

# Core Portfolio

## Sterling Quarterly Report 31 December 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:** The fourth quarter has seen sterling range from \$1.58 to \$1.68. Having drifted lower just before Christmas, sterling then strengthened fuelled by comments from Andrew Sentence, a Bank of England policy maker, that interest rates may have to rise later in the year. This came on top of the UK Producer Price figure in December jumping twice as much as forecast.

However, such talk seems premature and rates are very unlikely to move from their current lows in the next quarter. It is worth remembering that Japan has now had low rates for nearly 20 years and central banks are likely to wait until the green shoots have become saplings before applying the brakes.

**Bonds:** The diversity of the bond market was highlighted this quarter as corporate issues continued their positive trend, while government bonds suffered on-going weakness. Over the three month period gilts, as measured using the IBOXX Stg Gilts All Maturities Index, lost 2.19%, compared to the IBOXX Sterling Corporate Bond All Maturities Index which returned 1.02%. For the year, corporate debt has benefited from the normalisation of extreme dislocation in asset prices, helping investment grade bonds to significantly outperform to the tune of 15.80% versus gilts (based upon the two indices above). High yield issues have performed even better delivering a massive 57.27% in additional return (using the Barclays Global High Yield GBP H Index) compared to UK government bonds.

As concerns regarding corporate defaults dissipated, it was sovereign credit risk's turn in the spotlight. First, with the near default of what had been perceived as quasi-sovereign risk in Dubai and, subsequently, the on-going concerns regarding Greece's fiscal deficit, resulting in downgrades by all three rating agencies which pushed bond yields higher.

Looking ahead, the spectacular returns we have enjoyed from corporate bonds in 2009 are unlikely to be repeatable and there will be a need to be more discerning in order to identify the attractive relative value in the year ahead. Monitoring sovereign risk will be imperative and the up-coming UK General Election, which may unsettle markets near-term, will provide direction to both the gilt market and to sterling. Irrespective of the outcome, the new government will be faced with an unenviable fiscal position. The large scale borrowing needs are projected to drive the public debt to GDP ratio to a shocking 78% by 2014 – 2015 (source: Invesco). For these reasons we have a long-term negative outlook for gilts and are seeking better value in non-sterling fixed income investments.

<b>Model Return in 2009 #</b>	<b>0.87%</b>
<b>Standard Deviation^ (12 month rolling)</b>	<b>0.07%</b>
<b>Current Weighting</b>	<b>45.45%</b>

<b>Model Return in 2009 #</b>	<b>13.89%</b>
<b>Standard Deviation^</b>	<b>5.40%</b>
<b>Current Weighting</b>	<b>16.20%</b>

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**Equities:** Despite renewed credit concerns in Dubai, equity markets were able to continue their advance during the final quarter supported by corporate earnings and a generally improving economic picture. During the quarter, the MSCI World Index increased by 2.67% and reached 13.97% for the year in sterling terms. 2009 will be remembered as the year of stimulus and bail out, and markets recovered strongly after the first quarter on renewed confidence a financial meltdown had been averted and that so much government money was underpinning asset values.

Policy makers now face a huge challenge to remove stimulus in a way that supports continued growth, against the need to manage substantial fiscal deficits. If they get the balance right then we can expect to see improving economic indicators with rising employment, consumption and corporate earnings growth. Against this backdrop it can be argued that market valuations are not stretched and it is reasonable to expect continuation of the equity rally into 2010. Investors, however, will seek evidence that the economic recovery is sustainable and, specifically, evidence that strong corporate earnings will be achieved through revenue growth rather than cost cutting. In other words, they will require assurances that the private sector is strong enough to maintain the recovery in the absence of government liquidity.

We expect that there are many bearish catalysts and potential aftershocks that could derail the recovery, and there is much reliance on China which is in the driving seat of global economic recovery. The Chinese authorities face their own challenges in terms of managing interest rate and currency levels, and there is a risk that the potential emergence of protectionist measures could seriously hamper projected growth rates. Similarly, many commentators are confident that the US consumer will once again deliver on the optimistic side but the outlook for the banking and property sectors is far from certain.

We are cautiously optimistic that the rally in global equities will continue into 2010 and recent actions by the Chinese authorities should reassure investors that they have appropriate controls in place and are prepared to use them. Accordingly, we are actively considering defensive opportunities for reintroducing an element of equity risk in the portfolio.

**Property:** With the residential property market in the UK up 5.9% over 2009, many investors are considering whether property is now a good investment.

We choose to invest in commercial property and while this has some similar influences to residential property, investors are wise to consider them as different asset classes, with commercial property much more influenced by the level of economic activity.

