Butterfield

Third Quarter 2011

Investment Review

Butterfield Bank (Guernsey) Limited
Third Quarter 2011 Investment Review

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SUMMARY OF MARKETS AND OUTLOOK

GLOBAL STRATEGY

If for no other reason than the fact their economic forecasts are so often wrong, investment managers should approach the subject of their "macro outlook" with a fair amount of humility in even the best of times. And this is not one of those times. Absolute conviction may or may not be difficult to achieve, but it is downright dangerous. In such circumstances, it is too easy to overlook the "hard" data of what people are actually doing in favour of surveys which record what people are thinking, or theories which describe what people think should happen.

Merrill Lynch's "Global Wave" quantifies global trends in economic activity. It is an amalgamation of measures, most of which are derived from real activity: output, demand, productivity, the labour market, manufacturing prices, credit spreads, and earnings expectations. Having recovered strongly from the depths plumbed in early 2009, it is now clearly trending down. More unsettling is the fact that it peaked at a much lower level than previous cyclical turning points, and far sooner. It is a sign of how difficult an environment we live in that this was the best recovery money could buy, and lasted for such a brief period. But our central case remains that the US and global economies will avoid dipping back into recession, and the data continues to provide support for that view.

We have written often about the uncharted territory we find ourselves in. But in many ways the environment we're moving through is consistent with what historical research suggests we should expect in the aftermath of a credit crisis. Deleveraging at government and personal level will be a multi year phenomenon, and lead to low growth. A weak economic environment compounds the problem by reducing employment prospects and tax revenues. All in all, you have a drawn-out, feelbad recovery, and an inability to "shrug off" any bumps along the way. What's different this time is firstly the fact that a number of the world's largest and most developed economies are going through this process simultaneously, and secondly governments' interventions and private sector leverage have caused huge distortions.

Broken clocks only look as if they're right twice a day. In reality, they have zero informational content. In the same way, market prices can sometimes give misleading signals, especially if they are a result of forced liquidations or simple stampedes (due to either excessive optimism or pessimism). But, more often than not, it is wrong to completely ignore the information contained in market prices: it tells you far more about what's going on than the prognostications of any one individual. Thus, the sharp drop in Asian currencies in the last few weeks is sending a clear signal about growth across that region. Similarly, the price of copper (aka "Dr Copper, the metal with a PhD in economics" for its success as a lead indicator of economic prospects) has fallen by 25% in the last two months, and has just had its worst quarterly performance since 2008.

Amidst all the doom and gloom, US monthly railroad shipments in August were the highest for almost 3 years. As these represent the bulk of materials for industrial production – and are viewed as one of a handful of reliable key economic indicators by Warren Buffett – they indicate that the US economy is still growing. Likewise, the August durable goods report in the US suggested that economic activity has managed to hold up better than feared. Economic performance clearly isn't anything to write home about anywhere in the developed world, and the likelihood remains for a feel-bad muddle through. But even tepid growth that allows the US to skirt a recession might be more than the recent sharp declines in equity markets and bond yields are discounting.

On a number of measures, and looking back over the last 30 years, equities appear to be quite attractively valued. We have believed for some time that analysts' forecasts for corporate profitability were far too high, particularly given the weakening economy. Whilst consensus earnings expectations are now being reduced, they are still too bullish. However, experience suggests analysts are always too bullish, and if we are to wait for them to become realistic, we may be waiting for a long time. More importantly, falls in equity markets over the summer may now be discounting a drop-off in global earnings unseen in at least 20 years, and to a lower level than was seen during the credit crisis, which was itself one of the biggest "profit recessions" in history.

Valuation at the time of purchase is one of the major determinants of returns for long term investors, but it is not a reliable tool for timing investment decisions. Just because something is cheap is no guarantee it won't get cheaper. For the most long term of investors, this will be of little concern, although most others will understandably prefer to avoid the worst of any volatility if possible – and that indeed is part of our core ethos.

But a lot of fear has now been priced in. By some measures, August's falls came as more of a shock than the weeks following the collapse of Lehman during the autumn of 2008. There are a number of indications that negative sentiment is at an extreme. Investment banks Credit Suisse and Citi produce composite models which look at Risk Appetite and Risk Aversion. Importantly, these somewhat complementary indicators are based on "hard data" - the price dynamics of a wide range of traded assets, rather than more subjective measures such as "investor sentiment". The Credit Suisse Risk Appetite index tends to swing between "Panic" and "Euphoria". It is currently

indicating a level of panic unseen since its inception 30 years ago, and well below the levels set during either the recent credit crisis or the dotcom bust a decade ago. The Citi Risk Aversion index paints a similar picture, and indicates risk aversion amongst investors is higher now than at the height of the credit crisis. Irrespective of the underlying economic conditions, such extremes suggest – very strongly – that in their panic investors have dumped risky assets such as equities, and paid whatever price they had to for such supposedly safe assets as German or US government bonds, or gold.

