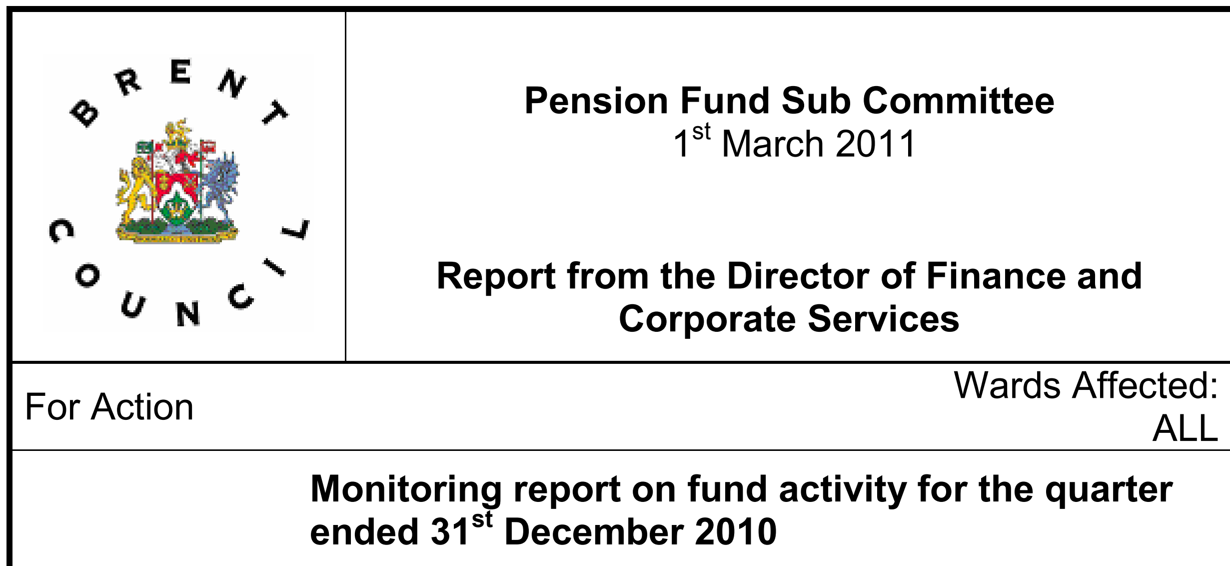


Pension Fund Sub Committee
1st March 2011

Report from the Director of Finance and Corporate Services

For Action | Wards Affected: ALL

Monitoring report on fund activity for the quarter ended 31st December 2010

1. SUMMARY

This report provides a summary of fund activity during the quarter ended 31st December 2010. It examines the actions taken, the economic and market background, and investment performance, as well as commenting on events in the quarter. The main points arising are:

a) Equity markets rose during the quarter. Bond markets fell, on concerns about inflation and strengthening economic growth. Other markets also rose, but less rapidly.

b) The Fund has risen in value from £454m to £476m, and has outperformed its benchmark over the quarter (+2.4%) as a result of stock selection (outperformance in equities, GTAA and private equity). The Fund outperformed the average local authority fund (+1.1%), mainly as a result of good returns in equities and GTAA, offset by asset allocation (higher exposure to alternatives / lower exposure to equities). Over one year, the Fund has outperformed its benchmark (+2.1%) as a result of higher exposure to equities and good stock selection (equities, bonds, private equity and GTAA). Over one year, the Fund has underperformed the average fund (-1.9%) as a result of lower exposure to equities / higher exposure to alternative assets and poor performance in global equities, hedge funds and private equity.

2. RECOMMENDATIONS

Members are asked to note this report.

3 DETAIL

ECONOMIC AND MARKET BACKGROUND - QUARTER ENDED 31ST DECEMBER 2010

3.1 Equity markets rose during the quarter on the bases of world economic growth and renewed Quantitative Easing in USA and elsewhere. The UK market rose by 6%, USA 11%, Germany 16%, Japan 10% and HongKong 5%. The UK economic background was:

- UK base rates remained at 0.5%. Medium and long-term interest rates fell during the quarter. Concerns about the European banking system and various eurozone countries (Greece, Portugal and Spain) have affected these markets, but UK has benefited from a safe haven status.The Quantitative Easing programme in UK has been suspended. Rates may rise to head off inflationary expectations.
- Headline inflation (RPI) rose by 5.1% in the year to January (4.7% August), and the Index of Consumer Prices (CPI) rose by 4.0% (3.1% August). It is expected that inflation will remain at present levels or even rise in the short term, but should fall over a two year period as spare capacity and low pay increases bear down on prices, but it is expected that CPI will be above the Bank of England 2% target during 2011. However, with productivity rising and pay pressures contained, unit labour costs are falling.
- Average earnings growth (including bonuses) was 1.1% p.a. in December (1.8% July), below the Bank of England's 'danger level' (4.5%). Unemployment (claimant numbers) has fallen to 1.46m, but may rise as public expenditure is reduced and taxes raised following the recent budget.
- The UK economy shrunk by 0.5% in Q4 2010 (growing by 1.4% in 2010), following disruption from poor weather and a slowdown in growth. GDP is expected to recover in Q1 2011, and to grow by 1.5% / 2% in full year 2011.
- It has been anticipated that consumer spending will fall, though retail sales were up 1.1% in the year to November. The squeeze on incomes, and the decline in equity withdrawal from the housing market following price falls, may depress demand. House prices have fallen by 2.4% over one year to January (Halifax). Mortgage approvals are only 60% of their level two years ago. Capital Economics still expects further house price falls (15%/20%).

In summary,the UK economy is growing at a modest rate but interest rates are expected to remain low. The government was using both fiscal and monetary policy to combat the downturn, but fiscal policy will be tightened over the next four years. The recovery is expected to be slow with occasional setbacks, but sentiment has improved considerably.

3.2 Central banks have co-ordinated activity to supply liquidity to markets so that credit is available to support economic activity. It is expected that the USA economy has grown by 3% in 2010 (and will grow by 3% in 2011) following tax cuts and quantitative easing (QE) programmes. Improved payroll data, strong retail sales and a rebound in home construction have indicated that a recovery is underway, but house prices continue to fall. It is anticipated that company earnings will improve. It is expected that Eurozone GDP will grow by 1.5% in 2011, supported by strong growth in Germany. Growth in China and India was around 10% and 9% respectively in 2010 (forecast 8% and 8.5% 2011) – emerging market growth is strong and providing export growth to developed economies. China has raised interest rates and tightened banks' reserve requirements, while India has also raised rates. The world economy is expected to grow by 4.6% in 2010, and by 4% – 4.5% in 2011.

3.3 A paper on market events and future prospects, written by the Independent Adviser, is attached.

3.4 Table 1 below shows the changes in asset allocation, how asset allocation compares with the benchmark and with the average fund (WM Local Authority average), and how the change in the market value during the quarter is allocated across asset classes. Items marked (*) in columns 4 and 8 cannot be separately analysed, but are included elsewhere. The WM Local Authority average asset allocation indicates little change apart from increased exposure to alternative assets.

