



Heartwood

Investment Management

Investment View

January 2012



Summary

- The final quarter of 2011 brought some better news for anxious investors.
- Global growth remains below par for this stage of the cycle, but the US is gaining momentum and Asian policy-makers seem to be managing their economies well.
- Politicians have made some progress on both sides of the Atlantic, but political risks still pose a threat to growth and prevent us taking a more positive stance in portfolios.
- We retain a broad spread of assets in portfolios, with a slight preference for equities.
- We see good value in Asian equity markets but remain wary of conventional government bonds and commodities.

Economic review

The final quarter of the year provided something of a relief after a distinct deterioration in the global economy over the summer. Although both consumer and business confidence remained depressed initially, sentiment improved over the three months as the fundamental data in the US proved resilient before picking up markedly later on. The improvement was broad-based, with signs of strengthening in the jobs market, housing, manufacturing and services. That said, growth remains subdued. Even in the US, it is not yet back to 2010 levels, while many European economies seem to be slowing sharply.

Political indecision over the summer had contributed to market volatility, but policy-makers played a more constructive role towards the end of the year. In the US, Congress

extended the Bush-era tax cuts for two months just before they were due to expire. Moreover, the Europeans have made some progress in paving the way for structural reforms. Crucially, the European Central Bank (ECB) has displayed a more pragmatic

approach under its new boss, Mario Draghi. As well as reversing the earlier interest-rate rises of his predecessor, he has injected massive longer-term liquidity into the banking system, buying politicians more time to reach agreement on the way forward.

Economic outlook

The prospects for the global economy appear finely poised. As usual, much depends on the US, where the latest indicators suggest that growth is accelerating. Encouragingly, confidence among small firms, which rely on bank funding and therefore suffered most from the credit crunch, seems to be on the mend at last. Indeed, confidence in general appears to be recovering after some mid-year jitters. Firms are starting to hire once more, and that should help to support consumer spending, which accounts for over two thirds of the US economy. Nevertheless, the overhang of public and private debt will continue to weigh on growth and may prevent it reaching the sorts of levels that would have been considered normal before the crisis.

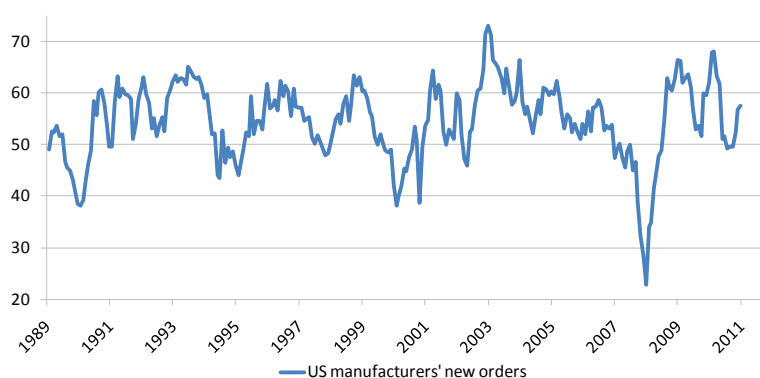
In Europe, the southern nations appear to be already in a recession, and the

latest figures suggest German growth ground to a halt in the fourth quarter, while the UK is struggling to maintain any momentum. Growth is also slowing in Asia, but from a much higher level.

Crucially, inflation is easing in most economies, most noticeably in China.

