Investment
Management

April 2012

Quarterly Strategy

Global equity markets recorded very strong gains in the first quarter of 2012, with investors buoyed by further signs of a US recovery and Europe managing to avoid the worst case scenario that many had feared.

While there are risks that still need to be considered, we believe that positive global growth and continuing loose monetary policy will remain supportive of equities and other financial assets, and we have increased our exposure.

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Our current investment strategy

The European Central Bank's long-term refinancing operations (LTRO) and better US jobs growth lifted confidence during the last quarter. This gave us the opportunity to reduce our fixed interest holdings in favour of equities in the UK and Europe. We also shifted some of our gilts into corporate bonds.

We expect global growth to make progress in 2012 and 2013, which will be supportive of equity markets and other risk assets. This growth outlook will be reliant on exports and trade, rather than consumers, meaning progress is likely to be choppy and volatile, requiring an active investment approach.

We are broadly neutral in equities

UK: neutral as risks are finely balanced

- Still tough consumer outlook
- Exports and trade provide some growth
- Equity valuations reflect caution

US: still positive, but wary that risks are lurking

- Jobs growth supporting prospects
- Fiscal and election risks later in the year

Europe: caution prevails

- Challenge on growth and budget deficits
- Risks remain high

Japan: possible upside

- Inflation target should weaken yen
- Economy and earnings rebounding
- We are looking for suitable opportunities

Asia ex Japan, Global Emerging Markets: negative

- Chinese downturn the key concern

We are positive on corporate bonds

Government bonds: negative

- Gilts to weaken as Quantitative Easing comes to end

Corporate bonds: positive

- Attractive despite financials concerns

We still have a positive view on alternatives

Gold: positive

- Negative real interest rates make gold attractive
- If economic growth disappoints, we could see further liquidity pumped in, which supports gold

Hedge funds: positive on UCITS structures

- Diversification benefits

We expect property assets to move sideways

Overall property market: negative

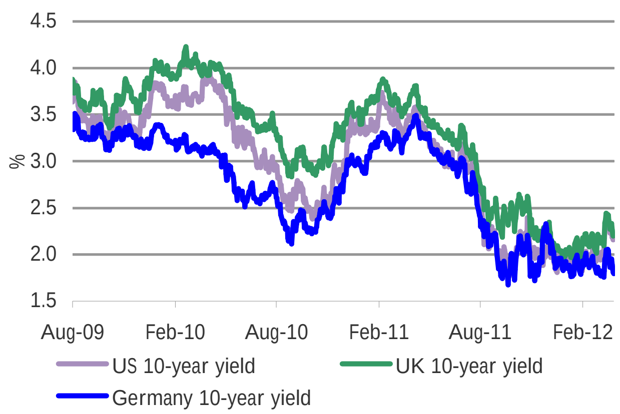
- Lack of credit and slowing rental growth

Inflation, interest rates and bonds

The inflation stories are the same in the UK, Europe and the US, with high oil and food prices making headline rates sticky, but with core inflation seemingly having peaked. Interest rates should remain on hold for the duration of the year at least, but investor attention is now switching to the potential for monetary policy to normalise or for more quantitative easing (QE).

Ongoing weakness in the UK recovery and in particular in its largest trading partner, the Eurozone, is likely to mean that the Bank of England opts to top up its asset purchase programme with another £25 billion when the current programme expires. The marginal impact of additional QE is falling and as such, we expect the next material move in the yield curve to follow a gently steepening path. We think the 10-year Gilt yield will be range-bound, with risks skewed to higher yields.

'Safe haven' bonds likely to be range-bound



Source: Bloomberg (GBL52)

We also believe that fundamentals will reassert themselves in European government bond markets. Last quarter, the liquidity afforded by the LTROs helped bring down bond yields from some of the Eurozone's peripheral nations, which had been trading at unsustainably high levels. In the next year, we certainly expect more volatility in these markets, but it should be around prospects rather than tail risks.

By implication, we think the narrowing of Spanish and Italian spreads has run its course until fundamentals improve, including the success of their austerity efforts.

Meanwhile, the difference between corporate bond and government bond yields (i.e. the spread) has declined steadily, and given our optimism toward the global economy, we believe there is room for further spread narrowing. This explains our rationale for increasing allocation to corporate bonds and reducing Gilts.

