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Newsflash

A new month and the forty issue of Viewpoint from FP.

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At the start of 2009 we were circumspect about the investment universe following a year of severe losses across all risky assets. We made the following statement in our December 2008 Viewpoint: *"All in all 2008 was a grim year for most investors. One would however do well to learn from the mistakes that we dearly paid for over the last eighteen months and to use those lessons to inform our judgments during the year that lies ahead. A prudent investor will utilise his risk budget to add positions to a portfolio in a measured way without trying to reverse losses in the same short period in which it happened. Patience, backed by the application of sound investment principles that have been tested through many cycles, will surely be rewarded in 2009."*

In this special edition of Viewpoint we look at what transpired during the last year of the decade and provide our view on asset classes that may be considered in the construction of portfolios in the coming year.

2009 started with a stutter as both the MSCI World and S&P 500 indices respectively recorded their worst January performances in the 39 years since 1971. With the exception of gold, oil and high yield bonds all the major asset classes started the year with negative returns in January. February was no better – swine flu had the world talking (albeit behind masks in some countries) and markets once again tumbled as the MSCI World lost another 10% following a 9% decline the previous month. Commercial and investment banks in the United States and the United Kingdom were under scrutiny as many investors believed that they were close to a complete collapse, and central bankers around the world lowered their interest rates to very low levels in a bid to try and stabilise markets. In hindsight the availability of cheap money and subsequent massive liquidity boost proved to be the main driver of asset class prices in 2009. March was the big turning point for global equity markets, as both emerging and developed markets powered ahead with what turned out to be a very impressive recovery in equities.

Prior to the beginning of March most market commentary was focused on the possibility of another Great Depression, deflation and bank bailouts. Moving through the second quarter investors gained renewed optimism and the focus shifted to prospects for an economic recovery and inflation. Although fears resurfaced somewhat through June and markets entered a period of consolidation that had continued into July, the shift in mood was significant. Global developed and emerging equities enjoyed exceptionally strong performance in the second quarter of 2009. Several markets posted their strongest quarterly returns on record as they rallied sharply from the lows of mid-March. Developed markets gained 20.7% in US Dollar terms, whilst emerging markets rose 34.7% over the quarter. For emerging markets the quarterly return was the largest since the index began in 1987, and was broadly in line with the annual returns in the bull market years of 2005, 2006 and 2007.

In spite of the stellar returns in equity markets many investors were wary of significant moves back into this asset class, and investments in high yield and convertible bonds instead proved to be reasonable alternatives. By the end of the year high yield bonds in the US (+58.8%) and Europe (+82.0%) were some of the best performing asset classes in local currency terms.

The third quarter of 2009 continued in much the same vein as the second quarter with risky assets continuing to perform well and an ever-increasing number of investors switched from cash to asset classes with higher expected returns. At the end of the quarter assets in cash funds in the United States still outweighed investment in equity mutual funds, and as these investors move into riskier asset classes (as cash yields are very low) current momentum in markets could just be supported for a little while longer.

In many instances, economic data during the third quarter turned out to be better than expected. This, together with central banks' confirmation that they will keep interest rates low for longer than originally expected, supported the momentum in the market. At the time increasing consumer confidence and the influx of governments' quantitative easing funds into financial assets played an important role in the recovery in markets and indeed the global economy.

During the third quarter investors were aptly rewarded for accepting risk as equity and property markets rallied along with the riskier fixed interest asset classes. Global equities enjoyed another strong quarter, as most developed markets produced double digit returns when measured in their local currency. Japan was the one exception, down 1.4% in Japanese Yen terms. Emerging markets continued to pull ahead of their developed counterparts, albeit not as notably as in the second quarter. Global government bonds followed a 2.9% return in the second quarter with a strong 5.9% in the third quarter (measured in US Dollars). This was mostly due to a weakening of the greenback against most other major currencies, but was also attributable to government bond yields decreasing throughout the quarter. It is somewhat unusual for both equities and bonds to rally in tandem, but it seems as if the markets were in somewhat of a sweet spot at the time.