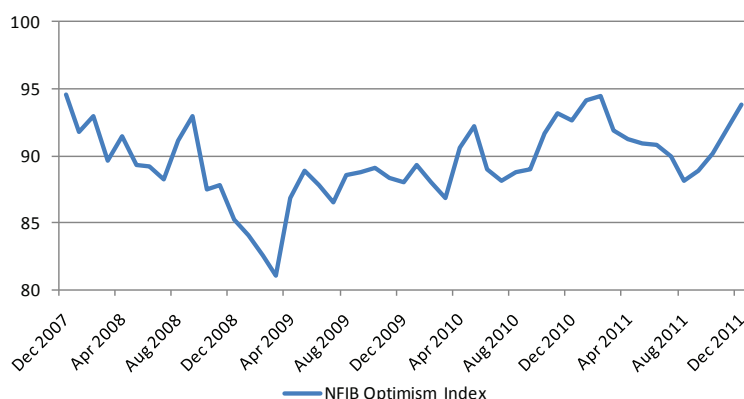
That should allow authorities around the world to focus increasingly on boosting growth, without having to worry about inflation. As growth is the best solution to high debt levels, that is clearly good news.

US manufacturing has clearly picked up since the summer



Source: FactSet, Heartwood

US small businesses are becoming less pessimistic about their prospects

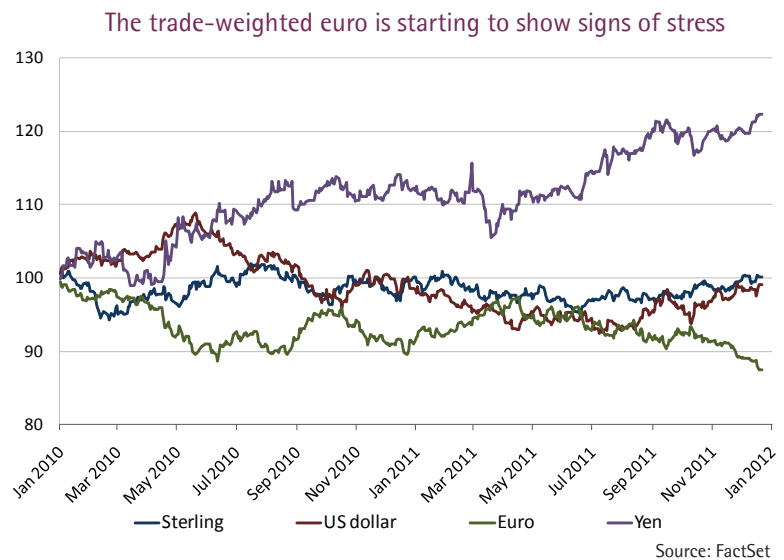


Source: National Federation of Independent Business

Market review

Despite continued volatility, risk assets staged a recovery in the fourth quarter of 2011. With the exception of Japan, all major equity markets ended the quarter with solid gains, but the strongest performer was the US (up 11.4% in sterling terms), taking it into positive territory for the year as a whole. As elsewhere, the bulk of the move came from a steep rally in October as the economic data improved. The UK was the second-highest gainer (up 9.4%), though it had a modest loss for 2011 overall. Commodities joined in the market advance, with oil enjoying a strong quarter as the outlook for global demand improved and concerns about Iran increased. In metals, copper recovered some ground after a steep decline in September, but aluminium and zinc were flat to slightly down, as was gold. Agricultural commodities were also mixed. The picture was more mixed in commercial property, with very strong gains for the US market while our UK instruments were split between solid gains and losses.

The greatest surprise was that government bonds continued their



recent strong run even during this upsurge in risk appetite. Conventional gilts made a gain of 5.5%, while inflation-linked were up a remarkable 8.8%, more than half their return for the year as a whole. This strength is hard to explain, but it seems that enough investors doubt the sustainability of the current improvement in the economic outlook or are seeking a haven away from peripheral eurozone debt. Less counter-

intuitively, corporate bonds also enjoyed a solid gain, up 3.2%.

