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Newsflash

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Produced in association with RMB Asset Management International Limited (trading as RMB Asset Management), authorised and regulated by the Financial Services Authority (UK).

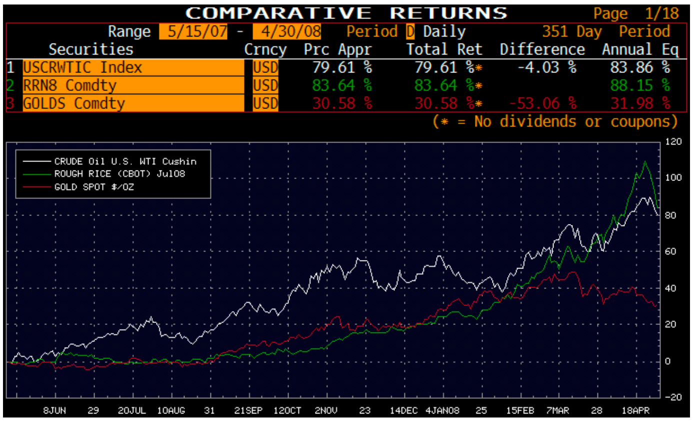
April saw a continuation of the broadly positive sentiment that was evident at the end of March. Throughout the markets there was a feeling that the Fed's action to prevent Bear Stearns from becoming insolvent represented a line in the sand. The Fed implied that it would take every action it could to prevent any major banking institution from going under. This definitely provided a degree of protection to the engine room of the financial system and markets rallied as a result, but outside of this arena there are still concerns regarding the housing markets, consumer and business spending and inflation to consider. Despite this, from looking at index performance alone, April would appear to be a step towards lower volatility conditions that favour risk assets, reminiscent of early 2007. As the month drew to a close the Federal Reserve made a further twenty five basis point (bp) rate cut, to bring the base rate to 2.0%. This was insufficient to prevent a negative month for bond investors.

Global equity markets enjoyed strong performance as investors collectively viewed the world in a more positive light. The MSCI World returned 5.3% in US Dollar terms, with the UK, US and Europe returning 6.3%, 4.8% and 5.5% in local currency terms. The strongest major was Japan, which returned 12% in Yen terms. The Yen softened against the Dollar in the month, but despite this headwind the Japanese market was ahead of the pack in US Dollar terms. Global Emerging Markets also enjoyed something of a bounce following an uncertain start to 2008. The MSCI Emerging Markets Index returned 8.1% in US Dollar terms, bringing their year to date return to -3.8%.

In the debt markets, Global Bonds returned -2.1%. Investors had been aggressively adding to their government debt portfolios in the past few months as any credit or equity related risk has been out of favour in comparison to the creditworthiness of government debt. These concerns were less prevalent in April causing global government bonds to underperform the broader index, falling -3.2%. Additionally this weakening of the fixed income markets may reflect the view that interest rates have less downside potential. The US has cut interest rates aggressively, but central banks such as the Bank of England and the European Central Bank have inflation containment mandates which may preclude them from making rate cuts were their economies to weaken. As the Fed stated in their April minutes "The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time and mitigate risks to economic activity". The fact that *"The committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability"* gives the Fed room for further cuts if necessary, but certainly does not commit it to this path. Furthermore in the April meeting two members of the ten person committee voted in favour of no change from the previous 2.25% rate.

In the currency markets, the US Dollar had a mixed month against the majors. The euro and Sterling lost -1.8 and -0.4% respectively, whereas the commodity currencies such as the South African Rand, Brazilian Real and Australian Dollar benefitted from strong commodity gains, returning 7.7%, 5.9% and 3.3% respectively. Interestingly both the Japanese Yen and Swiss Franc lost approximately 4% against the US Dollar, these currencies had benefitted from the higher volatility of recent times as investors sought to unwind their carry trade positions.

The commodity markets also experienced a range of returns, with oil and rice having a large volume of newsprint dedicated to their apparently unrelenting price increases. The crude oil future increased by 10.2% in April alone to close the month above $110 per barrel. Intra-month the price of oil had nearly hit $120. Rice futures also increased significantly; an event which will have a limited effect amongst the developed markets, but emerging economies, where food cost can account for a large proportion of their consumption basket, may be severely affected. Figure 1, below, demonstrates the increase in the cost of rice (the green line) against oil (the white line) and gold (the red line) since May 2007. Rice's increase is actually greater than oil and over 50% ahead of gold over the period. Overall broad commodities returned 4.8% in April, outperforming the Agricultural component which returned 0.5% in US Dollar terms. This trend is also reflected year to date, with the broad index returning 14.5% against 3.6% for the agricultural component.



