ETHNA | FUNDS

SEPTEMBER 2011 MONTHLY REPORT:
Phobophobic Capital Markets

Phobias are serious mental disturbances. Phobophobia – i.e. fear of fear itself – literally cripples sufferers, causing them to act in a completely irrational manner. It seems as if this disease has afflicted capital markets. Within hours, the slightest rumour drives markets, shares, and bonds in one direction or the other, and this in dimensions that until recently took weeks of trading, not hours! The markets are overreacting, both downwards and upwards, behaving as if on speed.

Regardless of how diversified a fund’s products may be, it is virtually impossible in this environment to avoid any losses whatsoever, and despite Herculean efforts, we in Portfolio Management were no exception. There are many reasons for this. But particularly worthy of note is the highly speculative character of the markets at present, where leveraged products in particular, i.e. all types of derivatives, are disproportionately pulling in one direction or the other. Since Ethna Funds exclusively uses exchange-traded derivatives as a hedging tool, but only OTC derivatives are available for credit products, this means that one of the funds’ risk components cannot be hedged to a satisfactory extent. And in the past several weeks, this has led to unwanted price trends in all three Ethna Funds. A majority of the losses could be offset by nimble moves in currency markets and non-credit-driven interest rate markets. However, since in many cases credit markets are now pricing in probability of bankruptcy in a manner that seems to reflect an end-of-the-world scenario rather than a slowdown in global growth, we are optimistic about the future trends for our funds. In the most recent Market Reports, we reported on how CDS markets are imputing various probabilities of default to very solid companies, such as Allianz or ING. For this reason, we would like to refrain from elaborating on the topic at this juncture. But it should be pointed out that in the past month, CDS prices have continued to rise, reaching a level of irrationality even higher than that seen in August. With ratification of the expanded EFSF progressing as the month draws to a close, most recently by Finland and Germany, we feel that this means at least the beginning of the end of irrationality. In these two parliaments, the most vocal critics, though perhaps not the most important ones, agreed to “hold their fire” and approved the expansions. But it remains open to question whether this expansion represents the be-all and end-all. In any event, it has at least somewhat calmed the markets for the moment, although they continue to be in “risk-off” mode, as the Germans say. A new collapse of the equities markets and, above all, the credit markets cannot be ruled out. It seems that European politicians are competing for the prize of who can make the most nonsensical, foolish comment at the worst conceivable time, judging by sound bites of the past several weeks. “And the Oscar for the biggest imbecile in politics goes to…” Since the crisis has unfortunately not yet ended, we do not want to be too hasty in naming the winner. The coming weeks will undoubtedly see still other candidates joining the fray, causing large share price swings in this fragile market setting. In one direction as well as in the other. We will be faced with volatility until a clear, credible position is enunciated for solving the Euro crisis, such as in the manner of the notification by the Swiss National Bank on September 6, where it gave the markets credible assurances that a EUR/CHR exchange rate of 1.20 was considered sufficiently low. Clear positions, credible tools – these do wonders for markets on speed. Ever since the notification, the CHF has remained above the minimum exchange rate and shown markedly less volatility.

This could also work for Europe, although it is likely that any proposed solutions would inevitably be too complex to be communicated in a short press release. However, (almost) anything is better than the current “cacophony” of politicians and bureaucrats, who in fact are the ones causing the markets to be susceptible to the observed price fluctuations in the first place.

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Figures 1 and 2 show price trends in the Dax Index and Bund Futures in the form of a so-called "high-low close" chart. We have chosen this form of depiction because the customary linear graphs do not fully illustrate price changes, since they are comprised merely of closing prices. What Figures 1 and 2 have in common is the dramatic expansion of daily trading swings that started in mid-July. Daily movements of several hundred points in the Dax and several points in the Bund, both of which would otherwise take weeks, have become almost normal – phobophobia, fear of fear itself. Whether it is the head of the German Bundesbank or some politician – sound bites devoid of context that are broadcast over the ticker lead to panic reactions by markets. In this environment, precise analysis and expertise have virtually no chance of cutting through the noise, at least in the short term. Panic purchases and sales are propelling the markets. There is really no end in sight at this point. The most we can hope for is a respite.

