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ASHCOURT ROWAN GROUP

Investment Strategy Report

August 2011

A Knowledge of Wealth

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Foreword

The Investment Strategy Report is part of our ongoing communication programme and is intended to keep all clients within the Ashcourt Rowan group updated with relevant developments and issues affecting their investment portfolio. The Report, to be published semi-annually, will deal with our general investment views, discuss ideas and strategies that we are pursuing for clients as well as deal with any topical issues we think may be of interest.

Within the pages of this Report, which represents our mid-year update, we look at global stock markets and consider factors as diverse as inflation, profit margins, business investment, valuations and investor sentiment. A very brief synopsis is that we certainly see obstacles that could cause markets to veer off-course but broadly speaking we think that many of these 'risks' are factored into current asset prices and thus we don't believe investors should get distracted from a longer-term investment strategy by adverse newspaper headlines. The 'real' risk to markets is the genuinely unknown risk; the next Libya, the next Greece, the next major earthquake...

Unfortunately we do not have a crystal ball and thus one of the best protections against unexpected short-term events is a long-term investment horizon, since this will tend to smooth out the effect of short-term disruptions and help to diversify risks within client portfolios. The alternative is to use a strategy that is explicitly designed to have a shorter investment horizon. Sometimes this diversification does not serve us as well as hoped and 2008 was a case in point for the vast majority of investors. We are always exploring new approaches that we can use for the benefit of our clients and in an investment world that sees constant change it is important not to stand still.

Sentiment amongst investors towards the global economy has soured significantly so far in 2011 and within the second half of this Report, we discuss some of the reasons for this and why perhaps investors do not need to be too concerned. Chief among them is the continued disruption to the global economy by the tragic earthquake in Japan during March that, whilst diminishing, is nonetheless still having a knock-on impact on economic data. As we approach the latter part of the third quarter and into the final months of the year we believe that data will likely prove better than currently expected and that will help to support a revival in fortunes for risk assets, particularly stocks.

You will notice from the front cover that this Report is, for the first time, available to clients of Ashcourt Rowan Asset Management and Savoy Investment Management. Both companies are part of the group owned by Ashcourt Rowan plc, formerly Syndicate Asset Management Plc, which remains a publically listed company on the Alternative Investment Market (AIM).

I trust you find this Report both useful and insightful but if you should have any questions or comments please pass them to your Investment Management or Financial Planning contact.

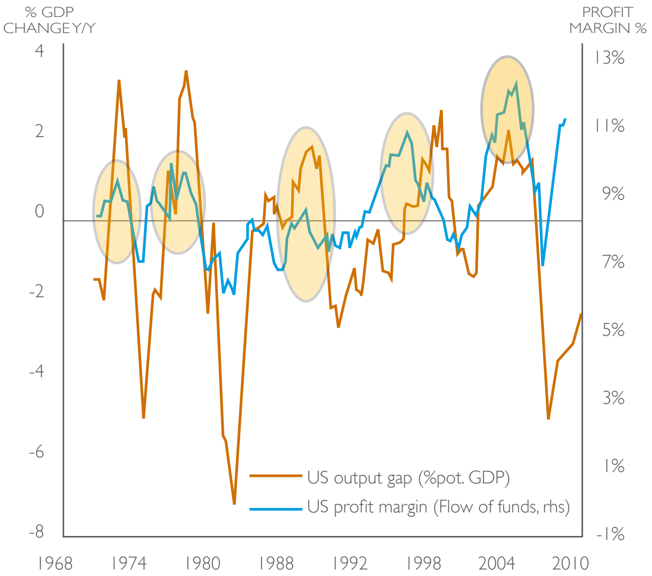
Christopher Jeffreys

Group Director of Asset Management

Where are Global Stock Markets Headed?

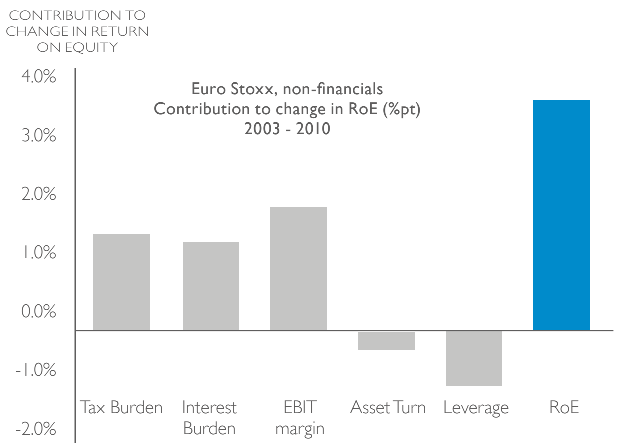
Now if we truly knew the answer to this question then not only would we be exceptionally rich, but it would be time to patent our design for the proverbial crystal ball. Thus, whilst we do not know where they are headed, we do have an **opinion** and what follows in the next few pages is intended to articulate this view in a cohesive manner. There is no end to the amount of data, graphs and indicators we could use either in support or to undermine our view, but we have hopefully chosen a handful that are most pertinent.

FIG. 1: US PROFIT MARGINS TEND TO PEAK WHEN THE OUTPUT GAP CLOSES...



Source: Thomson Reuters, OECD estimates, Credit Suisse

FIG. 2: EXPANDING MARGINS HAVE BEEN THE BIGGEST DRIVER OF THE IMPROVEMENT IN EUROPE'S ROE



Source: Thomson Reuters, Credit Suisse

FIG. 3:

	US nominal GDP ($bn)	Global nominal GDP ($bn), 2011E)	US ex-financial EPS (2011E)	S&P 500
Current	15,010	68,701	89	1271
Previous peak	14,485	61,221	74	1565
% deviation	4%	12%	21%	-19%

Source: Thomson Reuters, Credit Suisse research

Pretty fundamental to a view on global equities is an opinion on where we are in the profits cycle. Those investors of a more bearish inclination tend to argue that profit margins have peaked thanks to a combination of anaemic top-line revenue growth and an inability to pass on cost pressures to hard pressed consumers. Having seen corporate profitability fall significantly during 2008/2009 it would certainly be unusual if barely two years on from such a calamitous set of circumstances, profitability has 'topped out'. Fig. 1 (left) offers some cause for optimism.

It suggests that certainly in the US, and there is no reason to think it would be any different elsewhere, profit margins peak once the output gap has closed. The output gap is essentially the spare capacity in the economy which usually increases during recessions as companies scale back production and operations. When things improve they are then able to scale up their operations in response to increased demand both more quickly and, importantly for profit margins, cheaply.

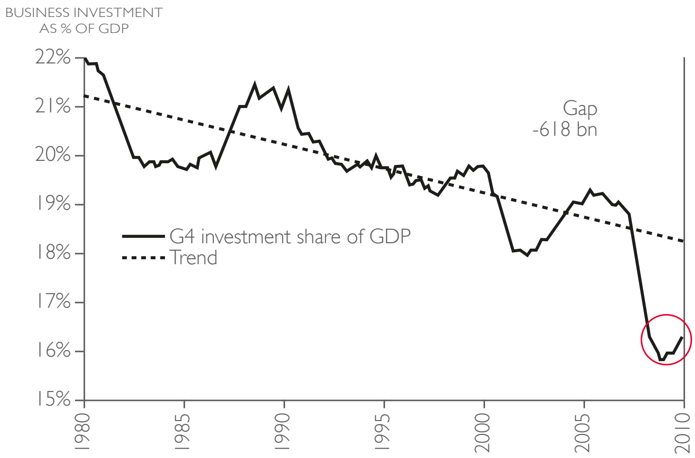
A key driver for valuations is not just profit margins but also the return earned by shareholders, Return on Equity (ROE). Fig. 2 shows what have been the key factors behind the improvement in ROE for European companies since 2003. Improving margins, lower tax and lower interest charges have all helped to boost ROE.

The lowest quality, and easiest, way for a company to boost its ROE is to increase leverage. By making equity a smaller percentage of total assets, you enhance the ROE but also increase the financial risk of the firm. The chart shows that the private sector has been deleveraging and that this has dented shareholder returns. As the economic environment (at some point) improves, leverage will increase and further boost ROE.

Fig. 3 (bottom left) perhaps illustrates what to many may be a surprising fact given all the apocalyptic reporting about the state of the global economy. In nominal terms (i.e. ignoring inflation) the US and the global economy are as large in US$ terms as they have ever been. Non-financial corporate earnings in the US have comfortably surpassed their prior peak and yet the key measure of the US stock market, the S&P 500 languishes well below its 2007 record.

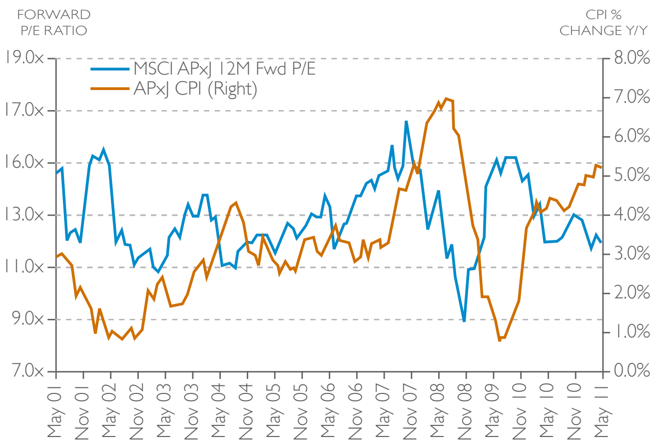
It is widely known that, certainly in the 'developed' world, governments have been spending beyond their means for some time. Whether this is a symptom or the cause of Fig. 4 isn't really our concern here. What is of concern to us is that the output of an economy is a function of consumption, government spending, business investment plus net exports (for countries like Japan and China) or minus net imports (for countries like the US and UK).

FIG. 4: THE INVESTMENT SHARE OF GDP IN THE MAJOR ECONOMIES IS CLOSE TO AN ALL-TIME LOW



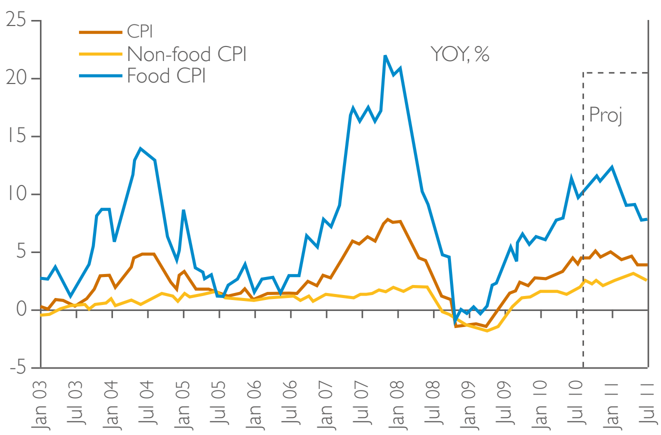
Source: GFMS, BNP Paribas

FIG. 5: VALUATION VS. INFLATION FOR MSCI ASIA PACIFIC EX-JAPAN



Source: MSCI, Factset, Morgan Stanley Research

FIG. 6: TRENDS IN CHINESE INFLATION



Source: Morgan Stanley Research

In many countries, consumers either lack the ability or the confidence to spend or, as in Asia, simply have a very high propensity to save. This means that consumption is unlikely to drive a rebound in growth. Most governments have belatedly made attempts to slow the growth in spending but this is easier said than done, as David Cameron is finding out. This means that government spending is likely to be neutral to a slight negative for the major Western economies. Whilst improving their trade position is an option for individual countries, it is obviously no use in aggregate since one person's export is another's import.

