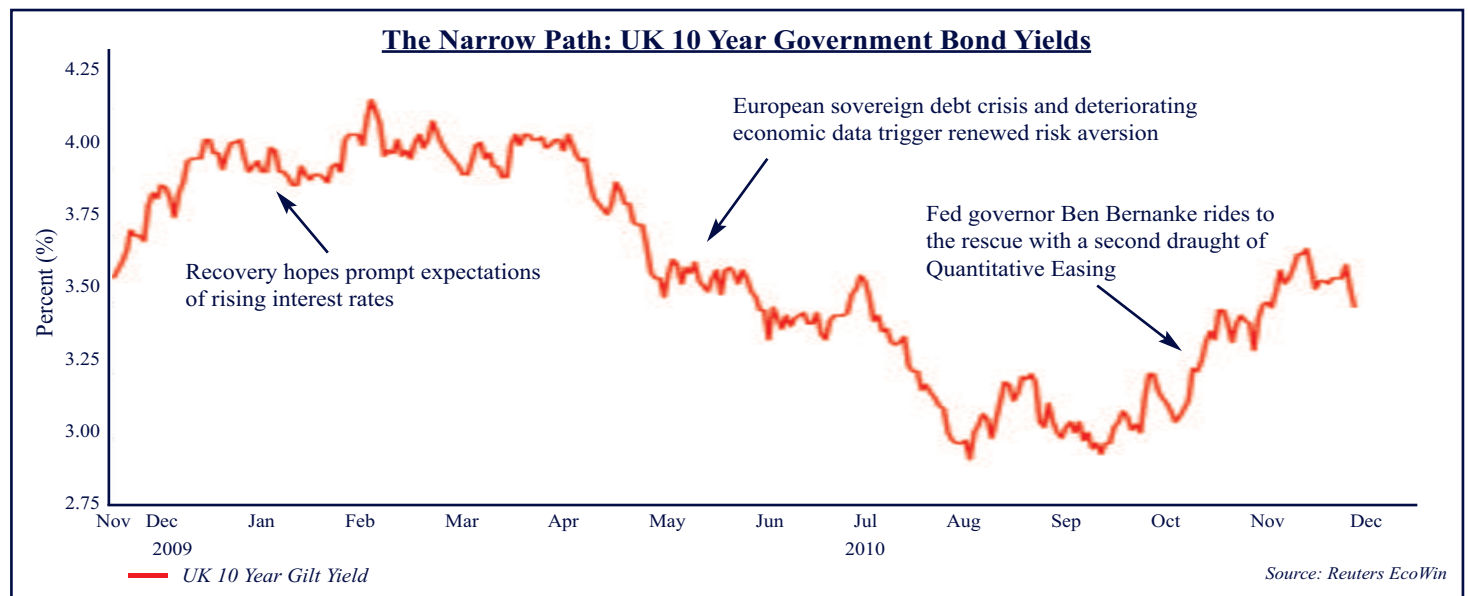


REFLECTIONS, RAMIFICATIONS AND RPI

In this note, we look back on some of the key events of what has been a demanding, but ultimately rewarding, twelve months for investors and look forward to the challenges of 2011. In summary, 2010 was another year of post-crisis muddling through for the global economy. As ever, there were upsets and surprises along the way, but for those who kept their nerve and remained in risk assets, the gains were very worthwhile. We believe that, while there will doubtless be unhelpful and unforeseen developments, such as this week's UK inflation data, 2011 may look similar to 2010.

Twelve months ago, we set out our view that developed economies would succeed in treading the narrow path between inflation, accompanied by renewed financial crisis, and deflation, accompanied perhaps by renewed recession. Our central expectation was for the liquidity-fuelled recovery, which had lifted economies out of recession during the second half of 2009, to give way to an extended period of lacklustre growth. In broad terms, this proved to be the case. However, 2010 provided a number of surprises, both positive and negative, which forced many investors to question the shape, sustainability and duration of the recovery. This note reflects briefly on the key developments and lessons of 2010 and reviews the performance of our model portfolio. We also revisit some of the highlights of our 2010 seminars and give our thoughts on the outlook for 2011.

The investment story of 2010 is well illustrated by the path of gilt yields over the year (below). It began with gilt yields and equity prices rising, as evidence of improving economic data brought forward expectations of interest rate increases, and prompted governments and central banks to take the first steps towards removing the policy support put in place during the financial crisis.



In the US, the Obama administration's first steps towards policy normalisation included the re-regulation of the US commercial banks. In the Far East, the Chinese government raised its reserve ratio for banks to curb the country's overheating property market while in Europe, the ECB, the eurozone's central bank, withdrew its unlimited liquidity facility. The latter proved to be a step too far, as it triggered a sovereign debt crisis in Greece and a rapid return of risk aversion. As a result, the beginning of the second quarter saw investors retreating to less risky assets, driving gilt yields downwards once more.

Investment Seminar - China



Anthony Bolton and Angus Tulloch

China was the subject of our first investment seminar of 2010 when we brought Anthony Bolton of Fidelity International and Angus Tulloch of First State together to debate the outlook for the Far East. Bolton's view was that China's strong economic growth should lead to strong equity market returns. Tulloch was slightly more cautious, particularly in the short-term, given the lofty valuations accorded to Chinese shares. While Angus's caution proved correct in broad terms (the Shanghai Composite Index lost c8% over the year, in sterling terms), Anthony's stock selection skills, aided by his new fund trading at a premium to net asset value, saw Fidelity China Special Situations gain c17% from its April launch to the end of 2010.

