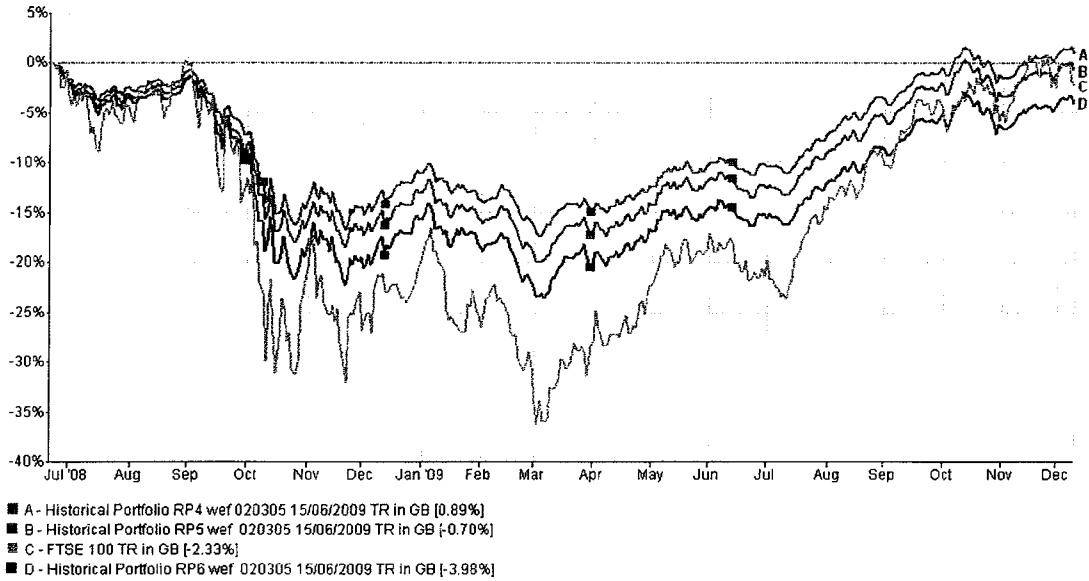


## Review of Markets - December 2009

I have pleasure in providing a further 6 month's update and I am pleased to report a less volatile period and a period where gains have been made across all risk profiles.

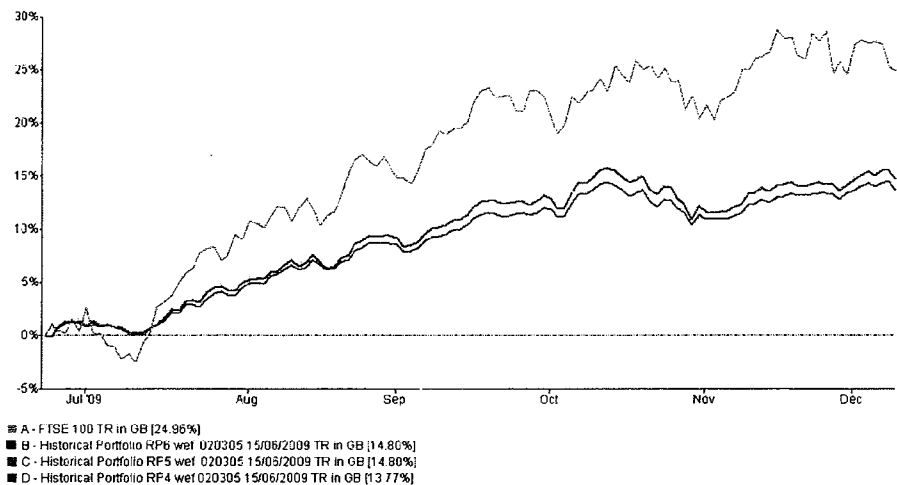
In order to give you some continuity, the graph below uses the same start date as in the previous report. This shows the lows of the FTSE100 and the subsequent



23/06/2008 - 09/12/2009 © Data provided by Financial Express 2009

bounce back to the current levels. It also highlights how risk profiling works and as clients, you do not have to endure the volatilities experienced in one asset class. By combining different asset classes a much smoother investment experience can be achieved.

