

INVESTMENT OUTLOOK & REVIEW – SUMMER 2007

SUMMARY

THE MAIN DEVELOPMENTS IN GLOBAL FINANCIAL MARKETS OVER RECENT MONTHS HAVE BEEN A SHARP RISE IN BOND YIELDS AND THE DECISIONS BY SEVERAL COUNTRIES' CENTRAL BANKS TO INCREASE THEIR OFFICIAL INTEREST RATES. WITH LOW BORROWING COSTS BEING A KEY DRIVER FOR RISING ASSET PRICES IN RECENT YEARS, INCREASING INTEREST RATES AND HIGHER BOND YIELDS HAVE CREATED MORE TESTING CONDITIONS FOR EQUITY AND PROPERTY INVESTORS. HOWEVER, STRONG ECONOMIC GROWTH, NOTABLY IN EMERGING MARKETS, AND A HIGH LEVEL OF MERGER AND ACQUISITION ACTIVITY HAVE PROVED SUFFICIENT TO SUPPORT SHARE PRICES, ALBEIT MARKETS HAVE BECOME INCREASINGLY VOLATILE.

Equities survive the bond market rout

Our analysis suggests that three things lie at the heart of the recent divergent performance of bond and equity markets.

“ Firstly, economic statistics have been sufficiently encouraging to suggest that the outlook for corporate profits remains positive. Not only has economic growth in emerging markets and continental Europe remained strong, but also fewer commentators now expect the setback in the US housing market to tip that country's economy into recession. However, while optimism about economic prospects is leading to greater pricing power for companies, it has shaken the generally complacent view about the outlook for inflation. A pick up in pricing power is good news for company profits and thus equity investors, but the resulting increase in inflationary pressures is unwelcome for bond investors.

- The second main reason behind the resilience in equity markets in the face of higher bond yields is that most of the rise in bond yields has been an increase in real yields (i.e. the yield less inflation). This is significant because rising real yields

normally coincide with a strong economy. This occurs when liquidity is diverted from investing in financial instruments such as bonds, and invested in activities more directly related to economic activity. In this respect there has been speculation that there will be a reduction in the heavy buying of US treasuries from countries running large surpluses such as China, Japan and the major oil exporters. While this is negative for bond markets, it is not necessarily negative for equities. Strengthening global economic activity will be positive for companies' profits, and there is speculation that the Chinese may start to use some of its vast surpluses to buy equities. A small step was taken in May when China invested \$3 billion with the US private equity specialist Blackstone.

- The third key reason for the divergent performance of bond and equity markets has been the difference in their supply and demand dynamics. The supply of government and corporate bonds has been increasing at a time when many investors' appetite for bonds has moderated. This contrasts with stock markets where the retirement of equity is still outstripping new issuance in most developed markets. While the number of new issues is increasing, especially in emerging markets, the continuing boom in merger and acquisition activity and share buybacks means that tight supply remains a force, albeit a diminishing one, helping to support share prices.

Following recent market movements, yields on cash and fixed interest securities are becoming attractive for the first time since the adoption of exceptionally low interest rates to stave off deflation in the aftermath of the bursting of the “TMT” bubble in 2001. However, it is not just that cash and bonds offer increasingly attractive competition to equities. Rising bond and cash rates also have an important effect on the dynamics of the forces driving the private equity-led boom in corporate activity in the stock market. The positive gap between the earnings yield of quoted companies and the cost of borrowing has reduced, and in areas of the market such as UK mid caps, the gap has turned negative. This does not mean that takeover activity will suddenly cease, but it does mean that the cycle is much nearer its end than its beginning. It took time for the current cycle of takeovers to start, even though for a long time the valuations of companies' shares were depressed and borrowing costs were low. In a similar way, it will take time for the pent up momentum behind the private equity boom to tail off even though the economics no longer look supportive. However, it could be that cracks are already appearing in the private equity edifice as illustrated by the postponement of the \$650 million high yield bond offering on 27 June to support KKR's buyout of US Foodservice.



