investment update

OVERVIEW
Running out of steam?

THE SUMMER OF 09
Hotter than ’99

WORRY BEADS
Be prepared

HEADWINDS AND COMPLEXITY INTO 2010
A tactical approach

BERRY

OVERVIEW


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Financial markets have come a long way since the depths of late summer last year, when the world's financial infrastructure was being placed under so much stress that its very survival was in serious doubt. The subsequent intervention by central banks to provide liquidity, cut interest rates and embark upon numerous rescue packages appears to have brought us back from the abyss, and it is principally this action that has allowed confidence and risk appetite to return. This has provided a backdrop for many asset classes to stage a significant and welcome recovery in recent months. This recovery has been seen most acutely in corporate bond prices, which in some cases have rallied as much as equities, as the threat of default has receded.

But after such a sharp and speedy recovery in asset prices, the big question now is whether there is a higher point as we climb this classic wall of worry. Some commentators are now saying that markets have run ahead too far and that this renewed wave of optimism cannot last. To some extent we agree, but we still believe there is a window of opportunity to see a further recovery in asset prices. So far the rally has been built on thin trading volumes, and with interest rates so low a mass of institutional liquidity needs to find a better home. Furthermore, the stronger the rally, the greater the propensity for investors to feel as though they are missing out, which in itself sucks more money into markets. This is the point where asset prices tend to become overvalued. With most equity and bond markets still currently in the cheap to fairly valued arena, we are not in bubble territory yet, so there is scope for further gains to be made. But we know that markets cannot keep rising indefinitely, and that the higher they climb the greater the worry and volatility. We expect to have to change course sometime in the next few months, but for now we are content to maintain our exposure to the recovery.

Mark Robinson

October 2009

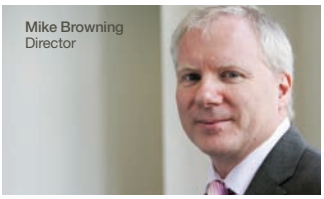
THE SUMMER OF 09

It is extraordinary that during the summer we have experienced the best ever quarter for the UK stockmarket (admittedly only as measured by the FTSE 100), with this index up by more than 20% and beating the previous best quarterly return of around 15% in late 1999 when the dot.com boom was in full swing.

That rally ten years ago was fed by wild enthusiasm and optimism for new growth opportunities, principally born out of the advancements in technology. As we now know, much of that optimism was hugely misguided. In contrast, the market rally which began in the spring was initially much more to do with relief and a realisation that certain assets were perhaps oversold and Armageddon had been avoided. As the year has progressed, however, expectations of economic recovery have turned more positive and there has been a gradual shift from what started as a relief rally to one which has become increasingly genuinely supported by signs of corporate, and therefore economic, revival. Global GDP forecasts are now being revised upwards by a broad church of economic authority; even the US economy seems to be staging a greater than expected recovery, with leading economic indicators now turning more positive.

As the year progressed, expectations of economic recovery have turned more positive.

WORRY BEADS


Mike Browning
Director

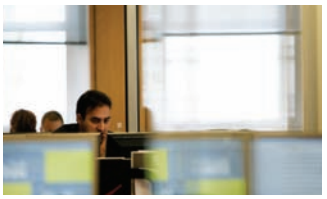

Neil Kennedy
Director

But what are we particularly worried about further ahead? In a nutshell, it is how we transition from a world of highly accommodative monetary policy to one that is more constraining, and at a time when the deleveraging by consumers and overhang of substantial government debt needs to be seriously addressed.

How we transition from a world of highly accommodative monetary policy to one that is more constraining.

The legacy of bailing out the financial system is going to be felt in individual government and taxpayers' balance sheets for some considerable time to come and it is therefore quite possible that economic growth rates, having staged a decent recovery into next year, will slip back again in the years following. We still feel that higher inflation is the likely by-product next year, particularly as a result of interest rates being left low for longer than is required, and that index-linked bonds will be an attractive investment over the coming years. Conventional bond exposure, whether government or corporate, will require even more careful attention than usual in a rising interest rate environment, but for now we prefer a bias towards corporate bonds given the attractive yield spread versus their government equivalents.

HEADWINDS AND COMPLEXITY INTO 2010



So, whilst the immediate future for financial markets still looks quite encouraging and supportive of a continuing recovery in asset prices, more complex economic headwinds are likely to emerge sometime in 2010 and beyond.

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How this will impact financial markets and various asset classes is very unclear, but it is likely that more nimble tactical shifts in asset allocation will be required. Furthermore, good stock selection by equity and bond fund managers is likely to become much more critical. This is particularly relevant should economic growth slow to a more pedestrian pace, commensurate with a more gradual repair of the fabric of the world's economy.

This is next year's worry, but for now we believe there is a window of opportunity to make some further gains as the recovery broadens out and sidelined cash returns from the wilderness to be committed to more attractive, and potentially more rewarding, investment opportunities. This even includes commercial property, which is now looking more attractive from an income and capital recovery perspective, and structured investments which are responding well to higher index levels and reduced counterparty risk.

We still have a preference for overseas equity markets, including the US, Asia and emerging markets, over the more troubled economies in Europe. In summary, whilst the low lying fruit has now largely been picked, we believe that there are some further gains to be made in a wide variety of asset classes before the year is out.

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