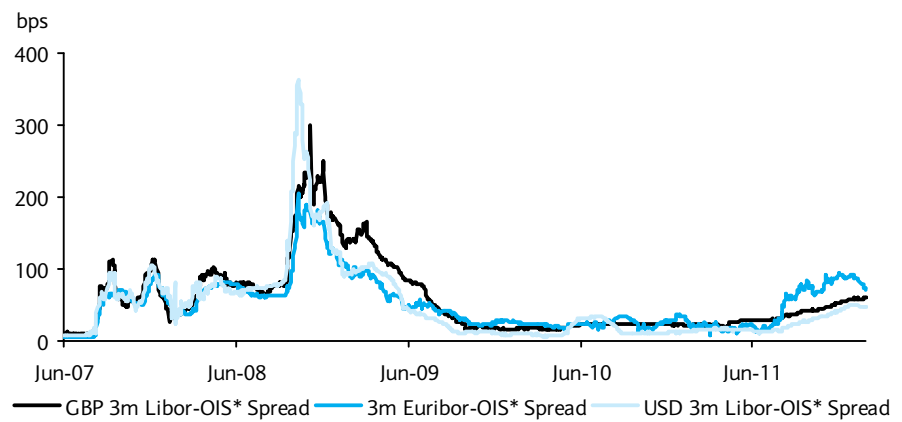
This lengthy and slow process can be tolerated by both investors and the ECB provided they believe it's genuinely underway – that politicians across the periphery realize they have to control their immediate borrowing and foster economic reform. We've collectively known about the single currency's missing fiscal architecture for more than a decade, and it wasn't a pressing issue for most of that time.

The ECB in particular is showing itself willing to act decisively on the back of political progress – namely, the advent of a 'technocratic' government in Italy committed to designing and implementing a mix of fiscal austerity and economic reform.

Many commentators argue the ECB needs to intervene more aggressively in the bond markets, and be more like the US Fed or Bank of England with its quantitative easing. We think this may be missing the point.

The ECB's intervention at the short end of the yield curve, in the money markets, is massive and potent. It lent the banking system half a trillion euros at just 1% for three years just before Christmas, and stands ready to lend as much or even more again in late February. Lending on this scale can meet banks' urgent refinancing needs, and also fund so-called carry trades, thereby offering indirect support to bond markets. This assistance is beginning to make itself felt in reduced interbank tensions (Figure 2) and in Irish, Italian and Spanish bond yields.

Figure 2: Market tension: interbank spreads



* Overnight Indexed Swap
Source: Bloomberg, Barclays Wealth Strategy

There are still plenty of unresolved issues even as far as this sticking plaster solution is concerned, any of which could yet trigger resumed volatility and another sell-off in risk assets. For instance, as we write it is still unclear exactly how large the loss to be taken on Greek bonds will be, and who will have to bear it; and the "fiscal pact" whose details were fleshed out a little more carefully at the 30 January EU summit still looks unconvincing. But there has been some progress made, and such a sell-off might be short-lived, in our view.

Meanwhile, the risk of wider damage from the crisis may be fading. We always doubted it was solely responsible for much of the downturn in euro area economic indicators. Instead, we thought that the downturn was at least partly a typical (and global) mid-cycle pause, following as it did hard on the heels of surprising strength in early 2011, and amplified

perhaps by the aftermath of the Japanese tsunami. Some key forward-looking economic indicators for the euro area seem to have picked up in the last three months, even as the euro's financial crisis was at its most intense, strengthening our skepticism in this respect. At the risk of stating the obvious, investor (and voter) tolerance of the euro's design faults would stretch further if there was a little more growth out there.

Growth: US Consumers to the Rescue (Again)

The much-maligned US consumer, Global Inc's biggest single customer, continues to spend. And not only are they spending, they're feeling less bad about doing so: measures of confidence have picked up markedly in the last few months. We're not surprised or concerned that recent spending growth has been largely financed from a lower saving ratio. As we see it, the rebound in consumer savings – and even more so in free cashflow – after 2006 was always likely to finance much of the recovery.

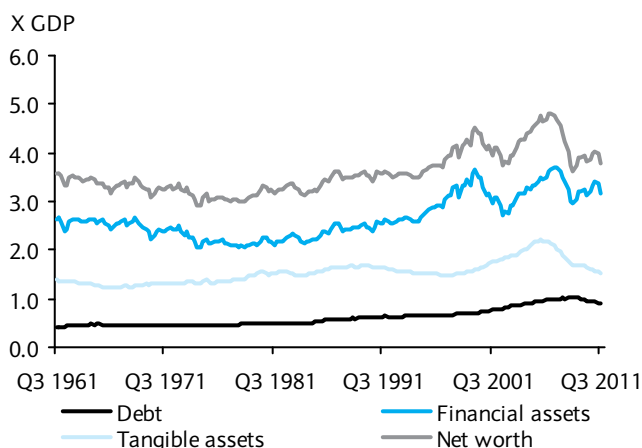
As we've often noted in *Compass*, we think the fragility of consumer balance sheets has been overstated. The net worth of the US household sector is still (of course) strongly positive, and historically respectable (Figure 3). If we're right, US consumers may not need to deleverage drastically, and so don't need to save as much. And if aggregate deleveraging is modest, the economy can continue to recover, as has been the case to date (Figure 4).

In a delicious irony, at the very point last year when economists were worrying most about US growth, the economy was actually accelerating, thanks largely to this consumer resilience. GDP growth in the fourth quarter was a respectable 2.8%, and we think a similar rate might be achievable in 2012 as a whole.