The liquidity fuelled rally in risky asset prices continued into the last quarter of 2009 as equity markets recovered further towards the end of the year. Equity market gains were somewhat more muted than in the second and third quarters of the year, which could be an indication that growth in this asset class may be relatively modest as the rally moves from a liquidity driven phase to one underpinned by increasing earnings. Concerns about the ability of some governments to repay their ever-increasing levels of debt enjoyed more attention as Greece's government debt was downgraded in December. This has given rise to fears that Greece and

Source: RMB Asset Management / Bloomberg. January 2010.

some other European countries might even default on their debt, and the request for a debt repayment standstill from Dubai World added more fuel to the fire. Global interest rates remained low throughout the quarter, but Australia and Israel took the lead in starting to increase their base lending rates.

This took us to the end of the year in which the first ten weeks belonged to the bears and the rest of the year to the bulls.

The table below summarise the returns in a wide range of asset classes over the last two years:

Asset Class Performances

Asset Class/Region	Index	Currency	Currency Returns		
			2009	2008	Combined
Equities					
United States	S&P 500 NR	USD	25.6	-37.4	-21.4
United Kingdom	FTSE All Share TR	GBP	30.1	-29.9	-8.8
Continental Europe	MSCI Europe ex UK NR	EUR	28.4	-42.7	-26.4
Japan	Topix TR	JPY	7.6	-40.6	-36.1
Global	MSCI World NR	USD	30.0	-40.7	-22.9
Global Emerging Markets	MSCI World Emerging Markets TR	USD	78.5	-53.3	-16.6
Bonds					
US Treasuries	JP Morgan United States Government Bond Index TR	USD	-3.8	14.3	10.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	10.5	-1.7	8.6
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	18.7	-4.9	12.9
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	58.8	25.9	17.7
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-1.0	13.6	12.5
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	11.1	-3.6	7.1
Euro Government Bonds	Citigroup EMU GBI TR	EUR	4.3	9.3	14.0
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	15.7	-3.8	11.3
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	76.3	-33.5	17.2
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.9	3.9	4.8
Global Government Bonds	JP Morgan Global GBI	USD	1.9	12.0	14.1
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	5.8	7.1	13.3
Global Convertible Bonds	UBS Global Convertible Bond	USD	41.4	-31.7	-3.4
Global Emerging Market Bonds	JP Morgan Global EMBI+	USD	25.9	-9.7	13.7

Asset Class/Region	Index	Currency	Currency Returns		
			2009	2008	Combined
Property					
US Property securities	MSCI US REIT TR	USD	26.3	-39.1	-23.1
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	14.9	-46.1	-38.1
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	40.2	-41.3	-17.7
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	39.0	-50.0	-30.5
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	27.6	-47.6	-33.1
Currencies					
Euro		USD	3.2	-4.9	-1.9
Sterling		USD	12.3	-27.8	-18.9
Yen		USD	-2.6	23.2	20.0
Australian Dollar		USD	29.0	-20.6	2.4
Rand		USD	25.5	-26.1	-7.3
Commodities & Alternatives					
Commodities	RICI TR	USD	26.2	-41.3	-25.9
Agricultural Commodities	RICI Agriculture TR	USD	6.4	-30.5	-26.1
Oil	ICE Crude Oil CR	USD	96.9	-58.4	-18.1
Gold	Gold index	USD	30.6	3.0	34.5
Funds of Hedge Funds	Credit Suisse/Tremont Hedge Fund	ZAR	17.5	-19.1	-4.9

Source: Bloomberg. January 2010.

FOCUS:

The important question of course is not so much what has happened but what our view is with regards to portfolio construction for the coming year. In short we expect interest rates to remain fairly low well into the year, with the Federal Reserve likely lead the Bank of England and the European Central Bank with respect to increasing their respective short term rates. The United States have a wonderful ability to rejuvenate themselves following an economic downturn and this may assist them in leading the rest of the developed world's recovery. In line with this view the US Dollar should not be discarded and investors that have written the greenback off should at least consider the consequences of possible US Dollar strength to their investments.

Following extraordinary large equity issuances and the availability of relatively cheap bond funding, the corporate sector has gone a long way towards the reparation of balance sheets and seems to be in a reasonably strong position at the start of 2010. Current and consensus forecast price / earnings ratios seem to be at undemanding levels. Coupled with the current fiscal stimulus programmes around the globe equity markets could continue to tick up, albeit with some volatility along the way. Within equities we prefer an overweight allocation to emerging markets and quality managers. There exists risk that emerging markets may continue to trade at an increasing premium to developed markets and for that reason we would caution against piling into the asset class without diversification to developed market equities.

