INVESTMENT OUTLOOK & REVIEW – SPRING 2007

SUMMARY

THE STRONG RUN IN GLOBAL MARKETS ENDED ABRUPTLY ON 27TH FEBRUARY WHEN THE CHINESE STOCK MARKET DROPPED BY 9%, ITS LARGEST DAILY FALL IN A DECADE. THE SETBACK CAME AFTER A DRAMATIC RISE, AND WAS A REACTION TO CONCERNS ABOUT THE CHINESE AUTHORITIES' MEASURES TO CONTROL SPECULATIVE EXCESS. ON THE BACK OF THIS, AND COMMENTS BY ALAN GREENSPAN THAT THE US ECONOMY FACED A RISK OF GOING INTO RECESSION, INVESTORS TOOK FRIGHT. EQUITY MARKETS, COMMODITIES AND HIGH YIELD CURRENCIES WERE ALL HIT HARD IN A SELL-OFF REMINISCENT OF THE ONE LAST MAY. BY CONTRAST TO LAST MAY WHEN THE FALLS IN MARKETS WERE TRIGGERED BY AN INFLATION SCARE, ON THIS OCCASION THE MAIN ISSUE WAS CONCERN ABOUT A DETERIORATING OUTLOOK FOR GLOBAL ECONOMIC GROWTH. NEVERTHELESS, THE STEEP SELL-OFF WAS SHORT LIVED, AND MOST MARKETS ENDED THE FIRST QUARTER OF 2007 LITTLE CHANGED FROM THEIR LEVEL AT THE START OF THE YEAR.

Stock markets resemble a village tug of war at the moment. At one end of the rope strong corporate profitability, lots of takeovers, the buoyancy of emerging economies and relatively attractive valuations, are all straining every muscle to win. At the other, more sinister end of the rope, are the heavyweight fears of higher interest rates, worries about inflationary pressures, and in the anchor position, the spectre of recession. So far in 2007, this tug of war has created an awful lot of noise and excitement without either side decisively gaining the upper hand. While investors are anxiously watching a number of indicators to determine what is likely to happen next, at the moment it is the US housing market that has become the bellwether for the overall direction of markets.

US housing becomes the centre of attention

Global financial markets often go through periods when one issue assumes particular importance in the minds of investors as a cue for price movements. The reason why the US housing market has been at the forefront of things that investors have been watching over the past few months has been because of the negative impact a sharp slowdown in US housing activity could have on credit markets and the general health of the US and global economies. With house prices falling in parts of the US, and mortgage rates having increased, there has been considerable pressure on highly indebted householders with little equity in their homes. Such homeowners, normally referred to as the "sub-prime" borrowers, account for fewer than 20% of mortgages and home sales. However, the downturn in the US housing market has caused a large rise in defaults on sub-prime mortgages, causing a number of providers to file for bankruptcy. So far these problems have been relatively contained. Economic growth has continued in the US at a healthy rate and consumer and business confidence remains fairly upbeat.

Critical to the ability of the US economy to withstand the problems in the housing sector are the health of the employment market and the level of interest rates. A sustained downward trend in house prices, and the knock-on effects this would have in undermining consumer confidence, is unlikely to occur so long as US mortgage rates are at or near their peak, and unemployment remains low. Reasons for optimism that this will be the case include the facts that economies in continental Europe continue to recover, and emerging market economies such as China and India are becoming an ever more important engine for global growth.

Furthermore, although the US Federal Reserve has made comments to suggest that it is possible that inflationary pressures will lead it to increase interest rates further, it appears probable that rates are close to peaking. Although high resource utilisation is creating upward pressure on inflation, the year on year falls in energy prices and weakness in house prices give cause to be relatively sanguine about the outlook for inflation and thus interest rates.

Investors' complacency shaken

Among our main concerns entering 2007 had been the low level of risk premiums in markets and the tight correlation in the performance of different asset classes. Such conditions make it not only more challenging than normal to build a diversified portfolio, but also to be confident that the downside risks in asset prices is adequately discounted. Although the turbulence that affected financial markets in February and March was far from extreme, it did at least have the positive impact of shaking investors' complacency and thereby created a number of interesting opportunities. The following are some examples of this, and how we have taken advantage of it in the management of iimia clients' portfolios;

- Discounts to net asset value of many closed ended funds have widened and we have added to several of our favoured funds at highly attractive levels. A combination of rising discounts and an overloaded calendar of potential launches have begun to create resistance among investors to new issues. Against this background, some of the most interesting opportunities are appearing in funds issued around a year to eighteen months ago that have seen their share prices lag the progress made with their net asset values;
- Asset prices have become more volatile creating good opportunities for active managers to add value. These conditions particularly favour managers of small flexible funds managed by experienced investors in boutique firms. We hold a number of such funds, including those chosen for our clients' fixed interest exposure;
- The volatility in markets has caused the prices of some securities to be hit unduly hard, including the share prices

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of many companies producing commodities. The prices of most physical commodities remain buoyant and we have increased exposure to specialist funds in this area in anticipation of good performance.