There are of course some short-term risks looming in the spring if tax cuts and labor market supports are not extended further, but more dramatic fiscal retrenchment is unlikely this side of November's elections, and possibly not even in 2013. Moreover, history reminds us that such retrenchment does not always have the impact feared.

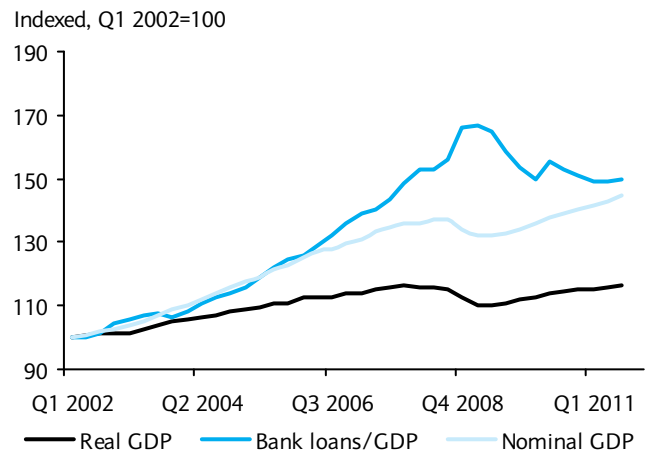
The other big source of global growth concern has of course been China. A hard landing has looked unlikely to us, and the latest data suggest that the slowdown in the fourth quarter of last year was statistically insignificant (a growth rate of 8.9% after 9.1% in the

Figure 3: US household net worth as a multiple of GDP



Source: FactSet, Datastream, Barclays Wealth Strategy

Figure 4: US deleveraging is modest, and hasn't stopped growth



Source: Datastream, Barclays Wealth Strategy

previous quarter²). Retail sales and industrial production were robust through December at least, and forward-looking business surveys have begun to stabilize (albeit at below-trend levels). The importance of China to aggregate global growth can be overstated – it is still a huge net exporter after all – but it does play an important role in shaping commodity demand and, most recently, in coloring investor risk appetite.

Overall, and at the risk of oversimplifying the picture, we think the global economy in 2012 will likely slow, but remain firmly above stall speed. The highly visible risks from financial volatility and fiscal austerity are, in our view, largely balanced by low real interest rates (which may remain in place for even longer than we previously thought, if the Fed's latest statement is anything to go by), and by ongoing growth in productivity – that is, by structural growth (which is no less real for being so often overlooked).

We think the developed world will likely grow at a similar pace to 2011, with a mild and short recession in the euro area largely offset by an uptick in growth in the US and Japan (the latter flattered by the rebound from 2011's earthquake). The slowdown is likely to be located in the emerging world, particularly in Eastern Europe, but in our view is unlikely to prove dramatic, thanks largely to that resilience in China.

Inflation rates globally may fall back as last year's surges in commodity and energy prices – and in some cases, indirect taxes – drop out of the arithmetic. But this is not the sort of economic climate in which deflation, or a collapse in corporate profitability, is likely to materialize.

Portfolio Conclusion: Stay Invested

A successful ECB backstopping operation, and mediocre but ongoing global growth, may come as a pleasant surprise in 2012 to investors fearing much worse, and facing negligible nominal returns on cash and core government bonds.

For investors whose financial personalities or circumstances require sheltering wholly in safe haven assets, we continue to prefer cash ahead of government bonds, precious metals or 'hard' foreign currencies: barring banking collapse, the former is at least fixed in nominal terms.

But for investors able to take a balanced long-term view, we would advise continuing to own a diversified portfolio in which the weight allotted to risk assets is slightly higher than usual.

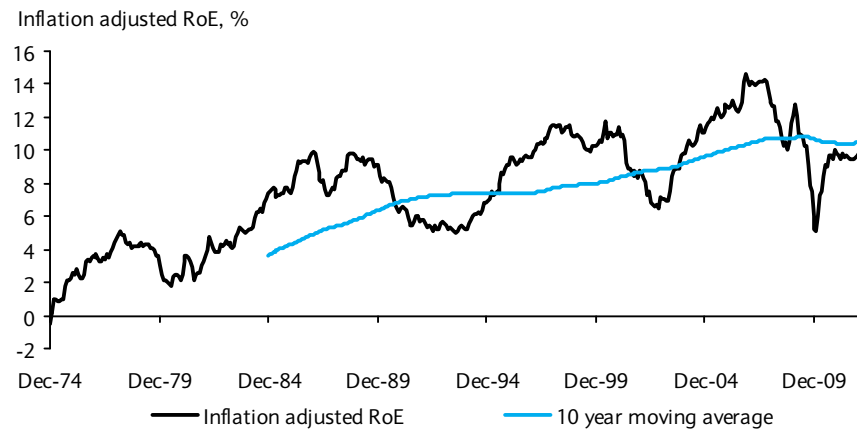
We prefer many corporate securities to core government bonds, not because we're worried about worsened creditworthiness for the latter, but simply because the cycle and valuations may count against them. We also think developed equities and high-yield credit in particular look relatively attractive.

Developed equities look to us to be by far the cheapest of the nine asset classes included in the Barclays Wealth Strategic Asset Allocation (SAA). Valuations don't count for much when investors are nervous, but if the European banking system and the global economy muddle through as we expect, they may start to matter more. Many investors fear a decline in profitability, and see its recent rise in itself as making such a fall more likely.

² National Bureau of Statistics, China

However, in addition to our glass-half-full view of the immediate growth debate, we think the long-term trend in quoted sector profitability may prove more sustainable, and has likely owed less to leverage than is generally realized (Figure 5).

