

# **HALF YEARLY INVESTMENT REPORT**

**16 June 2005**

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## **Half Yearly Investment Report – June 2005**

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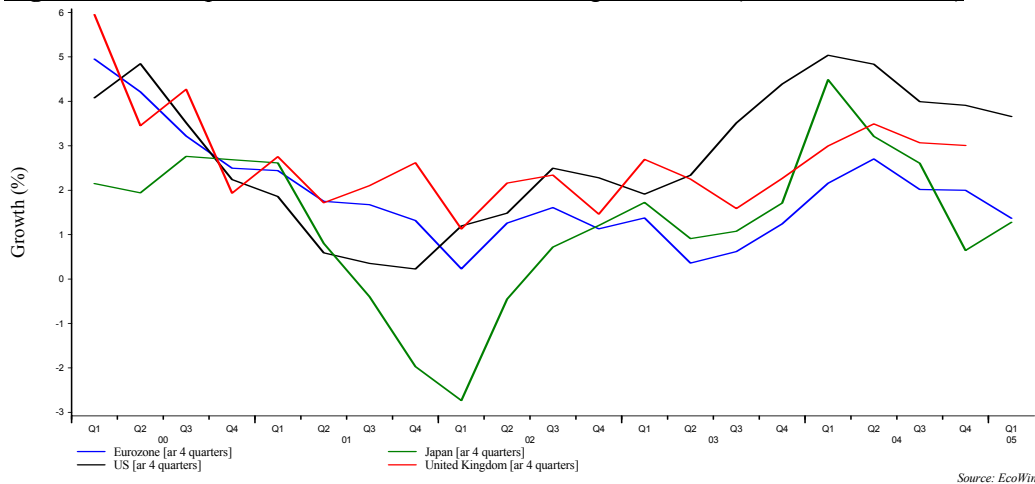
This report is for general guidance only and represents our understanding of law and Inland Revenue practice as at 16 June 2005. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income from them may go down as well as up and you may not get back the full amount you invested. Also past performance is not a guide to future performance. Levels and bases of, and relief from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor.

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## 1. Market Overview

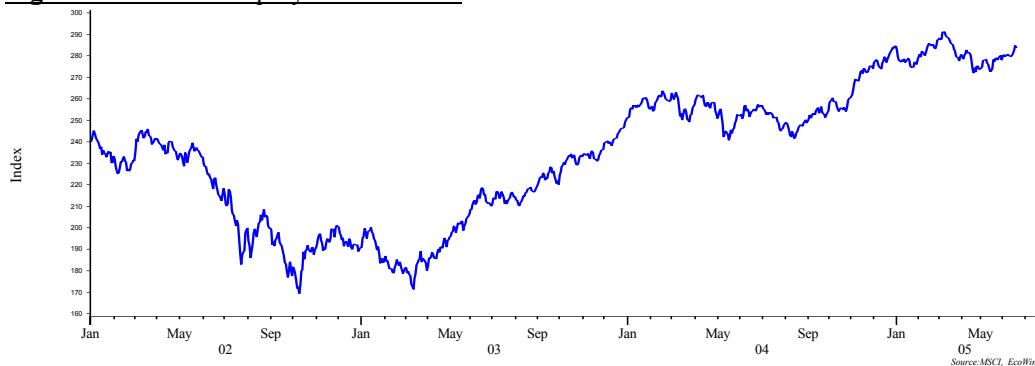
Over the last six months the world's major economies have experienced a slowdown in economic growth (see Fig.1). This is in accordance with policy makers' aims in Anglo-Saxon economies where concerns surrounding excessive consumer borrowing and nascent inflation have prompted base rate increases. The slowdown has also been felt, less helpfully, in the Eurozone and Japan.

**Fig 1: US, UK, Japanese and Eurozone annual GDP growth rates (real GDP Y-o-Y %)**



Government bonds have provided the surprise in global markets over the last six months. Whereas most commentators, including ourselves, had expected flat or even slightly increased government bond yields, as base rate increases moved interest rates higher across the yield curve, bond yields have in fact fallen. Alan Greenspan, the Chairman of the Federal Reserve, has referred to the falling US long bond yield, despite base rate increases, as a 'conundrum'. Whether falling government bond yields signal investor fears of recession or simply a 'flight to quality' as investors, particularly hedge funds, switch out of riskier assets into the relative safety of government bonds remains to be seen. Low bond yields have historically been good for equities but fears of a sharp slowdown in growth, with its consequent impact on company profits have held back equity markets. The MSCI World Equity Market Index has advanced by less than 2% over the six months to the end of May (see Fig.2).

**Fig 2: MSCI World Equity Market Index**



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### **2. Summary of Conclusions**

#### The World Economy

- Economic growth has slowed. Looking forward, we believe that moderate growth will be maintained through 2005 and into 2006.
- There are likely to be further base rate rises in the US. Elsewhere, interest rates are probably at their cyclical peak. A rate cut in Eurozone is becoming more likely.
- Oil prices look likely to stay at around \$50 per barrel. This is acting as both a dampener on global activity and a driver of higher inflation.
- Inflation has moved higher reflecting sharp rises in commodity prices. However, monetary authorities appear to have acted in good time to head off any threat.

#### Financial Markets

- We expect the US dollar's decline against most major currencies will resume later in the year.
- The rejection of the new European constitution by the French and Dutch has caused the euro to weaken. We expect a recovery against sterling and the dollar during the second half of the year.
- After a strong rally in recent weeks, we expect government bond prices to hold steady or even fall back slightly.
- Equity markets should continue to make modest headway.