Equities remain the asset class of choice

Equities continue to perform well compared with the other major asset classes, and they remain our asset of choice despite their superior performance to most other assets. The main reasons for this is their comparatively attractive valuations, and the fact that we do not foresee the economic conditions necessary for bonds to usurp equities as the asset of choice. While we expect global economic activity to slow, we believe that it will remain sufficiently strong to support a healthy level of corporate profitability. Certainly there are rising pressures on profits. However, this is to be expected given the longevity of the current economic cycle and the difficulty of increasing margins from already elevated levels. Companies are generally being disciplined about the use of their cash, illustrated by the way in which net purchases of US stocks in the form of buybacks by companies less new stock issued added 3.3% to the dividend yield in 2006 (Source: Dresdner). Furthermore, plentiful liquidity in the hands of the private equity industry continues to fuel a steady stream of takeovers, thereby partially underpinning markets.

Normally bull markets end when assets become clearly overvalued. Although there are expensive pockets within equity markets, as an asset class equities are good value. Nevertheless, with the bull market setting records in terms of its length if not its magnitude, we are being increasingly selective. In the UK market, we see best value at the large company end of the spectrum, and believe that the shares of mid-caps are less attractive as they reflect a lot of bid premium. Geographically we continue to favour Asian markets although our focus on particular industries on a global basis is of more importance. The lacklustre performance in recent months of growth specialist funds, specialising in areas such as technology, commodities and biotech has been used to add to positions. Conversely, positions have been reduced in some mainstream UK equity funds, particularly those invested in high yield stocks, where opportunities are becoming sparser following the sustained strong performance by value stocks.

In securing yield income portfolios we are favouring a combination of funds invested in overseas property and equity income funds, structured products and strategic bond funds. We continue to be wary of holding investments in traditional fixed interest funds. We anticipate that major government bond yields will remain trapped within a relatively narrow range, and with credit spreads at inappropriately low levels for the current stage in the cycle, it will be hard for all but the very best bond managers to achieve decent returns.

Investors remain in love with property

It would be negligent to write an investment review and outlook without commenting on the asset class that continues to grab most of the headlines - property. Property has strong attractions as an asset class, with good historic performance combined with a modest level of volatility. Moreover, unlike investment in most fixed interest securities, holding property also provides some protection from inflation through the ability to increase rents. Nevertheless, like any asset class, property goes through periods of undervaluation and overvaluation making it important to switch between different areas of the property market. We have been concerned for some time that most parts of the UK commercial property market offer very poor value for long term investors. Yields have steadily fallen, in many cases below the cost of debt, and prospects for rental growth are mixed.

The most vulnerable sector of the UK commercial property market, the retail sector, is also its largest. While buoyant profitability supports rising rents in the industrial and office sectors, the same can not be said of retail where there is an increasing number of store chains such as Jessops, HMV and Woolworths under severe pressure. The UK commercial property market is thus heavily dependent on liquidity support from money flowing into specialist funds. Currently the supply of liquidity remains plentiful. For example, statistics from the Investment Management Association reported in March showed that £4 billion had flowed into property specialist funds over the year ended 28 February 2007, more than the net sales of all the different equity fund sectors combined. Although an increasing number of commentators have cautioned about the high valuation of UK property, flows into property funds have showed no signs of slowing. Indeed, net inflows into property funds were over £400 million in the month of February alone, over £50 million more than the net sales for all equity funds. Surging liquidity could easily cause UK commercial property to move from being poor value to being even worse value. However, the combination of money influenced by fashion and chasing short term performance going into an asset class that is illiquid is a perilous combination.

We do however see value in property in some markets, and among the strongest contributors to performance in our funds in recent months has been from exposure to Japanese and German property. The attributes of the Japanese and German property markets are in many ways the mirror image of the worries we have about the UK property market. In other words, property prices are depressed rather than overheated, rental yields are above rather than below the cost of borrowing, and local sentiment is pessimistic rather than exuberant.

The Pound remains strong

Sterling has continued to be well supported, finding favour with global investors for its comparatively high yield. It has flirted with $2.00 to £, a level that we would be surprised to see breached for any sustainable period. Sterling looks very expensive on a purchasing parity basis, and once it becomes clearer that the UK economy is set to slow and the level of interest rates has peaked, the value of the Pound could decline quite quickly. The strength of Sterling has proved to be a considerable headwind for our overseas investments, but that headwind is now lessening in force, and could soon turn around quite suddenly.

Sterling has been a sideshow to the main attraction of recent months in currency markets which has been developments with the carry trade (borrowing in one currency to finance investments denominated in another currency). The favourite strategies for carry trade investors have been to borrow in yen and Swiss francs and invest in high yielding assets elsewhere. This has caused these currencies to become significantly undervalued, thereby setting them up for sharp rallies at times of nervousness in markets and from February 27 to March 5 Sterling fell by 6.6% versus the yen. A sustained unwinding of the carry trade remains one of the major risks facing investors as it would have a depressing effect on most asset prices.

CONCLUSION

We remain optimistic that financial markets offer sufficient attractive opportunities to achieve reasonable returns over the balance of the year, and it is encouraging to see shares making progress despite the downside risks that continue to threaten prices. It is impossible not to be troubled by developments in the Middle East, the danger of negative fall-out from weakness in the US housing market, and continuing signs of reckless exuberance in some areas of asset markets. It is therefore an environment to take some risks in investing for growth, but to have a prudent eye on the downside as well.

The opinions expressed here represent the views of the Fund Managers as at 12 April 2007 and should not be interpreted as investment advice. Past performance is not a guide to future performance.