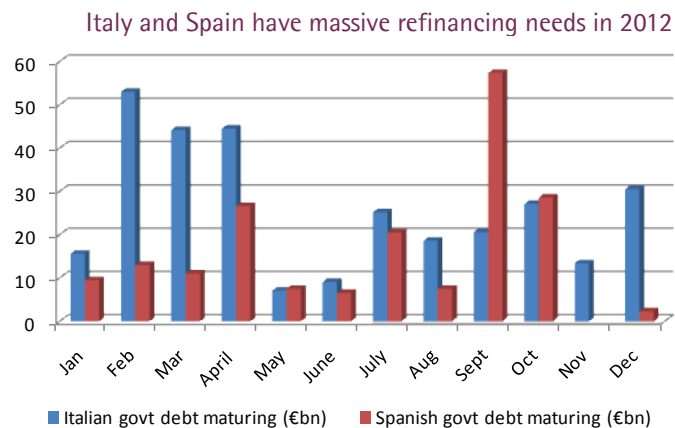
In currency markets, the euro surprised many observers with its continued resilience in the early part of 2011. However, its gradual slight depreciation picked up momentum towards the end of the year.

Market outlook

On balance, we still think that risk assets should outperform government bonds over the year ahead. However, we see enough risks on the horizon to suggest that markets are likely to remain volatile, especially if investors prove unwilling to absorb the large amount of debt some eurozone countries have to issue in 2012.

Even after the rebound in the final quarter, equities offer reasonable valuations in most major markets, which suggests that they should produce solid gains over the long term. In particular, the Pacific ex Japan region looks very attractive after its steep falls earlier in the year. And, as we have previously noted on many occasions, companies outside the financial sector are in robust health, with very strong balance sheets. At the sector level, we now think that the more defensive sectors are starting to look fairly fully valued after their recent strong gains.

By contrast, government bonds, which we thought looked poor value at



the start of 2011, seem even more overpriced now, after a year of strong returns. It is hard to pick the turning point for any prolonged bull market, and bonds could enjoy further gains in 2012, especially if inflation continues to fade. However, we think they are likely to underperform equities and other real assets over the long term. One other feature of bond markets in recent months is likely to reverse in 2012: longer-dated gilts' outperformance of shorter-dated. This was at least in part due to selling of

shorter-dated bonds by institutional investors in order to raise funds to absorb the government's heavy issuance of longer-dated bonds. Index-linked gilts could be expected to suffer in an environment where inflation is likely to fall steeply. However, the Bank of England is close to its limit for purchases of conventional gilts, so any extension of its quantitative easing programme could well target index-linked, thus giving the sector some support.

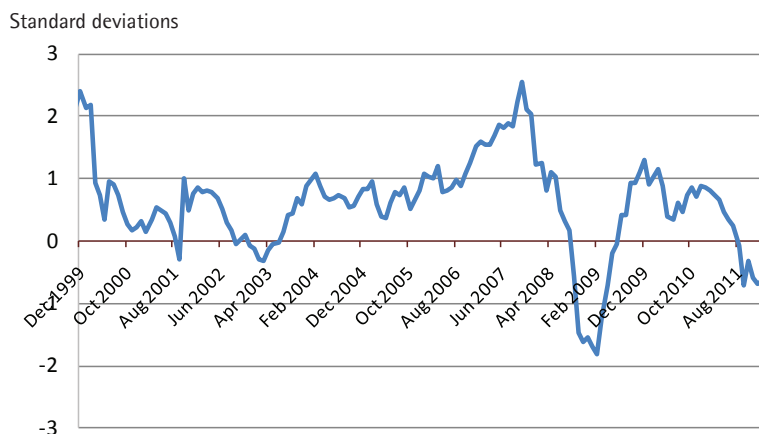
Strategy and asset allocation

As we noted earlier, the economic outlook is finely poised, with growth recovering in the US but distinct weakness in Europe and a question mark hanging over Asia, particularly whether China will avoid a hard landing. Certainly, some of the risks are already priced into markets, but a major blow-up in the eurozone or a sudden escalation of the tensions in Iran is clearly not. Furthermore, with growth in developed economies at subdued levels and likely to remain so while deleveraging continues, any deceleration is likely to prompt a whiff of panic in markets, as happened last July and August.

That is why we are unwilling to have a larger exposure to equities at present, even though they appear to offer good long-term value, especially relative to government bonds. Instead, we are content to hold a good mix of assets, with substantial cash in hand both to protect against any further market falls and to allow us to take advantage of any opportunities such falls might throw up.