#### Investment Recommendations

- Cash deposits, earning 4.75% in sterling, are reasonably attractive.
- We remain wary of corporate and high yield bonds where the risk premiums, in our view, are still inadequate.
- Property yields are still quite attractive. However, with slowing economic growth we do not anticipate further capital gains.
- Equities represent reasonable value in most regions. We favour positions in the UK, Far Eastern and the European markets in preference to the US.

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### 3. Economic Outlook

In 2004 the **global economy** grew total GDP by 4.9%, the most rapid rate of economic expansion since 1976. Unsurprisingly 2005, thus far, has not matched this pace. Base rate increases in the **US, UK** and other countries over the past 18 months, together with the rising oil price, meant that economic activity was already slowing as 2005 began. This slowdown has continued as the year has progressed.

The speed and likely extent of the slowdown in activity are the key topics for economists and investors at present. Data releases have been mixed. For example, the US has continued to create jobs but confidence indicators and retail sales data have shown marked weakness. While the US, UK and most Far Eastern countries look likely to manage a slower but still healthy rate of growth this year, some concern surrounds **continental Europe**, especially the core of the Eurozone, and **Japan**. In both of these areas, low but improving economic growth in 2004 appears in danger of being snuffed out prematurely by the global slowdown. It is within this context that the recent rejection of the new European constitution by the electorates of France and Holland is of particular concern. The 'no' vote will delay reform in the structure of European markets, further hindering an already weak economic performance. It is of little surprise that, as a result, the euro has weakened sharply versus other major currencies and German bond prices have advanced to all time highs. We believe that the European Central Bank (ECB) will now have to cut base rates to promote stronger growth, while politicians will need to address the electorates' concerns on unemployment and seek new mandates for reform.

One area of undisputed policy success for politicians has been anti-inflationary policies. The global economy appears to have withstood a substantial oil price shock with consumer price indices showing a muted move upwards but no secondary effects. The use of inflation targets by independent central banks, aided by a more competitive international economy, has meant that inflation has remained under control. With economies now weakening, inflation should provide no unpleasant surprises.

Looking forward to the second half of 2005 and into 2006 there are, as usual, many sources of concern for investors. The US deficits, on the current account and federal budget accounts, still loom large - though the recent strength in the dollar implies that there is no shortage of credit for either the US consumer or government. Elsewhere, concerns about the indebtedness of consumers in the US, UK and Australia, and the corresponding weak consumption picture in mainland Europe and Japan, are also issues. Finally there is the risk that weakening economic growth turns into recession.

Our view remains that these global imbalances will correct over the medium term, notably through a revaluation of the renminbi, the Chinese currency, slower consumption growth in the US and reform in continental Europe. In the shorter term, we believe that the global economy has sufficient strength to avoid recession and that consensus forecasts for global economic growth of 3.0% to 3.5% in 2005 will be proved broadly correct.

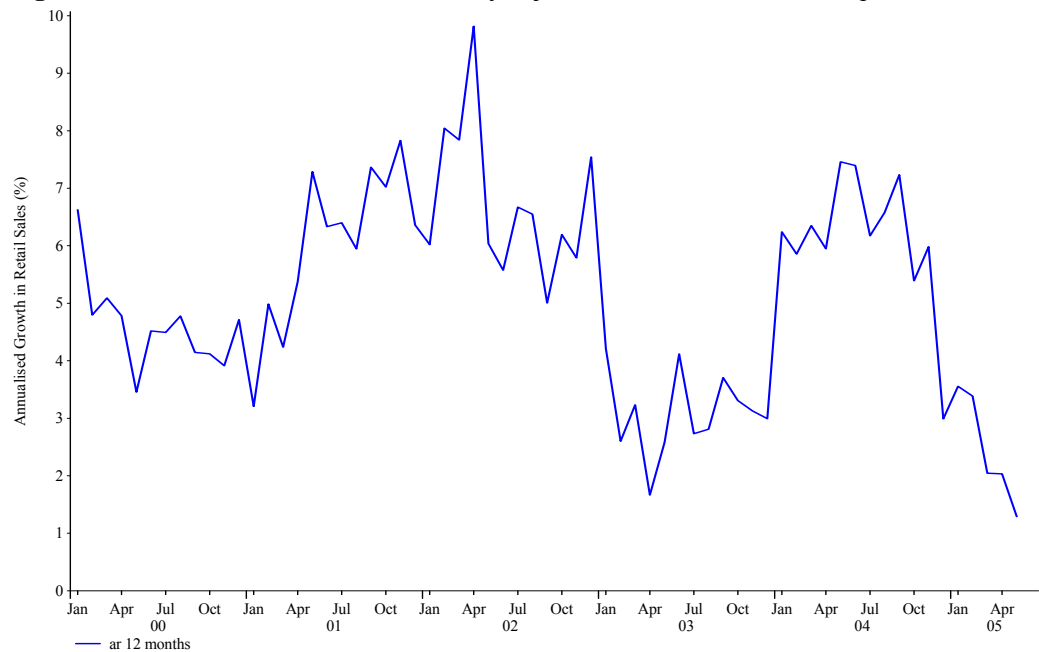
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While there is some debate about whether the UK's current economic expansion is the longest in history, there can be no debate that the performance of the UK economy remains very impressive. GDP growth of 3.1% in 2004 was better than all other G7 economies except the US and better than all of the UK's western European neighbours except Ireland.

Unsurprisingly, after five base rate rises, the pace of growth is slowing and signs of weakness are appearing, most notably in the retail sector and in the housing market. Figures for GDP growth for the first quarter of 2005 were confirmed at 0.5%, compared to 0.7% in the last quarter of 2004 indicating that, so far at least, the slowdown has been gentle. Forecasts for growth for calendar year 2005 are around 2.4%.