Table 1: Asset Allocation as at 31st December compared to the Benchmark

Market (1)	Market Value 30.09.10 £M (2)	Market Value 30.09.10 % (3)	WM LA Average 30.09.10 % (4)	Fund Benchmark 31.12.10 % (5)	Market Value 31.12.10 £M (6)	Market Value 31.12.10 % (7)	WM LA Average 31.12.10 % (8)
Fixed Interest							
UK Gilts	17.4	3.8	10.6	4.5	17.5	3.7	9.5
Corp.Bonds	25.1	5.5	*	4.5	23.8	5.0	*
IL Gilts	-	-	4.8	-	-	-	4.7
Overseas	0.0	0.0	2.2	-	-	-	2.2
Emerg. Market	8.5	1.9	-	2.0	8.4	1.8	-
Infrastructure	0.9	0.2	-	-	0.9	0.2	-
Secured loans	4.3	0.9	-	2.0	4.4	0.9	0.7
Credit Opps.	12.0	2.7	-	2.5	12.1	2.5	*
Credit Alpha	12.3	2.7	-	2.5	12.3	2.6	*
Currency Fund	0.7	0.2			0.6	0.1	
Equities							
UK FTSE350	109.1	24.0	30.9	12.5	72.3	15.2	30.9
UK Smaller co's	15.6	3.4	*	4.0	15.9	3.3	*
O/seas - developed	92.5	20.4	34.5	22.5	116.4	24.5	34.4
O/seas – emerging	13.4	2.9	*	8.0	37.1	7.8	*
Other							
Property – UK	23.8	5.2	6.2	8.0	25.2	5.3	6.0
Property – Eu.	6.6	1.5	*	*	6.6	1.4	*
Hedge funds	41.1	9.0	2.0	10.0	42.0	8.9	2.4
Private Equity	41.7	9.2	2.8	10.0	47.8	10.1	3.0
GTAA	12.7	2.8	1.3	4.0	16.5	3.5	1.7
Infrastructure	4.6	1.1	*	2.0	5.3	1.1	*
Cash	11.8	2.6	4.0	1.0	11.0	2.1	3.6
Total	**454.1**	**100.0**	**100.0**	**100.0**	**476.1**	**100.0**	**100.0**

3.5 The main changes to the Brent Fund have occurred as a result of market movements, agreed rebalancing and increased exposure to private equity (£5.6m, the main items being initial investment in the USA Solar Fund £2.5m, and further investment in the European Co-Investment Fund £1.5m), property (£1m), and infrastructure (£0.9m). The main rebalancing changes have been:-

a) exposure to UK Small Companies has been reduced (£2.4m) on the basis of concerns about the stability of the house, balanced by increased exposure to Global Tactical Asset Allocation (£2m).
b) Increased exposure to overseas equities (including emerging markets) and reduced UK equity exposure (£36m) in line with the revised benchmark.

Since the end of the quarter there has also been further investment in overseas equities (£2m – reinvestment of dividends relating to the AllianceBernstein portfolio) UK property (£1m) , GTAA (£2m), infrastructure (£0.2m) and private equity (£0.5m).

Performance of the Fund

3.6 The independent WM Company measures the returns on the Brent Pension Fund. Table 2 sets out returns for the quarter to 31st December 2010.

Table 2: Investment Returns in Individual Markets

Investment Category	RETURNS						Benchmark/ Index Description
	Quarter Ending 30.12.10			Year Ended 30.12.10			
	Fund %	Benchmark %	WM Local Auth %	Fund %	Benchmark %	WM Local Auth %	
Equities			8.6			16.2	
UK FTSE350 Equities	8.1	7.3	7.6	16.3	14.4	15.7	FTSE 350
UK Small Caps	15.8	8.6		21.6	16.9		FTSE Smallcap ex IT
Overseas	14.5	8.2	9.3	11.8	10.0	16.9	FTSE World 75% Hedge
Emerging markets	-	-	-	-	-	-	
Fixed Interest							
Total Bonds	-0.8	-0.7	-1.0	7.9	5.5	9.0	Brent benchmark
UK Bonds	-2.2	-2.1	-2.3	6.6	6.2	8.6	FTSE UK over 15 years
Index Linked UK	-	-	1.1	-	-	9.1	-
Corp Bonds	-2.1	-2.4	-	8.1	8.4	-	iBoxx Sterling Non-gilt
Secured Loans	3.3	0.9	-	12.9	3.7	-	3 month LIBOR +3%
Credit Opportunities fund	0.1	1.4	-	10.6	5.7	-	3 month LIBOR+5%
Other							
UK Property FOF	2.3	2.2	2.0	22.1	17.4	11.9	IPD Pooled index
Eu Property FOF	0.1	1.9	-	-2.2	8.0	-	IPD All properties
Hedge Funds	2.3	1.1	2.5	1.9	4.6	7.0	3 month LIBID+4%
Private equity	4.1	0.1	3.2	8.0	0.4	12.7	LIBID 7 Day
Infrastructure	-1.2	1.1	-	-1.4	4.6	-	3 Month LIBID +4%
GTAA	12.3	6.9	-	35.4	12.6	-	FTSE 100
Cash	1.0	0.1	0.1	n/a	2.4	1.7	GPB 7 DAY LIBID
Total	**6.8**	**4.4**	**5.7**	**11.5**	**9.4**	**13.4**	

3.7 Details of individual managers' performance tables are attached in Table 3, which shows three month, one year and longer-term information. Returns for the quarter outperformed the benchmark by 2.4%, despite transition costs. Part of the outperformance arose as a result of asset allocation (overweight equities), but there was also outperformance in most asset classes. The main stock selection factors were:-

a) UK Small Companies. The manager added value through investments in takeover targets (such as Nestor and Scott Wilson), companies that grew their profits, and the avoidance of underperformers such as Southern

Cross, Mouchel and Antisoma. The fund is overweight capital intensive industries and technology companies, and underweight financials, resources and consumer discretionary stocks.

b) Fixed interest. The core portfolio outperformed, but the satellite portfolio underperformed their investment target. The core portfolio benefitted from good sector selection in corporate bonds. The satellite fund rose in value as secured loans outperformed, but returns from other funds were positive but below target.

c) Overseas equities. It appears that AllianceBernstein outperformed (by 5.7%) during October and November. Performance was also helped by the overweighting in Emerging Markets during December.

d) GTAA. The manager outperformed sharply as equity and currency strategies added value. In equities, additional (long) exposure to Germany and Japan were particularly helpful. In currencies, the overweight to higher yielding currencies (such as Australia and Canada) added value, as did the short on the dollar.

e) Property. In the UK, there have been new entrants to the Fund, allowing the manager to purchase assets at a discount. The manager expects the market to fall slightly this year, and is positioning the fund to avoid lower quality assets. In European property, returns were flat. The european market has begun to improve, and the manager is looking for new funds to commit cash.

f) Hedge funds. In benign markets, the manager added value from equity hedged, long bias macro managers, event driven, and multiple strategies. Short bias managers continued to underperform. Fauchier have been active in removing managers that are suffering style drift or have become over cautious, and has increased exposure to event driven and specialist credit managers.

3.8 Over one year, the Fund outperformed the benchmark by 2.1%. Stock selection added value – UK equities, overseas equities, UK Small Cap, bonds, GTAA and private equity outperformed the benchmark.

3.9 The Brent fund has outperfomed the WM Local Authority average in Q4 (1.1%) despite asset allocation - low exposure to equities / high exposure to alternative investments. Both equities and GTAA have outperformed the average.