Figure 5: Corporate profitability – developed world (%)



Source: FactSet, MSCI, Datastream, Barclays Wealth Strategy

We remain only neutral on emerging equities, and emerging markets in general. They have underperformed modestly for the better part of the last two years. However, while they no longer look relatively expensive, expectations there are still higher than in the developed world, leaving less room for them to surprise positively (China may be an obvious exception to this theme, given the worries about hard landings). As noted, it is the emerging bloc where growth in 2012 may be slower than in 2011. It is developed Europe and the US where investors have been most nervous in 2011 and which likely will do best if risk appetite stabilizes.

High-yield corporate bonds are not as inexpensive as stocks, largely because their spreads are likely flattered by the general level of interest rates being so low. However we think those spreads are wide enough to absorb a likely rebound in government bond yields, while still delivering an attractive return. The potential capital gains are much more limited than those of stocks', but arguably so too is their potential volatility.

And Keep an Eye on Correlations...

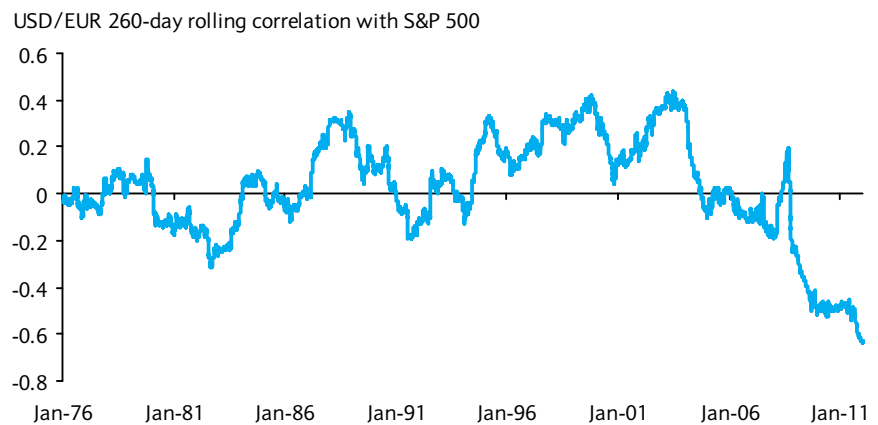
More generally, and reinforcing our emphasis on diversification, we remain on the alert for signs that recent extreme correlations across asset classes, and between some asset classes and currencies, are poised to fall back. The 'risk on, risk off' trading worldview that has characterized much of the post-2008 period – and which was very much in evidence in 2011 – may be approaching its sell-by date (as it were). Some assets and currencies that are today viewed as relatively 'safe' may not always be seen in that way.

What this means is that we can imagine a situation in which, for example, equity markets rally, led by the US, but in which the dollar trades strongly and the euro stays weak. We can also imagine the correlations between developed and emerging equities, and commodity prices, at some stage falling sharply. In 2008 those asset prices all fell together; in 2009 they all went up. But long-term portfolio analysis tells us that this was a crisis-driven exception, not the norm.

The 'beta', or sensitivity to general investment risk, of various assets and currencies is not fixed, but usually varies with circumstances, just as it does (for example) within stock market sectors. If risk appetite stabilizes as we expect, investors will become more discriminating. They may start to view the dollar (for example) as not so much a safe haven, but instead as offering pro-cyclical exposure to a resurgent USD economy and an eventual rebound in interest rates there.

This particular view is, to some extent, implicit in our current views on currencies: we feel the euro will remain soft, undercut by falling interest rates, even as we see the ECB offering its sticking plaster solution and equity markets rallying. Our currency strategist notes that the correlation between the dollar and the S&P 500 has recently been at an all time low. The dollar did well as investors were worried about stock markets, and this correlation may be ready to rebound or even eventually turn positive (Figure 6), though as we write it is being restrained by the Fed's latest dovish statement.

Figure 6: A measure of the dollar's correlation with risk



Source: Barclays Wealth Strategy

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Alternative Trading Strategies: Using Market Unrest to Your Advantage

An allocation to the Alternative Trading Strategies (ATS) asset class is a key component of the Barclays Wealth Investment Philosophy. In light of the market volatility in 2011, we recently increased our strategic allocation across the four ATS categories, reflecting our expectation that volatility will remain elevated until the Eurozone crisis is resolved. That could take a very long time.

Global Macro Strategies: Overweight *(change 25% allocation to 27.5%)*

The market environment for macro-orientated funds could hardly be more favorable, given the large macro imbalances of the global economy. As national fiscal deficits and concerns regarding developed market sovereign debt persist, fixed income, foreign exchange, credit and equity markets may provide significant trading opportunities as risk is shifting faster and more erratically between markets than ever before.

Emerging equity and currency markets have sold off significantly over the past few months. We believe the opportunity set for emerging markets (EM) macro investment managers has increased. Local central banks are likely to slow or reverse recent rate hikes, and that should impact interest rates, credit conditions, exchange rates, and equity markets in different ways at different times over the coming year.

Skilled global and EM macro managers that are tactically positioned with disciplined risk management controls may be able to produce more attractive risk-adjusted returns than usual. Hence our overweight recommendation.

Managed Futures: Underweight *(change 25% allocation to 20%)*

The futures market is likely to stay volatile and range bound. This is not a comfortable environment for managed futures managers, most of whom depend on relatively stable, momentum-driven markets with clear direction to generate returns. A worsening of the geopolitical situation or speedy resolution of the Eurozone sovereign debt crisis would lead us to change our underweight recommendation for this sub-asset class.

