

PanVIEW



Evercore Pan-Asset's Global Asset Allocation and Investment Review

4th QUARTER 2008

Asset Allocation Overview John Redwood

Last year we recommended a very cautious strategy based around cash. Holding money in good quality deposits earning in excess of 5% felt comfortable, whilst we waited to see just how bad the downturn and the Credit Crunch were going to be. Putting some of the cash into stronger currencies than sterling was a way of raising the returns without too much risk.

This year is not so straightforward. The returns on cash on both sides of the Atlantic have plunged, leading investors to consider taking more risks. Sterling has devalued by more than a quarter last year, with much of the fall occurring in the last few months. Equity markets have fallen a long way, especially in the Far East where growth is still stronger and the financial position better than in the US and UK. US and UK government bonds have surged on the back of the falls in interest rates, offering low yields to new buyers.

So what should an investor do now? If this were a normal cycle it would be easy. You buy equities as interest rates fall, and wait for the turn to come in the underlying economies as lower interest rates work their magic.

The issue before us is the state of the banking systems in the US, UK and Euroland. They remain very weak. There are worries shared by investors, commentators and the authorities that as a result this is not a normal cycle. Lower interest rates may not flow through to increased activity, as the banks remain unwilling or unable to lend much. Final demand for the bigger ticket items like homes and cars has fallen sharply owing to a lack of credit. Businesses struggling with reduced order books then find

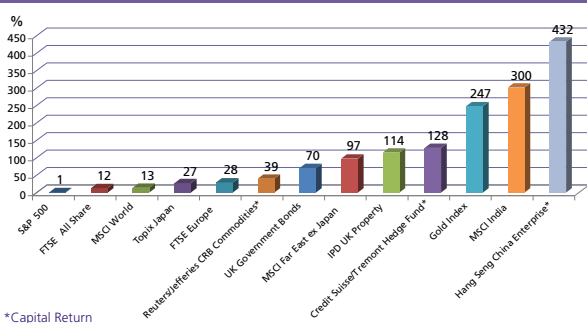
it expensive or impossible to borrow all the money they need to tide them through poor trading. Some go bust, and many make staff redundant. Rising unemployment depresses the wish and the ability to spend, further reducing demand. As more companies go under, as house prices fall further uncovering the asset cover for mortgages, so banks have to write more off their loan books and experience more bad loans.

There are at least three possible scenarios from here. One is that the banking problems are so severe that none of the actions being taken can mend them quickly, leading to prolonged recession or slump. On this analysis investors have to learn to live with low returns, and remain cautious as there will be more losses in shares and properties. The second is that time will produce a cyclical upswing, given the huge sums the authorities are pumping into money markets and economies, so now is the time to buy equities. Indeed, if the authorities do not reduce the extra liquidity in time there could be a future inflation problem, given the scale of interest rate cuts and the money supply boost. The third is that the authorities will eventually produce measures which enable some modest improvement in bank lending, which in turn will lead to a very slow and mild upswing. On this scenario the Western economies will have to get used to no growth and slow growth for quite a time whilst the debt overhang is worked through.

We cannot be sure which of these will develop in 2009. In part it depends on what the authorities do next. Can they, for example, hit upon the right combination of regulatory and monetary responses which can get their banking systems and economies moving again? It remains in the balance.

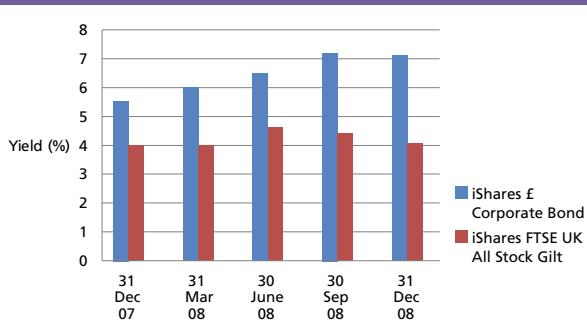
So we try to set out what seems more likely. We think the Asian economies will still grow faster and perform better in the years ahead than the Western ones. The fact that their share markets have fallen further will represent a buying opportunity over the early months of 2009, to add to positions in that part of the world. Corporate bonds offer a much more attractive yield than government bonds or cash. We recommend buying some of the best quality ones on a portfolio basis. If economic recovery develops, they will be re-rated. If we muddle through you should be able to enjoy the better income, and in a slump they will outperform equities and junk bonds which will suffer further from rising bankruptcies and falling profits.