3.10 The Brent fund has underperformed the average local authority fund by 1.9% over one year, mainly because it has had a lower exposure to equities (higher exposure to alternatives – mainly hedge funds and private equity) in a period when equities have performed very strongly. However, there has been outperformance in UK equities and GTAA, partially offet by underperformance in overseas equities, hedge funds and private equity.

Actions taken by the Brent In-House UK Equity Manager during the Quarter

3.11 The main activity during the quarter was to sell stock (£22m) as part of the change in asset allocation to reduce exposure to UK equities and increase exposure to overseas equities. The strategy adopted was to sell large, mainly FTSE100 stocks that were liquid. The cost of sale was £22,000. Since the initial sale, there has been further action to rebalance the portfolio so that tracking error

is low. This has involved selling larger FTSE 250 stocks. There have also been some purchases and sales during this quarter to invest dividends (£0.9m), improve tracking error, pay retirement lump sums, and invest in private equity.

Purchases
a) Took up rights issues.
b) To reduce tracking error.

Sales
a) Sold stocks to ensure more accurate index tracking or as they left the index (such as Edinburgh Dragon Trust).
b) Sold stocks to fund investment elsewhere or to pay retirement lump sums.

Future Strategy for the UK FTSE350 Index tracking fund

3.12 The strategy is that of tracking the FTSE 350 within 0.5% over the year. Activity during January included buying and selling stocks to improve tracking error and to invest dividends.

NEW DEVELOPMENTS AND FUTURE INVESTMENT OUTLOOK FOR THE BRENT FUND

3.13 Equity markets rose during January and early February, supported by increasing evidence of economic recovery and quantitative easing in USA.

3.14 Following the announcements that the head of small companies (Gervais Williams), the leading hedge fund manager and the chief investment officer were leaving, Gartmore Investment Management announced that it was conducting a strategic review of the business, and meeting interested companies with a view to a potential takeover. The Brent Fund had previously decided to reduce exposure to the UK and Irish Small Companies Fund, and continued that approach.

3.15 In January 2011, Gartmore announced that it was being taken over by Henderson Global Investors. It appears that the business 'fit' is very good – Gartmore runs some attractive retail funds and continues to employ some highly considered managers. As part of the agreement, Henderson has secured most of the leading managers at Gartmore (with long term agreements involving Henderson shares), in particular the two lead small companies managers (Rob Giles and Adam McConkey) and the rest of the small companes team. Following discussions with Adam McConkey and David Jacob (the Chief Investment Officer at Henderson), it is apparent that the UK and Irish Small Companies Fund will continue to follow the same investment processes as before. Undoubtedly there will be further 'rationalisation' to reduce costs, but the industry view is that Henderson undertook its previous takeover of the manager New Star very successfully, and has learnt more lessons (in particular with regard to securing leading managers) from that experience. Henderson had some smaller company funds, but the approach and emphasis (mainly on FTSE250 companies) has been different. Initially the small companies team will remain a discrete group within Henderson.

3.16 From the Brent viewpoint, the takeover secures our small company investment against the possible implosion of Gartmore. Henderson is a sound, well capitalised company. On this basis, further reduction in exposure to UK small companies has been suspended (£2.4m sold), but will not be reversed until the takeover is complete. It is ironic to note that the price of UK and Irish units has risen by more than 15% since the sale process commenced.

4. FINANCIAL IMPLICATIONS

These are contained within the body of the report.

5. STAFFING IMPLICATIONS

None directly.

6 DIVERSITY IMPLICATIONS

The proposals in this report have been subject to screening and officers believe that there are no diversity implications arising from it.

7 LEGAL IMPLICATIONS

There are no legal implications arising from the report.

8. BACKGROUND INFORMATION

Henderson Investors – December 2010 quarter report
Legal & General – December 2010 quarter report

Persons wishing to discuss the above should contact the Exchequer and Investment Section, Finance and Corporate Services , 020 8937 1472/1473 at Brent Town Hall.

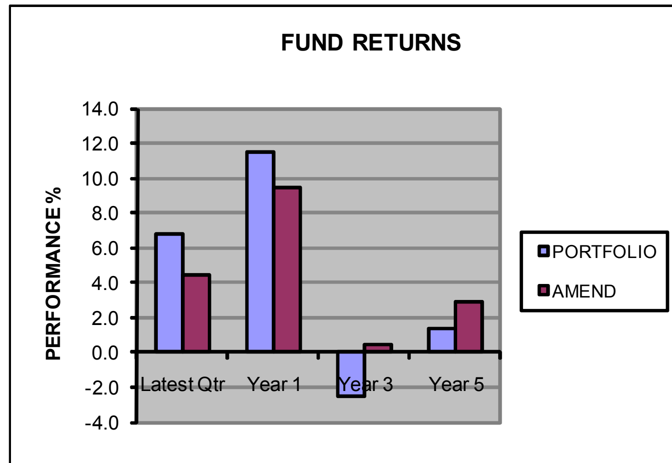
CLIVE HEAPHY
Director of Finance & CS

MARTIN SPRIGGS
Head of Exchequer and Investment

PERFORMANCE FOR INDIVIDUAL PORTFOLIOS 30th DECEMBER 2010

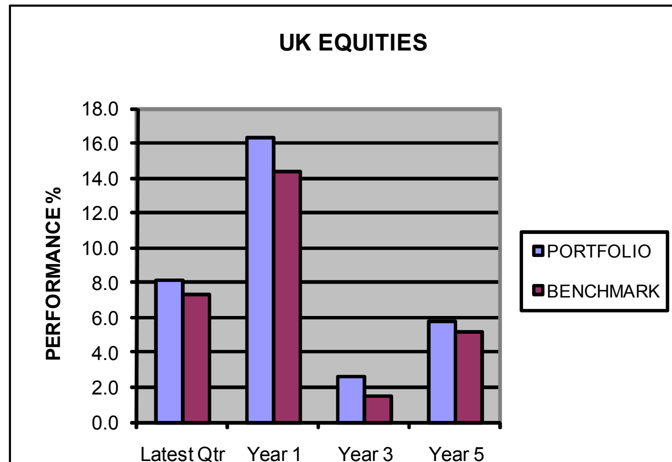
FUND RETURNS

	PORTFOLIO	BENCHMARK
Latest Qtr	6.8	4.4
Year 1	11.5	9.4
Year 3	-2.5	0.4
Year 5	1.4	2.9



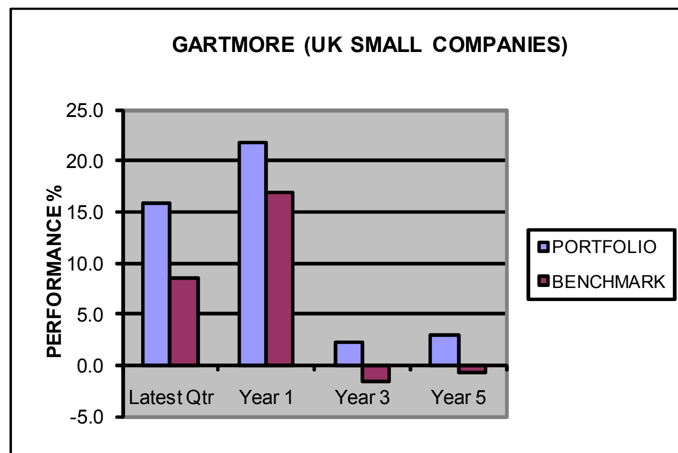
UK EQUITIES

	PORTFOLIO	BENCHMARK
Latest Qtr	8.1	7.3
Year 1	16.3	14.4
Year 3	2.6	1.5
Year 5	5.8	5.2



