



Butterfield

Third Quarter 2009

*Investment Review*

# Butterfield Bank (Guernsey) Limited Third Quarter 2009 Investment Review

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## SUMMARY OF MARKETS AND OUTLOOK

### GLOBAL EQUITIES

During the third quarter of 2009 equity markets have continued the upward move which began in early March, with the Morgan Stanley Capital International (MSCI) World Index gaining a further 16.9% in US Dollar terms. This brings the rally from the March low to an impressive 63.7%, albeit this still leaves global equities 33% below their high point, reached in October 2007.

The key question currently facing all investors is obviously how long this rally can be maintained? In order to consider this question, it is worth briefly recapping on recent history.

**Where have we come from?** First, we faced the financial crisis, and the last quarter included the anniversary of arguably the most critical individual event, the collapse of Lehman Brothers. Commentators remain divided on whether it was appropriate to let Lehman go. However, without the chaos that ensued it is hard to imagine world Governments and Central Banks justifying the unprecedented course which they subsequently charted. It is worth remembering that, even amidst the darkest of days following the Lehman collapse, it took the US House of Representatives two attempts to set the Troubled Asset Relief Program (TARP) on its way.

Then came the economic crisis, and concerns that the world economy was set to fall into a prolonged period of depression, akin to the 1930's. Here too the action of world policymakers was exceptional, and consensus would suggest that the most extreme of negative outcomes have been averted. A significant proportion of the recent rally in equity prices can therefore be simply put down to the reversal of a previous overly pessimistic economic outlook.

**Where are we now?** Although the financial crisis has passed, many of its ramifications, such as potential over regulation and tax increases, are yet to be felt. The economic environment has also improved from the darkest days, with the last quarter dominated by talk of "green shoots" of recovery. However, it is important not to confuse slower rates of decline with actual improvement. In general, unemployment is still rising, wages growth is declining, there is enormous spare capacity in the global economy, credit growth is weak or negative, and governments have backed themselves into a very extended period of belt tightening. Nevertheless, things are generally not deteriorating as quickly as they were previously. There has also been one critical area where real improvement has been seen, namely corporate profitability. This has been seized upon by investors frustrated by the exceptional low nominal returns on cash and fixed interest investments. Unfortunately, when you look beyond the headline numbers and listen to what companies are saying, especially those closely tied into the consumer, you do not get a sense that the demand picture has materially improved. Rather, companies have been exceptionally aggressive in their response to the downturn. Whilst very positive in the near term, this does not naturally point to a sustainable recovery, for which there would need to be an ongoing improvement in end demand.

On balance, falling government spending and consumers reducing debt through higher savings represent significant obstacles to a rapid recovery. At best we would say that the recovery in growth will be more subdued than has historically been the case, and that risks are still weighed towards the downside.

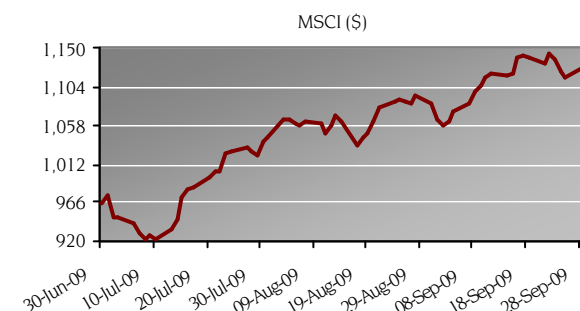
In short, equity markets have temporarily dislocated from economic reality.

**Where do we go from here?** There are obviously two ways of dealing with this dislocation. Equity markets could retreat back to reflect a more sanguine economic recovery. Alternatively, vast amounts of stimulus could gain traction and cause a surprisingly sharp rise in economic activity. This could then be left to run for longer than would otherwise be the case by developed world policymakers who, amidst massive levels of debt, are far more scared of deflation than they are of inflation. Whilst excess capacity is high, it is rarely possible for this to be transferred between segments of the economy, so it is hard to imagine that the aggressive intervention of the last eighteen months will not result in at least pockets of significant recovery, or indeed excess.

Looking far into the future, there is global vested interest in addressing the imbalances which have developed amidst the rapid expansion of globalisation. The developed world will have to settle into more appropriate patterns of saving, whilst the emerging world, not least of all China, will need to foster a much higher level of domestic consumption at the expense of saving. This is a simple statement, but is unfathomably complex in terms of execution, both at a domestic and international level. Essentially, it is anything but a quick fix.

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## SUMMARY OF MARKETS AND OUTLOOK

More likely, the world is set for an extended period of relatively moderate growth, as imbalances are gradually unwound. Intuitively, this paints a negative picture for equity markets, but opportunities will undoubtedly still exist. In particular, companies who are able to grow profits in such an environment would become increasingly attractive, and potentially re-rate significantly. Companies with convincing multi-year restructuring programs and a credible ability to execute could also benefit.

Looking at the more immediate future, we reiterate that the market is ahead of reality, but a significant proportion of investors have clearly not participated. High levels of available cash and the feeling of “missing out”, combined with negligible levels of return from low risk assets, are likely to encourage many investors to accept diminishing premiums for risk assets. It is impossible to say how long this will last, but experience tells us that market psychology tends to drive prices well beyond levels that can be supported by fundamentals.

