



Investment Outlook & Review

Autumn 2009

ON A YEAR TO DATE BASIS THE IIMIA DISCRETIONARY MANAGEMENT MODEL ASSET ALLOCATION HAS ADDED VALUE RELATIVE TO THE APCIMS PRIVATE INVESTOR INDICES; WHEN COMBINED WITH STRONG FUND SELECTION THIS HAS RESULTED IN CONSIDERABLE OUTPERFORMANCE RELATIVE TO THE INDICES. SIGNIFICANT CONTRIBUTORS INCLUDE:

- DIVERSIFIED FIXED INTEREST EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS ARE UNDERWEIGHT GILTS AND OVERWEIGHT CORPORATE BONDS.
- DIVERSIFIED EQUITY EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS ARE UNDERWEIGHT UK EQUITIES AND OVERWEIGHT INTERNATIONAL EQUITIES, IN PARTICULAR ASIAN AND EMERGING MARKET EQUITIES.
- STRONG STOCK SELECTION INCLUDING IMPRESSIVE OUTPERFORMANCE BY OUR CHOSEN ASIAN AND EMERGING MARKET EQUITY FUNDS, OUR HIGHER YIELDING STRATEGIC BOND FUNDS AND PROPERTY.

OUR CONTINUED BELIEF THAT LONG-TERM UK INVESTORS WILL BENEFIT FROM PORTFOLIOS WHICH ARE WELL DIVERSIFIED BY GEOGRAPHY AND ASSET CLASS HAS STOOD US IN GOOD STEAD SO FAR THIS YEAR, THE FOLLOWING REVIEW AND OUTLOOK GIVES AN INDICATION AS TO WHERE WE BELIEVE PORTFOLIOS SHOULD BE POSITIONED IN ORDER TO BENEFIT FROM A RECOVERY IN THE GLOBAL ECONOMY.

The third quarter of the year saw most of the major stock markets stage impressive rallies, continuing the rise in equity values started in early March, none more so than the UK where the FTSE 100 index recorded its best three months since its launch in 1984, rising almost 21%. Nevertheless, views on where the global economy is heading after such a rebound remain divided. For example, the major GDP figures show that many of the world's economies are now in a positive growth phase again, and in the case of the UK, "officially" out of recession. But this is just the numbers – economies have witnessed a huge contraction in their outputs since the start of the recession and it is likely to take several years for them to return to the pre-recessionary levels. Unemployment is still rising, whilst there is also a huge amount of spare capacity around the globe. These forces will serve to keep inflation low and global growth forecasts to remain very subdued and we might justifiably question the implied pricing of world stock markets against this background.

One notable difference with the markets is their improving ability to withstand the shocks of poor economic data, as investors' appetite for risk returns, but there is considerable polarity of opinion on how sustainable the recovery will

be. The VIX volatility index to which we referred in our last update is returning to near normal levels, implying improved investor sentiment in what appears to be a more certain world. We also know that governments and central banks have continued to work hard to restore normality to their economies, but the evidence to substantiate this is proving elusive and there is a risk that authorities, lulled by the return of GDP growth and fearful of inflation, may remove their loose monetary policies too quickly, and stifle the recovery. However, we must not forget that this rally follows what has been one of the most severe financial crises on record and it is a recovery founded on very weak economic fundamentals and corporate fragility. There is no doubt that all commentators agree we have entered a phase where thrift and reduction of debt are likely to be the norm for some considerable time. In this environment, one should question whether economic forecasts and corporate earnings can remain so positive.

There are, as always, investment opportunities to be exploited in any economic environment and that's still the case now, with conditions favouring several themes. One of these is investment in emerging countries and in particular those which are able to detach themselves from their reliance on the G7 economies and open new borders to trade, whilst having a banking industry that was relatively unscathed by the credit issues that affect the western banks. In the fixed income sector, there are still opportunities to invest in many attractively valued corporate bonds as investors look for sources of yield that are no longer available from cash