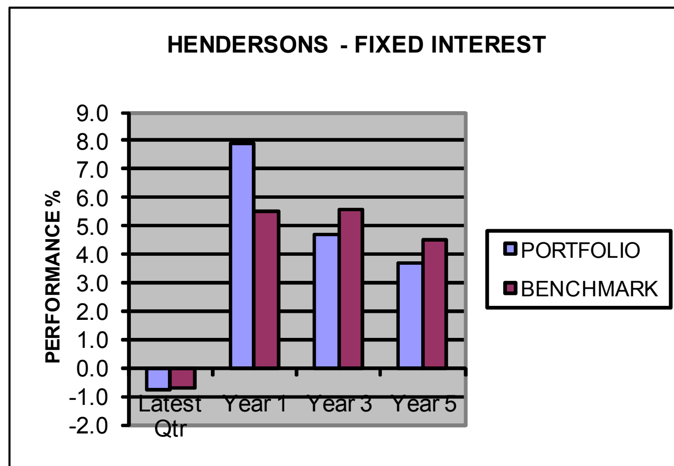
GARTMORE (UK SMALL COMPANIES)

	PORTFOLIO	BENCHMARK
Latest Qtr	15.8	8.6
Year 1	21.7	16.9
Year 3	2.3	-1.6
Year 5	3.0	-0.8



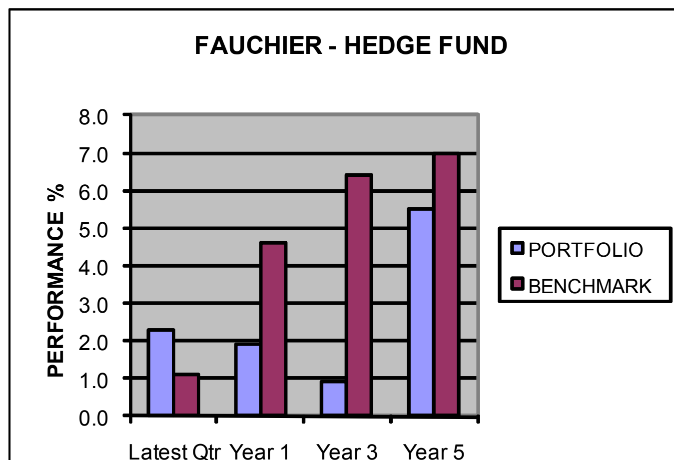
HENDERSONS - FIXED INTEREST

	PORTFOLIO	BENCHMARK
Latest Qtr	-0.8	-0.7
Year 1	7.9	5.5
Year 3	4.7	5.6
Year 5	3.7	4.5



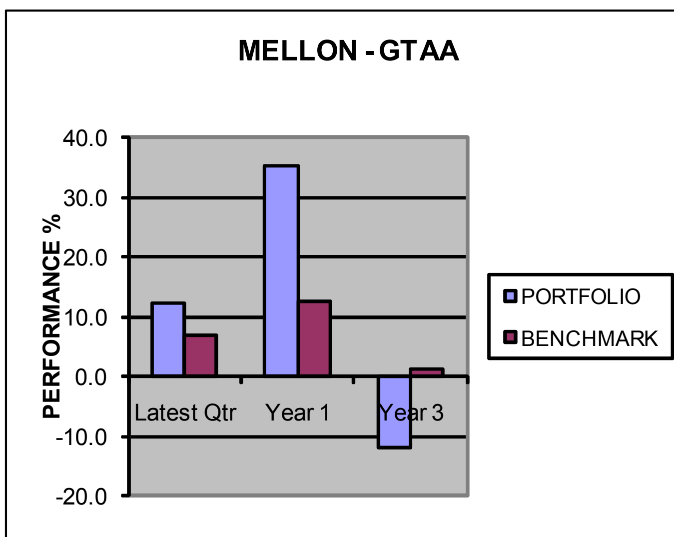
FAUCHIER - HEDGE FUND

	PORTFOLIO	BENCHMARK
Latest Qtr	2.3	1.1
Year 1	1.9	4.6
Year 3	0.9	6.4
Year 5	5.5	7.0



MELLON - GTAA

	PORTFOLIO	BENCHMARK
Latest Qtr	12.3	6.9
Year 1	35.4	12.6
Year 3	-11.7	1.2



Report from the Independent Adviser

Investment Report for the Quarter ended 31st December 2010

Market Commentary

The index returns and currency movements both for the quarter and year ended 31st December 2010 are shown in the tables below.

Index returns expressed in sterling

		Q/E 31.12.10
		%
Equities		
Japan	FTSE Developed Japan	12.8
North America	FTSE North America	11.6
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	9.3
Emerging Markets	MSCI Emerging Markets Free	8.1
UK	FTSE All Share	7.4
Europe	FTSE Developed Europe (ex UK)	4.7
Fixed Interest		
UK ILGs	FTSE British Gov. Index Linked Over 5 years	1.1
UK Gilts	FTSE British Government All Stocks	-2.1
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	-2.4
Property	IPD	N/a
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency Movements for quarter ended 31st December 2010

Currency	**30th September 2010**	**31st December 2010**	**Change %**
USD/GBP	1.576	1.566	-0.6
EUR/GBP	1.154	1.167	+1.1
USD/EUR	1.365	1.342	-1.7
Yen/USD	83.540	81.105	-2.9

Index returns expressed in sterling

		Y/e 31.12.10
		%
Equities		
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	23.7
Emerging Markets	MSCI Emerging Markets Free	22.9
North America	FTSE North America	19.1
Japan	FTSE Developed Japan	19.0
UK	FTSE All Share	14.5
Europe	FTSE Developed Europe (ex UK)	5.7
Fixed Interest		
UK ILGs	FTSE British Gov. Index Linked Over 5 years	9.1
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	8.5
UK Gilts	FTSE British Government All Stocks	7.2
Property	IPD	17.6*
Cash	Merrill Lynch LIBOR 3 Month	0.1

* For the year ended 30th November 2010

Currency Movements for year ended 31st December 2010

Currency	31st December 2009	31st December 2010	Change %
USD/GBP	1.615	1.566	-3.0
EUR/GBP	1.126	1.167	+3.7
USD/EUR	1.435	1.342	-6.5
Yen/USD	93.095	81.105	-12.9

As the return table for the quarter shows, the leader was Japan (+12.8%) making up for its lacklustre negative performance earlier in the year. This reflected a degree of increasing confidence in the Japanese economy which had disappointed for so long. Next came North America (+11.6%) on the realisation that its economy was demonstrating appreciably better economic growth than expected by most economists. Asia/Pacific (+9.3%) continued to be a favoured area for investors as it managed to maintain very robust rates of GDP growth. For much the same reason Emerging Markets returns grew by 8.1%. The UK featured next with a very respectable +7.4%. Last, but certainly not least, came Europe (+4.7%), despite the well publicised financial and economic problems within the smaller Eurozone countries and fears for the future of the euro. As so often in the past, it was Germany with its dominating export powered economy which continued to be the bedrock of the Eurozone. All in all the quarterly equity returns provided an exceptionally strong end to a truly banner year.