UK commercial property ends 2009 4% higher than it started and late in the year the investment committee decided to allocate capital to this asset class. However, as with many asset classes, there was a rally late in the year causing us to defer our investment for a point that we believe will show better value than we are able to buy at the current time.

Therefore, while we expect UK commercial property to outperform cash over a 12 month period, our faith this will occur is more marginal at current valuations. However, we expect to take advantage of a buying opportunity within the next three months and have identified an appropriate fund.

<b>Model Return in 2009 #</b>	<b>-19.76%</b>
<b>Standard Deviation^</b>	<b>19.93%</b>
<b>Current Weighting</b>	<b>0.00%</b>

\* Asset class exited on 2 March 2009

<b>Model Return in 2009 #</b>	<b>0.00%</b>
<b>Standard Deviation^</b>	<b>0.00%</b>
<b>Current Weighting*</b>	<b>0.00%</b>

\* Asset class exited on 19 February 2008

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**Alternative Investments:** **Hedge funds:** Hedge funds, as measured by the HFRX global hedge fund index (US dollar terms), delivered returns of 2.15% through the final quarter of 2009. This completed the best calendar year for the asset class for 10 years (+13.40%) and the first double-digit returns since 2003. Following the severe losses in 2008 (-23.25%), this provided at least some sign of a recovery in the fortunes of less constrained asset managers, although it should be noted that more conventional risk assets - notably equities and corporate bonds - provided greater rewards through the year. Anecdotal evidence from established hedge fund managers suggests that fund inflows continued through the year as the sector regained some of its lustre, although it is not thought to have repaired aggregate fund values following the massive withdrawals after the events of 2008. Efforts by the industry to enhance its marketability through more transparent and better regulated fund structures became evident through 2009 as managers seek new ways to build assets under management.

**Commodities:** Benchmark commodities registered strong positive movements in the fourth quarter with Brent crude oil gaining 14.08% and gold appreciating 8.86% (both US dollar terms), locking in rises of 84.87% and 24.36% respectively for the full year 2009. Commodity prices have certainly benefited from a weakening dollar with the currency falling by circa 11% against sterling through the year by way of example. The prospects of a return to economic growth - however anaemic - in the US and other developed economies has clearly played a role in advances across energy and industrial raw materials. Opinion is now split as to the near-term economic fortunes of the larger economies of the world and the impact this may have on productive commodities. The future path of gold as the classic safe haven asset may also depend on its use as a hedge against the fortunes of major developed currencies, which face pressure from the weight of huge government borrowing in the years ahead.

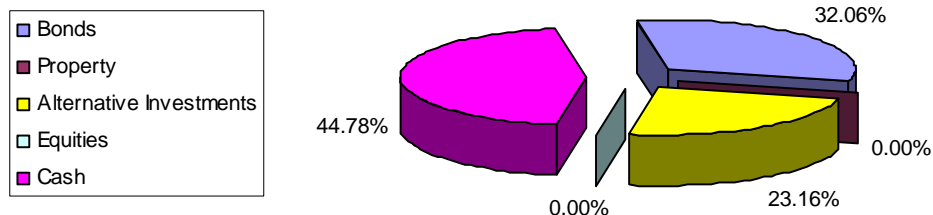
The investment committee has retained the core portfolio allocation to a hedge fund focused on commodity investments but we remain out of more general hedge fund exposures. Following the commitment made to a global total return bond fund through the second quarter of 2009, we have added a further specialist bond fund to the alternatives allocation. This is a UK focused fund with relative insensitivity to interest rate risk and a current strategy geared towards careful credit selection in the corporate bond space. We are now fully invested to alternatives.

**Manager's Comment:** Risk appetite continued to rise through the final quarter of 2009 as corporate earnings surprised on the upside and macroeconomic data continued to support the view Western economies were emerging from their period of sharp contraction which began in 2008. Policymakers have been buoyed by the progress made, however, they recognise this is a direct result of unprecedented stimulus which will have to be tempered during 2010. At the same time, fiscal deficits and servicing the interest accruing thereon will be a significant constraint on growth. Monetary, fiscal and regulatory policy issues are set to dominate the minds of investors and we sense volatility may return as news flow is avidly analysed and assessed. Against this backdrop, we will maintain our cautious stewardship of the assets within the core portfolio and use the tools available to us to maximise risk adjusted returns.