Over the last twelve months, we have remained mildly conservative in terms of asset allocation, but this has been offset by a strong contribution from the fundamental themes which we have incorporated within portfolios. Both our near and long term outlook presents significant potential risks, which we feel justify an ongoing level of prudence. However, our outlook also suggests that it should continue to be possible for portfolios to benefit from variations within and between markets. As one prominent CEO said at a recent investor presentation “If you manage based on averages, you may as well not manage at all”.

## SUMMARY OF MARKETS AND OUTLOOK

### GLOBAL FIXED INTEREST

The quarter under review has been positive for bond markets, with yields moving lower across the entire yield curve. Despite improving confidence in the economy and a strong rally in risk assets, bond investors remain comfortable that the current low interest rate environment will prevail for a period of time yet.

Recent trends in financial markets have been interesting, with bonds and equities both outperforming the returns available from cash deposits. In the near-term, an improvement in investor sentiment can justify money flowing from risk free assets into both bonds and equities in search of return. However, bond market valuations are pointing towards a period of near-term deflation, followed by a glacial recovery in the economy, with an extended period of sub-par growth combined with low inflation. Arguably, equities are pointing to a far more positive economic outlook.

From an economic standpoint, we believe that bond markets are somewhat closer to predicting the future path of the economy. A number of leading indicators are suggesting that the economy has turned, which we would not dispute. Whether the fragile recovery is sustainable, or just the result of an inventory re-build after the de-stocking at the turn of the year, is yet to be determined.

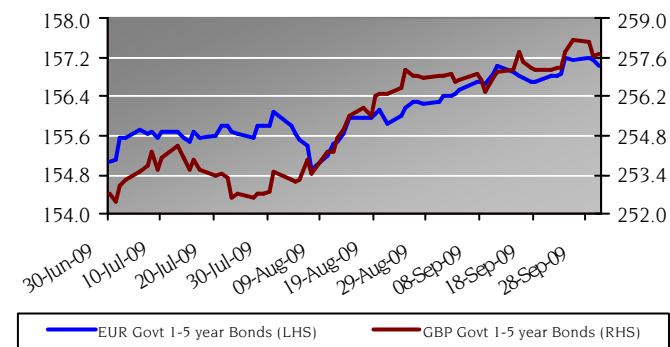
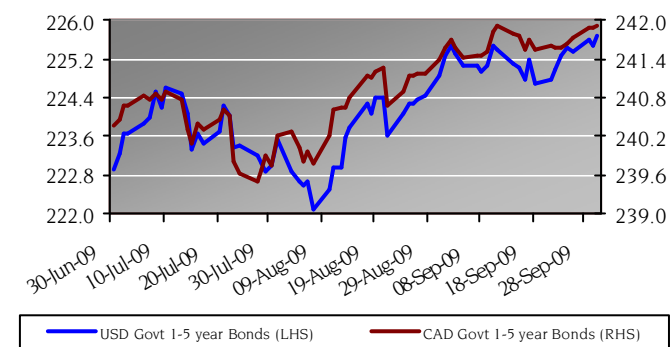
Perhaps the most important metric presently is employment data. With headline unemployment measures reaching levels not seen since the recession of the early 1980's, and little sign of improvement on the horizon, we see few catalysts to boost consumer demand in the near term. When this is combined with de-leveraging of household balance sheets, it is highly unlikely that the economy will display anything but a weak recovery.

It is fair to suggest that the concerted efforts of Governments and Central Banks across the globe have averted what could have been a global depression. While showing signs of improvement, the economy is still reliant upon a steady dose of fiscal and monetary stimulus to recover. However, with some more positive data, attention is turning as to how and when the economy is weaned off support – too soon and the economy will likely revert to recession, but wait too long and policy makers run the risk of creating another asset bubble.

The first change will be a fiscal one. With deficits spiralling out of control, Governments will be committed sooner rather than later to reducing spending and upping the tax take. With economies facing this headwind (some more than others) it is likely that in the low growth environment we predict interest rate policy (conventional and unconventional) may be easier than otherwise anticipated. In all, this suggests that from an economic perspective, despite their low nominal yields, bond markets will continue to be supported through the coming months as economies flirt with near-term deflation. Furthermore, the slack in the economy from excess labour and limited demand suggests that the risk of inflation in the future is well contained. However, we continue to advocate against being aggressively positioned in bond markets as there are other factors that should be considered.

In our last commentary we referred to the flood of Government Bonds (especially in the UK and US) due to be issued during the coming year to meet the present shortfall in Government finances. We repeat our concern as to who will buy all of the bonds issued. Recent supply concerns have been eased by the expansion of quantitative easing programs, but over use of such techniques runs the risk of monetising debt and debasing currency and bond valuations. In addition, we remain convinced that Central Banks will do 'whatever it takes' to avoid prolonged deflation. In fact, a little inflation may be secretly welcomed by Central Bankers and politicians alike.

