



CLARION plc

Market and Portfolio Review

Summary

- Central Bank Co-operation
- Improved Economic Data
- Improving Investor Sentiment

Review and Outlook

Stock markets in developed markets, excluding Europe, rebounded sharply in the last quarter of 2011, with the FTSE 100 providing a return of c. 9.5% and the S&P 500 returning c. 12.5%, rounding off an eventful year.

During 2011, stock markets have been blown around by numerous global events, including a spike in oil prices, the Japanese Tsunami and subsequent nuclear threat, the European debt crisis, the Arab Spring, political wrangling over the US debt ceiling and continued fear of a global recession and second banking crisis.

Investor confidence fell sharply in the summer months as political and central bank co-operation, seen in the financial crisis, eroded on both sides of the Atlantic. Whilst the Federal Reserve and Bank of England continued to relax monetary policy, the ECB increased interest rates. Republicans and Democrats fought over plans to tackle the budget deficit, stripping Barack Obama of control and leaving a lame duck president. In Europe, politicians were unable to agree on a solution to the on-going crisis, holding summit after summit with no real tangible progress.

In the last quarter of the year confidence has improved as politicians and Central banks have made some progress in addressing the real issues.

In October, Dexia, a Belgium bank, collapsed but was quickly bailed out by European governments in the course of a weekend. This

seemed to draw a line under fears of bank collapses in Europe, by demonstrating that when required quick, collaborative and effective action could be taken.

Also in October, a European summit provided a boost to the existing bail-out package, leveraging the European Financial Stability Fund, EFSF to c. 1Tr Euros.

In November, six central banks, including the FED, BoE, ECB and the BoJ agreed to provide unlimited US \$ finance to European banks at a discounted rate to help improve liquidity.

In December, the ECB reduced the base interest rate and provided unlimited 3 year loans to any European financial institution at 1%, which has a similar effect as QE. Both of these actions bring the ECB more in line with action taken by the BoE and Federal Reserve, indicating a renewed level of global co-operation.

Although the above action has taken longer than many have demanded and does not go far enough to alleviate market concerns entirely, the steps represent positive moves in the right direction. We would expect that there will be more disagreements between European Governments or politicians and central bankers, which will lead to renewed volatility. However, the steps provide more commitment to a full solution and have calmed investor nerves, leading to significant increases in value at the end of the period.

UK Government issued bonds (gilts) continued to increase in value over the last quarter returning c. 5%. The investment team continue to be surprised in the strength of the asset class, which investors have used as a safe haven. The current yield on a ten year gilt is c. 2%, which is historically extremely low. Usually, investors have demanded roughly 2% above inflation, which is currently over 5%. Inflation protected gilts, now trade at a negative yield, i.e. investors are willing to pay the government to hold their money and return it adjusted for inflation, rather than demand to be paid interest for their loan. We cannot see the value in this strategy under anything but the worst scenario imaginable.

To put the risk of government debt into perspective, it is easiest to provide an example. Should yields rise, then investors holding a standard portfolio of gilts stand to lose c. 10% of their capital for every 1% rise in the yield curve. If yields rose to 7%, the average yield over the last 25 years and 2% above inflation, then investors

could lose roughly half of their capital value unless they hold the portfolio until maturity, in which case they will suffer real losses due to the effects of inflation.

The reason that gilts have been so popular over the last twelve months is that concerns in Europe have led many investors to reduce their risk by selling risky assets such as Emerging Markets or European assets and re-allocating to Gilts. US Government debt (US Treasuries) and German Government debt (Bunds) have also experienced the same fall in yields.

Whilst the level of Government debt in the UK is lower than some other developed markets, it is still historically high and is growing faster than most of the European countries that are facing a crisis. If we consider the liabilities that do not count towards the official figures or when private debt is considered, then the combined debt of the UK is greater than most of the P.I.I.G.S.

The same can be said for the US, which to date has not made any efforts to tackle the huge deficit and lost its prized AAA rated status (the highest credit rating possible).

Despite a strong end to the year, we believe that 2012 is likely to remain volatile as significant global imbalances play out and fears over the European Monetary Union continue to play on investors nerves.

As your investment manager we have to consider the value attached to different asset classes to create an investment strategy.

Investors are in an extremely difficult position, when uncertainty is high, normally investors are happy to hold cash and receive bank base rates. However, with rates close to zero and inflation at 5%, this option isn't viable for any reasonable length of time.

As previously stated, we cannot see value in government debt and even corporate debt, where we find more value, is likely to suffer if yields start to rise.

Commodities are volatile and cyclical, relying on growth in the Emerging Markets to remain strong. Gold, which recently hit a high of \$1900 an ounce (Gold traded at c. \$300 an ounce in 2002), has now quickly fallen to \$1600. Often being used a hedge against inflation or due to fear about currencies, it is difficult to see how at

these levels it will provide further protection and the danger is that investors could continue to see rapid falls.

Property is domestically influenced and yields, whilst fair relative to historic levels, are under pressure outside of prime real estate where yields are low. In addition, property is illiquid and therefore represents a higher risk.

Taking everything into account the investment team come back to equities. Following a lack of capital increase and following the tech bubble and credit crisis, the asset class has become extremely unloved over the last ten years. However, valuations are near lows seen in the credit crisis and companies are cash rich.

The biggest problem is finding a catalyst that releases the value in companies' shares. Most boards are happy to hold onto their cash stores, retaining profit for a rainy day. In most economies companies have built record levels of cash on their balance sheets and have access to extremely cheap finance in the bond markets. In the short term, this provides protection to investors, but with governments unable to drive economies forward companies need to start investing otherwise we end in a vicious cycle.

This position could be easily broken if some of the political uncertainties improve, or governments look to tax the high cash balances, forcing companies to invest or return cash to shareholders, driving up prices. Unfortunately, the timing of change, especially political change is hard to predict.

Therefore, we must remain patient. Our strategy has favoured companies that are cash generative and will survive if the economic data deteriorates, but should also benefit if and when things improve.

Emerging Markets and Asia Pacific funds underperformed UK and US funds last year as China tightened monetary policy and investors reduced risk. This trend reversed slightly at the end of 2011 and the team will monitor this situation.

We expect to keep portfolios internationally diversified in order that exposure is spread.

Matthew Jealous CFA
Fund Manager

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