



A Review of our 2010 Outlook

In this note we review our thoughts and predictions we made at the beginning of 2010. At the beginning of 2010 many were still shell shocked from the rollercoaster ride that was 2009 but some investors, including us, predicted a profitable investment year for 2010. Indeed we believed that the 2010 would mark the beginning of a new era of opportunity for investors, an era that would not take its cues from the 'lost decade' we had just witnessed but one that would see the beginnings of solid longer term growth. Never one to hide behind the annals of time we present, as we do every year, our January 2010 note and throughout this document critically assess the preciseness of our thoughts and predictions.

What did we Suggest May Happen To Investment Markets in 2010

EQUITY MARKETS

In January 2010 we wrote "in our opinion, will remain turbulent but less volatile than 2009. We anticipate this will offer above-trend return and we remain positive for the 2010 outlook for Equities." Further we

concluded that “Generally, we do not believe that 2010 will be a year for an Equity index tracking strategy!! We believe this is specifically a time when individual themes, sector or country opportunities present themselves and is an environment far more suited to an active discretionary investment strategy, unlike 2008–2009 where strategy was much more generic in flavor. It will be fine to “buy and hold” but this will not make the most of the specific positives unfolding from economic recovery. We will, therefore, seek to follow an opportunistic Equity investment mandate, which may result in a more focused investment strategy than has been the case over the past 2–3 years.”

Despite starting the year brightly equity markets took a tumble in the summer months as worries over the sustainability of the economic recovery and sovereign debt issues in the euro zone turned investor optimism in to pessimism. Subsequent coordinated intervention by central banks (most notable from the US with the recommencement of their now nicknamed “QE2”) improved sentiment with the UK stock market making to new highs for the year in December. The 2010 annual return of the UK stock market (FTSE 100) a return of approximately 12% for the year was within our “10% to 15%” prediction made in January; albeit at the lower end of the range. We are pleased that we were able to capitalise on this gain through both changes to our asset allocation modeling (specifically being overweight equities during the bullish phases) and our underlying fund selection. A focus on more alpha-generative and unconstrained stock pickers, for example, was also a major contributor with several of our UK equity fund picks returning over 17% for the year.

We added further alpha to our portfolio through a focus on the dislocation between international equity markets. Investing in the US markets during the first half of the year offered us the double benefit of an out-performance in the equity terms (against the UK market) and added return as the dollar appreciated against Sterling. Another example was our investment in the Japanese equity markets specifically aimed at capturing the widening gap between European and Japanese equity markets. Given our concerns over the strength of the Japanese Yen we chose a yen-hedged investment, to negate any potential fall in the value of the international currency. This position continues to out-perform and is still held across the majority of our portfolios.

We even exploited opportunities within Europe where negative sentiment following the default crisis pressured the prices of even the most robust markets and companies. Again we reduced our currency risk associated with such international investment by utilizing a currency hedged product.

FIXED INCOME MARKETS

In 2010 we wrote “FIXED INCOME markets will face significant challenges throughout the year” and concluded that “Sovereign Debt now faces significant risks during 2010. The withdrawal of Central Bank buyback programmes, record levels of Government Bond issuance, the underlying potential for a moderate rise in inflation and the ensuing increase in interest rates, will certainly undermine valuations. A wider recognition that public finances are in a perilous state, particularly in the UK and US, further increases the danger of a Government Bond sell-off as the year progresses. We, therefore, do not expect to have any exposure to the Government Bond markets in the UK and US (the Euro zone is less susceptible to the aforementioned risks) except where we can gain short-exposure to the market and benefit, should valuations fall. We will be underweight Government Debt – if not with no allocation in 2010.”

It is often said that timing is everything and that was certainly true of the fixed income markets in 2010. The economic improvement we anticipated did not really start to assert itself until the second half of the year and even then it was initially overshadowed by further sovereign credit concerns in Europe culminating in the bail out of Ireland, and the announcement of yet further quantitative easing in the US. As investor risk aversion rose, a flow of capital into the fixed income markets (also supported by central bank buying) pushed yields on UK sovereign bonds (or Gilts) to record lows. The yield on a ten-year Gilt, for example, sunk from over four percent at the start of the year to a historic low of two point eight percent in August.

This proved a period of great soul searching for us as our underweight government security exposure, resulted in us falling behind our non-directional benchmarks in our most cautious minded portfolios. However, by the end of the year our thesis that the risk inherent in investing in even government backed securities was not being adequately factored into prices became more generally accepted. Indeed between Mid-October and mid-December, bond prices collapsed with yields expanding to levels near to where they started the year. The reasons for the capitulation are clear even if one ignores the credit worthiness of the UK (an ever-present spectre of ratings downgrade) and that inflation is persistently above target and shows no signs of falling. With commodity prices continuing to rise and 'real' interest rates in negative territory there is little to suggest that inflation will fall without monetary tightening, or higher interest rates. Add to this the eventual appreciation that blue-chip equities yielding near five percent offer a more attractive proposition than bonds and it is clear why bond values fell so dramatically towards year end. Fortunately we did not deviate from our asset allocation modelling throughout the year, and resisted the urge to jump back into the gilt market, which resulted in any underperformance (against benchmark) quickly evaporating in the fourth quarter.