Amongst the global property markets, the regional performance differentials were somewhat less noticeable, with most regions providing positive returns. In April, the UK was the exception, returning -5.1% in US Dollar terms. American listed property, on the other hand, followed a strong March by returning 6.0%. This was low, however, when compared to Asian property which returned 11.7% over the period after a poor first quarter. Overall, global property returned 6.3% in April, providing some degree of respite for investors in this recently difficult asset class. Indeed, year to date global property is now broadly flat, returning 0.3% in US Dollar terms, which compares favourably to equity markets.

Statistics source: Bloomberg, Lipper Hindsight, Citigroup, Federal Reserve, April 2008.

Asset Class Performances

Asset Class Performance (%)	Apr 2008	2008 YTD
US Equities $	4.8	-5.2
UK Equities £	6.3	-4.2
Cont. European Equities €	5.5	-10.2
Japanese Equities Yen	12.0	-7.0
Global Equities $	5.3	-4.3
Global Emerging Markets Equities $	8.1	-3.8
US Bonds $	-1.7	3.0
European Bonds €	-0.6	1.7
Japanese Bonds Yen	-1.6	-0.3
Global Bonds $	-2.1	5.1
US REITs (property) $	6.0	8.3
FTSE Real Estate £	-5.1	-3.4
FTSE EPRA Real Estate ex UK €	0.6	2.1
FTSE EPRA Real Estate Asia $	11.7	-6.6
Euro vs. US Dollar	-1.8	6.5
Sterling vs. US Dollar	-0.4	-0.5
Yen vs. US Dollar	-4.8	6.9
Rand vs. US Dollar	7.7	-9.5
Commodities $	4.7	14.4
Agricultural Commodities $	0.5	3.8
Oil $	10.2	20.9
Gold $	-6.7	4.3

Source: Bloomberg, Lipper, Citigroup, April 2008.

FOCUS: Leveraged Loans as an alternative fixed interest asset class

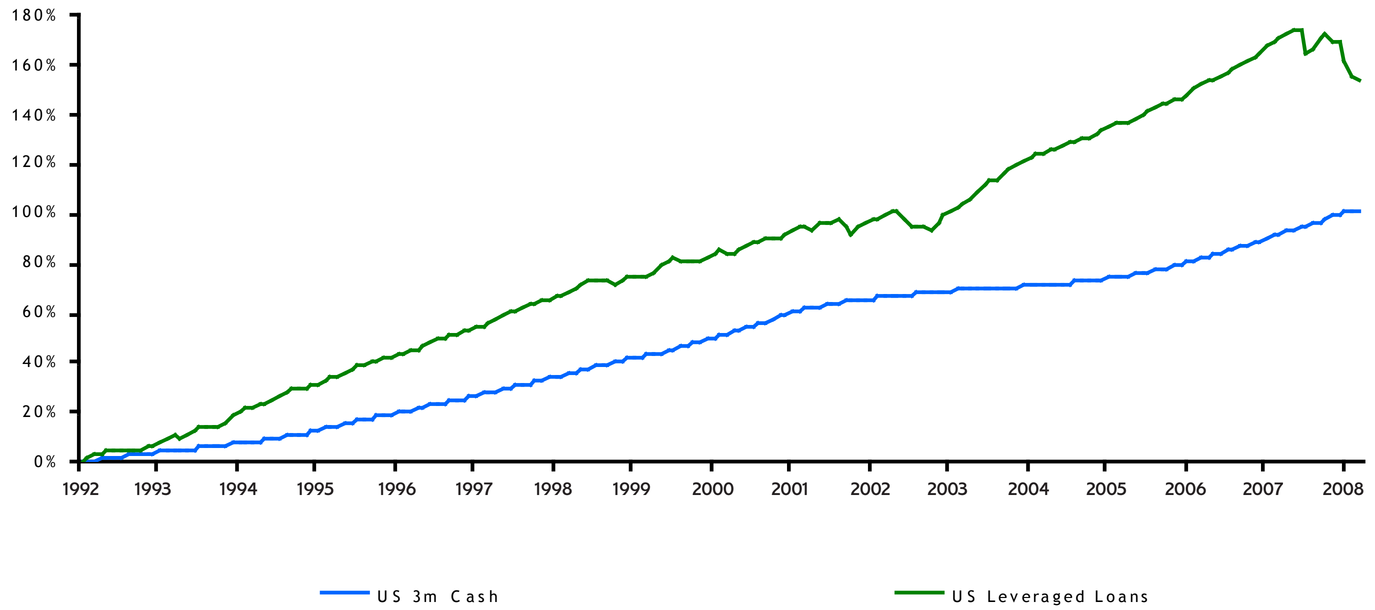
Leveraged Loans, or Bank Loans, are loans extended to companies to finance internal growth, acquisitions, mergers and leveraged buy outs. The term 'leverage' refers to companies that already have a high degree of borrowing - typically Debt/EBITDA of 4x or more.

