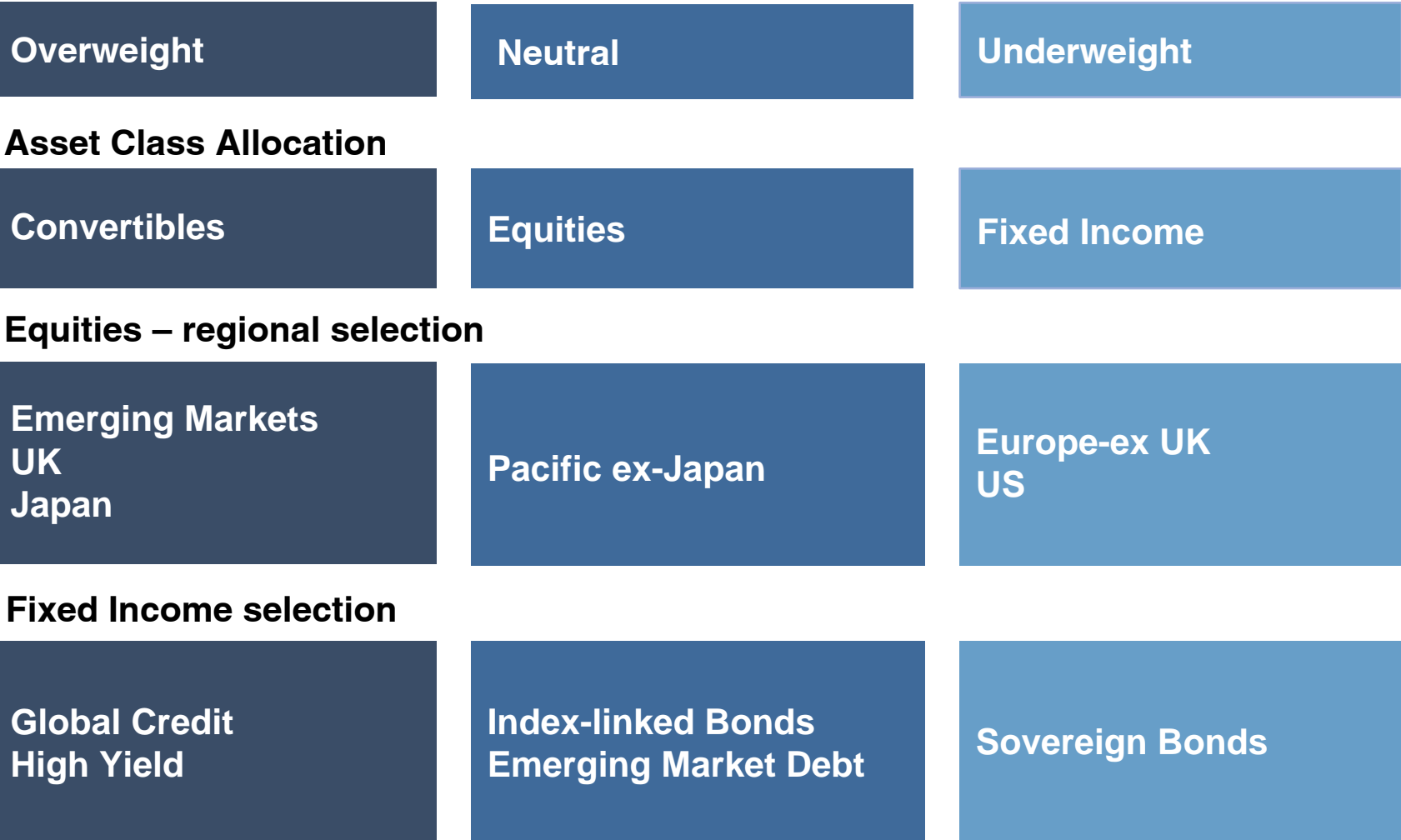




Asset Allocation Game Plan

January 2012

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Economics

- The eurozone's sovereign debt crisis is dragging down growth in the region. Meanwhile, US economic data has improved of late.
- Liquidity is abundant as central banks are pumping money into the financial system.