The quarter point base rate increase from the Bank of England's Monetary Policy Committee (MPC) in August 2004 looks likely to have been the last in the current business cycle. This monetary tightening has already caused the rate of growth in retail sales to ease (see Fig. 3). Non-food retail sales are now actually declining, although this may paint too bleak a picture as many food retailers, such as Tesco, are expanding rapidly into non-food product areas - artificially depressing the non-food retail sales numbers. However, judging by the number of profit warnings from quoted retailers there can be little doubt that consumer spending has moderated significantly.

**Fig 3:** Growth in UK Retail Sales seasonally adjusted and shown at constant prices

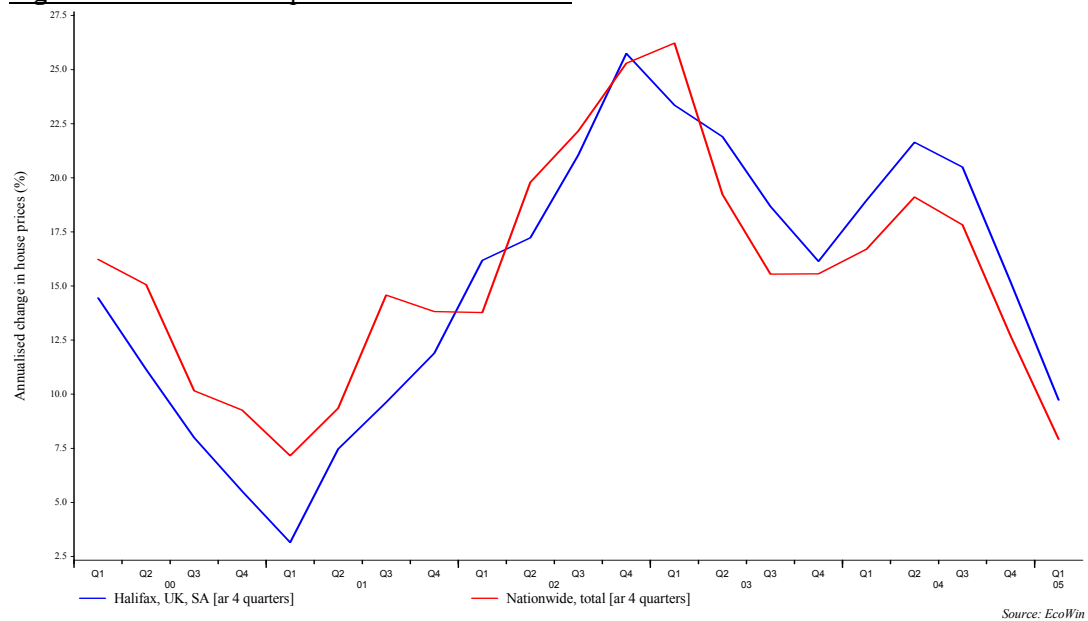


Source: EcoWin

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Evidence of the weakening economy is also apparent in the UK housing market (see Fig. 4). According to the Halifax House Price Index, prices declined in both April and May and the annualised rate of price increase has now fallen to 5.7% from 22.1% in July 2004. Economists at the Halifax are now forecasting a 2% decline in house prices for the year as a whole. We maintain our view that house price inflation will continue to moderate and that a prolonged period of stagnation remains more likely than a house price crash. Our rationale for this is that, with low unemployment and low interest rates, there is no trigger for panic selling or higher repossessions. One or both of these conditions would be required to cause a sharp fall in house prices.

**Fig 4: Annual UK house price inflation since 2000**



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### 4. Investment Outlook

The outlook for slower economic growth outlined in the previous section leads us to conclude that base rates, outside the US, are now at a peak. Even within the US, further base rate increases are likely to be limited. In anticipation of slower growth and possibly even base rate cuts in some economies, **government bond** prices have risen sharply in recent weeks and yields now stand at historically low levels in many countries. We believe that price rises have gone far enough and that, at current yields, government bonds are only fair value.

**Investment grade** and **high yield bonds** have underperformed government bonds markedly since mid-March. Fixed income investors have sold higher risk corporate and high yield bonds in favour of holding government debt, judging that the yield premium paid on corporate debt is too low and that a weakening economic picture has increased the risk of default. We believe that this process may continue for some time and would prefer to maintain our exposure to fixed income through government bonds.

We still regard **equity markets** as reasonable value in most regions. This is most notable when comparing the yield available on equities with that on fixed interest. Whether slowing economic growth brings corporate earnings and dividend growth to a halt is the key consideration for equity investors at present. We believe that this is unlikely and that strong corporate cash flows and P/E ratios below historic averages should compensate for slower earnings growth.

In the US, equities still appear relatively expensive while the dollar, after a rally in the early part of 2005, still appears vulnerable in the medium term. This further reduces the attraction of unhedged US assets. We therefore maintain our preference for UK, Far Eastern and European equities.

Despite weak growth and some structural issues in Europe we believe that the case for investing in the region is still intact. Continental European equities, despite slow growth and the recent turmoil surrounding the rejection of the new European Union constitution, have performed well (see page 15). In P/E terms they still offer reasonable value while corporate mergers, acquisitions and restructurings offer fund managers opportunities for profitable stock selection.

The yield on **cash deposits** is linked to the base rate, currently standing at 4.75% p.a. This is above both 10 year bond yields and inflation. While rates may fall later in the year we see no more than a half point total reduction over the next 12 months.

