VIEWPOINT

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Newsflash

A new month and the thirty first issue of Viewpoint from FP.

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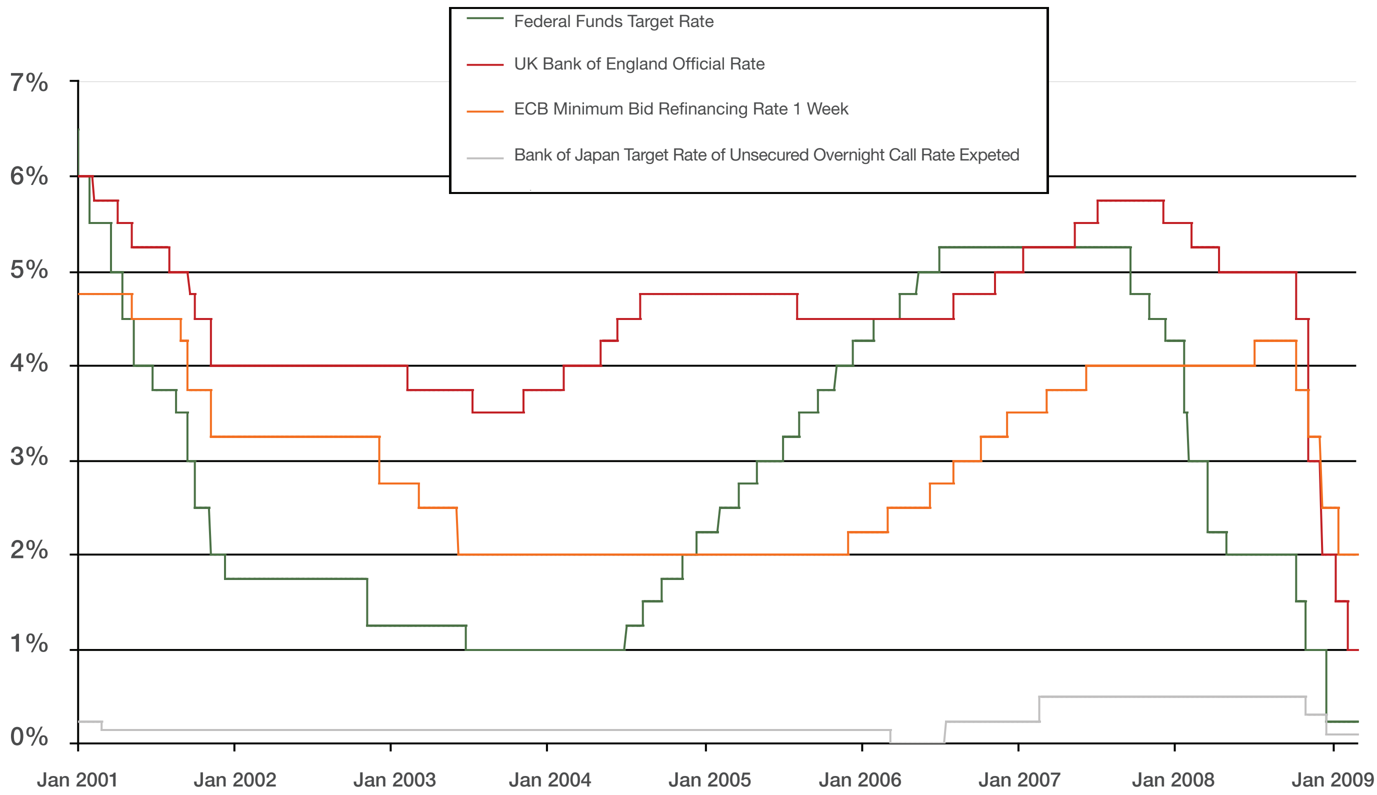
Mark Twain once remarked that history does not repeat itself, but it does rhyme. In December, January and February global central banks lowered their rates to very low levels – historically low at least in the United States and United Kingdom – in order to stimulate the availability of credit. From an interest rate point of view we seem to be in a similar position to that of 2002, at the end of the previous bear market. There are arguably other factors that will provide a drag on credit extension this time around (the absence of leveraging and stricter loan to value requirements come to mind) but from a monetary policy point of view the world's central bankers have done a lot to allow economies to put a stop to the current global slowdown. Interest rates have come down faster than in 2001 / 2002, and the reductions have been more extreme.

