

INVESTMENT OUTLOOK & REVIEW WINTER 2008

SUMMARY

IT IS OFTEN THE CASE THAT DRAMAS IN GLOBAL FINANCIAL MARKETS PASS BY THE MAN IN THE STREET. HOWEVER, 2007 WAS A YEAR WHEN A CREDIT CRISIS IN FINANCIAL MARKETS ALMOST CAUSED THE COLLAPSE OF NORTHERN ROCK AND EVEN MADE THE HEADLINES IN TABLOID NEWSPAPERS. THE CREDIT CRISIS WILL REMAIN THE PIVOTAL ISSUE AFFECTING THE WORLD ECONOMY IN 2008. CENTRAL BANKERS HAVE A DELICATE BALANCING ACT WHEN SETTING POLICY; THEY FACE A THREAT THAT THE IMPACT OF THE CREDIT CRISIS WILL CAUSE A RECESSION IN SOME COUNTRIES, WHILE ALSO NEEDING TO BE COGNISANT OF INFLATIONARY PRESSURES FROM HIGH COMMODITY PRICES. IN THE LIGHT OF THIS IT IS NOT SURPRISING THAT INVESTORS' CONFIDENCE HAS BEEN SHAKEN AND CAUTION ABOUNDS.

2007 - The Year of the Credit Crisis

Financial markets exist to price risk, matching the providers of capital with those that need it. If markets are functioning logically market prices of high risk investments should be such that they provide superior prospective returns compared with lower risk investments. Through this mechanism investors are matched with those seeking finance in line with their risk profile. However, until recently risk was being mispriced in large areas of global financial markets, a concern raised in several previous editions of this Outlook and Review. Two areas where this was most evident were global credit markets, with high risk bonds offering insufficient additional yield to low risk bonds, and the UK commercial property market, where many rental yields had fallen below the cost of borrowing. Warren Buffett once made an analogy about risk in financial markets when he remarked that it is only once the tide had gone out, that you can see who has been swimming without their trunks on. A rising tide of a bull market fuelled by easily available credit leaves few investors embarrassed, and causes many to misread short term profits as a sign of skilful investing rather than reckless risk-taking. However, once market conditions deteriorate and liquidity is withdrawn, investors quickly rediscover their appetite for low risk assets, and the market for high risk assets can evaporate overnight.

It was in conditions such as these over recent months that bosses of some major global financial firms including Citigroup have owned up to vast losses in credit markets before falling on their swords as fast as generals of a defeated Roman Legion. It has been extraordinary how quickly markets have moved from credit being freely available to a state in which even major banks have been unwilling to

lend to one another. The Bank of England's Monetary Policy Committee and the US Federal Reserve have both cut interest rates, and together with other central banks including the European Central Bank have injected liquidity into financial markets to offset the effects of the credit crunch. Despite these actions, the central banks have been only partially successful in restoring normal conditions in credit markets, illustrated by the fact that the rate of interest (LIBOR) that banks charge to lend to one another remains unusually high relative to the rates set by central banks. This has meant that the real cost of debt has increased for most borrowers even though some central banks have cut rates.

Against this background there are now widespread fears that the weakness of the US housing market which acted as the catalyst to start the credit crisis, will gather further downward momentum such that it tips the US economy into recession. In a number of important respects the US and UK economies are at a similar juncture. Weakness in their housing markets is undermining consumer confidence at a time when public and consumer finances are stretched, although currency depreciation and the strength of overseas markets have assisted exports. While it is unclear whether or not either or both of the UK and American economies experience a recession in 2008, it seems almost certain that economic activity will weaken. Despite lingering concerns about inflationary pressures this is likely to lead to steady downward pressure on interest rates through the year. Concern about the state of the US economy is already easing fears of over-heating in other key economies, notably the major emerging economies and continental Europe, and continuing growth in these areas should mean that the world economy continues to expand at a healthy rate in 2008. The comparative weakness of the UK and US economies and further cuts in interest rates are likely to keep downward pressure on the value of Sterling and the US dollar, although having had a wretched 2007 the US dollar's cheapness on a purchasing power parity basis should lend it some support.

Opportunities in credit markets

The turn in the interest rate cycle with the US and UK central banks reducing interest rates is supportive for fixed interest markets. Government bond yields have fallen since the summer, dramatically so in some areas such as short term US Treasury bonds, which benefit from a flight into safe liquid investments out of high risk assets. At current levels 10 year government bonds hold little attraction, with yields in the UK, US and continental Europe all below 5%, which is a measly prospective return, particularly bearing in mind the effect of inflation.

Although government bonds have little appeal at current prices, other areas in fixed interest markets offer more value than they have for a number of years. This is because the impact of the credit crisis has led to investors being more adequately compensated for accepting risk. The problems in the US subprime sector caused yield premiums over government bonds to widen sharply in most areas of credit markets. The balance of power has decisively shifted in favour of the purchasers of bonds from those needing to issue them. There are now excellent opportunities for skilful bond managers to achieve decent growth in capital in addition to attractive levels of income. As a result 2008 is likely to be the best year for a long time for good quality actively managed fixed interest funds.