However, as it has for so many months, the spectre of the Club Merde crisis continues to keep us under cover for now. President Sarkozy and Chancellor Merkel continue to dismiss fears that Greece may be forced to leave the currency union. They are “convinced that the future of Greece is in the Eurozone”. Meanwhile, the Greek PM confirms “the absolute certainty of his government to take all necessary measures to meet conditions set as part of a rescue package”.

Such comments can only be met with the obvious question: so what? I have things in my refrigerator which predate the promises for fiscal rectitude which the Greek government is now breaking. Why should investors place any weight on the possibility they will suddenly “get it”? When the EU started kicking the can down the road, they were aiming for something beyond 2013. The line now seems to be drawn only days and weeks hence. And, anyway, a Greek default would end nothing; we can be confident that markets would immediately move on to the next one in line, or maybe just cut out the middle-merde and jump straight to France.

If we can’t assume politicians will suddenly “get it”, the implication is that a sustainable solution will only be achieved after further crisis. But, in many respects, the crisis is already occurring (or never stopped). Strains in Europe are approaching a crescendo. There may already be a “run” on some banks happening below the surface, and the vital interbank loans market continues to exhibit signs of distress. The systemic strains are most clearly seen in the European TED ratio (the yield spread between 3 month Bunds and 3 month EURIBOR), which is now higher than at any time save the weeks immediately following the collapse of Lehman Brothers in on September 15, 2008.

The destiny of European markets is more about politics than economics or valuations. Current solutions to the Crisis are inadequate, but even they were only in response to market pressure. There are some indications, however, that a “Shock & Awe” package is being prepared. European equities rallied strongly at the end of September in anticipation, although it was significant that Italian bond spreads barely moved.

Whether it will actually be “Shock & Awe” is also questionable? We’ve been here before, and at least up to this point, seen the essential difference between US and EU politicians: there’s no point at which the US Fed and administration give up and simply walk away, whereas in Europe there is a point at which they stop talking about how they won’t give up…

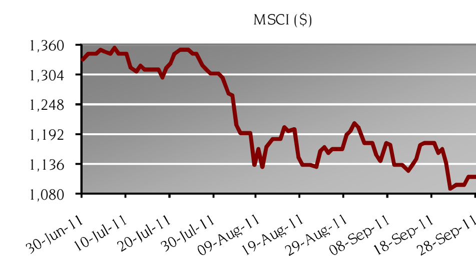
The Euro Crisis would be a disaster if left unaddressed, ie if Governments didn’t step in to support their banks, but it’s unlikely to be the “New Lehman”: everyone’s been talking about it for a very long time, and had time to at least partially prepare. The likelihood must be that European governments, the ECB, the EU and the IMF will ultimately do whatever they can to avert such a repeat. But it would be wrong to nurture too much optimism about the European response. We must remember that the political and technocratic elites in the EU do not want to do this, and have attempted to ignore the issue (by their continual efforts to “kick the can down the road”) until markets forced them to do otherwise. They will therefore enact policy responses with what has been characterised as all the enthusiasm of a teenager forced to tidy their room. They will sulk, there will be tantrums and go-slows, and they will find other things to distract them (“a transaction tax – like, how cool is that!”) But, eventually, they will get something done. Kind of.

Thus, there is strong and increasing support for the possibility that, sooner or later (but probably sooner), we will have to gird our loins and increase our weighting to risk assets quite significantly. Yet, as we get our loin-girdling equipment ready, some things are becoming increasingly clear about the kind of investment world we need to deal with over the next few years. In a low growth environment, made more volatile by an ongoing need to deleverage and a consequent susceptibility to external shocks, periods of growth - just below zero rather than just above – become statistically more likely. In effect, and as we’re currently seeing, this means shorter business cycles and hence shorter stock market cycles. In such an environment, simple buy-and-hold strategies are unlikely to be effective. But, within that, our top-down approach is identifying some strong and consistent long-term themes, an increasing premium for Quality and Growth companies, and an ongoing demand for Yield/ Income being perhaps the most important and durable. Opportunities are starting to appear, and we need to be able to take them. But, for now, we will be satisfied with the prospect that, amidst the gloom and fear, there are some glimmers of light starting to appear.

SUMMARY OF MARKETS AND OUTLOOK

GLOBAL EQUITIES

Equity markets, as measured by the Morgan Stanley Capital International (MSCI) World Index lost 17.06% in US Dollar terms during the third quarter of 2011. This represented the worst quarterly loss since 2008, with investors rattled by the inability of political leaders to present credible plans to deal with enormous structural issues. In July, focus fell upon US political brinkmanship surrounding the debate over raising the country's debt ceiling. However, as the quarter developed European leaders clearly took centre stage in the markets eyes, as they failed to find answers the regions' escalating crisis.



Disappointing economic news throughout the quarter has also reignited fears over whether the critical US economy can avoid falling back into negative growth within an environment where; recession in Europe is almost a given, emerging world growth shows distinct signs of moderating, and the domestic economy is plagued by persistently high unemployment, a weak housing market, and the recent impact of declining equity prices.

