INVESTMENT OUTLOOK & REVIEW – AUTUMN 2007

SUMMARY

RECENT MONTHS HAVE BEEN A TURBULENT TIME FOR INVESTORS. AN ESCALATION OF PROBLEMS IN THE US SUBPRIME MORTGAGE MARKET TRIGGERED A CHAIN OF EVENTS THAT CAUSED CHAOTIC MOVEMENTS IN ASSET PRICES. WITH LEVERAGED INVESTORS RUSHING TO SELL, THERE WAS A FLIGHT INTO SAFE LIQUID INSTRUMENTS. THIS LED TO WILD MOVEMENTS IN FINANCIAL MARKETS. LIQUIDITY SUDDENLY EVAPORATED FOR LOW QUALITY FIXED INTEREST SECURITIES, WHILE THERE WAS A SURGE IN DEMAND FOR SHORT-DATED US TREASURY BILLS WHICH SENT THEIR YIELD PLUNGING TO 2.51% ON 16 AUGUST, LESS THAN HALF THE LEVEL OF THE FEDERAL FUNDS RATE. THE US FEDERAL RESERVE ACTED DECISIVELY TO RESTORE CONFIDENCE, CUTTING THE DISCOUNT RATE BY 0.5% THE FOLLOWING DAY, A MOVE THAT TRIGGERED A SHARP RELIEF-RALLY. SINCE THEN EQUITY MARKETS HAVE CONTINUED TO RECOVER AND MANY EMERGING MARKETS HAVE MOVED TO NEW HIGHS. HOWEVER, CONFIDENCE IS FRAGILE WITH INVESTORS NERVOUSLY WAITING TO SEE WHETHER THERE ARE FURTHER HORROR STORIES TO BE UNCOVERED IN FIXED INTEREST MARKETS, AND IF THE SHOCK TO THE FINANCIAL SYSTEM WILL HAVE SERIOUS KNOCK-ON EFFECTS ON ECONOMIC ACTIVITY.

A crisis hits credit markets

It is often said that the two main emotions driving investors are greed and fear. Asset prices are frequently driven to excess when one emotion gets the upper hand for an extended period of time. Over a number of past editions of iimia's Investment Outlook and Review we have raised concerns that investors in credit markets have been unduly complacent. The gap between the yields of low quality bonds and government bonds had been very narrow for so long that many came to regard it as the "new norm". This state of affairs relied on the belief that sophisticated financial instruments spread the risk among sufficient investors to justify low risk premiums because defaults would be broadly diversified across a large number of counterparties. However, we felt investors were being paid too little to compensate for additional risk, although it was impossible to judge when risk premiums would increase, or what the catalyst for that would be.

Two years ago Dr. Alan Greenspan in a speech to fellow central bankers said "Any onset of increased investor caution elevates the risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supports higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums." (Jackson Hole 26 August 2005). While this warning was two years too early, it proved prescient. The reason the crisis in credit markets became severe enough to cause a run on the Northern Rock Bank in the UK was because financial institutions around the world suddenly lost confidence in the valuation of debt instruments, and were unaware where problem loans resided. With huge uncertainty about the extent of the problems, banks became unwilling to lend to one another, which proved particularly damaging for those financial institutions such as Northern Rock which are most dependent on money markets for their capital needs. Against this background many leveraged hedge funds were forced to close down investment positions at distressed prices.

iimia plc

The US Fed and European Central Bank (ECB) quickly injected liquidity into markets to restore confidence, although the Bank of England initially resisted this policy. The Bank of England was keen that those that had taken irresponsible risks paid the penalty for their actions, although the threat of the run on Northern Rock snowballing into a full-scale banking crisis in the UK forced them to follow the lead set by the ECB and Fed.

Ramifications of the credit crisis

We are currently too close to the start of the credit crisis to properly assess its consequences for the prospective performance of financial markets with any degree of certainty. The critical issue will be to gauge how far problems in credit markets might hurt the international economy. With banks no longer so keen to lend, consumers in the US and UK struggling to service high levels of debt, and the US housing market in a depressed state, significant components of the engine that has driven the American and UK economies are now misfiring. Much will depend on the ability of continental European and emerging market economies to decouple from the US slowdown. So long as the US slowdown remains just that, a slowdown rather than a recession, then the strong likelihood is that the world economy will continue to grow at a sufficiently supportive rate to keep financial markets in reasonable health. The quick response of the world's leading central banks to the credit crisis, and initial signs that they are being effective, give grounds for optimism. Emerging market economies are also in rude health, and corporate balance sheets are generally far stronger than in 2000 when the technology bubble burst. Nevertheless, recent meetings with bond managers and derivative specialists have indicated that problems in the banking system are severe, and likely to persist for some time. In this environment not only are financial markets likely to remain volatile, risks to economic growth forecasts are skewed to the downside.