Equity markets have historically tended to recover some time before the end of a recession, and have also benefited from higher inflation expectations. The World Bank expects the global economic output to contract by one to two percent in the next year, and deflation is a worry for most governments. Over time stimulus packages should reverse this situation which will herald the return of global growth, as well as inflation (as a result of quantitative easing) which are both supportive of equity prices. Whether all the bad economic news has been priced into equity markets will only be revealed retrospectively, but Viewpoint believes that this asset class is getting closer to offering the value that was evident in fixed interest assets at the start of the year (see December 2008 Viewpoint).

Global central bank rates



Source: Bloomberg March 2009

During February equities continued their descent towards levels last seen before the tech boom near the end of the nineties, with all of the major equity indices in the red. The graph shows the MSCI World Total Return index (dividend reinvested) since January 1996:

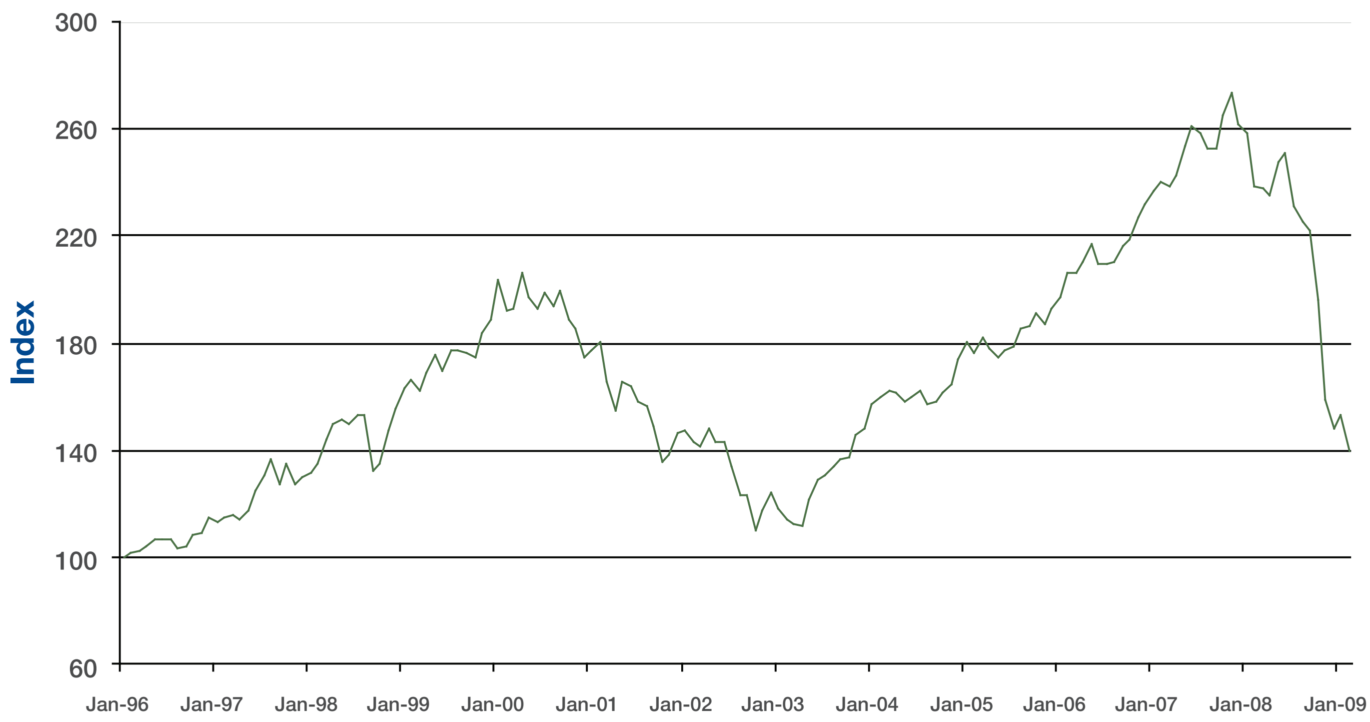
US Equities (S&P 500) led the decline by losing -10.8% in the month, followed by Europe (MSCI Europe ex-UK) down -10.3%, and globally the MSCI World index retracted with -10.2%. The FTSE 100 in the UK fared slightly better by shedding only -6.5% in local terms, with emerging markets (-5.6%) and the Nikkei 225 (-4.7%) being the best of a bad bunch.