Relative Value: Overweight *(change 25% allocation to 27.5%)*

Our overweight recommendation here is driven by credit relative value and arbitrage strategies. Government pressure on European banks to increase their capital ratios quickly and significantly will likely block many of the continent's normal channels for credit flows. This may create a large number of attractive relative value opportunities across sectors and individual borrowers. Consequently, we favor market neutral, rather than long-biased strategies in this area.

We expect high volatility to persist both in credit and equity markets, especially in Europe. Increased volatility is beneficial for good relative value/arbitrage managers.

We also prefer an overweight in managers that are active in the residential mortgage-backed securities market; valuations in this sector are attractive following the sell offs in 2011 and improving fundamentals in the US. Some price volatility may persist in the short run as EU banks further liquidate portfolios. Commercial mortgage-backed securities may start to offer attractive entry points later in 2012.

As usual, liquidity remains the key risk factor in this sub-asset class. Regulation of the derivatives market is the other.

Event-driven: Neutral *(maintain 25% allocation)*

We prefer to maintain a neutral holding for the traditional event funds, at least for the first quarter. We note potentially attractive spreads on risk arbitrage, but this component of return may not be sufficient to compensate for the risk that credit scarcity may impede the successful completion of many deals. A high degree of cross held names and crowded trades still plague many event managers, which would increase volatility if managers need to de-lever under increased market pressures.

Distressed debt managers look appealing in the long term. It is possible that investors will be paid good yields to wait until the European situation starts to improve.

Real Estate: Stability at Last

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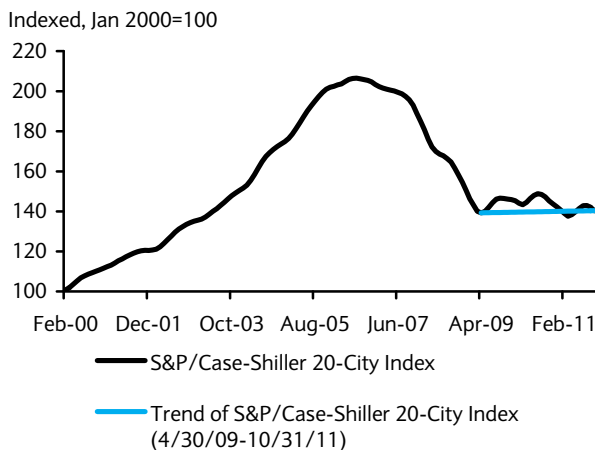
While activity in the housing market remains muted, it is showing signs of stabilization. Bear in mind any further normalization of this important sector will boost marginal economic growth. In our view, this nascent recovery in the housing market will likely continue, and the increased residential investment this brings will be a major contributor to GDP growth in 2012.

Forming a Base

House prices, as measured by the S&P/Case-Shiller 20-City Composite, have failed to gain any momentum in the past few years and remain 32% below the peak reached in July 2006 (Figure 1). However, prices appear to have stabilized, albeit at these low levels. More importantly, existing home sales have begun to rise³ (Figure 2) and total existing homes for sale are at their lowest level since early 2005⁴.

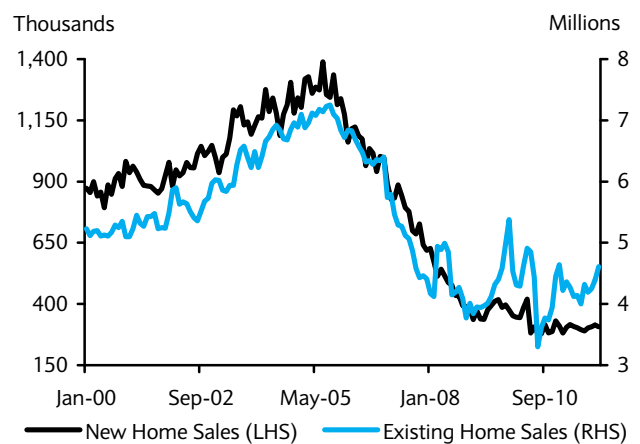
As the economy improves, demand for housing will rise and the supply of housing from foreclosures will decline. Household formation has failed to keep pace with population growth since 2007 and has been far slower than its historical trend. Undoubtedly, this is partially attributable to the recession. People who might otherwise have started their own households have postponed starting families or moved in with relatives or continued to rent. Household formation should accelerate as the economic environment improves and the unemployment rate declines. Foreclosures have historically been closely correlated with the