In summary, bond markets have performed strongly over recent months, driven by an expectation that monetary policy is likely to cause interest rates to stay lower for longer and a general allocation to all asset classes outside of cash. However, the market fully reflects a low interest rate, low inflation and tepid growth environment. Any risk to this outlook, or concerns over how fiscal deficits will continue to be funded could weigh heavily on bonds. We therefore re-iterate our cautionary stance, preferring to invest in short dated, high quality bonds over the coming months.



## SUMMARY OF MARKETS AND OUTLOOK

### CURRENCY

We have previously highlighted that investor risk appetite and market sentiment have been key factors determining short term direction and global flows in international currency markets. These trends are increasingly influential, particularly in relation to the value of the US Dollar. As we moved through the summer months, the fear and risk aversion that was so dominant in investors' minds during the final quarter of 2008 and first quarter of 2009 has been replaced by a renewed acceptance of risk, in the search for investment opportunities. The Dollar's role as a global reserve currency has again been the subject of intense debate and this combined with higher oil and commodity prices has weighed heavily upon the US currency's value.

The Dollar has traded in a relatively narrow range versus the Euro for much of the last quarter, however in recent weeks the trends to which we have referred earlier have contributed to further downside pressure. In late September, the Dollar fell through the 1.47 level against the Euro, which represents a fall of almost 18% from its mid February highs. Despite some early evidence of improving trends in the US economy, the Federal Reserve have made it clear that monetary policy will remain extremely loose for the foreseeable future. Foreign exchange markets will likely become more focused toward the timing of any changes in monetary policy within the World's developed economies and the Fed's comments do not suggest a change of approach any time soon.

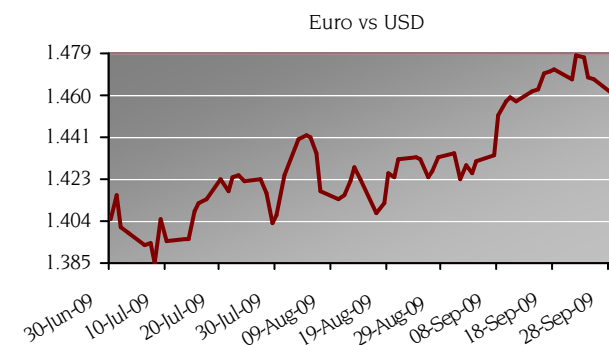
Therefore in the near term the Dollar is likely to remain vulnerable to commodity related currencies and global flows, as central banks within developing economies continue to look for ways to broaden diversification and reduce their reliance upon the Dollar. Looking longer term, the aggressive expansionary fiscal and monetary policies pursued by the US authorities will likely eventually stimulate recovery and it is also important to remember that the US was one of the first countries into a recession. As a result the Dollar should recover ground as the economy stabilises and speculators begin to anticipate a change in monetary policy. The value of the Dollar would undoubtedly also benefit from any renewed risk aversion, triggered by a meaningful correction in equity markets.

Recent Eurozone economic data has surprised a little on the upside, which has enabled the Euro to continue to strengthen and record new 2009 highs against the Dollar during late September. While we do not rule out continued Euro appreciation in the near term toward the 1.50 level, we do not forecast a further sharp down leg in the Dollar's value versus the Euro in the immediate future.

In the United Kingdom, a combination of concerns about rising debt levels and overall economic prospects, due to the economy's reliance on foreign capital inflows and a weakened Banking and Financial Services sector, were the initial contributory factors in Sterling's sharp sell off. Having reached lows of USD1.37 and EUR1.02 during the height of the financial crises, Sterling stabilised and managed somewhat of a recovery through the spring and early summer months, as investors risk aversion diminished.

More recently the pound's recovery has stalled, as the market has reassessed the UK's economic prospects relevant to those of the Eurozone and other western economies. The Bank of England (BOE) announced in August that it was going to increase its current quantitative easing program by a further GBP50 billion, which added to the already negative sentiment impacting Sterling. Investors interpreted this announcement as evidence of just how concerned the Government and the BOE are about recovery prospects. More fuel has been added to these flames by recent comments from Governor King suggesting that Sterling's decline will aid overall recovery, which was also interpreted negatively, as it appeared to suggest this as a deliberate policy. We believe the pound will likely remain under pressure versus the Euro in the near term, with downside a little more cushioned versus the Dollar, due to some similar difficulties at play within US Economy. How the BOE executes and manages its exit strategy from quantitative easing will also be a key determinant of Sterling's fortunes.

The Yen was an initial beneficiary of global deleveraging and risk aversion during the latter part of last year and early months of 2009, strengthening against both the Dollar and the Euro. Japan's currency has subsequently given back some of those gains in the wake of a change in investors' attitude to risk, in combination with the country's industrial export sector being particularly impacted by the global downturn in economic activity. Going forward, a high domestic savings rate and the likelihood that the Country's key institutional investors will continue to invest domestically, means that Japan does not have to rely on foreign investment and capital to finance its deficit. We view the Yen as being range bound versus the Euro and expect continued trading around the Yen130/135 levels. More recently, as the Dollar has come under further pressure globally, the Yen has strengthened back through 90. However, we would see limited potential in the near term for further significant gains from this point.



## SECTOR REVIEW

### CONSUMER DISCRETIONARY

The Consumer Discretionary sub group of the MSCI World Index rose by 17.15% over the third quarter, largely in line with the broader market advance of 16.9%.

