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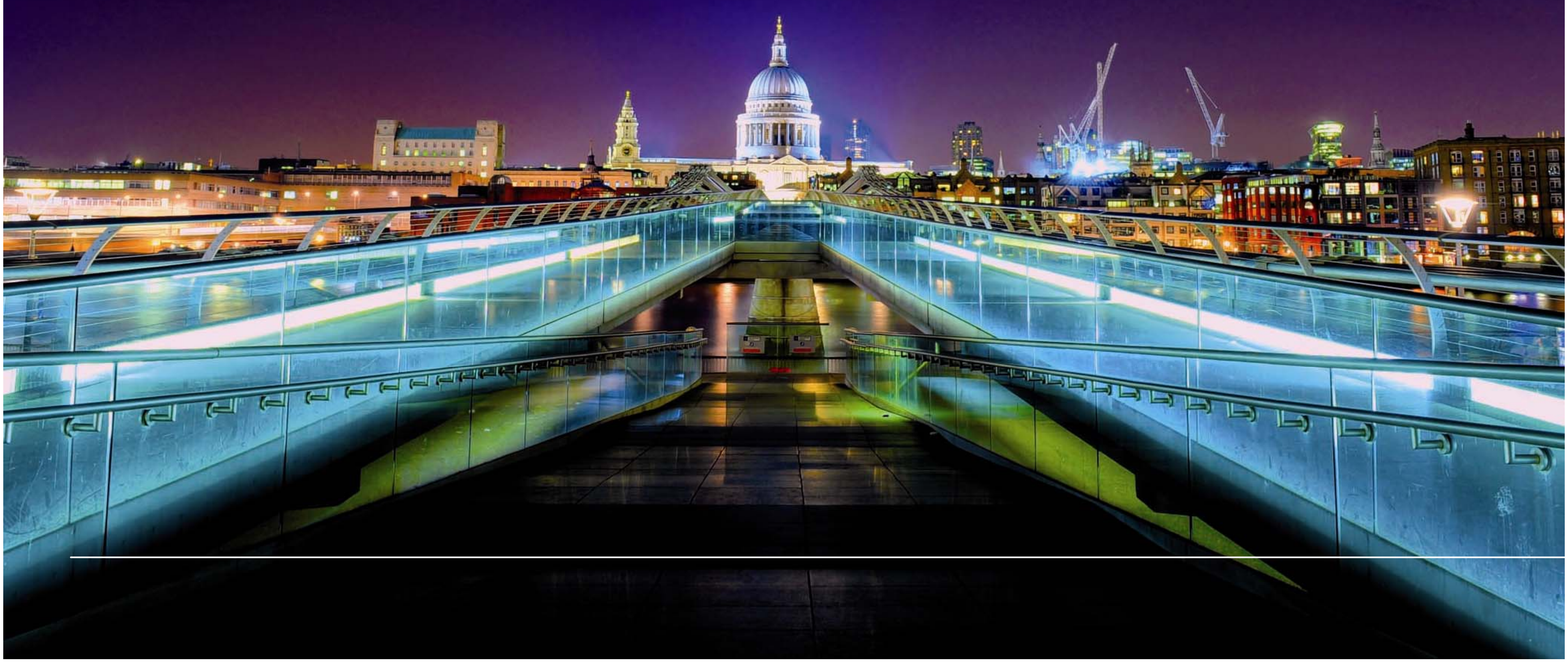
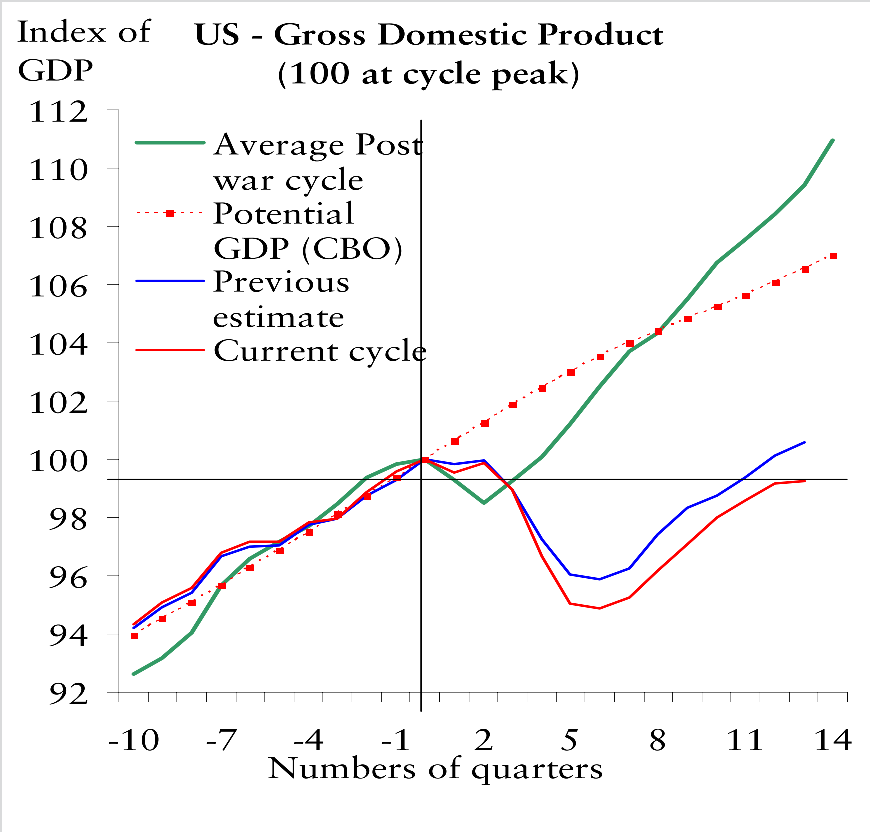
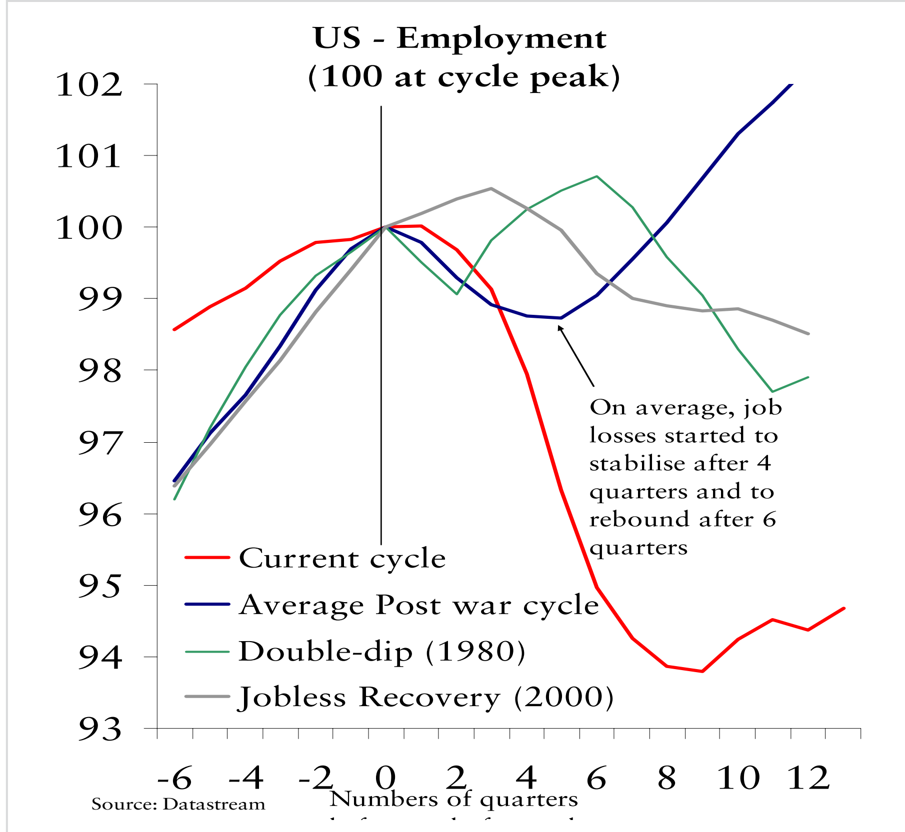
Global Strategy

Guy Monson, CIO & Managing Partner
October 2011



This cycle looks weak in comparison to any previous one





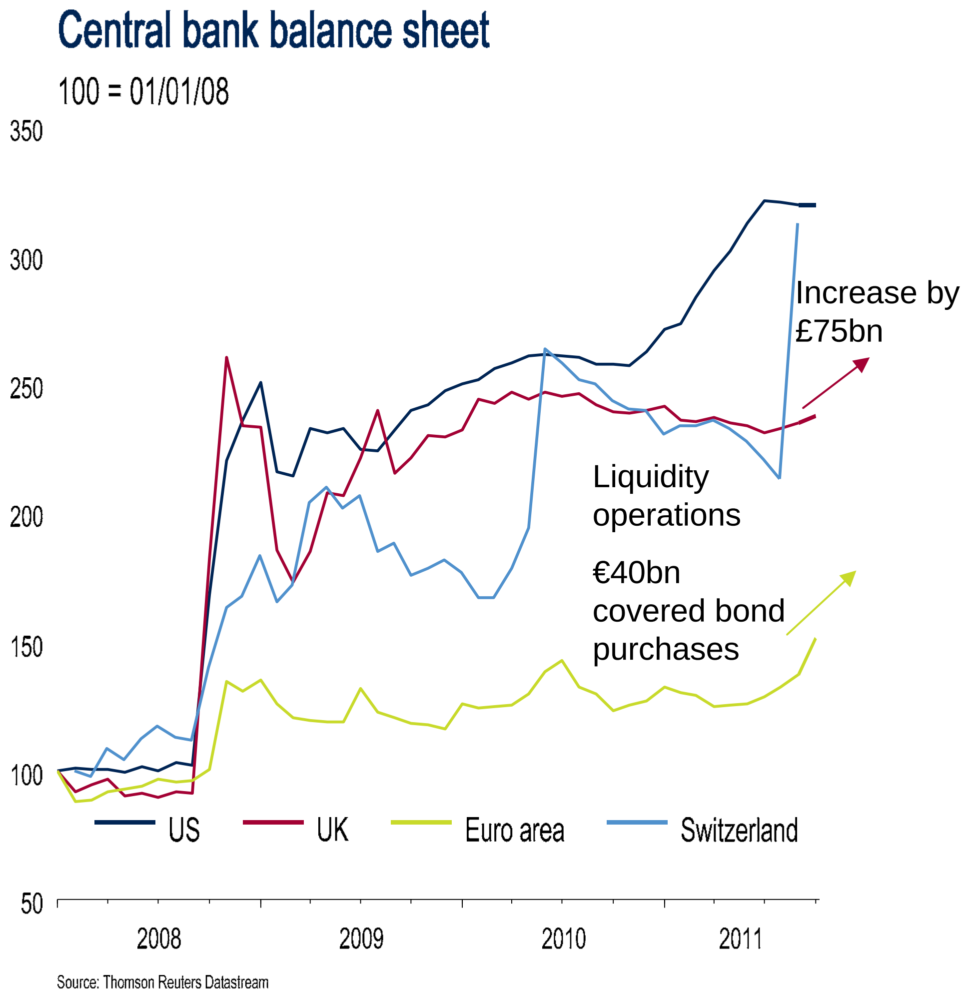
Source: Datastream

Economic growth so far this year has been considerably slower than the Committee had expected. Indicators suggest a deterioration in overall labour market conditions in recent months, and the unemployment rate has moved up.

