

INVESTMENT OUTLOOK & REVIEW SPRING 2008

"THE STRUGGLE OF TODAY, IS NOT ALTOGETHER FOR TODAY IT IS FOR A VAST FUTURE ALSO"
ABRAHAM LINCOLN

SUMMARY

THE OPENING MONTHS OF 2008 HAVE BEEN A WRETCHED PERIOD FOR MOST INVESTORS. FINANCIAL MARKETS HAVE FACED THEIR GREATEST CRISIS FOR MANY YEARS AND SEVERE PROBLEMS IN CREDIT MARKETS UNDERMINED INVESTORS' CONFIDENCE IN MOST ASSETS. WITH LARGE PARTS OF BOND, EQUITY AND PROPERTY MARKETS IN DISARRAY, INVESTORS FOCUSED ATTENTION ON THE FEW THINGS THAT APPEARED TO OFFER POSITIVE MOMENTUM AND SAFETY. COMMODITIES INCLUDING GOLD AND AGRICULTURAL GOODS WERE BENEFICIARIES OF THIS TREND, AS WERE SOME "SAFE-HAVEN" CURRENCIES SUCH AS THE SWISS FRANC.

ALTHOUGH FINANCIAL MARKETS HAVE BEEN IN A STATE OF CRISIS, THE SAME HAS NOT BEEN TRUE FOR THE WORLD ECONOMY. INDEED, WHILE SOME OF THE MAJOR DEVELOPED ECONOMIES HAVE SEEN A SIGNIFICANT SLOWDOWN IN THE RATE OF GROWTH AND THERE IS SPECULATION THAT AMERICA IS NOW IN MILD RECESSION, MUCH OF THE WORLD HAS BEEN CONTINUING TO GROW STRONGLY. AGAINST THIS BACKGROUND INVESTORS ARE FACING A DILEMMA. TO WHAT EXTENT IS THE CRISIS IN FINANCIAL MARKETS FORESHADOWING A SEVERE GLOBAL ECONOMIC SLOWDOWN THAT JUSTIFIES THE WEAKNESS IN ASSET PRICES, OR IS THE FALL IN ASSET PRICES OVERDONE IN THE LIGHT OF ECONOMIC FUNDAMENTALS AND A TREMENDOUS OPPORTUNITY TO BUY?

The credit crisis

No one assessing the investment outlook should start anywhere other than the crisis in credit markets. The crisis started last summer with problems in the US subprime mortgage market (mortgages to those with substandard credit records). A rapid escalation in the level of bad debts in US subprime mortgages acted as a catalyst to reverse the confluence of factors that had led to exceptionally benign conditions in credit markets over a long period. The virtuous, if perilous, cycle of increasing risk appetite, higher borrowing and easily available credit supported speculative investment across asset markets. This drove down yields on UK commercial property and corporate bonds to exceptionally low levels compared with those of "risk-free" government bonds. Problems in US subprime mortgages triggered selling by investors such as hedge funds and investment banks, many of whom were caught out with high levels of borrowings tied up in investments whose prices were in free-fall and proving increasingly illiquid. In recent months this selling became a self-perpetuating negative spiral, with losses creating margin calls leading to yet more selling and the collapse of a number of hedge funds. This negative spiral of selling and poor liquidity forcing further selling and worsening of the problems in the financial system has been a critical issue over recent months, and restoring confidence in markets to arrest this trend has been a major concern for the authorities and the motivation behind their actions to shore up Northern Rock in the UK and Bear Stearns in the US.

The rapid and decisive action by the global authorities to the credit crisis has been encouraging. This has included substantial actions by the monetary authorities led by the US Federal Reserve, and tax cuts in America to help the beleaguered consumer suffering from a sharply weaker housing market and high oil prices. The Chairman of the Federal Reserve, Ben Bernanke, is well known for being a student of the authorities' mistakes that led to the great depression in the 1930s. In the light of this it is not surprising that Bernanke is showing that he is far more likely to risk stoking inflationary pressures than being caught at the helm during a deep and painful recession.

