

Annual Report 2010: Better Red Than Dead

No doubt, 2010 will go down as one of the more exciting years for the wine market. Whilst difficult economic conditions prevailed in traditional economies, the buoyant EMEs and loose global monetary conditions combined to light a fire under commodity based risk assets.

After a solid 2009, when Fine Wine (5.6%) played 2nd fiddle to an incredible, post crash, rally in equities, 2010 has been nothing short of astonishing.

It is worth underlining that 2010 was as much China's year for wine as in the wider sense. Following on from an extremely busy 2009, BI sales to Asia jumped almost 90% YoY and for the first time overtook those to the UK. With one of the most hyped en-primeur campaigns in memory and trade for earlier releases that appeared, at times, to be bid only, conditions were always set to deliver fireworks for investors and drinkers alike. At close of December, the Bordeaux Index had returned 32.4% on the year making it by some way the best performing asset class of 2010.

We've commented previously the cyclical nature of wine performance noting that the greatest returns are often frontloaded into H1 when new En-Primeur releases act as a catalyst for relative value trading in physical wines. With the 2009 prices shattering all expectations, conditions could not have been more favourable for a strong rally in back vintages.

When considering the 2009s back in the spring, we speculated that many seemed to offer little value and in the absence of either a strong US Bid or a large emerging HK one, prices could soften for many wines almost from the point of release. Indeed, with the exception of a very select group, this has been the case, with both high residual inventory in the UK and discounting by Bordeaux ahead of 2010 serving to depress prices by 10% or more for many. That these implausible prices still managed to evoke such sustained, relative value purchasing of back vintages talked more of an inherent optimism than it did for the immediately rational. That said, the Bordeaux Index surged some 18.5% through H1.

Far from being a story of consolidation and cautious optimism however, H2 turned out to be almost as rapacious, with turnover through the traditionally quiet summer months up 26% over 2009 and November an enormous 90%. This incredible surge is demonstrative of how sensitive the market was becoming to what were occasionally, quite irrational, exogenous events. The presiding influences that precipitated the late Autumn rush, in particular, make H1's pressures appear almost conservative.

Way back in spring 2009, rumours had begun to circulate that Mouton Rothschild were to commission a Chinese artist for the Label of the 2008 release. This in itself was sufficient to spark a surge in interest. With delivery imminent, it was actually Lafite Rothschild that took the initiative, confirming that their 2008s would be shipped with a small Chinese symbol on the bottle. The ensuing frenzy saw prices climb over 50% in just a few days and leaving them at a level that eclipsed all but the most treasured vintages (read 82 / 2000.)

Not to be outdone, when Mouton finally confirmed their own designs, prices rocketed up an even more extravagant 90%, again making the 2008 more expensive than all but the 82/00 duo. These almost surreal movements seem doubly irrational if we consider that, not only was 2008 amongst the least bought vintages by Asia but that the precedent for including the work of a Chinese artist had been tried by Mouton previously in 1996, with little discernable effect on pricing. With huge locked in profits and the

universe of tradable inventory set to expand as the wines are delivered to private clients this spring, smart money could consider fading positions in both wines.

If marketing gimmicks alone were not enough to persuade investors to roll over the H1 party for another few months, an extraordinary set of HK auctions in November proved irresistible. In back to back sales, almost GBP11m of stock changed hands at premiums of 80-120% over market prices. Speculative revaluation, a busy mid-autumn festival and advance buying for Chinese New Year saw sales explode with BI turnover for the month up 200% over 2009, marking it as the second busiest month of the year.

Going into 2011, things continue to look positive for the market over the mid-term. In the macro sense, there are few signs of tightening in emerging markets with bumper growth projections forecast again for the key market of China. Back in the west, with US QE3 already being openly discussed as the current program expires in the spring, a weakening dollar, above expectation growth and the spectre of inflation look likely to support both equities and real assets. While the developing schism / banking / sovereign crisis in Euroland is certainly a potential headwind, it appears that with growing support for an expanded bailout fund and intervention by surplus nations (read China) these problems will be kicked down the road for another year. Of note will be the forthcoming Irish elections. If a new government were to reject the existing bailout proposals and enforce haircuts on bondholders, expect the response from the market to be cooler than a nightwatchman's toes.