Leveraged loans are similar to high yield bonds in terms of credit rating and financial profile but rank higher in the capital structure and are therefore of higher credit quality. They are usually secured against assets of the company which ensures a high recovery rate in the event of a default.

Leveraged loans often contain covenants to restrict the borrower's ability to take on additional debt beyond specific limits, further improving the quality of the loan. In the US, loans have exhibited an average recovery rate of 75% while high yield bonds have recovered around 44%.

The chart below, showing cumulative performance of US Leveraged Loans against 3 month USD LIBOR, demonstrates the stability the asset class can offer. It is only recently that loan prices have come under pressure as technical selling and deleveraging has forced prices lower.

Fig 2: Cumulative Returns of US Leveraged Loans and US 3m LIBOR



Leveraged Loans have floating rate coupon payments which are reset periodically, usually quarterly, to a spread above LIBOR. This is an important difference when compared to a high yield bond as leveraged loans carry no interest rate risk, effectively providing a hedge to the investor against interest rate rises. This characteristic alone gives loans a natural diversification benefit from traditional fixed interest investments.

Loans do exhibit spread duration risk as evidenced in recent pricing movements but this should be viewed relative to the duration risk of high yield fixed rate bonds which typically have a longer maturity profile than loans.

The table below (Figure 3) shows how loans exhibit a low correlation to most other fixed interest asset classes and a negative correlation to Treasuries due to their lack of interest rate risk. Correlation to High Yield debt is under 60%.

Source: The Economist, Bloomberg
Statistics source: Bloomberg, Lipper Hindsight, April 2008.

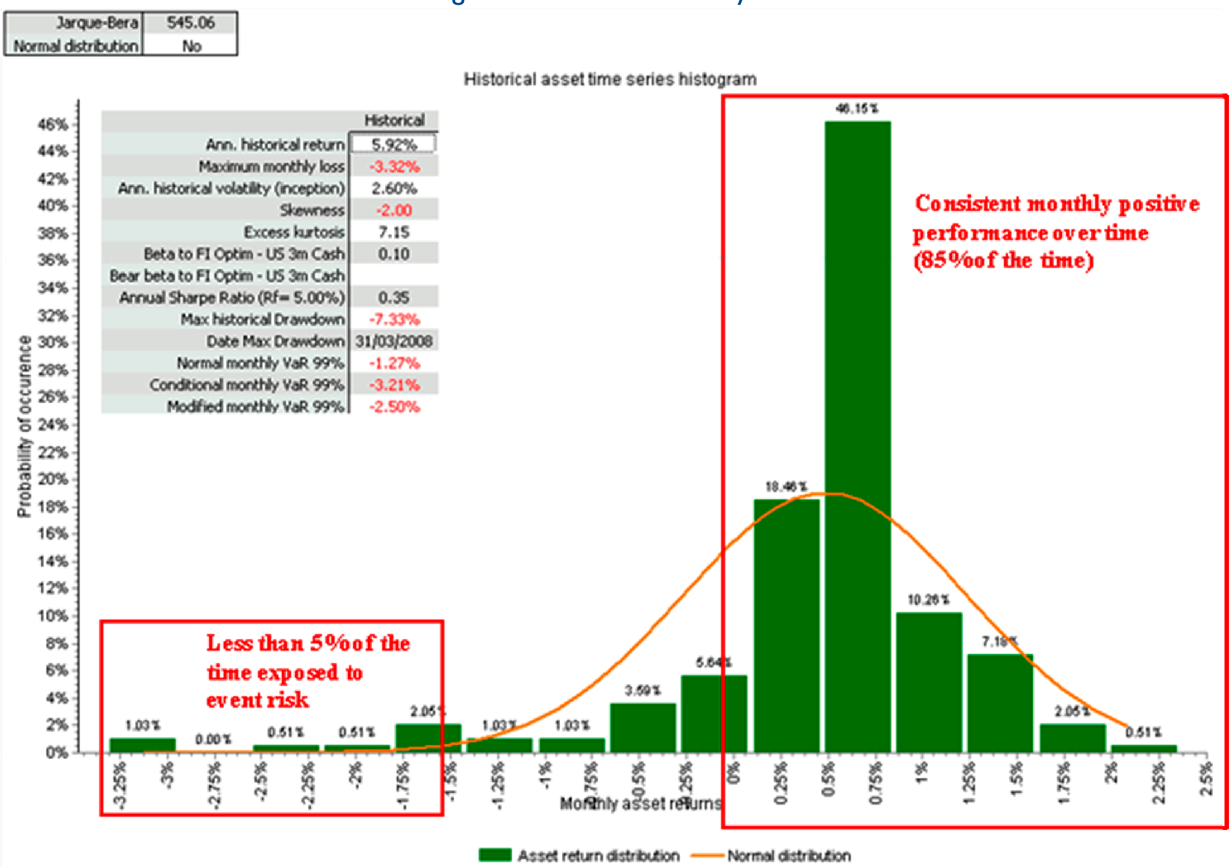
Fig 3: Correlation between Asset Class Returns