One issue that the authorities have had to face is the declining potency of monetary policy. Although the Fed has cut US rates from 5.25% to 2.25% since September 2007, 30 year mortgage rates are hardly changed and high yield bond rates have actually risen by around 2%. This means that the cost of borrowing for most borrowers has risen rather than fallen during a period when official interest rates have been reduced sharply. Nevertheless, by slashing interest rates the Fed has been creating the conditions necessary to restore the profitability of the banking sector which is the necessary prelude to unblocking what one commentator termed the "constipation" in the financial system. Moreover, the Fed has also employed a number of direct actions to help the financial system, including providing guarantees to embolden JP Morgan to take the risk of rescuing Bear Stearns from bankruptcy. In another step, Bernanke employed a clause in the Federal Reserve Act to provide liquidity to Wall Street broker-dealers who are normally legally barred from borrowing directly from the Fed.

Despite the authorities' steps to restore confidence even those securities such

as secured loans which are among the least risky form of debt instrument, fell in value by unprecedented amounts within a short period. The credit crisis affected equity markets, albeit not in a directly proportional way to the price movements in bond prices. This was because liquidity issues rather than rational assessments of valuation drove prices. The weakness in credit markets hit equity markets in a number of ways. With corporate bond yields rising, the implied current value of future earnings and dividends was reduced, whilst deteriorating conditions in credit markets halted the boom in private equity led merger and acquisition activity. Equity markets were also not immune from the negative liquidity issues which undermined credit markets. Not only were some hedge funds forced sellers of equities, but also the rapid deterioration in investors' sentiment has had a negative impact on flows of funds into retail investment products, leading to an usually high level of net redemptions.

The credit crisis and the economy

It would be foolish to discount the risk that the credit crisis will linger, and that it will undermine economic growth across the world. Nevertheless, it is too easy to write off the global economy. A number of things suggest that the global economic boom of recent years is also far from over. For example, commodity prices have had their strongest start to a new year since 1957 notwithstanding pullbacks in late March. The Reuters/Jefferies CRB Spot Index measuring a range of commodity prices rose by 12% in one month alone (February), and the latest strength in prices comes on top of advances in key commodity prices recorded in 2007. While demand for commodities from investors disenchanted with the performance of other assets must have played a part in the sharp price rises of commodities, these gains would not have occurred without continuing demand fuelled



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by robust global economic activity. Moreover, even in the UK which has been one of the worst affected countries by the credit crisis, economists are not forecasting a recession. UK economists' forecasts for growth in 2008 range from a low of 1.2% to a high of 2.1%, while growth forecasts for 2009 range from 1.5% to 2.7% (source; HM Treasury). Nevertheless, the Bank of England has reacted to turmoil in markets by reducing interest rates, although nothing like as much as in the US. Not only is the Bank of England inhibited by having an inflation target (unlike the US Fed), but Mervyn King, Governor of the Bank of England, commented recently that "The heart of the problem is not in the real economy; it is in the financial sector itself."

With reasons to suggest that emerging market economies continue to grow strongly, it is hard to foresee the extremely negative economic conditions that would be necessary to justify a worsening bear market in financial asset prices. A dramatic fall-off in US consumer demand is the chief risk to the economy, although this would take a worse deterioration in the employment situation than most commentators are currently anticipating. In the near term the main threats to bond and equity prices come from continued turmoil connected with the process of unwinding positions within the banking and hedge fund community. More spectacular collapses of hedge funds like those managed by Peloton Partners and The Carlyle Group are possible if not probable. While the fragile state of the financial sector in developed markets and the weak state of the US consumer are concerns, there are a number of powerful positive factors. The continuing strength of emerging economies has led to huge pools of liquidity in Sovereign Wealth Funds, which provide a stabilising influence in markets. Moreover, balance sheets of the corporate sector are generally far stronger than they have been prior to other cyclical economic slowdowns. The robust health of most of the corporate sector and gloom in financial markets which has driven share prices lower has led to a burst of buying of shares by directors in their own companies. This buying is currently running at an unusually high level in terms of buys versus sells, and suggests that those closest to their businesses do not share the financial community's downbeat assessment of their prospects.