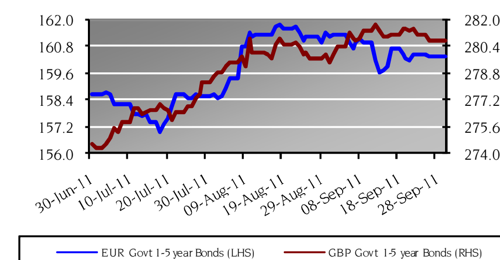
As we have consistently said, within a prolonged low growth environment there is a finer margin for error, with any slowdown quickly feeling recessionary. This inevitably results in higher levels of volatility, as reflected in the VIX index (the so-called 'fear gauge') which averaged 35.09 during August and September, as opposed to just 18.2 during the first seven months of the year.

Prior to recent declines, equity valuations looked reasonably attractive on both an absolute and relative basis. Sharp declines during the third quarter must therefore incorporate a significant amount of fear that earnings forecasts will be substantially reduced in the months ahead. This is undoubtedly true but, as with anything, it is a question of magnitude. Unsurprisingly, given a confused and disappointing political backdrop, markets appeared to be constantly searching for bad news as the third quarter drew towards a close. With relatively subdued valuations, reasonable technical support, and anaemic returns from competing asset classes, it may not take a quantum shift in the geopolitical landscape to encourage markets to begin searching for more positive messages. To this end, almost any outcome in Europe is potentially better than no outcome at all.

Whatever the outcome for Europe we continue to believe that, for those who can tolerate near term swings in asset prices, the economic environment can be supportive for risk assets, and that equities therefore still warrant a place within our investment strategy. However, a selective approach is considered even more necessary now than ever. Our prudent approach to the management of money is built upon a framework which aims to benefits from growth themes, whilst minimising potential exposure to more problematic issues. Amidst the current environment this feels even more relevant than ever, and will remain at the core of our investment approach.

GLOBAL FIXED INTEREST

High grade bond markets have continued to make progress through the third quarter as a combination of 'flight to quality' trades and Central Bank policy have kept bond markets in Northern Europe, the USA and UK well supported. A weakening global economic environment - driven by the debt crisis that is slowly enveloping Europe and stubbornly high unemployment levels in the US - has weighed heavily on risk assets and diverted funds back into the relative safety of these Government Bond markets.



At present, heightened levels of volatility in financial markets and expectations of low interest rates for the foreseeable future are sufficient to see bond yields remain at these historic low levels for a period of time. The lack of credible, and indeed sizeable, alternatives to high grade bonds as low risk investments will also provide a key level of support. This can be evidenced clearly in the market's nonchalant attitude to the downgrading of the United States' credit rating by S&P from AAA to AA+.

The economic backdrop and decreasing risk appetite in financial markets provide additional support for bond markets at this time. This is further compounded by specific support from major Central Banks, whether it be 'Operation Twist' from the Federal Reserve, bond buying from the ECB, or the consideration of additional quantitative easing by the Bank of England. However, it appears to us, that all this is priced into what is now a flattening yield curve.

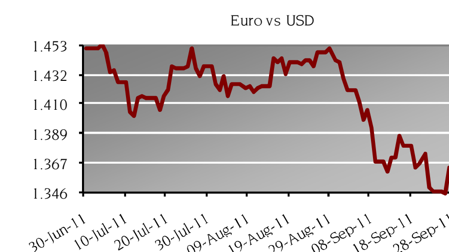
SUMMARY OF MARKETS AND OUTLOOK

With the market priced for perfection, there are a number of factors which we believe could disappoint aggressively positioned bond investors. In particular, we would highlight the potential that near-term inflationary pressures may be more than temporary, the length of time that investors will accept negative real returns, or the ability for Governments to demonstrate that they can reduce their budget deficits without committing their economies back to recession. For this reason, we prefer to remain short of duration as the rewards for extending duration at present are limited, while risks could be quite substantial.

CURRENCY

The debt crises on either side of the Atlantic dominated currency markets throughout the third quarter. The spectre of July's messy political impasse over the raising of the US debt ceiling has now firmly shifted towards Europe and the continued uncertainty over how the region's debt problems are to be resolved. This question remains largely unanswered with European politicians currently unwilling, or perhaps not yet inclined, to address the problem with the leadership and sense of urgency that is required.

The market is looking to Europe's leaders and Germany in particular to lay the foundations of a credible policy framework that addresses the issues facing Greece and prevents the fallout spreading to some of the larger heavily indebted Eurozone countries. Any solution would also have to simultaneously ensure support of the broader European banking system. Clearly some hard and courageous decisions in terms of re-shaping the framework of the Euro need to be taken. However, for the moment it is difficult to see a near term solution, as political objectives and individual political careers continue to override the economic inevitability.



Against this backdrop the US Dollar has once again been the "safe–haven" beneficiary in a risk adverse environment and has appreciated by over 7.5% versus the Euro during the last quarter. At current levels the US Dollar has managed to recoup the ground given up to the Euro during the first two quarters of the year.