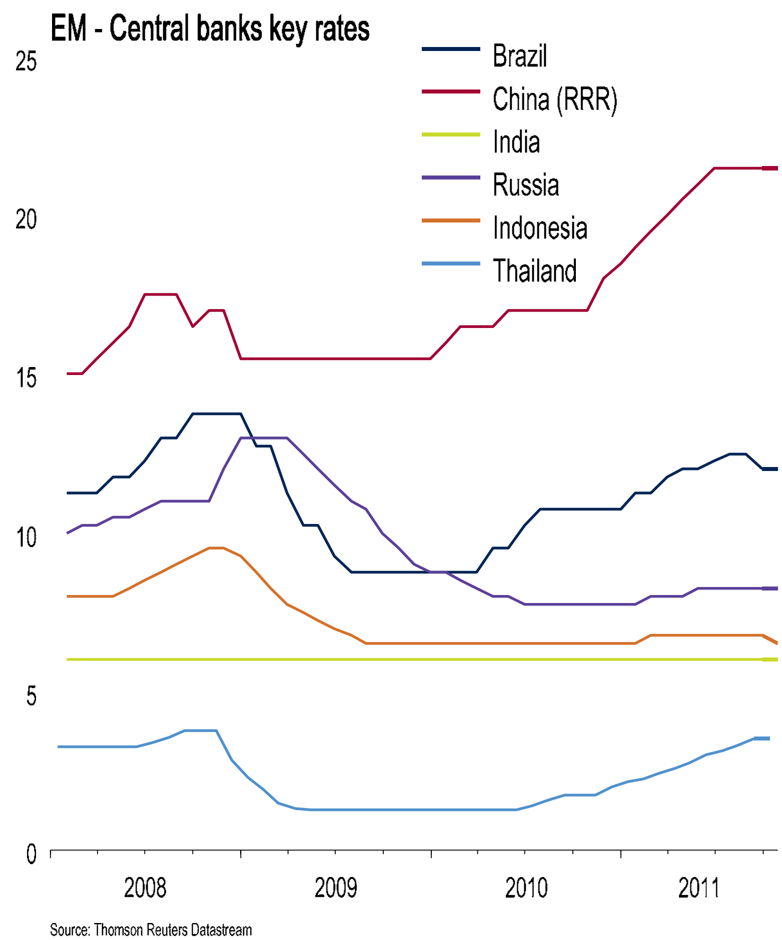
FOMC Statement, 9 August 2011

On the positive side, global monetary conditions are very being loosened

Developed central banks resume monetary easing



EM monetary tightening is over – Brazil and Indonesia have already started to ease



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Source: Thomson Reuters Datastream

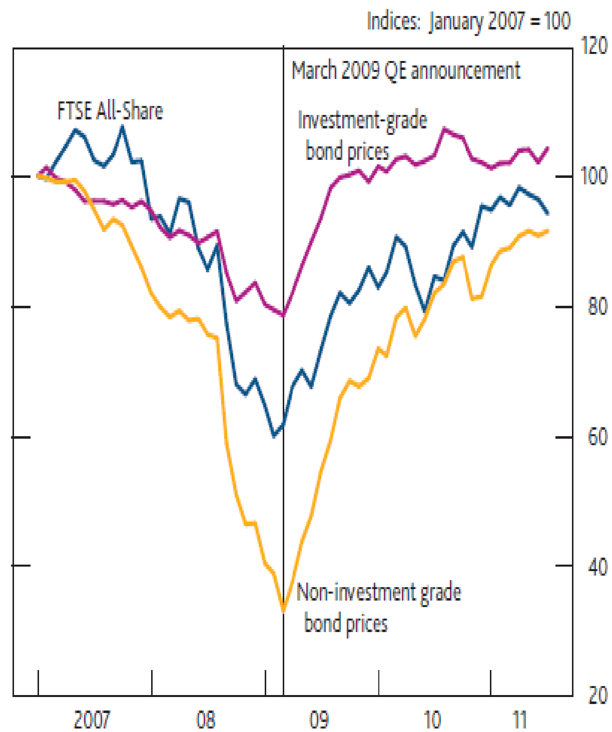
QE and action by other Central Banks will support riskier assets - Corporate bonds and equities should benefit…

Table B Summary of asset price movements

Asset	Change around announcements	Change 4 March 2009–31 May 2010	Comments
Gilts	-100 basis points (bp) (*of which* -90bp in gilt-OIS spreads)	+30bp (*of which* +15bp in gilt-OIS spreads)	Portfolio balance channel dominates the signalling effect.
Gilts (reaction to QE 'news')	-125bp (*of which* -80bp in gilt-OIS spreads)	+30bp (*of which* +15bp in gilt-OIS spreads)	Portfolio balance channel dominates when controlling for QE news using Reuters survey.
Corporate yields (investment grade)	-70bp	-400bp	Smaller fall than gilts perhaps due to shorter average duration. Spreads flat around announcements but significantly down over the period.
Corporate yields (high yield)	-150bp	-2,000bp	Larger announcement effects, possibly reflecting the removal of tail risk.
FTSE All-Share	-3%	+50%	No announcement effects, but prices up during the period.
Sterling ERI	-4%	+1%	Small announcement effect.

Source: Joyce *et al* (2011).

Chart 8 Changes in major UK asset prices



Sources: Bloomberg, Merrill Lynch and Bank calculations.

Source: Bank of England

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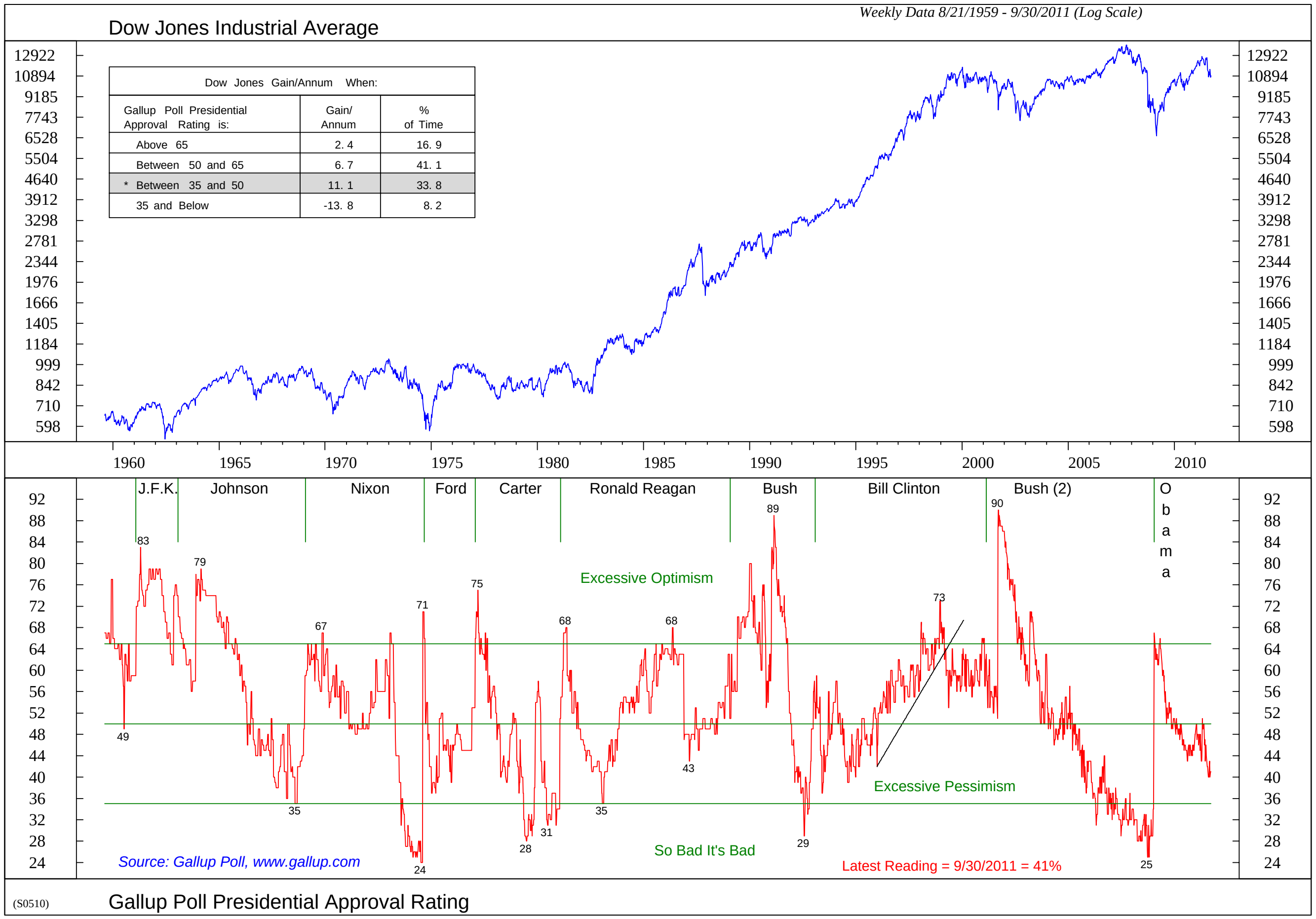
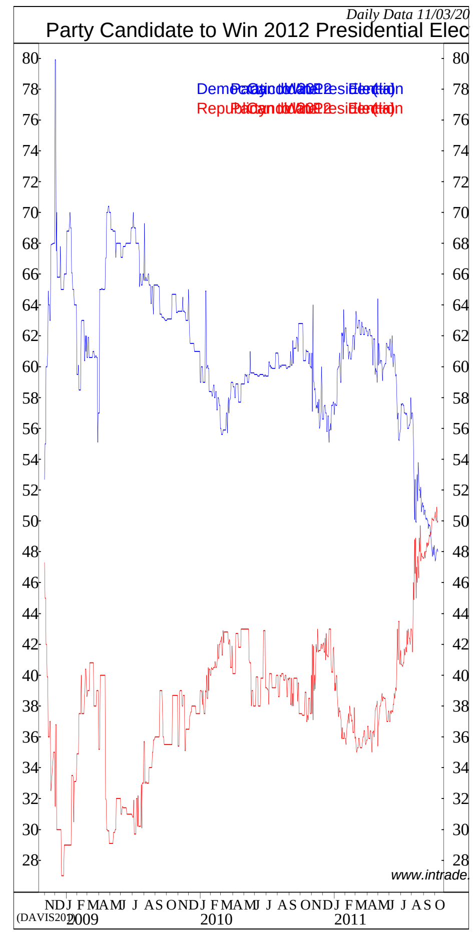
This has damaged Obama, although markets *may start to look through the political uncertainty…*





Source: Ned Davis Research

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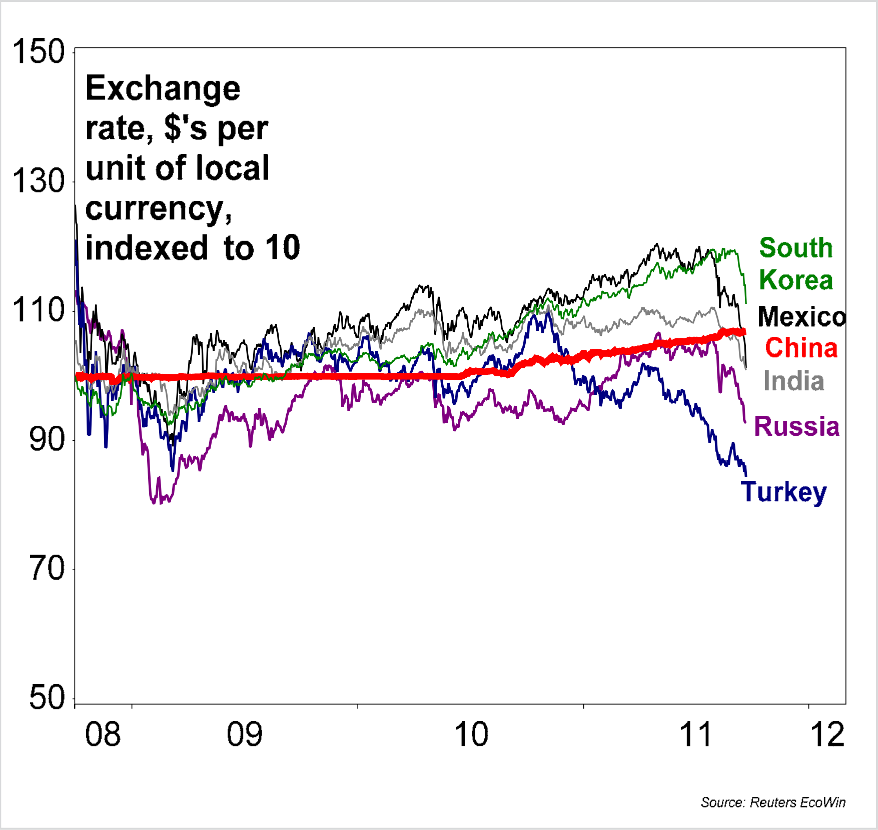
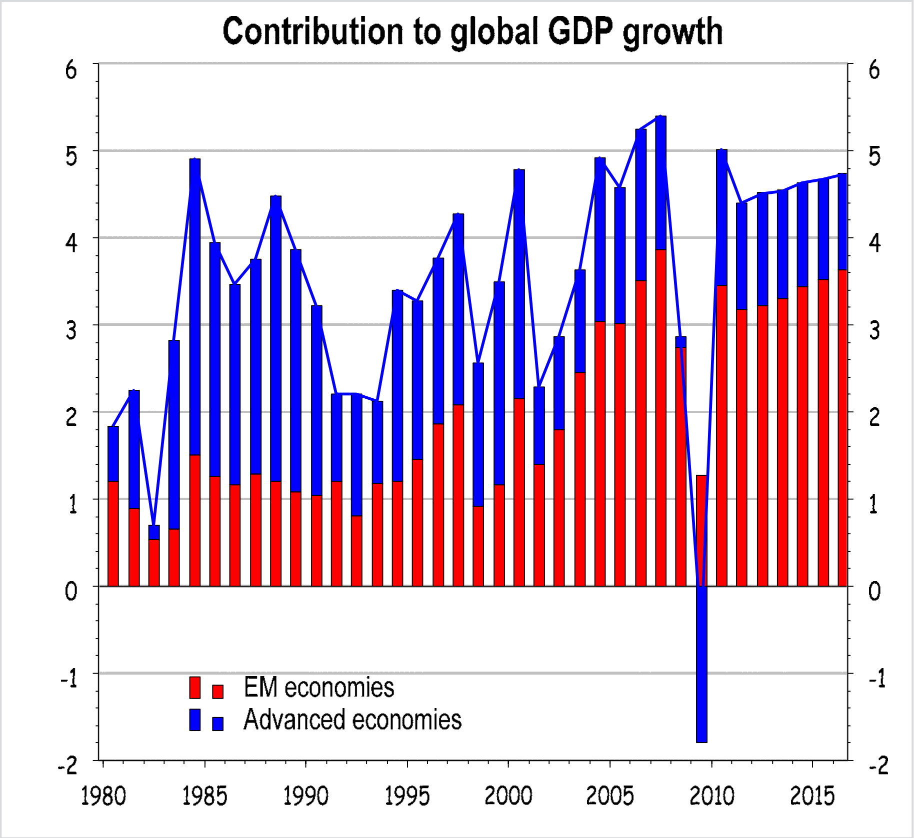
Economic Challenge # 1: China centric Emerging Markets have fuelled a two speed recovery …





Tight currency pegs have allowed emerging markets to import low interest rates from advanced economies, allowing them to grow without 'speed limits' and leading to the 'bifurcation' in global growth.

