

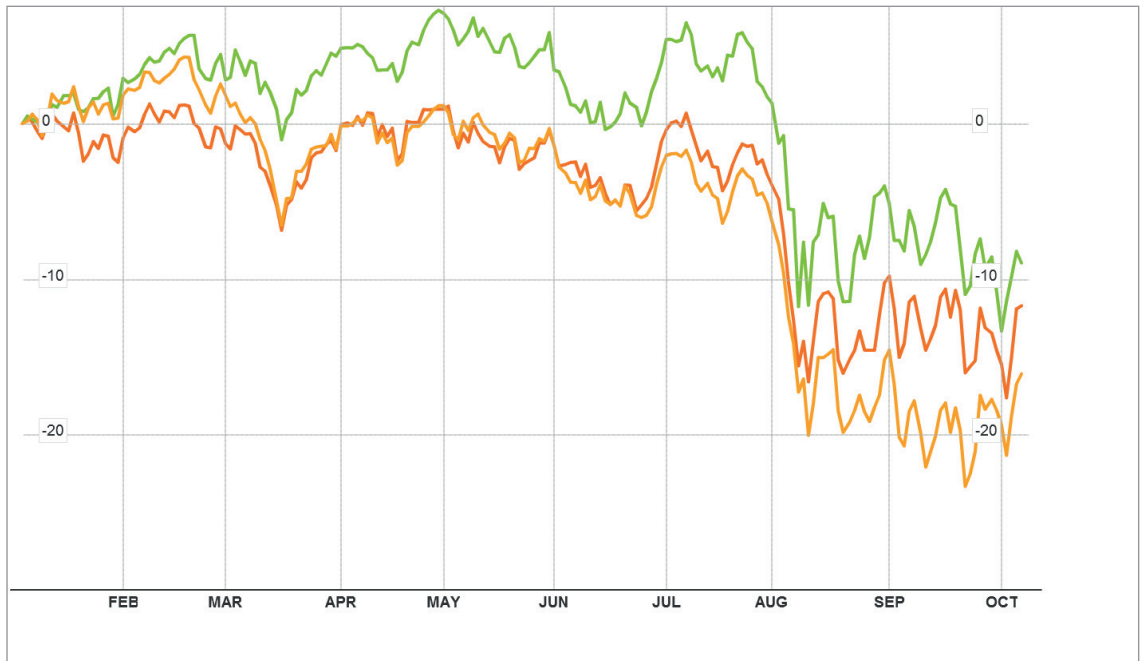


### THIRD QUARTER 2011 INVESTMENT REVIEW

#### I. THIRD QUARTER 2011

During the third quarter of 2011, world equities, as measured by the MSCI FTSE All World Index, declined heavily by 18.05% most of the decline occurring since the end of July on a mixture of geo-political concerns, sovereign debt issues and further downturn in shorter term economic indicators. The VIX (volatility measure) increased by more than 100%. Amongst the major country indices at local currency level, the decline was broadly spread, with Germany however, recording a decline of 25.41% taking the “wooden spoon” for the period under review. In sterling adjusted terms and Japanese and German indices showed the least and most movements respectively. Emerging markets could not escape the downdraught, falling more steeply than developed markets in many instances.

Particularly large moves were experienced by the higher beta sectors such as mining, banks and insurance companies, where, in addition to slowing economic growth issues, there were questions on solvency, write downs etc. Pharmaceuticals, telcos and utilities, not surprisingly, experienced more resilience. Actual takeover activity was lighter than the previous quarter, but there was no shortage of rumours encompassing both large and small companies.