Strategy/Outlook

- In response to the macro-economic worries, which risk recession beyond the eurozone, our equity exposure in balanced portfolios is neutral.
- Government bond yields offer little value, with longer-term inflation and credit issues a concern.
- Fundamentals point to outperformance by credits.
- Our preferred equity markets remain the emerging markets. Our main underweights are Europe ex-UK and, to a lesser extent, the US.

Risks

- Contagion affecting financial markets feeding into the economy.
- Inadequate policy response from politicians and central banks.

Overweight

- Convertibles

Neutral

- Equities

Underweight

- Fixed Income

Economics

- Economic data including manufacturing, retail sales and jobless claims has improved of late. However, the outlook for 2012 remains uncertain.
- In the equity markets the uncertainty has been reflected in defensive stocks, such as utilities, household product makers and health-care providers outperforming banks and commodities companies.

Outlook

- Although sentiment towards the US economy is less bearish than it was a few months ago, investors remain wary of cyclical stocks reliant on growth. Meanwhile valuations of defensive stocks have become more expensive.

Risks

- The economy tips into a double-dip recession.

- The F&C North America portfolios employ a purely quantitative stock selection approach. We apply a proprietary alpha model and portfolio construction methodology to come to an active portfolio, without taking exposures to styles - market direction, momentum, market capitalisation, value - industries and countries.

Economics

- Growth in the UK economy remains anaemic. Unemployment has been rising since the summer and this makes reduction of the fiscal deficit more problematic.
- Inflation has fallen back slightly (to 4.8% in November from a peak of 5.2% in September) but remains elevated (the Bank of England's target rate is 2.0%).

Strategy/Outlook

- Against the uncertain macro-economic backdrop we remain underweight companies dependent upon European earnings. We are also trimming our holdings in emerging market-facing companies in favour of those with exposure to the US.
- On the capitalisation scale we prefer larger companies, which are more resilient to weakness in the economy, at the expense of mid-caps.

Risks

- Austerity measures accelerate a decline in the economy, the eurozone falls into recession, inflation remains high, interest rates rise, increased trade & currency tension and on-going issues in the eurozone sovereign debt crisis.

Overweight

- Travel & Leisure
- Healthcare
- Telecoms

Underweight

- Utilities
- Tobacco
- Household goods

Economics

- Ongoing sovereign debt issues ensured European equities were volatile.
- Although the UK refused to be part of any agreement, Europe moved towards closer fiscal union at the December summit. Later on, the ECB looked to ease liquidity problems by issuing around €500bn in three year loans to the banking sector.
- Corporate data (especially in Germany) continued to contrast with the relatively sluggish economic backdrop. The IFO rose for the second consecutive month reflecting the strength of Europe's export sector.

Strategy/Outlook

- Against an uncertain backdrop we believe that there are opportunities for well-capitalised European companies to build on dominant market positions.
- We continue to favour those companies with the potential to strengthen their franchises but where this is not yet reflected in their valuation levels.

Risks

- A sustained period of deflation, as ongoing problems in the financial sector lead to further credit contraction.

Overweight

- Consumer Discretionary
- Technology
- Insurance

Underweight

- Utilities
- Telecommunications
- Personal Goods

Economics

- Japanese industrial production fell 4% in November, with the contraction explained by weak global demand, a high yen and supply disruptions (as a result of flooding in Thailand).
- For 2011 as a whole, official forecasts now expect the economy to have shrunk by 0.1%, rather than having grown 0.5% (the previous estimate).

Strategy/Outlook

- We believe that the Japanese market is very cheap at current levels and offers significant upside once economic conditions improve.
- Japan remains a highly cyclical economy as the main drivers of growth are exporting companies.
- We will remain flexible in our strategy as the spread of possible outcomes in relation to the global economy continues to be extremely hard to forecast.

Risks

- Exporters will be under renewed pressure if global growth falters.

Overweight

- Telecoms
- Oil & Gas
- Financials

Underweight

- Consumer Services
- Healthcare
- Consumer Goods

Economics

- Growth across Asia is moderating because of weakening external demand and earlier monetary tightening. Uncertainties in Europe and a slowdown in global growth are also impacting on production.
- China and other emerging markets are expected to ease monetary policy in order to ensure their economies do not slow down excessively.