Fixed interest returns were negative for the quarter except for Index Linked Bonds. This was not surprising given the strength of fixed interest earlier in the year and the recent perception that yields on gilt edged securities stand at extremely low historic levels. This is reflected in their return of -2.1%. However, Corporate Bonds, after a strong positive 8.5% return for the year, produced a negative 2.4% for the quarter on the apprehension that the best may have been seen. The return of +1.1% for Index Linked bonds was due to the continuing relative popularity of this class as an insurance against the possibility that UK inflation rates experience further rises.

Property continued its recovery and benefited from increased investor confidence in the sector both from the UK and internationally. City of London offices performed particularly well with the largest increase in markets for 22 years. Residential property values, on the other hand, continued to fall.

The reported quarter brought to an end a year of unprecedented market and economic activity triggered by a plethora of mostly urgent initiatives from both governments and central banks in order to control and resuscitate their respective economies with the emphasis on growing their rates of GDP. This was especially prevalent within the industrialised nations of the Western Hemisphere, especially within the peripheral Eurozone countries together with the UK and the USA with their high trade deficits. These resuscitating actions included an amalgam of financial bail outs, quantitative easing programmes, bank rescue packages including nationalisations, and emergency economic stimulatory measures. For the year as a whole the market pendulum swung between fear and greed. The former was particularly prevalent in the first quarter of the year with worries of double dip recessions and the increasingly parlous economic state of the Eurozone peripheral nations.

There is no doubt that the above litany of gloom and doom acted as a severe depressant to equity market levels, particularly towards the end of the first quarter of 2010. However, very few investment strategists and commentators could possibly have foreseen the strong rate of equity recovery that was to come between March and the

end of the year. The cause of this recovery was the fact that, as time went by, it became increasingly apparent that the government and central bank measures outlined above were causing respective economies to “muddle thorough” despite quantitative easing programmes (printing money by any other name) which, in the past, have almost always been followed by rising inflation rates. Apart from the surprising resilience of economies, it also became apparent that corporate health was in much better shape than once forecast. Earnings were better than expected, balance sheet strength was greatly improved with lower levels of debt and, most importantly, dividends were appreciably better than expected. It also became evident to investors that fears of double dip recessions were receding. Another important market influence was that, within the Western Hemisphere, the maintenance of extremely low levels of interest rates were helpful both to consumers and corporations alike. So, for all the aforementioned reasons equity markets took heart as is clearly shown in the above return tables both for the year and quarter ended 31st December 2010.

With regard to the markets of the Eastern Hemisphere and Emerging Markets, their economies grew at an appreciably faster rate compared with their Western counterparts. Particular strength was shown by China, India, Australia and Brazil.

UK

Positive Influences

- On Christmas Eve the FTSE 100 Index broke through the 6,000 barrier at 6,009, a level it reached 2 ½ years ago. However, at the year end it reacted to 5,900.
- Private Equity demonstrated a strong revival and accounted for a record 75% of all UK mergers and acquisitions in the first nine months of 2010.
- The newly formed Office for Budget Responsibility estimates economic growth in the UK of 1.8% in 2010 followed by 2.1% in 2011.
- The purchasing managers’ index for December reached a 16 year high of 58.3 (November 57.5).

Negative Influences

- In the quarter to 31st October unemployment increased by a larger than expected 35,000 representing a rate of 7.9%, fractionally higher than the previous quarter’s rate of 7.8%.
- The Office for National Statistics reported that the Consumer Price Index (CPI) in November was 3.3% p.a. versus the Bank of England’s target of 2.0%. CPI has now exceeded its target for the past 49 months.
- The British Bankers’ Association reported mortgage approvals for October of 30,766, down from 31,058 in September. This compares with an average rate over the previous 6 months of 33,914.

USA

Positive Influences

- November durable goods orders rose by 2.4% recovering strongly from October’s fall of 1.9%.
- On 14th December the Federal Reserve Board left interest rates unchanged and stated that the Federal funding rate would remain at “exceptionally low levels” for an extended period.

- On 7th December President Obama transacted a fiscal deal with the opposition Republican Party in order to extend the Bush era tax cuts for two years. This could boost GDP in 2011.
- New claims for jobless benefit in November fell to a 2 year low of 407,000.
- The Institute of Supply Management's non manufacturing index advanced to 57.1 in December from 55.0 in November. This compared with estimates of 55.6. The Institute's index of factory activity rose to 57.0 in December (November 56.6) representing the seventeenth monthly rise.
- The private sector added 297,000 jobs in December up from 92,000 in November. This was the eleventh consecutive month of expansion. This result was appreciably higher than consensus economists' estimates of 100,000.
- Chicago's purchasing managers' index (a measure of manufacturing activity in the Mid West of America) increased markedly to 68.6 in December from November's 62.5.

Negative Influences

- Although October house prices rose by 0.7% they recorded a fall of 3.4% on an annualised basis.
- The unemployment rate in November rose to 9.8% from 9.6% in October.
- In mid December US Treasury stocks were hit by the biggest sell off for two years, directly attributable to soaring borrowing costs.
- October housing starts dropped by 11.7%.
- On 30th December, the US $ fell to a record low against the Swiss Franc of 0.9351 and a 28 year low against the Australian dollar of 1.1098.
- The Conference Board's index of consumer confidence decreased to 52.5 in December from 54.3 in November versus misjudged estimates of 57.0.

Europe

Positive Influences

- On 28th November the European Union arranged a €85B bail out for Ireland and agreed a formal mechanism for dealing with future debt crises in the Eurozone. This mechanism is specifically designed to head off further corrosive contagion. In that regard there is to be a new institution called the European Financial Stability Facility.
- The German economy has benefited considerably from the weakness of the euro.
- The German IFO November business survey hit a post unification high.
- Angela Merkel the German Chancellor was re-elected as leader of the ruling Christian Democratic Union.
- German industrial orders advanced strongly by 5.2% in November (October +1.6%).

Negative Influences

- Silvio Berlusconi's centre right coalition came under acute pressure and only just survived a vote of no confidence by 314 votes to 311.
- Financial contagion spread to Spain which is of distinct concern as it accounts for approximately 11.7% of the Eurozone's GDP.
- Eurostat stated that Eurozone inflation in December rose to 2.2% p.a. from 1.9% p.a. in November. This compares with the ECB's target of "close but below" 2.0% over the medium term.

- The Eurozone unemployment rate in November was unchanged at 10.0%. This masks a wide variation within the individual member countries e.g. Germany 6.7%, Ireland 13.9% and Spain a staggering 20.6%.

Japan

Positive Influences
- GDP increased in the third quarter of 2010 by 3.9%.
- The purchasing managers' index for December increased to 48.3 from 47.3 in November.

Negative Influences
- The Finance Ministry stated that November exports grew by 9.1% p.a. whilst imports advanced by a marked 14.2%. Thus, the all important trade balance deteriorated.