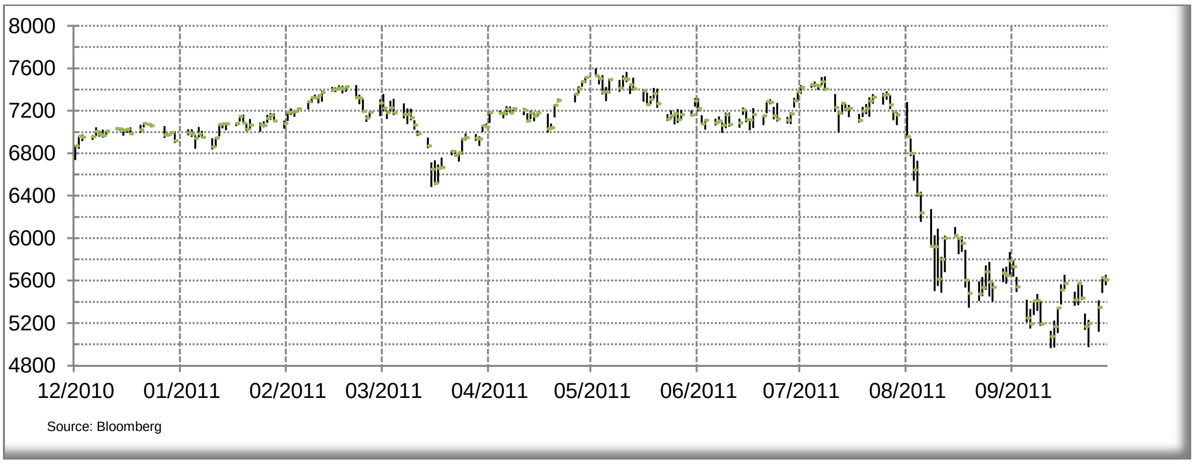

Figure 1: Daily movements in the DAX Index

Figure 2: Daily movement in Bund Futures

Even gold and silver, which had long been considered safe havens by many investors expecting a meltdown in the Eurozone, declined dramatically just several days ago. To us, these price movements are proof that it is not so much long-term buyers of physical precious metals who are setting the prices but rather speculative types, whether oft-vilified hedge funds or even just ETFs. In any case, it was speculators more than investors who

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drove prices upwards and who are now driving them downwards as well. Although, as is well known, we in Fund Management are not enamoured with precious metals as an investment class, we are not feeling the least bit of schadenfreude or the like. The uncertainty among small investors that was triggered by this price collapse is not beneficial for the capital markets.

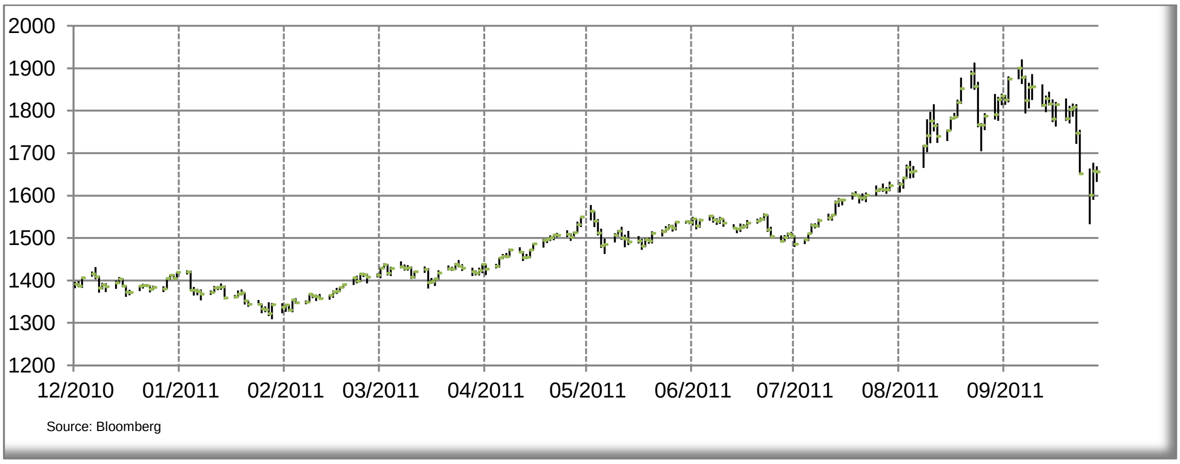

Figure 3: Daily movements in spot gold price, in USD

Figure 4: Daily movements in spot silver price, in USD

Figure 5 likewise illustrates the deterioration in value that commodity currencies have been experiencing since early August. The hardest hit is the South African rand, which together with the Brazilian real has lost more than 10% in value against the euro. High volumes of sales in so-called emerging markets due to the above-described “risk-off” have consequently also led to declining exchange rates – phobophobia. The fear felt by markets of news that might confirm this fear is likely to drive emerging markets, which thus far have been growing at a reasonable pace but now have scarce capital, ultimately into recession! This is tantamount to a self-fulfilling prophecy.

