Client Investment Update
Issue 11

Introduction

Welcome to the latest edition of our newsletter.

In this edition we look at how the global credit crunch has impacted the major asset classes in portfolios over the last twelve months.

Throughout the last quarter of 2007, the problems caused to the financial system and the major banks by the US sub prime mortgage debt defaults continued to reverberate around the capital markets of the world, increasing volatility and making investors more reluctant to enter in to certain financial transactions. Banks, particularly in the UK, have become extremely reluctant to lend to each other as part of the normal inter bank activity and this has caused the short term interest rates which banks demand for this lending to rise dramatically. A consequence of this sudden risk aversion by the banks has led to problems not only in stock markets but also other areas of the investment universe, which depend on regular flows of capital to function properly. In this issue we examine these areas and the means that we employed to help limit their impact.

With best wishes,

Nigel Baynes
Investment Director

Commercial Property
Historically an area of investment which exhibits low volatility, the commercial property market has seen valuations fall sharply, as the financial institutions that normally provide some of the strongest demand for property have withdrawn from the market. This has led to a sharp decline in values of new properties coming on to the market and therefore a significant revaluation of the existing commercial property book. Property funds, which were launched early in 2007 to invest in this market, have been hit particularly hard with redemptions, which has put further downward pressure on prices as managers struggle to raise liquidity to meet these redemptions. Fortunately, our exposure to this area has been small, and predominately through well established funds with experienced managers. It should also be remembered that, long term, one of the main reasons for investing in this sector is the yield generated by income from rents and, for the moment at least, these continue to be paid. It is unlikely to be the case that this long term dynamic will change and property fund managers with cash will be able to take advantage of the current short term mark downs for long term gain.

Bank shares
Banks' stock market valuations have been hit very hard as investors continued to be unsettled by the amount of money these organisations were losing as a result of investing in the products used to package the US mortgage backed debt, which was now turning in to worthless paper. In the UK and most mature economies of the west, bank shares usually make up a large sector of the major stock market indices, therefore poor performance from the banks has a significant negative impact on the indices. It is therefore not surprising that we saw the FTSE100 index struggling to make any positive progress over the year.

Equity Income Funds
In addition to their contribution to the make up of the major stock market indices, financial companies' often provide the highest paying dividend stocks. Therefore, funds targeting higher levels of dividend income as part of their overall return have been impacted by the poor performance of the companies underlying share prices. However, the dividend yields on these companies have risen, as the share prices have retreated, and if the companies maintain these dividends then dividend stocks will become increasingly attractive over coming months. Historically, the majority of returns from equity income investments have come from the dividends, not an increase in share prices so, once again, a longer term view has to be taken. Some of the overseas equity income Exchange Traded Funds have fared better than the UK invested funds and with an increasing range of these funds available, we will shortly be moving investments held directly in these type of funds into a new sub-class of our OEIC, to take advantage of this fact.

Bonds
The US Federal Reserve, the Bank of England and the European Central Bank have all responded to the credit crunch by providing billions of additional liquidity to the financial system, in order to try and prevent a significant economic slowdown turning in to a global recession. A consequence of this powerful stimulus is to re-flate the global economy at the same time as energy, metal and agricultural prices are on the rise, posing a significant inflationary threat. This backdrop has not been favourable to the bond market, particularly on longer dated bonds, which continue to fret about the long-term outlook for interest rates. We have therefore seen a negative return from UK government bonds over the last 12 months. Company debt issues, referred to as corporate bonds have struggled, concern regarding company defaults as borrowing costs rise has kept values at best flat. Inflation liked bonds have been the best asset class within the fixed interest sector supported by a rise in the underlying inflation measures.

The benefits of diversifying our asset mix
A key word we use in the investment world is diversification, which, put simply, means not putting all your eggs in one basket, investment wise. While we are not immune to the negative influences mentioned previously, diversifying our asset mix has helped to limit their impact and we can analyse how we did this below.

Overseas Markets
Equity markets in Europe and the Far East have performed better over the last twelve months than the UK domestic indices, assisted by stronger levels of growth and weakness in the value of Sterling particularly against the Euro. Our investment processes continue to guide us away from UK based equities whilst European and Far Eastern markets remain considerably more attractive.

The iFunds managed funds administered by Marlborough have highlighted the benefits of employing an active asset allocation approach to the management of low cost index based Exchange Traded Funds (ETFs), These investment vehicles have enabled us to steer clear of some of the major underperforming assets, such as Japanese and US equities, and as mentioned before we will continue to develop this area of our portfolio management to encompass the dividend based equity ETFs held within portfolios.

Property
The property content within portfolios was scaled back in line with our process and ETFs covering European and UK Property REITS were sold during the summer. Our exposure to physical property i.e. bricks and mortar via the Scottish Widows Property Fund has been retained as part of the long term diversification strategy of the portfolio.

Commodities
A clear winner this year has been commodities and iFunds continues to believe that this area of investment will remain strong, supported by the economic growth in India and China. We backed this view by launching the first fund in the UK specifically designed to invest in physical commodities via ETFs. Most of our managed portfolios hold a position in the MFM iFunds Commodity Fund and this has provided strong returns over the year against a backdrop of very volatile equity markets.

Bonds
On the fixed interest front we have moved away from specialist fixed interest funds, such as those provided by UBS, which provided downside protection against a very weak government bond market. However, this type of fund struggled as a consequence of the credit crunch and we have moved towards index-linked bonds, as a result of continued inflationary pressures.

Summary
2007 from an investment stand point has been very volatile and has once again highlighted the need to have investment processes that can adapt to a fast changing world, where risk is not static and that passive asset allocation and diversification are not sufficient on their own to meet clients long term investment objectives. At iFunds we continuously strive to ensure that our investment processes are flexible and can cope with an ever changing investment world.

Outlook

The central banks, of which the US Federal Reserve is the most influential, are in danger of falling behind the curve in terms of providing financial support to their economies and preventing a recession. There is a strong likelihood there will be a financial package, including further interest rate cuts and we should expect to see equity markets assisted as a result. We are seeing the Asian and Emerging markets developing a greater degree of independence from the usual influences exerted by the US capital markets so it would not surprise to see this divergence between western markets and the higher growth areas of the world continue.

Nigel Baynes
Investment Director, January 2008