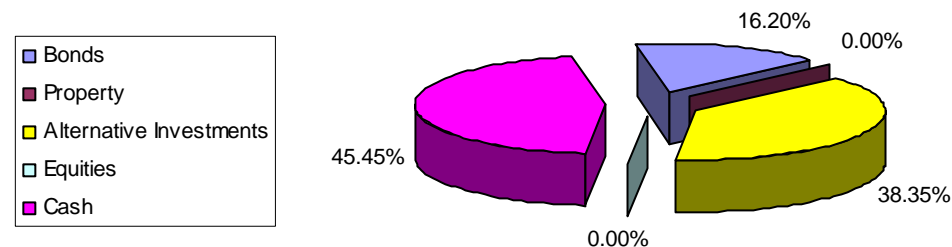
<b>Model Return in 2009 #</b>	<b>20.27%</b>
<b>Standard Deviation^</b>	<b>7.97%</b>
<b>Current Weighting</b>	<b>38.35%</b>

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**Quarter 3 - Asset Allocation**



**Quarter 4 - Asset Allocation**



## Model Performance Versus Benchmark:

	2005	2006	2007	2008	2009	Rolling 12 Months Return	Since Inception**
Total Model Portfolio Performance	10.21%	8.58%	2.01%	-18.96%	6.76%	6.76%	7.54%
Cash Rate* (benchmark)	4.49%	4.48%	5.39%	4.64%	0.87%	0.04%	21.90%
Standard Deviation^	4.15%	3.56%	5.46%	9.12%	1.90%	1.90%	6.02%

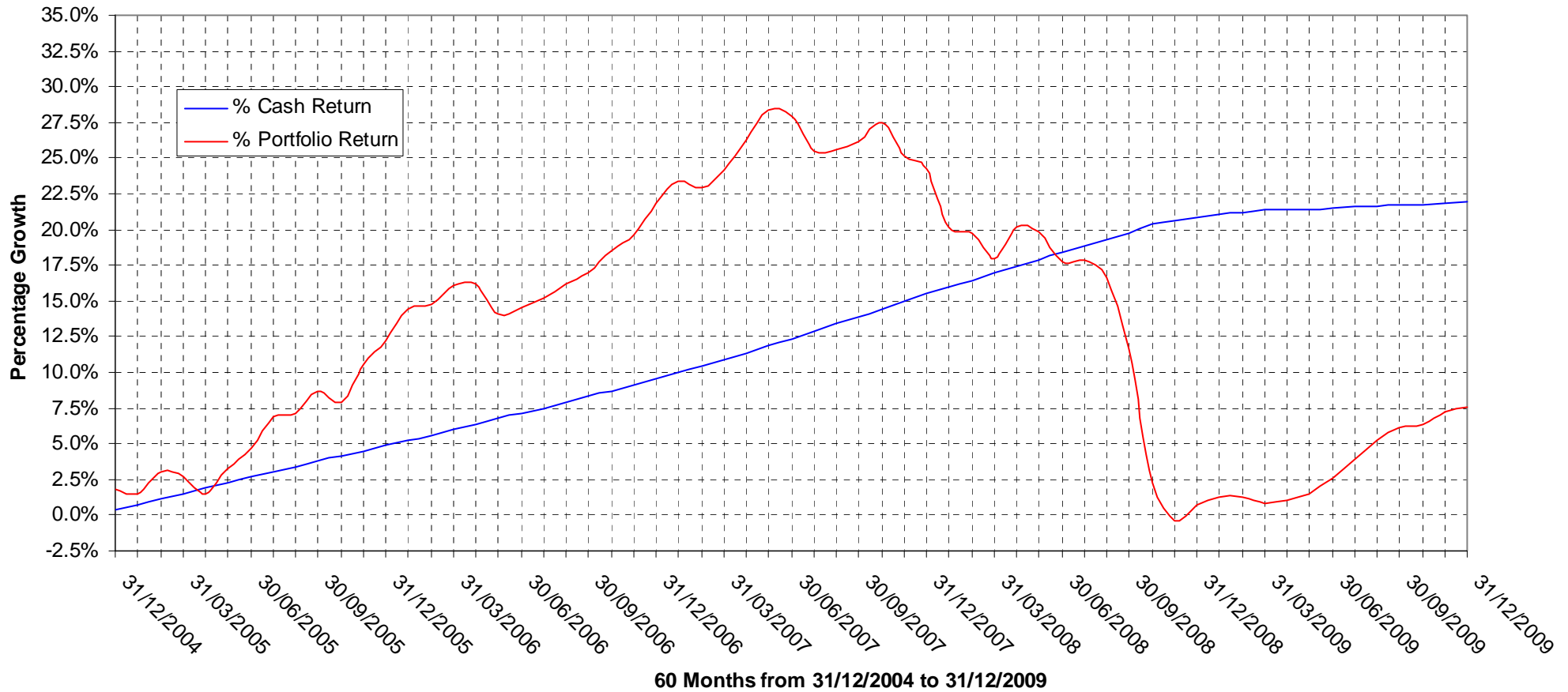
# Performance figures are for the sterling core portfolio model (based on income reinvested and gross of fees).

\* 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



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