Equity markets offer value for brave investors

Barely had some equity markets regained the heights from which they had fallen in 2000 than the credit crisis triggered renewed falls. For a number of the world's developed markets there have been large upward and downward moves on a frequent basis, but the absolute changes in the level of the market over the year have been surprisingly modest in most cases – "Full of sound and fury signifying nothing" to quote Macbeth. Of the developed markets, Japan has been the weakest, while continental European markets have mainly fared better than the US and UK. Emerging markets continued to perform strongly, notably the Chinese and Indian markets. Much of this strong performance can be attributed to strong



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growth in corporate earnings in emerging economies, but valuations have also improved so that emerging markets are now valued at a premium to developed markets, a fact that limits their potential further outperformance.

At a superficial level it is easy to make the case that equities are cheap. The valuation of most equity markets looks modest on the basis of price earnings ratios and dividend yields, although less so judged on price to book. Relative to government bonds equities appear exceptionally cheap, and in Japan the yield on the equity market is roughly equivalent to that of the 10 year government bond - something that has generally proved to be a strong buying signal in the past. The controversy therefore is not whether equities look cheap, but whether they are cheap for a good reason. In this respect, as with much else, the debate focuses on the outlook for the world economy.

Assessed on the simplest measure of price earnings ratio, the greatest risk to equity markets lies with the possibility that earnings fall short of expectations. This has already happened in some areas, notably the US financials sector, which on its own accounted for over 10% of the total profits generated by quoted companies in the world until recently. While a recession would prove very damaging to earnings, corporate profitability could also be undermined by pressure on margins as cost pressures are increasing at a time when margins are at elevated levels. Nevertheless, equities look sufficiently attractive to provide the basis for optimism that 2008 should be a positive year for most markets so long as the global economy continues to grow as seems most likely. With the exception of some areas of the financials sector which are raising new capital, in most areas of the world corporate sector is in good health. Corporate balance sheets are strong, and dividend cover is such that companies should be able to deliver growing dividends even though it is going to be a challenging environment for profitability. With equities now mostly conservatively valued, there is potential for stock markets to rally strongly on good

news, particularly as sentiment outside of emerging markets is cautious towards shares, as illustrated by record monthly outflows of money from equity funds (according to reports in the UK from the IMA in December). This backdrop gives the basis for believing that equities should be the strongest performing of the major asset classes in 2008.

Last year saw growth stocks begin to outperform value stocks, even though many specialist growth funds failed to capture the upturn in the fortunes of key parts of the growth stock universe (such as the technology sector) because the strong performance was concentrated in a relatively few number of large companies' shares. With emerging markets now looking fully valued compared with developed markets, it is going to be increasingly important to invest in the right stocks and sectors within markets rather than relying on a few top down geographic asset allocation calls to generate performance. It is probably now the case that some of the cheapest emerging markets shares are not the ones listed in emerging markets themselves, but the shares of companies listed in out of favour developed markets such as Japan, whose businesses are growing strongly on the back of their high exposure to booming economies like China.

Full circle in the property sector

Investor sentiment could hardly have been more positive towards UK commercial property going into 2007, and huge inflows of money kept the asset class performing strongly until the credit crisis caused an abrupt reversal. The severity of the downturn in the sector's fortunes has caused us to revise our previously negative stance even though the news-flow over the next few months will remain poor. Although official industry figures normally take some time to adjust to what is happening in the marketplace, the IPD figures released in mid-December showed that the capital value of all UK commercial properties fell by 4% in November, with the retail sector bearing the brunt of the falls, declining by 4.3%.

In recent weeks a number of the UK's highest profile fund management companies have hit their property fund investors with a double blow, writing down steeply the valuation of their holdings and placing restrictions on dealing such that some investors wishing to sell will have to wait up to a year for their money. The failure of many open-ended funds invested in physical property to fully keep pace with gains in the bull market, and then locking their investors in once markets have turned

down, is ample evidence to justify our negative view of investing in property in an open-ended structure.

Pessimism is now rife about the prospects for UK commercial property, and fears of further sharp declines are such that it has had a serious negative impact on the valuation of virtually all property companies and funds listed in the UK regardless of the quality and location of the underlying property portfolios. Even those property funds solely exposed to overseas markets where conditions remain favourable have seen their shares negatively impacted. While some investors are panicking, no doubt remembering the prolonged slump in property markets in the early 1990s, the comparisons with that time do more to supply comfort than they do to supply reasons for gloom. Certainly the economic conditions are more stable, the balance between supply and demand for property more favourable, and interest rates are much lower. Given the opaqueness of the outlook for the world economy, it is right to be careful, and shares in highly geared property companies and funds are risky. However, the indiscriminate sell-off has created some outstanding opportunities, particularly among the top quality UK real estate investment trusts, and funds listed in the UK with overseas property portfolios whose shares have been sold down in the panic to flee the property sector. One catalyst for a turnaround in the sector's fortunes could be corporate activity, with investors including sovereign wealth funds attracted by the distressed valuations placed on many property securities.