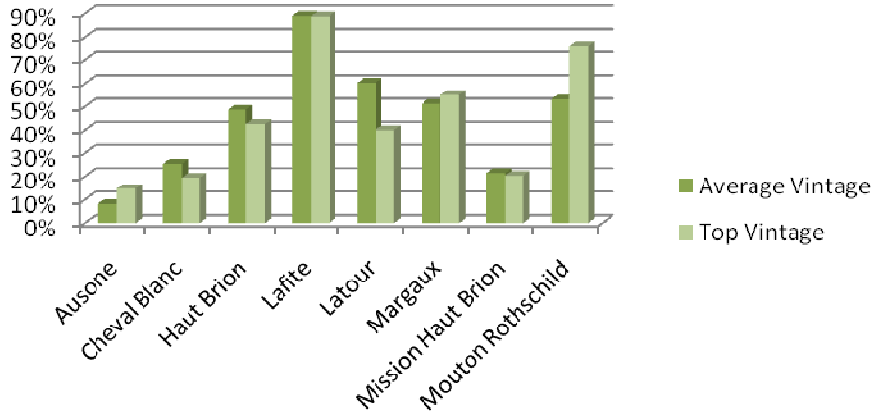
Fine Wine also has a number of key tests in the spring, with multiple showcase auctions in HK and restocking post Chinese New Year both offering bellweathers for demand durability. With new investment in 2010 climbing almost as fast as prices, it may also be expected that a certain level of profit taking is likely. Indeed, early trade patterns seem to support this, though to date these have been more than adequately balanced by new flows. Finally, while many will concentrate on bonanza results in 2010 to conclude that prices are frothy, with wine returns essentially flat from Jan 08 through Jan 2010, a return (BI Index) of 34% in the last year still puts us some way south of the long-run, 15% average.

Key Trends For 2010:

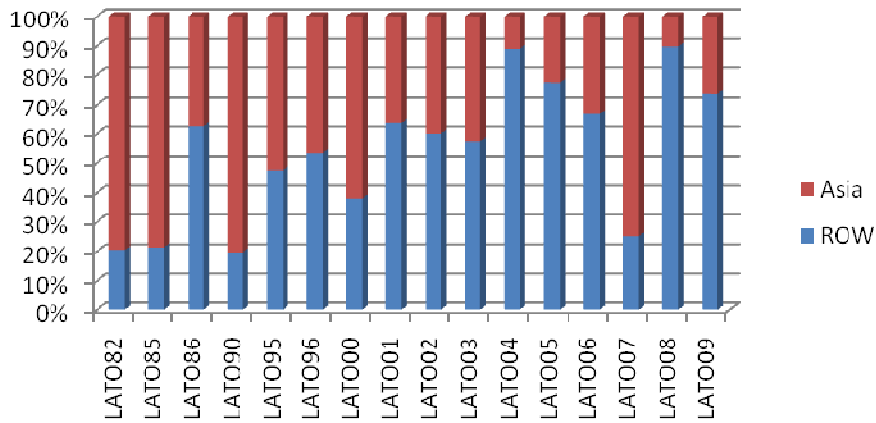
Big 9 (Ausone, Cheval Blanc, Haut Brion, Lafite, La Mission, Latour, Margaux, Mouton, Pétrus)

Latour / Mouton - The UK market dominated buying for post 2000 vintages. The dramatic outperform of 'off-prime' over 'prime' vintages for Latour looks a little uncomfortable as real Asian demand for such vintages is limited. Indeed the only vintages to gain traction in the region appear to be pre 1990 (exception of 2007.) A further caveat here is that the vast majority of 07 Asia sales were at the very beginning of the year when it was at a considerable discount to the other cheap vintages. The policies of limited release (and subsequent ex-château sales) may act as a 2-fold brake on Latour as they suppress both market penetration in Asia and 'new' supply dilutes traditional inventory squeezes. Pre 2000 Mouton looks cheap, particularly for wines like the 86/96, though limited inventories may act as a bottleneck on turnover. Mouton 2006 also looks promising - with strong global support it remains significantly undervalued compared to similarly rated releases, 2010 release price could be a catalyst for revaluation. Paradoxically 2008 Mouton has been almost pathologically avoided by Asia to date and with Parker's final review slated for April, the exaggerated price looks frothy to say the least.