While the political impasse over agreeing the debt ceiling did few favours in terms of instilling confidence, the Dollar still remains the global reserve currency, and as such, will likely continue to be supported as issues in Europe remain a focus for the Market. However the US economy has its own debt and growth problems and there has been further speculation of an additional QE program, which may temper the Dollar's ability to make significant gains.

In the United Kingdom, for much of the third quarter Sterling managed to remain reasonably well supported, benefiting from the gloom surrounding other major currencies, though the Government's commitment to their deficit reduction program also helped credibility. More recently, disappointing economic data has prompted the Market to begin to price in an increased likelihood of the Bank of England implementing a further round of QE in the relatively near term.

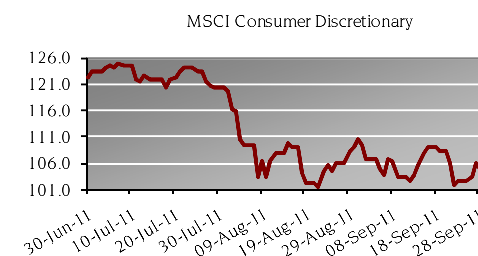
Having traded above 1.66 in the early summer, the Pound has also given up ground to the Dollar and at current levels is some 6% below the year's high. Recent weakness has left Sterling's value virtually unchanged against both the US Dollar and the Euro when viewed over the course of 2011. Looking forward, the UK is still battling rising unemployment and fiscal tightening, which suggests economic growth will in all likelihood remain very subdued through 2011 and into 2012. Against this backdrop and with another QE program looking likely, Sterling's ability to strengthen materially against either the Euro or the US Dollar appears limited.

In Japan, despite the currency's apparent overvaluation on a fundamental basis and intervention by Bank of Japan's (BOJ) to surpass its value, the Yen has strengthened against the World's major currencies during the third quarter. We remain of the opinion that the BOJ will continue to maintain extremely accommodative policies for the foreseeable future and this will only deepen Japan's deficit and budgetary imbalances. On this basis, we have continued to hedge Japanese Yen exposure within client portfolios back to base currencies.

SECTOR REVIEW

CONSUMER DISCRETIONARY

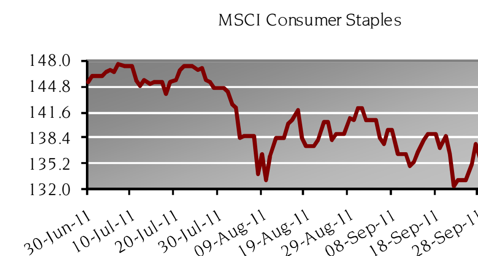
The near term fortunes of the Consumer Discretionary sector generally magnify overall market and economic sentiment. The sector fell by 14.56% during the third quarter, placing it sixth in the table of ten MSCI sectors and, if anything, it is surprising that performance was not worse in light of the overall market decline. A look through to sub-sector constituents is required in order to understand why this has not been the case. The discretionary group is extremely diverse in nature and more economically sensitive sub group did indeed perform very poorly during the quarter. For example, automobiles and auto components fell by approximately 24%, whilst media stocks declined by 17%. Offsetting this was a strong performance from the retail sub-group, which fell by just 4.83% against a market decline of 15.14%. This reflects the relatively defensive characteristics of this area of the "discretionary" world, where negative earnings revisions have been far less dominant than elsewhere in the market.



Overall, we continue to believe that the more economically sensitive areas of the sector will be vulnerable within an environment where consumer spending is broadly under downward pressure, and inflation is eroding margins. On the other hand, the more defensive areas of the sector, where equity prices have held firmer, appear relatively expensive, and we feel that better value in "defensive" names can be found elsewhere. Overall, this leads us to maintain our underweight stance towards the sector, with exposure coming through companies who's products will appeal to emerging and developed consumers alike.

CONSUMER STAPLES

As we have highlighted in previous commentaries, the consumer staples sector is classically "defensive" in its makeup, and this generally leads to relatively robust performance during difficult market conditions. It is therefore unsurprising that the sector was the best performing of the ten MSCI sectors during the third quarter, falling by 5.81% within an environment where the broader market gave up 15.14%.



Within the outlook that we anticipate for markets over the coming quarters, Staples appears amongst the most attractive areas from a fundamental perspective. However, valuation metrics are also more stretched than in other classically "defensive" areas of the market. This serves to temper our outlook and, whilst we remain overweight, the magnitude of our position is slightly less than in areas such as Healthcare and Energy.

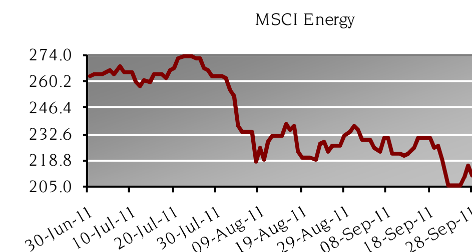
Focus within the sector remains upon those companies who are able to maintain margins in their developed markets, whilst benefiting from the higher growth rates associated with emerging world consumers.