Figure 1: House prices have stabilized, albeit at low levels



Source: Bloomberg

Figure 2: Existing home sales have finally begun to rise

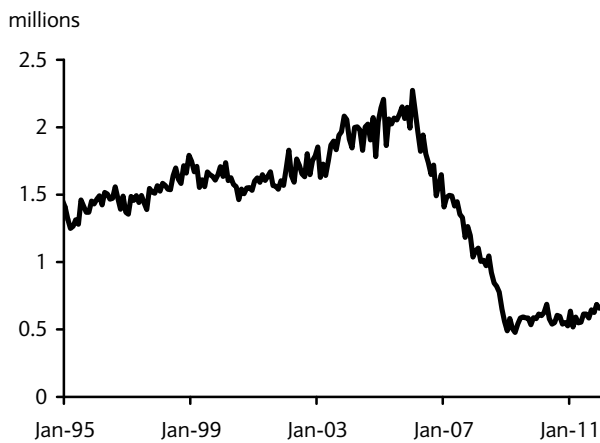


Source: Bloomberg

³ Existing home sales rose 5% between November and December 2011

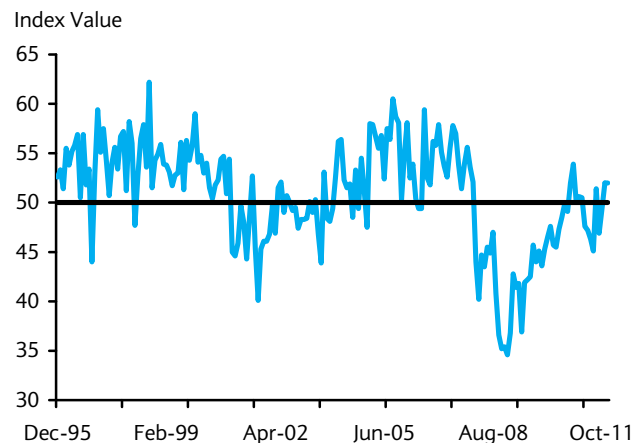
⁴ At first glimpse this is positive but the large inventory of properties working through foreclosure have yet to appear in public view. The fact that known inventory is clearing the market bodes well for further clearing of distressed properties.

Figure 3: Housing starts remain at very low levels



Source: Bloomberg

Figure 4: The Architectural Billings Index indicates that non-residential construction activity will accelerate



Source: Bloomberg

unemployment rate, so as the unemployment rate declines, so should the number of foreclosures. The supply of foreclosed properties has also weighed on the housing markets over the past few years, so a decline in foreclosures would further support the housing market.

On the building front, housing starts remain at very low levels, having declined from 2.2 million houses a month in 2006 to 685,000 in November 2011. But activity in this area appears to be stirring (Figure 3). In January the National Association of Home Builders market index⁵ rose to its highest level since June 2007, and the Architectural Billings Index⁶ remains above 50 (Figure 4), suggesting that non-residential construction activity will also accelerate in the coming year.

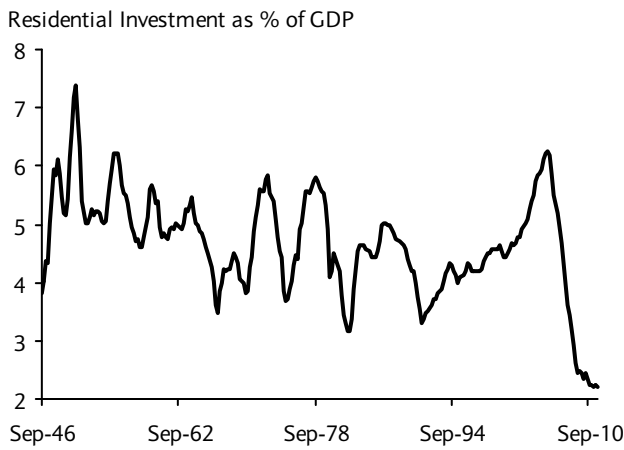
Residential investment as a percent of GDP has declined to its lowest level since the series began in 1946 (Figure 5). Residential investment contributed to GDP growth in the last three quarters of 2011, after subtracting nearly 1.5% from growth in most quarters from 2006 to 2009 (Figure 6). The contribution has been small, not least because residential investment has become a small portion of the US economy⁷.

⁵ The National Association of Home Builders has conducted a survey of home builders for the past 20 years. The survey attempts to gauge builders' perceptions of current home sales, their expectations for the next six months, and traffic of prospective buyers. A score over 50 indicates that more builders view conditions as good than poor. The index reached an all-time low of 9 in 2009.

⁶ The Architecture Billings Index (ABI) is a diffusion index derived from the monthly Work-on-the-Boards survey, conducted by the AIA Economics & Market Research Group. The ABI serves as a leading economic indicator that leads nonresidential construction activity by approximately 9-12 months. The indexes are developed from the monthly Work-on-the-Boards survey panel where participants are asked whether their billings increased, decreased, or stayed the same in the month that just ended. According to the proportion of respondents choosing each option, a score is generated, which represents an index value for each month.

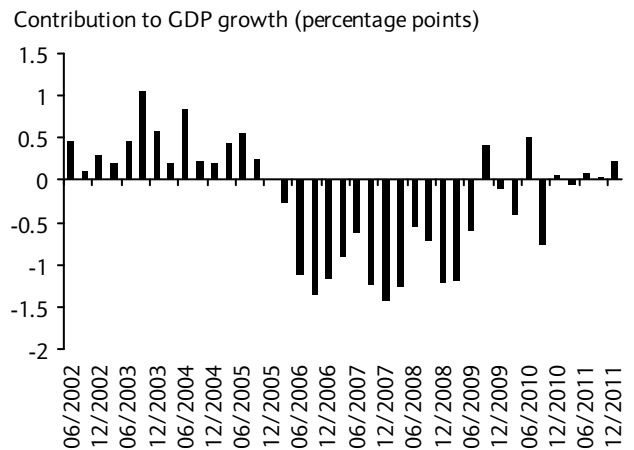
⁷ In the early part of the decade, residential investment regularly contributed a full percentage point to GDP growth, but residential real estate investment as a percent of GDP has now declined to such a low level that it would now take a full 50% increase in residential investment for this component to contribute a full percentage point to GDP growth.

Figure 5: Residential Investment as % of GDP has declined to its lowest levels since the series began



Source: Bloomberg

Figure 6: Residential Investment has contributed to GDP growth for the past three quarters



Source: FactSet

Consequently, residential investment's contribution to GDP is negligible and this type of investment will only provide a modest boost to GDP growth going forward. Housing starts have declined to such low levels and the supply of housing from foreclosures continues to fall, so any increase in demand will likely translate into residential investment. Putting all this together, it appears that the long awaited bottom in home prices is forming and the associated drag to economic growth is coming to a close. To be sure, housing won't drive the economic recovery, but it won't prove the economic headwind it was throughout the recession.