For equities, much depends on the direction markets take over the coming quarter. If markets continue to rise from current levels, we may decide to begin trimming exposure, in order to lock in some profits ahead of expected volatility later in the year. Conversely, if markets fall significantly without any major policy disaster, we would be looking for opportunities to buy. Regions vary between fair and good value, but we see particular opportunities in Asia, where we increased exposure over the quarter. We

Pacific Rim equities offer unusually attractive value



Source: FactSet, Heartwood

may look to make further purchases in the coming months, possibly funding them from our existing positions in the UK and the US, two of last year's best performers.

Most individual commodities have fallen from their 2011 peaks but still appear fairly expensive relative to their long-term histories. In addition, we have a preference for asset classes with strong earnings streams, and commodities have no yield. By contrast, commercial property still offers decent yields, though well down on the levels of 2009. US property has had a strong run over the past couple of years but remains at a discount and still appears to have further to go. For higher-risk portfolios, we also like some vehicles which offer higher yields, even though they have correspondingly greater illiquidity.

Within hedge funds, we are looking to reduce exposure to funds of funds but

are still assessing opportunities in other areas. We aren't expecting to make any purchases in the near future.

Although our bond positions made good gains in 2011, we should with hindsight have had a higher overall weighting. Nevertheless, we are wary of increasing exposure to conventional government bonds at an even higher price than they were at early last year. That said, we are exploring possibilities within US inflation-linked bonds. We also still like corporate bonds and have recently added to our exposure (see Product Review).

Opportunities

- Fading inflation leads to policy support in Asia, especially China.
- The US small business sector picks up as credit conditions ease.
- Euro weakness and pragmatic policy decisions bolster the eurozone, prompting a relief rally.

Threats

- Italian or Spanish bond yields soar, requiring a bailout.
- US political paralysis causes the recovery to stutter.
- The Iran crisis escalates, sending oil prices higher.
- Corporate earnings fail to match analysts' forecasts.

Past performance should not be seen as a reliable indicator of future results.

Portfolio activity

Although markets remained volatile in the fourth quarter, we broadly maintained our asset allocation in most portfolios. However, we made some minor adjustments, switching some of our equity exposure to Asia, with a particular focus on China, and slightly increasing our holdings of corporate credit.

At the start of the period, we sold the **iShares MSCI Japan**. We bought direct exposure to the market soon after the March earthquake but had always seen this as only a tactical move to take advantage of the value that had suddenly emerged. Although Japanese equities fell over the six months to the end of September, the move worked relative to other markets, as Japan was easily the best-performing major market during that period (in sterling terms).

However, we had started to see more value in other parts of Asia and so began what we expected to be a series of gradual purchases. The first was to buy **Newton Asian Income Fund**, an old favourite of ours which has successfully applied an income-themed approach to the region. We also thought that

Investment performance

The fourth quarter of 2011 may never have felt terribly comfortable for investors, and markets remained volatile, as the nervousness created by August's steep market falls lingered and the eurozone debt crisis rumbled on. Overall, however, financial markets made good progress during the quarter, thanks to a perceptible brightening of the economic outlook. Despite the continued volatility, our Investment Strategies had a solid end to the year.

Equities enjoyed a strong quarter, with the MSCI World Index gaining 8.0% in sterling terms. However, that reversed only a part of the previous quarter's 14.0% fall. In this environment, our general preference for equities clearly helped performance overall. In terms of our regional positioning, the decision to sell our direct holdings of Japanese equities early in October bore fruit, as it was the worst-performing major market by some distance in the fourth quarter of 2011, and the only one to suffer outright falls. Yet that was partly

