



CLARION plc

Market and Portfolio Review

Summary

- Green shoots emerge as economic indicators start to stabilise
- Risk premiums fall, helping credit risky bonds and equities stage a rapid recovery
- Government Gilts produce a negative return
- Rotation of portfolios for a change in the economic cycle

Review and Outlook

The most recent quarter has been positive as economic indicators stabilise and green shoots regarding the health of the global economy start to emerge.

Stock markets look ahead of the current economic scenario to price in future earnings. In 2008, the stock market appeared to be pricing in a future economic scenario in line with the Great Depression of the 1930s. This was exacerbated by the forced selling of many leveraged institutions, which led to a spiral of selling. It has always been our belief that this scenario was unlikely, given the policy action of both governments and central banks.

In the 1930s, monetary policy remained tight in order to keep the main global economies fixed to the Gold Standard. In addition, Classical Economics ruled and governments ran balanced budgets. This was essential at the time as financing of the government by the likes of J P Morgan insisted that the budget deficit was minimal. As

growth slowed and tax receipts diminished the governments were forced to reduce spending, ending in a spiral of lower tax receipts followed by lower spending. The depression was then accelerated by protectionist policies, which put the 'nail in the coffin' of global trade.

In the Financial Crisis starting in 2007, central banks have been quick to support the financial system and loosen policy with historically low, near zero, interest rates. This should allow firms to deleverage and manage borrowings more effectively. Central bank policy has gone further by guaranteeing loans and being the lender of last resort. This policy appears to be working as liquidity has started to ease in corporate markets, although from an extreme position. Unfortunately, mortgage lending and other private finance remains tight.

Governments have also shown willing, committing themselves to borrowings normally only seen during a world war, which could provide some support to the global economy. This area of the crisis appears to be the most controversial, especially in the UK where it is predicted that the UK Deficit will exceed 100% of the Gross Domestic Production (GDP) and has made a mockery of the Prime Minister's Golden Rules that he put in place as Chancellor.

In the first six months of this year, market sentiment has changed from a very negative standpoint to a far more optimistic one. From the lows seen in March, the UK stock market has returned c. 24%¹ and the global stock market c. 21%¹.

In addition to equity values, corporate bonds have recovered strongly as liquidity has eased. As described in previous reports, Clarion portfolios have been overweight in this market due to the attractive valuation of the asset class and its senior position in the

¹ FTSE All Share & FTSE All World TR - 3 Mar 2009 to 30 Jun 2009. Source: Lipper Hindsight

credit structure of a business compared with equities. The average corporate bond fund has delivered c. 9% and the average high yield corporate bond fund has returned c. 20% over the last quarter².

We remain cautiously optimistic on the outlook as any recovery is in the very early stages and is likely to remain sensitive to policy and other factors. We believe that the biggest risk to a recovery is if the high levels of gilt issuance by governments fail to attract investors at their current over valued levels (as discussed in previous reports) then yields may rise / prices fall. Most loans, including mortgages are priced according to the Government (or risk free) yield curve. Although this is likely to remain near 0% for short term loans, the five year yield is currently c. 3%³ and is far more important for the mortgage market.

If investors demand a higher return for holding Government debt due to the high levels of supply vs demand, or if inflation expectations start to increase, then the yield curve may steepen and interest rates rise. This will act as a brake on the economy and dampen growth.

It is our belief that should this scenario start to build, central banks will continue or expand their current Quantitative Easing [QE] policy, where they buy gilts in exchange for cash, therefore replacing slow money with quick money. The effect of QE is to flatten the yield curve as demand is artificially created for gilts. The risk of QE is that it creates higher inflation expectations in the same way as printing money, by devaluing a currency.

Gilts have provided the lowest rates of return of all asset classes in 2009. Clarion portfolios are largely underweight in their allocation to gilts, which has benefitted all portfolios year to date.

² IMA £ Corporate Bond & IMA £ High Yield TR - 1 Apr 2009 to 30 Jun 2009. Source: Lipper Hindsight

³ Source: FT.com as at 3 July 2009

During the period, the management have started to rotate investors' portfolios to reflect a change in the investment cycle. Although further bad news is likely, we believe that the economic cycle is moderating and it is important to address portfolios in anticipation of any sustainable recovery. The recent period of relative stability has given us time to more effectively analyse the assets held.

We have switched some of the poorer performing assets to stronger performers and have moved the portfolios in favour of equities, taking the opportunity to sell some of our bond positions, which may be negatively affected by a rise in the yield curve.

We have also taken the opportunity to remove some of the alternative asset classes, which were purchased to protect investors on the downside and have bought more long-only assets⁴, which should give greater exposure to a recovery.

This process is ongoing as the timing of a recovery is difficult to predict. The managers have been careful not to make rapid changes into areas that have already recovered strongly and present lower future returns.

We expect the markets to remain volatile and look for further opportunities.

Matthew Jealous CFA
Fund Manager

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⁴ Long only refers to investments that only buy assets. Many alternative funds/hedge funds can buy and sell derivatives to hedge exposure and provide short (sold) positions. This can provide downside protection to portfolios if hedged effectively.