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INVESTMENT ADVISERS

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More complex investment arrangements demand stronger decision-making skill sets by trustees

Welcome to the fifth edition of AllenbridgeEPIC Perspectives which has been redesigned for the New Year. In this issue, we take the opportunity to rehearse some of the major pensions and investment themes for 2008. John Heskett, AllenbridgeEPIC Senior Adviser, provides commentary on the prospects for global economies and the out-look for the investment markets in general.

And in this editorial article I concentrate on governance issues, which are becoming ever more central to the pension scheme management process. Indeed, a recently published research study from Watson Wyatt and Oxford University, entitled "Best-practice Investment Management: Lessons for Asset Owners", argues that good governance is the most important issue in investment management.

With Government bond yields at rock-bottom levels, and a deteriorating outlook for global economic activity in 2008, there is likely to be a further growth in fund allocations towards alternative asset classes and styles. Russell Investment's Eighth Annual Survey of large global institutional investors reports that allocations to private equity are predicted to increase this year, with hedge funds and real estate remaining steady. All of these classes are increasingly regarded as mainstream, the study finds, whilst there are other asset classes coming up quickly - these include currency overlay, absolute return, portable alpha and infrastructure, with diversified growth, or dynamic asset allocation strategies and 130:30 long/short extension funds also gaining traction.

Which brings us back to the issue of scheme governance, as more complex investment arrangements demand stronger decision-making skill sets by trustees. One of several 'elephants in the room', is the difference between large, well-resourced schemes and smaller funds which do not consider that they have adequate resources for governance budgeting, and accordingly do not necessarily benefit from adopting leading edge investment thinking. This however is a fundamental misunderstanding. By investing modestly in additional expertise and skill to improve scheme governance, returns can demonstrably be raised - an improvement of only a few basis points in a fund's overall value will improve the fortunes of scheme members, disproportionately to any extra expenditure on additional expertise.

A step down the improved governance route, which many schemes have taken in recent years, is the introduction of a professional independent trustee. A common misconception however, is that trustees can safely turn to a professional trustee for expert investment advice. Some trustees will be well qualified to provide such advice but most will not.

It is important to draw a clear distinction between a professional trustee and an independent investment adviser; the latter from a best practice point of view should be regulated by the FSA and have professional indemnity insurance cover.

Another approach which is gaining ground, particularly amongst smaller schemes, is 'fiduciary management' or 'implemented consulting'. This is effectively a 'one-stop shop' approach and goes against the grain of the best practice principles espoused by the reviews authored by Paul Myners and Sir Derek Morris. These reviews both clearly promoted the separation of functions with the clear intention of eliminating conflicts of interest as far as practicable, as well as encouraging a 'best of breed' approach.

Proponents of the fiduciary management model argue that it allows modern investment practices to be introduced to any scheme, regardless of size, and that it is the best way of aligning the interests of all the stakeholders involved in a scheme's management. Trustee boards who elect for the one-stop solution however, would be well-advised to introduce a professional and independent investment oversight to ensure that the fiduciary manager is achieving the fund's set performance objectives.

Chris Edge
AEIA Chief Executive

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Leading US and Swiss investment banks - bailed out by Far and Middle Eastern funds - signals the transfer of financial muscle to the East

- Much higher than previously forecast losses are announced by the banking system, arising from subprime credit and continued house price falls in the US. Leading US and Swiss investment banks were bailed out by Far and middle Eastern funds, signalling the end of easy credit and a transfer of financial muscle and strength to the East. Losses are now estimated by the Fed at over $200 bn.
- Central banks moved to ease liquidity dislocation, as inter bank lending volumes declined
- Hedge funds avoided the sub-prime fall out and benefitted from increased volatility in markets
- UK housing has started to trend weaker, with potentially 5-10% price falls possible for 2008
- The oil price continues to be very strong, with $100 per barrel reached in early January
- The combination of rising energy and food prices, rising interest costs and weaker housing markets started to be reflected in lower consumer activity - both in the US and UK
- Sterling began to trend weaker, as UK economic forecasts deteriorate
- The chances of UK/US recession in 2008 has risen from 25% levels to c 50% levels, as the economic climate deteriorates
- Economic activity levels for 2008 are materially reduced - with recovery forecast now for 2009
- Equity markets initially coped with the new reality remarkably well, reflecting underlying belief in the ongoing strength of the global economy, provided by the emerging world. More recently, however, equities have suffered a significant reality check

Going forward, we see that

- 2008 is going to be a very difficult year for the UK economy. Lower interest rates will provide only modest relief, as the cost of credit rises. It will take some time for recession and stagflation risks to clear
- A 2008 slowdown is going to put the financial position of the UK government - overspent and over borrowed - under pressure
- Sterling is likely to continue to retreat, giving support to UK multi-national equities
- Buying opportunities will eventually emerge in the UK, as uncertainties on activity clear and confidence rebuilds. In the meantime, the FTSE 100 is un-likely to continue to outperform the more domestically orientated FTSE 250. UK commercial property should re-emerge as attractive as the year progresses
- Attractive opportunities are more likely to reveal themselves sooner in overseas markets. Global growth remains solid (see table overleaf) and growth in the US, after two years of sub par growth, should be accelerating back towards trend, as we move into 2009

