Investment Newsletter
September 2011

A Summer of Discontent

It's fair to say it has been a difficult summer!

Here is a (non-exhaustive) list of the events that we have seen over the past couple of months:

- Concern that Greece will default, followed by a draft European bail out agreement
- Markets turn on Italy and Spain and worry that they may not be able to pay debts
- European politicians argue about the bail out and cast doubt on whether it will be formally ratified by parliaments
- US politicians are unable to come to agreement regarding raising their debt ceiling until the very last minute
- The USA had its credit rating downgraded from the top AAA
- Speculation that France would be next to lose its AAA rating
- Worldwide, and particularly US, economic growth figures have been far worse than expected

And that is not even mentioning the riots in our cities, civil war in Libya, and continuing unrest in other parts of the Middle East!

Remembering 2007

August was without doubt our busiest month since the summer of 2007. Those who were clients at that time will remember frantically signing switch forms, some even queuing outside the office to do so, as we dramatically reduced property holdings.

Since then, we have introduced our discretionary service meaning when speedy action was required this time, we didn't generally need you to sign anything; however we did want to keep you up to date and we issued seven briefings during the month.

Given all the frantic activity, we would not be surprised if clients are a little confused about our current thinking regarding investments and portfolio positioning. Therefore, we thought it would be worth going over our present thoughts, and explaining how this affects your portfolios.

The Three Scenarios

In our view, there are three broad scenarios that we think are the likely potential outcomes for the world economy.

1. Low economic growth

The consensus amongst economists is still that the global economy will avoid recession and continue to grow, but very slowly.

There may be pockets of high growth, particularly in emerging markets, and perhaps some areas which do enter recession. However, by far the most likely outcome overall is for low but positive global growth. There is almost no chance that global growth will be as high as it was pre-credit crunch for some time.

We have no crystal ball, but if we had to put a likelihood of this scenario occurring (out of the three postulated here), we'd say perhaps 60% likelihood.

If this happens, we think equity markets could do very well, since in our view they are already pricing in scenario number two, which is...

2. Recession

Whilst we believe growth is still likely, there is no doubt the prospects are now worse than they were 6 months ago. There is a chance of recession, and if we had to put a number on it, we'd say a 30% chance.

If this happens, we will see continued volatility, however large global companies, which make up a larger than normal proportion of our equity holdings, should hold up well. The dividend yields remain attractive and they are still sitting on large amounts of cash. For example, Apple currently has more cash on its balance sheet than the US government!

If scenario two happens, we think equities will be volatile, but ok.

However, there is also the possibility of scenario three...

3. Credit Crunch Number Two

We don't think this is going to happen but we have to accept that it is possible.

If European countries are allowed to default, banks which hold large amounts of their debt could become insolvent. Banks all owe each other money, and if they become concerned that other banks may go bust they will stop lending to each other. That's when we get a credit crunch, and a potential domino effect.

We would perhaps put a 10% chance of it happening. Put it another way, we think there's a 90% chance that it WON'T happen, but that's still a much greater chance than we would like!

If another credit crunch does come to pass, pretty much all the asset classes will fall as happened in 2007 and 2008. Although cash could be vulnerable in the event of banks failing, we would expect governments to bail out the banks before they collapse. We therefore would want to have cash in this scenario, to protect against falls in other assets and to allow us to buy in and benefit from the eventual (but hopefully inevitable) rebound!

Portfolio Positioning

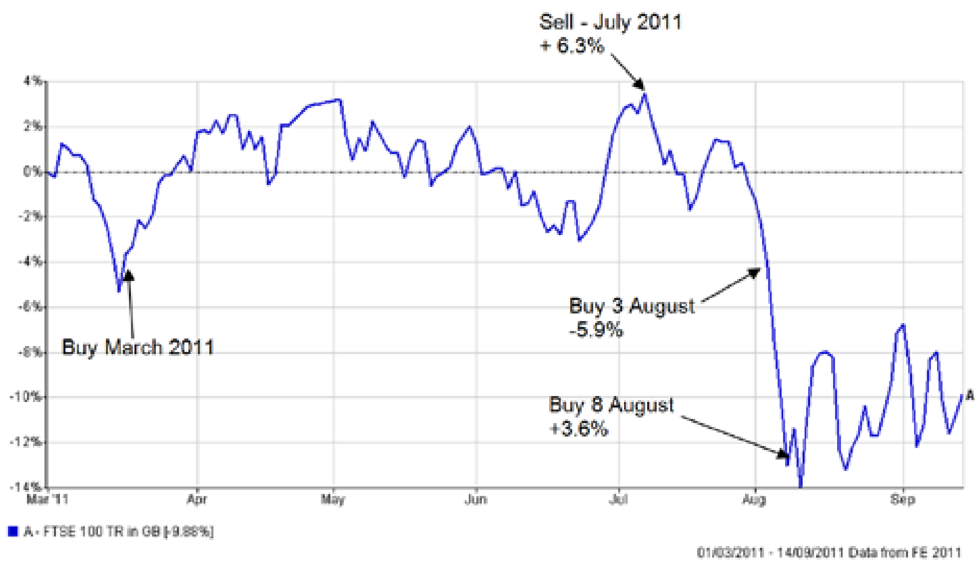
Given the above scenarios, your portfolios are generally:

- Overweight equities, which we believe could do well in scenario one and ok in scenario two
- Underweight property, which we think will be only relatively OK in scenario one but poor in scenario two
- Underweight fixed interest, which is likely to be only relatively OK in scenario one or two
- Overweight cash in the short term, in case of scenario three which would be dreadful for all the other asset classes!

Trades

For a typical model portfolio, we have made a number of trades which are detailed below.

The equity trades are shown against a graph of the FTSE 100. We are going back to March this year when we initially topped up equity following the tsunami in Japan:



(Gains or losses at 15 September 2011)

The trades we carried out in model portfolios to create cash from fixed interest and property are detailed below:

Date	Transaction	Amount
20/07/2011	Sold down all part of Property funds to cash (later invested in equity as above)	Approx 3% client portfolios
08/08/2011	Sold Monument Bond to cash	20% of Fixed Interest holdings
11/08/2011	Sold L&G Property, Threadneedle Property and Standard Life Property to cash	33% of Property holdings
11/08/2011	Sold M&G Inflation Linked Corporate Bond Fund to cash	20% of Fixed Interest holdings

Bespoke clients will have had similar trades, but they may differ slightly due to the tailored nature of your portfolios.

Those clients that take income from their portfolios should be assured that their income for the next two years can typically be funded from cash. This means that if we see further turbulence we won't be forced to sell at a market low.

We hope for a much more settled period going forward. If so, we hope we can deploy that cash to good use in the near future. We are already looking at new ideas and you are likely to hear from us again shortly!

In the meantime, we'd like to thank you again for your support and your kind comments over the past few months.

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Market Views | September 2011

General Economic Overview

Global economic growth is likely to remain muted. On balance we believe it will remain positive but the chance of recession has grown. As a result, interest rates are likely to remain low for the next two years.

European sovereign debt issues will continue to concern markets for some time but we believe we will avoid a second credit crunch. Inflation may die back in the short term but we remain worried about it in the long term.

Asset class key

+	positive	+5	strongly positive
-	negative	-5	strongly negative
=	neutral (normal behaviour)		

	Outlook
Equity Markets Based on valuations such as price/earnings ratios and dividend yield, many equities look good value. We were neutral in July when the FTSE 100 was around 6,000. Despite lower growth prospects, given the extent of market falls, we have moved to a +4 score.	+4
Fixed Interest Government and high quality corporate bonds have rallied due to risk aversion in other asset classes, whilst high yield has fallen back. 10 year gilts now yield around 2.5%, a record low, meaning investors will lose money after inflation. We expect below average returns from fixed interest, although there may be selected areas of value.	-4
Commercial Property Whilst the rental yield on commercial property remains attractive, this is diluted by high levels of cash in property funds. Capital growth is dependent on economic growth which is likely to be poor.	-5
Residential Property We believe prices are likely to remain flat over 18 months.	-5
Cash With interest rates remaining at record lows, returns on cash could remain below average for some time. However, there is a short term safe haven appeal.	-5

Balanced Asset Allocation

For a typical balanced portfolio we are overweight equity and cash and underweight the other asset classes. Based on our above scores we'd expect a Balanced Asset Allocation (excluding client cash) to return approximately 7.5% on average pa rather than the normal 8%pa over the medium to the long term.

A neutral score (=) means we expect the asset class to move in line with our long term assumptions: 10% pa for equity, 7% for property, 6% for fixed interest, 5% for residential property, and 3% for cash. A +5 score means we think the asset class could outperform by 50% or more. A -5% means we think it could underperform by 50%. A negative score does not necessarily mean we think the asset class will fall.

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.