Equity Market Total Returns in UK Sterling terms 31/12/98 to 31/12/08



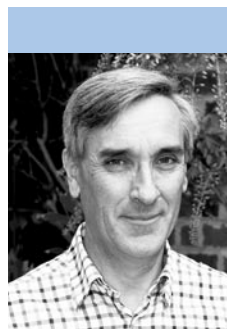
Source: Thomson Reuters

iShares £ Corporate Bond vs iShares FTSE UK All Stock Gilt



Source: Thompson Reuters and Barclays iShares

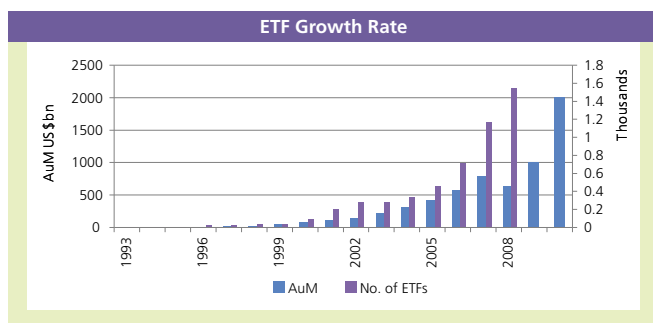
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John Redwood held senior investment roles at Robert Fleming and NM Rothschild in the 1970s and 1980s. Since, he has been a Pension Trustee, Investment Committee member for an Oxford College, Chairman of an investment company and a non-executive Director of a hedge fund and an Investment Trust. An early advocate of tracker funds, he has written extensively on economics and investment.

Exchange Traded Funds (ETFs) growth continues in 2008

ETFs continued to attract good investment flows in 2008. Despite awful conditions for other investments, the overall number of ETFs actually increased in 2008 with over 400 new ETFs launched. In Europe, their popularity and usage continued to rise throughout the year and net investments into ETFs were US\$61.6bn during the first 10 months of 2008, according to Lipper Feri, compared to minus US\$505.7bn over the period for mutual funds. Barclays, the largest global providers of ETFs with almost US\$300bn in their iShares brand and a 45% market share, forecast ETF assets in Europe will exceed US\$1000bn in 2009 and globally will reach US\$2000bn in 2011. These expectations are founded on strong growth in the number of institutional and retail investors who use ETFs, regulatory changes on both sides of the Atlantic which will allow funds to make larger allocations to ETFs and a growing number of exchanges planning to launch new ETF trading segments.



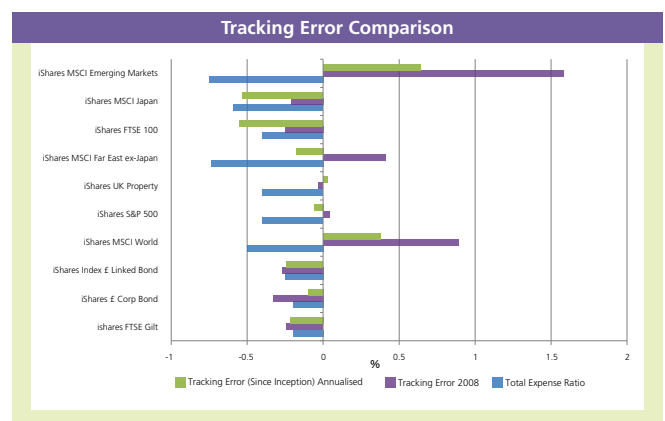
Source: Data and estimates from Barclays Global Investors

Whilst the chart above shows that the value of assets in ETFs fell by around 20%, this is impressive when set against a fall of over 40% in the MSCI World index in US dollar terms. But have ETFs been an effective way of tracking indices during one of the most volatile periods in equity market history? The role of the ETF is to produce as closely as possible the returns of an index which has itself been selected for its ability to mirror a particular asset class. The difference between the ETF returns and the index, net of management costs, is measured by the tracking error. For many straightforward indices it can be just a few basis points - an incredibly low implied cost for achieving performance so close to the index. Some ETFs even have positive tracking errors and manage to beat the index by as much as 1%.

ETF providers offset their management costs and produce such low tracking error by raising income from the ETF's underlying portfolio in a variety of ways. These include stock lending and dividend tax optimisation. They may also use synthetic replication or other optimisation techniques. The banning of shorting in financial stocks

during the latter part of 2008 and the malaise of the hedge fund industry had possible repercussions for the ETF industry and might have led to larger tracking errors. We feared that high levels of market volatility could also have had a negative influence on this implied cost of tracking.

The chart below compares stated management costs (Total Expense Ratios) and tracking errors for a range of ETFs both from inception of the fund and during 2008. In the event, ETF providers coped extremely well with the market environment and appear to have generally held negative tracking errors very close to the longer-term average, even in the case of corporate bonds, where the market experienced severe dislocation during H2. The main differences occurred where there was already a positive tracking error. This is a positive outcome for the industry and underpins the growing importance of ETFs in providing portfolios with an inexpensive, transparent and highly liquid means to access the returns of a comprehensive range of global asset classes.

