

Independent Financial Advice

Investment News

from Johnston Financial

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WELCOME

Welcome to our October Investment News. I returned in mid August from a month in Australia and Thailand to a very different investment world. Suddenly the "market", listening to Central Banks, believed that interest rates would stay "lower for longer" and that Quantitative Easing, the pumping of liquidity (money) into the financial system, would continue.

That coupled with clear signs that Armageddon was avoided or at least postponed and very low returns on deposits and risk free assets led to a rush to invest and up went the prices of almost every risk asset.

In View From The Top, Ken Forman asks "Is that it?" for the bear market and discusses what has happened over the summer and the influences he sees for the year ahead. He gives his regular round up of the asset classes and rather interestingly, comments on the trends in the commercial property market.

There has been some fascinating TV about the collapse a year ago of Lehman Brothers and what led up to it, particularly the politics. Our fund manager for The Nevis Fund, John Husselbee looks back in "North Point" over the last year and describes some of the things that flowed from that collapse and affected world investment markets.

John compares the last year with where we are today and explains his approach in selecting investments for The Nevis Fund in this new environment. Much of this is reflected in the recommendations we make for portfolios outside The Nevis Fund.

We hope you enjoy this Investment News.



Adrian M Johnston,
Managing Director

Funds in focus

Over the next few months, I am going to select one of the investments in the Nevis Portfolio Funds to write about. I want to start the ball rolling with a look at the Schroder Income Maximiser fund. This is a very interesting fund in which a position was opened for both Portfolios in March of this year and added to in August.

Johnston Financial has from its birth believed strongly in the case for UK Equity Income funds, for investors based in the UK. They give investment towards the lower end of the equity risk spectrum, into the UK stock market. As a result, exposure is obtained to the growth potential of stock markets and there is no currency risk.

However, what really interests us, is the reinvestment of dividends as part of the long term return from investment. All of the studies show that this is a major component of the long term return from shares. Growth funds tend to outperform Income funds when there is a prolonged

period of growth in companies' earnings (profits). But when growth in earnings turns down or is patchy, companies that can grow their earnings steadily and return that to shareholders as dividends come to the fore.

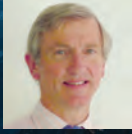
The investment manager of an Income fund has to make the right share selections, so track record is important. Schroder have a very successful Income fund with managers Nick Purves and Ian Lance who have been in charge jointly since 2007, and in Nick's case since 2003. No fund stays at the top of the performance tables, but this is a fund that has consistently bubbled back to the top and is there now.

The Income Maximiser Fund adds another twist to increase the income to a target yield of 7% p.a. This is achieved by an "overlay strategy" run by Schroder's Structured products team. In effect, they sell the growth potential of each share above a certain level in exchange for a premium that is added to the dividend income of the fund. The threshold of growth they retain is currently around 15% per quarter so you can see there is enough to ensure the fund can still benefit from rising share prices.

This strategy boosts the yield for income investors but importantly, dampens the volatility of the fund in that the extra income helps to protect the fund and add to its total return when markets are falling, flat or gently rising.

We can expect to see this as a core holding of the Portfolios for a considerable time to come.

Adrian M Johnston, Managing Director



Ken Forman

Is that it?

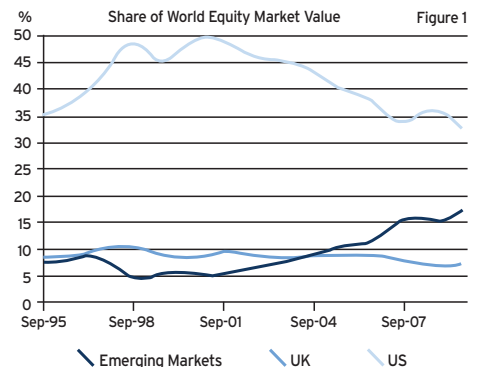
Equity markets have come a long way since the dark days of last winter and it now looks as though we are in a new bull market. It's hard to believe that the effects of the biggest financial crisis and economic contraction for many years have been shaken off so quickly. But given the massive liquidity injection provided by the public sector maybe we should not be too surprised. There will undoubtedly be market corrections ahead but the risk now is of being out of the equities during a period when they are likely to outperform most other asset classes. It will, nevertheless, take some considerable time for the financial sector to recover from the crisis and the countries that were hit hardest will be slow to regain peak output and some negative news along the way could be the trigger for market volatility.