Taking the above data but reproducing the graph over the last six months, it can be seen that the portfolios risk rated 5 and 6 have returned the same 14.8% and portfolio risk rated 4 has returned slightly less – 13.8%.

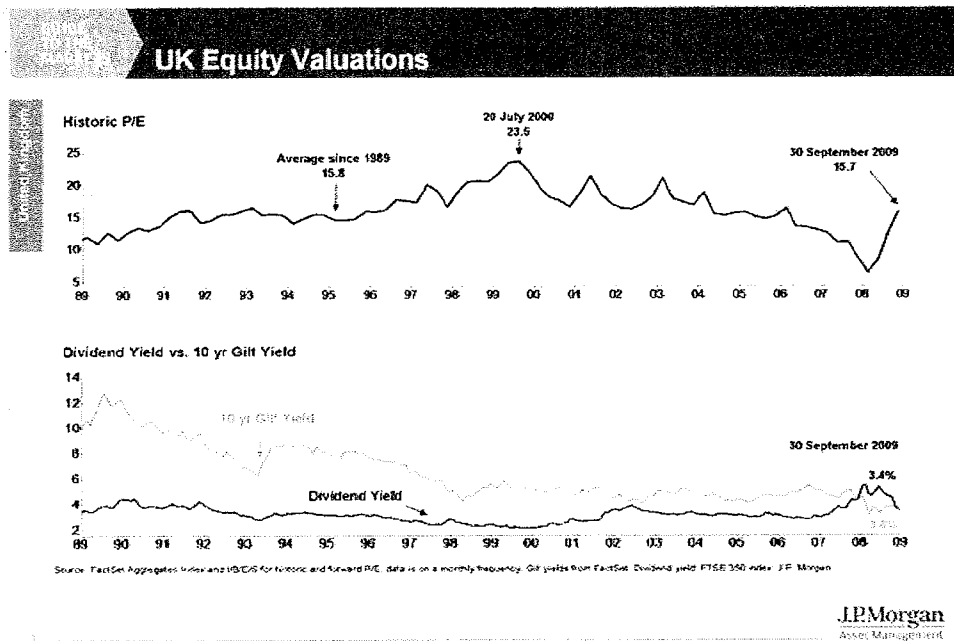


23/06/2009 - 09/12/2009 © Data provided by Financial Express 2009

## Where are we now - Is the Market Cheap?

In our last report we included comments from strategist Max King who said the bear market was over. It seems he was correct as markets globally have rebounded strongly.

Looking at the slide below, it can be seen that the equity market is no longer cheap if we look at **Historic Price / Earnings (PE)** figures. In fact company earnings are at the average point.



Usually, earnings growth is quite high coming out of recession. There is more chance of selling 2 or 3 Mars bars when the economy is growing than when it is going into or is in recession.

