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Premier Discretionary Team

Asset Allocation - For Professional Adviser Use

18th October 2010

Minutes

Present: F Fulcher, M Jennings, D Pendlebury, R Hallen, N Kelsall, D Hambidge, K Cushway.

Overview

It has been six weeks since the last meeting and equity markets have been charging ahead. Since 1st September, the MSCI World index is up 13% in Dollar terms and 8.4% in Sterling terms. Bond yields have remained low despite the strong equity markets and commodities have also been strong especially Gold, Oil and Corn although little has changed from a macro economic or corporate perspective.

Fears of a combination of double dip combined with deflation appear to have receded. Macro data has been relatively benign with the vast majority of indicators showing a stabilisation at lower levels and there is still some extremely robust data.

The current drivers of markets appear to be:

1. "QE2" - a second wave of Quantitative Easing is expected in the US imminently, probably early November following the FOMC meeting. QE is the purchase of assets, especially Treasuries, which injects liquidity into the financial system and lowers long term interest rates. This explains why all asset classes are rallying in tandem. Lower bond and cash deposit yields highlight how cheap equities are and also reduce the interest cost of buying commodities etc.

2. Earnings season - the US Q3 reporting season is well under way now. So far, earnings have been broadly in line with expectations (GE was worse, Google was better, JP Morgan was broadly in line). The consensus now expects +23.8% growth in S&P earnings in Q3 2010 (versus Q3 09), and +20.6% ex-financials. The data will be good as Q3 2009 was dreadful. For 2011 the market expects a more modest 14.8% rise in profits, and it will be guidance for next year that is watched closely with these results.

3. Seasonality - Q4 is often seasonally strong for equity markets. US active managers have substantially underperformed this year and may be playing catch up. The November mid term elections might be greeted with relief.

Certainly markets have become risk seeking with the Chinese market recording its biggest daily volume at $73.5 billion on Monday 18th October. In the last 20 weeks, emerging market equities have seen $47 billion of net inflows. AIA, the Asian arm of AIG Group, is being 'IPO'd' this week, raising approx. $20 billion. The books are being closed early due to overscriptions by 6 or 7 times so far.

Looking at global equity values and the more stable metric of Price/Book, global equities trade at 1.7x versus a long term average of 2.1x. The FTSE All Share still offers a 3.1% yield for 2010 versus 10 year Gilts at 2.9%. Consensus expects a 2011 yield on the FTSE All Share of 3.7% with the relationship between 10 year gilt yields versus UK equity yields similar to the first half of the 1900's.

In order to make an assessment of potential long term expected returns from equities, one rule of thumb that we can apply is the following formula;

Company return = Nominal GDP + dividend yield + operational gearing

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So if we make the following assumptions:-

- Real GDP for the next decade is 2% per annum
- The Bank of England hits inflation target of 2% per annum
- Dividend yield is now 3.1%, and
- Operational gearing might add, conservatively, a further 2%

So, on this basis, a reasonable corporate return would be 9.1% p.a for the next decade. Compound this over 10 years and this equates to a 139% return versus 33% from a 10 year Gilt yielding 3.1% pa.

What is missing from this analysis is valuation. In the decade of the 2000's, company returns were high, but equities started the decade on such a massive premium (price/book above 4x) that the de-rating of equities left us with a c. zero return from equities over the decade.

This time we would expect a modest re-rating which would add further to the already massive differential between expected equity and bond returns. Whilst equities have risen very sharply in the past six weeks after a tough year, it is tempting to take profits as we may have a short period to digest these gains. However, we feel that widespread profit taking would be unwise.

With PE's of around 10x, based on 2011 earnings in most European equity markets, 12x in the US, 14x in China, but yields still well in excess of their sovereign bonds across Europe, equities remain cheap as long as we are not on the brink of sharp economic contraction. This remains possible but we feel unlikely. In the developed world, mergers and aquisitions, share buy backs, and accelerating dividends will be three attributes which will drive equity prices higher.

It was agreed that no changes or adjustments were needed to the current asset allocation.

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