That leaves the elusive business investment. Fig. 4 shows that although business investment has been declining in significance to the major economies, it is currently a very long way below trend to the tune of around $600 billion annually. A meaningful pickup in investment – and trillions of dollars of cash suggests that the ability to do so is ample - could help really kickstart growth and result in a pickup in employment that would subsequently see consumption once again take a more prominent role in driving growth. An increase in business investment could certainly send stock markets higher.

With many having given up hope for the advanced economies, hopes now rest on the emerging economies led by China. From an investment point of view it has been a pretty challenging environment thus far in 2011 with ample reminders of the geopolitical risks involved in investing in emerging markets. This 'cooling off' of emerging markets has arisen from a decline in valuations that has come in tandem with higher inflationary pressures (see Fig. 5).

Fig. 6 shows that certainly in China, though this pattern would be seen elsewhere in Asia, the major inflationary pressure has come from higher food prices. The good news is that in the absence of a further leg up in soft commodity prices this upward pressure will ease as 2011 progresses into 2012. This could certainly set the tone for renewed outperformance by developing markets, possibly not immediately, but potentially before year-end.

The Importance of Sentiment

As much as investors tend to preoccupy themselves with economic data and corporate earnings figures, when trying to divine the outlook for investment returns in the future, the real trick is to try and work out what is factored into current prices and then try to evaluate how reality may differ from expectations. In the past this was a somewhat trickier task than it is today with the numerous electronic polling of big institutional investors offering valuable insight into what they think. The latest insight is provided by Barclays Capital's Global Macro Survey and on the following page you will see a number of charts 'grabbed' from the survey.

The first thing to observe in almost all cases is a lack of consensus. Indeed opinion is often sharply divided. This is, perhaps counter-intuitively, a comforting situation. One of the biggest causes of sharp increases in market volatility is when an entrenched consensus is 'holed below the waterline' by some new event and investors scramble to reposition themselves. It takes multiple views to make an orderly market. All the signs from this survey are that that is the case. Clearly only time will tell who is right but it is worth bearing in mind that there is often a contrarian message hidden within such surveys with high levels of bullishness amongst investors usually auguring a setback.

If we take Fig. 7 which asks which asset class will do best, three months ago comfortably the largest number opted for Commodities, essentially betting that the preceding rise in commodities would endure. It didn't. The next most popular selection was Equities with Bonds trailing in a sorry last place. Fast forward on three months and the outcome is the complete opposite of what was predicted. Investors now expect bonds to lead equities, which in turn will lead commodities. Whilst we struggle to get overly optimistic in the short-term, it nonetheless appears to us that the pessimism about global growth has overshot somewhat and that as we approach the year-end the data will prove to be more reassuring.

In tandem with the recent modest declines of global stock markets, we have witnessed a meaningful rally in the highest quality government bonds that has sent bond yields tumbling. When questioned, 48% thought that this trend was justified and would persist whilst 52% thought it would reverse. Given our expectations of markets rallying during the second half of the year (at some point) and more positive economic news, we would have to fall in the camp that sees bond yields heading back up. We would caution however that this does not make fixed income a terrible investment proposition as even with yields rising fairly substantially, losses are only likely to be a few percent. The potential downside in bonds is thus much more limited than the potential downside in equities if the market were to drop further, but this is often overlooked. Fixed income assets continue to provide a useful counterbalance to 'risk asset' exposures within portfolios and following recent relative performance we would once again favour high quality investment grade corporate bonds over conventional Gilts. Index-linked Gilts appear relatively less appealing given the high inflation expectations now priced in and taking into account our view that many of the components currently contributing to this high inflation are transitory rather than persistent in nature.

Fig. 13 is a measure of risk aversion which can be backed out from investors' tendencies to either buy insurance (puts) or bet on a market rally (calls). The 10 day moving average is a useful way of measuring it as it smoothes out some of the big changes from one day to the next and instead tries to capture the nature of the trend, if any. It can be seen using this measure that the tendency towards buying insurance has hit levels not seen since essentially a year ago when investors were doing a comparable amount of soul searching amid softer economic data and sovereign debt troubles in peripheral Europe – sound familiar?

The conclusion of all this is that we believe that it can be clearly demonstrated that risk assets, particularly equities, are 'cheap' in both absolute and relative terms. We think that corporate earnings generally can continue to exceed expectations in aggregate, particularly with earnings revision data suggesting that these expectations have been falling amidst a general uptick in pessimism. We obviously acknowledge the well-publicised risks out there such as the peripheral countries in the Eurozone, a possible slowdown in China etc. but we feel that these risks are, broadly speaking, priced in. As illustrated in Fig. 13, investors remain relatively risk averse and with sentiment relatively poor at the moment, it is arguably more likely that a pleasant surprise pushes markets higher than the reverse.

We are not inclined to get over-excited about the prospects for risk assets so whilst we still believe that on a multi-year time horizon that is the place to be, we would rather see a more notable decline in markets before seeking to take on more risk. If this does not happen, then there should be sufficient 'risk on the table' to deliver some very respectable returns.

FIG. 7: WHICH ASSET CLASS DO BEST OVER THE NEXT QUARTER?

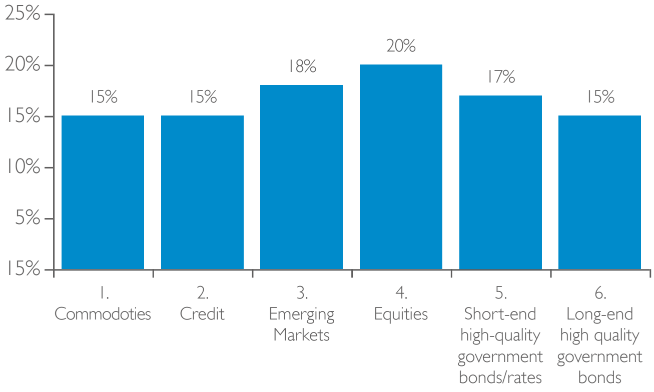


FIG. 8: WHAT WILL HAPPEN TO THE RECENT RALLY IN GOVT. BONDS?

FIG. 9: WHICH SECTORS WILL DO BEST OVER THE NEXT 3-6 MONTHS?

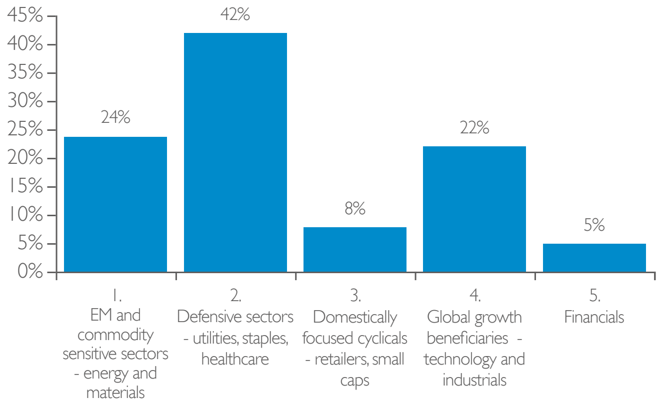


FIG. 10: WHAT WILL EQUITIES RETURN DURING THE NEXT 3-6 MONTHS?

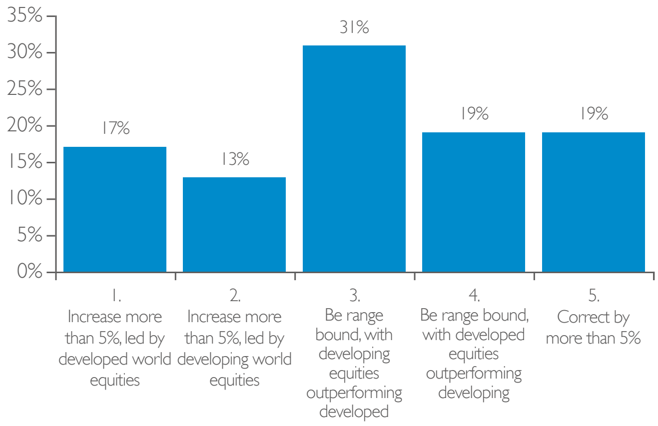


FIG. 11: WHAT WILL BE THE FX IMPACT OF QE2 ENDING?

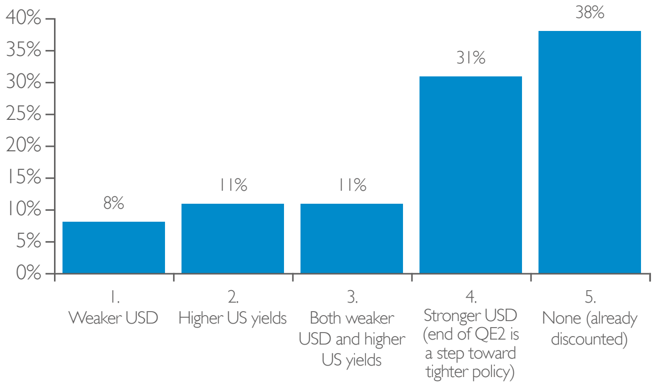
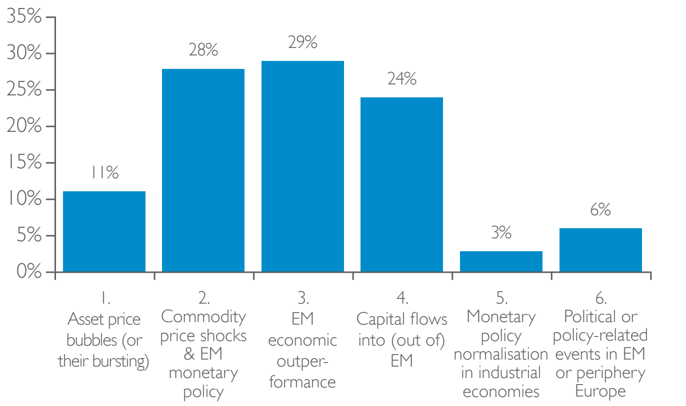
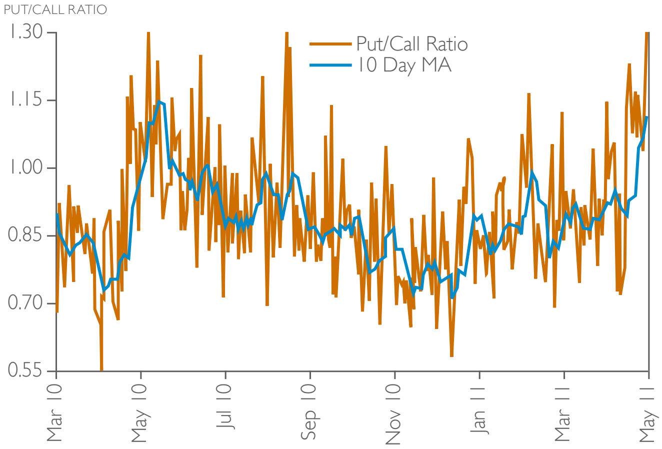


FIG. 12: WHAT WILL DRIVE EM ASSET PRICES DURING THE NEXT 3M?