From market bottom to recession end, leadership strongly favours “high beta” sectors which are closely tied into the fortunes of the economy, such as the consumer discretionary sub-group. However, even if it transpires that the worst days are now behind us, an element of caution is required, as the low interest rate environment associated with recessions has generally encouraged consumers to go “shopping by borrowing”, thus benefiting discretionary stocks. This time around, there is clearly pressure on consumers from; extended debt levels, reduced asset prices, declining wage growth, and increasing unemployment. It will therefore remain critical to be very selective in terms of discretionary stock holdings. Generally, our focus is upon companies with demonstrable global brand advantage, a proven track record in reducing costs, and profitable exposure to emerging consumers.

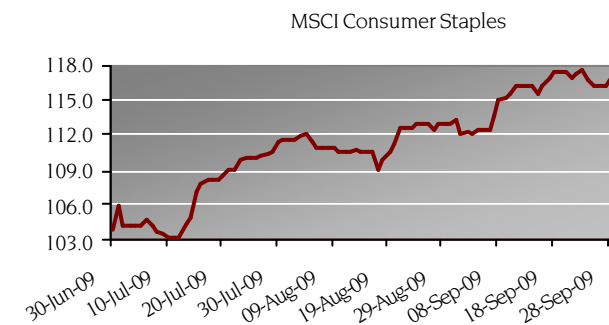
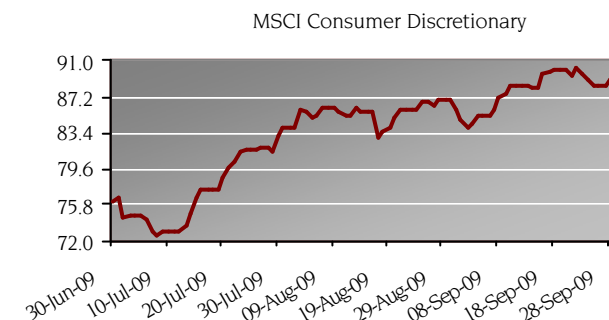
### CONSUMER STAPLES

Over the course of the last quarter the staples sub-group has rallied by 12.72%, placing it as the fourth worst performing sector, well behind the broader market’s 16.9% gain.

Looking back over the last eighteen months, the performance of staples has been far more impressive, only outstripped by healthcare and technology. Over this longer period, staples served their traditional purpose of reducing volatility, with declines during the market setback and subsequent gains during the rally both far more muted than those of the overall market.

Within this sector there is an exceptionally broad range of companies, some of which are clearly far more defensive than others. Food, alcohol and tobacco companies in particular exhibit some of the strongest defensive qualities, as volumes remain reasonably consistent during periods of economic instability. However, in this crisis volumes have been affected right across the subgroup. This has been offset by exceptional flexibility on the part of many companies in terms of pricing and cost reductions, and in the majority of cases this has allowed companies to avoid negative growth. Looking forward, the recent burden of high input prices should reduce, although our outlook would not point to a sharp recovery in volumes.

As opposed to the discretionary space, where global brand strength is important, success in the staples sector is more closely related to domestic dominance. We will continue to focus upon companies with this characteristic, who have proved the most flexible during recent market volatility. We also continue to favour companies that are able to sustain their market share in developed countries whilst driving margins and volume growth in new and emerging markets.



## SECTOR REVIEW

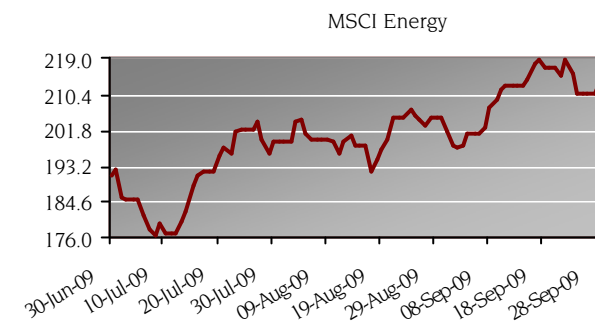
### ENERGY

The third quarter of 2009 saw Energy stocks continue to steadily appreciate, albeit underperforming the broader market. During the third quarter, the MSCI Energy Index rose in value by 11.32%, lagging the broader market's 16.9% advance. In the longer term, when viewed over the course of the last two years, the Energy sector has outperformed.

Having recovered strongly during the second quarter, bouncing off the sub USD60 levels witnessed in mid July, the price of a barrel of Crude has remained broadly unchanged over the last 3 months at just under USD70. While OPEC have continued to successfully maintain quota adherence, the sharp rebound in prices that occurred during the second quarter has been a key factor in enabling non-OPEC related production to exceed forecasts, as marginal costing improved. This increase in supply has seen inventories rise toward the top end of their 5 year average ranges. So far during 2009, the Oil price has averaged just over USD57, which represents an impressive recovery from mid February, when prices traded in the low USD30's.

While Energy related stocks have lagged the broader market over the last quarter, we continue to believe that prices will be supported by attractive longer term fundamentals. Growth in global Energy demand and consumption, driven by the rapid economic expansion in developing economies such as China, India, Middle East and South America, when set against a background of constrained and limited supply of fossil fuels, will ultimately drive prices higher.