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Commodities: The Future's Bright but Further Volatility is Likely

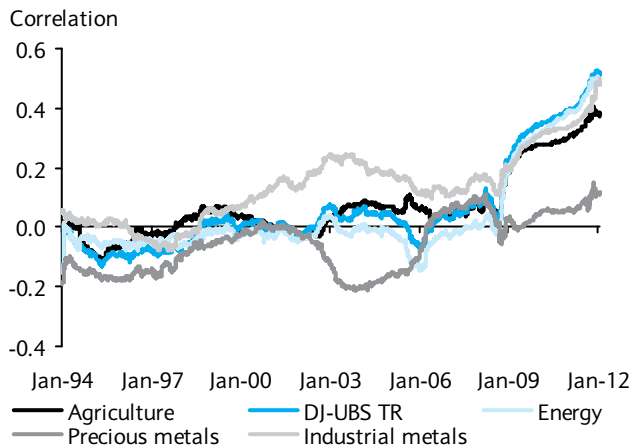
On a fundamental basis, the outlook for commodities looks bright for the year ahead. But with correlations being an increasingly important characteristic in today's markets, wider market sentiment will likely remain a key driver of prices in the short term.

The Emergence of the Correlation Bubble

Commodities had what seemed to be a year of 'two halves' in 2011. While solid supply-demand fundamentals supported commodity markets in the first half of the year, macroeconomic pessimism weighed on prices across the board in the latter. However, a month into 2012 the outlook may have brightened. Some better-than-expected macroeconomic data releases and a gradual improvement in risk appetite have supported commodities, despite the many uncertainties still present. At the time of this writing, the Dow Jones UBS commodity index had risen about 4% ytd, suggesting we may be seeing the start of a sustainable recovery in commodity prices. But is the current rally being driven by sentiment or is it fundamentally justified?

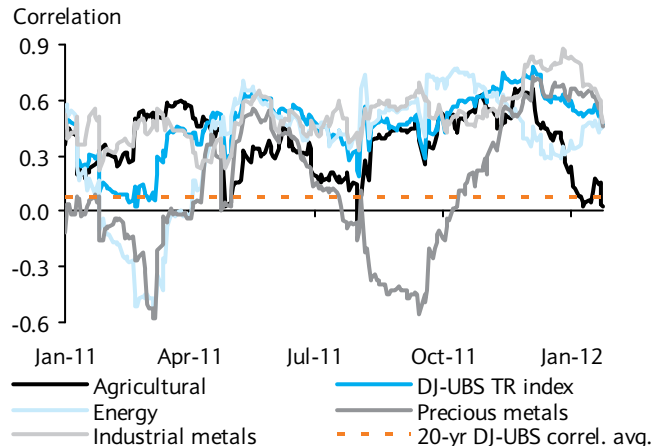
To judge whether or not commodities are being driven by wider market sentiment, a key factor to look at is the correlation of commodities and equities. Normally, over long periods of time, commodities and equities tend to be relatively uncorrelated with each other. It is this characteristic which may make it beneficial to hold commodities in a portfolio, as it improves diversification benefits. However, correlations had a massive shift during the financial crisis and have failed to return to the norm since then (Figure 1).

Figure 1: Commodities and S&P 500 3-year correlations



Source: Ecowin

Figure 2: Commodities and S&P 500 30-day correlations



Source: Ecowin

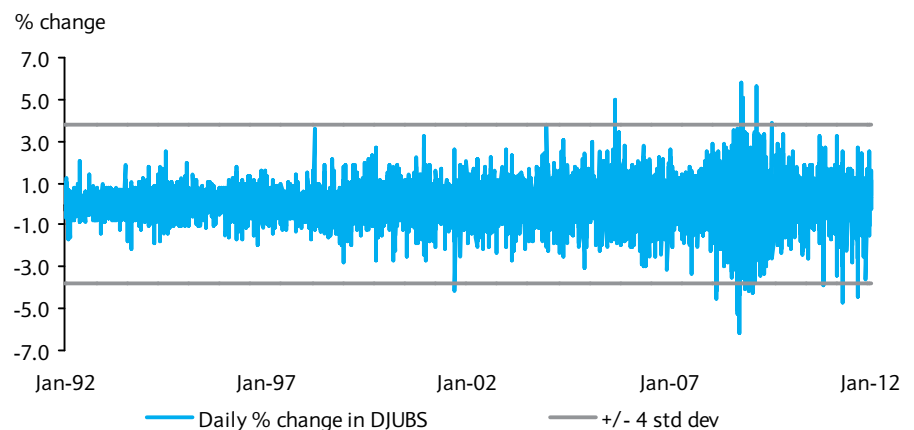
This spike in correlations was a result of significant demand destruction and the overall effects of global deleveraging in mid-2008. Subsequently, ongoing financial market uncertainty and political turmoil has kept these correlations at elevated levels. In particular, short-term correlations of industrial metals and energy have remained mostly above +0.5 in the past three years (Figure 2).

An interesting characteristic to note is the correlation between precious metals and equities, which has not necessarily panned out as expected. Looking at short-term momentum (30 days), while correlations of precious metals have been significantly negative in two periods during 2011, the correlation for most of the time has actually been positive. Moreover, on a longer-term basis (three years), this correlation has notably picked up and is currently near its all-time high of +0.15. Obviously this is considerably below other commodity correlations. But being in positive territory in the first place suggests that what is deemed to be a 'safe haven' play might not be that safe after all.