Risk Aversion

The rise in risk aversion at the beginning of the second quarter was sparked by concerns about the future of the European single currency, triggered by the onset of the Greek debt crisis. This more cautious outlook was augmented by weaker economic data, tensions in the Korean peninsula and the continued fallout from the Gulf of Mexico oil disaster. These factors all helped gilt yields to continue their retreat; reaching a low of 2.83% at the end of August. Rising risk aversion also drove a correction in equities, with the FTSE 100 Index of the UK's leading companies losing more than 15% in the three months to early July.

Investment Seminar - Shift to the East

July saw Stephen Green, the then Chairman of HSBC plc (now Lord Green of Hurstpierpoint and Minister for Trade and Investment), join Nick Fletcher who quizzed him on the opportunities and challenges presented by the shift of the global economy to the East. Green believed that this shift would be one of the defining features of the first half of the 21st century, with the newly developing nations in the East aspiring to similar standards of living to those enjoyed in the West. In his view, the opportunity to participate in the strong growth of emerging markets companies was very appealing, however, investors needed to be mindful of the valuations paid for such businesses.



Lord Green of Hurstpierpoint and Minister for Trade and Investment

Quantitative Easing

Risk aversion was bolstered further at the beginning of the final quarter of the year by a second leg of the eurozone sovereign debt crisis, with Ireland this time requiring a combined EU/IMF bailout. Further weak economic data, including poor US housing market and employment data, prompted the Fed to announce a second round of quantitative easing. This proved to be an inflection point for equity and bond markets as investors bought risk assets in anticipation of a renewed flood of liquidity. The safe haven status of government bonds waned and gilt yields began to rise again, reaching 3.40% by the close of the year.

Investment Seminar - David Sokol

In our final seminar of 2010, David Sokol, Berkshire Hathaway's 'Mr Fixit' and a potential successor to Warren Buffett, was interviewed by Nick Fletcher. They discussed the non-insurance businesses of Berkshire Hathaway managed by David Sokol, including utility giant MidAmerican Energy and fractional jet ownership business, NetJets. Also under discussion was Warren Buffet's management style, his 'value investing' approach to buying businesses and the Berkshire Hathaway culture.



*David Sokol,
Warren Buffett's 'Mr Fixit'*

Despite the twists and turns discussed above, taking investment market returns for 2010 as a whole, one might be forgiven for concluding that the global economy had recovered from crisis and regained a semblance of normality. Global equities rose by c16% (in sterling terms) for the year, with higher risk emerging market equities up almost 23% (though, as noted above, Chinese equities lost ground). For UK investors, returns from gilts and corporate bonds were c7-8%, while UK commercial property returned c9%. With interest rates pinned at emergency low levels, cash returns were very low. The Saunderson House Model Portfolio* captured a good slice of these returns, achieving 13.6% for the 2010 calendar year. This was achieved with a broad mix of assets, including approximately 50% in equities. This compares favourably on a risk-adjusted basis with the return of 16.3% from the FTSE World Index, which has 100% equity risk.

Outlook

We expect 2011 to see a continuation of the gradual convalescence of the global economy though doubtless there will be more surprises and challenges. For now, deflation concerns appear to have receded, leaving governments, central bankers and investors to focus on the threats posed by inflation. Rising prices were very much in evidence in the UK this week with the release of December's inflation data. According to the CPI (consumer price index), prices are now 3.7% higher than one year ago. On the older RPI measure, prices are rising at an even more concerning rate: 4.8% per annum. Once again, however, central banks will need to tread a fine line. There is clearly some risk that growth could falter once more if interest rates are increased to address inflationary pressures. Conversely, if rising inflation goes unchecked, there remains the risk that investors lose patience and reduce government bond holdings, driving yields sharply higher. This might trigger renewed financial crisis if governments find themselves unable to fund their deficits at higher yields.

In our view, there is cause for optimism that both of the extreme outcomes mentioned above can be avoided, as they were in 2010. The sensitivity to inflation of both bond investors and consumers means that the authorities are getting clear and unequivocal warnings that they cannot let rising prices become entrenched. Hence, while we do not believe such action will be required, we do expect interest rates to be increased if deemed necessary to ensure that inflation does not become a problem. Through these challenges, our focus at Saunderson House will, once again, be on tilting portfolios towards attractively valued assets, while resisting the temptation to react to every economic and political development.

**The Saunderson House Model Portfolio is the tactical model for clients in the 40-49 age band with a balanced attitude to risk. Models for other age bands and risk profiles are constructed on a similar basis with the allocations to core asset classes varied as appropriate. Returns for other models are comparable with the figures quoted.*

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About Saunderson House

Saunderson House provides conflict-free, independent and integrated personal financial planning advice including estate, tax, pensions and investment advice to City lawyers and accountants, entrepreneurs, industrialists, family estates, charities, trustees and pension funds. The firm advises on c£3 billion of clients' capital on an hourly rate charging basis, thereby eliminating conflicts.

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