



*“Right now we are in the worry season... I look forward to moving into the earnings season”*

David Bianco, Head of US Equity Strategy, BoA Merrill Lynch Global Research -Bloomberg 6 July 2010

With volatile and disappointing world stock markets over the past quarter, we once again include our thoughts on what has happened over the period, including comments from our Fund Managers which we hope will be of use and interest to you.

### I. SUMMARY

- After a positive first quarter to the year, the second quarter rally went firmly into reverse as risk aversion reappeared and economic growth forecasts worldwide were trimmed. Fiscal tightening in the UK, Continental Europe and in many emerging markets weighed on sentiment as investors mulled over its impact on economic growth. Oil prices weakened, but gold strengthened as a safe haven investment.
- The US Dollar continues to strengthen as the US economy expanded further (although economic growth softened during the quarter). The UK Sterling continued to rally from an oversold position as investors weighed the impact of the coalition budget. Cuts in government expenditure and increases in taxation were seen to be good for the currency, although negative for growth in the short term. In general, however, economic condition proves to be less desperate than originally forecast. Euro weakness remained with specific concerns about the solvency of European banks and the sovereign debts of constituent members of the Eurozone, specifically Greece, Portugal, Ireland, Spain and Italy. The general economy in Europe appears to be still fairly weak, although there are bright spots appearing in export sectors, benefitting from the weak Euro. The Spanish government were able to tap the bond market successfully during the quarter, thereby improving Euro sentiment.
- Equities took a back seat during the quarter as 10-year sovereign Bonds and Gold surged.
- Short-term interest rates look likely to remain historically very low for at least the next few quarters and perhaps beyond, as fiscal and monetary measures remain expansionary to reduce Government deficits in the developed world. Default and downgrade risks remain although now less serious but these make longer dated sovereign Bonds risky.
- Bond risk in Asia continued to fall and the market had a good quarter.
- Still great deal of uncertainty regarding extent and timing of inevitable fiscal and monetary tightening which is hindering an equity rally. Still a stockpicker's market, especially in the US. On a relative basis, developed markets look better on value on a short-term basis at least. Emerging Markets and in particular China had a very poor quarter.

- Property remains a good long-term value investment with quality properties being available at bargain prices.

## **2. INTERNATIONAL MARKETS**

- Despite a recovery in July, global markets ended the quarter significantly down, although there were signs of expansion in manufacturing output and rising bank lending. Most economies are now growing, although mainly at below long-term trend rates. Doubts, however, remain about the strength and duration of the global recovery, especially with the large government and private debt overhangs in Developed Markets. The Dow Jones Industrial Average dropped 10% from 10 856 to 9 774, the FTSE 100 lost a hefty 13.4% from 5 679 to 4 916 and the MSCI AC All World \$ index fell 12.2% from 307.49 to 270.02. This index is now down 10% for the year to date. In China, the Shanghai Composite index dropped no less than 22.9%, falling from 3 109 to 2 398. China was the worst performing major market in the six months to June 2010, being down 27%.
- Bond yields continued to fall, and conversely capital values increased, fuelled by market liquidity and an increase in risk aversion. Yield curves remained steep with sovereign debt in Western economies reflecting artificially low short-term interest rates, but higher rates at the longer end reflecting concerns about inflation and exit strategies by heavily indebted governments. The US 10-year debt yields dropped below 3%, and Sterling bonds also recovered as the economy improved beyond expectation and the market gave a positive approval for the Budget. The Euro dropped 8.4% on a weighted basis.

## **3. INVESTMENT MANAGERS' REPORTS**

### **3.1 VAM Equity Funds – Driehaus Capital Management LLC - “Driehaus”**

- Markets have experienced two very poor months, but this should not deter those who have a strategic asset allocation to equities as this set back is a normal feature of the investment cycle.
- Market currently over duly concentrating on negatives, which skews judgment.
- Global double dip recession would be highly unusual - the only one being 1982, with circumstances being very different from today's.
- Europe still a concern - it represents 17% of the S&P company profits, so it is of some impact, but a poor economic showing from Europe should not create a recession in the US.
- Investors should stay in alpha generating assets like Driehaus equity funds in this sort of market.

