



Allocation Fund - GLV  
Equity Fund - GLQ  
Opportunities Fund - GLO

## Letter from Chuck Clough

October 11, 2011

To Our Investors:

As we moved into the summer months, we thought equity prices were low enough and free cash flow among many of our holdings was sufficiently underpriced to protect us from a further market selloff and we were obviously wrong on that. Now prices are even lower and free cash flow yields are even higher. We go to great lengths to assure ourselves that cash flows in which we have invested are sustainable in an economy which is deleveraging and to date we have not been wrong on our fundamental judgments. However, money has been rapidly flowing out of stocks. Developed market mutual funds suffered withdrawals of \$92 billion over the three months through August reversing the total amount of money investors had put in these funds since the bottom in 2009, according to the Wall Street Journal. Those withdrawals continued in September. The result is the vast bulk of US household savings sit at the money rate, an investment which will likely provide negative returns for some time. Cash holdings now exceed the total value of US equities which says to us there is far too much cash on the sidelines.

What could turn things around? We think the European Central Bank has no choice but to monetize the sovereign debt it is buying, a move which equates to quantitative easing. In addition, the persistent weakness of the US economy will likely eventually force the Federal Reserve into further balance sheet expansion, or QE 3. Equity markets are likely to respond positively, particularly in those sectors where profits and cash flows can be sustained in a weak demand world. We also think that would reestablish the attractiveness of emerging markets.

The reality is corporate credit is cheap and cash flow is cheap, and we continue to hold a portfolio of companies that reflect that. Unlike 2008, businesses have more cash and less debt, bond maturities have been extended and never have we seen the same event, a collapse in business credit, occur in consecutive business cycles. We think the inevitable upward re-pricing of free cash flow will be the opportunity in the financial markets in the year ahead.

Moving our attention to the stresses in Europe's financial system, we feel that someone has to take a loss in that part of the world, and with governments unwilling to do so, that someone will likely be Europe's banks. This has not yet been recognized by the markets and inexplicably European bank stocks rally on every meeting announcement made by European officials. Yet talk of recapitalizing Europe's banks inevitably suggests shareholder value shrinks dramatically since the shareholder is the ultimate creditor. Our sense is there is little or no equity in many of Europe's banks. The various bailout plans at best provide short term fixes and they put off the need for banks to recognize the huge losses on their balance sheets. But Europe's banks are highly levered. Dexia's assets were more than 60x equity and many German banks sport asset to equity ratios of 35 - 50x (per Bloomberg). Eventually the (European Central Bank (ECB) has to become involved, buy Spanish and Italian bonds and create the Euros to do it. To us that seems Euro bearish and equity bullish.

Meanwhile, we think US banks could be great 1 - 3 year investments. Today's market has given them up for dead for understandable reasons. As the economy deleverages, the yield curve flattens, regulation is becoming more intimidating, and there is little question in our view that growth opportunities will be meager. Operation twist by moving long and short term interest rates closer together only threatens net interest margins.

But most bank stocks are down 30 - 50% in 2011 and the yield curve may offer more than it seems on the surface. Not only are funding costs moving negative in many instances as deposit fees exceed what is paid out, but reported net interest margins are quite favorable. Bank balance sheets have been substantially repaired, bad loans are down and many more have been already reserved for and asset to equity ratios now average 10% (per Bloomberg).

A slowing economy threatens bank and non-bank profits respectively but only bank stocks have moved to severely discounted discounts to book value. Regulation may remove some sources of profit but it is not clear the market paid much for levered earnings in the first place. Historically low p/e's (price to earnings ratios) may be a legacy of excess leverage. Regulation also has the effect of reducing real and potential competition. In our opinion, the industry will consolidate and that should provide opportunity.

Our emerging market exposure is low, about 7.5% at this writing, and is currently comprised mostly of Chinese consumer and Brazilian retail mall companies. As in earlier emerging market investment cycles, Shanghai often leads markets higher and that is not yet happening. China has the savings, the cash, and the external surpluses to sustain demand while the



developed economies do not. There are admittedly serious credit imbalances in China largely because its private sector is hugely liquid, and sidecar lenders, trust operations and private lenders have been lending at rates that few projects could support. The banks are only peripherally involved in this part of the lending boom. China's liquidity crunch is policy induced, and well along in time. Property sales and investments are falling and that will likely take some leveraged developers and non-bank lenders down, but China's economy is huge and still growing. Its private sector is unlevered and savings are equally huge. We think the liquidations that are coming in the real estate sector can be easily absorbed. It is still a command economy; although it would be a bit more complicated than in earlier cycles because they are publicly traded entities, we think the government can easily recapitalize the banks and policy can be reversed. Monday's announcement that an arm of the Chinese sovereign wealth fund is buying bank stocks is a welcome policy signal.

The corollary of rising wages in China is a growing and vibrant consumer. Our analysis suggests that consumption is rising and increasingly driving the economy. According to Dragonomics Research, exports, net of imports are now 3-4% of Gross Domestic Product (GDP), leaving China a lot less exposed to the global economy than the markets are assuming. Credit issues relating to shadow banks and borrowing by local governments are real but China's governments own a lot of assets and domestic private savings in China are huge. Inflation should peak as commodity prices decline.

An important issue in China is that the financial sector needs reform. It is far too heavily based on state-owned banks which are very inefficient at allocating credit and very poor at supporting private enterprise. Moreover current growth rates of credit are unsustainable in our view and that suggests a shift to less credit intensive consumption as the economic driver going forward. We also think concerns over excessive infrastructure building are wrong. Construction is 14% of Chinese GDP according to the Wall Street Journal. China's capital stock per capita is perhaps 6-7% that of the US according to Dragonomics Research, and the transportation infrastructure that is being built out will lead to higher productivity in China's services sector. Productivity and profits are highly correlated and that is why we think profits will boom among consumer related companies in the years ahead. We have added a third research analyst in our Hong Kong office and are looking to physically expand our office space there.

The stocks which capture our fourth strategy, deep water oil exploration and production have been weak in this market decline but that is the one producer durables cycle we are confident of. Backlogs are growing and they are highly profitable. The cycle should last years. Global production of crude oil is in a consistent downtrend and it is essentially a consumable product with little demand cyclicality. Demand is not very economically sensitive.

Outside the crude sector, we are short many commodity related capital equipment companies and long more consumption oriented companies that buy raw materials and whose margins have been squeezed by the run up in commodity prices. Commodity driven capital spending companies have enjoyed profit margins that we think are unsustainable in the world which lies ahead. We believe China's growth will be far less resource intensive, commodity prices will be in decline and it is the one sector where the capital stock is overbuilt.

An early mentor of mine gave me a strong respect for value and underpriced equities a while ago with the statement: "Price is the most important fundamental." In other words if the purchase price is low enough all that is necessary to be successful in the investment is patience. It is a bit strange that the threat of liquidity crunch hovers over economies and markets when there is so much stranded liquidity sitting on household and business balance sheets. We think this could change quickly.

We thank you for your confidence in us and will continue to work hard to sustain it.

Sincerely,



Charles I. Clough, Jr.

*Past performance is not a guarantee of future results.*

*Foreign investing involves special risks such as currency fluctuations and political uncertainty.*

*Forward-looking statements are based on information that is available on the date hereof, and neither the fund manager nor any other person affiliated with the fund manager has any duty to update any forward-looking statements. Important factors that could affect actual results to differ from these statements include, among other factors, material, negative changes to the asset class and the actual composition of the portfolio.*

*Clough Capital Partners, L.P. is a Boston-based investment management firm that has approximately \$3.8 billion under management as of 8/31/11.*