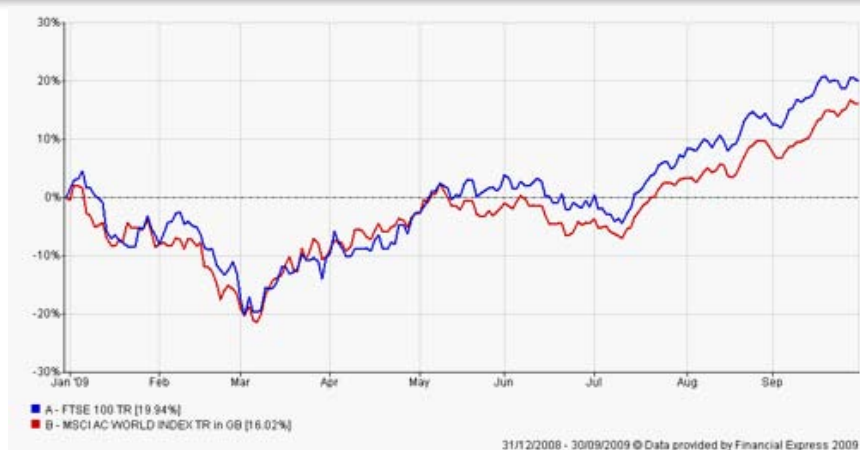


or government bonds today. Investors are also being well rewarded for buying certain more risky high yield bonds, although the choice of debt is more crucial at this end of the credit spectrum.

As confidence in the recovery continues, commodity prices should benefit as demand picks up and stock levels, which had been so drastically reduced in 2008, have to be re-built.

In addition, a weak US dollar should support this, but it will be specific commodities that see renewed interest. We might also witness some consolidation of the operators, especially as the biggest consumer, China, considers locking in its future supplies by acquiring mining companies. The risk to this model would be a further leg of contraction in the global economy.

United Kingdom



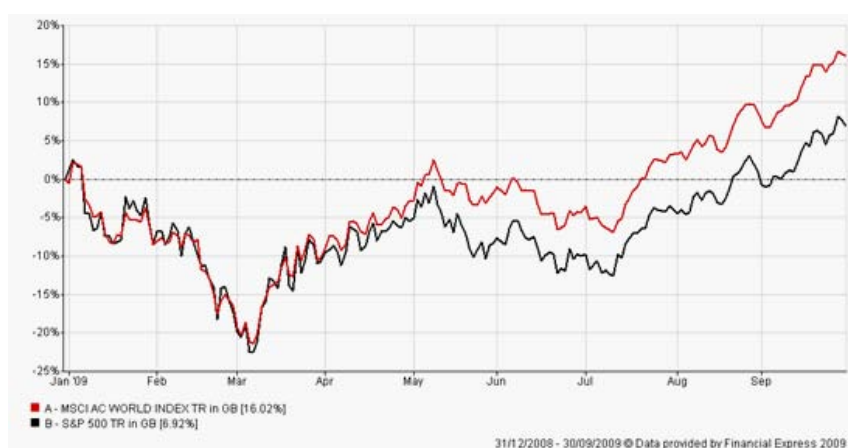
Economic data has stayed largely positive over the summer, with leading indicators improving and, one year on from the Lehman collapse, year-on-year comparisons over the next few months should look healthy.

But, and it is a very big but, the outlook for 2010 and beyond remains very cloudy. Reduction of debt must and will continue, the government (of whatever party) will have harsh and potentially damaging decisions to make, and, at some stage, interest rates must rise.

Many companies have produced results that have surprised analysts and the market. How much this is a one-off bounce from last year's depressed levels is a moot point and the fact that next year's forecasts have not been increased as a result is an indication of the caution still being felt.

UK plc will continue to suffer extremely tough trading conditions which could worsen in 2010. The FTSE, of course, does not reflect this as so much of its aggregate earnings come from overseas – where conditions arguably will be more promising.