SECTOR REVIEW

ENERGY

In keeping with broader trends within the more cyclically sensitive areas of the economy, the Energy sector corrected sharply during the third quarter, ending the period down 21% versus a 17.06% fall in broader market. When viewed over the course of 2011, the MSCI Energy Index has fallen by 7.24% compared to drop in value of 5.51% in the overall market.

Energy markets have not been immune to increased concerns of a slowing in the global economy. While the sector as a whole has weakened on the back of lower growth projections, companies whose operations are more sensitised to the oil price, such as Exploration and Production and Oil Services sub groups, have corrected more sharply than the more defensive International Integrated stocks.



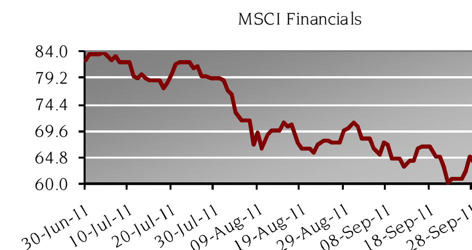
While current forecasts point to a slowing in global GDP growth in 2012, demand for oil led by China and other leading developing economies remains strong in an environment where capacity continues to be constrained. A marked step up in the technological challenges associated with the operation of deepwater offshore wells and ongoing geo-political risks in the Middle East and North Africa increase the marginal cost of developing new fields and therefore provide a positive backdrop for prices.

Within client portfolios, the emphasis of our exposure continues to be toward the Major Integrated companies, whose broader based activities mean they are less sensitised to short term price trends. Solid balance sheets and strong free cash flows enable these companies to continue to offer attractive dividend yields, which in the current environment provide a solid underpinning.

FINANCIALS

The Financials Sector has fallen in value by 23.56% during the third quarter versus a fall of 17.06% for the broad market. As with last quarter, the latest returns rank the Financials sector as one of the worst performing sectors during the quarter and hence, year-to-date. Sector returns have been poor across all financial industries, although concerns within Bank balance sheets remain the key factor leading the sector lower.

As was discussed in our previous commentary, it is the worsening situation with regard to peripheral European sovereign debt which is weighing heavily on financial stocks at present, given that high proportions of this debt is held on the balance sheets of systemically important European Banks The most recent three months have seen a worsening of the situation with regard to Greece, while market attention has also focussed upon Spain and now Italy as countries that have unsustainable debt levels.



To date, actions and proposals by the IMF and ECB have failed to convince market participants. Countries within the Eurozone will continue to wrangle, although the task of crafting a solution that will meet with the agreement of all 17 countries that have adopted the Euro is still some way off. Until there is clarification as to how the debt situation may be resolved and the consequences for the Banks holding the debt, markets will continue to mark down the value of financial stocks.

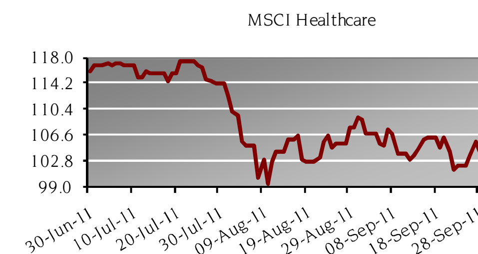
While the European debt situation is weighing heavily on the capital adequacy of financial companies, their day-to-day profitability is also being impacted by the myriad of new legislation and Central Bank manipulation of interest rates and bond yields. In this environment, we remain comfortable with the broadly diversified and heavily underweight allocation to the sector and see no reason to increase exposure at present.

SECTOR REVIEW

HEALTHCARE

The MSCI World Healthcare Index outperformed the broader MSCI World Index during the third quarter, although in a very nervous market the sector declined by 10.64%. Whilst the scale of decline was disappointing for a sector that is usually considered defensive, the Healthcare Index is largely unchanged on a year to date basis.

There are several long term themes that are likely to support sales for companies that operate within the Healthcare sector. Emerging markets remain a key area of growth for the sector, as increasing consumer wealth is shown to lead to a greater level of demand the treatment of preventable disease. This should provide increased sales for over the counter medicine, prescription drugs, and vaccines. In developed markets the key driver of Healthcare demand is the aging population, which will continue to shape the healthcare landscape for the next decade, and beyond. This demographic shift is likely to lead to strong demand for the orthopaedic, ophthalmic, and pharmaceutical sub sectors.

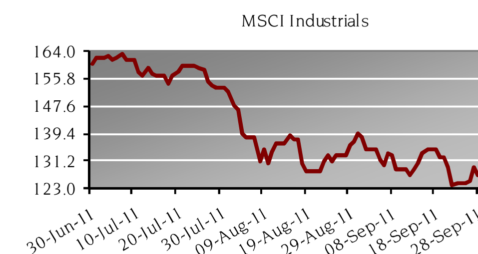


Whilst the longer term trends are supportive, in the shorter term it is likely that the austere nature of Governments' around the world will lead to the rationalisation of spending wherever possible. Whilst this might be negative for some of the larger healthcare providers, this should benefit those sectors and companies that can offer cost savings, such as generics. Our focus therefore remains on companies that are serving the needs of aging populations in the West, and the increasingly healthcare conscious emerging market consumer.