Major purchases and disposals in the third quarter of 2011

Fund	Action	Date	Rationale
iShares MSCI Japan	Sell	06/10, 02/11	Taking profits in our broad exposure to Japan initiated after the March earthquake
Newton Asian Income Fund	Buy	06/10, 27/10	Moving into Asia via a reliable manager with a focus on strong income streams
First State Greater China Growth Fund	Buy	27/10	A diversified active fund offering exposure to China, Hong Kong and Taiwan
Atlantis China Fund	Buy	27/10	An aggressive manager with focused positions in non-government enterprises in mainland China
iShares Sterling Corporate Bond	Buy	27/10	Reinvesting cash into passive investment-grade corporate bonds after a pick-up in spreads
AXA US Short Duration High Yield Fund	Buy	20/12	A low volatility way of obtaining some of the extra yield from non-investment-grade credit

Source: Heartwood

investors were over-pessimistic about the prospects for the Chinese economy (see Asia bulletin, in October's Investment View), so our next move was to buy two Chinese funds. For lower-risk Investment Strategies, we bought the **First State Greater China Growth Fund**, which gives exposure to China but also to the more established and transparent markets of Hong Kong and Taiwan. For higher-risk Strategies, we selected the **Atlantis China Fund**, an experienced manager which invests only in China, takes strong positions versus the equity index and generally avoids government-owned enterprises.

Over the quarter, we also increased our holdings of corporate credit, using cash, which had built up partly as a result of maturing government bonds. We bought passive exposure to investment-grade via **iShares Sterling Corporate Bond** (for more detail, see Product Review). For some Strategies, we also bought the **AXA US Short Duration High Yield Fund**, which aims to capture the vast majority of the income stream from the high-yield debt market while taking only a small fraction of the risk.

offset by our relatively large positions in Europe and by the fact that our active managers didn't fully capture the gains of UK equities, the second-best performing major market. Our US holdings enjoyed a very strong run, and some of our Asian and emerging markets vehicles also rebounded significantly.

Surprisingly, **bonds'** recent strong run continued despite the improved outlook for growth. Index-linked bonds led the way, with the 2022 Index-Linked Gilt gaining 4.9% over the quarter. However, our exposure to Norwegian bonds, introduced as a hedge in August, was adversely affected by the weakness of the krone versus sterling.

Commodities were the best-performing asset class over the quarter (GSCI index up 9.2% over the quarter), but our only exposure was through gold in lower-risk Investment Strategies. **Commercial property** had a strong quarter overall, particularly in the US, where the iShares

FTSE EPRA/NAREIT US Property was up a resounding 14.5%.

In **hedge funds**, our holdings of equity long/short and funds of funds were generally in positive territory, though our holdings of global macro strategies were broadly flat over the quarter.

Please note that, although we aim to follow a disciplined model portfolio approach, the results from any individual portfolio are unlikely to be identical to those of the relevant model, because of (among other things) the time of commencement of the portfolio, the precise mandate or risk profile you may have given us (including any investment preferences or restrictions), tax constraints, the tax status of any investment vehicles used, and the availability of certain funds or other investments. The value of any investment and the income from it is not guaranteed and can fall as well as rise, so that you may not realise the amount originally invested.

Product Review: Credit

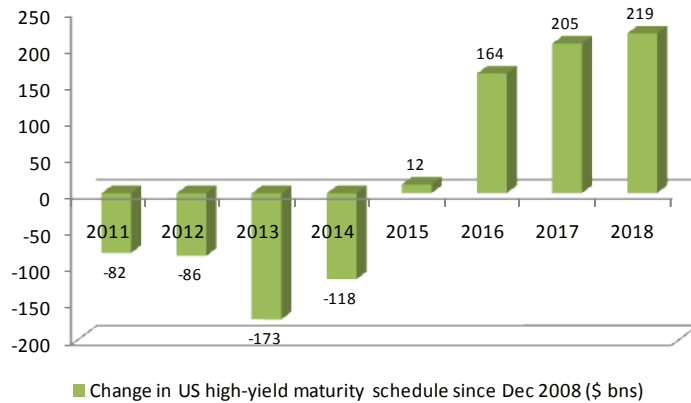
In October, we decided to increase our holdings of UK investment-grade corporate bonds. We have favoured this asset class since late 2008, when they were pricing in a depression which we thought would be avoided. Apart from this outstanding long-term value, corporate bonds satisfied two of our highest-conviction themes of the past few years: the belief that companies are a better credit risk than governments; and a preference for assets with strong and reliable income streams.