Source: Bloomberg, 07 October 2011, STOXX, FTSE, S&P



Source: Bloomberg, 07 October 2011, UK Gilts, US treasury

Conventional government fixed interest stocks had a relatively good quarter. The US 10 year bond yield for instance moved from 3.45% to 1.93% with the UK equivalent moving from 3.69% to 2.42% over the same period. Corporate bonds declined marginally. Interestingly, unlike their equity counterparts, lower quality corporate were relatively stable suggesting that the “search for yield” component was regarded more highly than the “default risk”. Emerging market local currency bonds actually appreciated by about 17%, though started to fall rapidly at the end of the quarter. The real index linked gilt yield fell to 0.18% and the response to the now withdrawn NSI issue, and the National Grid retail issue showed the strength of demand for new issues in this area.

# Q4, 2011

Over the quarter, the Euro and the Japanese Yen were the main fallers and gainers respectively amongst the major currencies. The Swiss authorities intervened to weaken the Swiss Franc after its dramatic "safe haven" rise on a trade weighted basis. The Japanese authorities resorted largely to verbal intervention, with limited effect.

Gold and some agricultural commodities were the few gainers during the period, although in general commodity moves were downwards during the quarter, especially the last weeks, as economic growth expectations were reduced.

## 2. FOURTH QUARTER 2011 GLOBAL BACKDROP

The late September edition of the IMF World Economic Outlook started with the words "The world economy is in a dangerous new phase"

Over the next few weeks, investors will be analysing certain key events and data points to see how this phase looks likely to develop. Five areas below will be under the microscope, as well as keeping an eye on the other factors mentioned at bottom of this report under "surprises"

Growth in advanced economies slowed to a crawl in the second quarter and a number of "special factors" such as Japanese supply chain disruptions, German nuclear shut down, British additional public holidays, high global fuel price, were cited as one off depressant factors. A bounce back in the third quarter (to be confirmed October onwards) would be very welcome

Greece triggered the euro zone debt crisis, and Greece will largely determine what happens next. Athens is being pressed hard by the IMF, European Commission and the ECB to put its emergency rescue programme back on track or face a halt to bail-out payments. We await votes on proposals to strengthen the EU bail-out fund and look for signs that George Papandreou can push through the reforms in an economy already contracting at over 7% according to latest quarterly GDP. Attempts to "ring-fence" Greece are being seriously studied.

Central Banks have limited tools available, and to a large extent, are relying on politicians to deliver other measures to stimulate growth. The problem here is that most of these governments are still saddled with large debt and consumers loathe to open their wallets, however low rates go, in the face of asset price uncertainty, job security etc. Some sort of co-ordinated initiative is sought.

Equity markets are showing clear signs of distress, for many of factors explained in this report. Weak share prices, daily headlines etc can themselves cause the tail to wag the dog...e.g. real and supposed destruction of paper assets reducing consumer confidence, the core of most developed economies. Of course, this can work both ways. One interesting corollary is that companies themselves are in generally good shape and actually buying their own shares.....

US policy-A divided congress threatens to shut down federal government and the impasse between Republicans and Democrats is creating a feeling of great uncertainty for corporate, consumer and holders of US assets. Some rational and determined US policy is needed.....but election year looming

**US** The US economy is still on a very slow track recovery, as reported in the last investment quarterly with successive data releases neither pointing to sustained upturn, nor, currently, a double dip recession. The August S&P downgrading of US sovereign debt to AA+ confirmed that action was needed on both the fiscal account and the growth within the economy. The September Conference Board consumer confidence index showed little signs of recovery while the widely followed Case Shiller house price index showed regional declines, but not as severe as expected. Recent labour figures showed sharply mixed trends, with the State sector firing and the private sector hiring. On the positive side, business investment continues to expand, reasonably strongly, prompting some economists to raise third quarter GDP growth estimates to 2.1 % compared with growth of just 1.3% (recently revised slightly upwards) in Q2. Recently released September manufacturing PMI was reported a higher than expected level. In terms of policy initiatives, operation "TWIST" was launched to help the long end of the fixed interest market and Obama continues to put emphasis on infrastructure projects and tax tweaks to ease the unemployment situation. Short term interest rates seem likely to stay very low for at least another year. Using longer term valuation measures, the Shiller and Tobin's ratio both suggest that US equities are still slightly overvalued by comparison with historic ranges. These two measures currently stand at 20.7 and 0.93 respectively. On Morgan Stanley current figures, the trailing dividend yield is approximately 2.2% and the price book ratio is 2.0, with the historic PE ratio of 13.7 times. Analysts will be closely scrutinising imminent third quarter earnings announcement and statements for confirmation of their "E" assumptions! Fund flow considerations are broadly equity positive with retail and institutional weightings still relatively low, while corporate buying of equities is strongly increasing.

