



CARTLIDGE MORLAND

INVESTMENT UPDATE

30 October 2008

During October, equity markets have remained extremely volatile with some incredible daily price movements. Fear of the length and depth of a global recession has been a major contributing factor to these extraordinary events. We expect volatility to continue as hedge funds continue to de-leverage, as investors seek to preserve capital and the prospects of further write-downs from the banks loom large. Governments and central banks are making concerted efforts to ease the extent and impact of the global slowdown through a combination of fiscal and monetary stimuli. A number of sovereign states, including Iceland, Hungary and the Ukraine have had to turn to the International Monetary Fund to support their economies. There are fears other sovereign states will default on their debts.

We may well be near or at the bottom of markets, but it really is too early to say, as it is impossible to predict how long it will take for the global concerted action outlined above to have the desired effect of improving liquidity in the money markets and stabilising equity markets. We expect market volatility to continue, but will not trade portfolios on volatility, as we believe that this would increase clients' risk as market timing is notoriously difficult. We seek to preserve capital and to combine that with capital growth and/or income on a sustained basis.

After a period of exceptional capital losses, and with the global economy on the brink of recession, we are having to redefine strategy and realign portfolios where necessary – to capture the returns that are there – even if there is no sustained rally in asset prices in the shorter term. From this point, we do expect financial assets to offer better returns than cash – not least because deposit rates seem set for substantial falls. Depressed asset prices, conversely, present an opportunity for exceptional yields.

Our investment team have been looking at income opportunities in the equity and fixed interest (bond) markets and comparing them to cash. Fixed interest investments are currently producing some attractive yields relative to cash, whilst offering the prospect of capital returns over the medium term. As interest rates fall as part of monetary policy

around the world, cash will become increasingly less attractive in terms of investment returns. We believe that stability will return to the credit markets as a precursor to equity market stability. Falling interest rates and the decreasing threat of inflation are immediately beneficial for bonds, whilst it may be some time before companies receive the benefit of lower borrowing costs and more readily available credit. Consumers will remain circumspect about spending, given all major economies are on the brink of recession and job losses are mounting. Demand for bonds is likely to increase and consequently capital values. Therefore it is prudent to act promptly to take advantage of yields at these levels.

We have devised a number of strategies to harness this income generation within new and existing portfolios, using both fixed interest funds and UK equity income funds. Whilst share prices remain volatile, many companies will continue to make profits and to maintain their dividends, even if their profits are lower, in a recessionary environment. For the time being, we wish to capture dividend yield, believing the capital return will follow – as bond yields eventually reduce when investors seek fresh sources of income. Given falling interest rates, we are seeking to reduce cash positions in favour of this income theme. As I have explained, our immediate imperative is to capture income yield but we believe sustained capital returns will follow, firstly in the bond market and secondly in equities, as volatility eases. We are of the view that equity markets are unlikely to rally on a sustained basis in the absence of stability in the credit markets.

Recapturing lost ground in our portfolios may be a drawn out process – but strategy will be key. Simply waiting for a dramatic and sustained recovery in equity markets on a value based argument will be too likely to disappoint, given recession. For this reason – and not least to ensure our clients achieve meaningful real returns – our focus is firmly on income. Capital returns will follow in the longer term.

If you have any concern with regard to the level of risk within your portfolio please contact your Cartlidge Morland consultant.

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