Independent Financial Advice

Investment News

from Johnston Financial

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WELCOME

Welcome to our January 2010 Investment News. As we start a new decade I am sure many of you will heave a sigh of relief and not be sorry to see the back of the last one. Two major stock market declines and one and a half recoveries is rather too much excitement for one ten year period!

In View From The Top, Ken Forman waves goodbye to the "naughties" but reminds us that investing on a regular basis can create better returns in volatile markets due to "Pound Cost Averaging". This is interesting as in the eighties and nineties when markets showed remarkably little volatility but rose fairly steadily, the view was that pound cost averaging added little. Clearly it is a strategy for volatile times.

Ken gives his regular round up of the asset classes and considers the risks to each.

Our fund managers for The Nevis Fund, look forward in "North Point", into the start of this new decade and find good reason to be weighted towards equities and underweight bonds.

However, as you will see they are well aware of the potential trip wires and are watching for them and positioning the portfolio to provide some protection should markets fall over one of those hazards. They explain their thinking behind the changes to the portfolio in the last quarter.

We wish you a happy and prosperous 2010 and hope you enjoy this Investment News.

Adrian M Johnston,
Managing Director

Fund in Focus

Allianz RCM BRIC All Stars

The second fund I thought it would be fun to write about is the Allianz RCM BRIC All Stars Fund. Allianz are that same very large company behind the Allianz Arena in Germany where the two Munich clubs play their football. The Allianz BRIC fund has now been in all of the portfolios where we can access it since almost the launch of the Nevis Funds in early 2008.

As the focus of world growth moves from the developed world economies to the emerging world economies investors have been seeking to obtain investment returns from that trend. However, not all emerging economies are equal hence our concentration on BRIC.

BRIC is an acronym that refers to the fast-growing developing economies of Brazil, Russia, India, and China. The acronym was first coined by Goldman Sachs in 2001. Goldman Sachs argued that, since they are developing rapidly, by 2050 the combined economies of the BRICs could eclipse the combined economies of the current richest countries of the world. The four countries, combined, currently account for more than a quarter of the world's land area and more than 40% of the world's population.

On June 16, 2009, the leaders of the BRIC countries held their first summit in Yekaterinburg, and issued a declaration calling for the establishment of a multipolar world order. We can expect to see them develop their political presence as their economic presence grows.

Brazil is already a major agricultural exporter – and could easily double its agricultural land without even touching the rain forest. Russia possesses huge oil and gas reserves and is one of the largest energy exporters in the world. The expanding Indian middle class now exceeds the entire population of the US and the rising affluence of this and the other BRIC populations is driving demand in many areas. China has already overtaken the US as the world's second-largest exporter, driven in part by booming domestic demand within other emerging markets. Plus, China is now the largest mobile phone market in the world with around 520 million subscribers.

The fund uses six key themes to select shares. These are: Agriculture, Infrastructure, Energy, Eco-technology, Commodities and Emerging wealth. Allianz RCM BRIC Stars targets opportunities created by these themes in companies in the BRIC economies and other emerging markets. This is another fund we can expect to see as a core holding of the Portfolios for some time to come.

Adrian M Johnston, Managing Director

JOHNSTON FINANCIAL LTD

"Two major stock market declines and one and a half recoveries is rather too much excitement for one ten year period." Adrian M Johnston

Ken Forman

Goodbye to a bad decade! Or was it?

On January 1, we welcomed a new decade as well as a new year. The old decade will go down in the financial annals as a poor one for long term investors, with the UK stock market ending the decade 15% lower than it started (admittedly at the top of a long bull market). However, that may be painting too bleak a picture. Regular savers, investing a constant amount on January 1 each year into the UK stock market, would have accumulated more by the end of the decade than if they had invested the same amounts in cash deposits. They would have done slightly better in gilts but the three results are surprisingly close given the financial market turmoil we have been through (see Figure 1). This demonstrates the merits of regular investment or "pound cost averaging" as it is sometimes called whereby in volatile markets, your money buys more units when prices are low and fewer when they are high, resulting in better performance than if all units had been bought at the average of the buying prices. Just as diversifying your investments by type is a sound strategy so too is diversifying your points of entry to the markets (assuming you have the ability to do this).