Source: Barclays Capital Global Macro Survey, June 2011 conducted June 1 – Jun 10 with responses from 862 clients across all types of investor

FIG. 13: PUT/CALL RATIO OF RISK AVERSION BACK TO MAY/JUNE 2010 PEAKS



Source: Bloomberg, Morgan Stanley Research

Investment Ideas for H2 2011 and Beyond

Remember that investing in financial markets puts your capital at risk; you may get back less than you invested. This is not intended to constitute financial advice and we recommend you consult your fund manager or financial adviser before making investment decisions.

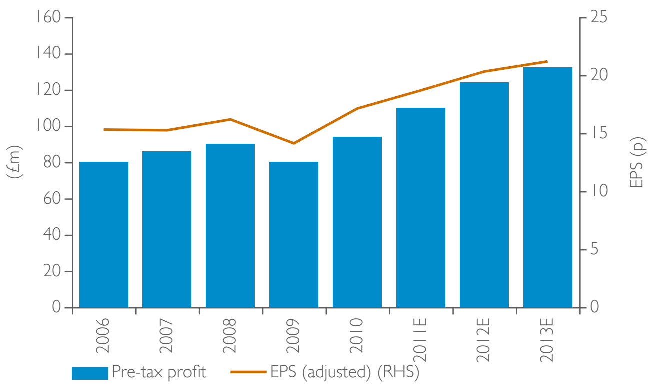
Over the next few pages we outline the investment rationale behind some of our currently favoured investments.

Whitbread – Notwithstanding a nice jump in the share price following recent results, the shares have steadily fallen out of favour with investors during 2011. Broadly speaking this is linked into widely held negative sentiment towards any stock reliant on the UK consumer. This tends to overlook the fact that in spite of little growth at the 'macro' level, Whitbread has substantial room to grow through the continued expansion of Premier Inns and the Costa Coffee chain as their respective markets are underpenetrated. The number of Costa outlets is projected to grow from just shy of 2000 to around 3500 over the next five years with most of this growth coming outside the UK; the UK outnumbers the International element approximately 2:1 currently but this is expected to move close to balance over this timeframe. With Premier Inn, 'budget' hotels are relatively under-represented in the UK and Whitbread is likely to grow room capacity by around 9%pa: a tougher (but not too tough) economic environment is actually positive for the chain. Whitbread is the epitome of the kind of stock we like for a multi-year investment horizon and we think the shares are too cheap given likely growth prospects. Whilst the gloom around the UK economy is unlikely to lift imminently we think that it will be worth the wait.

Smiths Group – This highly diversified industrials group has seen its shares fall from grace somewhat in recent months but in our view this reflects an excessive focus by investors on the high profile Detection division where order delays continue to result in near-term disappointment. It is not that long ago that Smiths rejected a bid from private equity house Apax for the Medical division. The bid was for £2.45bln, just shy of half Smiths' current Enterprise Value (net debt + market cap) yet the medical division only generates 1/3 of the profits. CEO Philip Bowman previously ran drinks company Allied Domecq before selling it to French rival Pernod Ricard. After a brief spell at Coral Eurobet, he took the helm at Scottish Power before selling them to Spanish rival Iberdrola; in both cases the shareholders did very nicely. Ultimately we would imagine the CEO will focus on continuing to boost group margins in order to maximise the value for shareholders when the corporate activity happens. Smiths is a high quality company and whilst unfortunately institutional investors today rarely appreciate this; usually at some point someone else will. The current share price presents an opportune entry point, in our view.

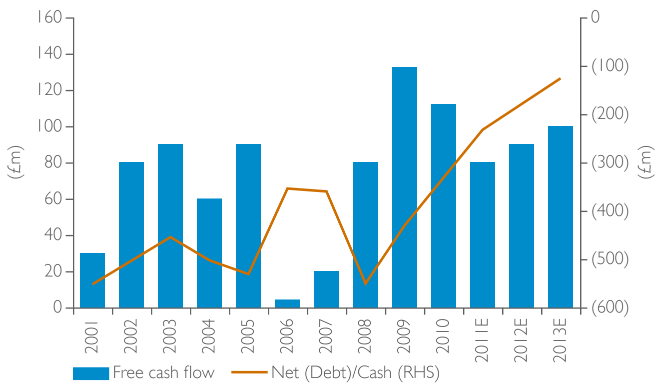
BBA Aviation – An aerospace stock with a difference that frequently flies under investor radars. The company predominantly operates in the niche area of Business Aviation. The majority of its revenues stem from providing terminal and refuelling services for business jets at private airports primarily in the US. It also has a nicely profitable sideline in the maintenance and repair of engines and related parts of said business jets. The recent recession exacted a heavy toll on many companies related to business jet use, particularly those that charter the planes, with flights in the US falling nearly 30% from peak (in 2007) to trough (in 2009). An 11% rebound in 2010 still leaves activity well below 'trend' and longer term it remains an activity that should grow faster than GDP. Figs. 14 and 15 below show how BBA successfully navigated the crisis pretty much unscathed with profits barely pausing and the company continuing to generate free cash flow. Whilst the shares are probably not that far below 'fair value', given the ongoing profitability of the business, we would expect this 'fair value' to grow over time.

FIG. 14: PBT AND EPS TRENDS



Source: Company, Oriel Securities

FIG. 15: NET DEBT AND FREE CASH FLOW

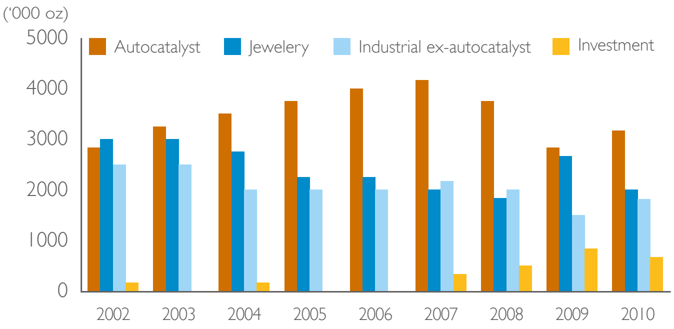


Source: Company, Oriel Securities

Johnson Matthey – Johnson Matthey is a specialty chemicals company that sits atop the global autocatalysts market alongside Umicore and BASF. In addition, they have a dominant market share in the deployment of catalytic converters for heavy-duty diesel vehicles that is expected to see the greatest growth in future. The company is also a leader in the refining, fabrication and marketing of precious metals, particularly Platinum. Johnson Matthey benefits from an industry with high barriers to entry, a limited number of competitors and a high level of 'intellectual property' with respect to their products and processes. The icing on the cake from our point of view is the secular growth prospects of their markets purely thanks to environmental and legislative trends around the world that are designed to reduce emissions from cars/trucks. The downside of all of this is of course that the shares are rarely 'cheap', although at the end of 2008 there was a very brief opportunity. Whilst we would not describe the shares as cheap, nor do we think they are overpriced. At around the £20 area, long-term returns for shareholders should be attractive given expectations of profit growth in the 10-15% per year range over the next five years and beyond. Transitory weakness in the shares would offer an even more attractive entry point.

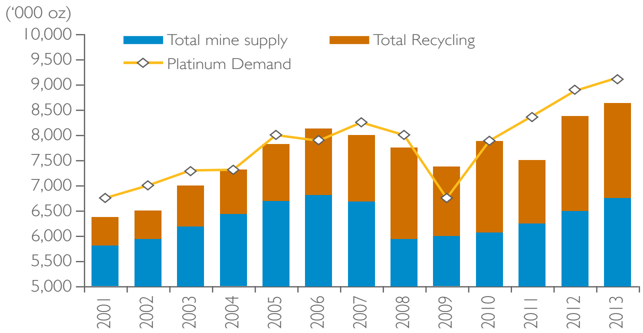
Aquarius Platinum – Aquarius should be a direct beneficiary of the long-term trends that favour Johnson Matthey since the end result really ought to be higher platinum prices. Current platinum prices are not sufficient to warrant the substantial capital outlays needed for expansion and even with platinum prices having recovered strongly since 2008, a lot of mines remain only borderline profitable. With shafts taking 10 years or more to reach production there is an increasing likelihood of a sharp price spike in a few years time, a spike that in the near-term miners will simply not be able to respond to. The plus point in the meantime for Aquarius is that their assets boast the lowest cost of production, barring Anglo Platinum, and can therefore make growth plans with more certainty than many of their rivals who have no assurance of profitability. The real benefits for shareholders will arrive when Platinum prices return to the $2,200/oz that they so briefly touched in 2008 and ultimately push beyond this level to $3,000/oz and beyond. There is only marginal excess supply at present (see Fig. 18 below) and as existing mines become exhausted it doesn't take a great leap of faith to envisage a material and persistent supply shortage in the not too distant future. With 76% of the world's platinum being mined in South Africa and seven miners controlling 92% of supply, the risk for platinum prices looks to be firmly to the upside. The share price rise seen earlier in 2011 on the back of an attractive corporate deal has since faded and with the shares around £3 there is the potential for some quick gains should mining stocks regain their favour with investors as 2011 progresses.