Source: Ecowin

But what does this mean for Chinese & EM borrowing?

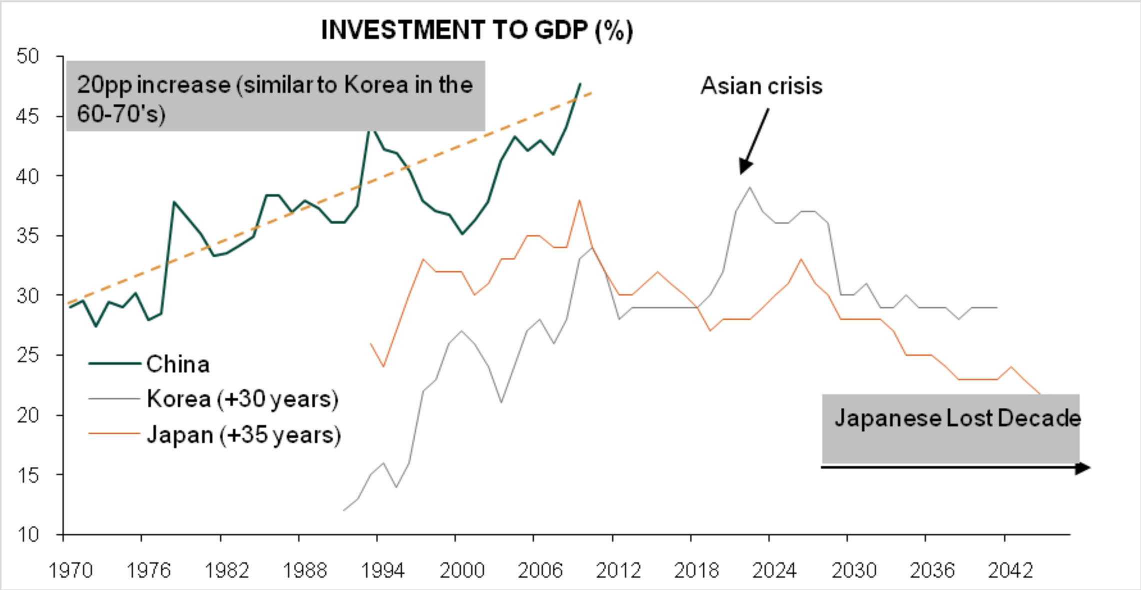
The many signs of poor investment decisions

The Qingdao – Hainan Seabridge

- 26m long (wider than the Channel)
- $8bn cost
- Saves commuters 20 minutes per trip

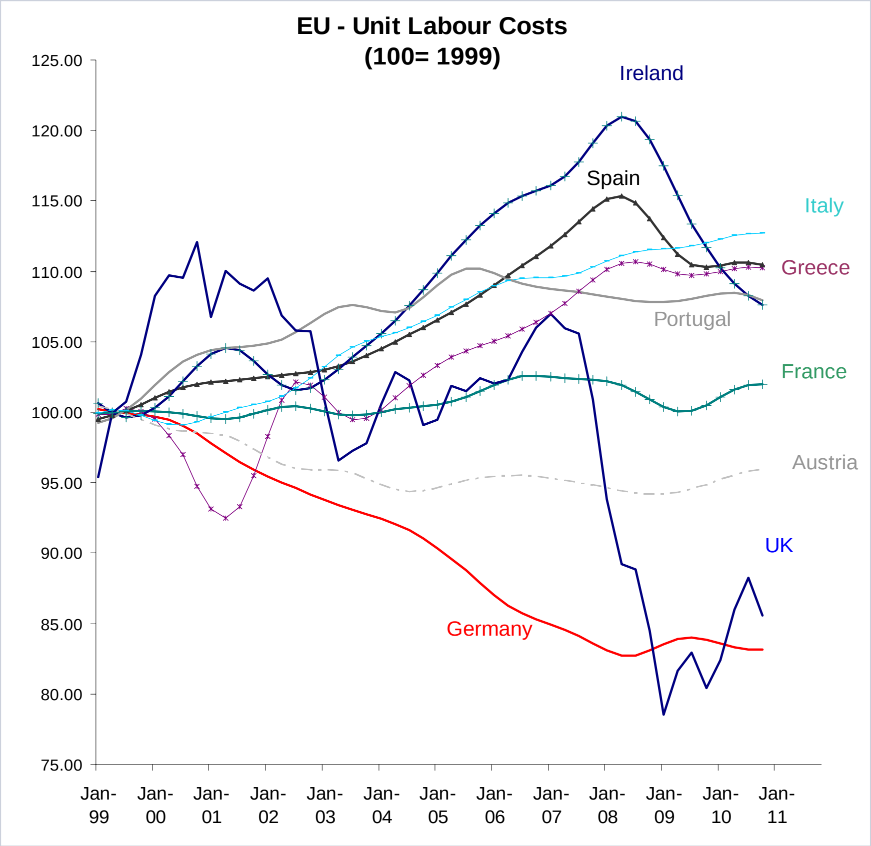
Numerous 'Ghost Towns'

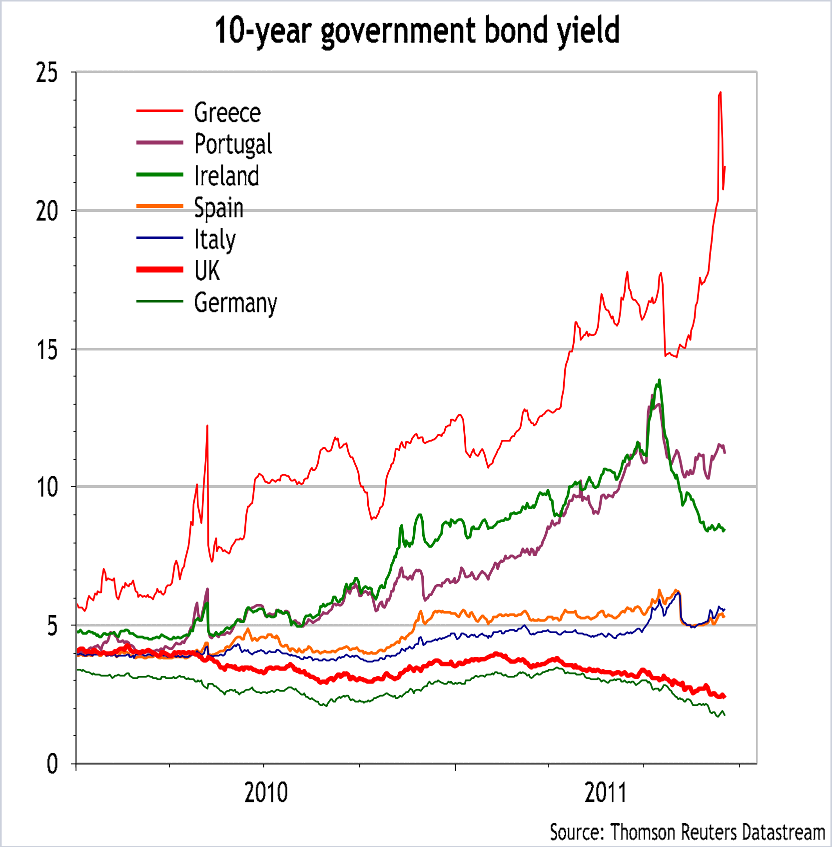
- 6m apartments lie empty
- Commercial vacancy rates exceed 20% in many areas



Sources: Jones Lang Lasalle, FT China Confidential, Daily Telegraph, World Bank, Business Insider, Datastream, 2011

Economic Challenge # 2: Fixing the design flaws in Europe… are contagion fears contained?





Overseas holding of government debt (%)

	Japan	Euro	UK	US	Germany	Spain	Italy	France	Greece	Ireland	Portugal
Overseas holding	5.6	23.0	29.9	46.6	39.1	43.8	44.0	60.0	74.4	82.0	92.9

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Source: EU Commission, National central banks, July 2011

Are we finally ‘lining up the ducks; for a Euro solution ? …

Disorderly default	Haircuts	Full-blown restructuring	Soft restructuring	Muddle through	Permanent fiscal transfers

Maturity extension and/or coupon reduction

Chaotic default and principal write down

Argentina 2001

Principal write-down

Russia 1998

No market agreement

Mexico 1982, Brazil 1983, etc.

Voluntary, agreed

Uruguay 2002

IMF provided loans, time & austerity

UK 1976

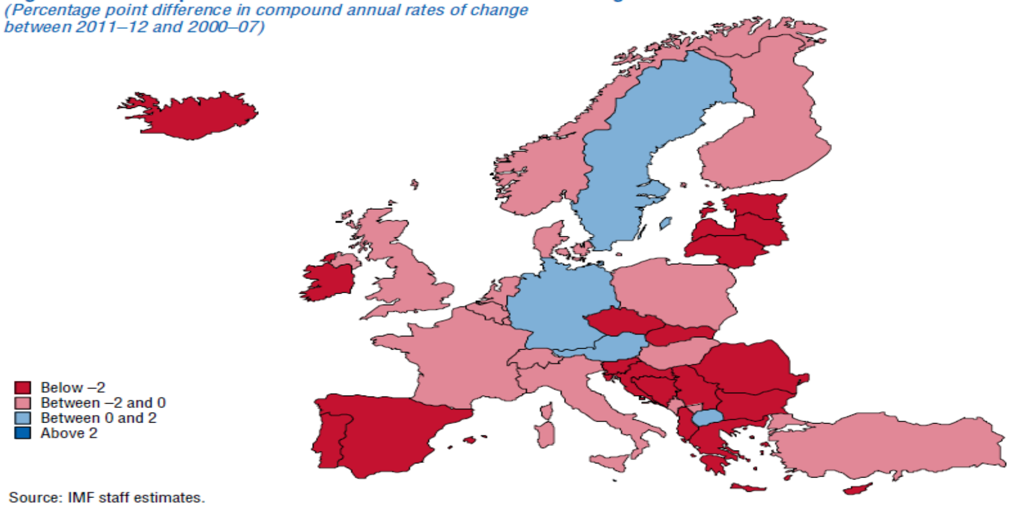
A fiscal union

US

Greece 2011

Figure 2.5. Europe: Current Growth versus Precrisis Average

(Percentage point difference in compound annual rates of change between 2011–12 and 2000–07)



Source: IMF staff estimates.
Note: Due to data limitations, data for Kosovo, Malta, and Montenegro are the growth differential between the average in 2011–12 and in 2001–07.