Government bonds did not move much during February, with the yield on both the US 10 year treasury and UK 10 year gilt hovering around the 3% level. There was slightly more action in corporate bonds with investment grade and high yield spreads over government bonds widening. This was mostly due to the second round of bank bailouts – Citigroup in the US and Lloyds TSB in the UK – and tier 1 bank capital (investment grade corporate bonds) being hit particularly hard. The increase in spreads, and consequently yields, in the non government bond sector resulted in bond indices across the globe ending the month with slight negative returns. The exception was Japanese bonds holding up with a 0.2% return in February. US (-0.4%), European (-0.8%) and global bonds (-1.8%) all shed some of the gains they made in the last two months of 2008. Following two months of negative returns US Government bonds are now starting to show more value and the pronounced downside risks that Viewpoint highlighted at the end of December had to some extent subsided.

Property markets, as measured by the US REIT and FTSE/EPRA Real Estate Indices have continued to disappoint in February, with all indices continuing the 2008 freefall – albeit some regions to a lesser extent than others. Viewpoint

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. February 2009

MSCI World TR Index (NDDUWI)



Source: Bloomberg March 2009

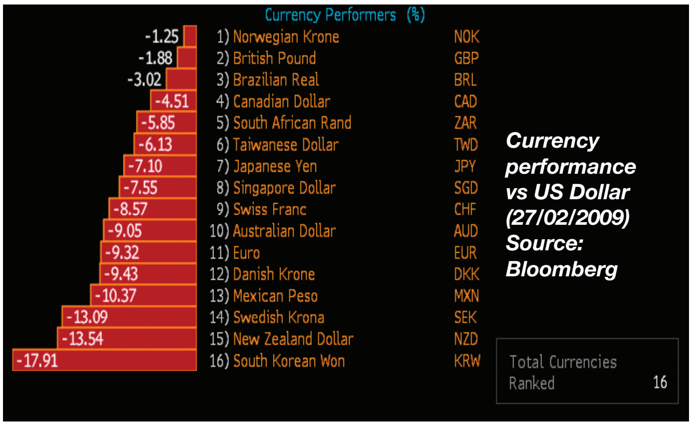
visited a number of UK and European property managers during February and for the first time in a long time they are starting to see interesting investment opportunities with yields approaching between 8% and 10%. It is clear that the credit tap is nowhere close to being fully opened yet, which means that the broad property market will probably not see a sharp recovery any time soon. Experienced fund managers may be able to pick the properties with the biggest return potential, but most are not keen to provide investors with the same liquidity mismatch in their funds as before. A lot of the forced selling, and subsequent write down in property values, were a consequence of funds holding illiquid assets but providing daily liquidity to investors. Viewpoint reckons that many investors will have to forego liquidity in the future if they would like to enjoy the diversification benefits that property could add to their client portfolios.

On the currency front the US Dollar has continued its relative strength against all major currencies, with the Japanese Yen being a noticeable loser in February (-8.2% against the greenback). Viewpoint still regards most major currencies as intrinsically weak and as a consequence run investment portfolios relatively neutral with regards to currency exposure.

As mentioned above both United States and United Kingdom interest rates are as low as they have ever been, with a little more scope for reduction in the UK. The European Central Bank's rate ended February on 2%, but was reduced to 1.5% early in March. The interest rate differential between the four major currencies – US Dollar, Euro, Japanese Yen and Pound Sterling – is now around 125 bps. With inflation rates in these countries approaching zero or even moving into a deflationary environment it is mostly currency speculation, change in competitiveness and the state of each currency's balance of payments that may play a role in the direction of these currencies in the near to medium term.

Commodities were still weak into February, with the Rogers International Commodities Index (RICI) losing another -3.9%, and the RICI Agriculture down -7.9%. Oil was slightly up at the

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. February 2009



Currency performance vs US Dollar (27/02/2009) Source: Bloomberg

end of the month (1.7%), taking its year to date gain to 15.3%. Gold ended the month on USD942.35 (up 3.5% from the end of January) after getting close to USD1,000 mid-month. At the time of writing gold briefly went below the USD900 resistance level, bouncing back in the subsequent trading days.

On our market indicator watch list (overleaf) only two asset classes are up for the year – gold and oil. Perhaps that is why no one has ever referred to the pot of equity at the end of the rainbow, or thought that they have struck bonds when making a discovery. It is also true that fools rush in where angels fear to tread, but certain scholars may just view this as the point where investors should slowly venture back into equity markets. We explore this in our FOCUS section.

