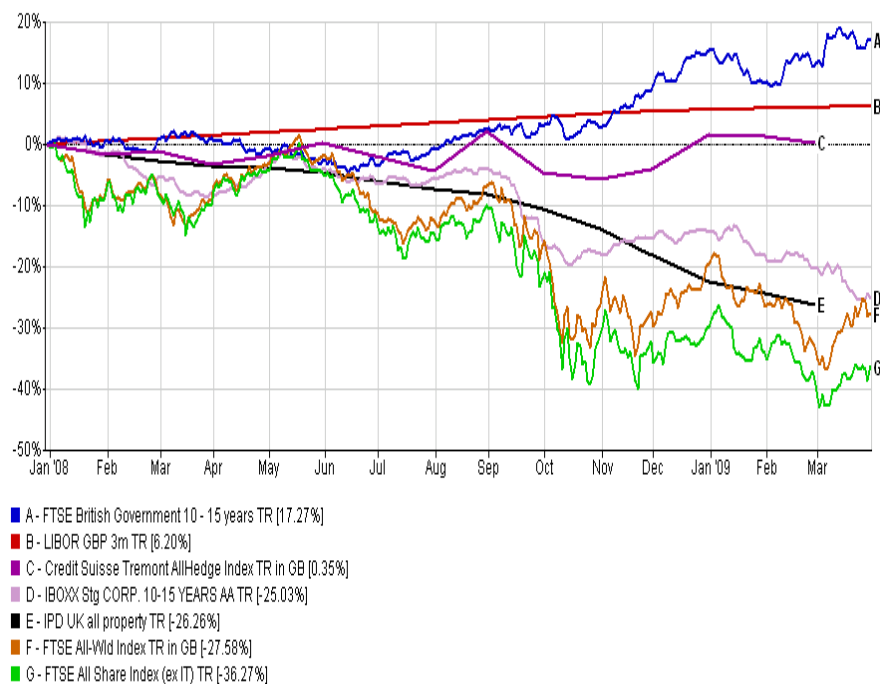


Market and Portfolio Review

Summary

- Governments and Central Banks continue to lead efforts to resuscitate capital markets; base rates are reduced further and Quantitative Easing introduced in March.
- As cash rates fall to near negligible levels, government bonds continue to outperform but offer little attraction over anything but the very short term.
- Diversification continues to fail to protect investors, 'risk' asset classes continue to weaken.



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- Equity valuations better reflect difficult trading conditions and value exists for investors prepared to be patient and able to withstand further volatility.

March 2009

Review and Outlook

The first three months of the New Year followed the pattern of the previous twelve. Trends established during 2008 continued unabated resulting in government bonds looking ever more expensive and equities moving to such low valuations that 10 year returns turned negative.

As such it might be thought that there is relatively little to write about, our summary bullet points are not very different from the end of last year and indeed this report is shorter than usual, however with another three months out of the way, the pathway for investors is a little less clouded and we can write of an increasing conviction in our portfolios positioning and a tempering of our cautious stance on equities.

Early 2009 brought with it further cuts in base rates from the central banks and an increasing commitment worldwide by governments to support those banks whose balance sheets have been decimated by 'toxic' debt. The banking systems of many of the worlds developed economies are now supported by debt issuance either implicitly or specifically guaranteed by government. Some banks have been nationalised and for many of those that have not the tax payer, through the government as nominee, is now the majority shareholder.

Economic data continues to paint a difficult picture, production is falling, unemployment rising and asset prices generally continue to retreat. Early March introduced Quantitative Easing as the latest tool to improve liquidity, stimulate growth and combat deflation. In the UK, this essentially means the government buying back its own debt, a difficult concept to take on board given the requirement to finance the massive packages already announced to support the financial system.

In the short term quantitative easing has resulted in government bond yields falling as prices have risen, a rational effect given the near term deflationary outlook. Looking further out however we remain concerned about the inflationary pressures building and over which the government have little control. In our opinion the government bond market is now a bubble, though prices may continue to rise for sometime yet. For the first time we have seen government bond

auctions struggling to get away and whilst not a significant obstacle to new issuance at present, it should be seen as a warning if Quantitative Easing push prices too high.

Regular readers will know that our government bond weightings in portfolios have been underweight for a prolonged period and this has proved wrong for 18 months now. Whilst recognising that our strategy has been incorrect so far we do not intend to reverse our stance.