**Commercial property** also offers a yield above 10 year bonds and inflation. However, investor enthusiasm for this asset class has driven prices sharply higher since the first quarter of 2002. We believe that this trend may now be coming to an end.

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### 4.1 Cash Deposits

We believe that a return of 4.75% per annum, or better, on sterling deposits remains attractive from a defensive perspective. Rate cuts, if they were to occur later in the year, would signal weakness in the outlook for the economy and in these circumstances we believe an allocation to cash deposits would be fully justified. Inflation has moved higher in recent months but now looks likely to decline once more as cyclical pressures from rising commodity prices and other costs recede. The real return offered by a cash deposit is, therefore, unlikely to be eroded by higher inflation.

### 4.2 Fixed Interest

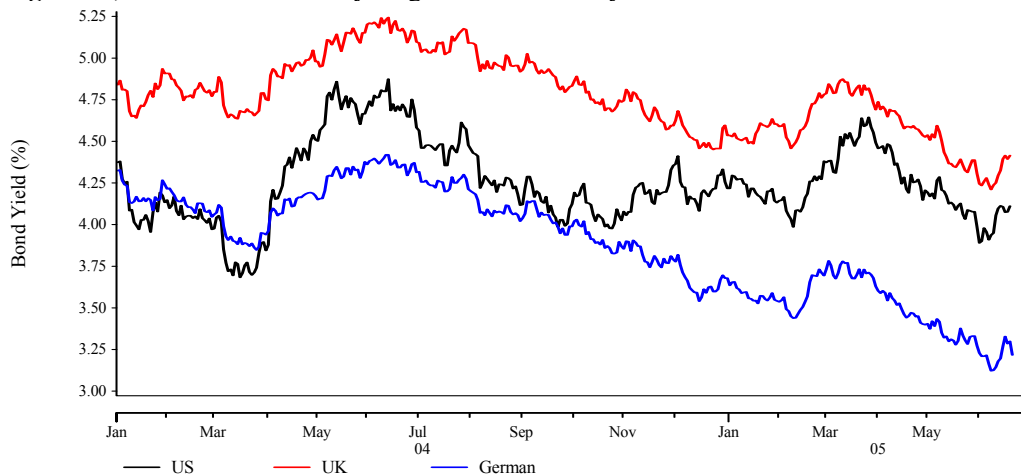
With the exception of a brief rally in February and March the yield on government bonds has trended downwards over the last six months (see Fig. 5), generating capital gains on bond holdings. We feel at present they are fair value.

There is considerable debate in the press at present concerning the reasons for the low government bond yields that now predominate around the world. Possible explanations include impending recession (with accompanying concerns about deflation), a shift in investors' perception of inflation risk and persistent buying by pension funds, hedge funds and central banks.

Our view remains that growth in the global economy will slow to long term trend rates of around 3% but no further. In support of this we cite continuing robust growth in the Far East, Eastern Europe and emerging markets, strong demand for oil, continuing job creation in the US (although the trend is volatile), and strong corporate balance sheets in most regions supporting growing capital investment.

The alternative scenario, in which the recent fall in bond yields is correctly signalling a sharp economic slowdown or even recession, remains only a remote possibility. However, it does justify an allocation to government fixed interest stocks. This would offer a degree of protection as capital values would rise if economic growth slowed.

**Fig 5: US, UK and German 10-year government bond yields**



Source: EcoWin

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### **- UK Government Bonds**

The gross redemption yield on the Treasury 4 3/4% 2015, the UK government 10 year benchmark gilt, is currently 4.39%. This is higher than that available on US or German government bonds of the same maturity (which offer 4.08% and 3.30% respectively). At this level of yield we believe that UK government bonds should be held within portfolios to give protection against a global shock, such as a further substantial oil price increase or an act of terrorism, but that they offer little scope for further capital gains.

Gilts carry negligible default risk and the par value is guaranteed if held to maturity. We generally recommend that clients buy government bonds directly rather than through funds, thereby avoiding ongoing management charges, which can be high relative to the yield.

### **- UK Index-Linked Government Bonds**

In tandem with the yield on conventional gilts, the yield on index-linked gilts has fallen during the last six months. The performance of conventional and index-linked gilts has been similar, which indicates that investors' attitude towards the risk of inflation has not changed and that the downward shift in yields is related to a general appetite for fixed interest and low risk investments. If investors believed that strong oil and other commodity prices would drive inflation markedly higher, index-linked gilts would have outperformed conventional gilts. Conversely if investors were concerned that the current period of slowing growth might turn into a full blown recession, with perhaps a Japanese style deflationary spiral, conventional bonds would have been the better performing asset. We therefore conclude that the strength in government fixed income markets is due to persistent buying, perhaps from pension funds addressing their funding deficits and hedge funds fleeing from riskier high yield bonds. To guard against an inflation shock we continue to recommend an allocation to index-linked government bonds within portfolios.

### **- Investment Grade Corporate Bonds**

Investment grade corporate bonds pay an additional yield over government bonds of similar maturity to compensate investors for the higher credit risk associated with lending to a company rather than to a government. This additional yield, known as the yield premium, has been declining for several years as investors have sought higher returns and accepted the accompanying higher risk. We noted in our last report that yield premiums were, in our view, too low for investors to justify taking this additional risk and we suggested selective profit taking from the asset class. Yield premiums hit lows in early March (see Fig. 6) and have started to move higher. We believe that the upward trend in yield premiums will continue and, therefore, continue to recommend that clients reduce exposure to corporate bonds.