Bond markets are in a somewhat precarious position as sovereign risk has been put under the spotlight in recent months. Central banks around the world could also not continue indefinitely to add treasuries and gilts to their balance sheets, which may lead to increasing yields to make these instruments more attractive to non central bank purchasers. The caveat to this view is that if the economic recovery slows down, deflation fears will flair up and risk assets could have another setback leading to increased demand for government bonds. In such a scenario sovereign debt may look attractive at current yields. Investment grade bonds, in our opinion, offer additional growth potential over government bonds with not much more risk on the downside. We would therefore suggest balancing any underweight exposure to government bonds with an overweight position in investment grade corporate debt. High yield, in spite of its impressive performance in 2009, still looks attractive at current spreads over government bonds, and as a result we would consider holding on to this asset class to enhance the performance of our overall fixed income allocation. The valuation anomaly that existed in convertible bonds at the end of 2008 has all but dissipated, and we would prefer to replace our holdings in this asset class with a combination of pure equity and corporate bonds. Lastly emerging market bonds issued in local currency and with relatively short duration would give investors access to the relative undervaluation of emerging market currencies against the majors, without exposing portfolios to too much interest rate risk.

Even though there seem to be a number of attractive opportunities in direct property investment many market commentators still expect this asset class to only perform later in the economic cycle when decreasing unemployment, increasing occupier demand and inflating rental income come into effect. Current conditions for property investments remain fairly tough, and with corporations unlikely to reverse the cost cutting of 2009 any time soon valuations in the commercial and industrial sectors of the market will remain under pressure. The interesting opportunity in the property market may be the current yields which exceed the returns on government bonds and cash by some margin, but do not be surprised by further volatility in capital valuations as leases are renegotiated with lessees clearly having the upper hand.
One other area that looks interesting in a year where many asset classes seem to be fairly priced is the “bête noire” of 2008 – funds of hedge funds. The market neutral versions of these funds managed to beat cash rates by approximately 5% to 7% in 2009, and whereas fewer attractive opportunities seem to be present one year down the line, a return of cash rates plus 4% may still prove to be a decent contribution to overall portfolio returns in 2010. One important lesson of the

hedge fund crisis in 2008 must however be borne in mind – investors need to be convinced that they demand a high enough illiquidity premium when they consider an investment in funds of hedge funds.

In many ways 2010's investment environment seems more daunting than that which money managers faced at the same time last year as most asset classes seem to be fairly priced, and tail risks looming in the wings can't be ignored. For this reason our broad asset allocation position would be to remain fairly close to asset class and currency benchmarks, whilst aiming to produce alpha through manager selection and style allocation within asset classes.

There is and old proverb (some debate on whether this wish or potential curse originated in China or America) that consists of the following three wishes:

- May you live in interesting times
- May you come to the attention of those in authority (sometimes rendered "May the government be aware of you")
- May you find what you are looking for.

Our wish in 2010 is to enjoy the first, as this will certainly come true. We will aim to steer clear of the second, in our efforts to remain within the regulations and ethical requirements of our industry. In addition, in the final instance we will relentlessly pursue alpha, as that is what we are looking for.

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Foreword to Viewpoint January 2010

As we enter 2010, the contrast with a year earlier could hardly be more stark. Then we faced a financial meltdown, the prices of risk assets were in free fall and investor sentiment was universally extremely negative. At the beginning of 2009, no doubt we all would have happily settled for the year's outcome; indeed had anyone in the early months of the year predicted anything approaching the investment returns actually achieved they would have been viewed with incredulity. In the event returns were more than satisfactory; the worst performing asset classes in 2008 turned round to provide the best returns in 2009, with credit leading the way, followed by convertible bonds, equities, property securities and commodities. Developed world government bonds, the ultimate safe haven in 2008, produced the weakest returns in 2009, as evidence mounted of an end to recession and investor risk appetite began to return.