Accepting that Western governments have only just embarked on the buy-back programmes necessitated under Quantitative Easing and that there is tremendous political will for them to succeed, the likely returns on gilts and treasuries over anything but the short term is now limited.

Often it is only possible to spot a catalyst after a change has occurred, but at some point markets will turn. Given the speed at which this can happen holding large weightings in government bonds is a high risk strategy and not one we intend to follow. High yields reward corporate bond investors for their patience and whilst defaults will increase, the rate suggested by current pricing over-estimates the likely outcome.

It has been interesting to observe that so far, whenever equities have rallied temporarily, corporate bonds have not shown any significant improvement. We see this as being symptomatic of investor scepticism regarding the permanence of any improvement in markets since normally bonds should also rally, as in the event of default, they rank ahead of equity investors in terms of the distribution of assets.

A theme core to Clarion's approach has always been that diversification aids long term performance since in a portfolio of non-correlated assets, if one investment falls in value another performance will rise, smoothing returns over time and lowering volatility.

Recently diversification has proved worthless as all asset classes associated with risk have fallen as investors moved to the safe haven of government bonds, which we have argued now offer almost no value, aside from security. We under-estimated the significance of risk aversion and did not appreciate just how low a return investors would accept in return for security. This resulted in our thesis that government bonds were over-valued materially underperforming, negating our correct calls to hold cash and exit commodities.

The authorities' decision however to pursue a policy of Quantitative Easing marks the start of the end game for sovereign debt valuations in the developed economies. The amount of money being committed to the programme of purchasing government bonds is truly enormous and central banks are not price sensitive buyers, this feels like the last few breaths of air into an over inflated asset balloon and we are worried about the broader implications this has for the UK economy.

The objective of Quantitative Easing is to reignite the economy; to fight recession by making funding more easily attainable and ultimately will prove inflationary. For the developed economies it's likely that growth when eventually it returns will be at levels little more than trend, but inflation could well spike higher, particularly as the authorities are likely to pursue for longer an approach based on lax monetary policy to absolutely ensure no return to recession.

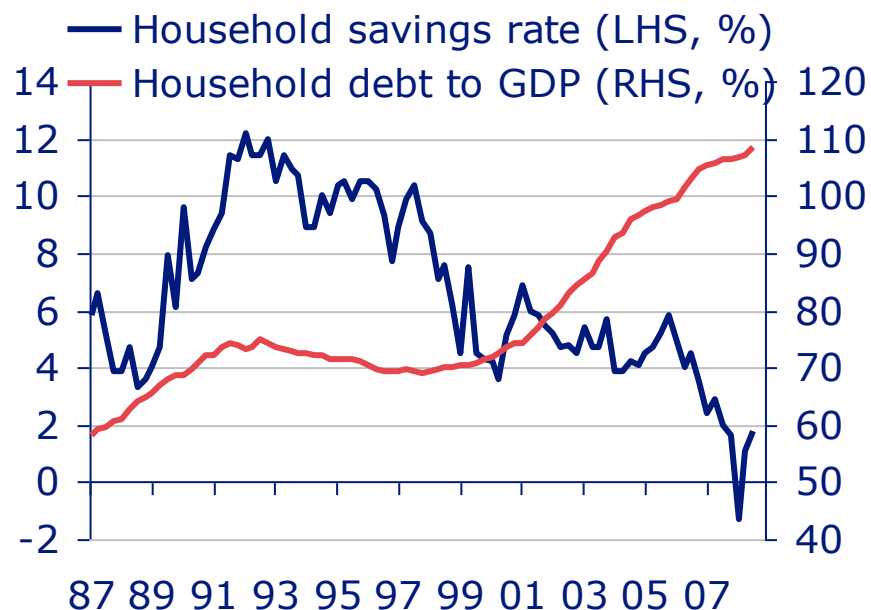
This outlook poses a significant risk for any fixed income investment and for sterling debt in particular since inflation erodes both capital and future income flows and whilst corporate bond prices offer some defence against this, the pricing of government bonds provides nothing at current levels.

This situation gives us the conviction that our approach is correct, where we lack certainty, in common with many of our peers is in predicting the timing of a correction and this means that we may continue to underperform in the near term. We are also concerned that government policy will ultimately prove negative for sterling, the position of which as a reserve currency is now largely marginalised and therefore we have moved to increase our exposure to funds able to benefit from sterling weakness.