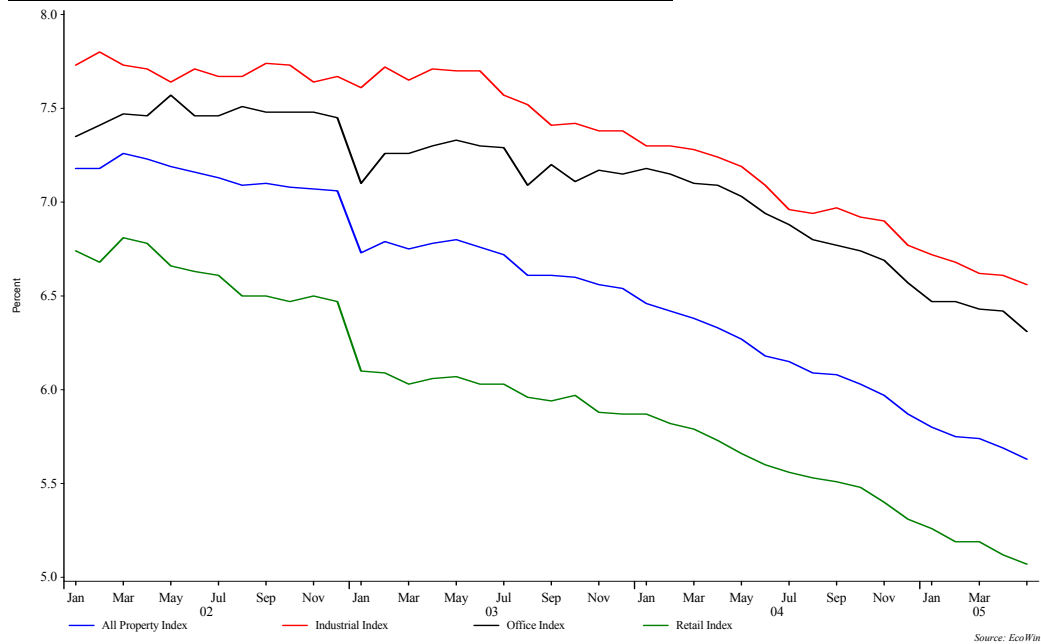


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### 4.3 Commercial Property

UK commercial property has provided very strong returns over 1, 3 and 5 years (see page 19). It has benefited from low interest rates, falling bond yields and a strong consumer spending environment. The very strong growth in consumer spending in recent years has boosted the demand for retail space and indirectly supported the demand for industrial property of which retail warehouse space accounts for a significant proportion. While bond yields remain supportive, the slowing consumer environment, which is showing up in profit warnings from general retailers, and falling job vacancies in the retail sector, may eventually exert downward pressure on commercial property prices and therefore upward pressure on yields. There is no sign of this yet - the chart below shows yields have continued their steady decline (see Fig.8). The yield available on investments in retail space, as measured by Investment Property Databank (IPD), is now only a little over 5.1%. We are concerned that commercial property values are increasingly being driven by money allocated to the sector rather than genuine tenant demand. We are therefore holders of well diversified property funds for diversification purposes but expect further capital gains to be limited.

**Fig 8: Falling yields on UK Commercial Property by Sector**



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### **4.4 Equity Markets**

#### **- UK Equities**

The UK equity market is offering a prospective yield of 3.7% and is trading on a prospective P/E ratio of 11.8x when measured to December 2006.<sup>1</sup> This is based on earnings growth of around 10% in 2005 slowing to 5% in 2006. Dividend growth is forecast to be 9% in 2005 slowing to 8% in 2006. This healthy level of earnings and dividend progression, together with ongoing strong merger and acquisition activity, special dividends and share buy backs, gives us comfort that the UK equity market can provide good total returns over the next twelve months.

Foremost amongst the risks to equities is that of slowing growth causing profit downgrades and thus removing valuation support. Falling profits, resulting from below trend growth or recession would clearly be damaging for equities. However, UK equities are considerably cheaper than at the market peak at the end of 1999. While the FTSE 100 index is still 27% lower than at the market peak, corporate earnings have risen in each of the intervening years meaning equities offer far better value now than five years ago.

#### **- European Equities**

While the continental European economy is not growing strongly, we remain believers that European equity markets are still attractive. Interest rate cuts are now coming onto the European Central Bank's agenda and the recent weakening of the euro will help international competitiveness. Additional cause for optimism comes from two other sources. Firstly, the pressure for structural and labour market reform is increasing. Reform, once firmly established on the political agenda, would be reflected quite quickly in equity markets. Secondly, the structure of the European Union, particularly the single currency and single interest rate, gives active investors good stock picking opportunities in smaller companies, in companies in peripheral countries which are benefiting from low interest rates and in companies which are set to profit from the accession of the ten new members to the EU. The European equity market, as measured by the Eurofirst 300 Index, recently reached a new three year high but is still more than 33% below its September 2000 peak. European equities are typically selling on P/E ratios similar to those for UK stocks.

