

Core Portfolio

Sterling Quarterly Report 30 September 2009

Objective: To achieve a real return in excess of risk free sterling cash interest rates over a three to five year period. Performance is targeted through the strategic asset allocation of a diversified multi-asset class investment. This means important changes will regularly be made to reflect changing market conditions. Asset allocation may be made across all of the major asset classes being cash, bonds, commercial property, equities and alternative investments. Our philosophy is to invest into passive investments (investment performance vehicles that mirror the respective market) through our core portfolio wherever possible.

Cash: Sterling has been coming under increasing pressure after reaching a recent peak against the dollar in May. While there have been some positives within the plethora of economic releases, especially as far as the housing market is concerned, there have also been negatives with the most recent being the Industrial Production numbers which fell 2.5 % month on month. Notwithstanding this, there is an acceptance the economic outlook has improved, a view recently endorsed by the International Monetary Fund who raised the UK's growth forecast for 2010, estimating that GDP will increase by 0.9%, up from July's prediction of 0.2%.

With regard to interest rates, the UK base rate has remained at its all time low of 0.5% over the course of the last quarter. It is very unlikely that we will see any near- term change in policy from the Bank of England and its quantitative easing programme is set to continue.

Bonds: It was another stellar quarter for corporate bonds, with particularly strong performance from issuers in high yield and subordinated financials, as investors continued their "reach for yield". The IBOXX Sterling Corporate Bond All Maturities Index returned 11.52% for the three-month period and is now up 13.94% for the year. The supply of new issues continued unabated and was met by strong demand from investors. The on-going inflows into corporate bond funds and lack of liquidity in the secondary market helped ensure the "hottest" deals attracted order books many multiples of their issue size.

The positive liquidity flows have also been supportive for global government bonds. Gilts had a strong quarter – helped in part by the announcement, in August, that the Bank of England would be expanding its quantitative easing by purchasing an additional £50 billion in government and corporate debt. The IBOXX Sterling Gilts All Maturities was up 3.22% for the three months and 1.52% for 2009. In contrast, sterling suffered over the same period, losing 7.1% versus the euro and 2.7% versus the US dollar. Concerns remain as to the ballooning UK budget deficit and associated supply of future government debt. As a consequence, the majority of market participants are of the view that over the coming months, the risk for both sterling and gilts is to the downside, with the potential for a small amount of further tightening in credit spreads. The main topics for debate are: when and how the bank will implement its quantitative easing exit strategy; the on-going vulnerability of the banking sector and the risk of triggering inflation by delaying rate rises. One thing is for sure, going forward, bond investors will need to consider the risk-return equation more carefully.

Model Return in 2009 YTD #	0.72%
Standard Deviation^ (12 month rolling)	0.46%
Current Weighting	44.78%

Model Return in 2009 YTD #	11.86%
Standard Deviation^	7.25%
Current Weighting	32.06%

Core Portfolio

Sterling Quarterly Report 30 September 2009

Equities: Equity markets continued their advance during the third quarter as government stimulus around the world helped to further restore confidence and an increased appetite for risk. During the quarter the MSCI World Index increased by 20.3% and now stands at 10.4%, up on a year to date basis in sterling terms.

Some commentators have named this recovery the 'Cash for Clunkers' rally referring to the action taken to support the US economy. Investors are encouraged to invest in capital markets in the knowledge that market valuations are not stretched, cash returns are near zero, and perhaps most importantly, that a collapse in value is unlikely while government money is underpinning asset values. Second quarter corporate earnings also surprised on the upside as companies were able to reduce costs at a level which more than compensated for the expected falls in consumer spending.

As we enter the third quarter reporting season, investors will require further evidence that the rally can be sustained. The corporate cost cutting exercise achieved in the previous quarter was a one off and any improvement in future earnings will depend much more on sustainable economic improvement and confidence that predicted growth rates can be achieved. At this point the evidence suggests that orders and consumer demand have only improved at modest levels and rising unemployment levels will not provide any support in the short term.

There is a wall of money sitting on the sidelines that investors will use to buy the dips but there is also evidence of several bearish catalysts which lie not too far behind the scenes. The economic newsflow can best be described as mixed in terms of sentiment and concerns grow particularly in the US and the UK of rising unemployment, fiscal deficits and what will support the economy when the government stimulus pot is empty.

Sentiment has clearly recovered but it may soon start to stall. We continue to maintain our core equity weighting at zero accepting that the rally may continue in the short term but we believe with ever increasing conviction that the potential upside is smaller than the downside. Accordingly we continue to seek capital preservation and diversification, and will continue to do so until we can see that value opportunities are starting to cyclically emerge.

Property: We have maintained a nil exposure to UK property throughout 2009, however, as we turn into the fourth quarter, we have recently decided to use some of the cash held in portfolios to invest into commercial property.

With the UK commercial property sector down significantly from its highs and with yields in cash at almost zero in comparison to an average of around 7.5% in UK commercial property, we now believe the asset class will outperform cash over the next 12 months.