From an investment perspective, compelling demand supply dynamics are supported by modest valuations, with PE multiples in the Energy sector well below their historic averages. In addition, particularly within the global integrated sub-group of companies, strongly positive cash flows support attractive dividend yields. We therefore remain of the view that an overweight position toward this sub group is an appropriate strategy within portfolios.

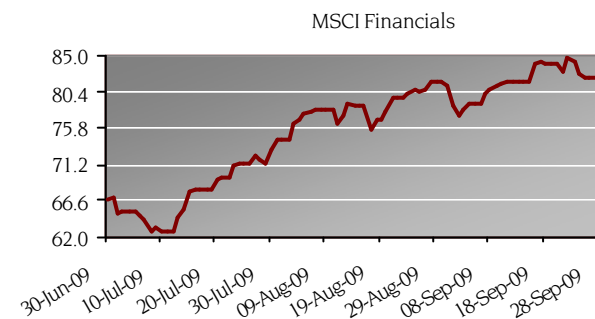


### FINANCIALS

The Financials sector has again been the best performing sector for the quarter, increasing in value by 25.87%, significantly ahead of the broad equity index which has posted returns of 16.9%. Performance has been broad based across the banking, insurance and capital market sub sectors, and has also been global in nature.

With hindsight, it is little wonder that following the indiscriminate selling the sector suffered through the turn of the year, there has been a compelling rally over recent months. A combination of low interest rates, cheap government funding, wider spreads and a steep yield curve suggest those that survived the fall out and avoided stringent 'bail out' capital will benefit from improved profit margins and a decrease in the level of competition. However, we do have concerns that valuations have come too far and overstate future prospects, hence, our underweight stance in the sector.

Our view is predicated upon two factors, the repeatability of recent positives that have driven results and weaknesses in the underlying economy. Turning first to results, the headline figures look good, with banks moving back towards profitability, giving them a chance to replenish depleted reserves. A closer look however, points towards profits temporarily being boosted by large trading profits, easier accounting rules and an improvement in risk asset prices. We find it of concern that current valuations take these skewed profits as a base and predict future momentum upon them.



While the effect of accounting changes and oversized trading profits will fade with time, we find continued weakness in the underlying economy, especially rising unemployment of particular risk to bank balance sheets and profitability. To date, most of the losses suffered by banks have been on their financial assets. However, higher unemployment is now causing a rapid deterioration in loans to what have traditionally been prime borrowers. At present this does not appear to be fully reflected in bank provisioning and with capital ratios still stretched, we would not discount further rounds of dilutive capital raising in the industry in the months ahead.

## SECTOR REVIEW

### HEALTHCARE

Although the MSCI World Healthcare Index has participated in the upward movement in equity markets, lingering concerns over healthcare reforms and patent expiries have led the sector to lag the gain in the broader market. During the third quarter, the Healthcare index increased by 11.87%, compared with the 16.9% rise in the MSCI World Index.

Competition from Generic drug makers continues to be one of the largest risks to the revenues of large cap pharmaceutical companies. In the next three years alone, branded drugs that currently generate as much as \$85 billion in revenues will lose patent protection. This should continue to provide attractive earnings growth for the Generic companies, at the expense of traditional Pharmaceutical manufacturers. Another strategy that has proved to be increasingly successful for the Generics is challenging the patent before it expires. This gives any successful challenger six months exclusivity in selling the generic version of the target drug. Despite these challenges, there are many companies within the sector that are investing in their future pipelines, which should enable the most innovative businesses to withstand the pressure from Generic competition.

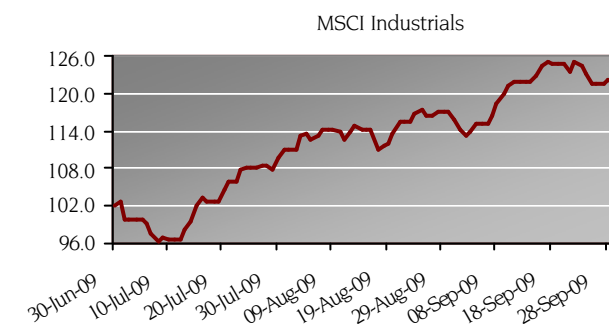
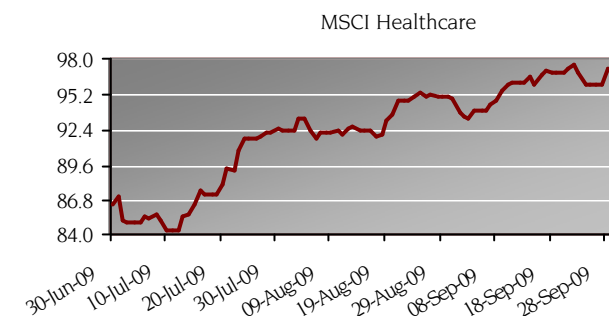
US Healthcare reform has been a key concern for investors in the sector. The Obama administration has stated that they intend on cutting \$80 billion in spending on drugs over ten years. Whilst it is a headline grabbing number, this only represents approximately 3.4% of worldwide Pharmaceutical company profits. In the longer term, demographic shift and an increasingly wealthy emerging market consumer is likely to result in a pick up in demand for healthcare services. In the shorter term, the sector benefits from low valuations and high dividend yields compared with the historical average, which leads us to maintain an overweight position in the sector.