Although government securities dominated the headlines in 2010, corporate bonds, continued to perform well. During the year we moved our exposure up the yield curve and benefitted thereafter. Each quarterly reporting season outshone the previous demonstrating the strength of corporate earnings and the success many have made in improving their balance sheets, reducing debt and costs.

PROPERTY MARKETS

In 2010 we took a slightly contrarian view and wrote "PROPERTY MARKETS may surprise us and are now offering an interesting opportunity". We went on to conclude that "we are, however, not so confident on the broader market outlook. Although residential property prices in the UK actually appreciated for more months than they fell in 2009, resulting in a near 6% increase, according to Nationwide, we are sceptical for such average growth this year. Many of the factors which buoyed prices last year, are running their course i.e. record low interest rates, a smaller than feared increase in unemployment, together with recent stabilisation in the Banking sector and signs of an economic recovery. The pent-up demand, particularly from cash-buyers, has also normalised. Should interest rates rise faster than expected and the employment landscape not improve as quickly as forecast, house sales may stagnate? We do, however, feel that both the yield and capital levels give us some upside potential for the first time in over 3 years." We are not short-term investors, however having re-entered the

property markets in early 2010, we exited later in the year, booking some attractive gains along the way. Property markets, decimated during the recession, were offering significant value, late 2009, early 2010, but as asset flows into the sector increased these opportunities quickly evaporated. We grew concerned during the summer that, with the valuation gap now closed; we were solely relying on the underlying investment fundamentals of the sector for returns, which we did not believe sufficiently supportive. Falling occupancy rates and rental rates (everywhere except for central London) does not bode well, and with significant amount of re-financing required in the coming years we grew concerned that we may again face the liquidity issues that many investors have only just emerged from (Sudden demand for redemption from property funds in 2008 and a fall in valuations forced many managers to suspend redemption or impose stringent gates this preventing investor access to their money). We therefore withdrew from this sector during the fourth quarter.

ABSOLUTE RETURN

In January we predicted that “ABSOLUTE RETURN focused investments will remain a source of lower volatility gains.” A statement that was backed up by our justification that Given the potential ebb and flow we expect from the Equity markets and our downbeat outlook for the Fixed Income sector, we believe that less correlated investments will help maintain a lower volatility of return within our portfolios. Secondly, there has been significant development within the sector in terms of objectives and strategies. We are now no longer constrained to focusing only on low volatility investments but can now select investments that offer higher betas and exposure to specific markets, once not available us.”

After solid gains in Absolute Return Funds in 2009, the returns in 2010 were rather subdued by comparison through positive across our investments choices. However, we believe the investment fully justified themselves and we did receive what was “written on the tin”, that is low volatility but positive returns throughout the year. Of concern going forward is the massive inflows of investor capital which certain funds within the sector have attracted. Often such growth is accompanied by subdued performance as managers struggle to put such levels of capital to work.

COMMODITY MARKETS

For the year we speculated that “COMMODITY MARKETS are set for further significant gains.” Further we wrote that “This year we expect Commodity prices to appreciate further; improvement in global economic growth and the accommodative monetary conditions we are now enjoying will be extremely supportive to the Commodity space as a whole. Indeed, the International Monetary Fund (IMF) supported this view in its 2010 Outlook when it said that the prices of many Commodities are likely to increase further because of strong demand and global economic expansion moving at a faster pace.”

Our prediction for higher commodity prices was entirely correct this year through even we did not fully anticipated the drivers of the gains, or even the gains that would be generated in certain markets. Adverse weather conditions across the globe both affected supply (destroyed crops boosting agricultural commodities) and demand (harsh winter conditions pushing crude oil to two-year highs for example). Further demand for all commodities from the emerging markets continued unabated as their economies continued to develop at a un-hindered pace.

The appreciation of precious metals generated the most headlines as gold, in particular, reached new giddy heights benefitting from weakness of the dollar, new sources of speculations (ETF's and other physically backed funds) and inflation fears. A belief by many that gold may prove to be the final currency of resort (we even heard calls for the reinstating of a gold-backed currency) contributed to its appeal and subsequent all-time high price.

IN CONCLUSION

In conclusion 2010 proved another interesting and ultimately profitable period especially against a backdrop of historically low interest rates. Positively we captured many of the major themes that developed during the year; some of which were overlooked by the investment community in general. The principal negative of the year was the powerful mid year rally in sovereign bond prices which we did not fully benefit from given our negative outlook. This view however, ultimately proved correct, and again underlined our ethos of looking past short term market movements and focusing on medium to longer term trends which we believe should drive our asset allocations policies.

Our “Outlook 2011” document will be published in January and again highlight our core investment themes for the forthcoming year. Request your copy now.

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