FIG. 16: PLATINUM USE BY SECTOR



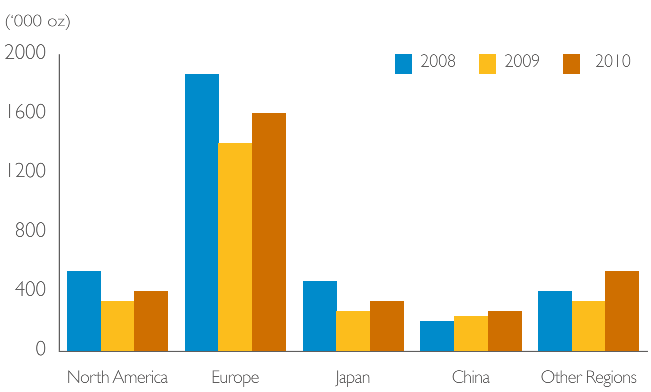
Source: GFMS, BNP Paribas

FIG. 18: PLATINUM SUPPLY/DEMAND– HEADING INTO DEFICIT



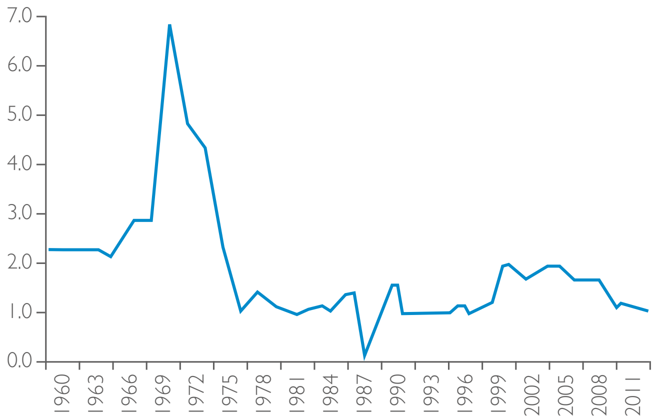
Source: GFMS, BNP Paribas

FIG. 17: PLATINUM USE IN AUTOCATALYSTS



Source: RCML Research, Johnson Mathey

FIG. 19: PLATINUM OZ / GOLD OZ RATIO



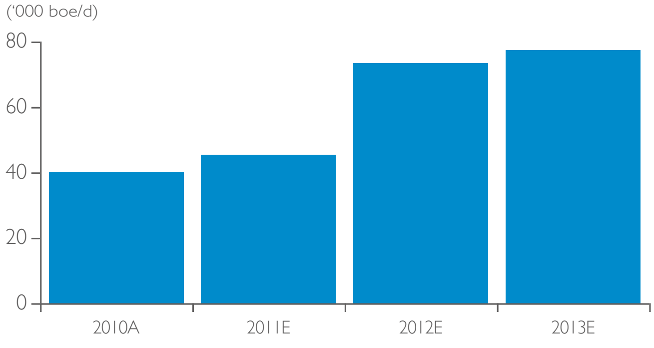
Source: Bloomberg

Premier Oil – Premier Oil is one of the stocks that tends to be caught 'betwixt and between' with many investors; neither large enough or diversified enough for big institutions to take much notice nor exciting enough on the exploration front to captivate the legions of private investors constantly searching for the 'next big thing'. The company has a passing resemblance to a successful investment of ours from yesteryear, Venture Production. With oil prices expected to remain relatively high i.e. north of $90 per barrel the stock has obvious attractions because of the production growth that is expected during coming years. From around 40,000 barrels of oil equivalent per day (boe/d) currently, the company plans to boost this to 100,000boe/d by 2015 (see Fig. 20 below). They are currently engaged in an active drilling schedule with 15 wells planned for 2011 spanning the UK, Norway, Indonesia, Vietnam and Pakistan although few of them are terribly material. As production grows, in the absence of the share price rising, the shares could become very attractive very quickly and thus leave the company open to an approach from a larger player in the industry.

Serco – If ever there were a company to which the mantra 'boring is best' applied, it is surely Serco. They are one of the largest of the many UK companies that inhabit the 'Support Services' sector in the UK that has spent the last 10-15 years benefiting from a trend of outsourcing/PFI across the UK public sector. This has led to concerns about the current climate of austerity in terms of public expenditure but paradoxically whilst this may exhibit some downward pressure on contract terms; it likely accelerates the trend that is already in place. Fig. 21 clearly shows that Serco is less reliant on the UK than it used to be with around 35% of 2010 operating profit coming from outside the UK. The recent acquisition of Indian business process outsourcing company Intelenet potentially opens another meaningful leg of growth which is also more profitable. The beauty of Serco as an investment proposition is the visibility of its revenues; expected revenues for 2011 are £4.6bln and yet they have a contracted order book totalling £16.6 billion and a bid pipeline of a further £29 billion. In our view this should make investors inclined to pay a premium for the shares but with the current valuation at pretty much an all-time low, this is clearly not the case. Another one to buy and hold for the long term.

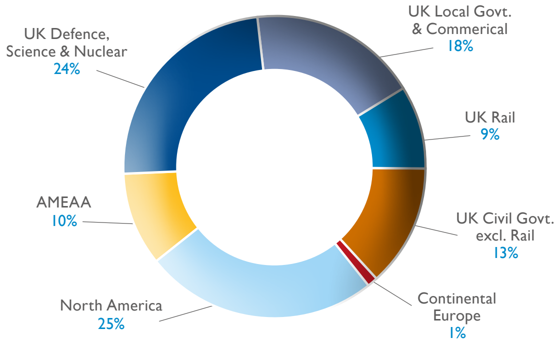
Anglo Pacific – An alternative take on investing in the mining industry and not as small as it once was: it is a member of the FTSE 250. In a similar fashion to Premier Oil, it is not one of the big established miners and nor it is one of the small, mining exploration companies so beloved of private investors; in many ways though it carries the best of both worlds. Essentially, the company seeks to build up royalty streams which can be used to pay dividends to investors whilst spare cash flows are reinvested in search of new royalties in the future. On the one hand its core cash flow comes from some iron ore deposits in Australia mined by BHP Billiton/Rio Tinto whilst on the other the company acquires stakes in either private or listed companies by putting up capital in return for royalty streams should those companies ever reach production. This approach diversifies the company geographically, as well as by commodity, and relatively small amounts of capital are involved in each investment. This serves to limit the magnitude of losses where things don't work out whilst offering unlimited upside if the miner is successful. The value of the stock is a combination of the discounted value of its future royalty streams, private investments, listed investments and cash and the highly capable management have demonstrated during the last decade the ability to consistently add value for shareholders and grow dividends. Mining stocks and income don't usually make good bedfellows but Anglo Pacific is the exception.

FIG. 20: OIL PRODUCTION, K BOE/D



Source: Barclays Capital

FIG. 21: SERCO'S 2010 OPERATING PROFIT IS ACROSS A BALANCED RANGE END MARKETS



Source: Company data, Morgan Stanley Reasearch

Globo – A truly fascinating small company of the kind that only occasionally pops up on our radar screen. Whilst its business is high tech and can be seen as a play on the growth of cloud computing, its customer base is distinctly low tech. They have developed software that turns a pretty antiquated mobile phone into a state-of-the-art smartphone and they are busily sealing deals with mobile network operators (MNO) across the developing world to roll out this service. The beauty of these deals is that they require no ongoing investment from Globo and they simply sit back and collect their share of the recurring revenue stream which is shared with the MNO. They have recently launched a cloud-based alternative to the traditional Blackberry server which provides another potential leg of future growth. In spite of the fact that its technology is really only at the very early stages of ramping up, the stock represents everything you don't normally find with emerging technology stocks. A multi-year track record of growth in revenues, profits and cash flows underpins the business and the shares, which we consider to be exceptionally cheap given the potential prospects. Whilst not for everyone, for those naturally inclined towards exciting small cap ideas, we believe that Globo should be near the top of your shopping list.

Electra – One of the truly 'old school' members of the Listed Private Equity (LPE) universe on the London market. The fund has delivered exceptional long-term returns for shareholders over almost any timeframe and has comfortably outpaced the stock market over pretty much any horizon you choose. This is not by chance and can be attributed to the compounding of value that the leading private equity managers tend to achieve over time. Already, the net asset value (NAV) has recovered from the falls of 2008/9 to hit a new high though thanks to general investor 'cautiousness' the discount is relatively generous at around the 20-25% area. We are at a stage in the market cycle where funds such as Electra will report an increased number of disposals and often these take place at sizeable premiums to the carrying value in the books which rather undermines the scepticism towards valuations that many investors have. Electra has a more focused portfolio than some and thus these individual realisation events can have a greater positive impact though of course the reverse is true and any company-specific problems can impact more. The shares have done little in recent months with most stock markets flattish, but going forward it is difficult not to envisage renewed outperformance from the LPE space helped by the dual tailwinds of higher NAVs and narrowing discounts. The fund targets returns of 10-15% long-term and in a very 'challenging' five years to 31 March 2011 managed a very respectable 9.7%, though that hasn't stopped the discount widening. We believe in the long-term strategic merits of an exposure to LPE and periodically there are opportunities to ratchet exposure up a little further; at the current time, the risk/reward relative to 'ordinary' equities looks pretty favourable to us.

Summary – The table below shows some very simple valuation metrics of the seven 'primary' ideas discussed in the prior pages. The focus was more on quality than valuation and yield but the table shows that certainly on 2012 numbers, the stocks in question are certainly not expensive. One of the key metrics that we focus on is Return on Equity (ROE) as a method of assessing whether a company is generating sufficient returns to create shareholder value. If a company is not exceeding its Cost of Equity consistently then it is not generating sufficient value for the risks that shareholders are taking. We view an ROE of between 15%-25% as a 'sweet spot' for many types of companies.

Additionally, a theme of strong positions in industries with attractive competitive dynamics should be readily apparent. This does not make companies immune from an economic downturn but it does make it more likely that the company will emerge the other side in a relatively strong position.

Valuation table

	f/c 2011 P/E	f/c 2012 P/E	f/c 2011 Div Yld	f/c 2012 Div Gth	f/c 2012 ROE
Aquarius Platinum	16.5x	11.8x	1.7%	61.6%	21.5%
BBA	12.3x	11.3x	3.9%	4.8%	15.1%
Johnson Matthey	14.9x	13.1x	2.5%	11.7%	19.4%
Premier Oil	13.8x	8.3x	0.2%	n/a	24.5%
Serco	14.5x	12.7x	1.5%	15.9%	19.2%
Smiths Group	13.6x	12.3x	3.0%	7.5%	26.6%
Whitbread	12.6x	11.4x	2.9%	11.3%	17.1%

f/c – Forecasted value

P/E – Price to Earnings ratio

Source: Bloomberg LP (data as at Friday 1 July 2011)

All figures are forecast and represent no guarantee of actual returns. Forecast dividend yield is net.

Global Economy Update

One of the primary causes of weaker investor sentiment so far this year, aside from troubles in the Middle East and North Africa, is relatively disappointing economic data. The purpose of this section is to firstly consider some mitigating factors and secondly to try and assess whether things are really as bad as the headlines would suggest. Finally, there is a special section written by my colleague William Argent that aims to sum up the very fluid situation in the Eurozone and its impact both on other Eurozone members, as well as other countries around the world.

At the top of the list of mitigating factors must surely be the Japanese earthquake that took place in March this year. Although damage to the economic centre of Tokyo was thankfully limited, it caused major disruption to swathes of Japanese industry. Whilst the Japanese economy may appear to have been in the doldrums for some time (though on a per capita basis its economic performance is comparable with other major economies) it remains the primary source for the global economy of specialised manufactured components, particularly electronic ones.