After a short pause in the summer equity markets have powered ahead again in the third quarter

This latest rise may be more a consequence of the liquidity (money) being provided by the central banks than because of more positive expectations for either economic growth or corporate profits. It is clear from an analysis of banking data that some of the liquidity has been finding its way into the bond market. Banks are using the opportunity provided by cheap money to invest in 'risk-free' government bonds yielding a solid margin over their funding cost to generate profits and so help repair their capital strength. The link to the equity markets is less transparent but nevertheless is still a driving force.

Emerging markets have risen more than developed markets...

since the bottom in the spring. Relative to the world index they are now back to the high point they reached at the beginning of 2008. As a group, emerging markets now represent 17% by market value of the world index as I demonstrate in *Figure 1*. This compares with only 5% as recently as 2000 when the US market accounted for close to 50%. Now emerging markets are up to half of the shrinking share of the US. From a parochial point of view, emerging markets overtook the UK in 2005 and are now more than twice its share.



These trends are a reflection of economic and political reality

Last year the International Monetary Fund estimated that developing countries' GDP would exceed that of the developed world within five years. This year, the G20 group of finance ministers and central bankers from 20 "important" countries (including several from the developing world) have been getting more attention than the G8 summit of government heads from the industrialised world and Russia because of its claimed success in ending the financial crisis.

China is a major part of the emerging markets story

It is widely expected to overtake Japan next year to become the second largest economy in the world. Its foreign exchange reserves are still rising rapidly and currently amount to about £1000 per head of population (all 1.3 billion of them!) or half a year's average Chinese earnings. To put this in context, the UK's foreign exchange reserves amount to only about a week's average UK earnings! China has become more assertive on the world stage in the past year, both in its political rhetoric and in flexing its financial muscle. It has been purchasing assets abroad largely to secure supplies of raw materials vital to its continued domestic economic expansion. We will no doubt hear a lot more about China in the years ahead.

View from the Top



The recovery in equity prices continues to set records

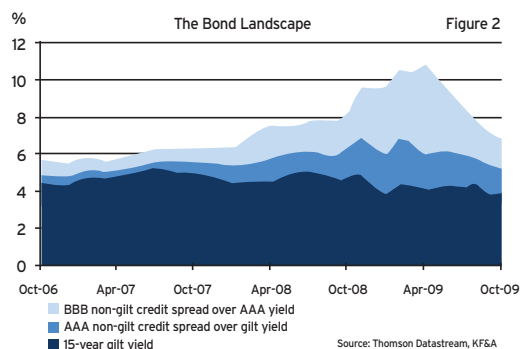
The third quarter was one of the best ever with most equity classes rising by about 20%. The consolidation that I expected when I wrote last quarter's article was contained to a fall of 8% over a period of six weeks in the summer before the recovery resumed. Although companies have reported sharp falls in their profits in their recent announcements, in many cases these were not quite as bad as were expected by analysts, so share prices often rose on the announcement. Companies seem to be reacting to the revenue weakness this time round with more aggressive cost cutting than normal. I still believe that markets are likely to remain volatile and over the course of the next year we may well experience bigger corrections than we have had so far in the recovery. The key triggers in my view are likely to be company trading statements, as expectations are for a substantial recovery in profits from this year's depressed level, and central banks reversing some of the liquidity injections, whenever that occurs. The first is good the second negative.



Bond yields have continued to fall as the yields on Government Securities (Gilts) edge lower and credit spreads (the extra interest rate that companies have to pay compared to the Government) narrow

The Bank of England's quantitative easing (along with similar actions in other countries) has contributed directly to the process. But the increase in liquidity has fuelled more general demand for bonds, particularly those with lower quality credit ratings. Figure 2 shows the yield on gilts and the additional spread for AAA (highest quality) and BBB (medium quality) bonds over the past three years. At the start of the period the spreads were relatively normal and you can see the effect of the crisis as they ballooned out, reaching a peak in spring this year. They have recovered quite a long way already but can still fall further to reach more normal levels.

The big question now is whether this final move back to normality will be accompanied by a rise in the gilt yield because of the massive new supply and concern about the inflationary consequences of high Government deficits. So far investors seem relaxed on both counts. The big test may come when the authorities start to reverse the quantitative easing programme but we should still have some time before that happens.



BONDS

It looks like the property market has turned

Prices for prime commercial properties have been firming as long term investors bid up the price from depressed levels. The market fell further, with the duration of the fall being shorter, than in typical property downturns. It may be that this market is also now starting to benefit indirectly from government and central bank intervention to rescue the financial sector. Certainly the supply of properties through foreclosures has been much reduced in this cycle as banks have not had the need of distress sales. As a result, there could well be a sharper bounce than normal in the initial stage of recovery, creating the potential to provide competitive investment returns over the next year or so. However, it will be a challenge for investors relying on property funds or other investment vehicles to match these returns as, in many cases, prices have already moved to discount the coming recovery.

