Core Portfolio
Sterling Quarterly Report 31 March 2010

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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 enjoyed a recovery towards the end of March both against the dollar and the euro. In the case of the latter, this is due to the Greek debt crisis and the wider implications this may have across the eurozone. With the outcome of the forthcoming UK general election currently too difficult to call, the near-term future direction of sterling will be heavily influenced by the political landscape post 6 May.

As for interest rates, the futures markets are now pricing in a rate rise in the final quarter of this year, although fluctuating economic releases make it difficult to predict this with any confidence. The recovery in the UK remains fragile and policymakers will want to maintain an accommodative interest rate environment for as long as they can.

Model Return in 2010 #	**0.12%**
Standard Deviation^ (12 month rolling)	**0.11%**
Current Weighting	**30.42%**

Bonds: The first quarter proved to be a good one for fixed income assets in general. As a consequence of cash rates remaining low, investors continued their reach for yield most notably in credit and emerging markets. This helped lead to an outperformance of both investment grade corporate bonds, with the IBOXX Sterling Corporate Bond All Maturities Index returning 4.63% over the period, and high yield as reflected in the Barclays Global High Yield GBP Indexed which delivered an impressive 5.53%.

Unlike the last three months of 2009, UK government debt also had a positive quarter as near-term inflationary concerns dissipated contributing to a 1.20% rise in the IBOXX Stg Gilts All Maturities Index. This was despite the ongoing negative sentiment towards developed country sovereign debt as a consequence of the deteriorating fiscal dynamics. The ongoing developments relating to the peripheral European countries continued at a frenzied pace with the rating agency Fitch downgrading Portugal to AA- and the ECB and EU providing support to Greece. Greek debt spreads remained very volatile and their issuance of a seven year bond was not well received.

For the UK, the next few weeks will be dominated by the general election. We expect that sterling and gilts will remain under pressure in the run-up to 6 May, however, the longer term outlook will largely be dependent on whether the UK's budget deficit is addressed quickly. A loss of confidence in the new government's commitment to doing this would see the currency sell-off, perhaps putting pressure on the bank to tighten monetary policy in spite of weak growth. However, should decisive action occur it could lead to a significant rally for both sterling and gilts.

Model Return in 2010 #	**4.84%**
Standard Deviation^	**3.42%**
Current Weighting	**42.58%**

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Equities: The global economic recovery continued into 2010 with the MSCI World Index achieving growth of 4.16% in dollar terms and 9.4% in sterling terms during the first quarter. Economic dataflow is positive indicating an improving picture with many commentators raising their forecasts for world GDP.

Model Return in 2010 #	**3.46%**
Standard Deviation^	**4.20%**
Current Weighting	**15.05%**

Equity markets are being driven by earnings which continue to surprise on the upside and also the strong recovery in corporate balance sheets due to cost cutting and low interest rates. With improving dividend payouts, share buy backs and increasing mergers and acquisitions activity it is not surprising that equity markets have the wind in their sails and it is reasonable to expect further upside while these conditions persist.

Despite this positive picture the macro concerns remain and in particular the deflationary risks stemming from the high levels of debt still facing both Western governments and consumers. Therefore, in the medium term, investors will continue to watch earnings and for signs that companies can continue to meet earnings expectations or whether potential falls in consumer spending will lead to sharp downward revisions in earnings forecasts in the coming years.

In summary, we are witnessing a strange dichotomy between a strong private sector and weak government finances - at this stage of the cycle the economic outlook remains far from clear.

In early January, we reinvested 15% of the portfolio back into equity markets via a defensive equity income fund reflecting our view of further momentum-based upside in the near term, with a more cautious medium-term outlook

Property: We have remained uninvested into UK commercial property throughout the quarter. We have contemplated making an allocation, however, the economic frailties in the UK could require decisive and swift action to return to cash if the recovery turns out to be a little too exuberant too early. Property is an illiquid asset class and is unlikely to allow a swift reversal and, therefore, we are remaining cautiously uninvested while continually monitoring the economic position.