Bonds or Equities?

In the light of these trends it is necessary to assess whether it is now time to alter our long standing preference for equities over bonds. We now believe that it is likely that there will be periods when bonds perform much better than equities. However, for the moment we believe that these periods will be fairly short, and that our strategic view favouring equities over bonds remains justified. While some bad news has been discounted in the price of bonds, it is hard to see bonds performing well in an environment when central banks are raising rates and there are serious inflation concerns. One interesting comment hidden away in the fine print of the Bank of England's Regional Agents' Summary of Business Conditions for May was "Many companies reported that the appreciation of the currency over the past year had offset the effect of rising prices of goods from China". The popular perception remains that China's role as a low-cost manufacturing base makes it an on-going source of deflationary pressure. The fact that the prices of Chinese manufactured goods have begun to rise off a low base is a reversal of a significant trend behind the forces that have kept inflation and interest rates at low levels in recent years. It is too early to determine whether this is a decisive change in a trend. However it will need to be watched carefully, and whether it starts to feed through to higher wage settlements, which generally remain fairly subdued.

It is not just concerns about inflation that mean that fixed interest markets are hardly the safe haven status that is often attributed to bonds as an asset class. Indeed investing in bonds is a treacherous occupation at present, illustrated by the recent bail out of two Bear Stearns hedge funds that ran into difficulties with their investments in mortgage backed securities. Moreover, even though the risks of investing in bonds have been rising, credit spreads remain exceptionally low (the difference in the yield between government bonds and bonds issued by companies and emerging markets). It therefore remains an environment in which we are focussing our limited fixed interest exposure in strategic bond funds whose

managers have complete flexibility within the bond markets including the ability to use derivatives to protect capital against rising yields.

Notwithstanding our concerns about fixed interest markets we continue to believe that the bull market in equities will continue. However, the upside opportunities for equities are becoming ever more finely balanced against the downside risks, and the recent increase in volatility is unlikely to reverse. While sharply higher interest rates would undoubtedly fatally undermine the bull market in equities, the outlook for inflation is not yet of sufficient concern to warrant that. In the meantime, corporate profits should remain healthy, and equity valuations are much lower than would be consistent with a significant sell off in share prices.

Finding opportunities in more challenging markets

As equity markets become more challenging the dispersion of returns achieved by active fund managers is likely to increase. With our thematic investment process, we are hopeful that we will be successful in rotating out of those areas that are set to fall from favour, and focus our clients' portfolios in parts of global markets with the greatest opportunity. An example of this approach is buying into cheaply rated closed ended funds with a high exposure to large companies' shares that currently stand on very large discounts to mid and small cap stocks. This has been partly funded by reducing exposure to Ireland, one of most successful themes of recent years. Europe's peripheral economies such as Ireland and Spain have boomed since the introduction of the Euro, helped by interest rates set by the European Central Bank being inappropriately low for their domestic circumstances. This has led to areas of their economies becoming overheated, and with European interest rates on the rise, the Irish property and stock market is set for a more difficult period.

One of the most profitable areas for our clients' portfolios in recent months has been investments in specialist commodity funds. Exposure to this area was increased early in the year, after the sector had been hit hard on

fears that the setback in US housing would lead to a recession. We have remained optimistic about the outlook for the global economy, and this assessment gave us confidence that highly profitable conditions would continue for commodity producers. Demand for commodities from emerging markets such as China remains exceptionally strong, and given the scale of spending on infrastructure and construction, demand seems unlikely to let up. For example, boosted by the Olympics, the amount of construction in Beijing over the past year is equivalent to all construction in the entire continent of Europe over the past three years. Soft commodities, such as food and timber, should also be in high demand, and we have recently invested in a newly launched specialist fund focussed on companies in the agriculture sector.

Among other themes represented in our clients' portfolios are investments in specialist growth funds. Some of these have proved very successful, notably those exposed to the environmental sector. However, traditional technology funds, and funds investing in smaller Japanese companies' shares have been more disappointing.

