

# Core Portfolio

## Sterling Quarterly Report 30 June 2010

**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:** During this reporting period the Monetary Policy Committee has maintained interest rates at a record low of 0.5% and the quantitative easing programme at £200bn. The newly elected coalition government has started its tenure determined to tackle the fiscal and budget deficits, imposing tax rises and cuts in public spending. This has been well received by capital markets and sterling has strengthened, particularly against the euro, as investors have seen the gilt market as a relative safe haven.

**Bonds:** Bonds had a relatively good quarter, both on an outright basis and versus most other asset classes. Government debt continued the rally it has enjoyed since the start of the year, as a convergence of risks undermined confidence and drove a flight to quality. The European debt crisis intensified, and along with it the stresses to its banking system. In addition, economic releases disappointed and led market participants to conclude that the tentative global recovery was losing steam; just at a time when governments are withdrawing their stimulus programs and fiscally retrenching.

In the UK, gilts and sterling rallied after the election result and government bonds took further solace from a tough budget; although some have expressed concerns that the latter was too aggressive and risks tipping the UK back into recession. The bond market pushed down inflation expectations, effectively re-pricing a 'V' shaped recovery into what PIMCO likes to call the "New Normal" world of muted growth. Yields fell across the curve and for the quarter gilts returned 4.75% to deliver an impressive 5.94% in the year to date.

Returns from fixed income spread products were more mixed. The IBOXX Sterling Corporate Bond All Maturities Index was up 3.66% over the period, however, high yield suffered from the risk aversion, especially in May, as reflected in the Barclays Global High Yield GBP (H) Index which fell 0.27%. In emerging markets, external debt spreads widened as the recent trend toward differentiation continued with high quality countries outperforming. Nevertheless, over the long-term investment horizon, and given their strong balance sheets, we continue to favour emerging market government debt – in particular local currency issues, where investors have the additional opportunity to benefit from anticipated currency appreciation.

Looking ahead, we anticipate that volatility will remain a theme of bonds markets for the balance of 2010 and thus careful management will be imperative. With yields at all-time lows, developed government debt would seem to have little upside from here. However, with falling default rates, low cash yields and little near-term risk of inflation, selective areas of spread product (including specific sectors of the high yield, investment grade and emerging markets) remain relatively attractive on a risk-adjusted basis.

<b>Model Return in 2010 #</b>	<b>0.20%</b>
<b>Standard Deviation^ (12 month rolling)</b>	<b>0.10%</b>
<b>Current Weighting</b>	<b>22.96%</b>

<b>Model Return in 2010 #</b>	<b>3.86%</b>
<b>Standard Deviation^</b>	<b>5.44%</b>
<b>Current Weighting</b>	<b>37.71%</b>

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**Equities:** Equity markets suffered a significant set back during the second quarter with the MSCI World Index dropping by nearly 12% in sterling terms. At the end of June the index was down around 4%.

Despite the continuation of strong corporate earnings, the markets were rattled as macroeconomic concerns took over. Specifically investors were concerned with the euro debt crisis and also disappointing data from the US, suggesting that the US is losing momentum and raising fears of a double-dip recession. Additional fears of a slowing Chinese economy placed further stress on the global recovery.

In the short term, it is reasonable to expect markets to stage a recovery based on the forthcoming earnings reporting season and valuations which are now looking more attractive, but in the longer term much will depend on how the macro events in the eurozone, US and Asia unfold.

Our decision to invest in the growth as opposed to value stocks is delivering outperformance relative to the broader market and will in our view be the correct position to deliver earnings growth in what at best will be modest recovery in terms of global economic growth.

**Property:** During the quarter, the investment team decided to make an allocation of 10.25% across the core portfolio into UK commercial property. We have selected a fund which invests into primary, commercial property with financially strong covenants, as tenants with the property portfolio are diversified across the whole of the UK and in varying sectors. The expectation is that yield (income) should make the majority of returns and, while there could be a small amount of movement in capital values, we anticipate much of the revaluation from their oversold position has already occurred and we are investing here for the opportunity of the income outperforming cash.