Asia/Pacific

Positive Influences
- On 25th December the People's Bank of China increased its lending rate to 5.81% in order to combat rising inflation.
- On 21st December China promised to take "concerted action" to support the Eurozone "if necessary" this includes purchasing Eurozone sovereign bonds.
- China's retail sales in October grew at a most robust 18.6% p.a.
- In the fourth quarter of 2010 China's foreign exchange reserves (the largest in the world) rose by a record £199B to $2,850B.
- India's GDP growth in the third quarter was a substantial 8.9% which was much higher than expected. It is therefore hardly surprising that the Reserve Bank of India intends to raise interest rates in order to cool economic growth. The government estimates that GDP growth for 2010 will be 8.5%.
- South Korea's industrial production in November increased by 1.4% compared to the 4.2% drop in October. Retail sales in November grew by 2.9% (October +0.2%).

Negative Influences
- China's CPI for November rose by 5.1% p.a. appreciably higher than the 4.4% p.a. increase in October. The government's target is 3.0%.
- China's purchasing managers' index for manufacturing slipped to 54.4 in December from 55.3 in November.
- New Zealand's third quarter rate of GDP decreased by 0.2% largely due to the strength of the New Zealand dollar and its negative effect on the nation's export growth.
- On 23rd November the inflammatory move by North Korea in shelling the South Korean island of Yeon Pygong reminded the whole region of North Korea's antagonistic regime with its nuclear capability.
- On 16th November South Korea increased interest rates by ¼% to 2.5% in order to better combat inflation which for October was up 4.1% p.a.
- On 2nd November the Reserve Bank of Australia raised rates by ¼% to 4 ¾%. This move caused the Australian dollar to temporarily reach parity with the US dollar.

- As widely expected, the Reserve Bank of India raised its interest rate by ¼% to 6 ¼%.

Principal influences of a general nature were as follows:-

- Most commodity prices boomed. On 7th December gold rose to a record $1,430.95 whilst silver rose to a 30 year high of $30. Copper achieved a record high of almost $9,447 a tonne in part due to the large demand from China. This represented a rise of 33% for 2010 which compared with an advance of 139% for 2009. Oil broke through a 26 month high of $90 with consumption levels the strongest for 30 years. Food commodities e.g. cereals also demonstrated substantial strength. It goes without saying that this unprecedented commodity strength was bad for the containment of inflation.
- The Organisation for Economic and Co-operative Development (OCED) forecast that the global GDP rate in 2011 would be 4.25% to be followed by 4.5% in 2012.
- Governments continued to be greatly influenced by wide spread trade protectionism as respective countries sort to benefit their vital export trade by manipulating their currencies.
- The pronounced build up of corporate balance sheet cash and lower debt levels caused increased merger and acquisition activity together with higher investment in research and development.
- Emerging Market economies were enhanced by a marked increase in the spending power of their growing middle classes.

Conclusion

As we start 2011 the background for capitalism both in the UK and globally appears to be distinctly more promising than that of a year ago. This more conducive background applies not just to equities, but to most other asset classes - private equity, property, infrastructure, hedge fund of funds, commodities, global tactical asset allocation and foreign exchange. The clear omission from this list is fixed interest. The reason for this is simply that the predominant allocation to this sector is usually in gilts, sovereign debt and index linked gilts. The yields on these sub sectors in such a low rate environment have been driven down to unprecedented low levels which makes them, with the exception of index linked bonds, look unattractive at this time, particularly as and when interest rates rise. Also sovereign risk is on going within the weaker economies of the Eurozone. However, with regard to the other sub sectors of Fixed Interest, corporate and secured bonds still seem moderately attractive with very few defaults likely. The sub sectors with more obvious attraction are high yield bonds, emerging market debt and absolute return bonds, provided they are sufficiently liquid. There is no doubt that future Fixed Interest strategies will need to be much more nimble and flexible than heretofore with gilts and sovereign debt constituting the minority part of a Fixed Interest portfolio from here on.

With regard to the other aforementioned sectors, private equity should continue to benefit from improved prospects for increased activity in IPOs and mergers and acquisitions which are both continuing to recover. Property also is recovering well with attractive valuations still available with a better environment in which to manage property assets. Infrastructure managers should continue to take advantage of an increasing flow of opportunities across the spectrum. Hedge fund of funds, after a generally poor 2010 relative performance, should be able to benefit from a likely increase in volatility with less correlation. Factors on which their returns are so

dependent. t is hoped that there will be a considerable improvement in their long/short and global macro activities which proved such a performance detraction last year. Although both hard and soft commodities boomed in 2010 especially in minerals, useful gains should still be possible in 2011. However, a nearer term pause for breath could easily occur. Both the GTAA and foreign exchange sectors should be able to produce worthwhile gains on the back of increased volatility in the currency market, caused by more central bank and corporate treasury hedging activities.

In sum, even after the strong showing of most asset classes last year, conditions exist which should translate into meaningful gains in 2011, especially for high quality equities with strong balance sheets and the ability to produce consistently rising earnings and dividends. However, it seems sensible to caution that the course of markets for 2011, though upwards, is unlikely to be smooth with many periods of volatile uncertainty. After a 9 month period of an unexpectedly strong equity run it would be all to easy to fall into the trap of unbridled optimism. As always, much will depend on the macro economic news flow from around the world which can be summarised with the following conditions:-

- In the UK, the coalition government must continue to hold firm as its belt tightening austerity measures impact consumers and corporations alike. The absorption of the VAT rise to 20% from 17 ½% will be important. So far the British propensity to take the necessary harsh medicine has been surprisingly good. But it needs to remain so, as severe austerity is destined to last at least three more years. It will also provide a test for the Trade Union/Government relationships, particularly in the area of unemployment. At their current valuations equities could surprise on the upside with appreciably stronger balance sheets than a year ago. A double dip recession seems most unlikely.
- In the USA, President Obama will need to show that he can live with the Republican Party majority in the House of Representatives and demonstrate an ability to compromise on essential issues. Corporate profitability is likely to remain strong and could translate into higher rates of GDP than market forecasters currently expect.
- In Europe, the joint efforts of the European Central Bank, Angela Merkel, the German Chancellor, and the International Monetary Fund should show that they can cope with the grossly indebted economies of Greece, Ireland, Portugal and Spain. Above all, it is imperative that the domino effect of leverage contagion can be contained and the future of the Euro assured. In the near future it seems probable that the Portuguese economy will have to be bailed out. Eurozone unemployment rates will likely remain of constant concern. Certain high quality equities are on surprisingly cheap valuations.
- In Japan, it is imperative that the Government can demonstrate that the policies of the past are undergoing a radical change in order to spur consumers and corporations to spend so that the nation can grow itself away from the systemic deflation in which it has been mired for so long. A weaker yen would be helpful to Japanese exports, particularly to the Asian region.
- In Asia/Pacific, rates of GDP growth should continue apace, although at marginally lower levels than in 2010. This applies to China, India, South Korea, Singapore, Australia and less so to Russia. In particular, the People’s Bank of China will need to continue with measures to cool down its very strong rate of economic growth and, at the same time, to be seen to revalue its currency the renminbi. China seems well capable of achieving this, but it will have to keep a close eye on inflation, particularly in respect of food for its massive population.