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<sup>1</sup> Source: UBS

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### **- North American Equities**

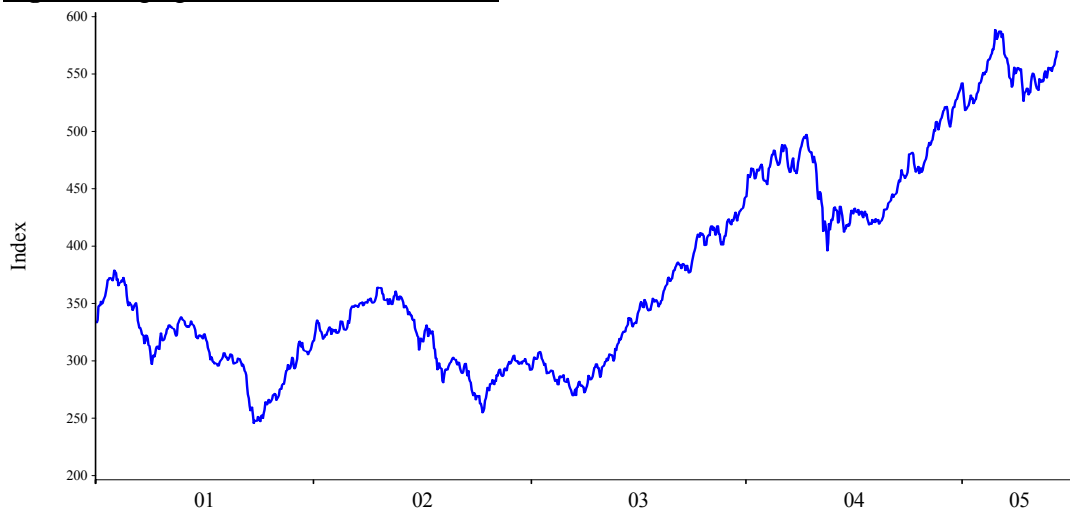
We believe the US equity market remains unattractive to sterling based investors. Interest rates continue to rise, which will eventually slow economic activity. The S&P 500 is still 20% below its March 2000 peak but the rating, at about 16x P/E for 2005, remains high relative to the UK and Europe. The difference is more pronounced when comparing free cash flow multiples. Also, while the US dollar has strengthened against other major currencies so far in 2005, we believe that the long term trend remains downwards. This would lower returns to sterling based investors holding US assets.

Finally, the imbalances on the current account and the budget deficit continue to worsen. The US current account balance reached \$666bn in 2004 (5.7% of GDP) up by 21% on the 2003 deficit while the government's budget deficit was \$412bn in 2004 (3.5% of GDP) up 9% on 2003. We continue to believe that these factors will eventually result in lower economic growth, lower company profitability and a weaker dollar exchange rate.

### **- Far East and Emerging Markets Equities**

We believe that Far Eastern and emerging market equities are attractive. The Far East is the fastest growing region of the world with China and India the main economic drivers, recording growth of 9.5% and 8.2% respectively in 2004. Japan, the region's biggest economy, is reliant on exports to China for its growth and is benefiting accordingly. Japanese companies are increasingly focussing on profitability rather than sales growth and the equity market now carries a higher yield than Japanese government bonds. Japanese equities, as measured by the Nikkei 225 index, are still 70% below their 1989 peak. Elsewhere in the region, growth, while slowing from the levels seen in 2004, remains strong and equities have continued to perform well (see fig. 9).

**Fig 9: Emerging Markets, MSCI Index, US\$**



Source: MSCI, EcoWin

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### 5. Fund Performance Commentary

Table 1 below contains performance figures for the major fund sectors while on page 19 there are tables with figures for some of our selected funds.

**Table 1: Average Fund Performance**

<b>UK Sectors</b>	<b>6 Months %</b>	<b>1 Year %</b>	<b>3 Years %</b>	<b>5 Years %</b>
UK Equities – All Companies	6.2	15.0	10.5	-5.5
Fixed Interest Sterling	3.3	10.6	23.3	33.4
Index-linked	2.8	8.3	21.9	26.0
Property	7.5	16.7	39.2	62.3
Money	2.0	4.1	10.8	21.2
Balanced Managed	6.1	13.9	9.6	-4.6
Managed Stockmarket	6.5	14.6	7.9	-6.0
<b>Overseas Sectors</b>				
Global Equities	7.2	15.3	5.0	-18.9
North America	5.9	8.8	-9.8	-33.4
European (excl UK)	7.9	20.9	13.0	-17.3
Far East (excl Japan)	9.2	23.4	18.3	14.3
Japan	2.9	4.4	-3.7	-39.1
Global Fixed Interest	2.5	9.4	15.5	26.1

*(Source: Reuters Hindsight ABI UK Pension Fund Series on a bid to bid pricing basis to 31 May 2005)  
The performance figures quoted below are in sterling terms and cover the six months to 31 May 2005.*

The FTSE All-Share index rose 5.9% in the six months to 31 May. Several recommended **UK equity** funds have done well. These include Rathbone Income (7.9%) and Fidelity Special Situations (7.5%). The Fidelity fund is now £4.67bn in size. This does not appear to be hampering performance. We will continue to monitor this closely as well as Fidelity's succession plans for Anthony Bolton, the fund's manager.

Funds in the IMA UK Equity Income sector (sector average performance 8.5%) have generally outperformed those in the IMA UK All Companies sector (average 6.5%). Funds such as Invesco Perpetual Income (11.7%), Jupiter Income (10.4%), Credit Suisse Income (9.2%) and Merrill Lynch UK Income (8.9%) are all in this sector and have performed very well relatively. The managers all take slightly different approaches to portfolio construction but broadly all invest in companies with high and secure dividend income.

Some funds in the IMA UK All Companies sector have also performed well using different investment styles from the income funds mentioned above. These include the Schroder Recovery (8.2%) and the Old Mutual UK Equity (8.0%) funds. GAM UK Diversified has marginally underperformed (5.1%). We met the manager of this fund, Andrew Green, recently. The period of weaker performance results from a repositioning of the fund away from smaller companies. We remain confident that this fund will deliver strong results in the longer term.