Euro Stability Proposals…

- Permanent ‘IMF’ (ESM) for Europe.
- Injection of equity into European Banks funded by ESM
- Managed Greek Default.
- Treaty Changes for enhanced long-term fiscal control…

Current Opportunity Set within Global Thematic Equities

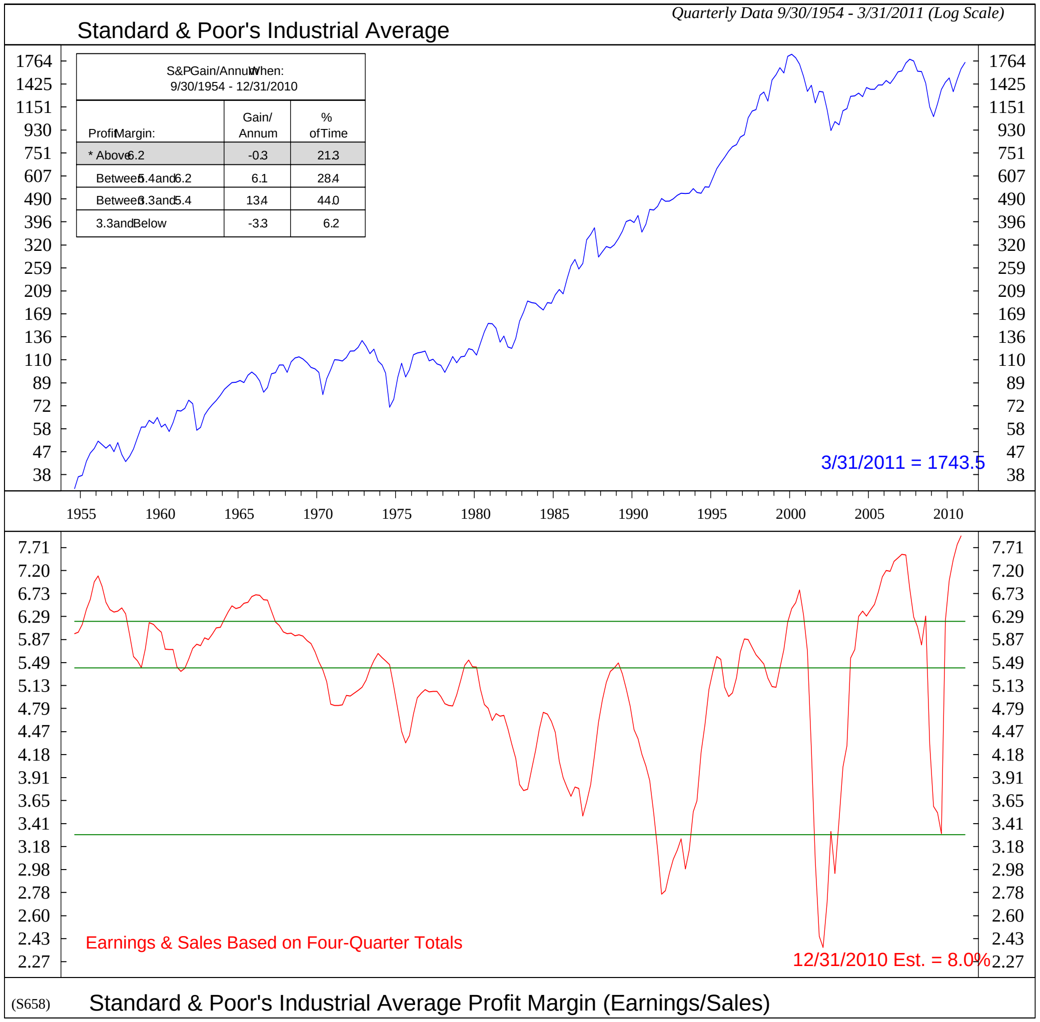
- **"Getting More from Less":** (where austerity, technology and productivity meet)
  - Trading Down: value for money
  - Optimising Inputs: agriculture and energy
  - More Wisdom from Data / Information Edge / Digital Obesity
  - Remote Robotics and Tele Technologies

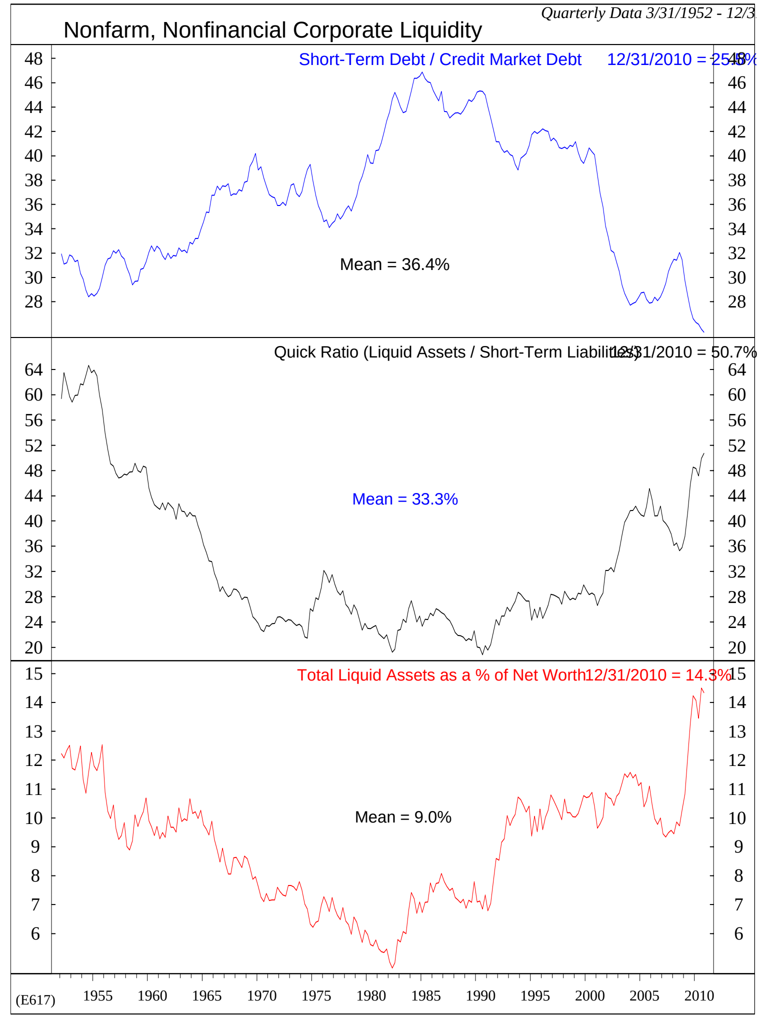
- **Demographic Consequences:** (demographics buffer economic cyclical effects)
  - Dietary Change – Proteins and Obesity
  - EM Middle Class – EM Brands
  - Ageing – Eyes, Ears, Pets, Cosmetics

- **Resource Security:** (strategic assets creating long-run value)
  - Stores of Value: from Gold to Google
  - Need for Base Load Electricity
  - Priority Infrastructure – gas infrastructure, coastal defences, deepwater offshore, (jobs jobs jobs)

Portfolio candidates are primarily sourced from opportunity sets with less exposure to the cycle and appropriate to the mood of consumer caution.

While Global blue-chip corporations are approaching the slowdown with robust margins and record liquidity…





Source: Ned Davis Research

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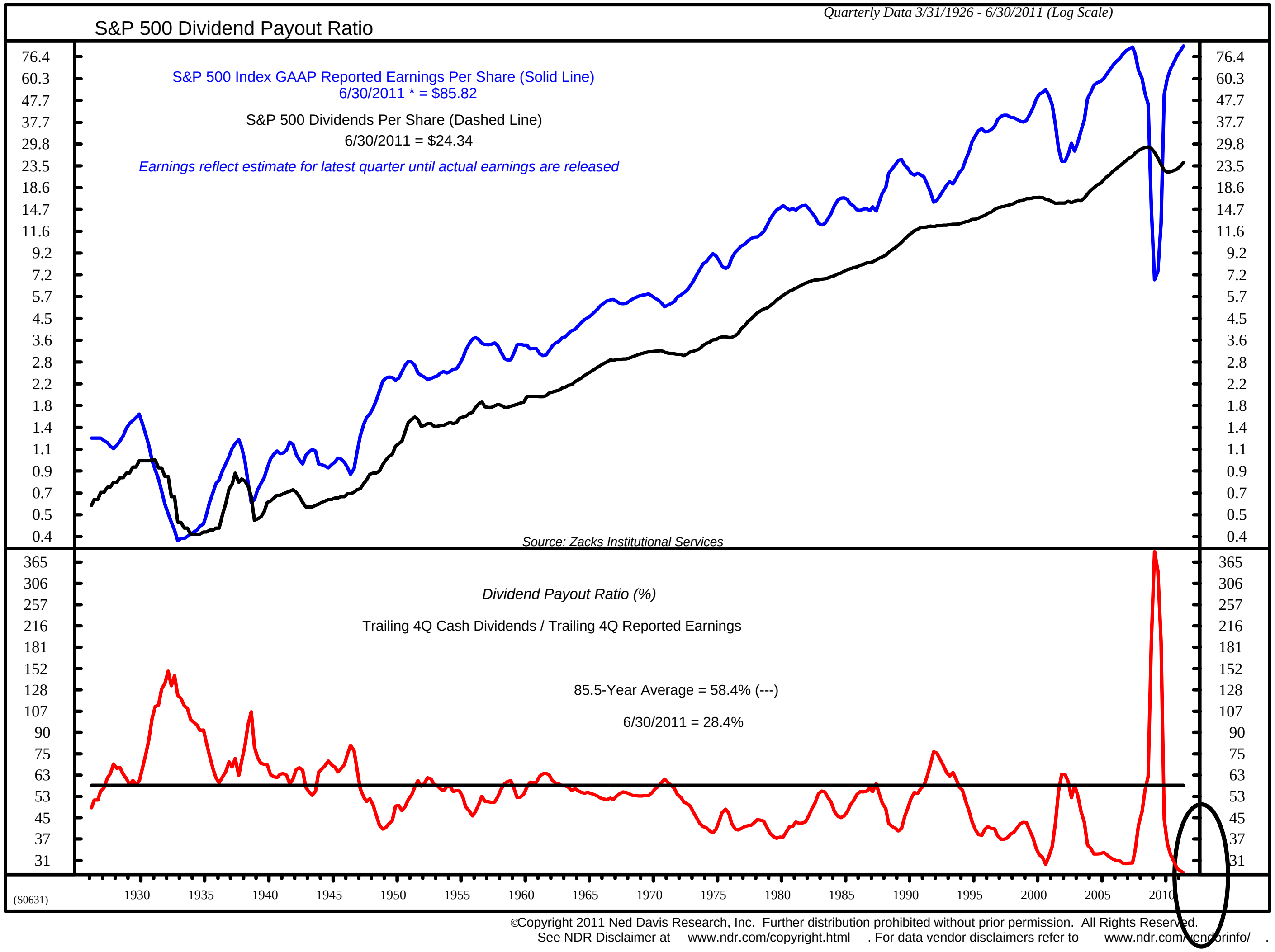
Payout ratio near historic lows suggests dividend upside



Dividends are set to increase as payout ratios normalise closer to the long term average

Source: Ned Davis Research

Summary

- When economies shift from early-cycle to the mid-cycle phase, equity investors typically get nervous about double-dips and earnings expectations, compounded by euro and sovereign balance sheets
- But Central Banks are reacting with ‘Twist’ (Fed), QE (BoE) , Bank Liquidity (ECB) and Capital injections (China/Huijin)
- While we don’t expect the world to ‘double-dip’, developed economies look fragile – Chinese growth model vulnerable
- Corporate earnings remain remarkably robust – but we should be alert to downgrades
    - **Government bond markets offer little value in real or absolute terms - Corporate yields are compelling**
    - **Company liquidity, valuations and dividend yields in excess of government bonds suggest that the returns from the equity of Western companies will exceed bonds – but equity selection must anticipate slower growth**
    - **Secure income streams from longer leased global properties look attractive**
    - **Infrastructure – a relatively high yielding asset class with some inflation protection built in – appeals too, together with small positions in hedge funds, gold and distressed debt**