### INDUSTRIALS

Evidence that manufacturing activity rebounded sharply in the third quarter led to a rally in the most economically sensitive areas of the market. This renewed appetite for stocks that are likely to benefit from an economic recovery pushed the MSCI World Industrials Index up by 19.72% in the period, outperforming the 16.9% gain in the MSCI World Index. On a year to date basis, the sector has lagged the broader market rise of 22.47%, increasing by 20.3%.

The August measure of US Manufacturing showed that industrial activity had bounced to its highest level since June 2007, as the largest two month increase since 1983 took the index to 52.8. An index level above 50 indicates that there is growth in the manufacturing sector, and suggests that Government led initiatives to stimulate the economy are feeding through into underlying demand. Whilst the strong pace of the increase is encouraging, much of the pick up is likely to be due to transitory effects, such as inventory restocking and the effects of the various Government stimulus packages. Whether industrial activity will remain robust as stimulus is withdrawn remains to be seen.

On the basis that it is very difficult to determine how much of the recent pick up in demand is not related to stimulus programs, we are maintaining a neutral position in the sector. Our focus shall remain on those companies that are Global leaders in their field, especially in areas of the market that have high barriers to entry. These companies should be better able to manage their business in a period of slower global economic growth, but also benefit when growth eventually returns to more normalised levels.



## SECTOR REVIEW

### INFORMATION TECHNOLOGY

The MSCI World Information Technology Index posted the fifth best performance of the ten MSCI World Sectors, rising by 15.73%. This was slightly below the 16.9% move in the broader MSCI World Index. The sector was led higher by the semiconductor companies, as share prices rose due to better than expected earnings for the second quarter, and improved guidance from company management for the remainder of the year.

Companies within the group have benefited from maintaining relatively strong balance sheets, and have shown the ability to react quickly to a slowing demand environment. A number of large capitalisation technology companies learned important lessons from the technology, media and telecom bubble of the late 90's, and have undergone extensive restructuring programs to reduce debt, stabilise earnings growth and ensure that they have enough cash to meet their working capital requirements. These positive actions have meant that companies within the sector have generally been able to withstand the recent slow down in end demand.

As the corporate world adjusts to slower global GDP growth, demand for products and services that enhance efficiency is likely to remain robust. Many areas of technology are beneficiaries of this trend, with technologies such as virtualisation and outsourcing proving particularly popular. Companies within the group are also able to utilise their strong balance sheets to enhance shareholder returns, through share buy backs and dividend payments. We are therefore maintaining a slight overweight to the Information Technology sector, focusing on companies that have strong balance sheets, stable earnings growth and are likely to benefit from corporate reorganisation.

### MATERIALS

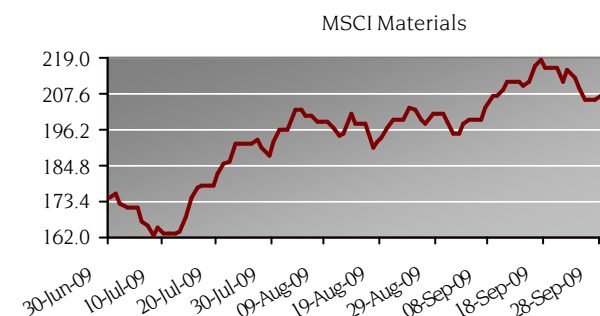
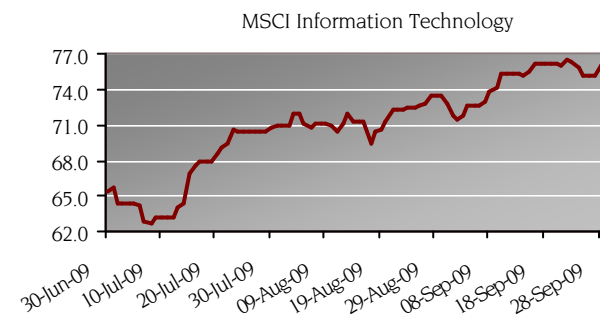
The Materials sector again posted strong gains during the course of the third quarter, rising by 19.4%, compared to a gain of 16.9% in the broader market. On a year to date basis, the group continues to be the strongest performing of the major sectors that comprise the MSCI, rising by over 40%.

All of the sub groups that comprise the Materials sector posted gains ahead of the broader market, with construction related materials leading the way on the back of better than expected corporate earnings. However, earnings growth within the group was primarily due to aggressive cost cutting.

When assessed over the course of 2009, the sector has been dominated by the strong recovery in the Metals and Mining sub group which has risen by over 50%, driven in the most part by demand from China. It is important to keep in mind that some of the rise in commodity prices can be attributed to US Dollar weakness, which is not always as positive in terms of companies' earnings. Dollar weakness can impact the profitability of some companies after local currency translations on their cost bases are factored in.