United States

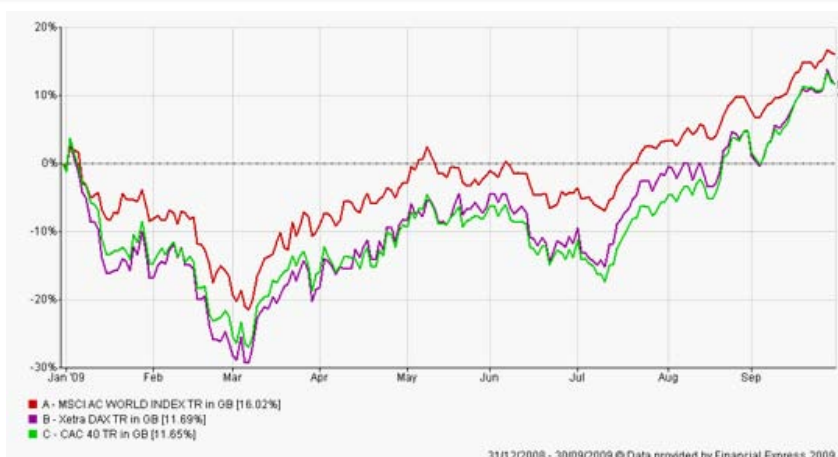


Whilst the global economy remains troubled, any sustained equity market recovery in the US is likely to be muted. Policy makers have done 'whatever it takes' to prevent the crisis from deteriorating further, and the infusion of cash has led to improved sentiment, and improving economic data. US companies appear to have adjusted quickly (as they traditionally do) to the changed environment and the corporate earnings season over the next few weeks will give the first indication of what the effects have been.

As elsewhere unemployment seems to be the key to the future course of interest rates, with some recovery in the figures necessary before the Federal Reserve will even consider raising rates. This is unlikely before the second half of next year at the earliest – with a knock-on effect on other economies around the world.

The market does not look expensive unless corporate earnings forecasts are overly optimistic, but is unlikely to make much headway until the economic outlook for 2010 and 2011 is clearer.

Continental Europe



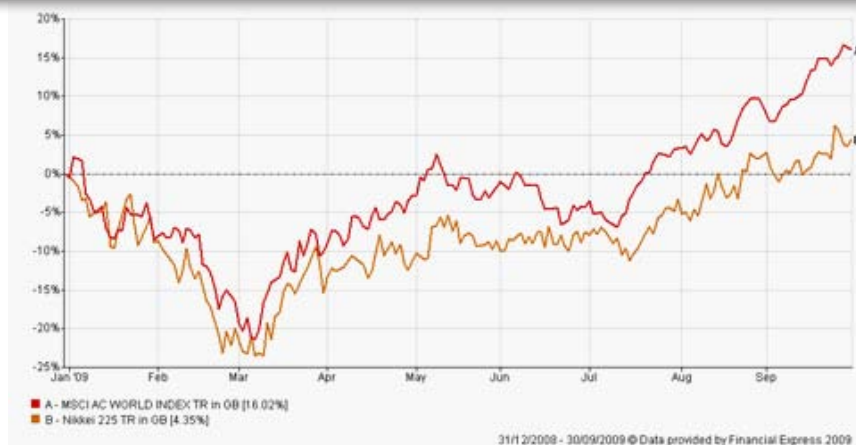
Over the summer there have been signs that Continental Europe was recovering (albeit patchily) from the depths of the spring. GDP growth was positive, just, in France, Germany and Poland. Like elsewhere, near zero interest rates have added to the liquidity being channelled towards equities (and bonds, where the doomsday scenario of default rates seen last autumn has not materialised).

Companies were much more nimble in emergency cost cutting last year than on previous occasions, and margins –

and thus profits – going forward should improve as a result. Valuations are not overstretched so better prospects for 2010 should lead to a further rise in share prices.

However, this is not a pan-European phenomenon. There remain major problems in Spain, Italy, Greece and some of the Baltic States, and rumours still abound that many European financial institutions, especially in Germany, need to write off considerably more bad loans than have previously been admitted. If true, this would probably put a brake on investors' enthusiasm in the short term.

Japan



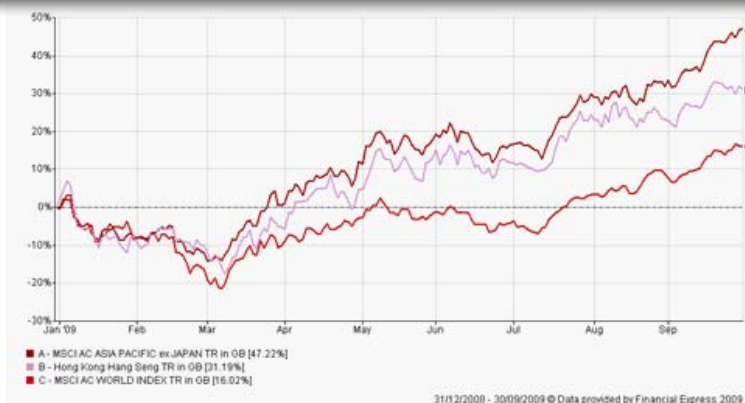
After several good months of performance Japanese indices declined in September. There were two main reasons why investors became more cautious. Most importantly the strength of the yen is testing the nerve of the newly elected government – their response, if any, is anxiously awaited. Also, as elsewhere in the area, very large stock issues, especially from the financial sector, are draining liquidity from the markets.