China has, without doubt, become the centre of global trading with its insatiable demand for minerals, cars and so many big ticket items. It seems certain that it will continue to flex its muscles on the international stage.

- Emerging markets will most likely continue to attract long term investors, particularly the BRIC group which has really already matured from its emerging chrysalis stage such is the rapidity of their development. The same could be said of South Korea and Taiwan. There seems no doubt that in the longer term the equities and economic growth of the emerging market countries will outperform those of the classic Western Hemisphere developed countries. However, an area of concern for many emerging nations is the rapid rise in their inflation rates.
- In general, it seems both likely and essential that the Bank of England, the ECB and the Federal Reserve Board continue to maintain their currently very low level of interest rates.
- The encouraging upturn in world trade is likely to continue with the International Monetary Fund forecasting global growth of 4.3% in 2011. There has been a sharp increase in shipping container transport which is usually a reliable barometer of trade activity.
- As always, inflation rates will have to be carefully monitored. In that regard pressure is likely to come from the accelerating rise in food and energy prices.

Finally, at the risk of being repetitive, it should be stressed that portfolios that embrace globalisation in all asset classes are most likely, in the long term, to be rewarded in peer group performance tables.

Valentine Furniss

Investment Update for the Month of January 2011

	Indices	**M.e 31.01.11**
		%
Equities		
Europe	FTSE Developed Europe (ex UK)	2.8
North America	FTSE North America	-0.2
UK	FTSE All Share	-0.5
Asia/Pacific	FTSE Developed Asia Pacific (ex Japan)	-2.1
Japan	FTSE Developed Japan	-2.2
Emerging Markets	MSCI Emerging Markets Free	-4.9
Fixed Interest		
Corporate Bonds	Merrill Lynch Sterling – Non Gilts All Stocks	-0.5
UK Gilts	FTSE British Government All Stocks	-1.9
UK ILGs	FTSE British Government IL Over 5 years	-2.6
Property	IPD	N/a
Cash	Merrill Lynch LIBOR 3 Month	0.1

Currency movements for month ended 31st January 2011

Currency	31st December 2010	31st January 2011	Change %
USD/GBP	1.566	1.602	+2.3
EUR/GBP	1.167	1.168	+0.1
USD/EUR	1.342	1.371	+2.2
YEN/USD	81.105	81.930	+1.0

In strict contrast to the heady equity returns of the quarter ended 31st December 2010, the returns for the month of January 2011 provided a dose of New Year realism with

many investors, both private and institutional, electing to take some worthwhile profits and to pause before making further market commitments. All returns with the exception of Europe were negative as is shown in the above table. Not surprisingly, the back marker on the leader board was Emerging Markets (-4.9%) which broke the extremely strong positive return for the year 2010, namely 22.9%. Apart from profit taking and fears of rising inflation, Emerging Markets also suffered as a result of the Middle East leadership successor crisis; although in reality the percentage that the countries in question bear to the total Emerging Markets capitalisation is extremely small. Japan malingered (-2.2%) as its stock market acknowledged that there was still no really clear evidence that the government was finally prepared to take the sufficiently radical steps necessary to address the country's woes and to place it on track for a meaningful and lasting economic recovery. Basically, Japan still has endemic problems with its stifling and outmoded culture. The Asia/Pacific markets (-2.1%) also suffered from profit taking, together with inflationary concerns, principally triggered by China. The UK was marginally lower (-0.5%) which should be seen as a reasonably resilient performance against a background in which the Coalition Government's austerity measures were beginning to bite. North America's performance (down a mere 0.2%) was also resilient in view of the country's ever increasing deficit. However, it benefited from generally encouraging macro economic data and also better than expected corporate earnings, especially from those companies experiencing strong demand from the Emerging Markets, particularly within the important car and heavy engineering industries. Another factor to influence North American returns was the perception that President Obama was making a much needed and better compromise with his political opponents. Of course, with the Democrats having lost their majority in Congress he really has no other choice. As mentioned, Europe was the star performer (+2.8%) as its markets reacted to the fact that, just possibly, the highly indebted peripheral countries of the Eurozone were slowly lifting themselves out of their grossly over leveraged mire.

As expected, returns from Fixed Interest as a whole were universally disappointing with UK Index Linked returning a negative 2.6%.

During January the factors and events of a general nature to affect the course of stock markets were as follows:-

- Air freight rose 20% in 2010 which reflected a healthy level of underlying world trade.
- IATA reported that airline passenger traffic grew by 8.2% in 2010.
- In the 2 months to mid January the price of steel rose by more than one third. For 2010 world steel output rose by 15%, the biggest annual increase for 50 years.
- On 19th January iron ore prices hit an all time high.
- On 19th January, Brazil's central bank increased interest rates by ½% to 11 ¼% in order to cool inflation. This runs the risk of attracting even more hot foreign money into the country.
- The ousting of Tunisia's Zein Al Abidine Ben Ali caused a wildfire contagion effect in the other dynastically ruled countries, namely Egypt, Libya, Syria and the Yemen. People power demonstrating in the streets came to the fore to challenge the long entrenched tyrannical dictatorships. One of the direct results of these confrontations was a steep rise in the price of oil, which on 31st January, broke through $100 per barrel for the first time since October 2008. Some of the rise can be attributed to disruption in shipping traffic through the Suez Canal. Another damaging effect was a pronounced fall in emerging market equities.

However, to put this in perspective, Egypt at the core of the current unrest, represents just 0.5% of the MSCI Emerging Markets index.

As a matter of possible interest, in addition to the leadership turmoil in Tunisia, the state of the other dynasties elsewhere in the Middle East is as follows:-

- In Egypt, President Hosni Mubarak has ruled for 30 years with the presumption that his reign will be followed by his son Gamal.
- In Syria, the dictatorship mantel was passed by President Hatel Al Assad to his son Bashar in 2000.
- In the Yemen. Ali Abdullah Saleh has been president since 1978 and it is generally assumed that he will be succeeded by his son, Ahmed Saleh.
- In Libya, Muammer Gaddafi has ruled since 1969 with a likely successor in his son Saif Al-Islam.

There is absolutely no doubt that the Middle East region will be beset by turmoil for quite some time to come. That is to say, until democracy is seen to replace high spending dictatorships and until poverty and living conditions and education can be demonstrably improved. The most worrying aspect is clearly the future politics of Egypt and its relationship both with Israel and of course the United States. Only time will tell and quite an amount of time at that.

During January the principal events and macro economic data within the regions were as below:-

United Kingdom

- With regard to job creation, for the 6 months to January both permanent and temporary placements accelerated.
- The January Purchasing Managers' Index level rose to 62 (December59), the highest level since records began.
- The National Institute for Economic and Social Research estimates GDP for 2011 of 1.5% advancing to 1.8% in 2012. This represents an increase in the Institute's previous estimates of 1.6% and 2.0% respectively.
- Dividends from companies listed on the Stock Exchange are estimated to rise by 11.5% in 2011.
- The consumer confidence index for January experienced its steepest drop since 1992. Not at all surprising in view of the Government's rigorous application of its austerity measures.
- Mervyn King at the Bank of England warned that inflation could rise to 5.0% this year.
- There are signs that action by the Trade Unions could become more concerted.
- Disappointingly, the Office for National Statistics reported that GDP fell 0.5% in the final quarter of 2010 versus a consensus estimate for a rise of 0.5%. This result was blamed on adverse weather conditions with the UK services traditionally unable to cope yet again.
- New home sales for November and December grew by a heartening 17.5%.
- December CPI was worryingly high at 3.7% p.a. up from November's 3.3% p.a. necessitating yet another explanatory letter from Mervyn King to the Chancellor of the Exchequer, George Osborne.

