BERRY

ASSET MANAGEMENT PLC

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Investment Update

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Groundhog Day

Global markets have been buffeted from several angles in the past quarter, and at times have come under quite strong selling pressure, reacting to weaker business confidence indicators and continued problems in the eurozone. It is tempting to take the easy option and repeat last quarter's commentary about stockmarket behaviour, since we are, quite extraordinarily, staring at virtually the same market levels that prevailed at the end of March and also at the start of the year.

Mark Robinson
Director
Chief Investment Officer

There is a kind of 'Groundhog Day' feeling to where we are, with the FTSE 100 Index putting on a spurt during the final stages of June to recover close to 6,000 points, and in America the Dow Jones Industrial Average climbing above 12,000 points again. Like previous quarters, what is not apparent from these headline numbers is the broad uncertainty and volatility that has run through stockmarkets' veins. As with a swan, the calm on the water's surface often disguises some fairly frenetic paddling underneath. Thankfully, however, only white varieties have so far graced the rougher financial waters, and not the 'unexpected' Black Swans – long may it remain that way.

Mark Robinson
1 July 2011

Greek tragedy

During the past quarter it has been Greece and the eurozone's indebted periphery that have given investors the most cause for worry. As this is written it is still very uncertain as to whether Greece will struggle through and somehow rebuild its economy: it may have won a stay of execution for now after the passing of key parliamentary votes, enabling the release of more IMF and EU aid, but the country has ultimately paid a very big price: with the overall unemployment rate at around 16% and youth unemployment nearing 40%, the planned massive austerity measures will further cripple an economy in very poor shape.

The reaction from markets hinges to some extent on whether the Greek situation can somehow be ring-fenced or whether contagion spreads to the eurozone's other troubled nations. This point is particularly unclear, but it seems increasingly likely that the days of the eurozone and its currency, in its present format, are numbered. Whilst we are happy to have some modest exposure to core European stockmarkets, where valuations are extremely attractive relative to other developed markets, we continue to steer well clear of the troubled periphery.

Where next for stockmarkets?

All this gloomy news does not necessarily mean a weak period for stockmarkets: there are many relatively cheap companies with strong and cash-rich balance sheets that are trading well and are less exposed to the cyclicality of the economic rollercoaster.

Some of these companies have survived not just one recession in their corporate history, but several, and are well placed to keep up their momentum in profitability, sharing much in generous dividend distributions to shareholders. Some will even be in a position to take advantage of the weakness in other businesses and embark upon mergers and acquisitions, which should also provide good support for stockmarkets. It is on these cheaper, more defensive and higher yielding companies where we intend to maintain an emphasis through the funds owned in client portfolios.

Britain's high streets – closing down sales now on

A short stroll down the typical UK high street does not paint a pretty picture. The past few weeks has seen a further wave of well-known retail brands closing branches or falling into the clutches of the corporate administrator: Habitat, Thorntons, Jane Norman, Dolphin Bathrooms, Moben Kitchens and Sharps Bedrooms have all announced they are closing branches or facing closure. These new names come hot on the heels of store closures at other well-known retailers such as Comet, Mothercare, HMV, JJB Sports and Focus DIY, to name but a few.

Some of these businesses may have failed to adapt to the onslaught from online retailing, which certainly cannot be ignored and now accounts for almost 10% of total retail sales according to the Office for National Statistics. But it is essentially a reflection of how cash-strapped the consumer remains in the aftermath of the recession and financial crisis. Headline-grabbing annual sales growth figures of 20% from the likes of John Lewis, seen as a bellwether of UK spending habits, may tell a slightly different story of high street spending, but the more cynical view is that numbers like this are relatively easy to achieve with heavy discounting and a virtually permanent 'Sale' message emblazoned across the glass of many shop windows – what really matter are margins and bottom line profitability, key financial metrics that appear to be harder and harder to come by for the traditional high street retailer. Leaving aside the problems for the retailers, this backdrop does not paint a particularly good picture for secondary and tertiary retail property, particularly in high streets up and down the country. Prime real estate, however, particularly offices in major conurbations or strategically located out of town retail parks, continues to provide property managers with good income flow and reasonable prospects for further capital growth.