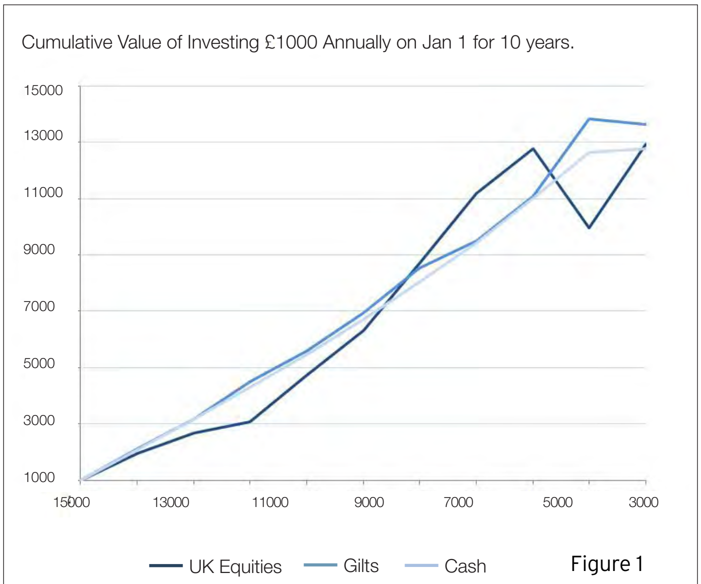


Figure 1

Turning to the more recent past, there has been little change in the investment landscape since the last bulletin

We have seen further evidence that the global economy is bottoming out and in some recession-hit countries output has already picked up. Although the data has not been released at the time of writing, the UK should in the last quarter of 2009 have recorded its first positive quarter since the start of the recession. The investor consensus (reflected in market levels) is still favouring a benign economic environment for the next few years, in which the global economy continues to recover and eventually makes up lost ground without inflation threatening to rise much above central bank targets. In this scenario, the policy stimulus measures would gradually be withdrawn, including a return of interest rates to a more normal level, without any significant market impact.

The risks to this rosy scenario are still high

Although it seems reasonable to accept the consensus view as a central case, there are several risks that investors should be aware of and, if possible, mitigate against. Today's consensus scenario suggests that the right asset allocation strategy is to be overweight equity-type assets relative to bonds (fixed interest). However, if the consensus shifts to anticipate renewed economic decline then equities are likely to underperform bonds, and possibly cash, for a while. This could happen if evidence builds that the private sector is failing to take over from Government stimulus as the main engine of growth.

A weaker economic environment could be associated with either deflation or high inflation, although the latter is less likely. Given the amount of spare capacity in the global economy, renewed economic weakness could well give rise to deeper and more persistent deflation than we have had so far. 'Risk free' government bonds should perform exceptionally well in these conditions. The high inflation scenario could be triggered by policy errors of judgment in attempting to withdraw the monetary stimulus or as a deliberate government policy to reduce its debt burden in real terms. Were investors to anticipate such a scenario, fixed-coupon bonds would fare badly, and possibly worse than equities, leaving cash as the best performing asset class out of the three.

View from the Top

EQUITY

Equity markets faltered towards the end of last year but should continue to trend higher

After rising by about 50% from the low last spring, it is unsurprising that the pace of increase is slowing. Markets, as always, moved in anticipation of a change in the economic environment, and this time they were helped along by the dramatic monetary policy stimulus. The monetary environment is still extremely conducive to further gains in equity markets but investors are anxious to see some evidence to support the scenario they have anticipated, before committing themselves to further investment. Essentially, as the stimulus by the public sector (Governments) fades, the private sector needs to take up the running and this depends to a large extent on consumer behaviour. During this period of waiting for evidence, there could well be some volatility in equity markets but I would not expect dramatic weakness. I take comfort from the lagging relationship between interest rate movements and the level of equity market volatility. There has normally been a period of about two years before a change in direction in interest rates has a big impact on equity market volatility, as I demonstrate in Figure 2 (below) for the US market. So, even if interest rates start to rise soon, equity market volatility should stay down around current levels for at least another year.

Figure2

BONDS

'Risk-free' government bond yields have been edging up

Investors are paying more attention to sovereign risk these days. For countries, such as the UK, running large public sector deficits and steadily building a debt mountain, the yield demanded by investors to hold their debt is starting to move up. The gap between the 10-year gilt yield and its German equivalent is approaching 1%, having been below zero last March. While the risk of outright default by the UK government is virtually nil, there is a risk of inflation rising to devalue the coupon and capital repayment. Corporate bond yield spreads (the premium over government bond yields for extra risk and poorer liquidity) have continued to shrink. But the shrinkage, at least in some sectors of the market, is now insufficient to offset the rise in government bond yields so that corporate bond yields, too, are rising. We may well see more of this as the year unfolds.

Suddenly, property is back in fashion!

But we are cautious if not sceptical. Open-ended property vehicles have been attracting large inflows in recent months as investors are attracted by signs that the market is bottoming and by a yield that is relatively high compared to Gilts. If the Gilt yield rises, this could change. Managers of these funds are finding it difficult to invest the inflows given the time consuming nature of property transactions and the shortage of supply. So it is likely that fund performance will be diluted by cash holdings for a time. There are signs that the occupier market is also bottoming out with some recent lease terms on London offices showing an improvement on what might have been achieved in the middle of last year. Nevertheless, the occupier market, being more closely related to economic performance, is likely to be slower to recover than the investment market. In this environment, investment returns are likely to be driven more by rising property prices driving yields lower than by rental growth.