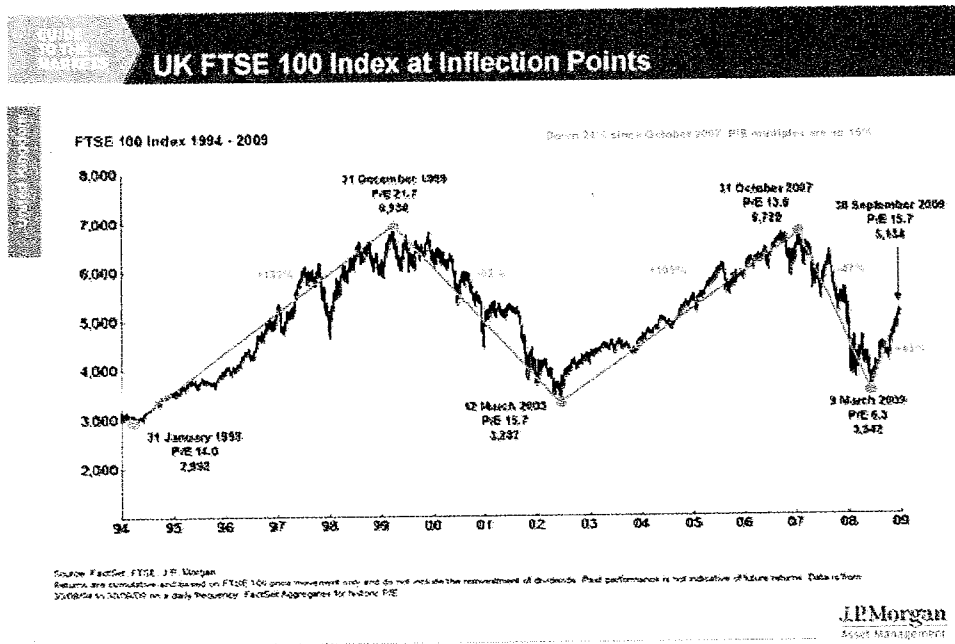
I think the second chart above – **Dividend Yield vs 10 Yr Gilt Yield** is more interesting and provides a more compelling reason to suggest buying equities now is a reasonable thing to do. From the chart, it can be seen that the dividend yield of 3.4% is almost the same as the 10 year gilt yield of 3.6%. This is not common. In other words the market is not pricing in any capital growth for equities. This is non sensible. With gilts, we know there is no chance of any capital growth or any protection against inflation. In summary, we can say that shares are significantly under priced on a yield basis.

Corporate earnings are going to improve as sales improve. Consumer confidence has rebounded sharply from the lows over the past 12 months. This means we are going to spend more in shops and in fact retail sales have already shown an increase year on year. Retail sales are important as they make up 70% of the UK economy, 70% in Germany and I believe 72% in the USA. That is good for all western economies.

When we add cost cutting as a result of the recession adding to the profit margins of companies then we can say that this will result in earnings growth. Unemployment is cost cutting. When we see companies reporting increased sales and they have undertaken significant cost cutting then clearly, this adds to improved profit margins. That is why we often see, coming out of recession, strong upwards revisions of earnings from companies. Unemployment then starts to fall, profit margins tighten etc. etc. and off we go again – another cycle. Perhaps nothing changes?

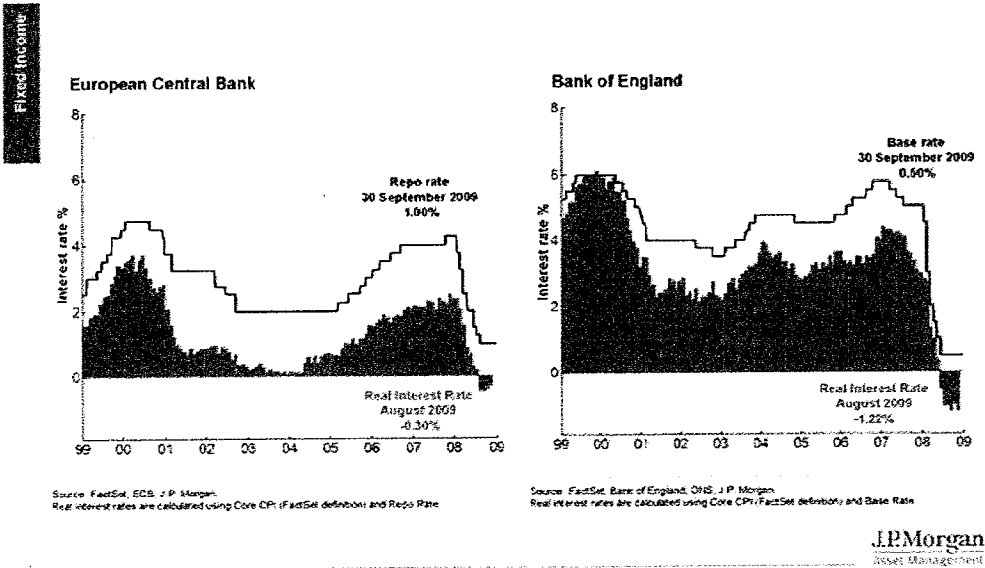
### Chart – Inflection Point

Same chart, updated from previous report shows how the markets bottomed in March and started to rebound.