Currencies

One of the effects of the turmoil in credit markets has been substantial movements in the relative values of currencies. Those countries at the heart of the credit crisis such as the US and

UK have seen their currencies fall sharply in value, while safe haven currencies with stronger fundamentals such as the Swiss franc, euro and the yen have gained in value. The flight from higher risk investments has had a particularly adverse impact on some small nations' currencies, such as the Icelandic krona. Currency traders have refocused their attention on fundamental supports such as current account balances, rather than the illusive attraction of higher interest rates in the carry-trade.

We have been pleased to see the steady decline in the value of sterling, given that anticipating a weakening pound has been part of our investment strategy for some time. The one major currency that the value of sterling has been fairly stable against has been the US dollar, which says far less about the merits of sterling than it does about the fact that global investors have struggled to determine which out of the UK and US currencies is the least attractive. Following such pronounced weakness in recent months, it would be surprising to see sterling fall sharply on a trade weighted basis over the balance of the year. However, with a less rosy outlook for the UK economy than for most other developed economies, and UK interest rates likely to fall further, we would still expect to see sterling fall modestly from current levels on a twelve month view.

A major reason for the strength of some commodity prices, notably gold, has been their attraction as a store of value compared with paper currencies. The liquidity crisis affecting global financial markets has meant the share prices of small and mid-cap gold mining equities have not done as well as expected given the sharp rise in the price of the underlying commodity. While this trend may persist for a while, gold mining equities have considerable upside should the current gold price be sustained around its current level, as such we continue to believe that exposure to the sector has a place in a diversified portfolio.

Investment opportunities

It is almost certain that a sustained rally in financial markets will need to be led by an improvement in conditions in credit markets, meaning that bonds now offer some of the best opportunities on a risk reward basis. At the moment the focus of investors' attention is on the short term. Investors react to bad news by selling bonds and equities, or at the very least delaying investing cash into financial assets. Whilst the outlook is unusually opaque, what is not opaque is the certainty that at some stage investors will be faced with a situation whereby low risk assets such as cash and government bonds are deemed to offer

unacceptably low returns and money will flow back into equities, corporate bonds and property. As a result, we believe for those able and prepared to tolerate the risks of losses in the short term it is worth buying into high quality financial assets set to be the targets of investment once sentiment improves. The history of financial markets shows that timing turns in markets is notoriously difficult, and the best buying and selling decisions are almost always those based on fundamental value rather than those seeking to time movements in markets. So what are some examples of the areas of greatest value in world markets?

As stated elsewhere in this document, we believe that the fixed interest universe offers its greatest value in many years. However, it is important to be selective, particularly since yields on government bonds have fallen to levels that make them unattractive. Indeed, real yields on US index-linked treasuries are now negative, meaning that holders will see the value of their investment eroded adjusting for inflation. The poor value of government bonds makes them vulnerable to further rises in the level of inflation, but low yields (for example the US 10 year Treasury yields less than 3.5%) are mainly a reflection of the huge risk aversion in markets and investors' quest for safety. The flip side to the logic that investors are now over-paying for security is that they are now getting over-paid for taking risk. This has encouraged us to place more money with experienced bond managers such as James Foster of Artemis and Paul Read and Paul Causer of Invesco Perpetual. These managers were rightly cautious about fixed interest markets last summer, but in recent meetings have been more enthusiastic than we can remember about the opportunities they are finding in their investment universe.

Equity markets offer greater upside than fixed interest securities, notwithstanding that conditions will need to improve in credit markets before equities can mount a sustainable rally. Although the financials sector has been the hardest hit in developed markets, we do not believe that it is necessarily the sector with the most recovery potential. The problems in the financial sector are deep-seated, and although many individual financial companies' shares are undoubtedly undervalued, the rapid disintegration of shareholder value in Bear Stearns shows that the credit crisis has made financial companies' stock-specific risk unusually high. Instead, we see some of the best value in equity markets at the moment in those shares with strong and relatively stable fundamentals that have been sold off because of investors' general

aversion towards equities. Corporations in many sectors are experiencing difficult conditions, with a squeeze on margins and weakening demand. However, a substantial setback in profits appears unlikely and this has left the earnings yield on markets (inverse of the price earnings ratio) looking abnormally low relative to the yield on government bonds. The prices of many funds investing in growth stocks and emerging market specialists have come back sharply in recent months, and while a weaker global economic environment will make things challenging for most companies, it should in time actually enhance the valuation of those sectors and companies, able to deliver decent profits growth. Even in the case of energy, which is one of our favoured sectors in the equity market, share prices have been comparatively lacklustre given the backdrop of a very strong oil price, thereby creating an attractive opportunity to invest.