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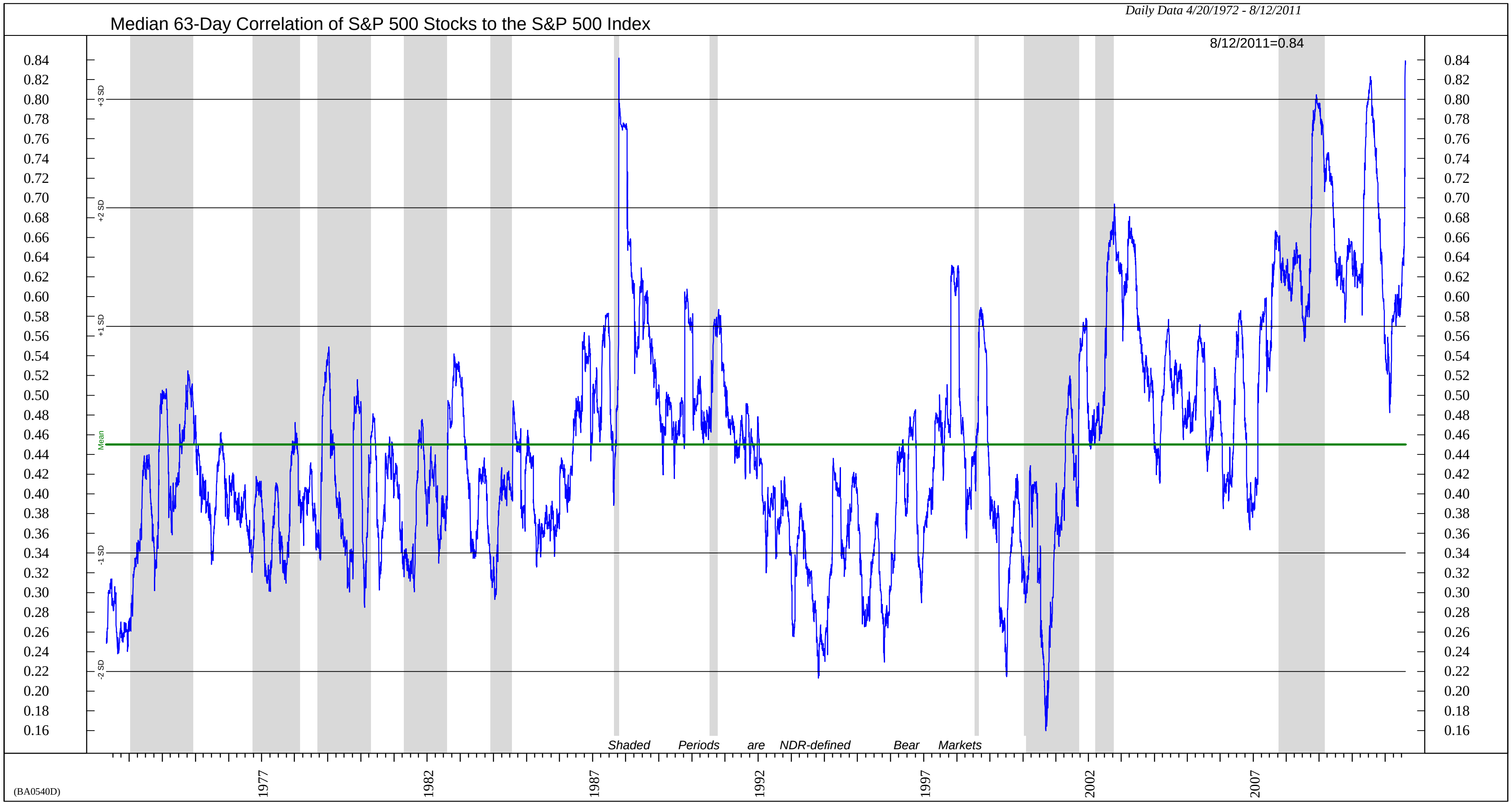
Market Strategy

Can normal service be resumed…?

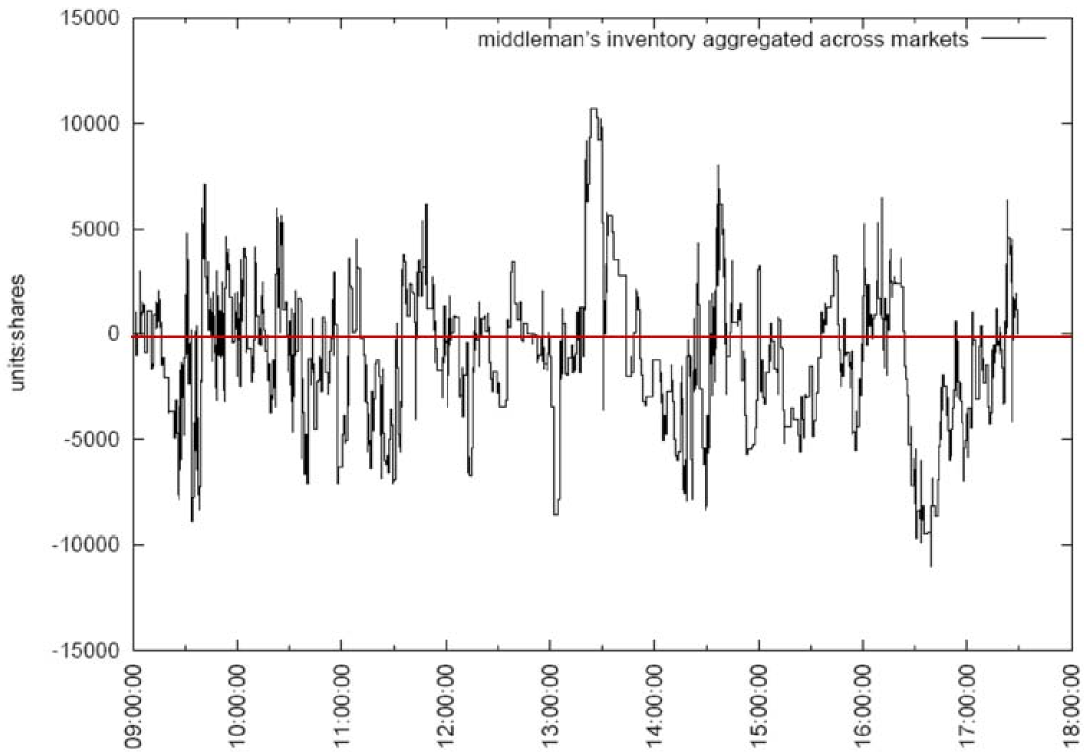
'Macro' dominated markets in the August decline – pushing stock correlations close to historic highs



Source: Ned Davis Research

I. New Market participants *may have* distorted the typical marginal buyer on market falls….

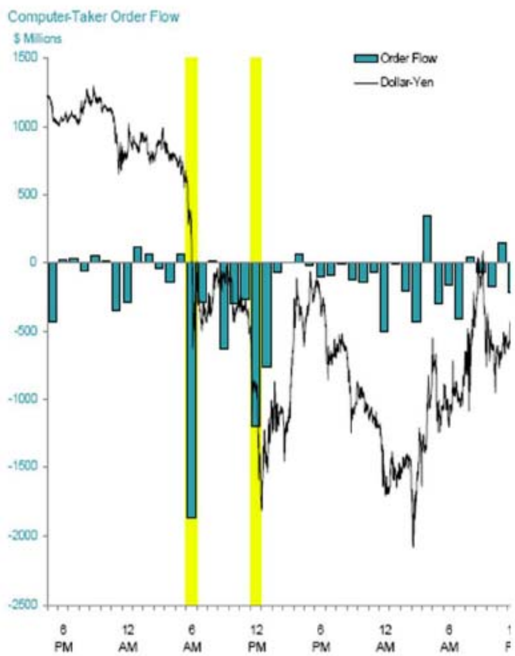
Position of the high frequency trader studied by Jovanovic and Menkveld (2010) , aggregated across Euronext & ChiX, January 30, 2008.



- High Frequency & Automated Market Makers make an est2/3 of US trades volumes.
- HFT traders represent c. 2% of 20k US equity trading firms but up to 73% of trading volume.
- 1 HFT trader is estimated to have traded 35% of volume on Chi-X one day last year

There is evidence that aggressive Computer (HFT) generated sells can be more highly correlated….

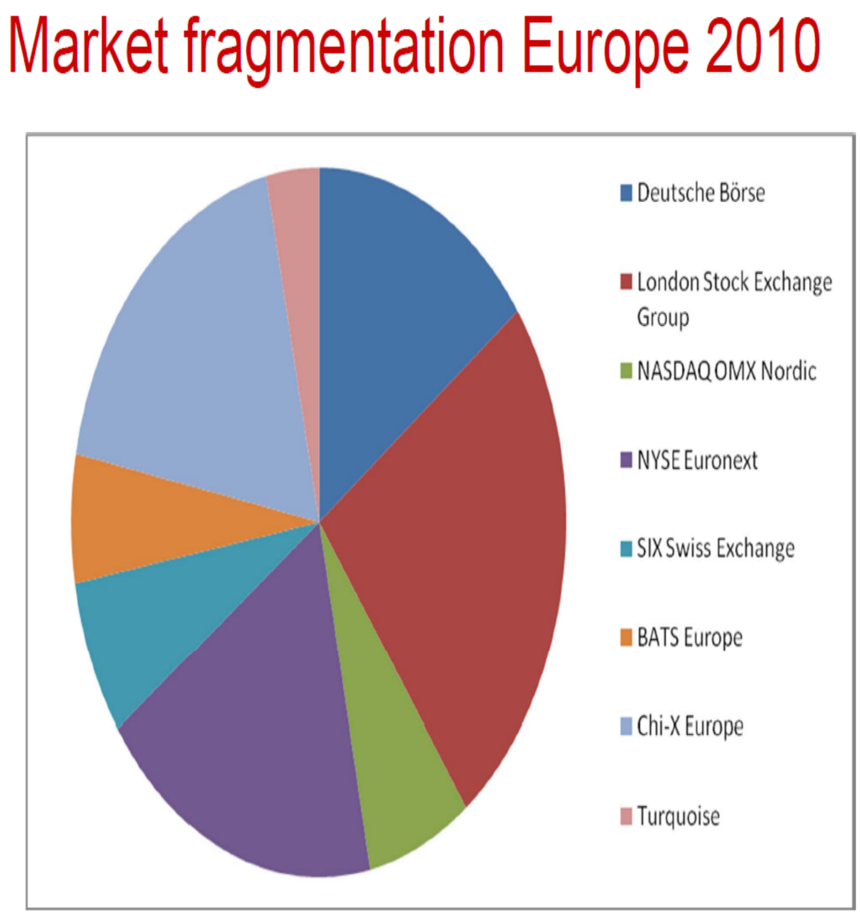
Chaboud et al 2009

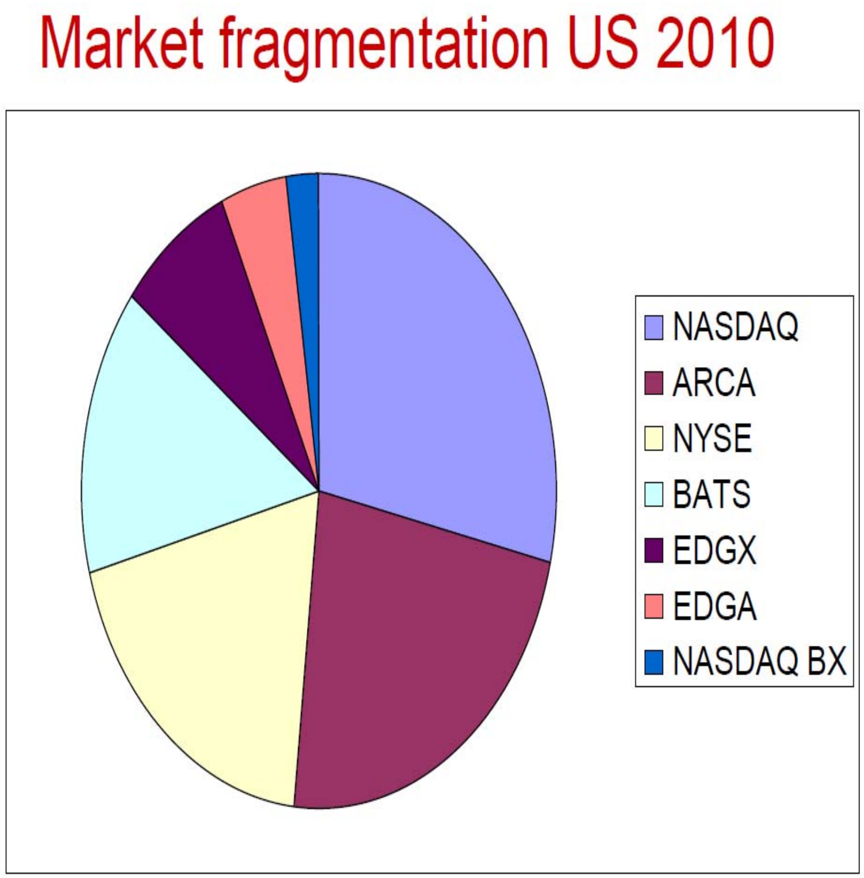


Correlated aggressive computer sales during drop

Humans buy $ during recovery

While MIFID along with other market changes have resulted in much increased market fragmentation…