**EUROPE (EX-UK)** Looking first at the economic data, the situation has deteriorated since our last quarterly. The strength previously being recorded in the likes of Germany and France appears to be abating, albeit still reasonably healthy, while the position in more southern states has worsened, largely due to actual or expected budgetary measures. Aggregate second quarter Euro zone GDP growth was reported as 0.2% with Germany slowing to just 0.1%, much weaker than forecast. Coupled with an easing of inflation pressures, the chances of a cut in official interest rates at near term ECB meetings have increased. Other measures to boost liquidity are also

# Q4, 2011

being pursued. At the time of writing, the German Bundestag has just voted in favour of beefing up the Euro zone rescue fund. While giving an immediate boost to equities and the Euro it must be remembered that over the next weeks, other national votes have to pass as well as a "troika" assessment of Greek deficit reduction to date and disbursement of aid tranches. It is generally felt that early November; the time of the next full G20 meeting is acting as a sort of informal deadline. It is felt that a move towards a stronger fiscal union combined with a large increase in the EFSF scope and amount is receiving more support. Help for banks and the degree of "haircut" for private sector bond holders are currently being debated. On the subject of stock market valuations, longer term indicators are mixed, with good value indicated by price-earnings (consensus estimate 8.5 for 2012), price book ratios in the lower half of the longer term valuation range and a dividend yield of nearly 5.0%. Despite these relatively attractive stock market valuation indicators, investor sentiment will be strongly influenced by both the sovereign debt issues and the reliability of current corporate earnings.

**JAPAN** After a 3% fall in the first quarter Japanese economic growth stabilised somewhat in Q2, with greater than expected progress post earthquake/tsunami/nuclear accident etc. Industrial production has grown in each of the past five months and some companies are operating extra shifts. On the ever important inflation front, Japan's headline and core CPI have turned positive for the first time since December 2008, but the consensus view is for a return to deflation, as the weaker trend in commodities and strong Yen, have their influence. The authorities have provided physical and verbal currency intervention as the Yen continued to appreciate for much of the quarter well below the previous "floor" of 80. Japanese equities are trading at just below historic book value, with a multiple of 16.5 and a yield of 2.2% (compared with long government bond yield of 1.0%). It would probably require a sustained period of yen weakness accompanied by a stronger global economic recovery for this value to be unlocked.

**CHINA/OTHER ASIAN** Recent economic releases, including September PMI figures suggest that sequential growth in China may have stabilized in the area of 6%-7%. This should help mitigate market concerns about the potential risk of a hard landing. Economic policy is likely to continue to manage the balance between taming inflation and keeping a stable and relatively fast economic development. We do not expect any near term monetary easing. Macro policy may lean more towards the fiscal side.

With export demand slowing (US pause, European debt etc) and domestic demand moderating overall GDP growth is expected to drop from over 8% to still healthy between 6% and 7% in the second half of 2011 for the Asia Pacific (non-Japan) region as a whole. Inflation pressures still remain strong, although we have seen very recent weakness in various commodities, industrial, energy and agricultural. Inflation in India, for example, is running near 10%, with GDP growth forecasts of approx 8% p.a. for 2011 and 2012 respectively. For the region as a whole inflation of approx 5.4% is expected for 2011.