<b>Model Return in 2010 #</b>	<b>-2.04%</b>
<b>Standard Deviation^</b>	<b>7.62%</b>
<b>Current Weighting</b>	<b>14.21%</b>

<b>Model Return in 2010 #</b>	<b>0.00%</b>
<b>Standard Deviation^</b>	<b>0.00%</b>
<b>Current Weighting*</b>	<b>10.25%</b>

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**Alternative Investments:** **Hedge funds:** The second quarter saw fundamental concerns returning to asset markets, which is reflected by a near doubling of the Vix Index - a commonly-used measure of implied equity volatility often referred to as the 'fear index'. Despite the drop in global equities of 13.26% over the same period (as measured by the MSCI World Index, US dollar terms), some hedge fund strategies are able to thrive when volatility spikes occur. While hedge fund investors as a whole have seen negative returns through the quarter - specifically a fall of 2.79% for the HFRX Index (US dollar terms) - they have found some protection from much larger falls elsewhere. Investors are increasingly looking for downside protection in the current environment and, while this is potentially costly and erodes overall returns, the expense is deemed worthwhile. Hedge fund strategies offering this return profile are receiving capital from global asset allocators and this trend is set to continue. The industry as a whole is repairing its damaged image, particularly through vehicles which afford investors liquidity and transparency.

<b>Model Return in 2010 #</b>	<b>-5.35%</b>
<b>Standard Deviation^</b>	<b>2.83%</b>
<b>Current Weighting</b>	<b>14.87%</b>

The investment team made an allocation to an equity market neutral fund during the period, which is capable of generating returns using equity exposures in most market conditions.

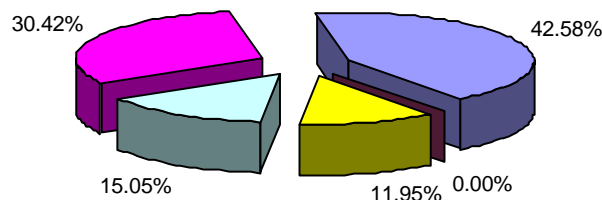
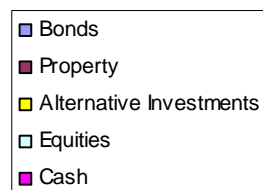
**Commodities:** Market risk aversion appeared to elicit a seemingly rational response from commodities markets through the quarter; the gold price advanced 11.59% (US dollar terms) and oil declined 9.14% (Brent crude, US dollar terms). The latter reflects fears of the second leg of a double-dip recession (ie, the demand for energy will suffer), and the former indicates wider systemic concerns, with the potential for a European sovereign crisis weighing heavily. The broad commodity benchmark, the Dow Jones UBS Commodity Index, lost 4.85% over the period and, therefore, continued the bearish theme. This serves to endorse the views of central banks that inflation remains under control for now.

The investment team took a position in gold through the quarter. Gold is our preferred hedge against future inflation, financial market instability and a collapse in confidence in the fiat money system.

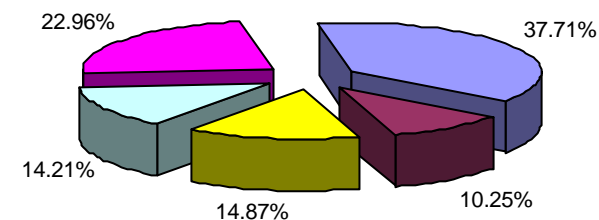
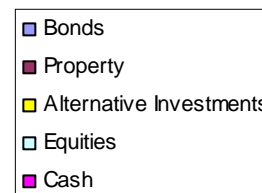
**Manager's Comment:** The cautious asset allocation we have maintained within the core portfolio has protected our client's capital during what has been a difficult quarter for markets. Continued fears over a potential sovereign default in the eurozone and the threat this would bring to the solvency of commercial banks in the region has drained investor confidence. Disappointing economic news in the US has further shredded nerves and deflationary forces appear to be building. This set back has not come as a surprise to us as we suspected markets had got ahead of themselves given the challenging environment faced by the global economy. The significant fall in asset prices has created attractive valuations, both on an absolute and relative basis, and we are well placed to take advantage of these once the outlook becomes less opaque.