Yet corporate bonds have made strong gains since early 2009, bringing their yields down considerably. We had therefore taken some profits in several stages from early 2010 while diversifying into less mainstream areas such as short-duration high yield and corporate inflation-linked bonds. That said, we still retained significant holdings in most portfolios.

So why the decision to increase exposure once more? The immediate catalyst was a rise in corporate bond yields over the second half of 2011. The Merrill Lynch UK Corporate index yield rose from 5.1% in July to 5.8% in December. At the same time, the yield on ten-year government bonds fell from over 3.1% to below 2%. So corporate bond yields not only look more enticing in absolute terms but also appear more attractive relative to gilts.

However, it can be objected that this is only a reflection of the deterioration in the economic outlook over the period. And, if we enter a recession, won't corporate bonds suffer losses? Certainly, corporates wouldn't be immune to a slowdown. Yet we think they are fundamentally healthier than at the start of the last recession and so should produce good returns over the long term.

Companies now have less near-term debt to pay off



Source: Federal Reserve, Moody's Investors Service, BofA Merrill Lynch

In recent years, companies have taken advantage of the lowest interest rates for decades to issue massive quantities of bonds paying very low coupons. By buying back existing bonds on which they had been paying higher coupons, they have reduced their overall cost of capital. At the same time, they have extended their maturity schedule – that is, they have reduced the amount of near-term debt outstanding and increased the amount of longer-term debt, so they will have less debt to roll over in the next few years (see graph). They have also increased the amount of cash on their balance sheets. As a result, companies are much better prepared in case of a recession. By contrast, the governments of many developed economies have barely begun to reduce overall public debt. Indeed, for some, the level of debt continues to rise.

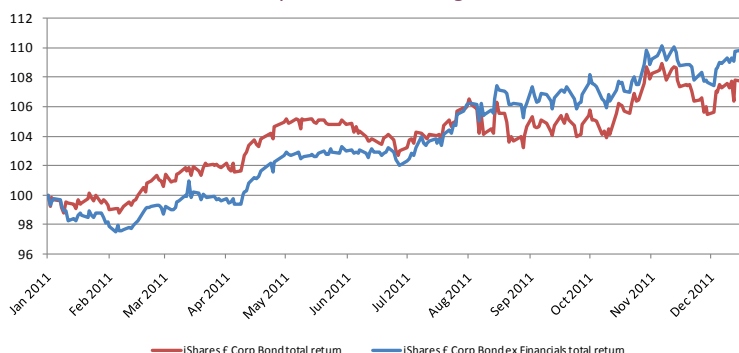
Having decided to increase exposure to sterling corporate bonds, we had to select an appropriate instrument. In general, we like to hold the same vehicles across our Investment Strategies, as that makes for efficient portfolio management, helps to achieve consistent returns and, of course, increases our buying power. But

sometimes a more nuanced approach is called for.

We like the iShares £ Corporate Bond, a passive fund which gives broad access to investment-grade corporate bonds issued in sterling. By contrast, most of the active managers in this area have flexible mandates and may at any time have a significant exposure to government bonds, say, or high-yield credit. That may not agree with our overall strategy (it certainly doesn't at the moment). In addition, the iShares funds have a low annual management charge of 20 basis points (0.2%), much cheaper than active funds, which typically have a charge of around 50-75 basis points.