Model Return in 2010 #	**0.00%**
Standard Deviation^	**0.00%**
Current Weighting*	**0.00%**

* Asset class exited on 19 February 2008

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Model Return in 2010 #	**-3.074%**
Standard Deviation^	**2.45%**
Current Weighting	**11.95%**

Alternative Investments: **Hedge funds**: The industry benchmark HFRX Index delivered returns of 1.63% (US dollar terms) for the year to 31 March, which lagged many underlying asset classes including global equities that gained 2.74% by comparison (MSCI World, US dollar terms). While the hedge fund industry has never been marketed on the basis of keeping track of equity bull markets, many investors need convincing of hedge funds' ongoing role in portfolio construction given the negative experiences of 2008, both from performance and liquidity perspectives. There is a wide spread between the promise of hedge funds, measured by the HFRI Index and the reality delivered of the investable HFRX Index. This lack of transparency is driving the growth in hedge funds adopting the highly regulated UCITS III structure and hedge fund replication products. It is nevertheless interesting to note relative value strategies such as those exploiting market inefficiencies (arbitrage) have performed relatively well in recent times suggesting such opportunities exist for skilled managers and, most importantly, they have the means of exploiting them.

Commodities: The Dow Jones UBS Commodity index had a fall of 5.05% in the general price of commodities (US dollar terms) through the first quarter. However, this hides a positive trend in energy prices with Brent Crude oil gaining 5.31% over the same period and breaching the $80 per barrel level. Technical analysts point to a level above $90 per barrel being the next critical price target. Such energy rises are exacerbated in the UK environment given sterling's fall of 5.93% against the US dollar and press reports suggest that petrol prices are now at record highs - an added headwind to economic recovery. The emergence of this positive price trend in energy has raised fears of cost-push inflation, which is at odds with many economists who are sanguine about inflationary pressures in Western economies, given assumed spare capacity. This debate is likely to rage for some time before it becomes clear whether inflation materialises in earnest and investors should be wary.

The investment committee decided to remove the core portfolio allocation to commodities through Ermitage Resources, which is a long-short specialist fund. While the fund has proved effective through the turbulence of recent years, near-term performance has not been compelling so an alternative solution is being sought ahead of the proceeds, which are due at the end of May.

Manager’s Comment: The mindset of the investment community can currently be split into two camps. The first captures those investors who are focused on the long-term structural problems facing Europe and the US caused by the huge public and private sector indebtedness. In the second camp lie those investors who are encouraged by the positive economic and corporate news flow and, in particular, the growth in earnings and profitability currently being delivered by the corporate sector. During this quarter we have introduced more equities to the portfolio but remain alive to the downside risks which could materialise, given the fragility of the recovery and set against the context of the huge stimulus which still has to be withdrawn.

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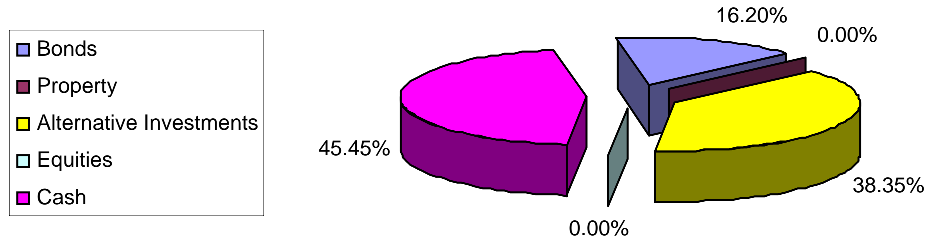
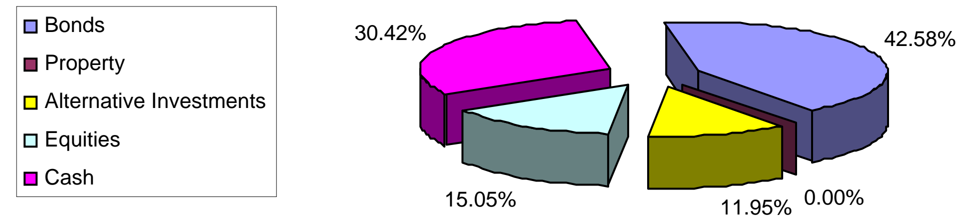
Quarter 4 2009 - Asset Allocation



Quarter 1 2010 - Asset Allocation



Model Performance Versus Benchmark:

	2005	2006	2007	2008	2009	2010	Rolling 12 Months Return	Since Inception**
Total Model Portfolio Performance	10.21%	8.58%	2.01%	-18.96%	6.76%	2.19%	9.06%	9.89%
Cash Rate* (benchmark)	4.49%	4.48%	5.39%	4.64%	0.87%	0.12%	0.51%	22.04%
Standard Deviation^	4.15%	3.56%	5.46%	9.12%	1.90%	1.51%	1.51%	5.90%

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.