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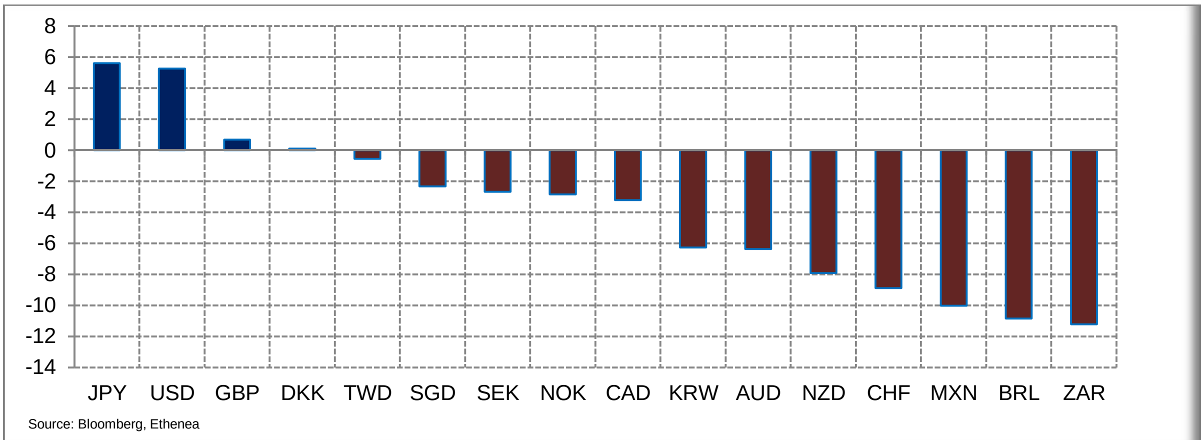

Figure 5: Percentage change in exchange rates vs. the euro from 1 August to 30 September 2011

The PMI indices, i.e. purchasing managers indices, have now begun declining in many countries (see Figure 6), hinting at a light recession, even in Germany. Although in the past, the conclusions of this and similar surveys always had predictive power, we are not so convinced of the interpretation this time around. Quite the contrary, due to the current uncertainty in world capital markets, we believe that the surveys are overly pessimistic. After all, it is only human when, for example, in response to a question about his estimates for future economic trends under the pressure of a Dax Index in free fall, a manager at a large DAX company says that all is not as rosy as his order books would otherwise suggest to him. Here as well, there is the threat of a self-initiated chain reaction.

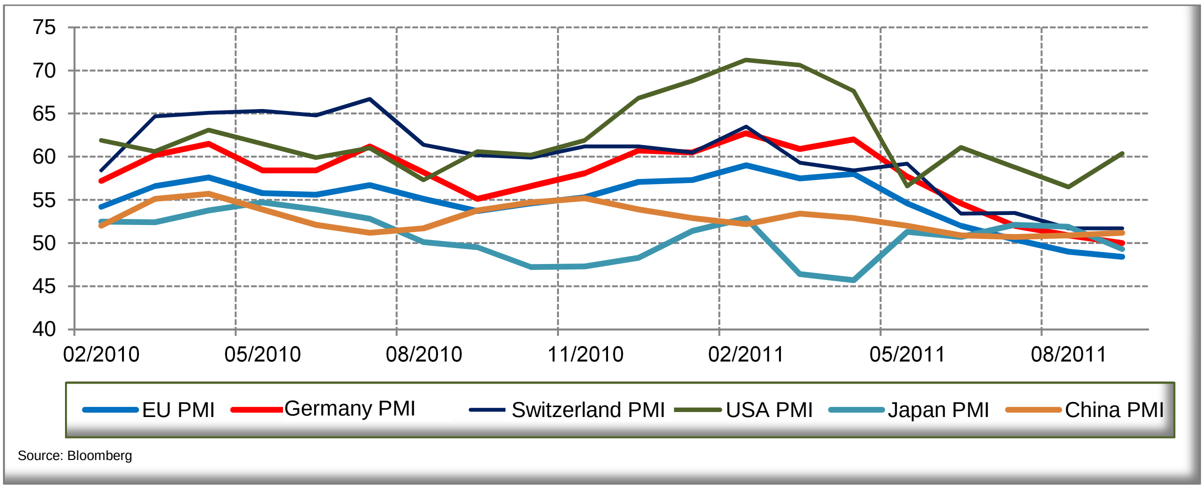

Figure 6: Trends in so-called purchasing managers indices in select countries

As it turns out, the real data tell a different story. In Figure 7, for example, we have depicted only German industrial production trends and orders received by German industry. Even though from an international comparative standpoint, Germany is doing better than many other countries, the overall picture there is similar. Growth, including future growth in the industrial sector, which, only through extreme shocks, could be so

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significantly reduced as to be likely to result in a global recession. At the same time, however, we live in times of extreme swings and thus of shocks as well, meaning that we are only cautiously optimistic.