However, while we like sterling investment-grade corporate bonds, the market has a heavy weighting towards the financials sector (around 30%). Financials have higher yields than the overall market, but for a good reason: the European banking system remains fragile, and the sector would take a hammering in the event of disorderly defaults of eurozone sovereign debt. We thought this posed an unacceptable threat to our lower-risk Investment Strategies. Fortunately, the iShares £ Corporate Bond is available in two forms, one with and one without exposure to financials. We have therefore used the ex financials version for lower-risk Strategies. It gives a slightly lower yield to maturity (4.21%, versus 4.51%) but should produce lower volatility within portfolios if the eurozone debt crisis escalates significantly.

Financials clearly underperformed during the summer volatility



Source: Bloomberg

Past performance should not be seen as a reliable indicator of future results. The above does not constitute any recommendation to buy, sell or otherwise trade in any of the investments mentioned. The value of investments may fall as well as rise.

Special feature: Still getting paid while you wait

Since the credit crisis began, the investment landscape has changed considerably, with a steep rise in volatility. However, some things have remained unaltered, one being our theme of getting paid while you wait. As it still heavily informs our decision-making, we thought it might be as well to reprise this theme and highlight some of the ways we are playing it.

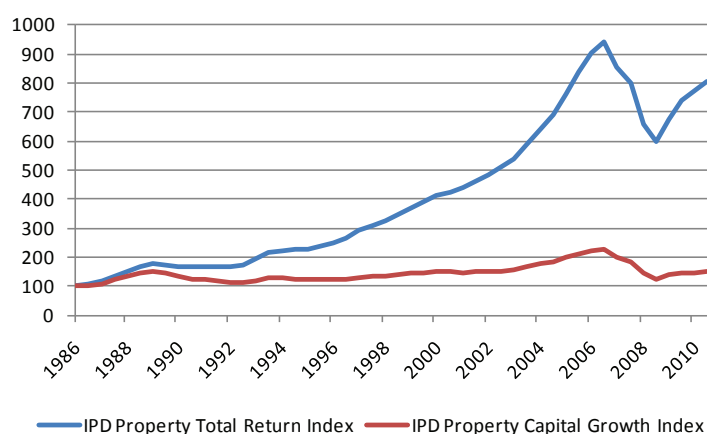
For most investments, the total return consists of two parts: capital gains; and income, or yield. The proportion of each will vary from asset to asset and in line with market conditions. For example, in the heady bull market of the 1990s, many equity investors felt they could afford to ignore dividend yields because markets were consistently delivering substantial capital gains.

Since then, however, capital gains have become less reliable, to put it mildly. As interest rates on cash deposits and government bonds are also at historically low rates, this has placed a huge premium on investments with high yields. But yield on its own is not enough: we want that yield to be sustainable over many years, so that we can enjoy its compounding effect over the long term. To achieve sustainable or ideally growing income streams, businesses need to generate strong free cash flow – that is, cash after all other liabilities have been met. And it helps if that cash flow is predictable, either because it comes from spending on the necessities of life or because it is from legally binding contracts, such as rental agreements.

The importance of the compounding effect is well understood by most investors. If an investment of £100 produces an annual dividend of 10% which is reinvested, it will be worth over £161 after five years, assuming no capital gain. After ten years, it would be worth more than £259 – a gain of over £159. If the annual dividend were taken as income and spent, it would of course have been worth only £100. The benefit of compounding by reinvesting positive cash flows is shown by this graph, which shows the capital-only returns from UK property with the total return (capital and reinvested income).

Unfortunately, not everyone shares our appreciation of compounding. At the

Income accounts for the vast majority of total returns from UK property



Source: Investment Property Databank Ltd (IPD)

company level, boards sitting on large piles of cash tend to feel the need to splash out on activities such as mergers and acquisitions (M&A). And much of that spending has in the past turned out to be wasteful: 69% of M&A deals were found to have destroyed value, according to a study by KPMG International in 2010. We would prefer to see businesses either reinvesting any surplus cash into proven profitable ventures or returned in the shape of dividends to shareholders, who can then reinvest it in the businesses' shares.