While end demand growth in China has been a key factor in driving up base metal prices, the role of the private investor in China has also been significant. By way of example, according to some commentators, Chinese Pig Farmers and other domestic speculators have been responsible for amassing more than 50,000 metric tons of Copper, which equates to roughly half of the inventory as measured by the Shanghai Futures Exchange.

These strong gains have had a meaningful impact upon valuations within the sector, which now trade well in excess of historic averages and at a premium to the broader market. While the long term fundamentals remain a compelling story, we believe that the sector may be due a period of some consolidation as recent speculative excesses are unwound.



## SECTOR REVIEW

### TELECOMMUNICATION SERVICES

The MSCI World Telecommunication Services sector increased in value by 12.9% during the third quarter, an underperformance of the broader market gain of 16.9%. The sector lagged the MSCI World, as increased risk appetite led investors to favour exposure to the most cyclically sensitive areas of the market. This is further evidenced by the year to date figures, which show that the Telecommunication Services index has posted the second worst performance of the ten MSCI World sectors.

The saturation of Western telecommunications markets has led to an evolution of the large capitalisation service providers, particularly since the bursting of the tech bubble in the late 90's. Like their counterparts in the technology sector, many tough lessons were learnt during the severe contraction seen in the early part of this decade. Companies within the group are no longer the huge engines of growth they once were, but are now more akin to a traditional utility, with relatively consistent free cash flow generation from a fully installed subscriber base. This change is demonstrated by the low price/earnings ratio, and high dividend yields that incumbents of the sector trade on, when compared with the average of the past ten years.

We remain neutrally weighted toward the sector, favouring companies with a high proportion of earnings in stable developed economies, which enables the generation of stable cash flows. These companies continue to trade at attractive valuation multiples, and whilst the mega mergers that have been seen in the past are unlikely, some consolidation within the sector could add further value.

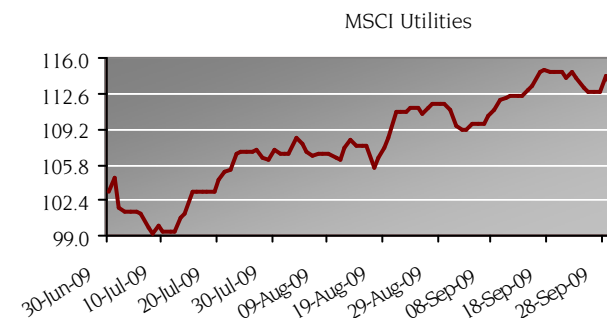
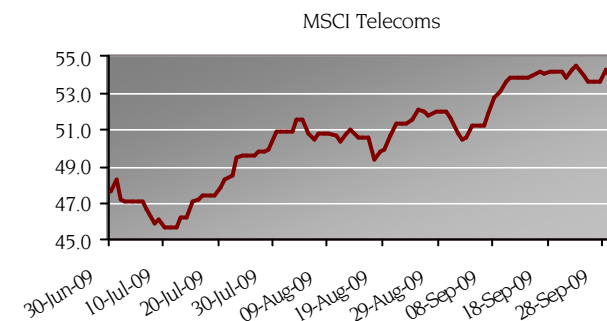
### UTILITIES

The sector has again failed to keep pace with the rally seen in the broad equity market, posting a return of 10.24% versus the aggregate return of 16.9%. In all, the sector has been positioned at the bottom of the sector rankings over both the quarter and the year to date.

In our previous commentary, we noted that the failure of the sector to keep pace with the broad market is not necessarily a failing in itself, but a consequence of the lower risk, more predictable nature of utility industries. This still stands true today, with returns relative to cyclical sectors more a factor of investor rotation in to higher risk sectors.

On an absolute basis, performance has been strong over the quarter. Headwinds that have held the sector back over recent quarters have continued to recede. In particular, we note that credit spreads have narrowed dramatically, easing re-financing concerns and improving margins for the industry. In addition, a more supportive price environment for commodities makes it more straightforward to justify elevated gas and electricity tariffs.

We have tended to remain underweight to this sector, preferring to overweight allocations in the Materials and Energy sectors in order to take advantage of the firmer commodity price environment. However, in a situation where we are starting to question the overall value of the equity market relative to the underlying economy, an allocation towards the more predictable, defensive, cashflow positive Utilities sector is starting to look more attractive.



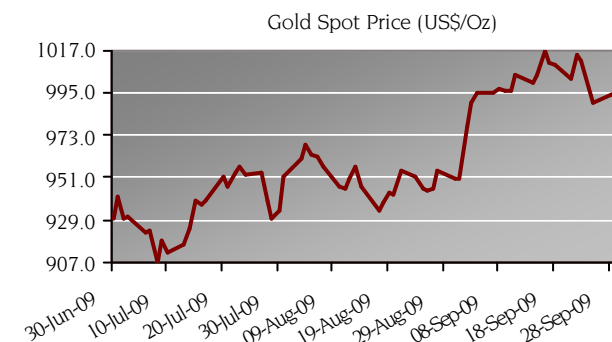
## GOLD

During the quarter, US Dollar weakness has strengthened investor appetite for gold, which drove the price to an 18-month high of \$1,023 during the period, before selling pressure eased it back to close the quarter 8.32% higher at \$1,007.65.