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In the smaller companies sector, the Throgmorton Trust has continued to generate strong returns. Over the period it has increased by 12.5%, though it continues to trade at a discount to net asset value (NAV) of approximately 19%. Aberforth Smaller Companies has also performed well (11.0%) and currently stands on a 7% discount to NAV. Among the many unit trusts and OEICs investing in smaller companies we have been recommending Merrill Lynch UK Smaller Companies (14.3%) and Standard Life UK Opportunities (8.2%). We believe that the managers of both of these funds have very strong investment approaches.

Returns to UK holders of **US equities** have been enhanced by the recent rally in the US currency. In dollar terms, the S&P 500 increased by just 1.5% in the six month period but this translates into a sterling gain of 6.2%. The JP Morgan Fleming American Investment Trust and the Credit Suisse Transatlantic unit trust returned 7.5% and 6.4% respectively. We are currently recommending an underweight position in US equities on account of the relatively high valuations and our belief that the dollar's downward trend will resume. We have implemented this strategy by recommending clients reduce their pure US funds but retain some exposure to the North Atlantic Smaller Companies fund as this is only 36% invested in the US. This fund invests predominantly in smaller quoted and unquoted companies. It focuses on attractively valued companies that are potentially overlooked by other managers. Although this fund only generated returns of 1.2% over the last 6 months, over longer time periods it is first or second quartile within the IMA North American Smaller Companies sector.

**Continental European** equities have performed slightly better than UK equities over the last six months. The Fidelity European fund continues to outperform its peers, growing by 11.5% while the Fidelity European Values Investment Trust, its sister fund, was up by 10.6%. The Jupiter European Special Situations fund and the Schroder European Alpha Plus fund have also performed well (9.8% and 7.2% respectively). We have met the managers of these two funds and believe they can deliver strong investment performance in future. Elsewhere, the European Assets Investment Trust returned 13.2% and the Gartmore European Select Opportunities Fund returned 8.2%.

**Japanese** equities produced only a small positive return over the period under review. The Schroder Japan Alpha Plus and the Schroder Tokyo funds returned 6.6% and 3.7% respectively. After a disappointing performance in 2004, the Japanese economy is picking up once more, with GDP growing at 4.9% in the first quarter of 2005. The recent weakness of the yen against the dollar is further good news for Japan's exporters and the Nikkei 225, Japan's main stock market index, recently hit an eight week high.

The **Far East including Japan** sector performed approximately in line with the Far East excluding Japan sector. The Invesco Perpetual Pacific fund generated strong returns of 9.3%. However, the Martin Currie Pacific Investment Trust fell by 0.6%. Many Asian markets weakened in April as concerns over the health of the US economy weighed heavily on investor sentiment. Martin Currie's underperformance was due to its heavy exposure to mid and small capitalisation stocks. Within the **Far East excluding Japan** sector Edinburgh Dragon produced strong relative numbers returning 11.8% (sector performance 9.4%).

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Over the last six months, **Emerging Markets** have made good progress. The Templeton Emerging Markets investment trust returned 10.5%. This sector will continue to do well if consumer spending increases are sustained in markets such as Taiwan, Thailand and Hong Kong.

**Stockmarket Managed** and **Managed Equity** funds have generally performed well over the period. RIT Capital Partners, which invests in quoted and unquoted securities, British Empire Securities and the Martin Currie Portfolio have grown 10.7%, 9.7% and 7.9% respectively.

The **Private Equity** sector has continued to provide very strong returns. Candover, Graphite Enterprise, HG Capital Trust and Pantheon International Participations rose by 22.6%, 10.4%, 31.7% and 21.0% respectively. Elsewhere in the sector, the Electra Investment Trust has continued to return capital to shareholders. Realisations from pre-June 2001 investments have been two-thirds returned to shareholders and one-third re-invested. Investment realisations since 2001 are being fully re-invested. Electra has a relatively mature portfolio. It also has a reputation for conservative valuations and showing patience when selling businesses. Since this is one of the few private equity investment trusts to be trading at a discount to NAV and to have more cash than debt, we are recommending clients retain holdings. Candover has had a strong six months as a result of an excellent run of realisations. It has a fairly high cash balance which gives flexibility to invest as opportunities arise.

Funds in the **Balanced Managed** sector have generally performed well. Framlington Managed Balanced (8.7%), Newton Exempt Global Balanced (8.0%) and Winterthur Schroder Managed (7.3%) all outperformed the sector average (5.7%), as they have done over most time periods. The lower risk Morley Sentinel Managed (6.8%) and Investec Cautious Managed (5.9%) funds also outperformed, beating the Cautious Managed sector average of 4.6%. These funds have approximately 45% of their assets in non-equity investments.

Investment grade sterling **Fixed Interest** returned 2.9% over the period. The Morley Corporate Bond fund marginally outperformed the sector average, returning 3.9%. Within the high yield sub-sector we have continued to recommend clients reduce exposure. The yield premium on these bonds over that available on government gilts does not look sufficiently attractive to compensate for the additional risk. We have recommended the complete sale of Threadneedle High Yield and partial reductions of Legal and General High Income and Isis Strategic Bond. It appears many hedge funds have also been reducing exposure to high yield bonds on account of increasing risk aversion and the downgrade of GM and Ford to sub-investment grade status. The proceeds from these disposals are being invested in government fixed interest securities such as UK government **gilts**. This effect may be in part responsible for driving up the price of gilts, with the yield available on the 10 year gilt having fallen to as low as 4.2% in recent weeks.