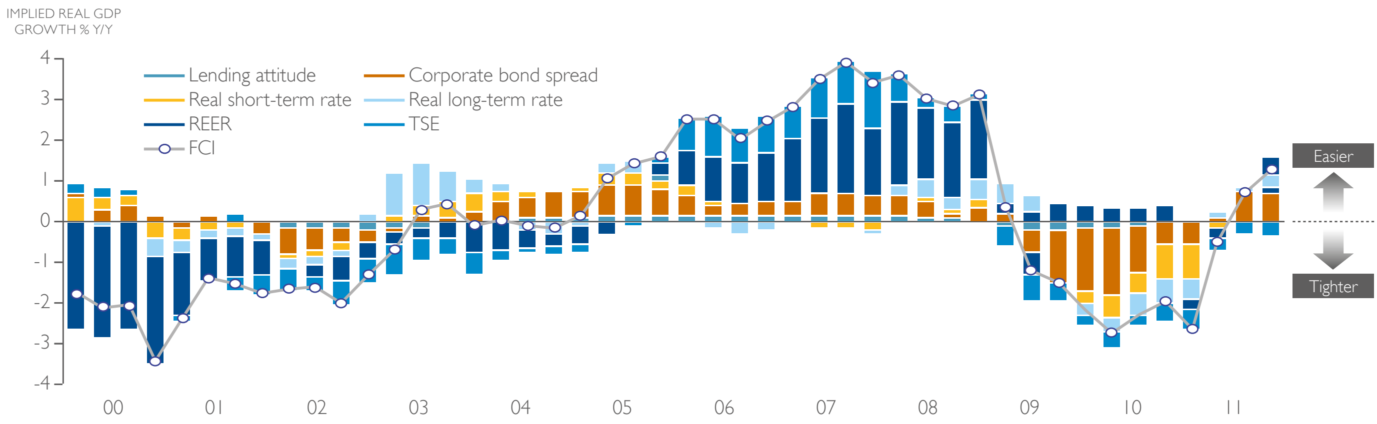
Recent years have seen an increasing trend towards 'just in time' inventory management. This is all about optimising a company's supply chain and ensuring that excess working capital is not being used up on 'idle' inventory. Improvements in technology have certainly made this a lot easier and though the motives are laudable, to make matters worse there has also been a trend towards relying on one, rather than many suppliers for the same product. However, what it also means is that any disruption to the supply chain will have a greater and quicker impact and companies are left scrambling to find an alternative source of supply. Economy-wide disruptions are obviously pretty rare but the disruption to Japan's economic output was severe and immediate. It really should not be surprising then that data related to jobs, industrial production and sentiment are thus rendered somewhat 'unreliable' in the near term. Fig. 22 below illustrates the extent to which various factors are combining to either stimulate or slow the Japanese economy.

On the far right of the chart it can be seen how quickly this has moved to an overall 'easier' situation, a trend that had already been in place for a year or so prior to the earthquake.

The good news is that this period of disruption is coming to an end, with Japan's industrial production expected to have recovered to pre-earthquake levels in August, having initially plunged by an unprecedented 15% in one month. To consider what impact this has had on others we only need to consider the concerns about a 'slowdown' in the Chinese economy, in their case that means about 9% GDP growth. Much of the industrial output that takes place in China relies on specialist components whose production takes place in Japan and indeed Japan is the source of 13% of all China's imports. It is not surprising therefore that some of China's economic numbers have come off the boil a little. At the same time the Chinese authorities have been battling with material inflationary pressures that, as noted later in this report, have stemmed largely from higher food prices - a situation that we expect to improve. On balance it seems reasonable to expect that this 'softer patch' will prove a temporary phenomenon though we should certainly not dismiss the potential risks posed by a misstep from the Chinese authorities; in this day and age if China sneezes, the world will catch a cold!

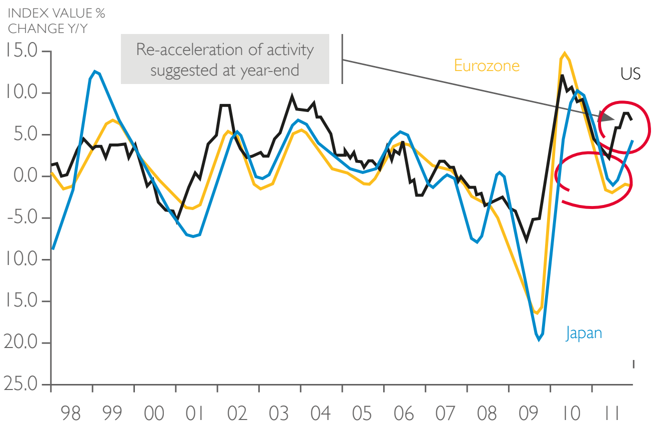
Fig. 23 (page 13) shows the Organisation for Economic Cooperation and Development (OECD) leading indicator measure for the US, Japan and the Eurozone. Most economic data is backward looking and thus of very limited use in gauging the future direction of the economy. There are some indicators that tend to 'lead' rather than 'lag' and these are put together and encapsulated in this OECD statistic. What we can see is that amidst the current mid-year slowdown, the indicator is suggesting that a pickup in economic activity is expected in the latter part of 2011 and into 2012. The functioning of the global economy is not an exact science and it is possible we are merely feeling the results of the inventory rebuilding phase peaking before final demand has returned sufficiently.

FIG. 22: JAPAN FINANCIAL CONDITIONS INDEX



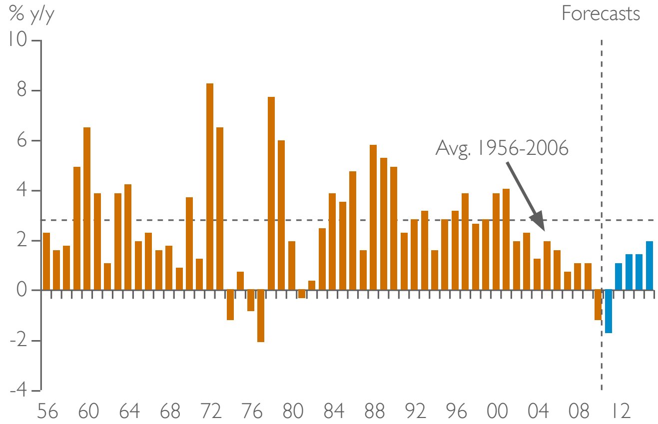
Note: The weights of the variables are standardized so that a one unit decline (rise) in the FCI is eqivalent to a decline (rise) of around 1% in real GDP during the subsequent year. Source: Barclays Capital based on respective indicators

FIG. 23: OECD LEADING INDICATORS (Y/Y, %)



Source: Reuters EcoWin Pro, BNP Paribas

FIG. 24: UK REAL HOUSEHOLD DISPOSABLE INCOME



Source: Haver Analytics, Barclays Capital

Closer to home there are also rumblings that the UK economy remains in dire straits and that this justifies an early abandonment of the Coalition's attempts to set the public finances on a firmer footing. One of the primary measures that people focus on is real gross domestic product (GDP) growth, but we believe that this is a misleading target since the growth of the economy can come from a variety of sources. As we noted earlier in this Report, some sources of economic growth are more desirable than others. The current period for the UK economy is an opportunity to challenge some long held beliefs as to what is 'good' for the economy.

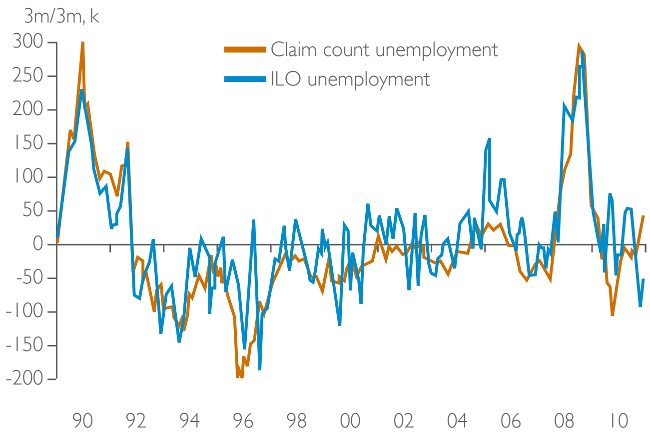
For example, it is widely believed that house prices that rise materially year after year are a good thing because it makes everyone feel wealthier and thus they spend more. The problem is that the benefit is skewed in favour of anyone who owns a house and away from anyone who aspires to buy. Even for homeowners it can be a 'money illusion' since they have only made the money when they sell and they possibly don't want to or as in the current climate, probably cannot. If prices rise continually then the size of the market of potential buyers will continue to shrink and thus the theoretical rising house price is increasingly unlikely to be realised. What is more, rising house prices tend to bring with them higher levels of borrowing that in turn is a potential destabilising influence on the broader economy. In fact, most of the world's most stable developed economies aspire to stable, not rising, house prices and then you get back to treating a house as somewhere to live, not an investment, and you get away from the housing boom or bust that tends to be prevalent more in the UK than anywhere else.

Thus whilst a deflating of the residential property 'bubble' is doubtless depressing consumer sentiment and as a result consumption, and thus by extraction GDP, this is regrettably a desirable situation in the short term. If we look at Fig. 24 we can see trends in disposable income for UK consumers over time adjusted for inflation. Of late, consumers have been 'squeezed' by either a lack of income growth that they have come to expect/rely upon or an actual very marginal contraction in disposable income, primarily because of higher, though we believe temporary, inflation. Living in a developed economy is not a 'free lunch' and people should not expect a perpetual increase in their absolute standard of living. We have just been through one of the most tumultuous periods for the global economy since the Great Depression so simply reigning in spending a little is not the greatest price to pay. Consumers are rightly responding to the tough economic situation by spending less, saving more and paying down debt and this is a responsible thing to do. We believe that we have probably passed the peak of this trend and thus little by little consumption will start to pick up gradually but a more durable economic recovery will ensue if the increase in consumption is built on a firm footing; it is after all a marathon, not a sprint.

The current gloom that is enveloping the High Street is thus a natural extension of this trend and the result is numerous retail businesses either scaling back their presence or closing. Whilst this is regrettably painful for those people who lose their jobs as a result, simple logic tells us that the number of retailers required when consumption is booming and people spend more than they can afford is far greater than when consumption has shrunk considerably and then remains subdued. The removal of excess capacity on the High Street is in fact desirable, as it is this excess capacity that provokes such aggressive discounting owing to excess supply, something that then negatively impacts all retailers to one extent or another.

The prime driver of an improvement in consumer sentiment is likely to be an improving employment picture. Given the multi-year pressures to keep public spending under control, the recent trend of rising private sector employment and falling public sector employment is in the broadest sense good for the economy. Earlier in the Report we talked about substantial under-investment by the private sector and a reversal of this situation is key to a sustainable improvement in the level of employment and a meaningful rebalancing away from the public sector in favour of the private sector. The recent increase in the 'claimant count' figure (see Fig. 25 page 14) is an anomaly as certain people previously in receipt of benefits but not counted as unemployed are now considered unemployed.