**OTHER EMERGING** Over the most recent quarter emerging market equities have underperformed by more than the small downgrades to their still healthy economic growth might warrant. Developments have served to highlight that, though the case for long-term emerging market investment is supported by compelling arguments, investors will still suffer contagion effects from the more developed markets. This has happened through a mixture of trade exposure, commodity prices or volatile currencies for example. On fundamentals, Russia has attractions on a PE of below 8 and earnings growth in the area of 10%-12%. The country has additionally been a beneficiary of recent events, mainly through higher oil price and higher LNG exports to Japan, and has the additional fantasy of an election (now a done deal) in the near term. India also has longer term attractions although inflation needs to be watched closely (inflation near 10%). Current Indian GDP growth estimates are in the area of 7.5%-8.0% to March 2012. Brazil continues to grow, with estimates of about 5% GDP growth this year. Major resource potential e.g. oil and gas, and iron ore and high profile infrastructure projects e.g. 2014 World Cup and 2016 Olympics will remain dominant themes. One common theme amongst emerging markets has been increased use of quantitative tightening (capital controls, currency intervention, and open market operations) to counter capital inflows partly generated by quantitative easing in many developed countries. And partly by tighter monetary policies in a number of developing countries.

## UK

**UK ECONOMY** After a flat first half of 2011, the jury is still out as to whether there was much economic growth within the UK during the third quarter. Figures for July and much of August showed, for instance little progress in the area of consumer spending and confidence, although September seemed to have shown a slight uptick according to first indications (Sept manuf PMI). Economists are warning of a winter of rising unemployment after the UK jobless total rose to a 17 year high of 2.57 million. Within the housing market, both the Halifax and Home track indices showed a monthly decline and annualised decline during the month of August. Industrial production remains patchy by region and product, and at the time of writing, the restructuring at BAE systems, is an unwelcome development within one of our traditionally stronger sectors. A recent statement by Mervyn King and the accompanying extension of the QE programme emphasise current official concern.

Overall growth estimates have been reduced to near 1.2% for the full year. Inflation is expected to remain between 4% and 5% throughout much of this year,

# Q4, 2011

but could drop quite sharply early in 2012, partly for the basis effect and partly as a result of recent weakness in a variety of commodity prices. Analysis by the OBR shows that the budget deficit in 2010-2011 was £40 billion lower than was expected two years earlier—largely on the tax rather than spending side. This has led some observers to suggest room for some infrastructure spending or temporary tax cuts. Although the UK situation is far from buoyant, there are some grounds for relative optimism (certainly compared with much of Europe), and there could be possible room for some simulative adjustments, without derailing the longer term debt reduction plan.

## UK FIXED INTEREST

Within the UK, the economic growth profile described above coupled with, say, a 4%-5% near term inflation assumption, and forecast global rise in developed bond yields, we see few attractions in the conventional gilt market and feel that the “safe haven” reasons will not be so pertinent going forward. At the time of writing shorts yield 1.0%, longs at 3.5% and the benchmark 10 year at 2.52% (3.5% at the time of the previous quarterly). Shorter term and overweighed accounts may wish to lighten their conventional gilt holdings.

In longer term, supporting factor may be purchases by pension or life funds for asset-liability or solvency reasons, but even these institutions may find current yields rather low. There may also be attractions during periods of uncertainty (growth scare, Euro sovereign debt, geo-political tension etc). The gilt reaction to the recent QE extension was fairly muted and many commentators have questioned the value of the exercise.

There are, however, other fixed interest products that may be attractive at this time and to which may be viewed as possible alternative fixed interest ideas.

Conventional corporate bonds have performed relatively well in the fixed interest space so far in 2011 rising by approx 2% (iShares GBP corporate bond, total return), but there are still examples where “the company has been mispriced...”, i.e. market attaching a much higher probability of default than we believe warranted. For example, on the iShares GBP corporate bond (a basket of bonds) the current yield of 5.87% might be expected to outperform conventional gilts, on a total return basis. But investors should prepare for more capital price volatility, especially in the longer maturities and within the financial sector.

We also see opportunities in the preference share market particularly in issues with relatively close call dates. Permanent Interest Bearing Shares will give income returns significantly above short and longer term government paper, but can suffer from liquidity issues. Zero-coupons have had a good run and we now recommend lightening up on these holdings.