With this in mind, we are seeking an appropriate vehicle to provide an investment into UK commercial property. Our research will be based on those managers actively seeking to invest in sectors that, in their opinion, are likely to hold value through the remainder of the recession, and therefore have some sustainability.

Model Return in 2009 YTD #	-19.76%
Standard Deviation[^]	3.72%
Current Weighting	0.00%

Model Return in 2009 YTD #	0.00%
Standard Deviation[^]	0.00%
Current Weighting*	0.00%

* Asset class exited on 19 February 2008

Core Portfolio

Sterling Quarterly Report 30 September 2009

Alternative Investments: **Hedge Funds:** Hedge funds in general delivered modest returns once again through the third quarter (HFRX Global Index gained 5.15% in US dollar terms) when compared to other risky markets - principally equities and corporate bonds. Even those segments within the hedge fund space with the ability to participate in equity market rallies (eg, equity long-short funds) failed to deliver surely reflecting a nervousness about how far markets have moved since March this year and the sustainability of the rally. One concern for investors may be connected with defensive positioning being so poorly rewarded that managers eventually capitulate and look to increase directional exposure at a time when greater risk aversion returns. Despite general concerns regarding the sector, anecdotal evidence regarding an increase in investor appetite for hedge funds is emerging with meaningful net inflows being reported for hedge fund providers that provided shelter through the market storms of 2008.

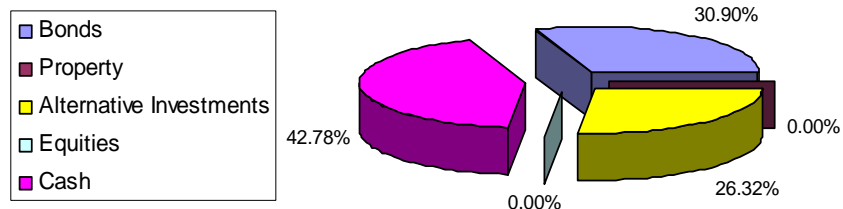
Model Return in 2009 YTD #	16.92%
Standard Deviation^	2.07%
Current Weighting	23.16%

Commodities: Broad commodity returns as measured by the Dow Jones UBS Commodity Index (US dollar terms) showed gains of 4.20% in the three months to 30 September. A notable laggard within the index was energy with benchmark Brent Crude oil recording a price drop of 3.15% (in US dollars) over the same period - perhaps an underlying sign of concerns emerging over the picture for global growth. By contrast, precious metals (gold and silver both gained 8.75% and 22.34% in US dollar terms respectively) surged ahead and this begs the question of whether commodity markets are giving investors different economic signals to those apparent in equity markets. Significant increases in the price of gold is classically a sign of heightened risk aversion and yet the two appear to be positively correlated right now. Only time will tell which of these signals proves correct or if new dynamics are emerging. One theory relates to risk free (ie, cash or equivalent) returns being so poor that investors are being attracted to a wide range of risky assets in a quest to add returns - this increased demand across the board could explain unusual positive correlations.

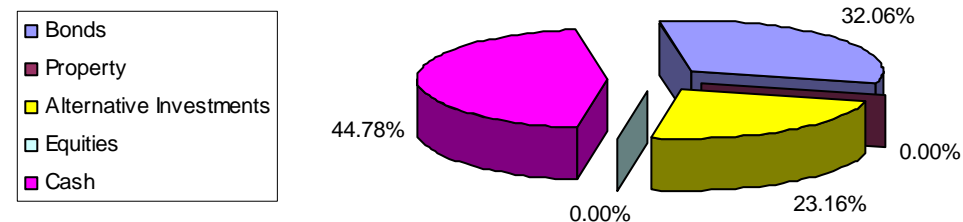
Manager's Comment: Capital markets rallied strongly during this third quarter and the multi-asset class core portfolio has delivered its strongest three months return since quarter four in 2006. Notwithstanding this, we have maintained a defensive asset allocation throughout the quarter, as we believe the economic recovery has to overcome challenging structural imbalances before policymakers and investors can be confident sustainable global growth has returned. The near term success of extraordinarily loose monetary policy and coordinated government stimulus is there for all to see, however, the imbalances caused by years of easy credit to the household and corporate sectors, and the subsequent ballooning of public finances as a cost for averting the collapse of the global financial system, will take years, not months, to repair. We are concerned western consumer spending will be weak as debts are repaid and savings are rebuilt; we are equally concerned low capacity utilisation, rising commercial property vacancy rates and a banking sector unwilling, or unable to lend, will not result in a meaningful pick up in business investment. These factors, coupled with the challenge faced by central bankers to exit current strategies neither too soon nor too late, make us believe it is right to err on the side of caution as we deploy risk capital within the portfolio.