Fixed interest markets – a strategy change

Whilst the broad backdrop for investment in stockmarkets remains quite positive, the backdrop for bond markets appears to be changing. We are now seeing some early signs of a shift in consensus view on both the interest rate and inflation front. Only as recently as four months ago, there was a widely held view that a small tap on the monetary brakes would be seen by mid-year – seen more as a symbolic move than something having direct and immediate impact on inflationary pressures – but the weakening in global economic growth, exacerbated by the earthquake and tsunami in Japan, has swiftly altered this scenario. In the past month, the timetable has shifted once again, with markets not now anticipating a rise in UK interest rates until possibly mid 2012. A similar scenario can be seen in the US. This is quite a big sea change in sentiment and something that is causing us to modify our strategy.

This shift in the interest rate outlook is due to a combination of factors, most notably an expected reduction in future global inflation, itself an automatic brake on economic growth. First, the oil price recently tumbled 20% from its end of April level, aided by the International Energy Agency's surprise announcement that it intended to release 60m barrels of oil into the market from its strategic reserves, citing supply shortages from Libya. Whilst this is a partially plausible explanation, the more likely reason is the desire by western governments to find alternative ways to tackle high inflation. Second, the Chinese appear to be doing their bit with a series of interest rate rises aimed at targeting inflation and moderating their rapid pace of economic growth. Third, Chinese imports of commodities such as iron ore, copper, cotton and oil have also been falling this year – either due to running down of stock levels or less demand, but helpful either way. Finally, but not exhaustively, there has been some encouraging news from America's farmers, where new planting has prompted some sharp falls in corn, wheat and other soft commodity prices. It will take several months for such price falls to filter through to the high street and garage, but there are some straws in the wind that suggest we may soon see a peak in inflation rates and moderation thereafter.

It is important to stress that we do not see global inflation suddenly collapsing to previous low levels: however, there has been a shift in the past few weeks suggesting that inflation risks will start to moderate soon.

These high levels of inflation have been entrenched in investment psyche for some time now, and it has been

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important to position clients' portfolios appropriately for these conditions. Our diversion into index-linked government bonds has been a successful move, and a great deal of money has now been channelled into index-linked bonds globally, pushing yields to extremely low levels. However, it is not only today's inflationary conditions that we need to react to, but the ones ahead of us. We are therefore reducing the commitment to index-linked bonds in favour of the relative safety of shorter-dated conventional government bonds. Moving into medium or longer-dated government bonds still carries some risk, particularly given that we do not yet know what impact the removal of the Quantitative Easing (QE) underpin will have on bond prices. If inflationary pressures begin to recede later this year as we expect, then a more mainstream shift into conventional government bonds may form part of our strategy. Such a move is also likely to confirm that low interest rates will be seen for much longer than originally anticipated, which will bring a whole new set of challenges and opportunities for markets, and us, to deal with.

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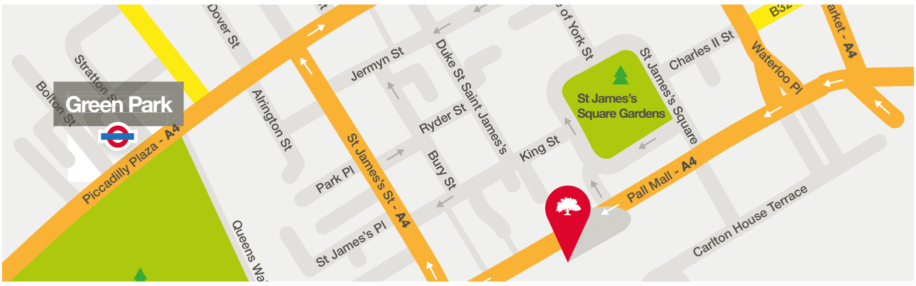

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