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Quarter 1 - Asset Allocation



Quarter 2 - 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%	0.71%	5.60%	8.30%
Cash Rate* (benchmark)	4.49%	4.48%	5.39%	4.64%	0.87%	0.20%	0.54%	22.13%
Standard Deviation^	4.15%	3.56%	5.46%	9.12%	1.90%	2.88%	2.88%	5.83%

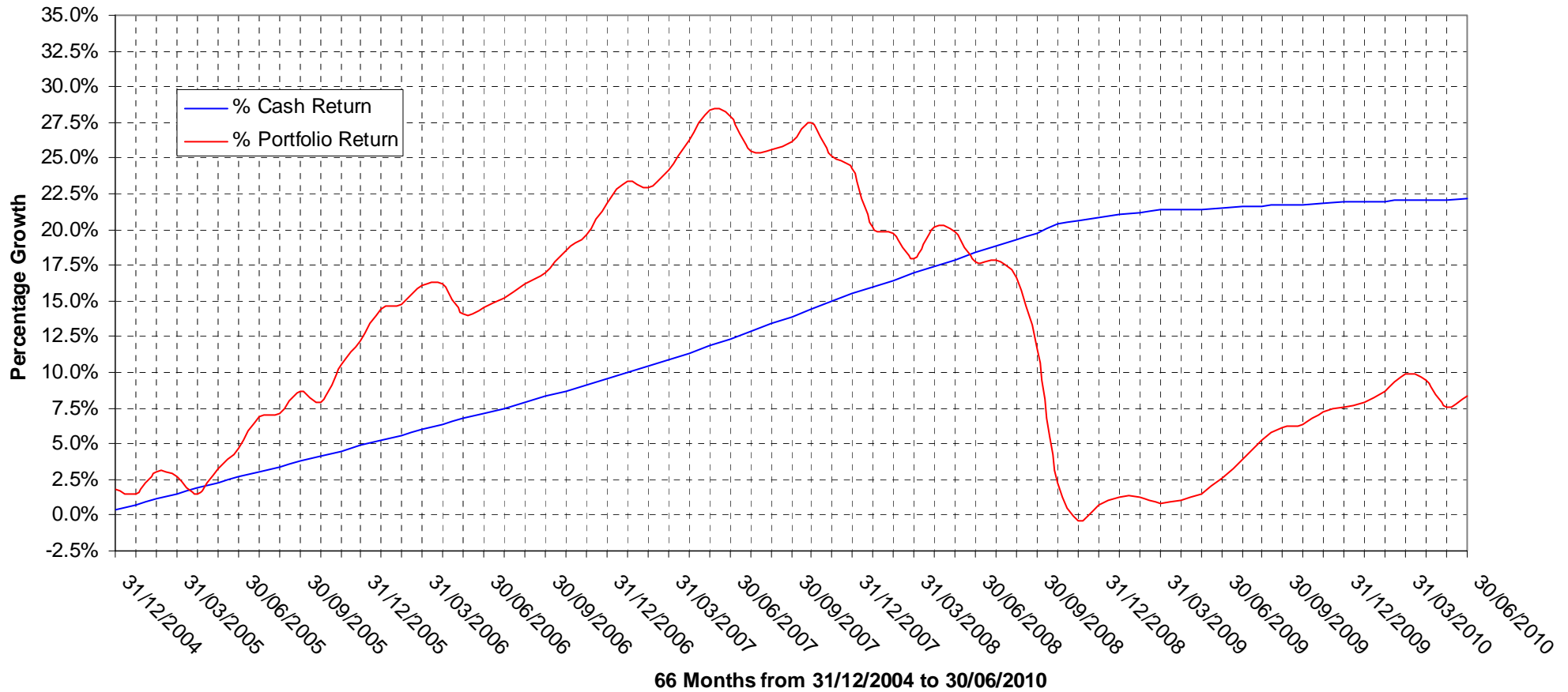
# Performance figures are for the sterling core portfolio model (based on income reinvested and gross of fees).

\* 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).

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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.