## Interest Rates and Inflation

### ECB and Bank of England Policy and Real Rates

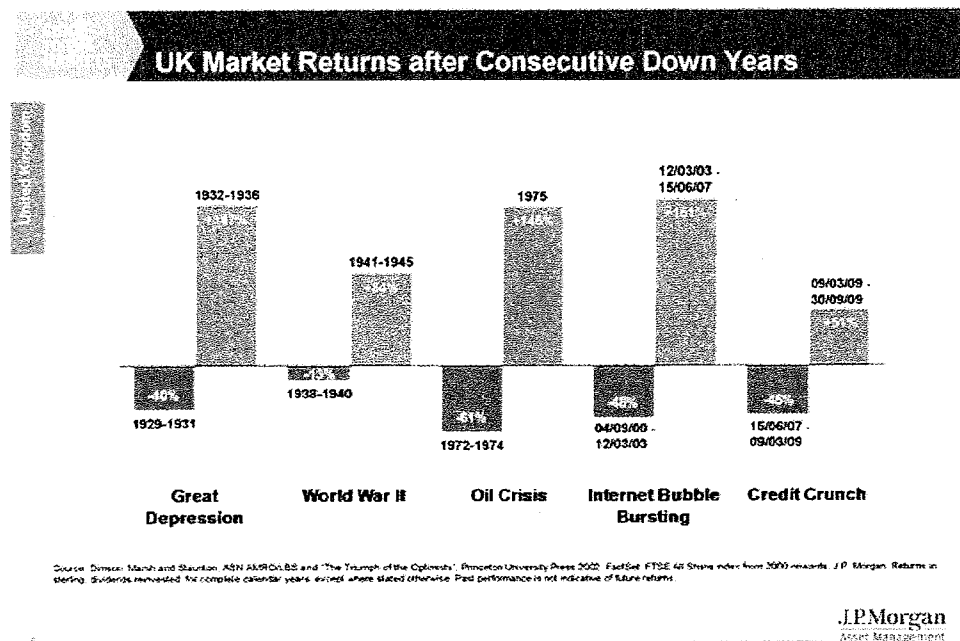


We actually have negative real interest rates at present. This means interest rates are below inflation. This is a period of “super loose” monetary policy at present.

Banks are still not lending money, instead they are putting this into the financial markets which is aiding the liquidity story. They are rebuilding their battered balance sheets and seemingly do not want to lend to business – apparently too risky for them. This situation is not likely to change in the near term. It’s hard to see the Bank of England getting back to normal rates of about 3% in the next 18 months. The lack of lending to business, particularly smaller companies will continue to hamper economic recovery which in turn suggests a cap on inflation for the time being.

## UK Market Returns after Consecutive Down Years

- A favourite slide, which has been shown to many clients over the past year or so.



This has now been updated and I wonder how many of us thought we would see such a rebound from the lows which turned out to be March 2009. The doom and gloom in that month was substantial and real.

A major point to make to all investors is that whatever happens, investors need to stay strong, have faith and let the economic cycles and stockmarket cycles take care of themselves. Just to illustrate this :-

### Using the chart above :- Portfolio worth £100,000

Suppose you had encashed in March 2009 and lost 45% - Value £55,000

Interest - 204 days at say 3% - Value £ 922

**Total now - Value £55,922**

Done nothing: Portfolio of £55,000 increased by 51% - **Value £83,050**

These are stark figures and use only equities to make the comparison. In reality, most investors do have a diversified portfolio and have not suffered the falls suggested above. *Even so, the message is a strong one - Try not to panic, stay put and things will only get better.* Easier to believe after the event than during it I know.