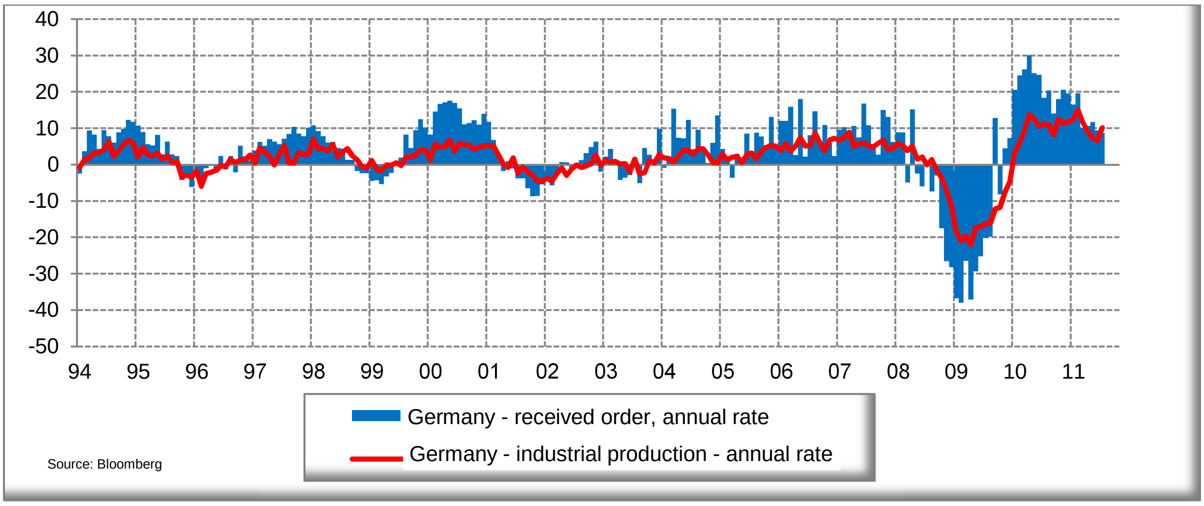

Figure 7: Trends in industrial production and received order in Germany, in percent

Date	Event
3-4 October	Eurogroup/ECOFIN meeting in Luxembourg
6 October	ECB meeting and press conference
date not set	Extraordinary Eurogroup meeting on the situation in Greece
14-15 October	Meeting of the G20 finance ministers in Paris
23 October	EU summit of government leaders, Brussels
31 October	End of term of ECB President Trichet; Mario Draghi becomes new ECB President
3 November	ECB meeting and press conference
3-4 November	G20 summit in Cannes, France
7-8 November	Eurogroup/ECOFIN meeting in Brussels
29-30 November	Eurogroup/ECOFIN meeting in Brussels
8 December	ECB meeting and press conference
12 December	EU summit of government leaders, Brussels

Figure 8: Important dates in Europe through the end of 2011

Since the situation in Greece is far from resolved, Europe continues to remain the focus of the markets. In particular, the various meeting scheduled up to the end of the year (see Figure 8) practically invite ill-considered remarks by publicity-seeking Euro elites, which then once again feed market fears. Capital markets will remain extremely volatile until the end of the year and likely beyond then, meaning that the Fund Management will be busy making the assets entrusted to us in the three funds even more “storm proof”.

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	Currency								
	TW €	€/$	€/CHF	€/£	€/JPY	€/AUD	€/NOK	€/CAD	€/TRY
Last	93.13	1.3449	1.21606	0.85954	103.75	1.38315	7.8504	1.39853	2.4953
-1M	-2.7%	-6.7%	4.9%	-2.9%	-5.9%	2.8%	1.8%	-0.7%	1.1%
-1Y	-3.2%	-1.3%	-9.0%	-0.7%	-8.7%	-1.9%	-2.0%	-0.2%	26.5%

	Germany Gvmt				ITRAXX 5y			
	2y	5y	10y	10/2y	Europe	Xover	SenFin	SubFin
Last	0.55	1.17	1.887	134	190	649	260	497
-1M	-17	-14	-33	-16	37	67	29	72
-1Y	-28	-31	-39	-11	79	237	121	289

	Yield pick-up to German 10y Gvmt										
	USA	UK	Japan	France	Austria	Holland	Italy	Spain	Portugal	Greece	Ireland
Last	3	54	-86	72	79	40	302	325	905	2080	575
-1M	0	38	-119	70	64	40	230	283	816	1559	641
-1Y	23	67	-134	38	53	23	112	185	403	817	430

	Equities					
	DAX	Dow	EuroStx	CAC40	FTSE	Nikkei
Last	5502.02	10913.38	2179.66	2981.96	5128.48	8700.29
-1M	-4.9%	-6.0%	-5.3%	-8.4%	-4.9%	-2.8%
-1Y	-11.7%	1.2%	-20.7%	-19.7%	-7.6%	-7.1%

