

Losing interest ...

Last month we issued an adhoc Newsflash in which we explained how we had reduced fixed interest exposure as we had become more concerned about the potential risks.

We believe corporate bonds may still produce a positive return over the next 18 months but the risks have increased greatly. Many bonds have fallen in value recently, partly because many investors are now very positive on equity, and so have switched out of their defensive bonds in the search for more growth.

Another reason we don't expect great returns is inflation, which we think will remain significantly higher than the Bank of England target, which is 2% pa (Consumer Prices Index – CPI).

Inflation has consistently come in ahead of the Bank's expectations and they have now acknowledged it will remain above their target for the remainder of this year. This has been mainly driven by rising commodity prices, particularly the oil price, and now the VAT rise will be factored into prices too.

The normal response to high inflation is for the Bank of England to put interest rates up. One reason they normally do this is to put up the cost of borrowing, leaving people with less money to spend which should reduce pressure on prices.

However, putting up interest rates will have little effect on the factors that have been driving inflation. The Bank needs to be careful not to put up rates too soon, as this may reduce economic growth. However if they don't start putting rates up soon then, when they do go up, they are likely to go up quite steeply which could have a significant impact.

We believe rates are likely to start going up at some point this year, which would also be negative for fixed interest.



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Fixed Interest

We use the term "fixed interest" to describe this asset class as the majority of bonds have their interest rates fixed when they are issued.

To recap how a bond works, by buying a bond you are simply lending money to a government or company. If you buy a bond at issue it will cost you £100 each and your £100 will be repaid at fixed date, say 10 years time.

During that 10 year period you will receive a fixed level of interest. Those fixed interest rates still look generally quite attractive compared to cash interest rates, which remain at historic lows. This means people are often willing to pay more than £100 to get these rates, and now bonds are starting to look expensive.

In addition, inflation makes that interest rate less attractive, increasing the risk that prices will drop. Therefore, as well as reducing fixed interest exposure, we have also changed the make-up of our portfolios.

Inflation Linked Bonds

Not all bonds have fixed interest rates. It is also possible to buy bonds where returns are linked to inflation.

The most well known of these are index-linked gilts. Again, these are issued at £100 each for a fixed term.

This time, the level of interest is not fixed. The interest usually starts at a nominal 2.5% per annum but increases each year in line with RPI. The maturity value is not fixed at £100 either and this is also increased with RPI.

For example, a 10 year index linked gilt where inflation is a constant 2.5% throughout will mature at £128. The interest rate will be 3.2% in year 10. The higher the rate of inflation the higher the interest paid and the higher the maturity value.

We have added the M&G UK Inflation Linked Corporate Bond fund to both our standard and strategic fixed interest portfolios. This buys inflation linked corporate bonds rather than gilts, which fits in with our view that corporate debt looks much better value than government debt, which looks expensive.

We have sold the M&G Corporate Bond and M&G Optimal Income funds in order to buy the inflation fund, not because they are poor funds, but so we are not overexposed to any one fund manager.

Other Changes

We have also added an "absolute return" style fixed interest fund, the Threadneedle Credit Opportunities fund. This can make money from bonds rising or falling in value. In the past it has produced very steady returns making it suitable for our mainstream fixed interest portfolio.

The fund can invest anywhere from safe government bonds to riskier high yield corporate bonds. It provides a good blend with our other funds, and our fixed interest portfolio overall will remain at least 80% investment grade bonds or cash.

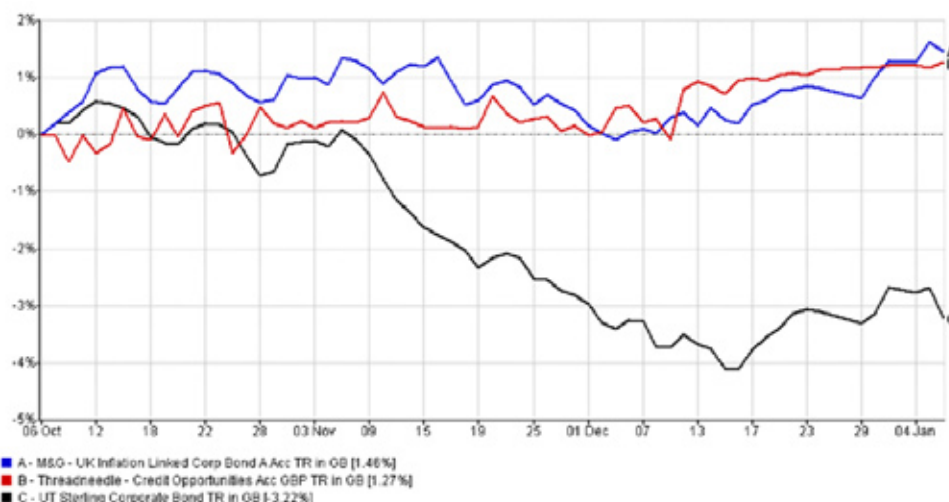
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The two funds are shown over that past few months in the chart below. As you can see, they held up well during a period where corporate bonds dropped in value:



Although past performance is not a guide to future performance, this chart does illustrate how the new funds perform quite differently to a typical corporate bond fund.

Future Changes

We are likely to make further changes very soon and will let you know when these are carried out. As always, our first thought is to keep risk to a minimum.

If we believe that on balance an asset class will return perhaps 4% over the next year or so, but there is a significant risk of a 15% drop, that does not look like a good risk/reward trade off. We would prefer to make less money and keep the risk of falls to a minimum.

As well as fixed or inflation linked bonds, it is also possible to buy "floating rate" bonds, where the interest is linked to Bank of England base rate.

Perhaps we need to stop referring to the asset class as "fixed interest"!



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Market Views | January 2011

General Economic Overview

GDP growth is expected to be muted but positive. We believe inflation may remain well above the Bank of England target for some time, and potentially be a concern in the long term.

We believe interest rates could rise mid way through 2011 but will remain relatively low to try and stimulate economic growth. Raising interest rates would have little impact on inflation, which is mainly being driven by commodity prices and the VAT rise.

If our scores below turned out to be correct, our balanced asset allocation could return around 7.46% over the next 18 months compared to our long term assumption of 7.6% pa.

Asset class key

+ positive

- negative

= neutral (normal behaviour)

+5 strongly positive

-5 strongly negative

	Outlook
Equity Markets Despite recent upward moves, equities still look fair value on current earnings. Earnings continue to be revised upwards and if next year's projections are correct there is the potential for relatively strong growth. We remain overweight "alternative equity" giving exposure to further equity growth but with some downside protection. We believe that high quality, well capitalised companies should outperform, as they have not seen the same growth as poorer quality stocks.	+1
Fixed Interest We are becoming concerned about the risks of investing in fixed interest. Given our views on inflation and interest rates, returns are likely to be much lower than they have been of late whilst the risk of losses is increased. We believe there is much more value in inflation linked bonds than fixed interest bonds.	-4
Commercial Property The rental yield on the commercial property index remains very attractive relative to other asset classes. However, we don't expect to see much more capital growth over the next 6 months. Growth may improve after that. Property funds are gradually reducing their high cash levels, which has been a drag on returns. Returns should improve again once the strong inflows into funds reduce to more normal levels.	-1
Residential Property We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.	-5
Cash With interest rates remaining at record lows, returns on cash are as low as they have ever been, and we don't see that changing for some time.	-5

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.