II. Marginal Buyers of Equities have very different triggers for adjusting asset allocation…

Global Pension Asset Study 2010

Key Findings - Figures

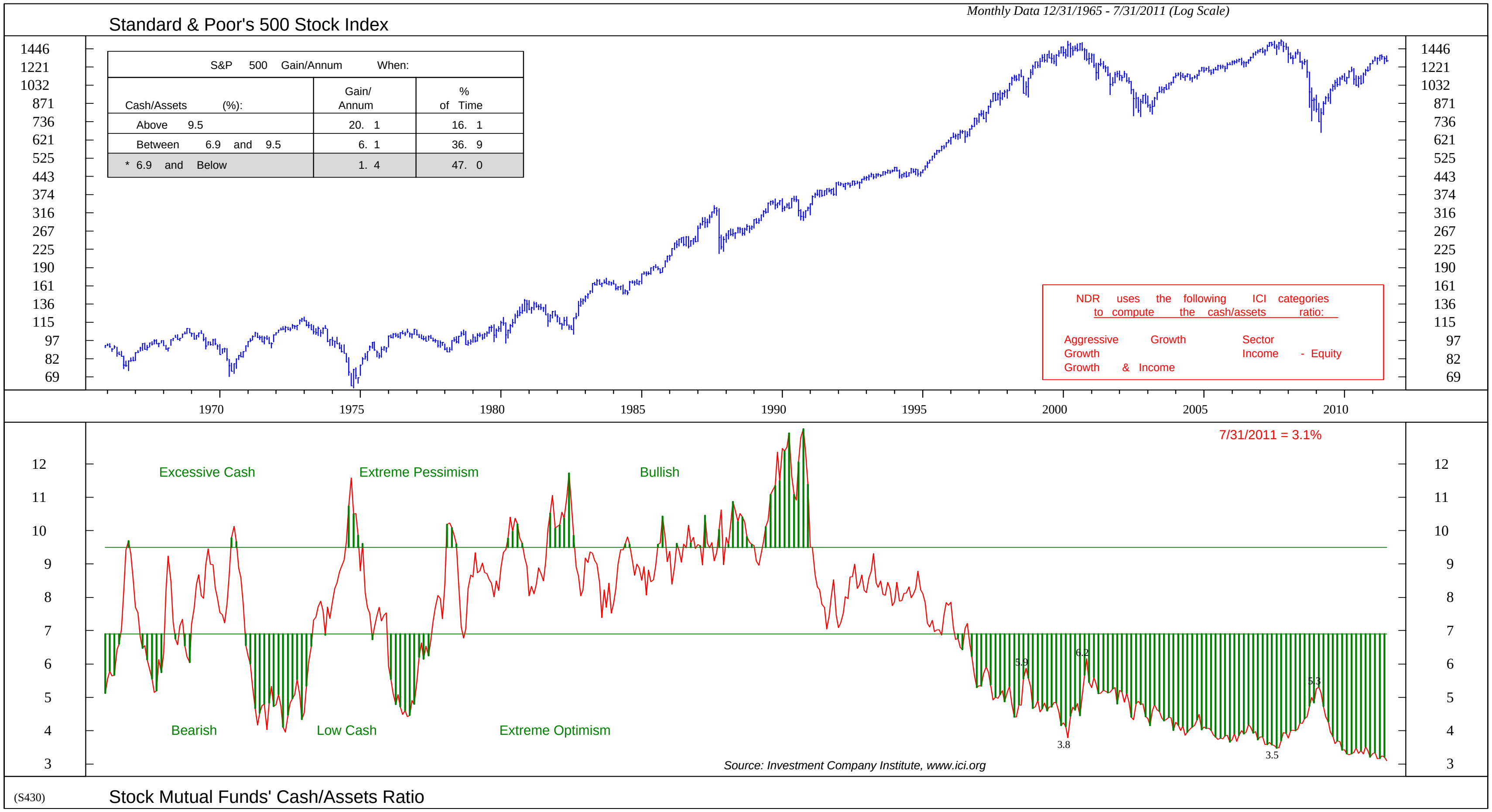
	Assets 2009 USD bn	%GDP in Local Currency	Asset allocation 2009: Equity	Bonds	Other	Cash	DB/DC Split 2009: DB	DC
Australia	996	93%	57%	13%	22%	8%	18%	82%
Brazil	392	22%	72%	21%	7%		34%	66%
Canada	1,213	84%	49%	26%	22%	2%	97%	3%
France	178	6%	33%	46%	12%	10%	75%	25%
Germany	411	12%	32%	62%	4%	2%	65%	35%
Hong Kong	85	41%	62%	23%		15%	22%	78%
Ireland	102	43%	59%	24%	7%	10%	61%	39%
Japan	3,152	61%	36%	55%	7%	2%	99%	1%
Netherlands	990	120%	28%	48%	24%	1%	92%	8%
South Africa	201	63%	62%	21%	7%	10%	27%	73%
Switzerland	583	113%	27%	36%	29%	8%	42%	58%
UK[1]	1,791	80%	60%	31%	6%	3%	61%	39%
US[2]	13,196	93%	61%	19%	20%		45%	55%
World	**23,290**	**70%**	54%	28%	17%	2%	59%	41%

Source: Towers Watson and various secondary sources
Assets/GDP ratio for the world is calculated in USD terms

[1] Excludes Personal and Stakeholder DC assets
[2] Includes IRAs

towerswatson.com 8

With the normal 'marginal' buyer (global mutual funds) already fully invested …



Source: Ned Davis Research

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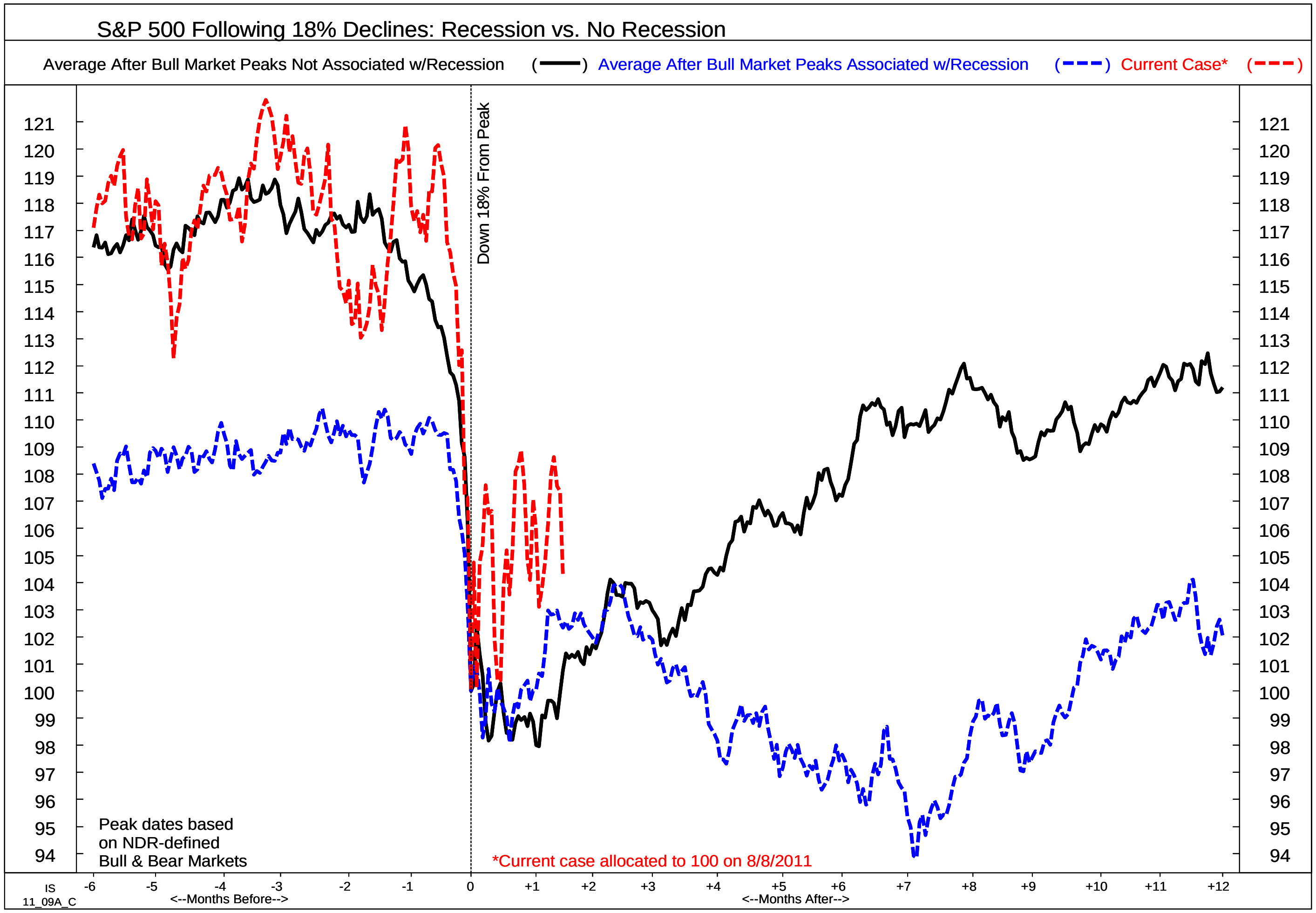
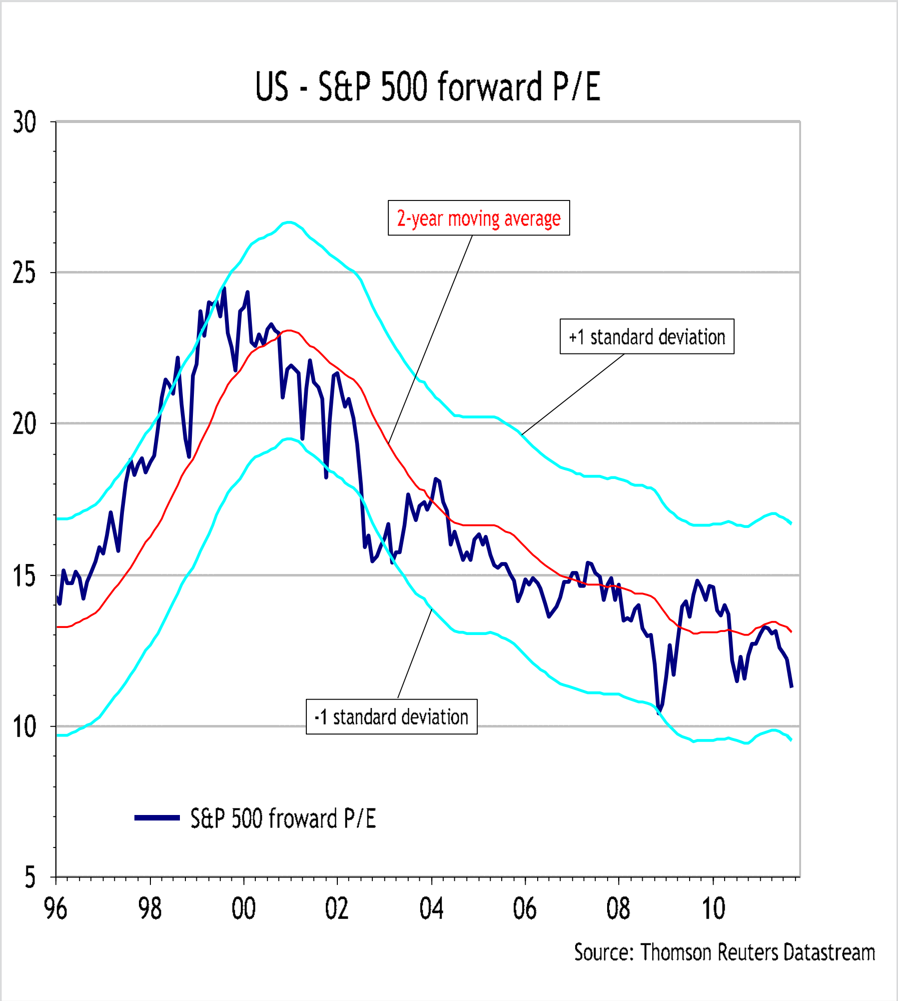
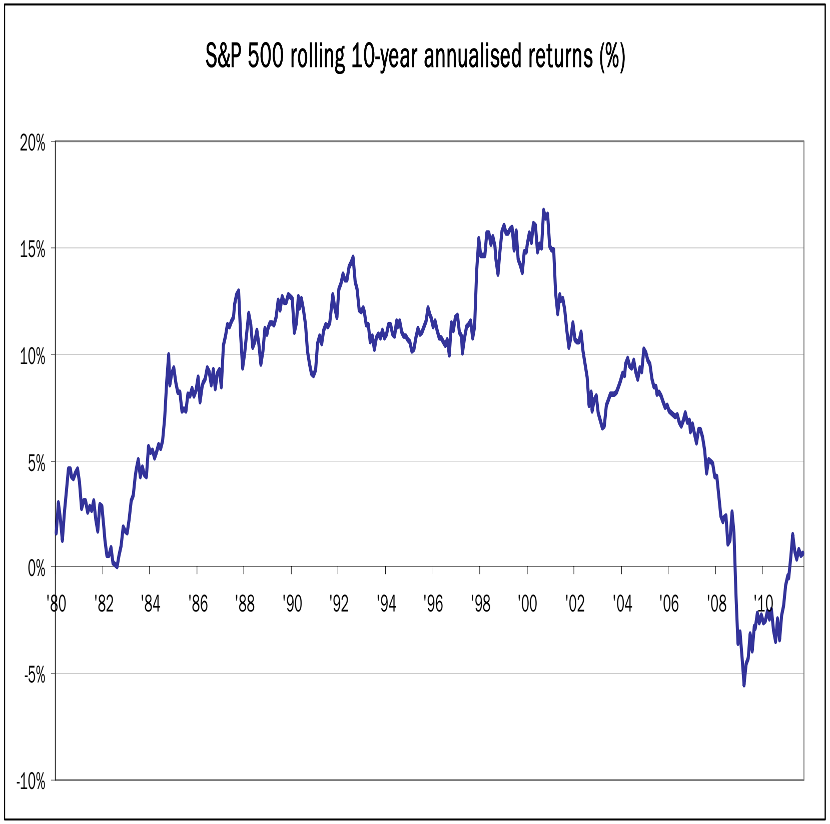
If Recession can be avoided (political will? then much of the earnings risk is already 'priced in….'