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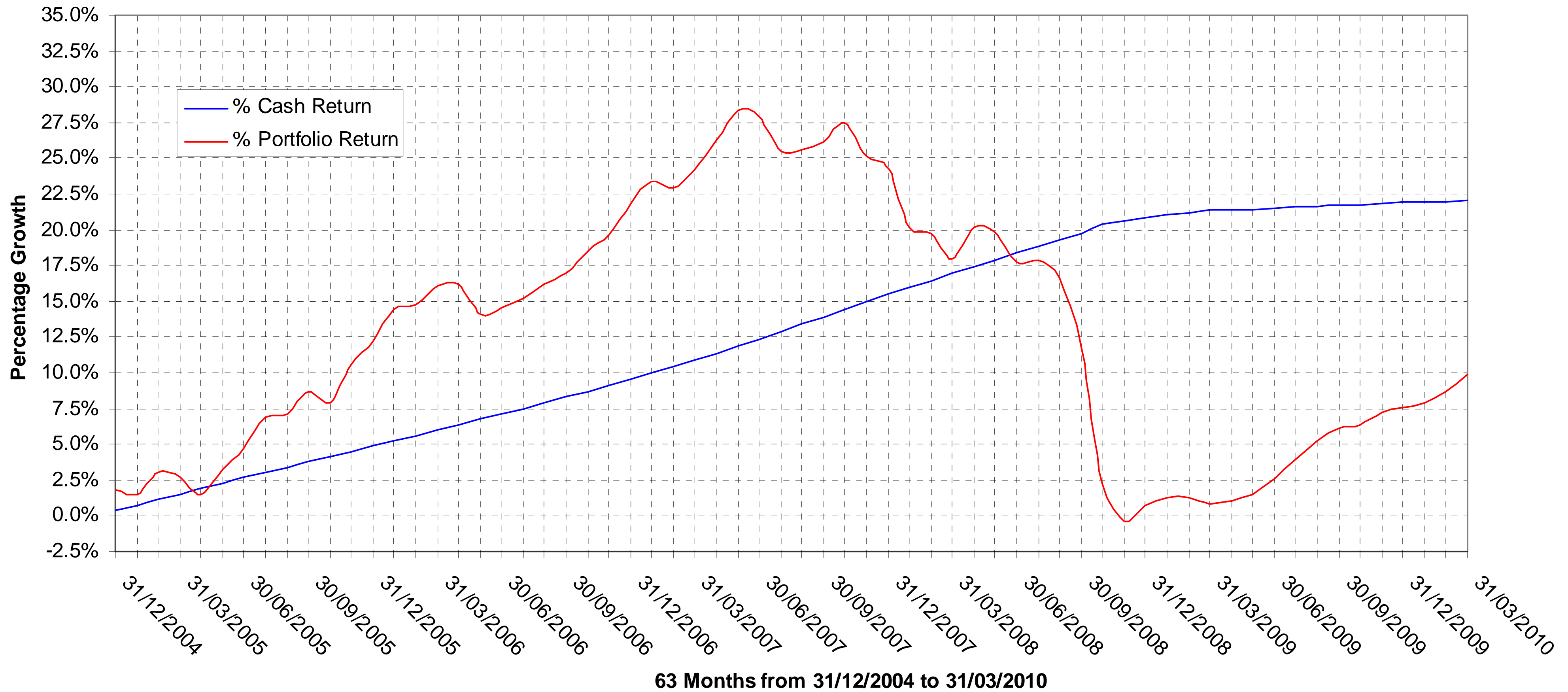

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Past performance is not necessarily a guide to future performance.

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