INDUSTRIALS

The Industrials sector has fallen in value by 22.28% during the third quarter of 2011, amidst mounting evidence that the global economy is weakening. Returns have fared worse than the market aggregate which fell by 17.06%, such that year-to-date returns for the sector are now amongst the weakest of the 10 sectors which comprise the MSCI World Index.

As has been mentioned in previous reports, the Industrials sector acts as a fairly reliable indicator for the health of the global economy. Following a series of weaker economic releases and the recent downgrading of growth expectations from the IMF, the sector has posted poor performance across all sub-industries.



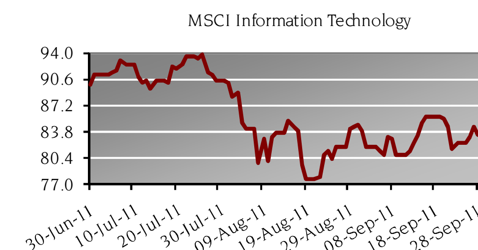
At the company level, revenue growth may be impacted by a weaker economic environment, although easing price pressures in a number of commodity markets (particularly energy) suggest that input costs should remain contained. Similarly, the weak employment environment suggests that escalating labour costs should not be on the radar for some time to come. We therefore believe companies should remain on track to make their 2011 numbers.

We remain neutrally positioned to the sector at present. As detailed earlier in the commentary, our central economic view suggests that the World continues to muddle through in a weak, but generally positive growth environment. With many stocks now priced for what is essentially a recession, evidence that the economy continues to move forward should see an appropriate move in valuations.

INFORMATION TECHNOLOGY

Although the MSCI World Information Technology index posted a decline of 9.79%, this represented the third best performance of the ten sectors that comprise the MSCI World Index. The third quarter decline was significantly less than the 17.06% decline of the broader index, as companies within the Internet Software & Services, and Computers & Peripherals sub sectors showed resilient performance.

Companies within the Information Technology sector have a long history of innovation that has improved efficiency for personal and business life, particularly in the past decade. Increasing use of the internet as a platform to deliver services to consumers and businesses has undoubtedly been a key aspect of efficiency gains, and it will continue to help drive sales for technology companies long into the future. As users access the internet at faster speeds, and from a wider variety of devices, the demand for data is set to continue to grow at a rapid pace, even within more developed markets. This trend should benefit those companies that offer market leading technologies that store, deliver, and secure data. As companies adjust to the lower growth environment, maximising efficiency remains a priority for management, a trend that is likely to benefit the outsourcing and services companies.



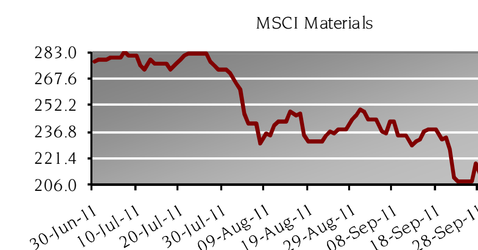
We are therefore focused on specific sub industries within the sector, which we believe are best positioned to benefit from the attractive long term trends mentioned above. In addition, our focus upon mature, market leading companies means that it is likely that the companies we hold within the sector will have strong cash flow characteristics, which can facilitate shareholder friendly action such as dividends and share buybacks.

MATERIALS

Increased concerns that slowing growth within the global economy will have a significant impact upon demand for commodities hurt sentiment within the Materials sector. During the third quarter, the MSCI Material index fell by 25.80% compared to a drop in value of 17.06% in the overall market.

The more cyclical sub groups, such as base metals, proved most susceptible to the downturn in sentiment and this price action was mirrored in the share prices of leading global mining companies such as Rio Tinto, BHP and Xstrata. In recent months, supply / demand dynamics, inventory data and other longer term factors have been overlooked by investors in favour of developments in the global macro and political spectrum. As a result, price volatility has increased dramatically and technical factors are currently playing a bigger role than fundamentals in determining trends and near term prices.

China remains the dominant force in terms of global demand for base metals and has so far been relatively immune from any material re-rating in terms of economic growth. However, near term sentiment has been hurt by events in Europe, as the region is an important export market for China.

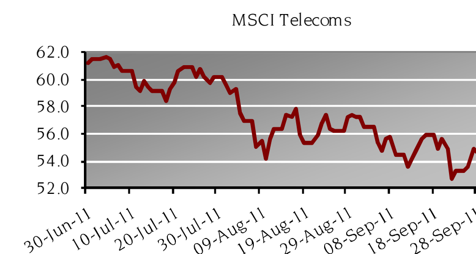


We believe that a reduction in near term demand for raw materials and base metals from China has been largely discounted in the share prices of the major miners. The authorities in China remain committed to maintaining their policy of allocating spending towards infrastructure projects, therefore when assessed over the long run, demand dynamics will likely remain supportive. Within the materials sector we have maintained a broadly diversified approach, balancing the cyclically sensitive mining positions with more defensive sub groups such as chemicals and gases for use in industry.