Nevertheless, performance of both of these areas has started to pick up. With sentiment towards these sectors still very negative, the upside potential looks very attractive relative to the downside risks. This is particularly true in closed ended funds, iimia's particular area of specialisation. Discounts on many funds, including those invested in technology and Japanese stocks, have widened to their most attractive levels for a long time, and discounts are now at levels where they are being supported by share buybacks.

Sterling running out of steam

The strong likelihood that the Bank of England's Monetary Policy Committee (MPC) will be increasing interest rates over the months ahead has kept the value of Sterling well supported compared with most other major currencies. However, while Sterling's value is higher on a trade weighted basis than it was a year ago, it has actually fallen slightly since the start of the year. Speculation that the MPC will continue to tighten monetary policy is

likely to keep Sterling from falling significantly, but we would be surprised if most of our overseas investments did not rise in value partly due to some weakness in the Pound over the next year. Of the major currencies the Yen remains the most undervalued, and it is hard to see its value declining much further. However, a substantial rally in the Yen is unlikely until there is greater confidence in the strength of Japan's domestic economy or if there should be a flight to safety in global financial markets that caused the "carry-trade" to unwind (borrowing in one currency to finance investments denominated in another currency).

Property

Although we adopted a prematurely cautious stance towards UK commercial property, our view has been vindicated in recent months by a sharp fall in the share prices of property companies. The sudden souring of sentiment was such that the planned floatation of Vector, the UK's first real estate investment trust focussing on the hotel sector had to be postponed in June. The background to this was how yields on commercial property investment had fallen at a time when the cost of borrowing to invest in property had risen. Indeed, in several areas of the commercial property market rental yields are below the cost of borrowing. While this compression in yields had begun to temper enthusiasm towards UK commercial property the other catalyst for the sell-off in the share prices of property companies were signs that prices of some of their properties were being sold for less than their book values.

As we anticipated, the sector of the market that has been weakest has been secondary retail properties, with Land Securities confirming that prices have begun to fall in this area. As ever, deteriorating sentiment towards an asset class has seen a disproportionate impact on the specialist closed ended funds invested in it. UK commercial property closed ended funds which were trading at substantial premiums have slid to discounts, in the process of which investors have experienced substantial losses. Notwithstanding the fact that UK commercial property is likely to

deliver far lower returns in the future than in the recent past, the sell off in property closed ended fund prices has begun to create some interesting opportunities. It is now worth considering the shares of some property closed ended funds. Large discounts on good quality property portfolios are unlikely to be sustainable particularly for those funds offering exposure to sub-sectors that are likely to out perform a lacklustre market, such as offices, and have high quality management able to add value through development. Corporate activity has already started with Scottish Widows seeking to wrest back control of UK Balanced Property Trust.

The comparative value of closed ended property trusts are compelling compared with open ended property funds that remain popular with many UK investors and financial advisers. It is nonsensical that investors are paying stamp duty and transactional costs amounting to around 5.25% to invest in open ended property funds when shares in fully invested closed ended funds can be purchased at significant discounts. Aside from modest tactical investments in closed ended UK commercial property funds, in strategic terms we continue to have a strong preference for property investments in Germany, Japan and some emerging markets. In these countries property prices are comparatively depressed and the economics between the cost of borrowing and rental yields are more in favour of investors than they are in the UK.

Conclusion

Financial markets have become more treacherous this year and it is hard to see that changing in the months ahead. While it has been possible to eke out strong returns in some areas, there have been an increasing number of investments in all the main asset classes that have experienced sharp falls in value. Rising interest rates and economic imbalances create significant headwinds for markets, but we believe that it would be unduly pessimistic to conclude that the bull market for global equities that started in March 2003 is at an end. We are therefore hopeful of building on the gains we have made for our investors in 2007, albeit in the same words as we concluded in the last Investment Outlook and Review "It is 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 at 2 July 2007 and should not be interpreted as investment advice. Past performance is not a guide to future performance.