FIG. 25: QUARTERLY CHANGES IN UNEMPLOYMENT



Source: BLS, Haver Analytics

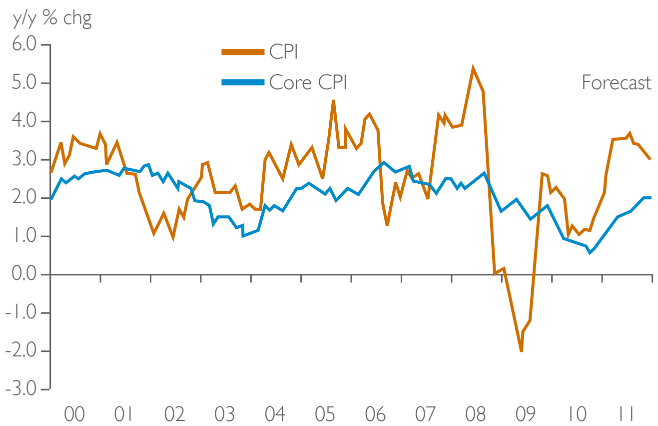
Over on the other side of the Atlantic, the economic data has also been 'softer' though is still indicative of economic expansion. Much of the focus recently has been on whether the Federal Reserve would have a third attempt at 'Quantitative Easing', known as QE, and potentially creatively titled QE3. The effect of the two programs so far is difficult to determine and experts are split on the benefits, or not, of doing so. Certainly, the response to the Fed's asset buying has been general rises in asset prices which help to boost sentiment and could trigger something of a positive 'wealth effect' as people feel the benefit of increasing net worth. They have undoubtedly contributed to lower bond yields than otherwise would have been the case and have effectively encouraged investors to move down the quality curve and up the risk scale in the search for higher yields. This can be seen with the alacrity with which high yield issuers have been able to refinance maturing issues and the emergence of new funds designed to step into areas where banks are retreating such as lending to private equity-owned companies.

Whilst this is a relatively welcome turn of events and it is not surprising that in the dynamic world of finance, when one participant steps back, another steps forward, there is nonetheless food for thought. Although it is always stock markets that fall further and faster by virtue of their liquidity, most market crises of the last 25 years have been primarily triggered by the fixed income markets in some shape or form. The reason is that whilst stock market investors are generally comfortable with the idea that their money is at risk, fixed income investors go through bouts of extreme sentiment; they are either willing to lend to any firm with a registered address or they won't lend to anyone. The former may be undesirable but it is the latter and the suddenness with which it often happens that causes such problems.

To consider the likelihood of QE3 we have to consider the primary purpose of QE and QE2 as far as the Federal Reserve is concerned. Whilst in the circumstances the rise in asset prices generally is not unwelcome, certainly for Ben Bernanke, the leading student of the Great Depression the primary goal was to avoid a slide into a deflationary spiral. We can ignore the volatile US Consumer Prices Index (CPI) going negative in 2009, but with core CPI on a steady downtrend to below 1% at the end of 2010 (see Fig. 26), the Federal Reserve clearly felt the need for QE2. The initial bout of QE was in the teeth of the crisis and was more or less intended to stave off disaster and restore stability to the financial system. Therefore, on a very simple level, QE succeeded because it staved off disaster and QE2 succeeded because it has helped to reverse the trend towards deflation. From Fig. 27, we can see that the decline in Core CPI has primarily been caused by what the Americans quaintly call 'Shelter costs' but this trend now appears to be reversing. As such, whilst the Fed may choose to leave QE2 in place by effectively rolling over maturing bonds, the case for QE3 does not look strong; growth will return in its own time.

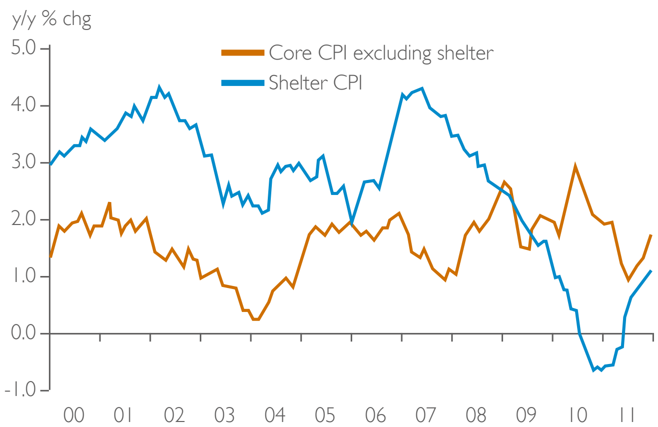
The spectre of inflation or from an alternative viewpoint, deflation, has loomed large during the last few years but much of this tends to coincide with swings in food and energy prices. The first thing to note is that the prices of both are heavily influenced by short-term factors and as we have seen in recent weeks, this upward pressure can evaporate in the blink of an eye. Rising food and energy prices do not represent 'true' inflation and that is why they are habitually excluded from the inflation measures that

FIG. 26: US CPI AND CORE CPI



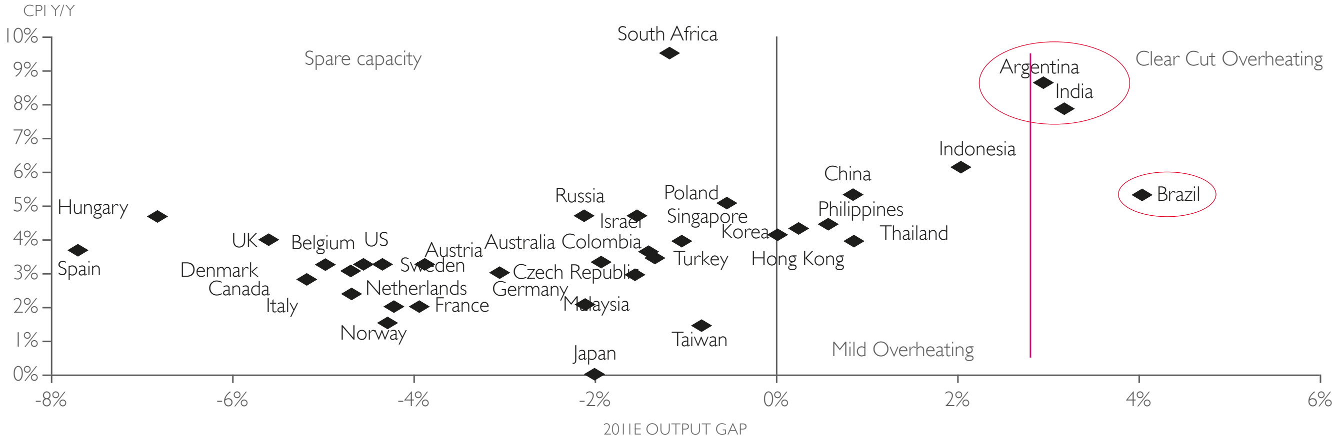
Source: Haver Analytics, Barclays Capital

FIG 27: SHELTER COSTS HAVE BEEN MAJOR DRIVER OF DISINFLATION



Source: BLS, Haver Analytics

FIG 28: OUTPUT GAPS AND CPI



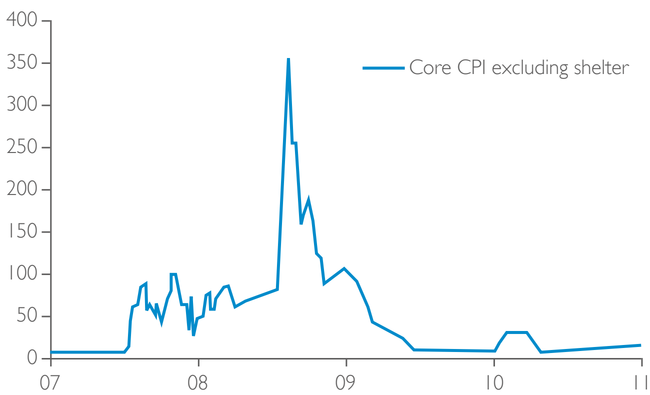
Source: Thomson Reuters, Credit Suisse

central banks look at; they cannot manage monetary policy on a daily basis. In fact, in the sense that rising commodity prices actually dampen aggregate demand, they are actually deflationary.

Fig. 28 is Credit Suisse's take on the 'output gap' in major economies around the world and how that sits alongside CPI. The output gap represents an attempt to gauge the level of spare capacity within economies and thus their ability to grow without triggering genuine inflationary pressures. It can be clearly seen that the vast majority of countries have a reasonably material output gap, which you would expect in the wake of a recession, and CPI is in a clear range of 2-4% in most cases. In only a handful of cases, most notably Brazil and India that are of course the 'B' and 'I' of BRIC fame, are economies operating sufficiently beyond capacity to fuel high inflation and in both cases the respective central banks are pursuing the appropriate policy of tightening monetary policy by raising interest rates.

There is much debate currently about the potential for the situation in Greece to resolve itself in a way that spreads 'contagion' not only to other peripheral countries in Europe such as Portugal or Ireland, but also to the banking system. The suggestion of course is that this could create a repeat of

FIG. 29: A GAUGE OF STRESS IN THE BANKING SYSTEM



*Source: Bloomberg, *Spread between 3 month LIBOR and overnight swap rate (OIS), indicator of bank stress benign, near record lows*

the 2008 financial crisis. One indicator that we kept an eye on a few years ago and which clearly gave an 'early warning' signal is something called the LIBOR-OIS spread (see Fig. 29). LIBOR stands for London Interbank Offered Rate (though we are talking about US Dollars here not Sterling) and is a guide to the rate at which a variety of banks are able to borrow from other banks for different periods of time. OIS stands for Overnight Interest Swop and this measure looks at the different between banks borrowing overnight and for three months.

This indicator looks at the difference between the rate at which a bank can borrow for three months and for borrowing overnight and the idea is that if the 'stress' on banks is increasing they will find it harder, and thus have to pay more, to borrow for longer periods of time. During 'normal' periods this difference would be minimal but as we can see, on Fig. 29 the initial 'blip up' came in mid-2007 as the sub-prime mortgage crisis started to gather steam (on this side of the Atlantic, Northern Rock was being rescued). After settling down a little, it then spiked up again around the time that Bear Stearns almost went bust (instead they got bought by JP Morgan). The real surge came when Lehman Bros went bankrupt over the weekend in September 2008 and came simply because banks didn't know which would be the next bank to follow suit. As we now know, authorities stepped in and little by little restored the trust that banks had with respect to other banks, which is essential for the financial system to function. We can see a few 'rumblings' around a year ago when the problems related to Greece first came to a head but these fears then subsided.

Whilst there is much afoot around Europe and as we discuss later on in this Report, there are a wide variety of possible outcomes, the key difference in our view is that there isn't really any fear of the unknown. In 2008 there was genuine fear that the world's major banks could go bankrupt one after another. The current situation is a sovereign debt crisis but these have happened before – countries have been defaulting on their debts for centuries.

Various approaches have been taken to dealing with sovereign defaults including various types of creditor committees but perhaps the 'Brady Plan' formulated in 1989 by the US and 'international financial institutions' should be the basis for action. That plan was used in negotiations with 17 different sovereign debtor nations from Mexico in 1989 to Vietnam in 1997. Institutions are offered a menu of options and can choose which suits them best. One option maintains 'par value' but merely reduces the size of the interest payments, which obviously helps liquidity. Another sees an erosion of underlying capital value, so-called discount bonds, but maintains market interest rates, which helps solvency. These 'par' and 'discount' bonds were usually issued for 30 years. Another option enabled creditors to swap the debt for shares of government enterprises expected to be privatised. For anyone who has been watching the Greece situation unfold, the plan outlined above will appear similar. The message we would like to convey is that it is a tried and tested approach that has, broadly speaking, been successful. The only real complicating factor this time around is the existence of the single currency and monetary union.