Volatility Spikes

This shift in correlations ultimately translated into higher volatility levels. Commodities are already known for being particularly volatile due to their susceptibility to rapid changes in supply-demand fundamentals (such as weather, labor strikes or geopolitical risks). Adding sentiment into the equation strengthens the point.

Figure 3: Volatility of daily commodity returns



Source: Datastream

Figure 3 shows that the daily returns of the Dow Jones UBS commodity total return index reached four standard deviations more times in the past few years than at any other time since 1991. Growing investor demand for alternative assets and increased ease of investing in commodities has also perversely affected the volatility of returns.

Looking ahead, while we think correlations will eventually fall back, as noted above, commodities are likely to stay positively correlated with equities in the short (and possibly medium) term, meaning wider macro sentiment will continue to be a significant driver of returns. This, in turn, implies that elevated levels of volatility will be a key characteristic in markets for some time. Although volatility has declined recently due to an improvement in risk appetite, the potential for another spike still exists.

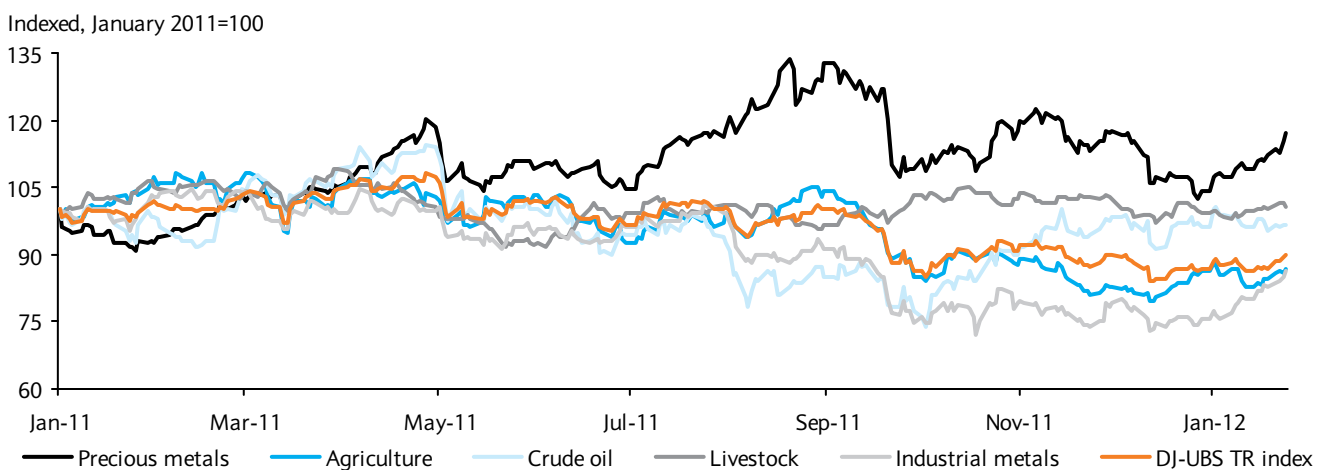
A Time to Be (or Not to Be) Bold?

Commodity markets appear to be dominated by risk appetite and this will likely continue in the year ahead. But when this trend in correlations eventually fades, will fundamentals support commodity markets?

In short, we believe so. Supply-demand fundamentals are actually quite supportive on the whole as a combination of supply-side constraints and strong demand, particularly from emerging markets, has tightened market balances significantly. Within the group, industrial metals and oil markets have the strongest fundamentals in the medium term and are our preferred sectors. Industrial metals were sold off significantly last year as concerns about global growth weighed on prices. But as these fears recede, prices are likely to gain momentum as they play catch-up with fundamentals. The outlook for oil is also constructive as geopolitical risks in Iran, Iraq and Nigeria remain a significant threat to global supplies. In fact, current volatility levels may present an attractive opportunity to take advantage of further oil volatility as potential supply disruptions in these key regions remains an ever present risk. In terms of the other sub-sectors, central bank buying and firm investor demand should underpin gold prices this year, while potential La Nina effects on grain output remains an upside risk to prices there.

So overall, is the current rally in commodity markets primarily a result of a pick-up in market sentiment? Probably. But that needn't mean that the rally doesn't have legs.

Figure 4: DJ-UBS commodity segment indices



Source: Ecowin

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Living in the Past

People tend to use the past as a basis for assessing the future. However, as an investor, being overly conscious or fixated on the price you paid for an investment impacts your ability to make sound investment decisions for the future. By recognizing how purchase price affects your decisions you can avoid a common trap – the disposition effect.

Sell a Winner or a Loser?

Investing can sometimes feel like a high stakes poker game, with constant decisions to be made on whether to hold stocks or let go of them. When making these decisions, one of the universal psychological tendencies is to focus too much on past performance. The past is the only thing we know with any certainty, so we use it as a crutch, even though the decisions can only affect future performance.

Investors had a difficult time in 2011. Many of the major equity indices posted losses for the year, meaning stock investors are likely holding some investments that are currently worth less than their purchase price. Coupled with our tendency to focus on the past, this can lead to a dangerous combination of behavioral biases.

Imagine you are interested in taking on a new position, but you have to sell an existing position to fund it. Individual investors have a psychological bias towards selling investments which have gained in value rather than those that have lost value. This is called the *disposition effect*.⁸ One estimate suggests you would be 50% more likely to sell an asset in the black than one in the red to fund your new investment⁹.

Why do investors tend to hold losers and sell winners? My colleagues in the Behavioral Finance team often talk about the danger of looking at your investments in isolation – it's a common theme here as well. When we buy a stock we mentally open an artificial 'account' that allows us to track performance relative to the purchase price. When we sell that stock we 'close' the mental account at either a gain or a loss. While this feels intuitive, it can leave us open to other damaging biases, including the disposition effect.