Figure 9: Trends in various market data versus prior month and prior year

In the following, we are pleased to address several questions posed during our most recent teleconference on September 20 and answer these to the best of our knowledge. Because we would like to keep the Monthly Report to its customary size, we will not be able to cover each individual question. Instead, we will attempt to give answers that are generally applicable to the topics of the questions. For the most part, we have already answered the reasonable questions about the unsatisfactory development of the value of the Ethna Funds during the last two months. Although the funds did not maintain investments in the crisis-ridden GIIPS countries (Greece, Ireland, Italy, Portugal, Spain), our performance has suffered through aggravation of the so-called "euro debt crisis" as a result of the declines in prices for the fixed-income securities of banks and insurance companies which are indeed invested in the PIIGS. Since all interest premiums in this segment have expanded significantly (see Figure 9), it made no real difference whether senior or subordinate bonds were held. Even industrial bonds have been forced to accept comparable price declines. Only securities such as bonds of the Federal Republic of Germany, the European Union, or the European Investment Bank, which beyond all doubt had no credit risk, performed well within Europe. Since we do not underestimate duration risk (yields of less than 2% with a current inflation rate of more than 2.5% do not appear reasonable in the long term), we constantly strive through diversification, i.e. investments in many different securities, and particularly those with credit risk, to keep yield income somewhat independent of duration. In the event of a systemic collapse, such as the one that has been facing us since 1 August 2011, the usual assumptions of diversification simply do not function optimally, since correlations (i.e. the imputed prices changes of individual investment classes) behave markedly differently than during "normal" market times.

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Put plainly, if everything is going south, it ultimately does not matter what you are holding. The capacity of the market to differentiate between a “good loan” and a “not so good loan” is severely limited. We think we are holding “good loans”, even if these bonds are currently experiencing pressure. Since the interest premiums in the capital markets for many of our bonds are currently much higher than at the height of the Lehman crisis, we also continue to believe that these will hold their value, with a very high catch-up potential.

In particular, we feel that subordinate or hybrid bonds will hold their value, particularly in this crisis. In fact, supervisory authorities could hardly be any less willing at the moment to make concessions to banks and insurance companies with respect to their capitalisation (see Basel 3 and Solvency 2)! Just recently, the BIS in Basel refused to yield to pressure from banking sector lobbyists to suspend the 2.5% capital conservation buffer. And as we have already discussed extensively in many documents, the implementation of this requirement will have positive effects for insurance companies and banks with respect to existing subordinate securities. This fact must be viewed independently of the current turmoil in the capital market. In addition, banks and insurance companies are cloaking themselves in an aura of strength, since in the current capital market environment, they continue to exercise their buy options for subordinate bonds when these become due. In just the last 12 months, more than €30 billion in subordinate bonds have become due. Nonetheless, the rates of many subordinate securities have essentially dropped by 50% during the past two months. Securities issued by Allianz, for example, whose first due date is three years away, can be purchased with a yield of nearly 11%! Similar examples abound.

All the same, we are not expanding our position in this market segment at this time. Although we are still convinced – and at this level, more convinced, rather than less – that this class will maintain its value, we continue to expect volatile times. As a result, we have taken steps, and are continuing to do so, to reduce positions that are not essential for us in order to achieve our volatility objectives once again. With respect to equities, we will also essentially continue to maintain a wait-and-see position, since the volatility we see here is more relevant for day traders than for investors. As a result, we have also reduced to nearly zero the equities ratio in Ethna-GLOBAL Defensiv, whereas about 4% is still on the books in Ethna-AKTIV E. The average credit ratings were improved for all three funds in order to get through the crisis in better shape. Impaired market liquidity in many classes caused us to focus particularly on highly liquid bonds in order to be able to react quickly in the event of an emerging solution to the crisis. Ethna-AKTIV E has an average yield of 5.60%, with a duration of 5.68 and an average rating between “A+” and “A”. Ethna-GLOBAL Defensiv has a yield of 5.25%, with a duration of 5.27 and a rating between “AA-” and “A+”. Ethna-GLOBAL Dynamic has a yield of 6.63%, with a duration of 6.4 and a rating between “A” and “A-”.