We like certain bank hybrids. Bank results, plus stress test ratios, plus the lighter Basel III proposals have highlighted the attractiveness of the sector. Index linked gilts currently offer a real yield of near zero. We cannot see value in existing government index linked stocks at this level. If some element of inflation protection is required we would look at some alternatives such as corporate index linked bonds, floating rate bonds, currently experiencing strong demand in the US, or perhaps certain commodity baskets.

## UK EQUITIES

Looking at the main UK equity drivers, factors are in place for rise overall UK equity market and we currently forecast a year-end FTSE value in the range 5800-6000, a little lower than our end June forecast. However, themes and sectoral mix will continue to be crucial as they have over the most recent quarter. Between June and September, defensive sectors such as utilities, telcos and pharmaceuticals have substantially outperformed banks and natural resource companies. At the global level it must be remembered that a high % of FTSE earnings derive from international sources (e.g. mining sector), while at domestic level, the unbalanced GDP growth breakdown could have large effects on sector and stock selection.

As described above, the rather sluggish economic growth profile and recent official statements suggest that short-term interest rates are set to remain low, well into 2012. This rate scenario will simultaneously help household and corporate balance sheets, help company profit and loss statements, allow a somewhat higher equity valuation (though long term interest rates will rise) and encourage a search for yield, which many equity vehicles currently provide (with varying degrees of risk).

The other key equity driver, corporate profits growth, will be analysed carefully over coming weeks as the third quarter reporting season unfolds. Both the actual numbers and the accompanying statements will be scrutinised. In recent weeks for example, shocks in the high street or government supported work or certain financials have led to sharp price declines.

On a valuation basis, UK equities (MSCI-UK index) stand on approximately a PE of 9.5 for 2011 (MSCI, Morgan Stanley, IBES) and dividend yield of 4.0% rising to 4.5%. Both of these rest towards the lower half of a 20 year range. The price book ratio has dropped to the 1.5 to 1.7 range while price/sales ratio is below 1.0 (well noted by some corporate raiders). These ratios are not particularly expensive either in absolute terms or relative to cash, overseas markets or gilts. On balance, considering the earnings growth and interest rate picture described above we believe that the UK equity market is fair value/cheap on domestic considerations on a medium term view. However, stock and sector selection will become increasingly critical, as domestic interest rates increase and earnings momentum fades. It is also important not to underestimate the effect of income in total return calculations, as many so called defensive stocks with high current

# Q4, 2011

yields are actually increasing dividends and many cyclical sectors are resuming payments e.g. banks and mining..and BP.

It is important at this time to remind that the UK equity market is not necessarily directly reflective of the UK economy. For instance personal consumption accounts for approximately 65% of GDP, but only 38% of the UK equity market and even that assumes the widest definition of consumer sectors. Conversely, oil and basic resources account for about 30% of the equity market (including recent newcomer Glencore). In addition, and often highly quoted, is the fact that 70% of FTSE companies sales come from outside of the UK. Hence one of our themes is to exploit faster growing economies and often stronger currencies by investing in the likes of Standard Chartered Bank, or Vodafone, or WPP, or GlaxoSmithKline. Concerning the mix between larger and smaller companies (which have outperformed so far this year), we have a balanced view as the FTSE style companies tend to be more "international" and thus subject to faster growth regions, whereas the smaller companies are receiving much attention in the area of corporate activity. On balance we think that the FTSE may outperform the FT-All share over coming months for index mix, relative valuation and recent performance reasons.

**UK PROPERTY** Property has a place in a well diversified long-term portfolio for its different return/risk and correlation characteristics. However, events of the last few years have shown the importance of critical due diligence in the areas of property type, location, management and financial structure.