The inevitable conclusion of all of this is a fair amount of uncertainty as to the direction of the global economy and the durability of the relatively nascent recovery. Unlike some, we cannot get overly emotional about day to day economic data and the tiny deviation from expectations that can trigger meaningful market moves. We would obviously concede that the tone of much recent data has been negative but we do not believe that in itself is of huge concern.

Largely speaking, businesses have repaired their finances, previously over-leveraged investors are now in a much better position and consumers generally have made good progress in improving their finances. To allow this process to take place, governments had to step up and play the role of 'spender of last resort' and with the current attempts to repair government finances, some of which will succeed and in other cases will result in default, we are moving into the final phase of the post-crisis 'rebalancing' that should then provide the sound base for a durable economic recovery. This recovery requires the private sector to once again take the lead as the public sector retrenches and this means spending some of their cash, expanding their businesses and boosting employment. This ultimately should have a positive impact on consumption, which can then become a major driver of growth once again. However, this all takes time and does not happen to suit the schedule of City economists or politicians.

If we are correct in our belief that the growth outlook will improve during the remainder of 2011, the other important swing factor for investors is that of inflation. Whilst some assets such as stocks are usually seen as a good hedge against inflation because of 'real' increases in earnings and dividends, in fact there is evidence to suggest that this is undermined by a decline in valuations that often occurs during periods of rising inflation. Arguably therefore, the biggest boost for equities would actually come if the inflation outlook became more 'friendly'. As we have argued in this section, we believe that in most countries inflationary pressures are not truly entrenched and we are past the worst of it.

With respect to interest rates, whilst the European Central Bank is raising interest rates gradually, which some might call 'brave' given the current sovereign debt situation in the region, the UK, US and Japan look set to keep interest rates low for a longer period of time. Whatever the role that other factors are playing, interest rates that are below inflation, in the US and UK anyway, should be stimulative for the economy and encourage businesses to invest rather than hoard cash.

Some might see the potential for a major slowdown in China to derail the global economy as the biggest threat to markets and whilst we don't deny it is possible, the policy levers at the disposal of the Chinese Government should be sufficient to prevent anything dramatic. The real 'elephant in the room' of course is the sovereign debt 'crisis' within the Eurozone. There are a wide variety of possible outcomes that we would expect to have very different impacts on investors and thus it is very difficult to have strong investment views ahead of a satisfactory resolution. One would have to think that the combined might of the European governments, the International Monetary Fund (IMF) and the European Central Bank would be enough to ensure a 'controlled' resolution but the unexpected may happen. In the next section we look at the situation in a bit more detail, though given space constraints this is very much a 'potted history' of what is going on, some of which may be superseded by events by the time we go to print.

Crisis for the Eurozone?

The ongoing malaise in Europe has been quite clearly the major topic driving market sentiment recently, and needless to say it has not been in a positive manner. Almost two years after the sheer magnitude of indebtedness and spiraling budget deficits prevalent in the Eurozone came under the spotlight, the region's economic leaders have failed to put in place a credible long term plan to stabilise the situation; the €750 billion financial stability facility set up in May 2010 appears increasingly insufficient. We have now reached a point where there are significant tensions between the stronger Eurozone states who are faced with contributing seemingly unquantifiable amounts in financial aid, and their weaker counterparts who are being 'asked' to embark upon draconian austerity programs in order to receive that support. This is particularly the case with Greece.

From our perspective, there appears to be a building resignation to the notion that Greece, which is by far the most troubled Eurozone member in terms of both solvency (see Fig. 30 below) and liquidity will inevitably 'default' on realise how unrealistic their expectations are. In addition, in light of recent weak economic data from the Eurozone and the US in general, wider economic strength is far from assured.

The only real option for the 'periphery countries' given that they cannot devalue their currency, which is the normal strategy to restore competitiveness, is an 'internal devaluation' that occurs through sharp declines in labour costs and/or big improvements in productivity. Thus far, there is little evidence of this occurring outside Ireland. The swollen public sector and the envious perks that employees of the State are accustomed to will of course be difficult to give up. Equally, the end to an undeniably relaxed attitude with respects to tax payments, a situation prevalent throughout the Southern Mediterranean region, will be difficult to adapt to.

As things stand, those arguing that there is no alternative but for Greece to default appear to have the upper hand as the challenges are undoubtedly great. Whilst the sheer scale of Greece's debt mountain is an obvious incentive for the country to default, another is that by reneging on their obligations

FIG. 30: DEBT STATISTICS FOR SELECTED EUROPEAN COUNTRIES

Country	Government debt to GDP			% haircut required to reduce government debt/GDP to 100%	Implied haircut in 5Y CDS	Fiscal tightening required to stabilize government debt to GDP using:		Estimated fiscal tightening 2011-14
	2014E	2014E	2014E (incl, deleveraging)			Current bond yield	EFSF rate (5.8% for Ireland, Portugal; 4% Greece)	
Ireland	96%	125%	147%	32%	34%	18.3%	10.6%	8.0%
Spain	60%	72%	99%	-1%	14%	9.2%	9.2%	4.2%
Portugal	83%	101%	134%	25%	34%	14.6%	5.7%	5.1%
Greece	142%	152%	155%	36%	63%	26.5%	6.2%	9.3%
				14%				

Source: IMF estimates, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse estimates

its debt obligations in some shape or form. The argument now is more about when it will happen and in that respect, whether there is any point to further funding a lost cause.

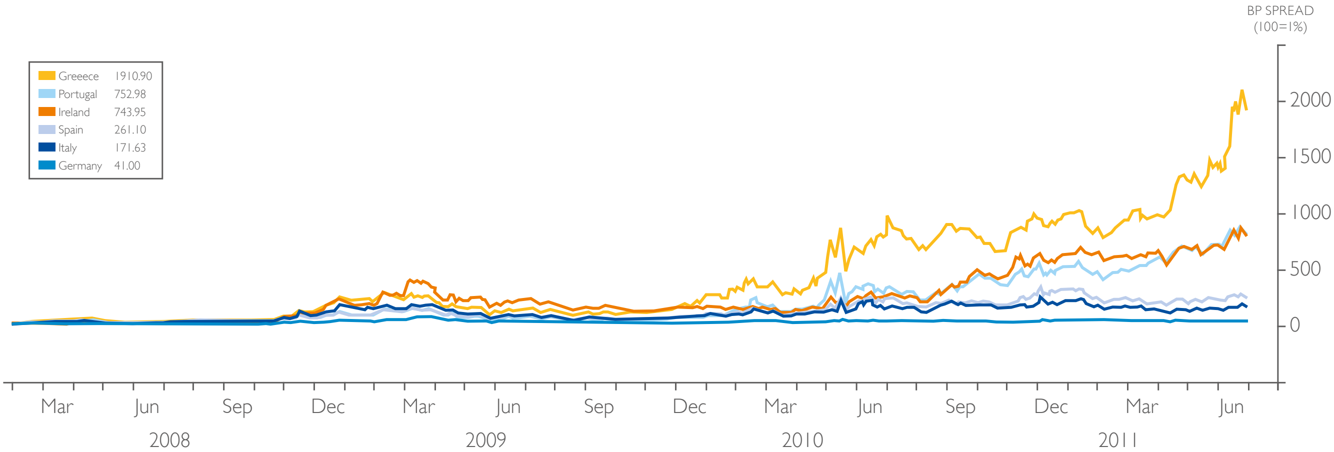
In reality, however, with the latest tranche of aid to Greece being approved by the Troika (a consortium of the International Monetary Fund, the European Central Bank and the EU) and many financial institutions showing willingness to extend or 'rollover' certain tranches of Greek debt into the future, it seems too fluid a situation to call either way with great conviction. After all, the aim is to insulate Greece from having to approach bond markets until 2014 and whilst this could be seen as 'kicking the can down the road'; it buys valuable time for Greece to get its house in order. Should we see a sustained economic recovery between now and then and also assume that Greece manages to deliver on its fiscal commitments, it is not beyond the realms of possibility to envisage an orderly outcome - from the point of view of Greece's creditors, those within the Euro currency and close trade partners at any rate. In many instances these parties are one and the same. Of course this would require significant and rapid cultural change within Greece, which the populace doesn't appear to have the stomach for. Nevertheless, one would hope that sooner rather than later the Greek population will take a glance at the rest of the Continent and

unilaterally and subsequently leaving the Euro (which we believe is a fair assumption) the country would be in control of its own fiscal and monetary policies and would therefore have tools at its disposal to kick start the economy – or at least provide a conducive platform from which the private sector can grow. A devalued local currency (one would assume they would re-adopt the Drachma) would theoretically boost the country's competitiveness in terms of trade, for example. However, taking the decision to default will have a longstanding impact on Greece's future ability to borrow. Argentina, for example, defaulted in 2002 and whilst this coincided with a return to economic growth and a significant trade surplus, they are still precluded from raising capital from international bond markets. No access to capital means no capital improvements, and as a result, were Greece to default, the country will only be able to spend what it receives in taxes. If it prints money, as it would be in a position to do, expenditure could rise but it opens up other problems such as inflationary pressures. That would require interest rate hikes that lead to appreciation in the currency and therefore offset the trade benefits of a weaker currency. It is far from clear that Greece is better off going it alone and perhaps the biggest advantage is that it might seem more palatable to the Greek people. One of the cardinal rules of sovereign debt restructuring is currently being ignored, which is that it should be seen to be led by domestic protagonists with international organisations agreeing rather than solutions being imposed from outside.

Perhaps the most likely solution is neither a full default nor a resolution but an organised default. In such an event, the fallout would undoubtedly be widespread throughout the Eurozone and further afield though as Fig. 30 shows Credit Suisse estimates that current bond prices for Greece more than factor in a partial default. Firstly, Greece's creditors, whether private institutions such as the banks or public entities such as the IMF, will obviously be forced to write off some of their assets. In the case of public entities, it is the taxpayers of contributing nations who will take the hit; with the banks, the losses are those of stakeholders. French and German financial institutions are considered to be the most exposed, but of course others are exposed to a certain extent. The nervousness of investors, or perhaps the wagering of speculators, can be seen in Fig. 31 below where the costs of insuring (the CDS spread) against a default by the economically much larger Spain (mauve) and Italy(dark blue) have risen though are not at what might be termed overly 'stressed' levels. Separately, Ireland (orange) and Portugal (light blue) meanwhile, which have already received financial support from Troika, have disconnected from Spain and Italy since the fourth quarter of 2010 and 'boast' the kind of spreads seen on Greek (yellow) bonds only a few months ago. The stability of German (royal blue) spreads is testament to their status as the 'rock' at the heart of the Eurozone.