Investors are becoming increasingly comfortable with owning gold as a hedge against the devaluation of paper currencies, and a readily tradable diversifier to equity and fixed interest exposure. This can clearly be seen in the longer term growth in gold held by Exchange Traded Funds (ETF's), and the dramatic increase in purchase of non-commercial futures contracts. Whilst ETF holdings declined in the first half of the quarter, a recovery towards the later part of the period suggested redemptions had run their course. A shorter term indication of demand is the non-commercial futures data from the Commodities Futures trading Commission. This showed that speculative interest has risen to reach over 720 tonnes this quarter, an increase of nearly 190 tonnes from last quarter.

Gold has benefited from US Dollar weakness in the period, as the increasing level of debt in the economy coupled with unconventional fiscal stimulus have led the US currency to fall out of favour. Signs that the global economy is recovering have led to a willingness to seek higher yielding assets. As a result, the Dollar weakened as investors switched out of the US currency, to fund the purchase of assets in higher yielding currencies.

Overall, gold's unique role as both a tactical inflation hedge and as a long-term strategic asset will continue to prove effective during uncertain times. As gold is not a liability of any government or corporation it does not, like currencies, bonds and equities, run the risk of becoming worthless through default of the issuer. Whilst the unwinding of open positions could lead to heightened volatility and downward pressure on the gold price, we may see safe haven buying return if the economic recovery shows signs of slowing down.



## QUARTERLY STATISTICS

### EQUITY INDICES

	30 June 2009	30 September 2009	Percentage Change
Global			
MSCI World Index	964.05	1,126.98	+16.90
MSCI World Index (Sterling)	585.59	703.66	+20.16
MSCI World Index (Euro)	686.16	769.64	+12.17
United States			
Dow Jones Industrial Average	8,447.00	9,712.28	+14.98
S & P 500 Index	919.32	1,057.08	+14.98
NASDAQ Composite Index	1,835.04	2,122.42	+15.66
Europe			
DAX Index	4,808.64	5,675.16	+18.02
FTSE 100 Index	4,249.21	5,133.90	+20.82
Dow Jones Euro Stoxx 50	2,401.69	2,872.63	+19.61
Far East			
Nikkei 225 Index	9,958.44	10,133.23	+1.76
TOPIX Index	929.76	909.84	-2.14
FT World Actuaries Pacific Rim X Japan (US Dollars)	309.81	385.30	+24.37
FT World Actuaries Pacific Rim X Japan (Sterling)	278.91	357.17	+28.06
Hang Seng Index	18,378.73	20,955.25	+14.02

### MSCI WORLD SECTORS

Consumer Discretionary	76.13	89.19	+17.15
Consumer Staples	104.04	117.27	+12.72
Energy	190.83	212.44	+11.32
Financials	66.57	83.79	+25.87
Healthcare	86.55	96.82	+11.87
Industrials	101.91	122.01	+19.72
Information Technology	65.46	75.76	+15.73
Materials	174.47	208.31	+19.40
Telecommunications Services	47.67	53.82	+12.90
Utilities	103.28	113.86	+10.24

## QUARTERLY STATISTICS

### BOND INDICES

	30 June 2009	30 September 2009	Percentage Change
Bloomberg Bond Indices - Global Bond Index (US Dollars)	239.54	254.09	+6.07
Bloomberg Bond Indices - Global Bond Index (Sterling)	243.30	265.27	+9.03
Bloomberg Bond Indices - Global Bond Index (Euro)	217.17	221.02	+1.77
Bloomberg Bond Indices - US Govt 1-5 Year	222.91	225.69	+1.25
Bloomberg Bond Indices - UK Govt 1-5 Year	252.75	257.78	+1.99
Bloomberg Bond Indices - Canada Govt 1-5 Year	240.39	241.93	+0.64
Bloomberg Bond Indices - Euro Govt 1-5 Year	155.07	157.07	+1.29

### FOREIGN EXCHANGE RATES

Sterling versus US Dollar	1.6463	1.6016	-2.72
Sterling versus Euro	1.1720	1.0937	-6.68
Sterling versus Swiss Franc	1.7862	1.6602	-7.05
Sterling versus Canadian Dollar	1.9118	1.7120	-10.45
Sterling versus Japanese Yen	158.56	143.64	-9.41
US Dollar versus Euro	1.4050	1.4643	-4.22
US Dollar versus Swiss Franc	1.0850	1.0365	-4.47
US Dollar versus Canadian Dollar	1.1612	1.0688	-7.96
US Dollar versus Japanese Yen	96.32	89.68	-6.89

### LIBOR 3 MONTH RATE

Sterling	1.19	0.54	-54.32
US Dollar	0.60	0.29	-51.78
Canadian Dollar	0.60	0.50	-17.40
Euro	1.10	0.71	-35.44
Swiss Franc	0.40	0.29	-27.01

### COMMODITIES

Gold Spot \$/Oz	930.28	1,007.65	+8.32
Brent Crude Index (London)	69.99	65.27	-6.74
Crude Oil Futures (New York)	69.89	70.61	+1.03

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