So where to for equities? Whilst it is difficult not to be negative on the outlook for the UK and most other developed economies, share prices are forward looking indicators and in this respect we feel that markets generally are reflecting the reality of the conditions faced by companies, particularly at the lower levels of the trading range that looks like it might be establishing between 3500 and 4000 in the UK.

The chart below indicates the collapse in the household savings rate over the last 15 years and the growth in indebtedness and shows clearly the need for consumer balance sheets to be rebuilt alongside those of the banks. This would tend to infer that the outlook for

consumer discretionary spending medium term is poor, although as consumers seek out better value for money some groups could benefit.



Generally speaking equity prices have moved to correctly predict the difficult trading environment and equity managers by and large appear relaxed with current valuations and positive on the longer term outlook, though wary short term.

Many companies looking to preserve capital have worked to actively destock and many observers are now predicting an increase in inventory spend sometime in the second half of the year. Whilst positive, it is important not to be overly influenced by such an event.

Many groups continue to lack any real transparency in terms of future earnings streams and overly indebted situations are best avoided since in the absence of banks agreeing to refinance, equity holders will be called upon to fill the gap.

However, when it is possible to make a reasonable forecast as to future earnings and particularly where dividends are secure, there are areas of real value in the market which yield significantly more than cash and government bonds. Broadly speaking whilst not overtly

bullish, we are happier now to pick up equities at these lower prices than we have been previously.

We expect the US and developing economies to ultimately lead the world out of recession, with the latter as we have discussed in previous reports, particularly well positioned to create domestic demand through internal investment, courtesy of a lack of debt and the large cash reserves they hold.

We are less positive on the outlook for Japan, where a lack of competitiveness in terms of pricing and a heavy reliance on automotive and electronics exports is likely to result in a significant contraction of the economy, relative even to other developed economies this year.

Whilst there has been some suggestion that Japan is now more reliant on China than the US for exports, there is an argument that we are sympathetic to that movements in exports to China are more correlated to the level of Chinese exports to the US than on Chinese growth itself, indicating that a Japanese recovery will probably lag that of the US and China. Our strategy has therefore been to reduce weightings in Japan in favour of the US and emerging economies.

As a result of our increased conviction, we are now reducing cash weightings in portfolios, seeking to take advantage of lower valuations although we recognise that these positions might take a while to perform.

A frustration in recent months has been a lack of liquidity in two of the fixed income hedge funds we hold. Signet and Guardian, which feature in the low and medium risk asset allocations within portfolios, have actually performed relatively well but as a direct result of the credit crisis the markets in the investments underlying these funds, have ceased to trade efficiently.

This is purely a function of the markets and does not mean that the vehicles themselves are failing, simply that the market in the underlying investments has stalled as a result of the banks pulling liquidity out of the system. As a consequence both funds have set up gates that prevent us liquidating positions, meaning that potentially we are hampered in being able to freely allocate assets, though in truth we are not unhappy holding these funds.

At present it is unclear when precisely liquidity will return, but Guardian has now instructed the sale of all its investments and eventually will return cash to investors and Signet continues to try and exit the illiquid investments in its portfolio.

Broadly speaking this has little impact on investors who are happy to invest long term, however where clients are looking to exit in the short term we will not be able to realise every investment within the portfolio and a small balance will remain unsold until the two managers receive proceeds on the sales they have in turn instructed.

Portfolios are presently structured more along traditional lines than has recently been the case. Cash weightings are being reduced and asset allocations concentrated in equities and fixed interest rather than in alternatives such as private equity and commodities. Hedge funds and other absolute return strategies continue to play a major part and have helped to reduce volatility.

Whilst the lack of liquidity in some areas of the hedge fund industry is a concern, the funds affected and held by Clarion's clients are in assets that offer value and the remainder of the funds held continue to trade normally.

We retain a negative outlook for sterling and consider that relative to the dollar and the currency of many of the developing economies it will remain weak. The poor state of the UK's national balance sheet and the high levels of debt built by this government through the growth period of the late nineties and early this decade mean that an economy overly reliant on banking and with little manufacturing content is condemned to a difficult future.

Fortunately the main domestic indices do not particularly reflect the make up of the underlying UK economy and are much more internationally focused. We retain our cautious stance and distrust equity market rallies not accompanied by a corresponding improvement in the valuation of corporate debt. Longer term however we can see value at or close to current market levels and for this reason are moving to lower cash weightings in portfolios.

*Tim Sedgwick
April 2009*