Source: Ned Davis Research

With reasonable valuations and sustainable earnings and dividends, equities could perform very well…

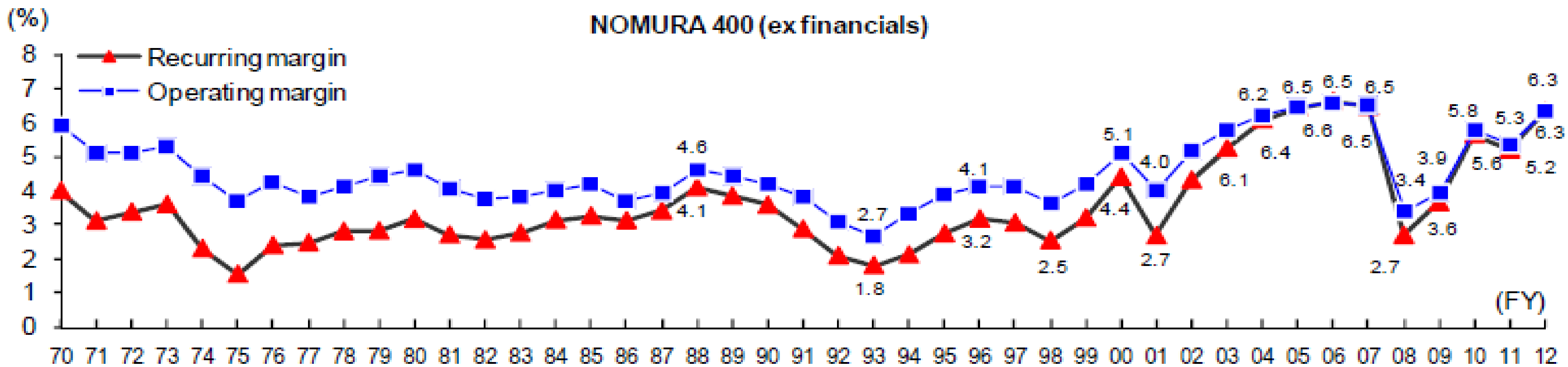




Source: Datastream

Japan: margins extraordinary resilient despite yen and natural disasters…stock prices only slightly above book value

Trends in margins and ROE



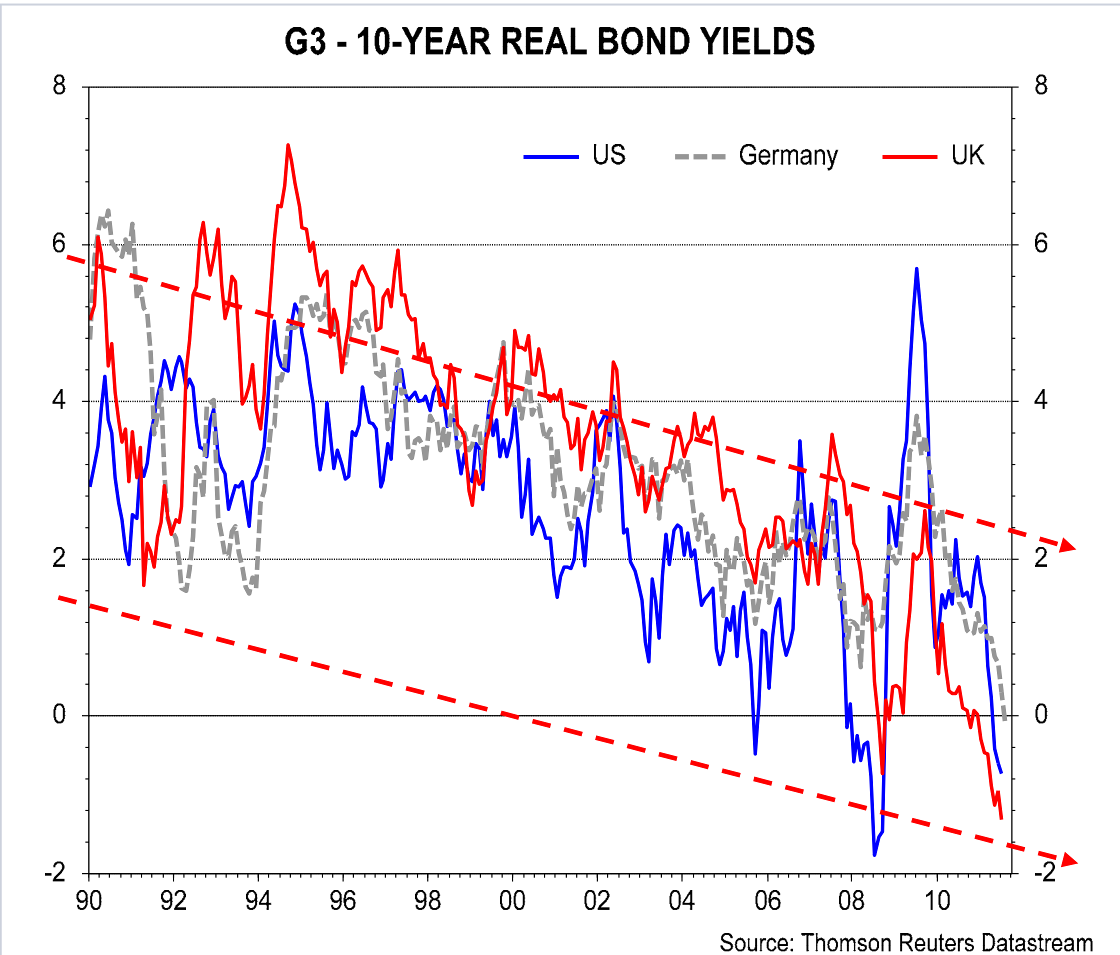
Share price indicators by sector (consolidated)

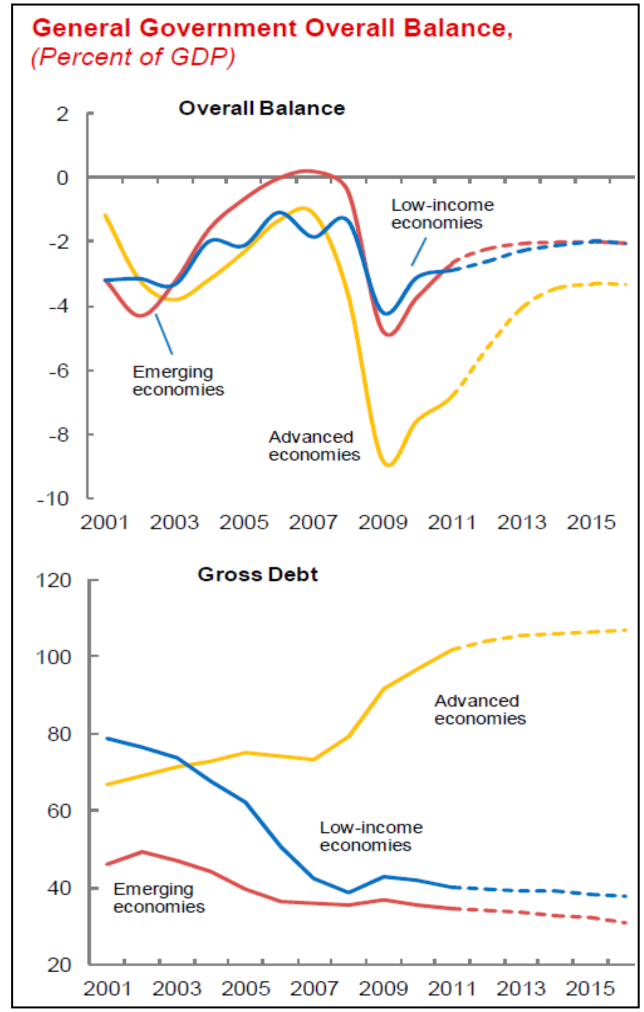
	P/E			P/CF		P/B
	FY10	FY11E	FY12E	FY11E	FY12E	FY10
	x	x	x	x	x	x
Industrial groups						
NOMURA 400	16.5	13.7	10.7	-	-	1.00
NOMURA 400 (ex financials)	17.0	15.0	11.0	5.6	4.9	1.07
Manufacturing	18.8	13.9	11.0	5.9	5.2	1.09
Basic materials	15.4	10.6	9.5	4.3	4.1	0.93
Processing	20.1	14.5	10.4	6.0	5.1	1.09
Nonmanufacturing	14.1	13.4	10.4	-	-	0.89
Nonmanufacturing (ex financials)	14.4	17.7	10.9	5.2	4.3	1.02

- Market now trading 1x P/BV, last seen in 1973/74 and late 2008 during financial crisis

Source: Nomura

Such low real yields on government bonds offer little protection from inflation or deteriorating credit…

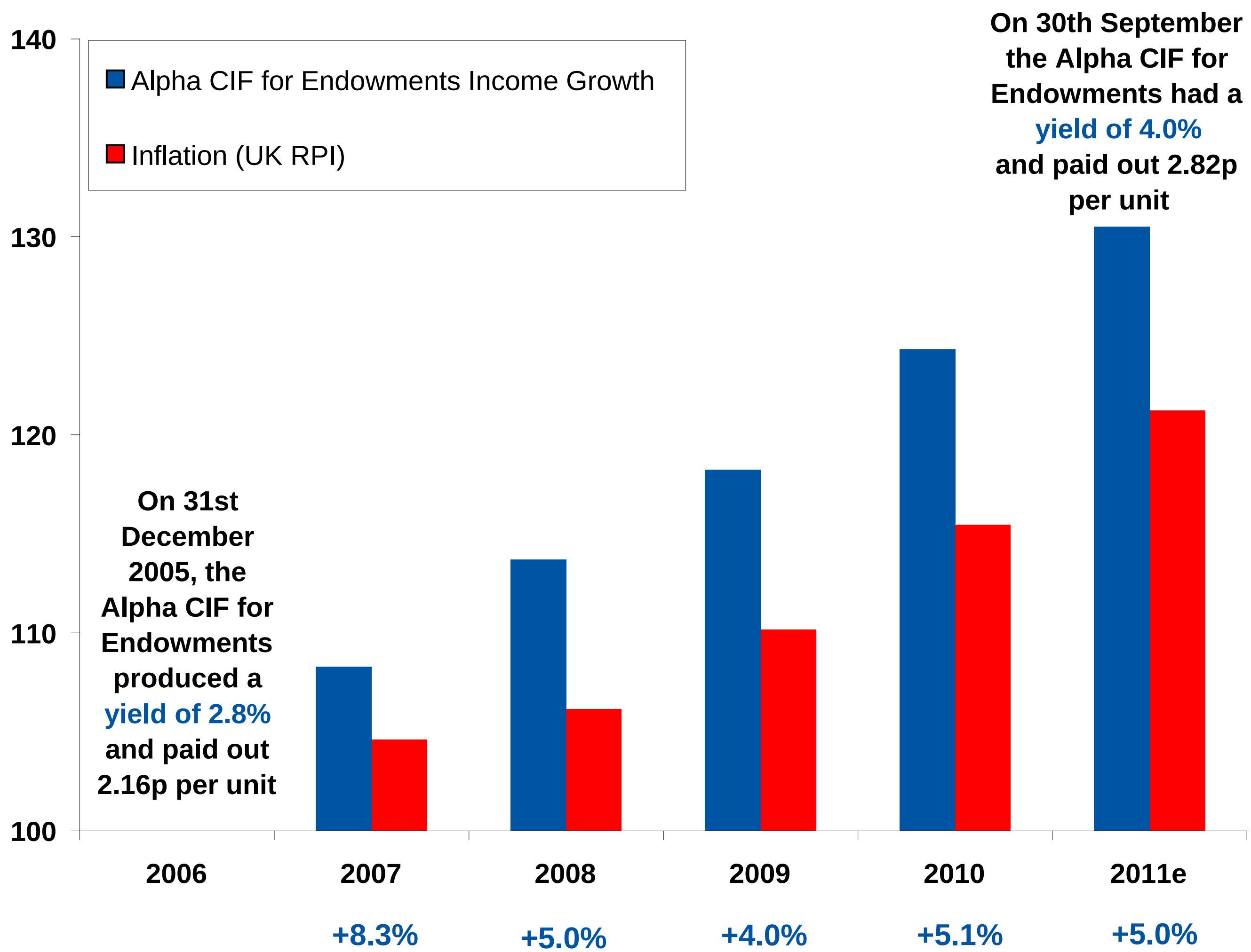




Source: IMF staff estimates and projections.