Strategy/Outlook

- The region's equity markets will remain sensitive to investors' perception about the health of the global economy.
- Earnings forecasts continue to be trimmed back as a result of decelerating growth.
- Valuations across the region are low by historic standards and equities should find support from easing monetary policy to boost financial liquidity.

Risks

- Western economies slip back into recession and demand for Asian exports falls.

Overweight

- Korea

Underweight

- India
- Malaysia

Economics

- The pace of growth in the emerging markets is forecast to slow next year but stay well ahead of that in developed economies.
- China and other emerging markets are expected to ease monetary policy in order to ensure their economies do not slow down excessively.

Strategy/Outlook

- Stuttering growth in the West and severe stresses in the eurozone financial system continue to present challenges.
- Across the emerging regions, both growth and inflation are moderating in line with our expectations.
- Our focus is currently on the so-called BRIC countries (Brazil, Russia, India and China) as we see an attractive blend of lower inflation, steady growth and cheap valuations.

Risks

- A 'double-dip' in OECD economies and an escalation of the eurozone crisis.

Overweight

- India
- China/Hong Kong
- Brazil

Underweight

- Taiwan
- Malaysia
- Mexico

Economics

- Volatile spreads remained a feature as the sovereign debt crisis continued. The ECB looked to ease liquidity problems by issuing around €500bn in three year loans to the banking sector.
- There were some grounds for encouragement among economic data as the IFO climbed for the second consecutive month.

Strategy/Outlook

- Risk exposure remains low. We are slightly underweight duration and see scope for tactical trading.
- We are underweight France. We have some small overweight positions in the periphery at the shorter end of the spectrum.
- Our 2-10 year flatener and 10-30 year steepener positions have been slightly reduced.

Risks

- Any flattening on the 10-30 portion of the curve and any spread tightening in France.

Interest rate direction

- Higher bond yields

Duration

- Slightly underweight

Yield Curve

- 2-10 yr curve flattening bias
- 10-30 yr curve steepening bias

Asset Allocation

- Overweight inflation-linked bonds
- Overweight covered bonds
- Overweight Netherlands
- Underweight France

Economics

- Inflation has fallen back slightly, to 4.8% (in November) from a peak of 5.2% in September and is set to decline further as base effects (primarily the VAT hike) drop out of the calculation.
- Interest rates remain at record lows and the UK's decision to stay outside of the new fiscal compact in Europe preserves its ability to forge an independent budgetary and monetary policy.

Strategy/Outlook

- Existing quantitative easing purchases (and the likelihood of an extension in 2012) plus the UK's attraction as a safe haven away from the turmoil of the eurozone should underpin demand for gilts.
- The yield curve has begun to flatten in recent months and this trend should continue, with longer-dated gilts outperforming short-dated gilts, given the current economic backdrop.
- Index-linked gilts lagged conventional gilts in 2011 and we believe that this presents scope for them to outperform in 2012.

Risks

- Escalation of the eurozone debt crisis, with the potential break up of euro members. This makes the outlook for the economy very uncertain.

Duration

- Bias to long duration

Yield Curve

- Overweight bias to longer-dated gilts

Asset Allocation

- Overweight index-linked gilts due to structural demand from pension funds

Economics

- Credit markets continue to be unsettled as solutions to the eurozone debt crisis have continued to disappoint.
- Despite measures agreed at the last EU summit, there is yet to be a solution to the European banking crisis and it is becoming increasingly difficult for peripheral eurozone countries to meet austerity targets.

Strategy/Outlook

- We foresee a period of low growth for developed countries but expect the emerging markets to support global growth.
- Despite the challenging outlook for the global economy, credit fundamentals remain healthy and financial policies are conservative. We maintain our cautious stance.

