We own selective bonds in emerging markets like

Turkey Government	Turkish Lira (after 20% sell-off)	at 18% nominal yield
Poland Government	Polish Zloty	at 2,6% real yield + inflation
Brazil Government	Brazil Real	at 7,5% real yield + inflation
Mexico Government	Mexican Pesos	at 3,5% real yield + inflation

We own great corporate bonds like

Vinci	Euro	perpetuals	at 6,34% nominal yield
Bayer	Euro	perpetuals	at 6,12% nominal yield
Linde	Euro	perpetuals	at 6,64% nominal yield
Solvay	Euro	perpetuals	at 5,68% nominal yield

Through hard and selective work we manage to have a 6% running yield for a 6 yr duration in our Bonds at Work fund, and a 2,80% running real yield (+ inflation) for a 8 yr duration in our Inflation at Work fund.

3. Investor sentiment and required returns

Obviously investor psychology is an important aspect of the overall problem and not the easiest to harness as humans are diverse, complex and changing. At Capital*at*Work we have the advantage of meeting a lot of investors, both amateurs and experts, and, so doing, we get a good sense of their current state of mind.

In 2005 and 2006 we hinted at gradually changing sentiment towards the asset-classes; a change for the worse for bonds and a change for the better for equities. This is exactly what has happened but we think there is further to go.

Again, this is basic human nature at work. People always tend to extrapolate past trends into the future. It was our take that it would take at least three years of equity-outperformance for perceptions of a trend to kick in.

In practice ?

- In a flat yield curve environment, asset allocators (ALM-comittees) are almost uniformely reducing the duration of their bond holdings, bracing themselves for potential higher long rates.

- Asset allocation intentions towards equities are clearly on the rise, but investors haven't yet put all their available money where their mouth is!

Sentiment is supposed to be a contra-indicator. Positive sentiment towards an asset or an asset-class being an indication of positive newsflows already being discounted (it's in the price) and obviously vice versa for negative sentiment.

If this is true (and it certainly is partly true) current improving sentiment is less bullish for equities than it has been over the last three years - but - we think a lot of money still has to come into equities and valuations must be much higher before we can talk of "fully discounted bullishness".

4. Asset Valuations and expected returns

For the broad averages, remarkable growth in earnings and a benign long rates environment, make for still very reasonable valuations as illustrated by the above of the expected returns on European equities and available yields on nominal and inflation-linked government bonds.

At Capital*at*Work, we spend a lot of time and efforts valuing company stocks and bonds, through our specific "Entreprise Value" & "Free Cash Flow" comparisons.

If we look at our "Core" and "Own" stocks,

- the average expected FCF-return on equity is 10,98% (11,75% last year), based on current market price for equity, the current FCF generation and future FCF-growth of +- 3%.

- were we to require an average 10,5% return on our equity investments, which is a 6% to 7% risk-premium above govt bond yields, based on the same current FCF and future FCF growth, the undervaluation of above stocks would amount to an average of 14,6% (20% last year).

- Our companies don't need to grow spectacularly to justify owning them. The implied future growth rate of the current FCF stands at 1,76% (1,00% last year), were we again to require an average 10,5% return on our equity investments at current market prices.

Two more views:

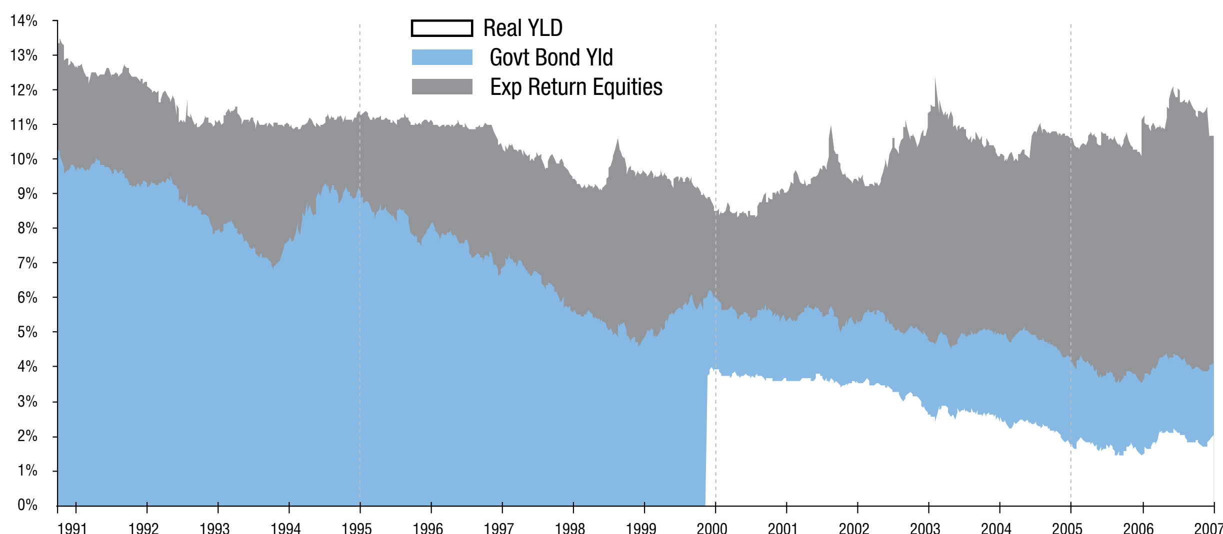
- The average current FCF to remunerate total Entreprise Value (Equity + Debt) at market prices stands at 5,6% (6,0% last year).