It goes deeper than this though. Working on the premise that Greece cannot default and remain in the Euro, their departure would be a huge blow to what is essentially a political union more than an economic one. The lack of economic union is what has undermined the Eurozone on the first occasion it has truly been tested and perhaps this will be a 'wake-up call' to the governments of the region that for a single currency area to work, much greater coordination on fiscal policy in particular is required. This will obviously require the somewhat 'tribal' national factions to put the greater good over that of their own country, something unlikely to go down well with the voters that elect the politicians; but that is a quandary that is unlikely to be solved overnight.

FIG. 31: CREDIT DEFAULT SWAP SPREAD ON VARIOUS EUROZONE GOVERNMENT BONDS



Source: Bloomberg LP

Commodity Outlook

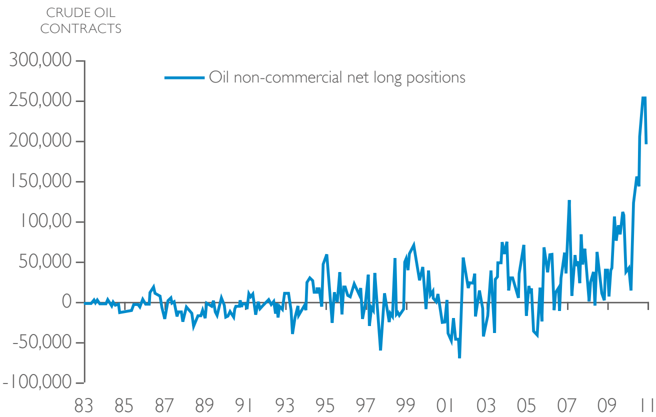
When this article was first conceived some weeks back, the plan was to argue that there was no fundamental justification for crude oil hitting the elevated levels seen during the first half of the year. In spite of grabbing lots of headlines, the so-called Arab Spring has done little to disrupt oil supply beyond wiping out Libya's production, equivalent to less than 2.5% of global supply. Leading producer Saudi Arabia responded by increasing its supplies to the market over and above its official OPEC quota so there was really very little impact and certainly no sign of supply shortages. In spite of all this, there was a sharp spike in crude oil in response to fears of further disruptions, though logic suggested that in such an event the leading economies would tap their very substantial strategic oil reserves – if not then, then when? Various reasons can be cited for this overreaction beyond simple investor sentiment and fear of the unknown.

Fig. 32 certainly suggests 'speculators' may have played a role though to clarify, the term speculator in this context means anyone who is not a commercial buyer or seller of oil. It cannot be a coincidence that the net long interest surges in tandem with the oil price and then subsides when momentum stalls; the record net long position was hit in early March when light sweet crude hit $105. In the wake of the unexpected decision by the International Energy Agency (IEA) to release some of the Strategic Oil Reserves held by a number of countries including the US, the oil price has been under some downward pressure and the net long futures position has halved since March and is now in more 'normal' territory. This decision by the IEA should act as a 'shot across the bows' of either speculators or OPEC that major economies around the world will not blithely sit back and let an excessively high oil price undermine their economies.

This decline in speculative interest in crude oil has been witnessed in a number of other commodities and combined (providing that they don't head straight back up again) should certainly provide a welcome boost to consumers around the world. Given the further falls since this graph was put together, we are not surprised to learn that the net long exposure has continued to fall sharply and indeed has been reflected across a wide range of commodities. Fig. 33 tracks crude oil inventories and shows that 2011 is proceeding in much the same manner as in 2010 and inventories are well above the five year average, suggesting there is no market-wide shortage of crude oil.

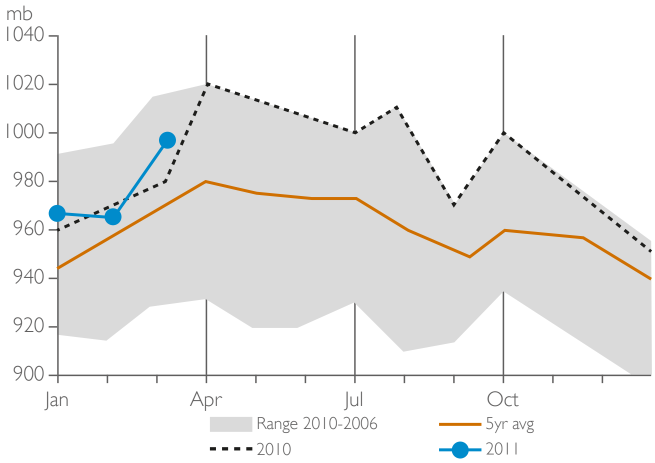
The commodities market does indeed operate in a strange fashion these days. Initially we get strong economic data which fuels expectations of rising commodity demand, so prices rise. Then, investors start worrying about the inflationary impact of these price rises and buy more commodities exposure as an inflation hedge. The prices have then risen sufficiently that economic data weakens because higher commodity prices stunt aggregate demand but this simply fuels fears about 'stagflation' since not only do people have higher prices to worry about but also the prospects of slower growth. Eventually, fears of falling demand emerge, reality sets in and commodities fall back to more 'normal' prices which in turn ease worries about inflation and provide a stimulative boost to the economy which then takes us back to square one and the whole process starts again. Whilst very simplified, this is a fairly accurate picture of what has been happening in commodity markets for some time and we think this can be attributed to the greater involvement both of 'passive' investors such as pension funds as well as 'active' investors such as hedge funds. We would appear to be on the cusp of the 'lower prices boost growth' stage and this helps to support our general optimism for the short-term outlook for asset prices.

FIG. 32



Source: CFTC, Bloomberg

FIG. 33: OECD INDUSTRY STOCKS: CRUDE OIL



Source: IEA Oil Market Report, May 2010 – March 2011

One of the difficult decisions to make is how to get the commodities exposure we seek as there are a wide variety of routes. The easiest access is via the stock market where an array of mining and oil companies of all sizes can be found and the UK market is particularly 'blessed' on this front with something for everyone.

Investors have the choice between the larger diversified miners where we favour **Xstrata** and **Anglo American** and the oil majors such as **BP** and **Royal Dutch Shell** where we would favour the former. There are a large number of small explorers where the outcome is unknown and the potential rewards are very significant. Generally speaking we don't try and pick the winners from this eclectic bunch and certainly on the mining side, we lean in the direction of something like **Anglo Pacific** which is discussed earlier in this Report. Alternatively, there are a number of high quality funds where exposure can be sought either to miners, where we prefer the **Blackrock World Mining** investment trust or a variable mixture of energy and miners through **JPMorgan Natural Resources** or **Blackrock Commodities Income**.

There is obviously much greater variety within the mining sector in terms of the individual commodities that different companies extract. Certainly, we let our views on the merits of individual commodities influence our decisions in an abstract sense. Broadly speaking we believe that metals can be divided into those where supply is constrained by the existence of exploitable resources and those where it is simply a case of spending more money to increase supply. Whilst in the latter case there is a time delay, prices will only stay at elevated levels for a short time until the supply deficit is remedied. Where there is a genuine lack of resource, once a commodity passes an 'inflexion point' where demand is depleting spare inventories and prices surge, there are far fewer options beyond substitution. In some cases this is practical, in others it is not. Xstrata's exposure to copper and zinc where there appear to be genuine supply constraints is one of the key attractions for us.

Beyond listed commodity stocks the alternative is to gain exposure via commodity futures. This exposes us directly to changes in commodity prices without the complicating factor of what is going on with the stock market and/or the individual stocks. This isn't a 'free lunch' however since whilst downside risks can be reduced, the upside potential is similarly curtailed. Additionally, expectations of future commodity prices play a role in determining returns since you have to 'roll' your exposure to a particular commodity future as it approaches expiry and this process can either boost your returns if the futures curve is pointing downwards or detract from them for an upward sloping curve, which is more common. We believe this type of investment is best suited to a more systematic, quantitative methodology and we generally use a fund called the **BNP Harewood Commodities Oscillator.** As well as providing exposure to a broad range of commodities, it uses momentum (or lack of it) to size positions in different commodities. One of the things that makes it appeal to us is a 'volatility control' so that during periods when the commodity market starts to move more violently, this fund scales back its positions and as a result the fund will tend to fare better during market selloffs whilst participating reasonably strongly in commodity 'bull' markets.

Whichever route we choose, the profitability (or not) of commodities investments is incredibly hard to predict and we generally try to boost our exposure when sentiment is weak and to head for the 'Exit' sign when things get a bit too euphoric for our liking. Commodity futures act as a greater diversifier for the rest of a portfolio and given our exposure to miners and oils within our various 'mainstream' equity positions, there is certainly a case for getting exposure to futures rather than increasing our exposure to commodity equities still further. Relatively speaking, now appears a pretty reasonable time to be adding to commodity exposure rather than reducing it in our view.

Conclusion

The first half of 2011 has been eventful in so many ways and yet in others little has happened. A regional 'uprising' against long established regimes in parts of North Africa and the Middle East appeared to gain a life of its own after Egypt kickstarted the process. Things like this unnerve investors and with so much of the world's energy supplies coming from the region, a sharp spike in the oil price was the predictable result. Whilst things outside Libya and Syria appear to have settled down, the process has surely shaken the foundations of those countries that lack full democracy.

Further to the East we had a more literal 'shaking of the foundations' with tragic results following a huge earthquake under the sea bed off the coast of north east Japan. The problem was less the earthquake and more the deadly tsunami that was unleashed, engulfing coastal towns and compromising the nuclear plant at Fukushima. Not only did this event disrupt the Japanese economy but it had knock-on effects all round the world, underlining the interconnectedness of the global economy, though we expect things to be back to 'normal' within the next few months.

This is perhaps a timely reminder of the ability of random events to have unforeseeable effects on global financial markets and the most carefully constructed investment strategy. Although the kneejerk reaction can sometimes be quite extreme, such events are usually 'one-off' in nature and markets quickly adjust.

Over a year on since the 'debt crisis' amongst some of the peripheral members of the Eurozone first reared its ugly head, there seems to have been a lot of talk but not a great deal of action. Although the Greece situation is approaching the point of resolution, though at the time of writing this is unknown, Portugal and Ireland continue to linger in the background. There are two separate strands of this that need to be considered, one that relates to the solvency of the country and the other, its liquidity. Portugal and Ireland are not in an enviable position either but whilst on the face of it Ireland's position is greatly imperilled by the magnitude of support for its domestic banking system, the advantage it does have is in terms of competitiveness, dynamism and flexibility. Of all those peripheral economies, it is the Celtic tiger that perhaps stands the best chance of being in good shape 5-10 years down the line.

Risks are ever-present in all forms of investing and the outcome is often determined by the extent to which risks are priced in. Our intention during this report has been to communicate some of the major risks that are lurking out there but also give some insight into where opportunities can be found. We have discussed the sharp divergence of expectations amongst investors and it seems reasonable to conclude that this will be resolved one way or another sooner rather than later. Overall we retain our guarded optimism surrounding the outlook for investment returns.

Stephen Walker
Head of Equities Research and Market Strategy

ON BEHALF OF THE ASHCOURT ROWAN GROUP INVESTMENT COMMITTEE

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