## Market Volatility

<b>Index Value:</b>	<b>22.66</b>
<b>Trade Time:</b>	<b>Dec 9</b>
<b>Change:</b>	<b>0.00 (0.00%)</b>
<b>Previous Close:</b>	<b>22.66</b>
<b>Open:</b>	<b>23.21</b>
<b>Day's Range:</b>	<b>22.54 - 24.20</b>
<b>52wk Range:</b>	<b>20.05 - 58.91</b>

In December 2008, this index had reached 89.53 and on the 11<sup>th</sup> December 2008 it had fallen back to 54.95. In the last report (June 2009) the figure had fallen to 30.58.

The index at the time of writing was down to 22.66.

Most commentators look for volatility to be in the lower 20s when buying the market.

Further support to the notion that markets are improving.

### Corporate Bonds Sector

**We hold two corporate bond funds within our portfolios and for a change, I am including the comments from the respective Fund Managers which may be of interest :-**

#### **Comments from Invesco Perpetual (Fund Managers Paul Causer and Paul Read) – November 2009**

In terms of strategy, we continue to prefer corporate over government bonds, as we believe there are risks to medium-term government bond returns given the sharp increase in supply. Nonetheless, recent volatility continues to present opportunities in government bond markets. Overall the fund's duration position (a measure of its sensitivity to changes in interest rates) remains at relatively low levels, although we have increased this over recent months through the purchase of long Gilt and Treasury futures. The modified duration of the portfolio was 6.6 years at the end of October. Despite corporate bonds having rallied considerably over recent months, we continue to see value in higher yielding investment-grade names and better quality high-yield issuers. In particular, we see value in insurance and financial names where both yields and spreads remain attractive.

## Comments from - M&G (Fund Manager Richard Woolnough) November 2009

October saw significant swings in the corporate bond markets. The first part of the month was led higher by broadly better-than-expected economic data from the US and Europe and positive third-quarter corporate results. In this environment, both government and corporate bonds performed well with gilt yields falling and corporate bonds spreads continuing to tighten. However, the release of the UK GDP figures for the third quarter, which came out lower than expected, rattled the markets in the latter part of the month. Contrary to the consensus estimates for modest growth, the British economy shrank by 0.4% quarter-on-quarter - the sixth consecutive quarter of contraction. As a result, gilt yields fell immediately after the release but this was not enough to offset earlier losses, with government bonds declining by 0.2% over the month. The budding rally in corporate credit lost momentum as well, with the asset class finishing the month up by just 0.9%. Fund manager Richard Woolnough has been taking advantage of good valuations offered by new financial issues to build up the fund's exposure to this asset class. He believes that the issuance of bank bonds will continue to be strong for the foreseeable future even as the supply of new industrial bonds is likely to taper off once companies have secured the capital they require. In this vein, the changes to the fund's composition over the past six months have been dramatic. For example, in May, only 15% of the fund was invested in financial bonds. Currently, the fund's exposure to financials is 30%. This shows how his bullish view on credit has evolved as he now considers the prices of bank bonds to be sufficiently low to warrant investment. While the supply of corporate bonds will weaken at some point when companies have completed their refinancing, demand from pension funds for these assets has not gone away. In an environment of restricted supply, this is good news for corporate bonds. Richard continues to believe that best value within investment grade bonds is to be found in A and BBB rated issues. In Richard's view, the housing market is close to bottom right now. He believes that the residential property market will be the first to turn as monetary policy tends to help that market more than commercial property, which has more hurdles and problems to overcome. Richard maintains a bearish view on government bond prices and he expects yields to come under pressure from a flood of new supply. Thus, he kept shortening the fund's duration over the month partially through the use of derivatives. At the start of November, the fund's average maturity was 5.6 years, down from 5.8 years in October.

### Property

The demand for good quality assets continues with a degree of optimism permeating the market with a number of funds and property companies having successfully raised funds. Much of the recent market activity has come from overseas investors and that continues to be the case with many seeing this as a rare opportunity to buy UK real estate at reasonably low prices. There is a definite lack of good quality stock available and where there are opportunities the competition has increased dramatically over the last few months, hence the increase in capital values. There are still concerns amongst a lot of investors over tenant covenant strength and therefore there will be a continued focus on the best tenants, locations and long lease terms given the real risk of tenant default and falling rental values.