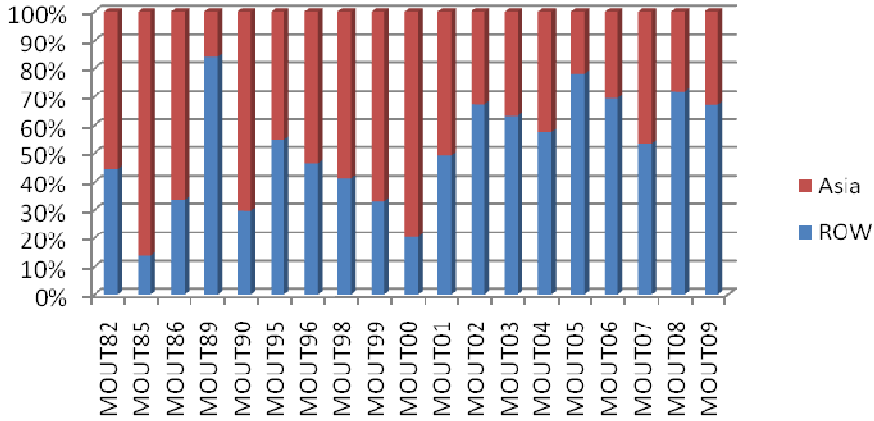
Performance Average vs Top Vintage



Sales By Region (unit) Latour

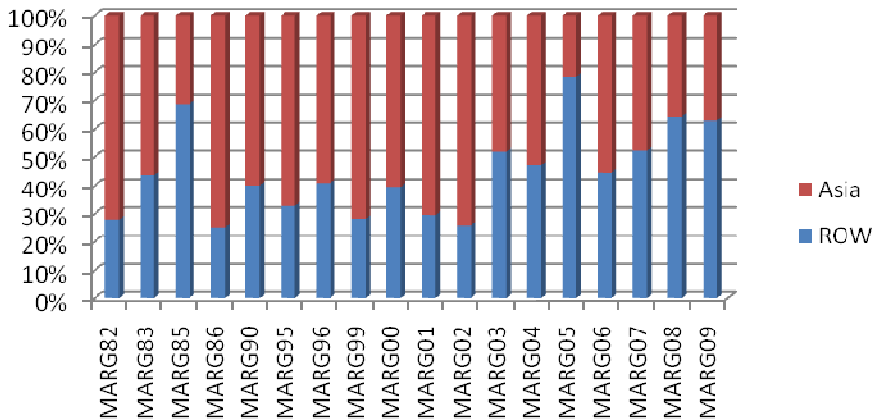


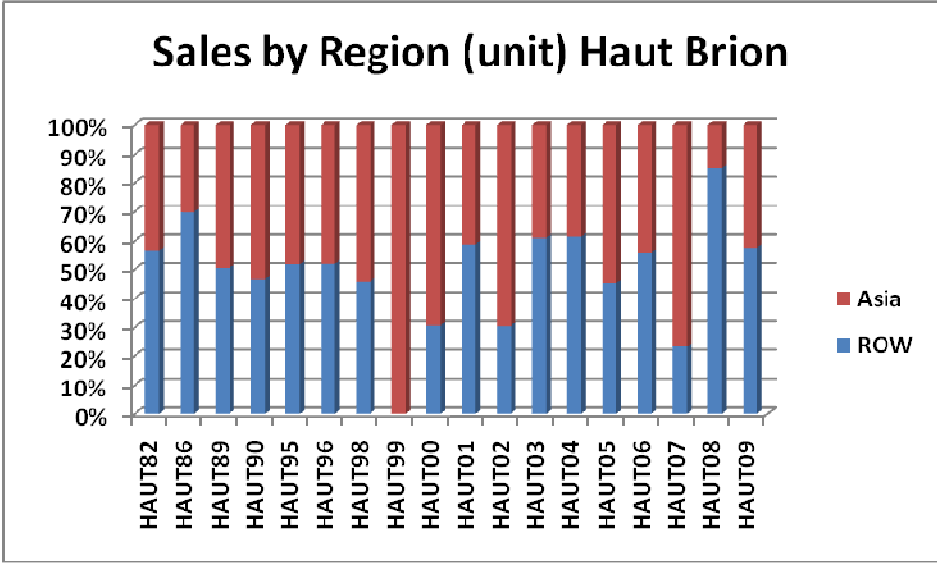
Sales by Region (unit) Mouton



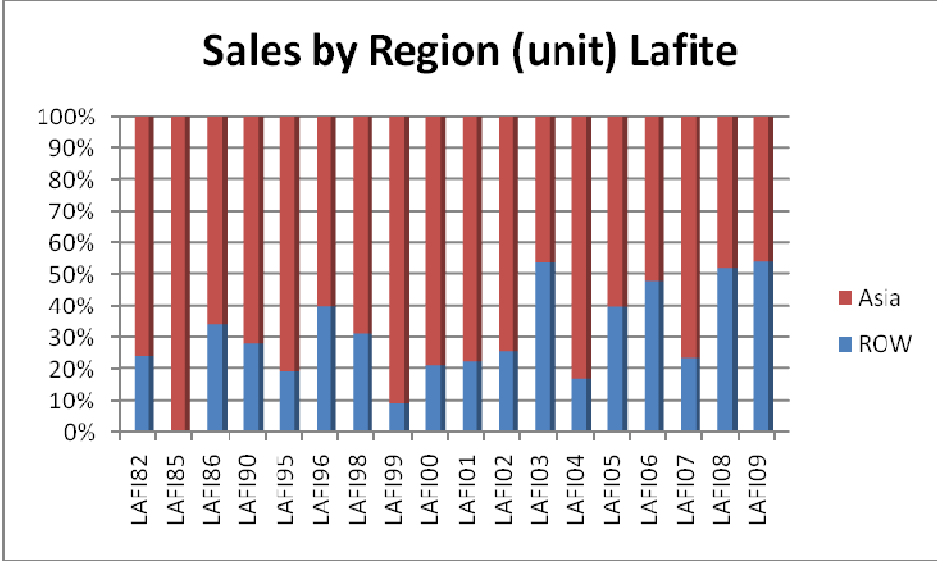
Haut Brion / Margaux – These 2 remain Asia’s favourite 1st growths after Lafite and we tip both for strong performances in 2011. Looking at the HB flows, Asia is most dominant for 00/02/07 with good numbers in 89/90 suggesting a growing appreciation of the wine as a drinking rather than just status / investment asset. Look for the cheapest vintages to outperform, but keep an eye on the 2000. For Margaux, established buyers in Asia favour pre-2000 wines. More recently, a strong aversion to 05/08/09 suggest that value is also still a key component in buying. We like 01/02/07 for the cheapies and 96 for the top end – 2010 should assist and it is probably the best of the 96’s to drink now (which can’t hurt.)