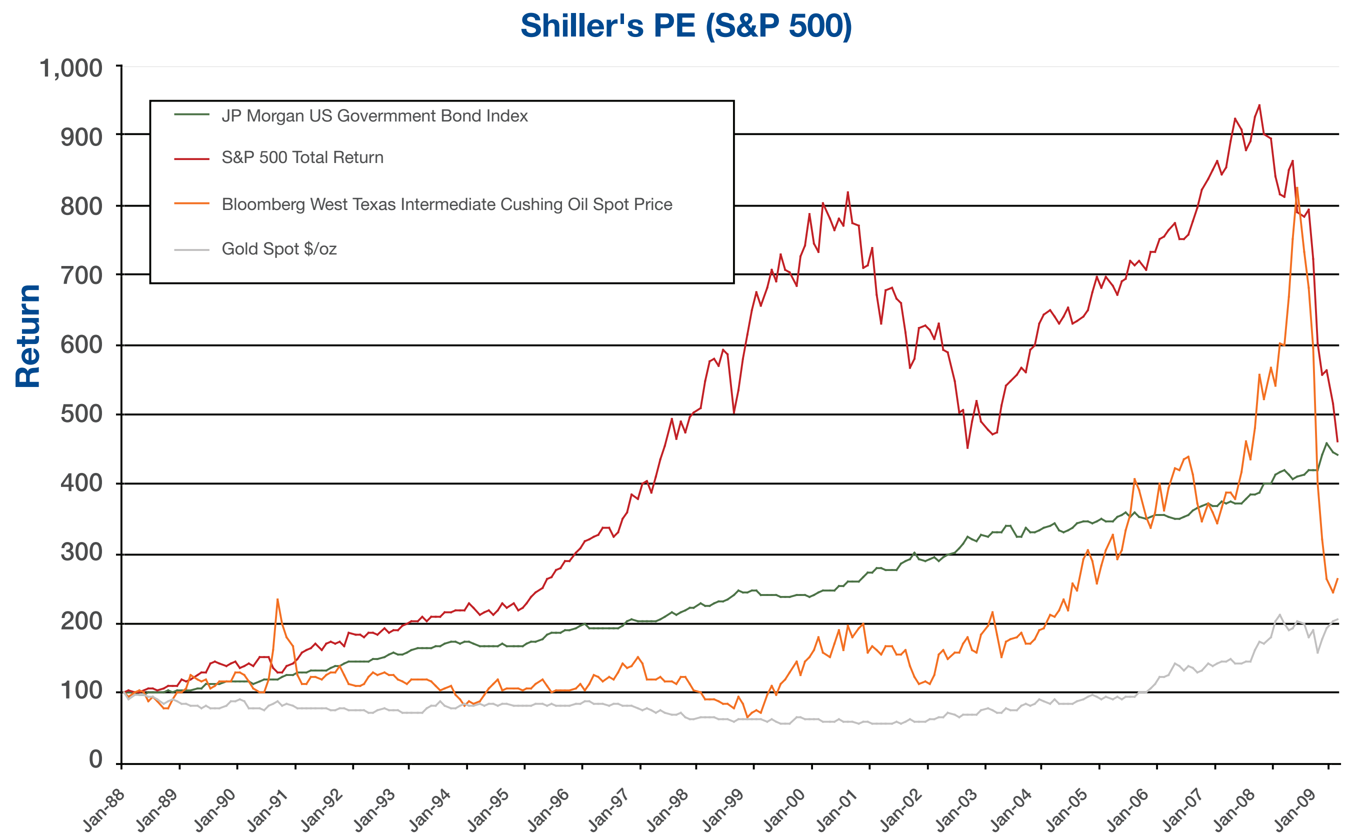
Source: RMB Asset Management / Bloomberg / Lipper Hindsight. February 2009

Asset Class Performances

Asset Class Performance (%)	February 2009	YTD 2009
US Equities $	-10.8	-18.3
UK Equities £	-6.5	-12.0
Cont. European Equities €	-10.3	-15.5
Japanese Equities Yen	-4.7	-11.9
Global Equities $	-10.2	-18.1
Global Emerging Markets Equities $	-5.6	-11.7
US Bonds $	-0.4	-4.4
European Bonds €	-0.8	-0.3
Japanese Bonds Yen	0.2	-0.3
Global Bonds $	-1.8	-5.1
US REITs (property) $	-21.1	-35.1
FTSE EPRA Real Estate UK £	-8.7	-27.5
FTSE EPRA Real Estate EU ex UK €	-7.4	-7.8
FTSE EPRA Real Estate Asia $	-15.8	-23.2
Euro vs. US Dollar	-0.9	-8.6
Sterling vs. US Dollar	-1.1	-0.9
Yen vs. US Dollar	-8.2	-7.4
Rand vs. US Dollar	1.6	-8.0
Commodities $	-3.9	-8.8
Agricultural Commodities $	-7.9	-10.6
Oil $	1.7	15.3
Gold $	3.5	10.6

