BERRY

ASSET MANAGEMENT PLC

A MEMBER OF THE BORDIER & CIE GROUP

Investment Update

Autumn 2011

The Fall

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Summertime blues

Yet another summer holiday season has been tainted by significant turmoil in financial markets, characterised by falls in many global stockmarkets and unusually high levels of volatility. This time it has been a nasty collision between weaker than expected global economic activity, and the eurozone's debt problems entering a more critical phase. Both were known entities earlier this year, but the dithering by policymakers and posturing by politicians have created an inflammatory environment which at times has been difficult for markets to handle.

Mark Robinson
Director
Chief Investment Officer

Alongside all of this the US has lost its AAA rating on its long-term debt, there has been rioting on the streets and an alleged $2bn fraud at UBS has done nothing to restore investors' confidence in the financial system, and appears to show that lessons from the last financial crisis have not been learned. All in all, it has not been a happy holiday season. Whilst there are still many challenges out there, it is also worth reminding ourselves that markets do have a habit of over-reacting both on the upside and downside. Whilst high levels of market volatility are expected to continue over the next month or two, we feel it would be wrong to second guess the next direction in markets and that there is potential danger in changing strategy at such a volatile time. Conditions may well deteriorate a little more before they improve, and for this reason we are happy to retain a decent dose of more defensive and alternative assets, including gold. But we are also mindful that from current low levels markets still have the capacity to bounce quite sharply on even some slightly better eurozone or economic news. There is still a lot to be resolved economically, but taking a medium term view, and to help fight the inflationary curse, shares have probably become a slightly safer bet from here than meets the eye – indeed they may even be the new 'fear asset'.

Mark Robinson
5 October 2011

Eurozone in crisis

The current problems faced by Greece and the wider eurozone implications of a default on sovereign debt are likely to cause further market instability in the short term. However, there is a growing feeling that if we get a firm plan of action on Greece, however painful it is, then there is a good chance that we could see a relief rally in shares from current levels. It is the current lack of an action plan, rather than the plan itself, which we know will have all sorts of additional ramifications for banks, that is causing so much market uncertainty - it seems as though we are edging closer to a firmer plan that will see some form of a Greek default, an enlargement to the existing European Financial Stability Facility and a euro version of the US Troubled Asset Relief Programme (TARP) introduced in 2008 to buy distressed assets from financial institutions.

It is hard to see a scenario where a TARP-like facility will not be needed, and whilst a Greek default may provide some form of a floor to market uncertainty, there will still be plenty of mopping up to do amongst Europe's banks. Politics have clearly become a key interference in any plan being finalised, but finding a resolution seems to be gathering a bit more momentum and is certainly becoming more urgent. The rather disturbing element to all of this is the apparent lack of overall control and the feeling that the authorities are not yet ready to put politics to one side. Quite what they are waiting for and quite how close to the wire things will be pushed remains to be seen, but something needs to happen, and quickly.

A tale of two markets

Whilst stockmarket indices have seen some sharp falls in recent weeks, there are still large tranches of the market that have been relatively unscathed, particularly in less cyclically-exposed sectors, where strong balance sheets and progressive dividend policies can be found and good long term value exists. In the quarter to the end of September, the FTSE 350 Lower Yield Index, comprising companies with low or no dividends (including many of 2010's darlings, the mining companies), saw a fall of almost 20%. The mining sector alone fell by more than 30% in this three month period and has had a big influence on overall market behaviour – at the time of writing many FTSE 100 mining stocks have virtually halved since early July.

In contrast, the FTSE 350 Higher Yield Index, which as the name implies includes leading UK companies with a high dividend yield, have fallen by around 8%. The same polarisation has been seen in other global stockmarkets as investors have sought cover in the relative safety of companies that are less exposed to the economic cycle and have something tangible to reward investors with, namely a healthy dividend. As many readers will recall, we made a decision last year to reposition our stockmarket exposure more defensively, in preparation for what we felt would be more challenging times ahead – we were sufficiently convinced about tougher times that we began to modify portfolios. Investing is not a linear game and often requires patience, and the fruits of early positioning can often take time to materialise. The trick is not to lose too much ground when the tide is running in the opposite direction. So whilst some investors were continuing to allocate capital to sectors that were, in our eyes, expensive and vulnerable to a slowdown, we were busy reorientating exposure in the more defensive areas of markets.

This has been a gradual process as we did not want to ignore completely the strong market momentum at the time, but this early move has paid off recently. It has still been very difficult to avoid losses in a market that has had a diminishing number of places to hide, but we have generally escaped some of the worst market falls. Investing in such defensive parts of the market may sound rather dull, but eating, drinking, switching on lights, making 'phone calls and doing the washing are everyday things that we need to do; it therefore seems sensible to skew stockmarket exposure towards those companies that should continue to benefit from the bare necessities.

Fear assets in bubble territory

Other so called safe-haven assets also helped limit the damage from equity market declines over the summer months, but many have now been taken into overbought territory. The recent sharp corrections in the Swiss Franc and gold demonstrate that 'fear' assets can be just as vulnerable to setbacks as equities – the same could be said of other traditional safe-haven assets, most notably government bonds, where yields have been driven to multi-year lows and prices to record highs.

Government bond yields are already pricing in a very large measure of uncertainty over the global economic outlook and in our opinion, other than those with short maturities, are now very expensive and vulnerable to a setback, whilst shares are sitting on the cheaper side of fair value. Investors are clearly worried that a subsiding economic backdrop will see a drop-off in corporate earnings, which is yet to be factored into the cheap valuation ratios mentioned above.

However, before we get too concerned we should not forget that a typical recession might see a drop in corporate profits of around 25%. The last recession saw declines of much more than this. Whilst some turndown in corporate profitability can be expected, we should not forget that there are many major corporations that have spent the past few years deleveraging their balance sheets and strengthening their businesses. This should allow them to get through a mild recessionary period, if that is what we are about to enter, without the sort of profit disappointments that were experienced in the past downturn. From this perspective, stockmarkets

"shares.... may even be the new fear asset"

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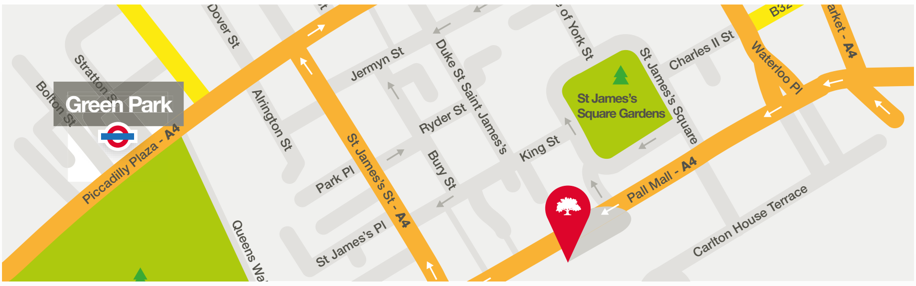

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