By John Heskett
Senior Adviser AEIA

John is also Chairman of Heartwood Wealth Group, sits on a number of investment committees and is a pension scheme trustee.

john.heskett@allenbridgeepic.com

Markets have been completely preoccupied with the health of the banking system. Leading banks - Citibank, UBS, Merrills and Morgan Stanley - have raised capital, without undue difficulty, from overseas sources to offset losses. This relative ease of raising capital, plus strong bank balance sheets, plus inherent competition within the banking system, would imply that the provision of credit should not be too severely impacted for sensible banking propositions. The price of credit is quite another matter. Strains in the banking system reflect an OECD banking issue, with little impact in the developing/emerging world - which has been the driver of the current expansion.

The areas which will suffer in this environment will be those areas reliant on debt or debt creation - private equity, commercial and domestic property, retailers, consumer discretionary. The US and UK consumer stand out as the most over borrowed.

Forecast Growth rates (source Consensus Economics/Citigroup) - forecast recovery in OECD in 2009, & strong growth elsewhere

GDP%	2006	2007(e)	2008(e)	2009(e)
US	2.9	2.2	2.1	2.9
Eurozone	2.9	2.6	1.9	2.3
UK	2.8	3.1	1.9	2.3
Japan	2.4	1.8	1.9	1.8
Asia ex Japan	8.4	8.5	8.7	8.3
China	11.1	11.4	11.0	10.0
Latin America	5.3	5.0	4.5	3.8
Eastern Europe	6.8	6.7	6.0	5.9
World	4.0	3.7	3.2	3.7

In the US, the impact of the above - coupled with a huge excess of housing inventory to move - has been to cause the economy to stall towards the end of 2007, after performing better than expected in terms of exports (the trade deficit has stabilised), job creation and income growth. The US is further through the pain experience than the UK, but 2008 economic growth has been marked down from 3% levels earlier in the year to 2.1% now. For now this has had limited impact on US equities, on the hopes that interest rates will decline materially in 2008, but equities will remain very recession focused.

In the UK, the recessionary risks are possibly higher. UK house prices are more divorced from incomes than in the US and are more vulnerable to a repricing of credit. Price falls will hold the consumer back, as these are digested. The UK is more exposed to the financial sector and a fall-out in the City than elsewhere. Pain on the consumer side coincides with government finances looking shaky in 2008/9.

The UK government faces a very tough pay round with a public sector fed up with 2% wage awards. The government's borrowing profile is poor - circa 3% of gdp - and consequently, there is little scope for fiscal relief. With UK RPI running at 4%+ levels, due to rising commodity/food prices and higher taxes, there is only so much scope to cut interest rates, until the wage round is over.

This gloomy backcloth has taken its toll on UK domestic equities - as reflected in the FTSE 250, banks, retailers, housebuilders etc. The market is cautious about the outlook for the UK per se, but this has not spilled over - as yet - into stocks benefitting from long term global/emerging market growth.

Equities continue to remain cheap relative to conventional bonds (by reference to the bond/equity earnings yield) and to index linked (by reference to the dividend/index linked yield gap). Long dated conventional bonds have attractions to pension fund trustees, seeking to immunise liabilities, and for those investors who need the certainty of income more than they need to protect themselves from inflation; otherwise conventional bonds have little value or appeal.

UK credit spreads have widened with the key 'A' spread widening to 135 bp from 75 bp half way through the year. This compares with spreads of over 200 bp in 2000, at the time of the last slowdown - so there is no cause for alarm yet. Credit risk is becoming more realistically priced but in the current economic context, there may be more adjustment to come. It is too early to be adding to credit.

UK commercial property continues to suffer, as activity dried up. Investors have become increasingly concerned about valuations, the ability to redeem unit trusts and the possibility of distressed selling. The preoccupations centre around a) rental profile in the predominant retail area, due for a difficult year, b) space release by the banking community as it retrenches and c) the impact of new space coming on stream, particularly City orientated. The price of quoted REITs have moved significantly downwards to reflect these concerns and have taken the strain of being the only asset which can be realised quickly. However, support here was beginning to gather by year end, with a number of commentators naming REITs as assets of choice for 2008.

Emerging markets/Asian equities remain well supported, notwithstanding the negative impact of a US slowdown spilling over into 2008. The economic news from BRIC remains constructive and China is now seen as much of a stimulant to Asian growth as the US - a big change from 15 years ago. Emerging markets are in some cases no longer cheap (see table below), and we have to remain alert to the two main dangers - political instability (rising in Pakistan, South Africa, Kenya, Venezuela but low - for the time being - elsewhere) and rising inflation. There is no threat to the asset class from rising US interest rates and investors should continue to add.

Elsewhere, Japanese equities are seen as cheap but probably going nowhere, principally because local investors do not want to buy. The macro picture looks dull and there is a fear of a US impact on profits.The sap of European confidence is reducing, as the Euro rises, business confidence erodes and the consumer remains cautious. However, Europe, like emerging markets, is a group of disparate economies, within which there are interesting investment opportunities. The outlook for the Eurozone looks reasonably solid.