- On 14th January BP instigated a share swop with the Russian state oil producer Rosneft. The rationale being that the two companies could explore the opportunities in the Russian territories and in the Arctic Ocean. Since this announcement there have been some serious challenges to this joint initiative.

USA

- The Bureau of Labor estimates that in January the US economy only created 36,000 jobs against an expectation of 146,000 new jobs. This poor showing was partly due to the country's extreme snowfalls.
- The January unemployment rate was 9.0% down from 9.4% in December.
- Demand for capital equipment has been growing sharply.
- The United Parcel Corporation reported a 48% jump in profits. This is a most welcome rise as this company is considered to be a reliable barometer of economic growth.
- The Institute of Supply Management's index for January increased to 60.8 (December 58.5). This compared with estimates of 58 and represented the strongest reading since May 2004.
- The Chicago Purchasing Managers' index for January grew to 68.8 from 66.8 in December.
- GDP for the fourth quarter of 2010 grew by 3.2% p.a.
- In December new home sales retreated at a rate of 7.6% p.a.
- The Commerce Department reported that housing starts fell 4.3% in December which is equivalent to an annualised drop of 8.2%.
- On 26th January the Federal Reserve Board left interest rates unchanged.

Europe

- Ireland's central bank estimates GDP growth for 2011 at 1.0% down from its estimate of 2.3% only last October. The Government's official estimate for 2011 is 1.7%.
- In Ireland the Green party left the ruling coalition, thus causing the embattled prime minister, Brian Cowen to resign. He also resigned as leader of his party Fianna Fail.
- There has been a heavy demand for the debut bond issue of the Eurozone bailout fund. The demand has come from respective central banks and large private investors.
- German inflation in January was 2.0%.
- Germany's construction sector output fell steeply in December by 24.1%, largely due to severe weather conditions. This was the biggest drop for 20 years. In turn this affected the nation's industrial production which fell 1.5% in December (November -0.6%).
- Germany's IFO Institute's business climate index rose to 110.3 in January (December 109.8).
- Germany's ZEW index of investor confidence soared to 15.4 in December from 4.3 in November.
- The German government estimates economic growth of "about 2 ¼%" for 2011.
- Germany's rate of GDP grew by 3.6% in 2010 (2009 -4.7%) mainly due to a strong rebound in investment spending.
- Turkey's central bank cut interest rates by ¼% to an historic low level of 6 ¼% in order to "deter speculative inflows".

- Belgium's central bank reported that its business confidence index increased to 4.5 in December (November 3.1).
- The French statistical agency INSEE stated that the manufacturing sentiment index for December advanced to 108 from 102 in November.
- On 13th January Jean-Claude Trichet made one of his typically Delphic statements saying "we are never pre-committed not to move interest rates". Quite an unhelpful statement for markets to absorb. Trichet also hinted that, after the surge in December inflation to 2.2%, the ECB had never ruled out an increase in interest rates. He added that inflation could rise further in February.
- There continues to be much jockeying for position with regard to a successor to Trichet head of the ECB whose term expires at the end of October 2011.

Japan

- On 28th January the rating agency Standard & Poors downgraded Japan's long term credit rating, suggesting that Japan does not appear to have "a coherent strategy to adequately address its debt burden".
- Japan pledged to buy 20% of the Eurozone's first bond issue by the European government's stability facility.

Asia

- On 13th January the Bank of Korea lifted interest rates by ¼% to 2 ¾% representing the third rise since July 2010. The Bank of Korea estimates that inflation could rise from the current 2.9% to 3.5%.
- There has been a marked increase in renminbi deposits in Hong Kong.
- In the fourth quarter of 2010 Chinese GDP grew by a substantial 9.8% and for the year as a whole it advanced 10.3%.
- Chinese CPI for December decreased to 4.6% from 5.1% in November. This compares with the Government's target of 3.0%.
- It is interesting to note that China has lent more money to other developing countries over the past 2 years than to the World Bank.
- The People's Bank of China allowed the currency daily lending reference point to strengthen the renminbi to RM6.6.
- China's housing boom continues to give cause for concern lest it develop into a property bubble.
- China has continued with its attempt to improve both its international reputation and its influence. If this means giving a panda to Edinburgh Zoo so be it! China continues to fine tune the delicate balance between export reliance and domestic consumption.

Conclusion

After the lacklustre returns of both equities and fixed interest for the month of January, whither the markets for the remainder of the year? The realistic answer has inevitably to be qualified with a number of ifs and buts. Taking all things into consideration it does seem that the equity markets in particular will be successful in regaining their poise and producing positive returns for the year as a whole. But for this to happen investors both UK and global will need to see the following items come to pass:-

- That earnings and dividends should continue to surprise on the upside.
- That respective central banks can be successful in containing inflation, particularly in the UK and the Asia/Pacific region, especially China. In that regard, much will depend on reducing the price of food and energy.
- That when central banks raise interest rates, particularly in the UK and the USA, they will be at a level which will not damage recovery rates of GDP growth which for some countries are expected to be somewhat fragile.
- That the current turmoil in the Middle East over leadership succession will abate and that friction with relationships with Israel can be avoided. This latter item seems most unlikely to happen in the near future.
- That Emerging Markets will recover from their current down draught particularly China. And that these emerging countries with their superlative economic growth rates will continue to outperform the economies of the industrialised developed countries.
- That the peripheral countries of the Eurozone will be able to grow their way out of their acute economic and deficit problems. This will take time.
- And finally that, world trade levels can be maintained at a robust level.

In short, the events and macro economic data since the writing of the quarterly report to 31st December 2010 have not materially changed the forecasts contained therein. That is to say, portfolios are advised to maintain a position of full investment in order to take advantage of the higher investment valuations expected by the end of 2011. How high? Not nearly as high as those achieved in 2010 as a whole, but hopefully in the higher single digit area i.e. a cautiously optimistic expectation. The returns from equities, property and most alternative classes will most likely outperform the returns from Fixed Interest, especially gilt edged and other sovereign debt. Indeed many investors are nervous about the Fixed Interest sector. The nervousness seems well justified. Particularly with regard to the outlook for traditional gilt stocks in view of the likelihood that, later in the year, both interest rates (courtesy of Mervyn King) and inflation will rise. This would obviously be detrimental to Gilts. ndex Linked Gilts, however, should provide a modicum of protection, but not to the same extent as in 2010.The best of Corporate Bonds has probably been seen, but with regard to their superior yields they are still worth holding. There should continue to be further corporate bond issuance (attractively priced to go) as corporations find it less expensive to raise cash in that way rather than to have possibly disruptive rights issues. In conclusion, a Fixed Interest portfolio should embrace globalisation (currencies will need to be hedged as appropriate). Also it is an undeniable fact that there is a need for Fixed Interest portfolios to be much more actively managed than heretofore with the use of a wider range of products.

Valentine Furniss
13th February 2011