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. February 2009

FOCUS



Equity markets have had a very tough time since the middle of 2007 when the two words 'credit' and 'crunch' suddenly became part of almost everyone's vocabulary and investors in almost all asset classes witnessed a decline in their holdings to a smaller or larger degree. In the previous two editions of FOCUS we highlighted when fixed income assets and gold may be considered as components of a well diversified multi-asset portfolio. Traditionally equities have formed a major holding in many balanced portfolios, but with many funds taking risk off the table in 2008, this may not be the case in the first quarter of 2009. The question that many investors have is if, and when they should start to add risk in the form of equity to their portfolios.

The table below shows the asset class total returns (in US Dollars) for four major asset classes since 1988: US Treasuries, US equities, oil and gold.

Over this 21 year period equities and bonds have returned in the region of 7.4% per annum (albeit with completely different levels of volatility), with oil returning 4.7% and gold 3.5%. The different paths that the asset class returns took to get to this point reinforces the case for long term strategic asset allocation being enhanced with shorter term asset allocation calls in order to enhance returns when investors take advantage of positions in undervalued asset classes. Overleaf we analyse one specific equity market valuation and how that could impact the timing of a return to equities in investors' portfolios.

The most commonly used valuation method for equities is the price/earnings (P/E) ratio. This is very simply the current price of the stock or market divided by the earnings of that stock or market. In very basic terms when two stocks, or two markets (even at different times) are compared to each other

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. February 2009

Shiller's PE (S&P 500)

the one with a lower P/E ratio would be seen as the better investment.

In the current market environment it is very difficult to measure the 'E' in the ratio – the expected earnings for the year ahead. Many investment commentators believe that recent historical earnings were unsustainably high, and that we are in for a period where earnings may first of all show a sharp decline from their 2007 and 2008 levels, followed by a period of lower growth in earnings than what we have seen since 2002. This may be due to a prolonged global recession and increased tax burdens in countries where governments are borrowing money to kick start their economies.

One way to remove the uncertainty about the earnings forecast on equities has been advocated by Robert Shiller, Yale Professor and economist. He suggested the use of the inflation adjusted average from the previous 10 years earnings on the S&P 500 to calculate the P/E ratio. What this does according to Shiller is smooth out the ". . . frequent boosts and declines that we see due to the business cycle". What is interesting to note is that the Shiller P/E ratio of the S&P 500 has only recently moved below the long term average of 16. Equity markets tend to overshoot at both the end of bull and bear markets, so even though this analysis points to value in the US equity market, FOCUS will not be surprised if the market approaches Shiller P/E ratios of closer to 10 before it turns around.

If Shiller's theory holds water the equity market currently offers value to investors. The question remains on what the best approach is to get back into equities, if we expect the market to remain volatile, overshoot at the lower end of P/E valuations and cannot predict where the bottom will be.

Many investors would have liquidated their risky assets during 2008, and have been hoarding cash since. Every decline in the equity market in 2009 has served to reinforce the wisdom of this decision. The danger is that 'terminal paralysis' sets in, where investors fall so in love with the security of their cash holdings that they miss the major part of the market recovery. One option is to move into asset classes that have the

Source: RMB Asset Management / Bloomberg / Lipper Hindsight / Yale Department of Economics. February 2009 potential for recovery when equity markets recover (such as high yield and convertible bonds) but provide better downside protection relative to equities. Another option, which could be blended with the first, is to have a plan for equity market re-investment and to stick to it.

Very few (if any) investors will be able to consciously time the market and get in right at the bottom, which means that the more sensible approach is probably to take a number of large steps back into equity risk territory. On average such a strategy will lead to reinvestment at a level that is clearly in the 'value' category, albeit not right at the lowest point. Company earnings could as easily surprise below or above expectations, although the market has already priced in earnings declines in the region of 40% to 50%. The key would be to focus on fund managers that can consistently identify companies whose earnings will not suffer this general expected decline, as these should rebound earlier in the recovery cycle.

Stepping back into equities in the current market environment will be a daunting decision. If you invest too much too early you could be criticised for taking this position in spite of the doom and gloom around you. If you leave it too late (and many will) after talking of "seeing value in the market", you will reap the dismal rewards. Jeremy Grantham from GMO makes the following point in his March 2009 article "Reinvesting when terrified": "Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

Source: RMB Asset Management / Bloomberg / Lipper Hindsight. January 2009.

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