Emerging markets – stable prospects (source HSBC/Citigroup)

	2008 EPS Growth %	2008 PER	2008 inflation %	2008 current balance % GDP
Mexico	18.5	13.0	4.1	-1.3
Brazil	10.0	11.5	3.8	0.0
Korea	16.0	12.0	3.0	0.7
Taiwan	16.5	12.2	2.5	6.2
India	20.0	21.0	4.3	-1.1
China	22.0	19.5	5.0	11.1
Russia	8.0	11.5	11.4	5.7

In each issue of Perspectives we give a list of ten questions trustees should explore with their investment managers. Here is our updated list:

1. How much should we rebalance away from UK equities to overseas equities - in the overseas segment, how much should we focus on Asia and Emerging Markets?

2. What do we do about currency overlay now that sterling has weakened?

3. Commodities/energy/ resources infrastructure - should we get involved?

How and when?

4. Hedge funds - what is the right exposure, given the turbulence in the traditional asset classes?

5. Commercial property - do we add now or continue to wait? Do we diversify into overseas property markets?

6. Private equity - as credit spreads widen to what extent is the party over?

7. What do we sell if we want to add to equity risk – reduce cash weightings, or sell property or bonds?

8. Is the time yet right to consider high yield bonds?

9. 130 : 30 'extension' portfolios – to what extent should these form part of a pension fund asset allocation?

10. Should we be considering so-called 'liability-driven investment' approaches ('LDI')?

With public sector expenditure dead in the water, the UK private sector will have to carry the load. Will it be able to do so?

By John Heskett
Senior Adviser AEIA

2008 is a year of political transition in the US, which, after the disastrous Bush second term, is likely to portend political renewal, coinciding with an economy coming out of a prolonged slow patch. A potentially powerful cocktail for investors.

In the UK, 2008 is seen as a year of economic transition, as banks regroup, normal lending patterns are restored and the housing market settles down at lower levels. It is also likely to be a year of increasing disenchantment with the current administration, as it becomes evident that it has shot its bolt and the stream of its policies is running into the sand. In the UK the government has no option but to remain neutral - no more can it be the driver of spending growth and job creation - and is unable to act in a positive economic way. If we are to believe the pundits, we are expected to see very modest economic growth and markets modestly higher, as the threats of recession and stagflation recede.

It follows that there are a large number of uncertainties attached to this muddy UK outlook. With the public sector dead in the water, the UK private sector will have to carry the load. Will it be able to do so? The markets are factoring further interest rate reductions over and above what we have seen already - both here and in the US. Sterling could well continue to weaken, if the economy and the Brown administration continue to limp along - but currencies are notoriously difficult to predict; inflation should not be a problem, unless wage push makes it a problem.

The first question for 2008 is how much more do pension portfolios diversify away from the UK in the pursuit of a better risk/reward ratio.

Will the US market - a serial under-performer - ever come back into the equation? Will the value in Japanese equities ever be recognised and what will be the catalyst? Equity exposure/diversification depends, as ever, on risk appetite and how compelling values are, as a compensation for potential volatility. It also depends on how imaginative trustees/investors are in accessing markets in an optimal way - through manager selection, long/short equity funds or well established global funds.

The question of property will have to be addressed. The introduction of REITs at the close of 2006 has been followed by very substantial falls. Do REITs now represent value?

Experts suggest that values on the IPD index as at the end September should fall by 10% to restore fair value, represented by a 2% risk premium over gilts. REITs have fallen by more than this already - so on a value basis for a long term investor, they deserve consideration. How portfolios should invest in overseas properties should take up more of the agenda.

It will be a year of transition for private equity. Bank finance is already being rationed and, when it is available, will be on more expensive terms. This is going to impact on internal rates of return, already impacted by a less expansive economic backcloth, and consequently on deal flow.

The Private Equity industry will have to be professional enough, selective enough and patient enough to live through more difficult times - and this might be difficult for some.

Commodities will continue to be an interesting area, while the emerging world prospers.

Since the last 2001-3 bear market, potential investment opportunities have proliferated - portfolios have much greater choice in terms of asset classes which can be bought and in the style of the investment manager(s) selected to give the optimal risk reward. The current slowdown should be an opportunity to spend time researching the future investment thrust. It may well be that we have seen the best of the UK in a relative sense for some time and we should seriously consider why portfolios should be so UK dependent. As 2008 progresses and the stagflation/recessionary concerns disperse, we need to be clear in which direction portfolios should be headed before considering the next moves.

Contact AEIA

London Office
17 Hill Street
Mayfair
London
W1J 5NZ
Tel: 020 7409 1111

Glasgow Office
180 Hope Street
Glasgow
G2 2UE
Tel: 0141 564 1638

Lancaster Office
PO Box 785
Lancaster
LA1 9DB
Tel: 01524 389326

E-mail
info@allenbridgeepic.com

Web
www.allenbridgeepic.com

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