There have been many lessons learned during the tumultuous past two years but 2009 has been a perfect illustration of the great benefits of multi-asset, multi-style investing, of dynamic asset allocation using the full range of asset classes, and of the critical importance of valuation (price really does matter!) in determining asset allocation positions. A year ago, many risk assets became heavily oversold, with some moving to multi-decade valuation lows as investors delevered with a vengeance. In particular, credit markets offered once-in-a-generation opportunities and those investors who missed that lost out on spectacular returns, achieved at low levels of volatility and risk. Equities too were supported by high dividend yields (a year ago most equity markets offered prospective dividend yields higher than government bond yields) and the corporate sector bounced back strongly with aggressive cost cutting and an end to inventory slashing. Within equities it was deep value stocks which rallied the hardest, leaving defensives and quality stocks well behind. Strategic diversification of equity style again paid off, as few investors were buying into deep cyclicals in early 2009, yet that is where the very best returns were produced in the rest of the year. Our portfolios and multi-managed funds participated fully in the rally in risk assets, generally outperforming benchmarks but with relatively low volatility, as our diversification and in particular our credit positions paid off handsomely, producing equity like returns but at much lower levels of risk.

The decade just ended has demonstrated vividly the importance also of understanding the behaviour of asset classes and why they are held in a portfolio. Exceptionally, the first decade of the millennium produced a negative return from the world's developed equity markets; the MSCI World index returned -2.5% between the end of 1999 and end 2009. In contrast global government bonds returned 91% over the same period, protecting investors from the ravages of two equity bear market crashes of over 50%, and in the past two years providing the ultimate safe haven as the world faced the prospect of a systemic financial collapse.

While there is no doubt that the actions of governments and central banks around the world have prevented the meltdown that had seemed entirely possible, and we are past the risks of a systemic collapse and depression, it seems to me that the uncertainties we face are as great now as at any time in memory and the challenges of investing for income and growth are daunting.

Many excesses of recent years are yet to be unwound. To date the global economy has been saved from deflation and a prolonged deep recession by extraordinary and unconventional monetary policy measures, which must end in due course, and by fiscal stimulus of unprecedented scale, which has had the effect of replacing private sector debt with public sector debt. The result of this policy and its ultimate unwinding poses huge uncertainties. Will it be inflationary or deflationary? Can the recovery become self-sustaining? Will the timing and execution of the exit strategy be sufficiently adroit to avoid a relapse into recession? For many nations the unwinding of excesses presents a choice between deflation, devaluation or default. With credit availability still restricted by the need for banks to restore balance sheet health, and with deleveraging likely to be a multi-year process, growth prospects appear to be muted. Yet interest rates in most of the developed world cannot fall further; they are already at near zero levels. The options available to governments and central banks are now much more limited; there is little or no room to counter any further shocks to the system. Clearly a prime aim of policy has been to push asset values higher, and to date this has been highly

successful. But a whole host of risks: a growth scare, rising protectionism, sovereign defaults, currency dislocation, a bond market collapse on rising inflationary fears to name but a few, could produce a sudden air pocket in markets.

These extremes of uncertainty come at a time when there are no longer valuation extremes in markets. The oversold and exceptional undervaluation of many asset classes a year ago has been corrected by the moves of the past nine months; in some cases markets appear to be getting ahead of the fundamentals, driven more by liquidity factors. On some measures equities are now fully valued while the credit opportunity has largely played out. Property remains over supplied in many countries. Commodity markets have boomed in the past year but face the prospect of more subdued demand for some time as the global economy rebalances. Without such rebalancing, involving much greater domestic demand growth in the developing world and a realignment of currency values between emerging and developed nations, a sustainable global recovery seems a distant prospect. Can growth in the developing world make up for weak final demand in much of the developed world, and will this justify the premium valuation to which many emerging markets have now moved? If inflation becomes a real threat, government bond yields would surely rise significantly. Against these unknowns and concerns is the reality of near zero interest rates on cash in the major currencies and a yield curve which has rarely been steeper, itself usually a reliable indicator of global recovery and strong performance from risk assets.

In this expanded and special edition of Viewpoint to mark the start of the year we attempt to throw some light on these difficult issues and set out our expectations, our policy response and plans for the structure of our portfolios. I suspect this will be a year for wealth preservation as we face such high tail risks and daunting uncertainties globally. A year of high single digit returns would seem at this juncture to be a reasonable outcome and expectation, albeit with some considerable volatility on the way. As ever we will be hoping for the best but planning for the worst! What I am certain of is that we will stick to our tried and tested investment approach of diversification across asset classes, markets, countries, currencies, styles and managers, seeking out uncorrelated investments to improve the risk return trade off in our portfolios, and dynamically allocating those assets taking into account valuations and the opportunities that will inevitably be thrown up during a period of unprecedented uncertainty.

Glyn Owen