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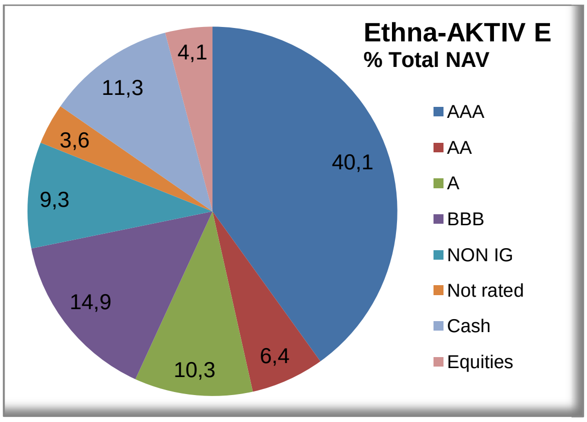

Figure 10: Portfolio Composition of **Ethna-AKTIV E** by Issuer Rating

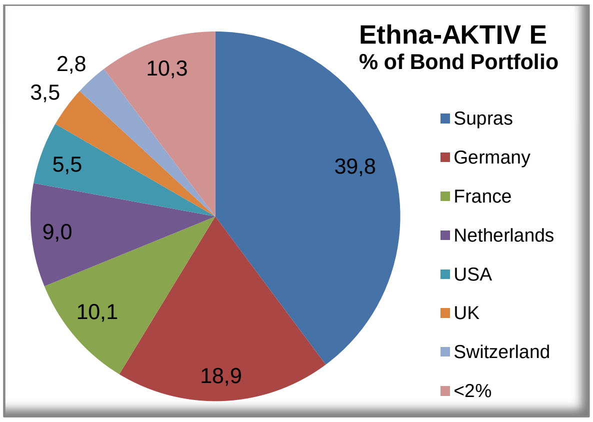

Figure 11: Portfolio Composition of **Ethna-AKTIV E** by Issuer Origin

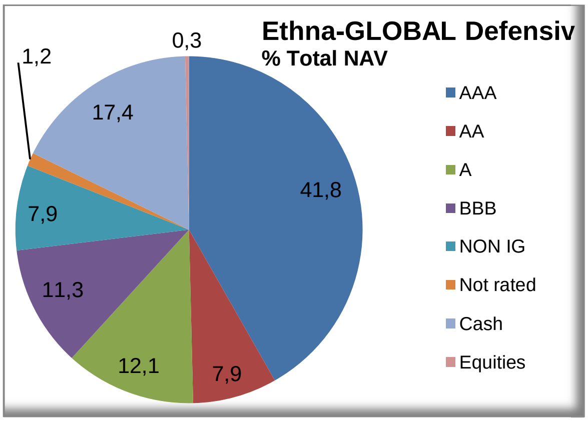

Figure 12: Portfolio Composition of **Ethna-GLOBAL Defensiv** by Issuer Rating

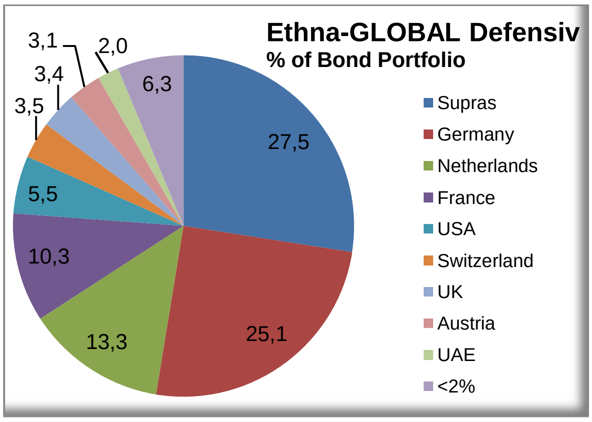