- In Emerging Markets, likes Brazil, Indonesia and Turkey, as well as domestically orientated stocks in China, notably pharmaceuticals, consumer cyclical and financials. In the Far East, well represented in Korea, China and India. In these areas underweight base materials and energy as economic growth stabilises in China.
- Confident that Driehaus can still deliver outperformance based on its stock selection process.
- Risk appetite remains high, impacting on valuations.
- Keep investment objectives in mind and leave emotion out of the equation.
- Active managers have an advantage over passive (e.g. ETFs) in this complex environment.

### 3.2 VAM Multi Asset Strategy Fund - Valu-Trac Investment Management Limited

- No allocation to equities in June, due to expectation of resumption of bear market.
- All equity moving averages for equities now falling.
- Recovery in earnings continues but is not yet enough to turn the tide for equities.
- Significant concern regarding levels of international debt and unsustainable monetary policies spell market instability.
- Scope for further market falls with no help from excess monetary liquidity.
- Gold and Bonds likely to outperform against equities, at least in short term.
- Commodities other than Gold not attractive in the short term. Long-term background is encouraging.
- Likes Yen most of all currencies with US Dollar second. Euro looking oversold.

### 3.3 VAM Property Fund - Fleming Family and Partners - "FF&P"

- Yields on property and relative longer term value will provide good returns over the cycle. Will benefit from demographics as "baby boomers" seek value investments upon retirement (Property, Bonds and Cash).
- Fund relatively defensively positioned. Cash component raised and hedges are employed (e.g. shorts on the S&P 500 index).
- Property investment seen as a safer haven for investors during times of market uncertainty.
- US will probably announce new stimulus measures to improve recovery picture ahead of the November elections.

- Redemption of the more illiquid property investments accelerating through secondary market. Investments redeemed or to be redeemed close to existing valuations. The proceeds to be used to invest in bargain property opportunities which presently exist.
- Fund now international, with around 50% in the UK, the rest in Europe, Far East and the US. Looking at Indonesia, Thailand, Brazil and Australia.
- Not all unlisted property companies have reflected the increase in market value.
- Overall, wary of present market and believes there could still be a further equity market sell-off later in the year.

### 3.4 VAM Asia Fixed Income Fund – Enhanced Investment Products Limited - “EIP”

- Fixed income market was characterised by an improvement in sentiment across most sectors, the benchmark iTraxxSovXAsia Pacific showing large gains during the month, before surrendering part after renewed jitters concerning European sovereign debt resurfaced.
- Fund components broadly unchanged. Biggest holdings in financials.
- Average maturities marginally reduced to 6.51 years.
- Likes Hong Kong, South Korea, Malaysia, Singapore and Australia as issuers. Japanese holdings were liquidated and a small position was taken in China.
- Maturities all remain under 10 years with largest being 2019.
- Cash holdings remain high with a view to providing better entry points in the market. Becoming more confident to use this cash.
- Stance remains defensive and these bonds should outperform in turbulent times.
- Political risk lower, with positives coming from China/Taiwan gradual rapprochement and reduced risk from North Korea.
- Forward yields of around 5% should be achievable.

## 4. CURRENCIES

- Pound stronger but still below its latest 10-year average against the Dollar. This suggests some future improvement once economic problems are resolved. Some element of safe haven status appearing. Euro remains under pressure but may well be undervalued.
- Dollar’s strength less pronounced.
- Top currency is the Yen. Dollar still looking attractive, however.

The Market remains volatile with uncertainty as to whether we are experiencing the beginning of a major bull market, or a rally in a prolonged 10-year bear market. Much depends on government policy going forward. We reiterate that, as always, investment choice is all about asset allocation, based on risk profile. This is especially important in today's highly volatile and difficult economic environment. Most gains are a reflection of both appropriate asset allocation and time in the market. This is, as usual, a good time to assess your asset allocation to ensure that it is valid in terms of the market as well as your own risk profile.

For investors who have their funds invested in accordance with the VFS Matrix, the Conservative Investors have seen growth of 1.31% since 1 September 2009, Balanced Investors have seen 0.41% for the same period and Growth Investors have seen rises of 2.54%. This can be favourably compared against cash returns of less than 1% and during a period of very volatile and negative markets.

Finally – a last word on the Euro....As reported by Jeremy Warner in The Telegraph on 9th July: “As Jean-Claude Trichet, President of the European Central Bank, yesterday pointed out, for all the denial and policy compromise, it is never wise to underestimate the eurozone. Any economic region that can produce three of the four World Cup semi-finalists, as well as the winner, must be doing something right.”