Source: Ned Davis, IMF, 2011

Our strategy emphasises long-term income growth as can be seen in our Charity endowment Funds



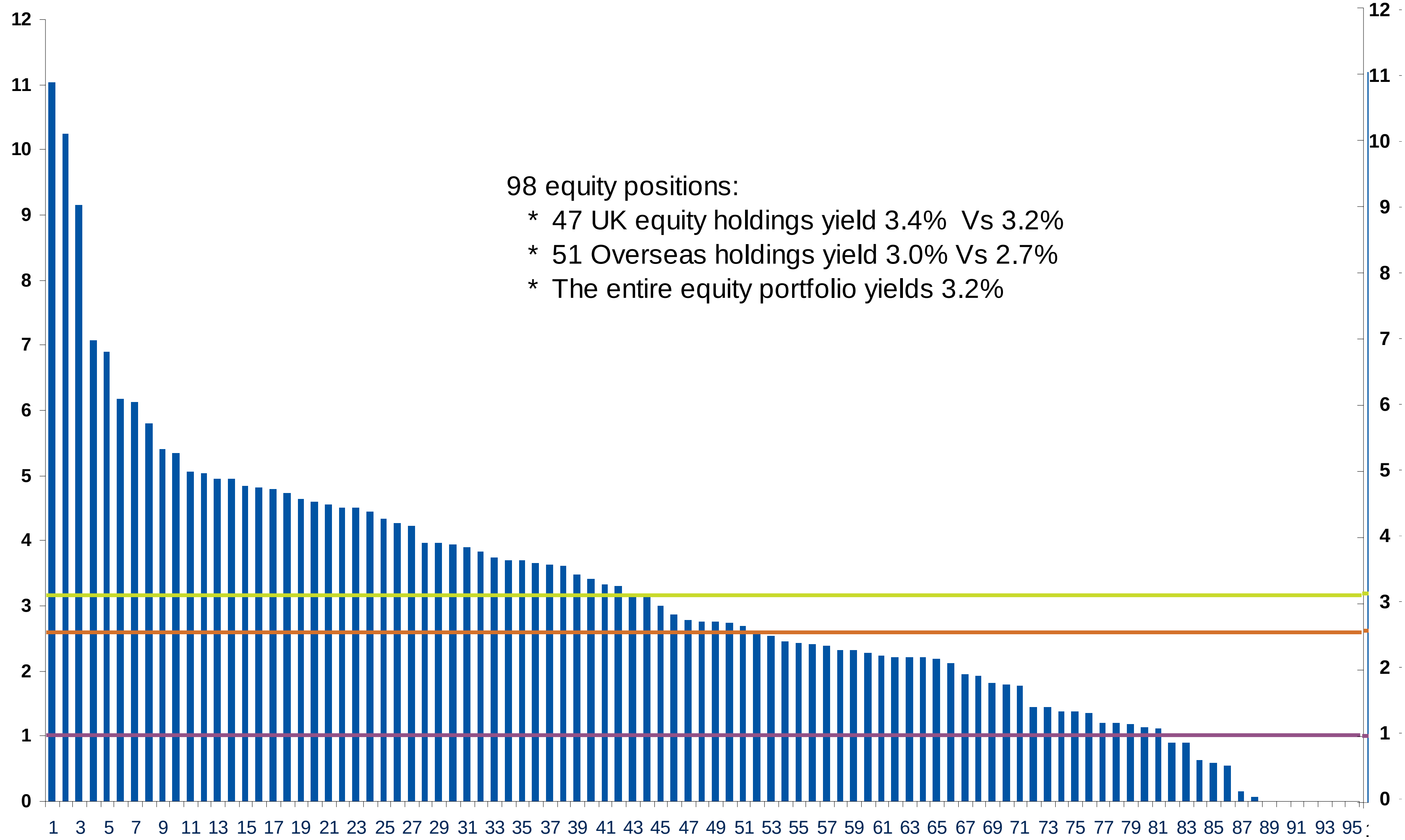
Alpha's income has grown by **5.5%**p.a. since 2005

Over the same period, inflation has increased by **3.9%** p.a.

This equates to 'real' income growth of **1.5%** per annum

Source; Sarasin & Partners as at 30.09.11 based on Alpha CIF for Endowments. The Sarasin Alpha Funds are for registered charities only. It should also be noted that some of the protections provided by the UK regulatory system do not apply to these products and in certain circumstances compensation will not be available from the UK Financial Ombudsman Scheme.

Drawn from global companies offerng a diversified
International diversification and yield…



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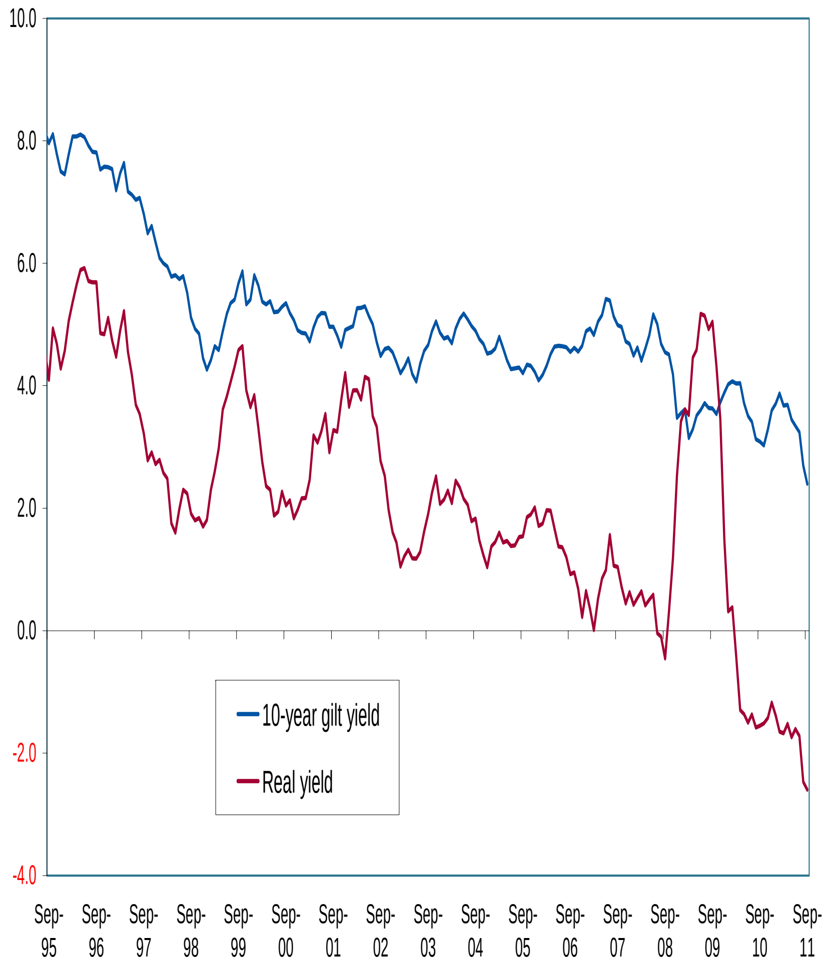
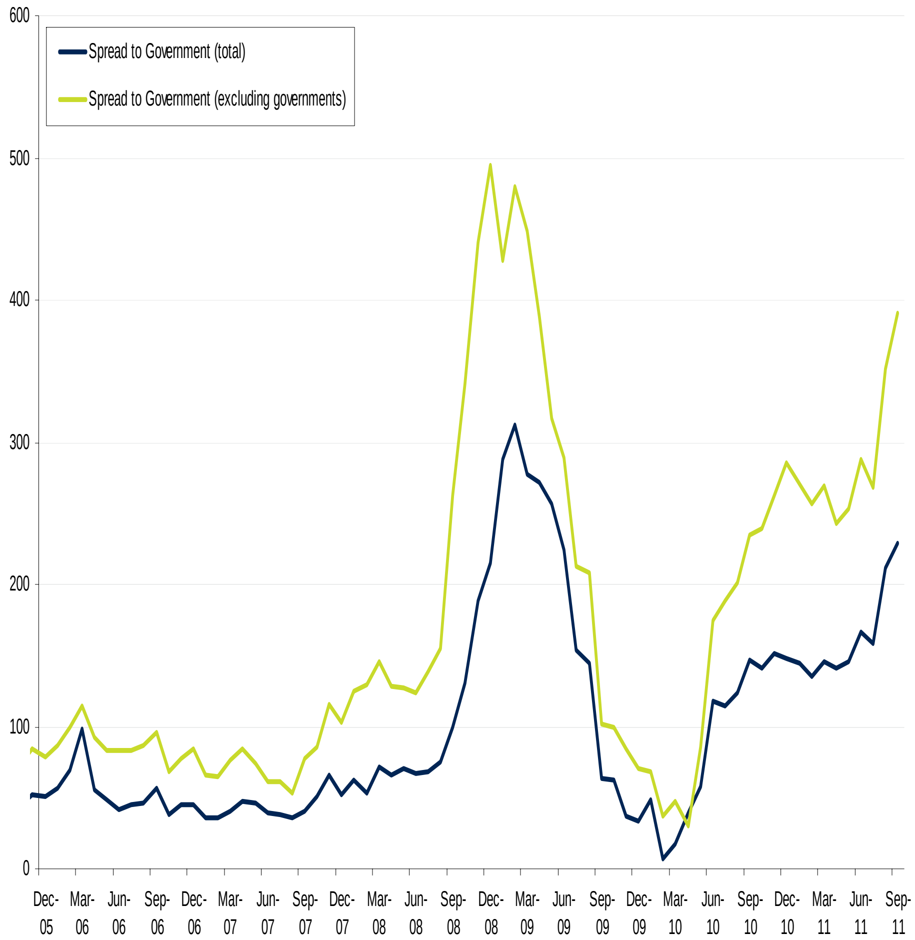
With painfully negative returns from UK Gilts and other Government bonds credit also looks attractive





Source: Bloomberg, 30.09.11

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Corporate Bonds
income now and capital appreciation to come?

- Aviva 6.625% June 2021 / 41
  - *Current price of 82.2p*
  - *Gross Redemption Yield: **9.5%** p.a. for next 10 years*
  - *Or, **16.9% p.a.** over the next 18 months if yields normalise to 7.5%*

- Bank of America 6.125% September 2021
  - *Current price of 90.0p*
  - *Gross Redemption Yield: **7.6%** p.a. for 10 years*
  - *Or, **12.0% p.a.** over the next 18 months if yields normalise to 6.5%*

- Enel 5.75% September 2040
  - *Current price of 79.1p*
  - *Gross Redemption Yield: **7.4%** p.a. for 29 years*
  - *Or, **+21.4% p.a.** over the next 18 months if re-rated to 6.0%*

- *UK Treasury 4.75% 2021 priced at 119.3p (GRY 2.2%) would produce a return of **-2.6% p.a.** if yields rose to 3.5% in same 18 month period*

Source: Sarasin & Partners, Bloomberg. October 2011. Please note the above examples of Corporate bond returns are for illustration only and do not constitute a recommendation to buy or sell these securities.

In summary investment conditions are normalising as volatility falls and stock dispersion widens

Investment Implications

- Bond yields after last month's collapse will likely rise again in the face of unprecedented funding requirements in the developed world and rising inflation issues across emerging economies. Note poor 30 year auction…
- Equity volatility has soared in recent sell-off - expect higher tracking error and leadership changes as managers adjust to income based, non-cyclical assets
- Developed world blue chips our 'Global Nifty Fifty' still offer powerful risk-adjusted exposure to EM growth.

Key Opportunities

- Bond markets – our focus remains shorter-dated credit, emerging world currencies and inflation-linked issues.
- Equity income continues to offer a strong alternative to traditional bond portfolios AND remains the investment of choice…
- Global real estate – offers similar earnings yields to global equities but with resilient rental growth streams…

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