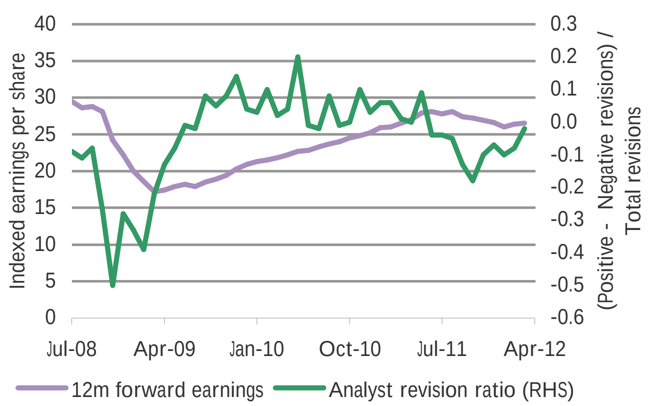
Within the corporate bond sector, yields on financial issuers continue to trade significantly higher than non-financial issuers. We expect this gap to remain given concerns over the regulatory changes impacting the industry and the continued worries over funding and Europe in the long term.

Our view on equities

Earnings estimates have edged upwards in recent months, with a marked improvement in the ratio of companies being upgraded versus downgraded. There are indications of a recovery in the US consumer sector, but pressure on infrastructure and real estate investment in China.

This is reflected in revision ratios, with IT and consumer discretionary companies being revised upwards, and materials companies downward. We will be looking for broad-based cyclical businesses to beat sales expectations.

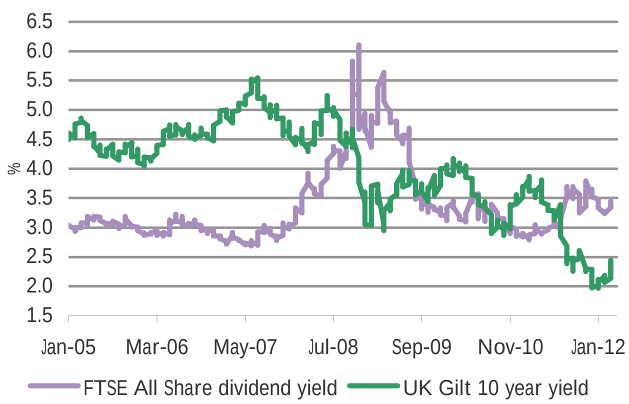
Analysts continue to revise earnings estimates



Source: Deutsche Bank Consensus Earnings (GBL68)

While we recognise that corporate margins are currently elevated, we are confident that economic weakness has left firms operating at below optimal capacity, and sales growth from here should be incrementally more profitable, balancing out the overall effect on margins in global markets.

Equities remain cheap versus government bonds



Source: Bloomberg (UK33)

Equities continue to look extremely cheaply valued versus bonds, but we are aware that this measure is currently flawed due to low rates and overall repression of government bond yields. As economies remain in low growth mode, and vulnerable to global shocks, there is logic in valuations remaining low, and the equity risk premium high.

From an investment perspective, this may partly cap upside in the year ahead, but also provide an opportunity. It appears the high risk premium is driving a compression of equity valuations across markets and across sectors.

There is a reasonable dispersion in earnings growth this year, with domestic cyclical sectors the highest, but this is not reflected in valuations, which are closely clustered around the average. With the exception of certain high sales growth companies, valuations remain low, as investors are unwilling to give companies the benefit of recovery potential.

	Earnings growth		Price/Earnings	
	2012e	2013e	2012e	2013e
Cons. discretionary	12.1%	15.9%	14.5	12.5
Consumer staples	7.4%	10.1%	15.5	14.1
Energy	1.4%	9.5%	10.2	9.3
Financials	15.8%	13.3%	11.0	9.7
Healthcare	2.0%	7.7%	12.3	11.4
Industrials	9.7%	14.3%	13.7	12.0
Technology	14.7%	10.9%	13.8	12.0
Materials	4.4%	14.7%	11.3	9.7
Telecoms	2.5%	8.5%	12.5	11.5
Utilities	0.7%	5.4%	12.8	12.2
World	**7.6%**	**12.4%**	**12.7**	**11.3**

Source: Deutsche Bank (GBL6)

Shifts in the economic growth outlook and bond yields have significant impacts on sector strategy. A slowing economy with falling bond yields benefits defensive sectors, while better growth, with rising bond yields, should see cyclical sectors perform well. Our view is that we are in the rising yield segment of the economic cycle, but the effects of financial repression and sluggish growth are masking the impact on yields and GDP growth.

We believe rotation into more cyclical sectors remains appropriate, and this strategy should benefit through the year from modest operational gearing and management self-help.

Our view on alternative assets

Gold recently weakened due to the improvement in the US economy, but we believe real interest rates will remain negative for some time, and if economic growth disappoints, further increases in liquidity may be needed, which should support the gold price.

We expect property to move sideways as an asset class, particularly in the face of restricted bank lending. Even Prime London property has shown signs recently that it is not entirely immune.

UCITS hedge funds continue to provide useful diversification tools for investors, particularly in low growth and interest rate environments.

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