Figure 13: Portfolio Composition of **Ethna-GLOBAL Defensiv** by Issuer Origin

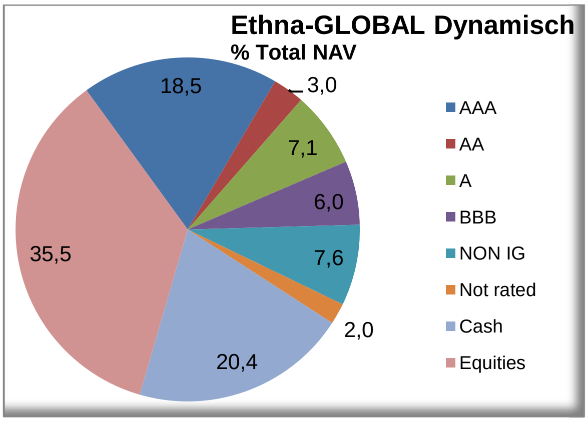

Figure 14: Portfolio Composition of **Ethna-GLOBAL Dynamisch** by Issuer Rating

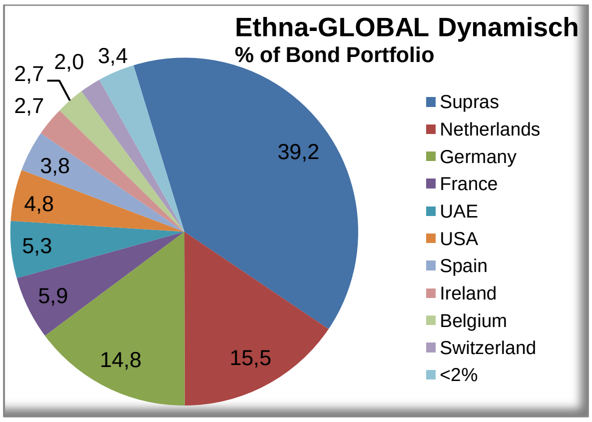

Figure 15: Portfolio Composition of **Ethna-GLOBAL Dynamisch** by Issuer Origin

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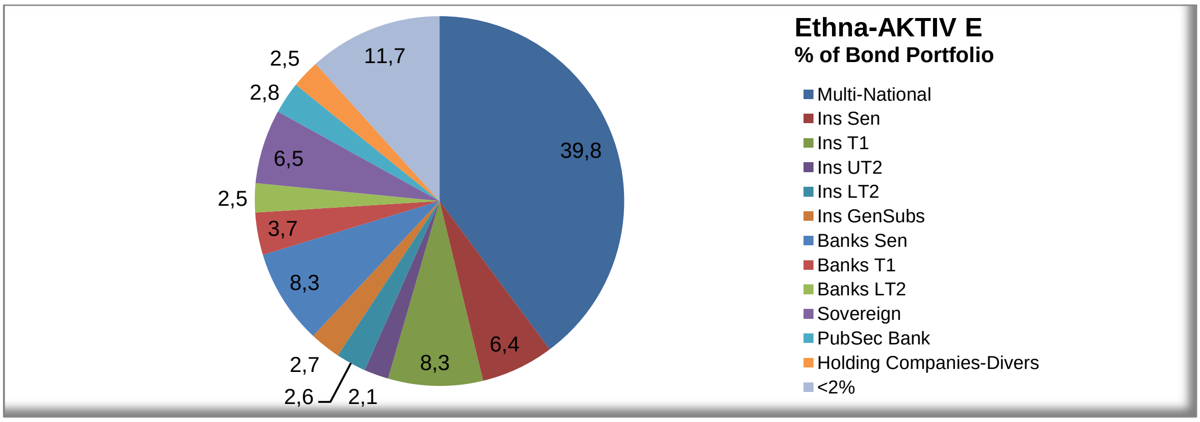