Sales by Region (unit) Margaux





Lafite – As you'd expect, Asia dominates across the board with a couple of notable exceptions. 03 Continues to be weak from HK but prices have certainly been supported by speculation in the UK. We would judge that it still has potential but is most likely to underperform in the short term. 08/09 are the 2 vintages least supported by Asia. The relative strength of the 09 is surprising given the regions limited en-primeur participation. While we suspect it offers little immediate potential, it seems likely that 09 may one day take the place of 00 as the ultra premium vintage of choice. While sales of the 08 have been reasonable in HK, as with 07 Latour, they were mostly before the cut in November. At current levels much is tied up in Parker's upcoming review, a perfect score will offer support (though probably little upside), anything less will likely see a moderate sell off. More widely, support for Lafite in general is a little less than expected in 2011 ytd. While it is unlikely that the trend underlying the Asia Lafite phenomena over the last 2 years will die out overnight, the dramatically asymmetrical returns of the last year (almost 90% for Lafite vs Market @ 32%) may spur a more significant spell of profit taking early on, perhaps leading Lafite in general to underperform slightly in H1. Best opportunities look like 06/07.

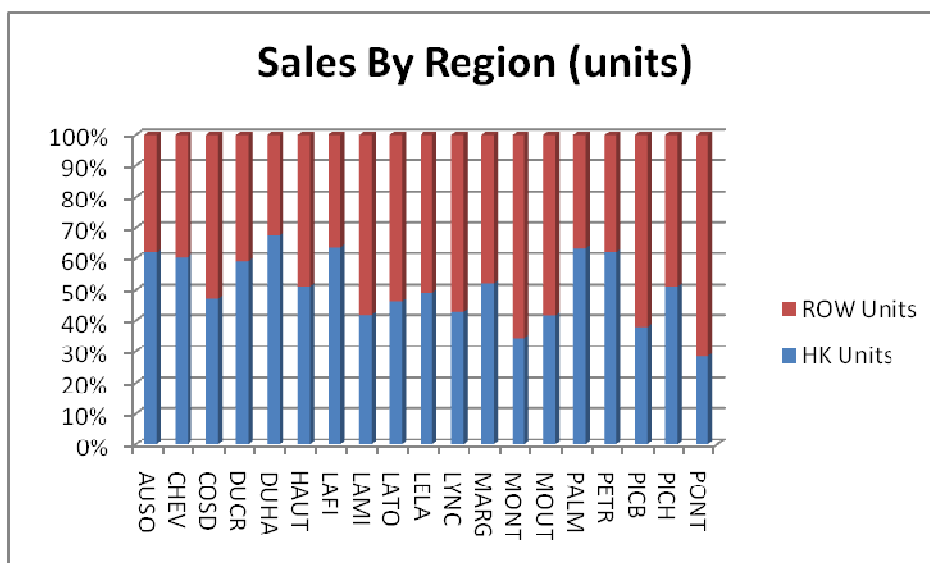


Pétrus – Asia dominates for both value and (especially) volume. Pétrus, as ever, remains a ‘good times’ elixir and thus looks set for a reasonable 2011. Our concerns are the perennial ones: minimal liquidity, small consumption market and vulnerability to supply exploitation. We’d strongly recommend following the flows, ensure you’re well represented by the most affordable vintages and limit overall portfolio exposures.

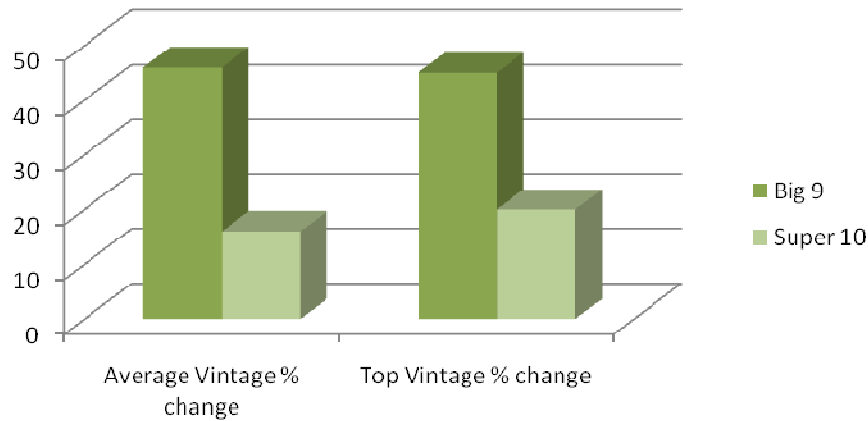
Ausone –2010 Should have been a good year for Ausone (as it was for Pétrus and DRC) but it appears that the paradigm shift in pricing from 2000-2007 remains overdone, curtailing trade and real price discovery. Some succour can be taken in that 2010 was the first year where Asia unit sales overtook ROW, further caution however that these were almost exclusively for the ‘average’ pre-2000 group of wines. Even more so when we consider that prime vintages still managed to outperform... Sell into strength around en-primeur.