The new administration has not yet given any indication of future policy, although the appointment of a very experienced Finance Minister (Mr Fujii, aged 77) has been viewed positively.

Overall, economic statistics have been more positive, with improvements seen since the lows in the spring (for instance, capacity utilisation and exports have risen 28% and 25% respectively since the lows in February). GDP is officially forecast to grow 1% in 2010 (other forecasts are higher). However deflation remains, with consumer prices falling 2.4% year-on-year in August.

Investing in Japan has been soul-destroying for years. The market looks cheap on any normal valuation method but we still await the catalyst to excite global investors' interest.

Asia Ex Japan



China remains the key to the region's outlook in both the short and long term. Despite a severe correction in local Chinese markets over the summer the consensus medium to long-term positive case is still intact and growth rates for both corporate earnings and GDP in 2010 are being increased. However in the short term there is some debate as to how China can rein in the aggressive liquidity injection used to reflate the economy after last year's export and inventory implosion.

One consequence of China's desire to own or at least control strategic mineral assets has led to a re-rating of medium and smaller capitalisation resource stocks in Australia (the large companies now being considered 'off-limits' for political reasons – at least for the time being). The Australian economy has largely survived the global turmoil unscathed, with

corporate earnings rebounding sharply. Share prices have responded accordingly, leading to Australia being the first member of the G20 to raise interest rates in recent weeks.

Elsewhere in the area there are signs that retail investors are returning to markets, especially in Thailand and Hong Kong, attracted by (perceived) low valuations and longer term growth prospects. However the recent failure of several large new share issues in the Hong Kong market strikes a cautionary note. The appetite for risk has not yet returned to the levels seen before the crisis.

The area still provides the best growth prospects for both the medium and long term, albeit often with greater volatility than seen elsewhere.

Fixed income

We do not expect inflation in the USA, UK or Germany (as a proxy for Continental Europe) to increase by any meaningful amount in the short term, nor interest rates to rise significantly. The dangers of repeating Japan's mistakes of the 90's (leading to their 'lost decade') are too apparent. With those assumptions, Treasuries, Gilts and Bunds look good value, and managers rotate between the various markets as value appears. Bond returns in real terms (i.e. allowing for inflation) are the highest for many years (eg in the US, CPI is negative at -2.1%, long bonds yield 4.5%, giving a real yield of 6.6% - against a long term return on equities of 6%). However the supply of government paper has increased, and continues to increase, to levels where it is possible that a 'buyers strike' may ensue. Yields may have to increase to attract potential buyers (thus leading to lower capital values). This is not evident yet, but is an area that needs to be monitored closely.

For the same reasons (inflation and interest rates) mentioned above, corporate bonds continue to provide good value with yields still well above average. Prices, even of the highest quality names, collapsed during 2008, with yields suggesting a default level above anything seen since the Depression. There has been some recovery in prices in the first half of 2009 as investors accepted that the world was not going to end and that most major corporations were continuing to honour their obligations. This process should continue, albeit with credit analysis of individual issues now being done with considerably more due diligence than previously.

There are two caveats. It is still not clear if the pricing of corporate bonds on a day-to-day basis accurately reflects reality, and, linked with this, the huge inflows of cash into the sector worldwide could cause an unmanageable bubble should this trend reverse.

Conclusion

Going into the quarter, we maintained our well invested but cautious positioning. We have invested in asset classes that provide defensive qualities and funds offering a more strategic opportunity, especially given that bank accounts pay paltry rates of interest. Our investment strategy is being rewarded, even though we believe markets may struggle to maintain the pace of their rise. We are now entering a season of earnings reporting which will give strong clues as to how far corporate balance sheets have to go to return to full health

and whether forecasts of global growth for 2010 are realistic. If the fundamentals within businesses aren't present, and the recoveries in markets are based purely on money chasing prices higher as it looks for a home, there is a risk of a sudden shock which could lead to a dip in markets. We will therefore continue to focus on asset allocation to enhance returns within portfolios and invest in the funds of those managers that we believe demonstrate superior stock picking skills, and in themes that add good risk diversification.