Commodity markets set for a quieter year

Most commodity prices had a strong run in 2007, and a number look vulnerable given the prospect of a slowing global economy and signs that some commodities including those in the agricultural sector have benefited from a surge in demand from investors. Less buoyant prices are likely to temper the share price performance of the commodity producers after a boom year in 2007. However, any significant weakness should be seen as an opportunity to buy for long term investors, given that the negative impact of a slowdown led by the "first-world" economies will be more than made up for in time by the rapid economic development of China, India and other emerging economies. The sovereign wealth funds from emerging markets are likely to be keen buyers of commodity assets on any weakness, illustrated by the rumours surrounding China's interest in preventing BHP acquiring Rio Tinto.



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One commodity that remains attractive despite its strong run is gold. Gold supply remains severely restricted, and dependent on selling by western central banks, while demand from emerging markets is growing in tandem with rising prosperity in emerging economies. Moreover, the value of gold as the one currency that is no one else's liability, a value derided by gold's detractors in recent years, has been borne out by the credit crunch.

A flight to liquidity

One of the effects of the sudden aversion to risk taking that took hold in the late summer and autumn was less a "flight to quality" and more a "flight to liquidity". In an environment in which credit was suddenly more difficult to obtain, those assets which were easily tradable were steadily upwardly valued compared with those which are hard to deal in. This was a trend seen across a number of different areas, such as the sharp fall in the value of UK commercial property and the sudden and significant underperformance of smaller companies' shares compared with those of large companies. As long as the financial market environment is characterised by risk-aversion, rather than risk-taking, it is hard to see this trend reversing in a general sense. However, some of the areas that have been de-rated have become sufficiently attractive to anticipate a strong recovery in 2008, with one area of particular interest being the closed ended fund sector.

Buy while discounts last

The closed ended fund sector had a disappointing year in 2007. The sector's performance was undermined by a combination of factors including the general de-rating of securities with limited liquidity. However, two other important factors hurting the performance of closed ended funds was the struggle of a majority of active managers to outperform benchmark indices, and indigestion in the sector caused by a surfeit of new issues. There have been a large number of specialist funds listed on AIM (the Alternative Investment Market) over the past two years, predominantly investing in hedge funds, overseas property and emerging markets. Many of these funds are poorly researched, and have relatively few large shareholders, some of whom show little indication of knowing much about the funds in which they have invested. Many of these holders have been indiscriminate sellers in recent weeks. Even though the performance of many of these funds has lived up to expectations their share prices have tended not to, falling to steep discounts to their net asset

value. The same has been true of many traditional investment trusts listed on the main London market, and there are now many investment trusts whose share prices stand at discounts in the high teens and in excess of 20% for the first time since the depths of the bear market in early 2003. Excessive discounts are having a cancerous effect on the rating of those trusts whose boards of directors are seeking to protect a stated narrow discount, and a number of trusts have abandoned the policy, quoting in their defence "unusual market conditions". In this environment those trusts that successfully continue to abide by their discount control mechanisms will increase the loyalty of their shareholder base, while those that fail to will leave themselves vulnerable to attack from arbitrage investors.

In view of the backdrop described above, 2007 was a challenging year for specialist investors in the closed ended fund sector. However, the prospective returns from the closed ended sector look exciting, with discounts returning towards the compelling attractive levels that prevailed in 2003, and less pressure on the ratings of existing trusts due to the difficulty in launching new trusts. There are likely to be many closed ended funds in 2008 which see a revival in their managers' performance relative to their benchmarks, a recovery in the fortunes of the specialist area in which they are invested, and a narrowing in the discount. Most overseas exposure should also benefit from further weakness in Sterling versus other currencies. Against this background investors are likely to look back in twelve months time and wish they had bought into the closed ended fund sector at wide discounts when they had the opportunity to do so.

Conclusion

Most investors seem cautious as they consider how their portfolios are positioned entering a New Year, and statistics show that flows into most areas of the fund industry have fallen sharply following the rising level of volatility in markets in recent months. It seems that most investors are waiting for conditions to settle down in markets before they make a decisive move. Economic statistics will be watched eagerly to see whether the US economy falls into recession and if weaker growth leads to an easing of inflationary pressures.

Nervousness among investors and a buyers' strike in many less liquid asset classes means that much caution has already been discounted. There are now

plenty of investment opportunities that appear to offer outstanding potential for strong returns, even though it needs to be recognised that until the full knock-on effects of the credit crisis have been revealed, it is necessary to accept a continuing high level of volatility in the next few months. However, by accepting the risk of short term losses investors can now establish positions that will do well in all but the most negative of scenarios for the world economy.

The opinions expressed here represent the views of the Fund Managers at 31 December 2007 and should not be interpreted as investment advice. Past performance is not a guide to future performance. Compliance number IMO02.



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