The share prices of many investment trusts have been hit particularly hard in the poor markets of recent months. As a result of this it is now possible to buy investment trusts specialising in some of the most depressed and attractive areas of markets at deep discounts to their net asset values. While the whole investment trust sector is not as undervalued versus broader markets as it was prior to the low-point in markets in March 2003, there are pockets of huge value. These include funds investing in technology companies' shares, UK and overseas commercial property, Japanese equities, private equity and UK smaller companies. We have made purchases in all these areas in recent weeks.

Property

UK property companies' equities were particularly poor performers in 2007, and were weak before the general fall in share prices that followed the worsening of the credit crisis around the turn of the year. The IPD UK Commercial Property Index fell by 7.7% in 2007, although this was reduced to a loss of 3.4% including income. However, this relatively modest loss hides a much greater fall of 13.5% since June, when the market reached its peak. Reflecting these falls, the yield on all UK commercial property has risen to over 5.3% from a low of around 4.5%. Despite a decent recovery in the share prices of some UK property companies, they remain at substantial discounts to their net asset values, reflecting the negative view held by most investors about future changes in capital values. The yield on UK commercial property implied by the discount on the quoted property sector is around 6.3% (source; Thames River), a yield not seen since

mid-2004. Obviously, forthcoming supply and the security of rents have become increasing concerns given the harsher economic climate. However, new supply is relatively modest in most areas, and although we have worries about the important retail sub-sector of the UK commercial property market, we believe that the level of voids on rents is now largely discounted in current valuations.

The ability to apply leverage is more important to the property market than most others. A rapid return to boom conditions in the property sector seems improbable given that the environment is likely to be one in which investors are more cautious to borrow, and lenders more reluctant to lend. Nevertheless, the yields on good quality commercial property relative to cash rates and government bond yields are sufficiently attractive to have made us more positive about commercial property investments when they can be accessed via the stock market at substantial discounts. It is important to be highly selective, and we continue to recommend avoiding open-ended property funds most of whose managers are struggling to manage their portfolios due to needing to deal with high levels of redemptions.

Property companies and property funds quoted in the UK, many of which provide exposure to overseas markets that have stronger fundamentals than the UK, are an area of particular opportunity at the moment. The share prices of these companies and funds have been dragged down by negative sentiment from UK investors towards anything to do with property, even when the property concerned is overseas. The activist investor Laxey, well known for its attempt to break up British Land in 2002, has renewed its interest in the quoted property sector, raising a fund called Terra Catalyst to release value from property companies and funds whose shares are trading at deep discounts to their appraised values.

Conclusion

Problems in credit markets have proved to be more deep seated than we had anticipated. Not only has this caused the setbacks in financial markets to be more severe than we had expected, but it has also meant that there has been significant collateral damage to a global economy already entering a cyclical slowdown. We believe that the impact of the credit market crisis will be felt for some time to come, and economic conditions will be challenging, particularly in developed economies such as the UK and US that are encumbered with deeply indebted consumer and business sectors. Nevertheless, such is the level of

pessimism now reflected in many asset prices that those investors prepared to buy or hold financial assets and property through the economic turbulence ahead should be rewarded well for doing so.

One of the most important disciplines for successful investing is to be able to assess valuations not just in the light of what is known, but what can reasonably be thought to be discounted in prices for future news. All investors react to events, and rightly so. However, many forget that when news is gloomy and financial markets are a struggle, investment is both for and about the future, rather than being for and about today. It is because of this, that time and time again over the years the very best times to invest have proved to be when it is most nerve-wracking to do so. It is for this reason that this Outlook and Review started out by quoting similar sentiments in the memorable words that President Lincoln wrote during the American Civil War "The struggle of today, is not altogether for today it is for a vast future also".



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