- The average current FCF, after debt service, to remunerate the Equity part of Entreprise Value only also stands at 5,95% (6,45% last year).

In our best judgement, these are still attractive propositions.

CONCLUSION:

With interest rates still near multi-decade lows, discounting low inflation and low default rates, bond valuations are generally not very attractive. Value is in extreme selectivity. With company FCF at all-time highs, equities are where the value still lies.



Our portfolios and our funds at Work

In absolute terms we have had a good year but in relative terms only a mixed one.

- The equity part of our portfolios went up by 7% to 17% (see table below) over the last year.

  In comparison, the MSCI World Index in Euro is up 8% in 2006.

- The fixed-income part of our portfolios basically broke-even last year with returns between -0,7% and +0,7%.

  In comparison the JPM Global Government Bond Index (75% hedged / 25% unhedged) had a -0,4% negative return and the Barclays Global Inflation-linked Index had a -1,7% negative return.

These returns are completely in line with the expectations we had at the beginning of the year.

What worked for us?

1. Our asset allocation was again right on the mark.

We have been overweight equities vs. bonds and cash to the maxima allowed by our client and fund guidelines. We have kept our exposure to the US Dollar as low as possible.

2. With few exceptions, our stocks performed well, both on a operating basis and on a stock price basis.

Most of our companies managed to grow their top-line, did a good job of cost-containment, therefore managed to grow their bottom-lines and have been rational users of the generated cash. Our companies tend to be in economic-sensitive industries and to have a strong international exposure.

What worked against us?

1. On the bond side, obviously higher interest rates.

Although not spectacular, the rise from 50-year low interest rates over the last 2 years has hurt bond returns. Just like in 1994 and 1999, did the most defensive portfolios suffer most. After years of great bond returns, low to negative returns were inevitable.

2. On the equity side, a rising tide of "Global Growth" and "Global M&A", lifted all boats and selectivity didn't play as big a role as we generally like.

Our rigorous focus on superior businesses has always led to ownership of top-quality companies which ironically have NOT been the favoured targets of the M&A players over the last two years.

This phenomenon is likely to remain a fact of life for Capital*at*Work and its clients as we are not going to change our discipline.

3. The international diversification of our portfolios sort of worked against us, relatively speaking, as our own Eurozone was very very strong.

This is even more ironic. In line with our outspoken positive stance on European growth and European stock prices, we have been overweight European stocks versus global benchmarks (which explains our strong outperformance vs the MSCI World Index) but ... underweight versus some of our local competitors.

It is not a new phenomenon that some of our competitors have played the investment game closer to home. It is unlikely to be because of vision but more because of old habits.

Under our "Globalization at Work" theme we continue to think that owning multinational companies which are able to profit from a globalizing world is the way to go.

4. In our Asia fund, a flat Japanese market and especially the 10% decline in Yen vs Euro, combined with a conservatively low exposure (8%) to Chinese stocks have led to unspectacular results.

Capital*at*Work - Equity Funds	Asset Class		Return 2006 in Euro
European Equities at Work	European Equities	Euro	+17,09%
American Equities at Work	American Equities	Euro	+2,17% (13,81% in Usd)
Asian Equities at Work	Asian Equities	Euro	+8,40%
Contrarian Equities at Work	Global Value Stocks	Euro	+14,77%
Growth Equities at Work	Global Growth Stocks	Euro	+7,30%

Capital*at*Work - Fixed Income Funds	Asset Class		Return 2006 in Euro
Bonds at Work	Global Bonds	Euro	+0,73%
Inflation at Work	Global Inflation-Linked Bonds	Euro	- 0,77%

Capital*at*Work - Mixed Funds	Asset Class		Return 2006 in Euro
Global Markets at Work	Global Equities, Bonds and Derivatives Strategies.	Euro	+4,64%
Global Opportunities at Work *	Global Equities, Bonds, Derivatives and Long / Short strategies	Euro	+8,66%

* The Global Opportunities Fund is only registered in Luxembourg. For other countries, local regulations are applicable. For Belgium a minimum investment of 50.000 Euro is required.

If you have any questions regarding the above or any other matter related to economics and finance, don't hesitate to call upon us for a clear, honest, and interesting point of view.

Capital*at*Work's strategic mission is to serve you and help you manage your investments in a rational, intelligent and fruitful way.

Responsible editor: Ivan Nyssen
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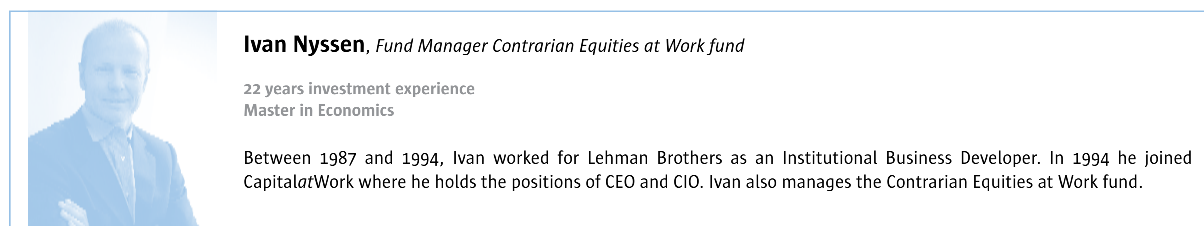

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Between 1987 and 1994, Ivan worked for Lehman Brothers as an Institutional Business Developer. In 1994 he joined Capital*at*Work where he holds the positions of CEO and CIO. Ivan also manages the Contrarian Equities at Work fund.