For example, if you're holding a losing stock you have two options: close your position with a certain loss or risk losing more for the chance of getting back to par. This is a widely observed tendency: we are risk seeking when faced with the prospect of losses, but risk averse when we have the opportunity to take gains. We prefer to sell positions and be certain about locking in the gain rather than risk losing those gains for the chance to get more. This can lead us to sell our winners and hold our losers.

⁸ Shefrin, Hersh and Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, *The Journal of Finance*, Vol. 40, July 1985

⁹ Barber, Brad M. and Terrence Odean, *The Courage of Misguided Convictions*, *Financial Analysts Journal*, Nov/Dec 1999.

Additionally, we like to avoid negative feelings. Selling a losing investment and realizing a loss makes us feel much worse than holding a paper loss, as we have to admit that we made a bad investment. While we hold the investment there is always some chance it will increase in value back to or above its purchase price. In contrast, selling assets that have gained in value makes us feel smarter, better, and proud of our investing prowess. This desire for pride, and avoidance of regret, also reinforces our disposition to sell winners and hold losers.

A Bit of a Drag (on Performance)

Ultimately, the disposition effect can reduce portfolio returns because it takes the momentum out of your portfolio. Holding losers becomes a drag on performance. For investors in some tax jurisdictions, the disposition effect is also costly from a tax perspective because selling winners and keeping losers increases capital gains as opposed to tax-deductible losses.

While respecting your risk tolerance, you should try and position yourself in those investments you think will give the best return in the future. Clearly this is easier said than done. There are a few ways you can protect yourself against the disposition effect.

Firstly, focus on your future expectations for your investments and not the past. Ask yourself “if I did not own that investment, would I buy it now?” If the answer is “no” then you should be looking for better places to invest your wealth.

Second, look for ways to keep your artificial mental account ‘open’. One way to do this is to think about rolling your exposure to a new investment. This simple reframing of the problem means you do not need to ‘close’ your account on a stock to ‘open’ a new account, so you avoid the pain and regret of closing out an account at a loss.

Finally, holding any investment carries a cost of not taking the opportunity to hold a different investment. This is true for winners as well as losers – if you hold a winner which you think has momentum left, restrain yourself from cashing in the gain and ride it for a bit longer. Good investing behavior means not thinking about your investments in isolation, but instead looking at their role in your wider portfolio, as well as the other investment options open to you. The value of your complete portfolio is what matters most, so focus on gains and losses at this overall level when assessing your portfolio performance.

The disposition effect can be damaging to your portfolio. However, recognizing its effects and making simple modifications to how you think about investing can reap rewards. As Kenny Rogers put it, “you got to know when to hold ‘em, know when to fold ‘em.”

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Risk tolerance	Composure	Market engagement	Perceived financial expertise	Delegation	Belief in skill

Risk Tolerance

This is an expression of the long-term trade-off between risk and return in your portfolio. Higher risk tolerance indicates a higher risk, higher return portfolio.

Composure

The composure scale measures how emotionally engaged you tend to be with the investment journey.

Market Engagement

This measures the degree to which you are inclined to avoid or engage in financial markets. It shows whether you have a mental hurdle to investing.

Perceived Financial Expertise

This dimension assesses how familiar and informed you feel you are with current financial circumstances, and how confident you feel in your financial knowledge and decision making.

Delegation

The delegation scale assesses how much you believe you can benefit from delegating day-to-day portfolio management decisions to someone.

Belief in Skill

This scale is used to determine how much you believe it is worth paying for an investment professional's potential to achieve above-market returns.

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Alternative Trading Strategies – These are investment approaches which aim to produce returns that are not dependent on broader directional moves in financial markets. Alternative trading strategies (“ATS”) are funds that aim to generate profits for investors by actively taking long and short positions in a wide range of markets. Many, but not all, hedge funds fit into this asset class, but investors can also access ATS through mutual funds in the United States, through UCITS funds in the European Union, and through a variety of structured notes.

Basis points – The relationship between percentage changes and basis points can be summarized as follows: 1% change = 100 basis points, and 0.01% = 1 basis point.

Beta – A measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

DJ UBS Commodities Index – Measures price movements of the commodities included in the appropriate sub index. It does not account for effects of rolling futures contracts or costs associated with holding the physical commodity. Commodities sectors include: Energy, Grains, Industrial Metals, Petroleum, Precious Metals, Softs.

International/Global Investing/Emerging Markets – International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Libor – The rate at which an individual Contributor Panel bank could borrow funds, were it to do so by asking for and then accepting inter-bank offers in reasonable market size, just prior to 11.00 London time. Banks borrow money for one day, one month, two months, six months, one year, etc., and they pay interest to their lenders based on certain rates. The Libor figure is an average of these rates. Many financial institutions, mortgage lenders and credit card agencies track the rate, which is produced daily at 11 a.m. to fix their own interest rates which are typically higher than the Libor rate. Libor is often used as a rate of reference for pound sterling and other currencies, including US dollar, euro, Japanese yen, Swiss franc, Canadian dollar, Australian dollar, Swedish krona, Danish krone, and New Zealand dollar.

S&P/Case-Shiller 20-City Composite (SPCS20R) is a composite index of the home price index for 20 major Metropolitan Statistical Areas in the United States. The index is published monthly by Standard & Poor's and uses the Karl Case and Robert Shiller method of a house price index using a modified version of the weighted-repeat sales methodology. This method is able to adjust for the quality of the homes sold, unlike simple indices based on averages.

Standard Deviation – A measure of the dispersion of a set of data from its mean.

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