Reassessing asset allocation

It is always important at times of violent movements in markets to reassess investment strategy even if the outlook is currently abnormally uncertain. A central plank of our investment strategy has been based on the view that the economic environment strongly favoured investment in equities compared with fixed interest. There have been a number of threads to this view, the justification for some of which have been challenged by recent events. In particular the dramatic falls in the prices of some fixed interest securities and UK commercial property funds relative to the continuing fairly robust performance of equities has tempered our strong preference for equities relative to other assets.

The period 1981 to 2003 was a golden one for fixed interest managers. Bond yields steadily fell in most markets with only brief interruptions. The UK 10 year Gilt's yield fell from 16%, to just 4% in early 2003. Since then bond managers have found it hard to make money, especially since the excess yields offered by low quality bonds versus government bonds has been very small. However, events over the last few weeks have changed all this. Partly this has been due to the sudden change in the outlook for interest rates. Not long ago there was speculation that the US authorities would increase interest rates to choke off inflationary pressures, and further rate increases in the UK were seen as virtual certainty. However, the US Fed Funds rate was cut by 0.5% on 18th September to restore confidence in credit markets and to try and arrest the tailspin in the American housing market. Against this background the prospect of higher rates in the UK has receded to be replaced by the possibility of rate cuts. The combination of a weaker economy and falling rates is normally bullish for bond investors.

There are also technical reasons to be more positive about fixed interest due to the impact of the US sub-prime mortgage crisis. Investors who previously gave no regard to risk have been fleeing from all but the very safest of investments. This has led to a surge in credit spreads (the premium yield over government bonds). In some risky areas this increase in spreads is justified, especially if the economic climate chills. However, the doubling in the spreads between high quality investment grade bonds and those of gilts within a few weeks is implying a level of risk last seen in the bursting of the "TMT" bubble when many companies were going bust. In short, the US sub-prime mortgage crisis has created a plethora of opportunities for seasoned bond investors who have the skills to take advantage of volatile conditions. We have therefore been increasing positions in actively managed bond funds that have flexible mandates to seize on the current rich vein of opportunities to be found in the corporate bond market. For the first time in a long while it appears there are sufficient opportunities for bond managers to achieve some growth in capital as well as delivering income.

Of course there are downside risks to the positive outlook for fixed interest markets. Chief among these is the fact that stubbornly strong inflationary pressures remain in the world economy which may limit the ability of the western central banks to ease monetary policy much further. Rapid growth in emerging economies such as China is continuing to buoy commodity prices and it will take some time for the weakness in the US housing and retail sales to feed through to a

general abatement in global inflationary pressures. It would be foolhardy to deny the threat posed by inflation to financial markets in general, and some commentators have interpreted the sharp rise in the price of gold as a sign of higher inflation ahead. However, it would take a sustained upturn in the rate of increase in wages to cause a serious rise in inflation and wage rises remain subdued in developed markets.

Opportunities in equity markets

One of the consequences of central banks boosting liquidity to restore confidence in credit markets has been fuelling further those areas of asset markets that were already performing strongly. Reflecting this trend share prices in emerging markets and many commodity prices have shot higher after a brief period of weakness during the initial stages of the credit crisis. Emerging markets have benefited from the combination of the strong long term story for their economies, and in the shorter term due to the fact that they have been largely escaped the credit issues that have unsettled developed economies. The combination of continuing strong growth in emerging economies and firm commodity prices is hard to reconcile with fears that the US is about to plunge into recession and drag the rest of the world with it. On this basis we continue to believe that commodity related funds are attractive and are emphasising Asia within the emerging market universe. However, we are conscious that the strong valuation case for emerging markets relative to the rest of the world is less compelling than it was. Although more challenging times in developed economies justifies caution about smaller companies following several years of strong performance, small and mid-cap commodity stocks would appear to be an exception given that they fell sharply in the market correction and have been relatively slow to recover. This trend has been typical of recent markets in which there has been a flight to liquidity. In other words, with things so uncertain investors are prepared to pay up for the ability to trade with ease.

Successful investment within developed markets is likely to become increasingly stock specific. Profit downgrades are likely to become more commonplace and merger and acquisition activity will be a less important driver for markets. The private equity led takeover boom relied heavily on the strong appetite for risk in credit markets and has thus been hit hard by the credit crisis. This can be illustrated by Home Depot's recent sale of its construction-supply business. The original sale price was set at $10.3 billion of which bank debt was going to be $8.4 billion. The price was cut by almost 20% (to $8.5 billion) after the shake-out in markets, and the banks reduced the amount they were prepared to lend to $4.8 billion of which Home Depot itself had to guarantee $1 billion. Taking this guarantee into account the gearing ratio fell from 5.5 times to 2.3 times.