So how are we playing this theme in portfolios? We are playing it first in our asset allocation. We have a preference for equities, whose dividend yields are elevated, especially when compared with abnormally low yields on government bonds. We also still like commercial property, where rental yields have subsided from their peaks in 2009 but remain elevated.

The theme also affects our security selection. Within equities, we have a strong focus on active managers which share our enthusiasm for this type of business. In addition to the overtly income-oriented managers (JO Hambro UK Equity Income and Newton Asian Income), we hold the Heronbridge UK Equity Fund, which focuses on companies with strong financial performance over the economic cycle, and Morgan Stanley Global Brands, which targets businesses that have quality global franchises and sustainable free cash flows.

In 2011, Goldman Sachs published research into the difference in share price growth between those companies in the MSCI Europe Index with a high return on their internally invested capital (cash return on capital invested, or CROCI) and those with a low return. It found that the stocks of companies with a high return in this measure have on average outperformed by more than 9% a year since 2002.

Within property, we have an emphasis on prime properties in the UK, where income streams from rents are inherently predictable. Outside the UK, Real Estate Investment Trusts are tax-efficient and have mandatory distributions of rental income, which we of course reinvest. Another intriguing income play is within high-yield bonds. The AXA US Short Duration High Yield Fund gives us something like 80% of the yield of the overall US high-yield market while taking only around a third of the duration. As a result, it is a lower-risk way of securing a strong, stable income stream.

Of course, we are not investing exclusively in these areas; this is just one theme within portfolios. But, at a time of high uncertainty and subdued economic growth, it still makes sense to us to play this theme, which relies on a patient approach and fundamental strengths, rather than rapid headline growth.

Asset class returns (as at 31 December 2011 in GBP)

The table below shows the performance over different periods of the various asset classes we cover.

Asset	Index	Historic Returns						
		3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs
Equity - UK	MSCI UK	9.4%	-4.6%	-1.8%	10.2%	40.7%	0.7%	7.3%
Equity - US	MSCI North America	11.4%	-1.9%	1.3%	21.2%	39.6%	20.2%	27.2%
Equity - Japan	MSCI Japan	-3.6%	-7.0%	-13.6%	3.1%	-2.4%	-4.2%	-9.7%
Equity - Europe ex UK	MSCI Europe ex UK	3.7%	-20.8%	-13.9%	-9.0%	8.5%	-17.4%	-4.6%
Equity - Pacific ex Japan	MSCI Pacific ex JP	6.3%	-12.1%	-12.0%	6.2%	63.7%	13.2%	46.6%
Equity - Emerging Markets	MSCI EM	4.7%	-16.3%	-17.6%	1.3%	61.5%	4.7%	43.9%
Bonds - Conventional Government	Merrill Lynch UK Gilts	5.5%	14.9%	16.9%	25.8%	24.2%	40.4%	47.8%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	8.8%	16.3%	21.4%	32.1%	40.3%	45.3%	57.6%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	3.2%	3.6%	7.0%	17.1%	34.8%	23.3%	24.1%
Commercial Property	IPD All Property Et FactSet UK Real Estate Invest Trust Index	-0.3%	-11.5%	-0.4%	12.2%	30.8%	-25.4%	-39.3%
Commodities	GSCI Index	9.2%	-0.6%	-0.4%	12.0%	13.1%	-16.2%	9.3%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	3.0%	-7.0%	-6.1%	2.9%	23.5%	1.6%	16.2%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	0.3%	4.8%	6.4%	21.1%	35.8%	32.7%	56.7%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	1.3%	-2.4%	2.1%	11.9%	40.2%	9.7%	21.5%
Cash	1 Month LIBOR	0.2%	0.3%	0.6%	1.2%	2.0%	7.3%	13.6%

Source: FactSet

Please note that the returns given for the hedge fund and property indices are estimates, because of the delayed release of the monthly index values. The historic returns shown above are gross of management fees, and therefore do not take into consideration any commissions, fees or other charges. Past performance should not be seen as a reliable indicator of future results.

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