We currently believe that a longer-term recovery is in place in terms of capital values and rental income as confirmed by the widely followed IPD index, although we would expect the pace of recovery to slow following the 2010 bounce. The implications of expected increases in the risk-free rate, mentioned above under Fixed Interest, should be borne in mind when considering relative property valuation. Legal and General Property division recently forecast total returns in the region of 5%-6% pa across the property market as a whole

Anecdotal evidence for quoted companies reporting in spring 2011 would suggest that London, by location, and offices, by type are outperforming national averages.

Strong rental growth is being reported in parts of London and the Southeast, often driven by overseas investors

**OVERSEAS EQUITIES** Apart from gaining overseas exposure through a number of our FTSE size UK stock recommendations, we would also make selective use of ETFs and investment trusts. Investors should study the currency implications of their choices as regards currency of investments, business of underlying, hedging policy etc. One of our more contrarian overseas investment ideas include small exposure to "out of favour" Russia.

**ASSET ALLOCATION** While accepting that there are economic headwinds ahead, but that a double dip recession can be averted, we propose a continual switch from Fixed Interest to Equities. Within each asset class we would make the following brief points:

**FIXED INTEREST SECURITIES** – Negligible conventional gilt holdings. Favour alternative fixed interest plays.

**INDEX LINKED GILTS** – Government index linked stocks not attractive, at current levels, in our view.

**UK EQUITIES** – Defensive bias with strong balance sheet, high yields and some suitable overseas earnings. Watch out for more profit warnings from a number of UK domestic stocks.

**OVERSEAS EQUITIES** – ETFs and discount investment trusts. Watch FX exposure.

**COMMODITIES** – Would start to revisit some industrial metals after recent falls and also certain agricultural names.

**OTHER** – It is likely to be productive to look at selected absolute return funds, but watch dealing and other expenses carefully; as well as certain structured products, e.g. Synthetic Zeroes where transparent pricing and live dealing.

# Q4, 2011

## I. SUMMARY

We see a modestly higher equity index over the year and would play close attention to themes to maximise performance. Will move certain fixed interest components towards equity, simultaneously increasing the overseas equity percentage both directly and through a FTSE bias.

## POTENTIAL NEGATIVE FORCES/SURPRISES

- Government borrowing. Very high levels of government borrowing will limit the scope for equity multiple expansion.
- Industrial action, especially in the government sector.
- Renewed sharp fall in house prices.
- Subdued institutional demand for equities (risk aversion, asset/liability, demographics etc)
- Issuance-equity and fixed.
- Cost push inflation especially soft commodity driven and effect on consumer disposable income. Disproportionate effect on lower income families. Possible social unrest.
- Euro zone sovereign default issues intensify-rating agency action?
- Possible failure of a European bank as Europeans choose to save states rather than banks.
- Israel/Iran/Korean/Afghanistan tensions escalate.
- North African contagion-possible Saudi instability.
- Lingering effects from Japanese disasters.
- Extreme FX uncertainty e.g.US Dollar, Yuan, Japanese Yen and of course, Euro.

## POTENTIAL POSITIVE FORCES/SURPRISES

- Announcement of bold new measures from governments to recapitalise banks and to leverage the EFSF
- Stabilisation/improvement in macro news flow from the eurozone and US respectively
- Measures from central banks to support banking systems and economies, including looser monetary policy in emerging markets
- A better than expected Q3 reporting season

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  - Generally, equity prices will vary and dividend payments will also fluctuate in line with the fluctuating trading performance of the issuing company
  - Currency movements can impact positively on investments but they can also have a negative impact and profits can be eroded by a fall in the value of a particular currency
  - Investing in "emerging" or "developing" markets or specialist sectors has the potential for higher returns but is also likely to be more volatile and higher risk. This is largely due to the fact that these markets and sectors can be more vulnerable to cultural, political or economic change
  - The tax laws currently in place may change in the future which could affect the value of investments
  - The value of investments can go down as well as up, and as a consequence, upon withdrawal or transfer, the investor may not realise the sum originally invested. Income from investments may fluctuate as part of the capital invested may be used to pay that income
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