## Half Yearly Investment Report – June 2005

**Property** funds have continued to attract large volumes of money. Scottish Widows, Standard Life and Threadneedle have all imposed restrictions on the proportion that can be invested in their funds subject to policy value, or they are operating waiting lists. Standard Life has had a waiting list since the end of 2004. This is currently £16m in size and the typical waiting period is 2 to 3 months. Such investor enthusiasm to gain exposure to the sector supports our concern that commercial property values are increasingly being driven by money rather than tenant demand. Yields have now fallen to levels last seen in the late 1980s. Investors face the risk of a slowing consumer environment potentially exerting upward pressure on yields. The Isis Property Trust 2 Ltd has returned 8.5% in the last 6 months with the yield falling to 5.3%. The Morley Property Fund has also continued to perform well returning 7.3%. We recommend clients maintain a strategic weighting in commercial property but for those clients with an overweight position we are suggesting some tactical sales. The TR Property investment trust has had another good six months returning 12.1%. This trust, as well as buying commercial property directly, invests in the quoted equity of property companies which have performed very well. This has helped the trust advance by an impressive 50.9% over the last 12 months.

After the dramatic surge in the final weeks of the 2004/05 tax year, **Venture Capital Trust (VCT)** demand has now, unsurprisingly, subsided. Many commentators expect the record total of approximately £500m for 2004/05 to be beaten in the current tax year as more investors become aware of the generous VCT tax breaks, which are almost certain to be scaled back in 2006/07. The two main VCT players, Close and Baronsmead, had their 2004/05 VCTs fully subscribed. They have had the best track records both in terms of distributing money to shareholders and managing share price discounts. Ventus, a specialist VCT that will be investing in companies building wind farms across the UK, was the most successful specialist trust in terms of funds raised during the 2004/05 tax year. They raised over £13m, which is the largest amount ever raised from UK retail investors to invest in renewable energy. Ventus is the first investment vehicle that will allow individual investors in the UK to benefit from the Government's Renewables Obligation while also maintaining a diversified portfolio of wind farm investments.

We favour the Morley Deposit Fund, the Merrill Lynch Institutional Sterling Fund and the UBS Active Cash Fund for **Cash** held in SIPPs. All of these funds carry low charges and have consistently outperformed their peers. For cash not held in pension funds, investors can achieve 5.0% Annual Equivalent Rate (AER) using ING Direct or 5.31% with AA Internet Saving, though large cash holdings should be held with several institutions to diversify risk.

We continue to look at all **With Profit** policies on their own merits. Generally with profit funds suffer from a lack of transparency and mediocre prospective returns. Subject to policy guarantees and the individual insurer's internal procedures for setting transfer values relative to asset share, we recommend clients transfer their policies to a unit-linked policy or a SIPP. Many with profit funds over the last two to three years have changed their asset mix, increasing fixed interest with a corresponding reduction in equities. This has the effect of securing the guarantees made to policy holders but limiting the upside potential of the fund which would have normally materialised in the form of higher bonus rates.

Christopher Sexton  
**Investment Research Manager**  
**June 2005**

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### Main Client Funds - Performance Summary to 31 May 2005

**Table 2: Fixed Interest**

	Gross Redemption Yield (%)	Average Duration (Years)	Performance Over 6 Months (%)
<u>Investment Grade</u>			
Morley International	2.4	5.0	1.2
Morley UK Fixed Interest	4.3	8.4	4.4
Winterthur Fixed Interest	4.6	7.3	3.5
Legal & General Fixed Interest	4.6	n/a	3.1
Morley Corporate Bond	5.1	7.8	3.9
Morley Long Corporate Bond	5.0	12.6	4.5
<u>Non-investment Grade</u>			
Legal & General High Income	5.8	n/a	1.8
Threadneedle High Yield Bond	3.8	3.0	1.2
F&C Strategic Bond	4.9	4.8	3.1

(Source: Individual companies 31 May 2005 actual portfolio yields).

**Table 3: Property**

	6 Months %	One Year %	Five Years %
<u>Pension Funds</u>			
Allied Dunbar	7.5	17.3	70.2
AXA Sun Life	5.6	12.9	63.9
Legal & General	7.1	15.8	70.1
Norwich Union (4)	6.6	15.7	57.4
Scottish Amicable	5.5	14.6	57.7
Scottish Widows	8.1	16.4	76.2
Standard Life	6.2	15.4	65.0
Morley	10.2	19.3	80.9
Sector Average	6.5	14.6	52.4
<u>Other Property Funds</u>			
Isis Property Trust 2	8.5	n/a	n/a
Morley Property	7.3	13.4	n/a
Standard Life Investment Property	6.0	13.4	n/a
TR Property Investment Trust	12.2	51.3	223.5

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series bid to bid pricing basis to 31 May 2005).

**Table 4: Equities**

	6 Months %	One Year %	Five Years %
Aberforth Smaller Companies	10.9	25.6	130.2
British Empire Securities	9.8	36.6	119.8
Candover Investments PLC	22.8	36.9	96.7
European Assets	13.2	35.6	14.8
GAM UK Diversified	5.1	9.8	63.4
Liontrust First Income	6.9	15.3	71.5
Martin Currie Pacific	-0.6	7.8	3.4
North Atlantic Smaller Companies	1.2	19.4	45.2
Norwich Union (UP) UK Equity	6.9	14.3	-15.8
RIT Capital Partners	10.7	29.1	79.9
Schroder Recovery	8.2	15.2	76.7
Standard Life UK Opportunities	8.2	22.0	n/a
Standard Life UK Equity	7.2	17.3	1.5
Winterthur Credit Suisse Income	8.5	19.4	57.2
Winterthur Fidelity Special Situations	7.6	18.3	87.8

(Source: Reuters Hindsight ABI UK Pension Fund, IMA, AITC Investment Trust Series on a bid to bid pricing basis to 31 May 2005).