Figure 16: Portfolio Composition of **Ethna-AKTIV E** by Issuer Sector

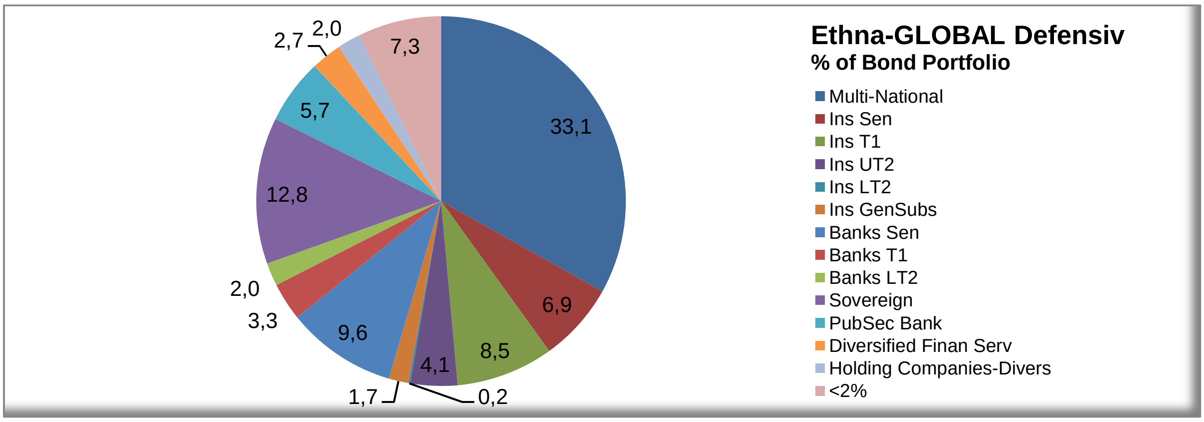

Figure 17: Portfolio Composition of **Ethna-GLOBAL Defensiv** by Issuer Sector

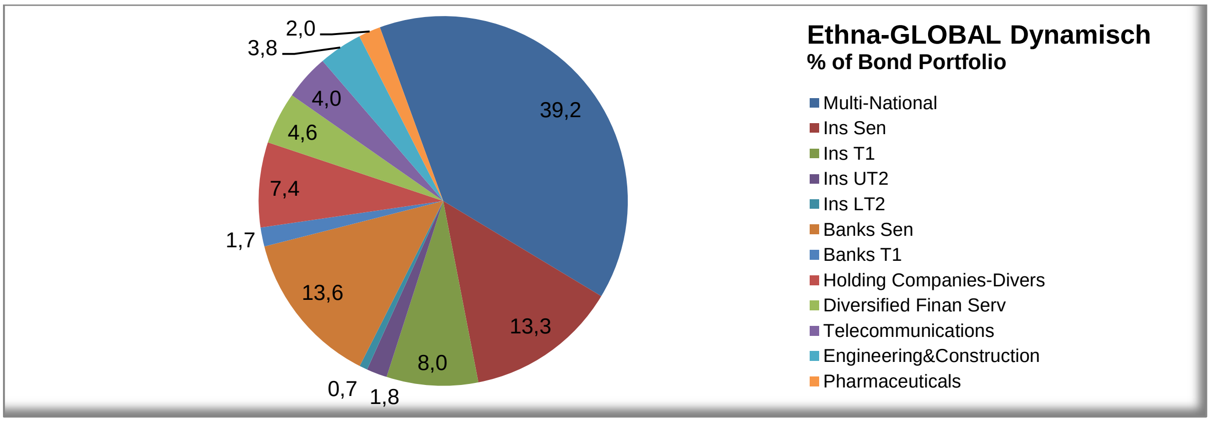

Figure 18: Portfolio Composition of **Ethna-GLOBAL Dynamisch** by Issuer Sector

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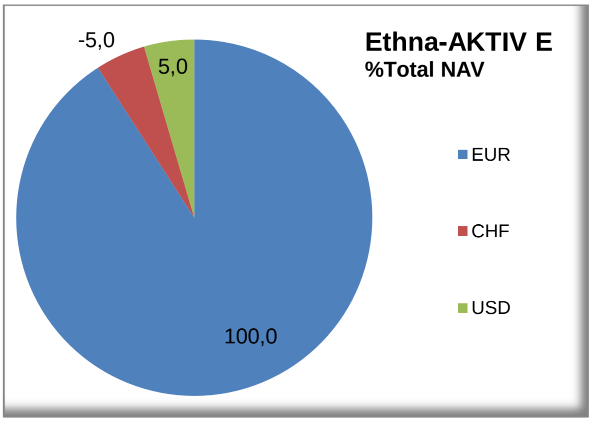

Figure 19: Portfolio Composition of **Ethna-AKTIV E** by Currency

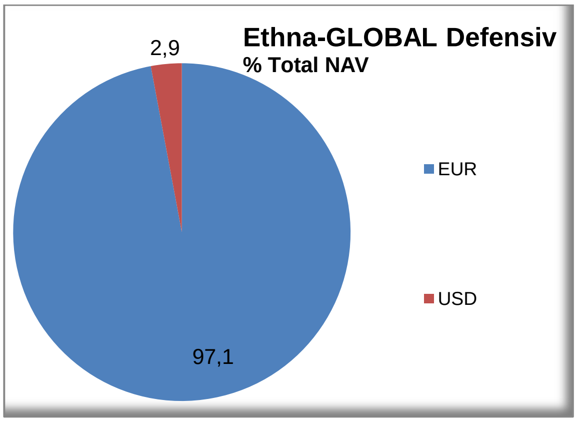

Figure 20: Portfolio Composition of **Ethna-GLOBAL Defensiv** by Currency

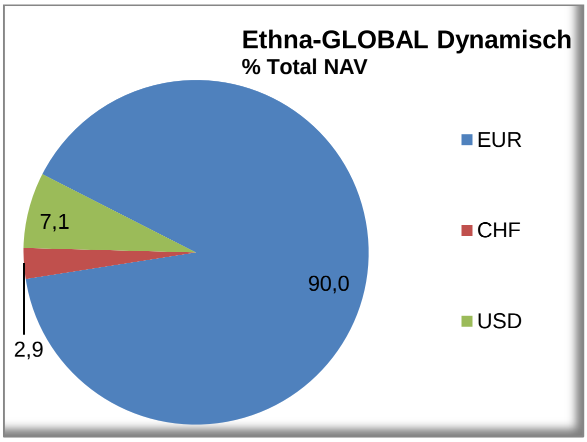

Figure 21: Portfolio Composition of **Ethna-GLOBAL Dynamisch** by Currency

If you have any questions or suggestions, you are more than welcome to contact us.

Kind regards,

Guido Barthels (*Author*) Luca Pesarini

Note:

Like any investment in securities and similar assets, investment in a mutual fund entails a risk of trading and currency losses. This risk extends to the prices of fund units and to yields, both of which fluctuate and cannot be guaranteed. The costs incurred by the investment fund affect actual investment performance. The legally mandated prospectus is controlling with respect to the acquisition of fund units. All information provided here is intended solely as a product description and constitutes neither investment advice nor an offer to enter into a contract for advice or information or to buy or sell securities. The content has been carefully researched and compiled. However, no guarantee is given as to correctness, completeness, or accuracy. Munsbach, Luxembourg, 30 September 2011.

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