Cheval Blanc – Remains as popular as charity. CB’s pricing policy over the last few years has won few friends in value obsessed emerging markets. Although (as with Ausone), we note that Asia is again the dominant buyer, overall turnover is still pretty abysmal. If anything, buy the value here...prices remain depressed over long term averages for all the cheap vintages (at least up to 2004). Although it has all the credentials, Cheval Blanc continues to fall short.

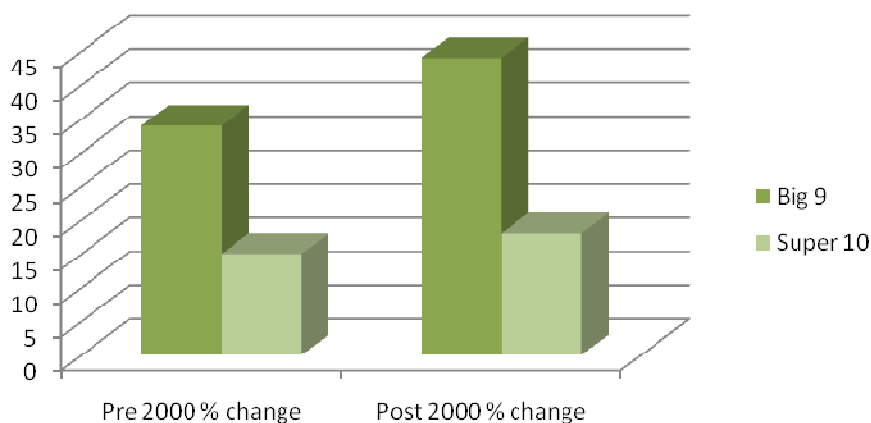
Super 10 – (Cos, Ducru, Duhart, Leoville Las Cases, Lynch Bages, Montrose, Palmer, Pichon Baron, Pichon Lalande, Pontet Canet) These are being talked up as the play for 2011, mostly on the basis of rapidly rising first growth prices tipping traditional HNWI purchasing into the best vintages of the second growth and equivalents. Looking at the numbers we can see that both average and top vintages of the super 10, underperformed dramatically last year, a theme that has become common since the emergence of Asia as the prime market. Taking that into consideration we feel that these wines offer more of a ‘developed’ market play. Over the next year it seems likely that Chinese buyers will diversify into the wines that they already know, but have overlooked thus far in the rush to Lafite – expect this to benefit the other first growths, 2nd wines of first growths and established names such as Lynch and Pichon Lalande first. However with growth in traditional markets such as the US expected to pick up in H2 and prices of the 2010 unlikely to be cheap, some of the other super 10 do certainly offer compelling value on a long term, relative value basis. Of the group, we like the wines with the strongest crossover between new and traditional markets across all vintages, with an overweight on those that are approaching early maturity.



Performance Average vs Top Vintage



Performance Pre vs Post 2000



Summary – Buy the cheap vintages, be overweight Haut Brion, Margaux and top rated 1st growths that offer relative value (think Mouton 06). Worth underlining that the market has a structural shortage of ‘average vintages’ – it will be 2013 at the earliest before we could see the possibility of the next. In the meantime, this will exert tremendous pressure on 01,02,04,06,07 and several vintages in the 90’s where they offer value. Keep an eye on top vintage prices (especially Lafite) and maybe sell a little into strength in the run up to en-primeur. Finally, take a look at the Super 10 but make sure selections are supported by flows.

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