less than 20%
between 20% and 70%
more than 70%

	US Loans	Global Aggregate	Global Treasury	JPM Emg Debt	US 3m Cash	US Aggregate	US CMBS High Yield	US CMBS Investment Grade	US Corporate	US Corporate High Yield	US Municipal Bond	US Treasury
US Loans	100%											
Global Aggregate	-19%	100%										
Global Treasury	-24%	98%	100%									
JPM Emg Debt	9%	14%	6%	100%								
US 3m Cash	0%	16%	18%	-4%	100%							
US Aggregate	-16%	95%	89%	17%	12%	100%						
US CMBS High Yield	28%	46%	40%	9%	2%	48%	100%					
US CMBS Investment Grade	4%	83%	75%	16%	8%	88%	59%	100%				
US Corporate	6%	88%	80%	31%	4%	92%	54%	82%	100%			
US Corporate High Yield	57%	7%	-2%	49%	-11%	10%	22%	12%	38%	100%		
US Municipal Bond	5%	75%	69%	15%	6%	79%	43%	83%	74%	15%	100%	
US Treasury	-28%	92%	90%	5%	11%	96%	41%	81%	83%	-7%	75%	100%

The distribution of monthly returns and statistics since 1992 are shown in Fig 4 below.

Fig 4: Distribution of Monthly Returns



Source: Alternative Soft, April 2008.

The distribution above is typical of credit markets. Bonds that are issued at par have little upside, but significant downside should any bond default and the loan market is no different. The chart tells us that 85% of the time US Loans provide a positive monthly return but investors should be aware that they are exposed to sharp negative months approximately 5% of the time. To date the largest monthly loss has been -3.25% and we are currently in the largest drawdown period with loans having fallen just over 7% peak to trough

Why are loans attractive today?

Loans traditionally offer the investor a spread over LIBOR but little in the way of capital appreciation. For this reason many of the players in this market would gear up their funds to make the returns more attractive. As the credit crunch took hold in July 2007 hedge funds and other levered players were forced to sell high quality assets to meet margin calls against leverage on lower quality assets. This ultimately triggered a technical sell off as loan prices fell further despite no change in the underlying quality of the credit.

Structured products such as Collateralised Loan Obligations (CLOs), a significant source of demand in the past, virtually shut down overnight. Banks found themselves unable to shift the significant loan exposure already on their balance sheets and were thus unwilling or unable to buy more loans.

Worse followed in Q1 2008 as loan prices spiralled down to the mid 80s having priced at par some 6 months prior. We believe they now offer significant value with the technical selling flushed out and only a modest pick up in prices since the bottom in March leaving scope for capital appreciation as well as yield spread.

With loans issued at par and currently priced around 90, we expect the asset class to deliver 10% per annum in GBP terms. Loans usually pay around LIBOR plus a spread of 250-300bps but will also benefit from the capital appreciation as they reprice back to par. Assuming 4 years until maturity and selection of a manager who can successfully avoid defaults, this ‘pull to par’ effect will add another 250bps annually to the investor’s return.