PROPERTY



North Point



What a Year!

The first anniversary of the Global Financial Crisis is upon us, a crisis which has dominated our daily headlines since the collapse of Lehman Brothers. But it all began almost a year before that with the US housing bubble bursting as rising inflation caused interest rates to rise. With homeowners unable to keep up with their ever increasing mortgage payments, defaults began. Despite a number of smaller financial institutions being allowed to fall by the wayside, there was a firm belief that the key institutions were just "too big to fail." This belief evaporated instantly with the Lehman experience and the threat of deflation looming large.

Deflationary periods are particularly damaging to companies and their investors. As the price of goods and services begin to fall, so the risk that companies cannot pay their debts starts to rise. Equity prices begin to suffer as company profits become unpredictable and the threat of default increases. Last autumn, in response to these deflationary concerns, we saw governments and their Central Banks begin to respond with an "unconventional policy." Prudence was abandoned as authorities flooded the market with much needed liquidity. Their aim: to reflate the global economy and restore confidence in the World's financial markets. Understandably, investors treated these actions with suspicion and fear, seeing this as a sign of desperation and resulting in the classic capitulation in markets in March.

It now seems that investors overreacted and the equity market has certainly staged a remarkable and dramatic rebound over the last six months. Reflating the economy encourages credit growth and inflation. As deflationary fears abate the chances of company default decline and so corporate bond prices can rise. This has happened and we have seen equity like returns from corporate bond funds over the past year. For equity prices to continue to rally from here we will need to see signs that the battle against deflation has indeed been won. Indicators such as rising government bond yields and commodity prices will provide signs that inflation is returning to the system.

Whilst commodities, particularly oil and gold, are showing signs of inflation, the ten year gilt yield is being stubborn. Instead of the negative impact on gilt prices we

Nevis Portfolios Performance

Nevis Conservative Portfolio
Conservative Composite benchmark
Nevis Growth Portfolio
Composite benchmark
MSCI United Kingdom (TR)
B of A Merrill Lynch UK Gilts All Stock TR USD
IPD UK All Property Monthly TR
LIBOR GBP 1 Year

Performance YTD
9M 31/12/2008 to 30/09/2009

Performance Since Launch
19M 29/02/2008 to 30/09/2009

14.1%	-1.7%
10.4%	-0.4%
13.9%	-3.5%
13.7%	-4.1%
20.5%	-5.8%
1.0%	13.2%
-8.3%	-27.1%

Source: Lipper Hindsight; Bid to Bid, Income Reinvested.

anticipated, yields have remained fairly stable, in fact, they have fallen slightly since the summer months. Whilst, many equity investors have decided that the fiscal and monetary stimulus will eventually succeed in leading to a recovery, bond investors have their doubts. Many suggest that it is Quantitative Easing that is temporarily supporting gilt yields. However, the amount of debt already issued and the willingness to issue more if necessary will eventually undermine gilt yields. Sterling has already been devalued by fears of supply and it is only a matter of time for gilt yields.

A year ago investors were anticipating a depression. Today the unprecedented actions of the authorities are showing signs of working. The question is how sustainable is this recovery when the economic fundamentals remain poor? Unemployment continues to rise against a background of high levels of indebtedness amongst the government, businesses and households. The fact that corporate earnings continue to surprise is more a reflection of the behaviour of analysts who have swung from overly optimistic to, perhaps, too pessimistic in less than a year. For now corporate earnings are being driven more by cost cutting than sales or revenue growth. However, we believe that we have seen the worst in terms of this economic slowdown

and that next year we will see the beginnings of a sustainable recovery. Interest rates will stay low until the deflationary battle has been won. In this environment we continue to favour equities and corporate bonds.

Within the Nevis portfolios we have continued to focus on quality companies with strong cash flow and sustainable earnings rather than chasing the "dash for trash", cyclical companies heavily exposed to the economic cycle that have driven the market higher as investors have re-assessed the likelihood of bankruptcy. Quality companies with reliable cash flow are currently cheap and in this environment, many provide excellent growth potential. Consequently, we have increased the Nevis funds exposure to Neil Woodford's Invesco Perpetual Income fund and Adrian Frost's Artemis Income fund. Both run by experienced and widely respected managers. We believe that for the equity market to continue upwards it will broaden out into those areas of the market offering outstanding value which is where these two funds are positioned.



John Husselbee
Fund Manager
North Investment Partners



Johnston Financial,
49 Northumberland Street
Edinburgh, EH3 6JQ
T: 0845 166 7095 F: 0845 166 7093
E: mail@johnstonfinancial.co.uk
W: www.johnstonfinancial.co.uk
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