PROPERTY

North Point

John Husselbee
Fund Manager
North Investment

An optimistic start for a new decade

Although the Noughties were far from good for long term equity investors the final quarter did provide us with cause for some optimism. Global Equities rose with the MSCI World increasing, in sterling terms, by 3.2% over the quarter and UK Equities, measured by the FTSE All Share, returning 5.9%. Equities rallied initially on the back of undervaluation but this rally was then supported by improving economic fundamentals. So, whilst there remain concerns about what lies on the horizon for stock markets for now, we find ourselves in equity friendly waters. Investors have continued to react positively to stronger than expected economic data and corporate earnings surprises although the pessimists continue to question whether these earnings surprises are driven by cost cutting rather than growth in sales.

The global economic recovery continues with the US and the major EU countries officially emerging from recession. Weak third quarter data means the UK remains in recession for now which has prompted the Bank of England to extend their policy of quantitative easing by a further £25 billion. Global growth indicators are above trend, inflation is just below trend and policy remains extremely accommodating. Central Banks in the major developed markets continue to stick to their ultra low interest rate policy with no signs that their will be any imminent hikes in rates.

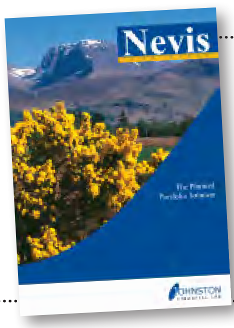
For much of 2009 it has been the most distressed companies that have fared the best but we believe in the value offered by larger companies with more stable earnings and stronger balance sheets. With their growth potential and their dividend policies these companies have outperformed their smaller counterparts over the last quarter. In developed markets we continue to favour equity income managers that favour these stocks. With Emerging Markets outperforming developed markets over the quarter our bias to these areas particularly Asia has served us well. After the excellent run we had in corporate bonds throughout 2009 we reduced our weighting in late November on the back of a belief that yields, which rose sharply in December, will continue to rise through 2010. In Europe we have added the stock picking Neptune European Opportunities Fund and introduced exposure to gold shares through the Blackrock Gold & General fund. The gold price has been rising steadily although this has been more a sign of US dollar weakness rather inflation. A key asset class for the portfolios in the latter half of 2009 has been absolute return funds. These funds provide valuable downside protection against market falls whilst also allowing a significant level of upside participation. The latest addition to the Nevis Portfolios is the Blackrock Hedge Selector managed by Richard Plackett. The Blackrock fund joins the stable of absolute return funds we hold which include: Gartmore UK Absolute Return Fund, Insight Market Neutral, Cazonove Absolute UK Dynamic and Artemis Strategic Assets.

Nevis Portfolios Performance	Performance YTD 1Y 31/12/2008 to 31/12/2009	Performance Since Launch 22M 29/02/2008 to 31/12/2009
Nevis Conservative Portfolio	**17.0%**	**0.8%**
Conservative Composite benchmark	12.7%	2.0%
Nevis Growth Portfolio	**17.3%**	**-0.5%**
Composite benchmark	18.6%	-0.2%
MSCI United Kingdom (TR)	27.7%	-0.2%
B of A Merrill Lynch UK Gilts All Stock TR USD	-1.9%	10.8%
IPD UK All Property Monthly TR	-3.4%	-21.6%

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

The outlook for 2010 remains supportive for equities. There are naturally a number of longer and shorter term fears that may upset this environment. Longer term concerns, particularly with regard to monetary policies and the exit strategy of central banks, remain at the forefront. Another spike in oil prices could accelerate the still present fears of a double dip recession but whilst oil moved up last month, for now it remains ranging rather than upward trending. Despite these fears, it would be a mistake to sit on the sidelines.

Company profits are improving and interest rates remain low, which underpins the equity story. Developed economies in particular could deliver surprisingly strong growth in 2010, coming off a low base which should boost commodity prices and the technology sector. The year ahead may look great for the global economy but there is some debate about how much of this is already priced in. If it is then equities markets, particularly in developed markets, may move sideways in 2010 and the money will be made through the stock picking skills of individual managers rather than through any major market calls. We face the prospect of interest rate hikes on the horizon coupled with a decline in what was abundant liquidity in 2009. This could prove challenging for Investors in 2010. So whilst we proceed with optimism, it is tempered with caution. We are aware that the economic recovery that we continue to see remains fragile, as does investor confidence. One only needs to look at the negative reaction to the Dubai World debt issues in October to see evidence of that. So we press ahead with our bias towards equities in the Nevis Portfolios, but are conscious of the need to protect against any potential market volatility. We have done this in a number of ways; by focusing on experienced fund managers and quality companies with strong balance sheets and stable dividends. But we also use absolute return funds which provide the ability to participate in the equity market rises but provide some valuable protection against any short term falls we may see along the way.



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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