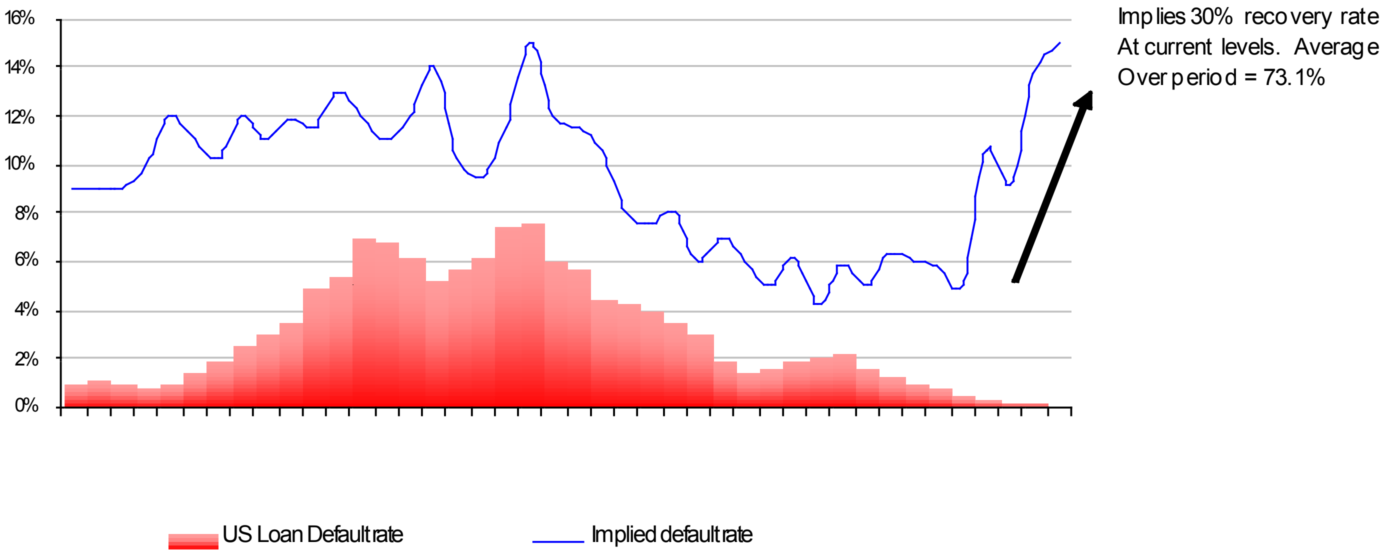
Loan metrics	Issued at Par	100
	Current Price	90
	Years to Maturity	4
	Spread to Libor	250
	Libor	600

Annual return	Libor	600
	Spread	250
	‘Pull to Par’	250
	Less Management fees	(100)
		1,000

This ‘pull to par’ is the premium investors would require to compensate them for an increase in the level of defaults in their portfolio. At current levels, the market is pricing in a high level of implied future defaults or conversely a level of implied future recovery significantly below the long term average.

Statistics source: Bloomberg, Lipper Hindsight, April 2008

Fig 5: Actual and Implied Loan Default Rates



Source: Moodys, Credit Suisse, M&G, Absolute Return Partners LLP

Based on US data and 70% recovery rate

Figure 5, above, shows the default experience of US Loans against the default rate implied from the spread level. Current levels imply a default rate of around 15% - far above the long term average of approximately 2.5% and the peak of approximately 8% in the last cycle.

While default rates for sub investment grade debt are expected to rise to around 5% by the end of 2008 from the current 1.5%, there are a number of mitigating factors that may see the actual default rate come in lower.

In the previous credit cycle non financial corporates had more leveraged balance sheets. This time around they have higher cash levels and better interest cover thus lowering the likelihood of a default.

Given the low refinancing rates available in recent years, US corporates are less exposed to near term refunding risk. Balance sheets that might normally have been susceptible to higher funding costs were able to refinance at historically low rates.

The recent increases in HY spreads are more likely attributable to increased liquidity and risk premiums than to an increase in expected credit losses. Effectively the investor is being paid more for the same credit risk.

We believe that leveraged loans make a good addition to any fixed income portfolio, but that the risk reward trade-off today is particularly compelling. Investors should be aware that as an asset class European loans is much larger than European high yield and so by combining investments in both asset classes they take full advantage of the available opportunity set. Minimal issuer overlap between HY and leveraged loans also adds another layer of diversification.

Moody's Credit Transition Model (CTM). The Corporate Default Rate Outlook: An Update. Moody's Global Credit Policy, April 2008. Statistics source: Bloomberg, Lipper Hindsight

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