TELECOMMUNICATION SERVICES

The defensive earnings profile of many companies within the MSCI World Telecommunication Services Index led the sector to outperform the broader market during the third quarter, declining by 11.15% compared to the fall of 17.06% for the MSCI World Index. Wireless providers outperformed the diversified group, as increased demand for data helped to support earnings.

Mobile broadband has the potential to revolutionise the way in which consumers access the internet, and widen the services that can be offered to them, particularly given the increasing number of devices that can be used to connect to the internet wirelessly. The key challenge is ensuring that mobile networks have sufficient capacity to provide a stable connection. It is therefore important that wireless providers continue to invest in their networks, and secure licences that will allow them to roll out 4G services, as the new technology will allow a greater number of users to access the network with fewer base stations. In fixed line, companies that have exposure to Fiber Networks should have an advantage, as they will be able to offer very fast broadband to consumers, and provide wireless operators an opportunity to move traffic from their networks, which are likely to become more constrained as smart phone use becomes more widespread.

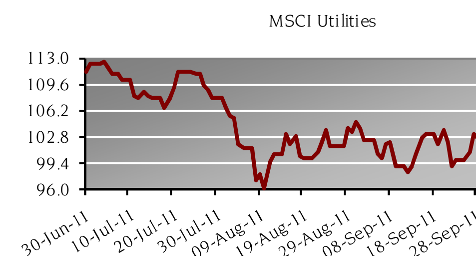


One area for concern is that regulation and tax within many European countries is likely to be somewhat more onerous going forward, with many countries considering special taxes to specifically target the large stable cash flows of telecom companies. We therefore focus exposure on companies that have sufficient geographic diversity to help navigate this period of slower economic growth.

UTILITIES

The Utilities sector has fallen in value by 8.12% during the third quarter of 2011. This compares favourably to the broader market, which fell in value by 17.06% over the same period. Within the sector, it has been the regulated businesses that again have outperformed the de-regulated energy generators.

Fundamentally, little has changed in the sector over recent months. Low interest rates and weak economic growth point to the sector posting reasonable returns on a relative basis, as investors seek the safety of steady cashflow and a high dividend payout. However, we have two areas of concern as to whether recent returns can be sustained going forwards. Firstly, we question what may happen to the dividend rich sector if the beneficial 15% (US) tax rate on dividends was to expire as is currently under consideration. Secondly, we question whether the valuation of the sector could retract if bond yields started to move up from their historical lows.



We have also discussed how the sector can become a 'political football' from time to time as it is the one industry where authorities can reflect the political mood in how favourably they set the regulatory environment under which utility companies operate. Governments are currently wrestling with the conundrum of siding with the utility companies to allow them more favourable returns on new business investment, or siding with the consumer to lower their utility bills. At present, we maintain that politics will outweigh the re-investment needs of the industry in the near-term, and ultimately, this will mean lower returns for the industry in the coming years.

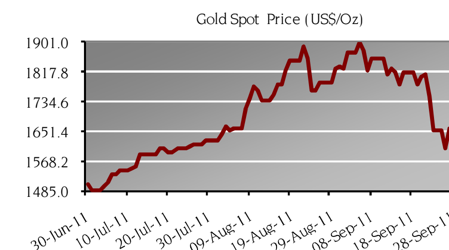
Given the above, we continue to hold an underweight allocation to the sector. We continue to review the sector, but will refrain from increasing exposure until we see evidence that utility industries are actively being encouraged to invest through favourable regulation.

GOLD

The price of gold has been uncharacteristically volatile during the third quarter of 2011. Investor concern that Greece's debt problems might lead to contagion within the European financial system led the price to rally to over US$1,920 per ounce during the quarter. However, a stronger US Dollar, and an increase in margin requirements led to an unwinding of derivative positions, which in turn resulted in a sharp drop in price toward the end of September. Gold ended the quarter at US$1,628.68, which represented a gain of 8.27% over the period.

The supply and demand fundamentals for gold remain supportive in the long term. Central Bank buying has changed the supply landscape for the metal in recent years. In the period between the first quarter 2008 and first quarter 2011, Central Banks increased reserves of gold by 807 tonnes. Whilst this might not seem like a huge increase, particularly given they hold a combined 30,000 tonnes, when you consider that in the preceding three year period they supplied almost 1,800 tonnes into the market, the reduction in metal available for use in jewellery, industry and dentistry is quite significant. This trend is likely to continue, as Russia, China and India have all openly stated that they will increase the amount of foreign currency reserves that they hold in gold.