The continued shortage of bank lending still limits investors seeking to enter the market and means deals over £50 million are very difficult to put together except where the buyer is perhaps a well capitalised fund or has established finance available. Demand remains weak for secondary assets and therefore capital values will remain under pressure.

### **Commodities – Comments from Ian Henderson, Manager of JPM Natural Resources Fund**

I often get asked if there is any sparkle left in the current natural resources run. And despite current uncertainty in markets I always answer with a bullish long-term outlook for the sector. Because my conviction is rooted in a simple fact – supply and demand. It seems there is no end in sight to the precipitous hunger of the rampant Chinese, Indian and other emerging economies have for commodities. China, for example, is the largest consumer of every commodity except oil, devouring 20-30% of the global demand for base metals today – which is likely to double by 2010. All of this is to meet rapid urbanization and the needs of the mushrooming middle class: the stainless steel for their new kitchens, the lead in the paint for their walls, the fuel for their cars and power stations – it's all based on strong, tangible demand, not hype. One of the main beneficiaries of this expansion is coking coal.

Essential to the steel and iron making process (imagine the amount of steel needed to build a country) its price has steadily climbed as demand creeps upwards. The spot Uranium price surged to \$125 at the end of May 2007, before slipping to \$78 at the end of January 2008. Much of the recent sell off has been overdone, as many of the companies that produce it are not greatly affected by any sub-prime or credit crunch woes. But there are currently 442 nuclear reactors in the world needing 180 million pounds of uranium each year – in 2005 only 110 million pounds were produced. This shortfall was compounded by floods and heavy rain affecting production. Now, with the global push for less CO2 emissions, 28 new nuclear reactors being built and 34 planned, you can see why uranium still has a lot of upside potential. Precious metals growth is driven by strong fundamentals, too. Demand for platinum rises as diesel engines become more popular around the world due to its use in catalytic converters. And despite gold's steady climb over the past couple of years, once you strip out inflation it's far below its historic highs. Central banks could increase their holdings and a traditional flight to gold may ensue over concerns of a US recession. Even with 23 new mines being built, that still isn't enough to offset recent declines in production.

Oil has also bubbled upwards recently but OECD crude oil stocks are trading well below their five year average and again, when you strip out inflation, the oil price is also far below its peak. With no sign of demand cooling, particularly from emerging markets, the outlook remains robust. This is why I am so positive about natural resources. Because what drives the sector are massive supply and demand disparities. And irrespective of uncertainty in the markets, the needs of the masses – especially in emerging economies – are not likely to drop off in the medium to long term. Of course, it's always worth mentioning the diversification benefits of commodities, too, and why it's always worth having some exposure to balance a portfolio – especially now.

The causes of stock market fluctuations are often different from what makes commodity prices rise and fall – so it's a good idea to maintain some alternative holding to potentially minimize market risk.

**In summary,**

I am pleased to report significant gains across all risk profiles over the past six months.

Whilst economies may struggle for some time to come the threat of an increase in inflation also appears to be small. Companies, having undertaken significant cost cutting measures, are reporting increased sales. This will continue and profit margins should expand to give increased earnings. Whilst we are currently at "market average" historic Price Earnings ratios, improved company earnings will make the market cheaper and supportive of equities. Other asset classes can contribute to an overall improvement in investor sentiment with the possible exception of commercial property which is expected to remain a subdued asset class for a while yet.

Please remember our website [www.admiral-online.co.uk](http://www.admiral-online.co.uk) where you will find our asset allocations, fund selections, risk profiler etc. I would ask that you simply make sure that the risk profile you have is the right one for your nature. If you are at all unsure, please contact us and we will be more than happy to help you re establish this and guide you through, what if anything needs to be done.

**Peter Waller**  
**Investment Director**