Risks

- A global collapse of the banking system and a severe global recession

Overweight

- Banking
- Life Insurance
- Metals & Mining

Underweight

- Sovereign & Supranational
- Utilities
- Energy

Duration

- Neutral

Economics

- The political games being played out within the eurozone mean the market is becoming increasingly difficult to call as announcements from politicians continue to have a dramatic impact on markets, in either direction.
- The risk of sharp market movements over the shorter term are not limited to the downside as we see an increased chance of central banks intervening in 2012 to support asset prices, which could lead to a snap back in credit spreads.

Strategy/Outlook

- While we remain positive on credit over the medium to longer term, we remain cautious of having large risk positions in the portfolios.
- Recent market moves have been severe and while we reduced risk over 2011 we remain overweight some sectors such as insurance, which we prefer from a fundamental perspective.

Risks

- Continued volatility from sovereign debt problems, uncertainties from increased regulation (particularly for financials), the full impact of austerity measures (especially in the US).

Overweight

- Insurance
- Senior Banking
- Asset backed

Underweight

- Supranationals
- Industrials

Duration

- Neutral

Economics

- The failure to move towards a sustainable solution to the European debt crisis continues to impact investor confidence.
- The high yield market recovered some ground in December.

Strategy/Outlook

- The asset class remains attractive on a relative basis. Valuations in all sectors now appear cheap compared to recent trading ranges. This presents some attractive opportunities but there are reasons to be cautious as there is an increased likelihood of defaults if the economic slowdown becomes more entrenched.
- On a fundamental assessment we would have a preference for US high yield, although the valuation of European high yield remains appealing, especially in the single B tier.

Risks

- The full impact of austerity measures, further escalation of sovereign debt concerns, Middle East macro events creating an oil shock.

Overweight

- Basic Industry
- Energy
- Transportation

Underweight

- Communications
- Consumer Goods
- Capital Goods

Economics

- The macro economic outlook for Europe has deteriorated with a mild recession now widely forecast.
- Meanwhile, recent US economic data releases have been slightly better than expected.

Strategy/Outlook

- We believe the current uncertain environment is supportive for investing in convertibles, as investors are protected on the downside, while the upside is unlimited.
- We do not yet expect a global recession and in view of this valuations appear attractive on a long term comparison.

Risks

- On-going problems in the Sovereign debt markets of Europe, the impact of fiscal measures to address over extended budget deficits and inflation expectations in the emerging markets.

Overweight

- Asia
- US
- Financials
- Property

Underweight

- Europe, especially PIIGS
- Electronics
- Pharmaceuticals

Economics

- Uncertainty in global financial markets, as a result mainly of diverging eurozone statements, drove spreads wider.
- Emerging market spreads increased by 26bps to 396bps, while the yield on the 10-year US Treasury came down slightly, to 2.07%. The emerging market index returned -0.9%.

Strategy/Outlook

- Despite their relatively stronger domestic fundamentals, emerging markets will not be immune to drag from slower growth in the US and the Eurozone.
- Nevertheless, if global growth in 2012 slows only to a pace of 5.0%, then creditworthiness could still continue to improve and spreads tighten.

Risks

- Impacts from a significant global economic slowdown on both exports and commodity prices as well as capital flows, contagion of the eurozone periphery crisis to other European sovereigns and the banking sector, and a sharp slowdown in China.

Overweight

- Brazil
- Mexico
- Venezuela

Underweight

- Turkey
- Russia
- Hungary

Duration

Neutral spread and
interest rate duration

Economics

- Property continues to deliver total returns broadly in-line with income but the pace is slowing.
- Rental growth remains restricted to a few areas and several parts of the market are recording falls in capital values.

Strategy/Outlook

- Total return forecasts are being revised down to reflect slower economic growth and eurozone uncertainty. Investors are cautious, focusing on the security of income, with long leases favoured.
- Banks are releasing stock, but the process has some way to go and there remains a gap in price expectations between buyers and sellers in the secondary market.

Risks

- A deterioration in economic performance or further intensification of the Eurozone crisis could put more pressure on rents and capital values, especially at the secondary end.

Overweight

- Assets with good location, lease length, tenant covenant and building quality.
- London and the South East expected to outperform but the gap is narrowing, some stock may be fully priced.

Underweight

- Secondary stock.
- Property vulnerable to rental decline/voids.

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