The likely reduction in takeover activity and increasingly difficult economic environment both serve to diminish the attractions of mid and small cap stocks relative to large cap stocks in most sectors and markets. Large companies' shares are valued at a substantial discount to those of small and mid-cap companies in most markets. Large caps have begun to outperform, and in the UK this trend is being given added impetus by the weakening trend in Sterling's value against most major overseas currencies. With iimia's clients' portfolios relatively highly exposed to overseas investments and large companies' shares these trends should prove helpful for performance. One other encouraging sign is the improving relative performance of growth shares. For example, the technology sector held up well in most markets during the worst of the falls and has also been participating in the subsequent rally.

Towards the end of September the Japanese stock market showed signs of recovery after a prolonged period of dismal performance. Economic indicators in Japan have generally been disappointing in recent months, and the unexpected resignation of the Prime Minister Mr Abe was the culmination of a negative sequence of political events that has depressed the market. Nevertheless, with expectations about the prospective performance of Japan having now reached such a low level it is possible that returns will surprise on the upside. The comparative valuation of the Japanese property and smaller companies sectors look favourable compared with those in other developed markets and should rebound strongly once sentiment improves. The attraction of the smaller company and property sectors contrasts with the position in most other developed countries, reflecting the fact that Japan is at a totally different stage of the economic cycle.

Closed-ended funds fall victim to the flight from risk

Avoiding higher risk areas of credit markets and favouring equities over bonds have proved successful strategies in the management of iimia's clients' portfolios. However, the knock-on effects of the credit crisis have had a more significant impact on portfolios than we had anticipated. This has primarily been because the setback in markets has had a disproportionately negative impact on the prices of many closed ended funds. While this has hurt the performance of iimia's funds, it has created numerous opportunities to buy into attractive areas at low prices. Purchases have included adding to commodity related closed ended funds, and those specialising in growth stocks. While the disappointing performance of many closed ended funds was largely a reflection of widening discounts to net asset value, it was exacerbated by the impact of gearing in many cases. The worst damage to iimia's funds has been from the weak performance of our exposure to the Japanese property market which was accessed through a geared fund. The seriousness of the setback in the US housing market has tempered investors' views of property in most global markets, even those like Japan which are at a very different stage of the cycle to western economies. Looking ahead while a positive impact from the use of gearing by closed ended funds is obviously dependent on a sustained improvement in markets, improving relative performance from narrowing discounts should occur in most market conditions. Poor investor sentiment has caused the discounts of many investment trusts to widen to levels at which they are supported by share buybacks. This means that the upside versus downside risks in buying at current levels is firmly skewed in investors' favour.

Property

One area where discounts on closed ended funds have widened particularly dramatically has been the UK commercial property sector. While we have been cautious about UK commercial property for a while, it has been hard not be taken aback by the suddenness of the deterioration in sentiment among investors. For some time we had been concerned that property yields were too low relative to borrowing costs. This fact was the fundamental issue behind the setback in the sector, although the catalyst seems to have been a change in the supply and demand dynamics in the marketplace. A number of property companies sought to realise properties taking advantage of buoyant market conditions. However, once buying demand was satiated it became increasingly apparent that property values were vulnerable. The crisis in credit markets, served to further damage sentiment. Not only has debt financing for property projects suddenly become more difficult to arrange, but the damage done to financial companies' profitability has undermined forecasts for rental increases. Against this backdrop high profile open-ended funds that had been recipients of vast inflows from investors were forced to change the pricing basis of their funds to cope with outflows. The movement of UK commercial property closed ended funds from premiums to large discounts mirrored this souring of sentiment.

The immediate outlook for UK commercial property is unclear for even the most experienced experts. For example, Chris Turner of Thames River recently commented about his TR Property Investment Trust "We have taken a decision to bed down the portfolio in what we think are low risk assets on the basis that we have an insufficient view of what the credit crisis will mean for the asset class." (Fact Sheet September 2007). While uncertainty is notoriously unhelpful for investments, it has led to such an indiscriminate sell-off in share prices across the property sector that some attractive opportunities have emerged. Among these are the off-shore listed closed ended UK commercial property funds, which have been de-rated from significant premiums to large discounts. Shares in some of the best quality of these trusts can now be purchased at discounts around 20% with yields around 6%. For long term exposure to property these trusts appear highly attractive even if their performance is likely to be dull in the short term.

Conclusion

The current outlook for financial markets is unusually opaque. The world's leading central banks are struggling to set monetary policy that both prevents a renewed crisis in credit markets, but simultaneously avoids the risk of taking the lid off inflationary pressures. In these conditions it would be foolhardy to take extreme views when economic trends are uncertain. Against this backdrop we are holding well diversified portfolios and focussing exposure on those areas where valuations look most attractive relative to downside risks.

The opinions expressed here represent the views of the Fund Managers at 28 September 2007 and should not be interpreted as investment advice. Past performance is not a guide to future performance.