As witnessed during the third quarter, elevated levels of speculative interest in the metal from investors in ETF's, and in the derivative markets, is likely to lead to greater volatility in the price. Investors in ETF's tend to be focused on generating a financial gain from the metal, and therefore trade more frequently than holders of physical metal. According to Bloomberg data, the largest 31 physical gold ETF's currently hold over 2,100 tonnes, up from 1,900 tonnes at the end of June. This is almost as much as China and Switzerland's combined Central Bank holdings. A shift in investor sentiment could therefore lead to a large amount of metal coming onto the markets in a very short space of time. According to the US Commodity Futures Trading Commission, the level of non commercial interest held in futures and options on COMEX spiked to over 760 tonnes in July. Whilst net open interest levels declined in August and September, the overall level is still elevated, at 575 tonnes.



Although risks to the European financial system remain, our base case economic outlook suggests that the environment may be better than the price of gold would indicate. It is therefore possible that short term pressure on the price remains. In the longer term, the strong fundamentals mentioned above, and the increasing level of debt accumulation on Government balance sheets, is likely to be supportive for the price.

QUARTERLY STATISTICS

EQUITY INDICES

	30 June 2011	30 September 2011	Percentage Change
Global			
MSCI World Index	1,331.18	1,104.06	-17.06
MSCI World Index (Sterling)	828.52	705.56	-14.84
MSCI World Index (Euro)	917.42	820.92	-10.52
United States			
Dow Jones Industrial Average	12,414.34	10,913.38	-12.09
S & P 500 Index	1,320.64	1,131.42	-14.33
NASDAQ Composite Index	2,773.52	2,415.40	-12.91
Europe			
DAX Index	7,376.24	5,502.02	-25.41
FTSE 100 Index	5,945.71	5,128.48	-13.74
Dow Jones Euro Stoxx 50	2,848.53	2,179.66	-23.48
Far East			
Nikkei 225 Index	9,816.09	8,700.29	-11.37
TOPIX Index	849.22	761.17	-10.37
FT World Actuaries Pacific Rim X Japan (US Dollars)	481.60	378.17	-21.48
FT World Actuaries Pacific Rim X Japan (Sterling)	444.74	359.91	-19.07
Hang Seng Index	22,398.10	17,592.41	-21.46

MSCI WORLD SECTORS

	30 June 2011	30 September 2011	Percentage Change
Consumer Discretionary	122.16	101.45	-16.95
Consumer Staples	145.26	135.11	-6.99
Energy	262.46	207.34	-21.00
Financials	82.43	63.01	-23.56
Healthcare	116.02	103.68	-10.64
Industrials	160.38	124.64	-22.28
Information Technology	89.92	81.12	-9.79
Materials	277.57	205.96	-25.80
Telecommunications Services	61.25	54.42	-11.15
Utilities	111.29	102.25	-8.12

QUARTERLY STATISTICS

BOND INDICES

	30 June 2011	30 September 2011	Percentage Change
Bloomberg Bond Indices - Global Bond Index (US Dollars)	274.11	281.40	+2.66
Bloomberg Bond Indices - Global Bond Index (Sterling)	285.28	300.70	+5.41
Bloomberg Bond Indices - Global Bond Index (Euro)	240.62	266.51	+10.76
Bloomberg Bond Indices - US Govt 1-5 Year	237.71	241.31	+1.52
Bloomberg Bond Indices - UK Govt 1-5 Year	274.54	280.76	+2.26
Bloomberg Bond Indices - Canada Govt 1-5 Year	252.88	259.05	+2.44
Bloomberg Bond Indices - Euro Govt 1-5 Year	158.62	160.81	+1.38

FOREIGN EXCHANGE RATES

	30 June 2011	30 September 2011	Percentage Change
Sterling versus US Dollar	1.6067	1.5648	-2.61
Sterling versus Euro	1.1071	1.1634	+5.09
Sterling versus Swiss Franc	1.3527	1.4147	+4.58
Sterling versus Canadian Dollar	1.5491	1.6271	+5.04
Sterling versus Japanese Yen	129.4330	120.7000	-6.75
US Dollar versus Euro	1.4510	1.3449	+7.31
US Dollar versus Swiss Franc	0.8420	0.9042	+7.39
US Dollar versus Canadian Dollar	0.9642	1.0399	+7.85
US Dollar versus Japanese Yen	80.5600	77.1400	-4.25

LIBOR 3 MONTH RATE

	30 June 2011	30 September 2011	Percentage Change
Sterling	0.8256	0.9525	+15.37
US Dollar	0.2458	0.3743	+52.32
Canadian Dollar	1.1742	1.1967	+1.92
Euro	1.4906	1.4950	+0.29
Swiss Franc	0.1750	0.0233	-86.67

COMMODITIES

	30 June 2011	30 September 2011	Percentage Change
Reuters/Jefferies CRB Commodity Price Index	338.05	298.15	-11.80
Gold Spot $/Oz	1,504.32	1,628.68	+8.27
Brent Crude Index (London)	110.82	104.82	-5.41
Crude Oil Futures (New York)	95.42	79.20	-17.00

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