Core Portfolio Sterling Quarterly Report 30 September 2009

Quarter 2 - Asset Allocation



Quarter 3 - Asset Allocation



Model Performance Versus Benchmark:

	2005	2006	2007	2008	2009 YTD	Rolling 12 Months Return	Since Inception**
Total Model Portfolio Performance	10.21%	8.58%	2.01%	-18.96%	5.39%	-4.88%	6.17%
Cash Rate* (benchmark)	4.49%	4.48%	5.39%	4.64%	0.72%	0.46%	21.71%
Standard Deviation^	4.15%	3.56%	5.46%	9.12%	N/A	9.10%	6.16%

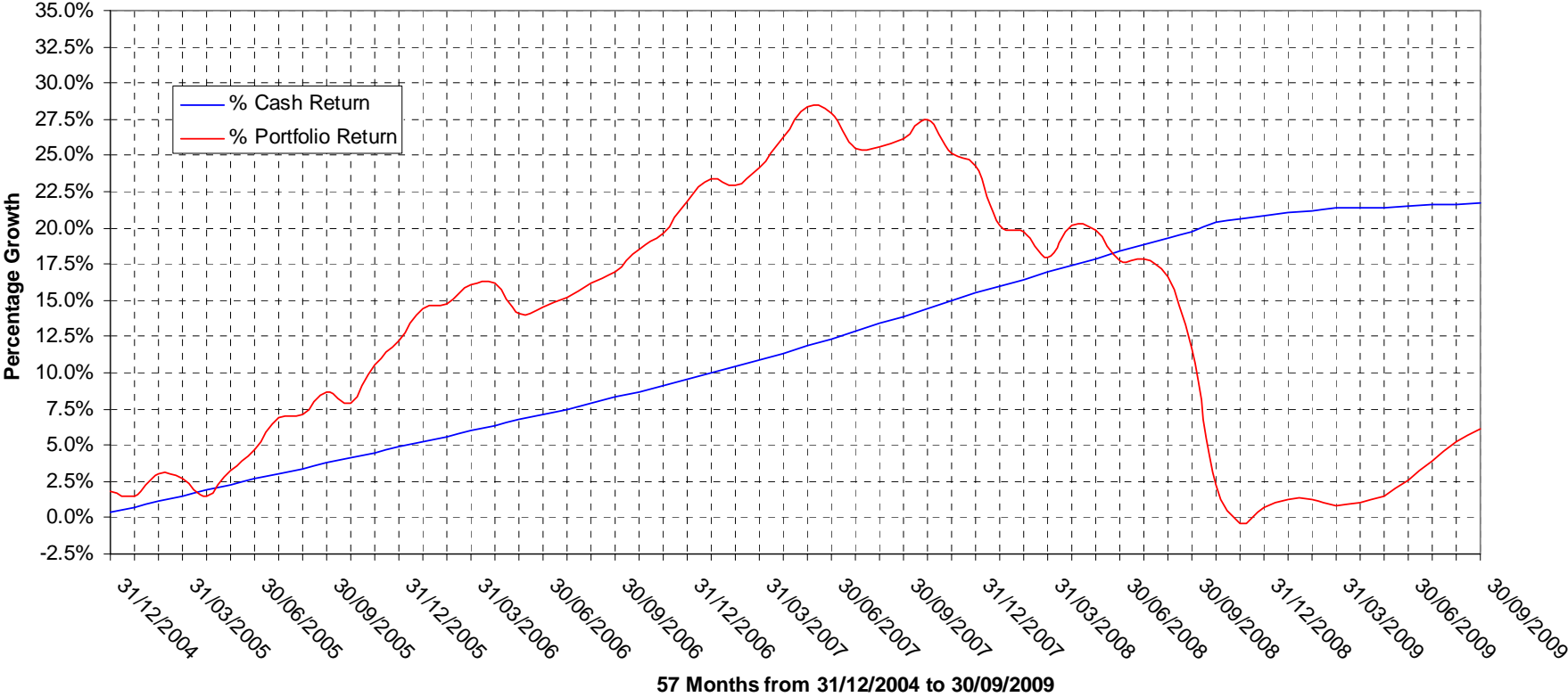
Performance figures are for the sterling core portfolio model (based on income reinvested and gross of fees).

* Cash rate is based on 3 month LIBID

** Launch Date - 1 December 2004

^ Standard Deviation is a measure of how widely "spread out" the returns of an investment are. The more spread out the returns are, the bigger and more frequent the losses on that investment. An investment's return over a year will be within one standard deviation of its expected return roughly two-thirds of the time, and within two standard deviations roughly 95% of the time. So, for example, if an investment has an expected return of 10%, with a standard deviation of 2%, then its return should be between 8% and 12% two-thirds of the time; and between 6% and 14%, 95% of the time. From November 2006 this is the annualised standard deviation of the returns for the core portfolio model.

Percentage Growth Return in GBP



Performance figures are for the sterling core portfolio model (based on income reinvested and gross of fees).

Core Portfolio

Sterling Quarterly Report 30 September 2009

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Where daily prices are not available for valuation or performance measurement purposes, individual holdings within the core portfolio will be valued using the last available price. The value of your investments and the income from them can fall as well as rise and you may not get back the original amount invested. Exchange rate changes may affect the value of investments. Past performance is not necessarily a guide to future performance.

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Source: All data has been provided by Fairbairn Private Bank and other sources.