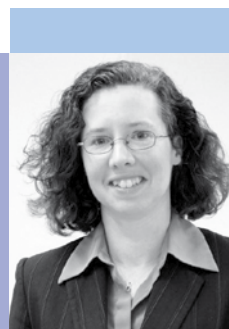


Source: Barclays Global Investors

Longer-term, these instruments are likely to become as widely used in the UK as they are in the US, spurred by the move towards asset allocation-driven investment methodologies and stimulus from the regulatory proposals in the UK Retail Distribution Report (RDR). The RDR proposals outline the changes which the FSA aims to bring about to remove any commission bias within the Independent Financial Advisor (IFA) community. They aim to achieve this by requiring clarity for the customer by ensuring that the cost of all advice is clear whenever it is given. This is intended to encourage IFAs to charge for advice and to recommend the best option for the customer, rather than the one which will produce the best commissions. The UK may then follow the US where advisors (paid by fees) have embraced ETFs to a much greater degree.



Guy Davies was until recently Head of Charities at Barclays Wealth in London. After a commission in the Army he began his career in investment management at Barclays Private Bank in 1994, followed by roles as private client and charities Director at UBS Warburg, Lazard and Barings. He is a Trustee and Investment Committee member of the Army Benevolent Fund and Army Central Fund.



Jane Bransgrove, worked as an investment manager at Sarasin Chiswell (formerly Cantrade) for over 13 years with responsibility for private clients, charities and investment strategy implementation. She is an Associate member of the CFA Society of the UK and holds a degree in Accounting and Financial Management from Loughborough University.

Market and Investment Overview Christopher Aldous

2008 proved to be an exceptionally difficult year for all types of investors. Heavy falls were registered by equity and property markets around the world. Last year diversifying the portfolio between different assets didn't work as they all turned out to be highly correlated. Even alternatives brought no comfort. Commodities sold off sharply from a speculative high and private equity underwent its own slump in both liquidity and value. Hedge funds produced their worst annual returns on record due to a catastrophic mixture of seized-up markets in asset-backed securities and distressed debt, unprecedented level of redemptions from nervous investors and huge losses on currency hedging positions.

So where do we go from here in 2009? Government bond yields are no longer attractive and high levels of issuance loom on both sides of the Atlantic as well as from Europe. Any recovery prospects will transmit most strongly into the equity markets, but it is still hard to look ahead and see anything but further declines in earnings and dividends. However, opportunities do exist. Credit spreads between government and corporate bonds are still near record levels and with the high yields on offer from corporate bond ETFs we see this as a very good way of generating returns during the first half of 2009. We also see value in some of the Asian markets after the sharp falls of 2008 and are beginning to increase exposures during market setbacks.

Economic Growth - The US authorities have demonstrated that they are determined to limit recession and prevent further market seizure by using the tax payer to guarantee large parts of the financial system. There will be a continuing bad recession in the West and global economic growth in 2009 will be low at best - risks to this view are more on the side of no growth at all or even global recession as the Credit Crunch transmits into real economies.

Inflation - The 2008 bout of global inflationary pressure is now diminishing rapidly. There has been little sign of the sort of wage pressures that would embed higher inflation in the system in the developed economies. China, and to some extent India, are now exporting their inflation, pushing up the prices of their goods and services in the West. We expect inflation to continue to fall sharply this year because of the fall in commodity prices and owing to the sharp fall in output and in consumer borrowing for new purchases.

Bonds - Monetary authorities are now trying everything to reflate economies especially in the US and UK. We expect further interest rate cuts where this can be done in response to deteriorating real economy news. Inflation-linked stocks look more attractive, especially in the UK. Holding them can be viewed as a longer-term insurance policy against inflation. At some point, the high level of US, UK and Italian government borrowing may become an issue, especially for longer duration bonds. Well diversified portfolios of high yielding corporate bonds issued by stronger companies have attractions as we work through the Credit Crunch.

Equities - By historical standards Equities are cheap. However, Credit Crunch worries, slower profits growth, less takeover bid support and poor sentiment will all hinder recovery from the current weakness but we will begin to accumulate positions in our preferred markets on bad days. Worldwide governments are now fighting recession by monetary and fiscal stimuli. Once the Credit Crunch eases, we anticipate that equities will be the major asset class that performs best. It is more important than ever to invest globally – the UK faces some difficult local problems in the next couple of years. Geographically, we prefer the US, China and India but they will only make sustained progress once monetary authorities manage to ease credit conditions by encouraging more bank lending.

Property - General outlook in the UK is poor on valuation and sentiment grounds with valuations adjusting sharply downwards. There is likely to be a substantial overhang of space in the City for some time, adversely affecting rents and values. The residential market is falling after a period of low volume with people waiting on events. However, listed UK Real Estate Investment Trusts have experienced big falls and already discounts much. Similar arguments apply internationally where REITs have also been much weaker than physical property. Risks to this view are more on the side of even weaker property prices as economic slowdown results in forced disposals and weaker tenant demand.

Hedge Funds - The Credit Crunch has highlighted the risks in choosing individual hedge funds. There have been a number of sudden and spectacular failures, some amongst hitherto very successful funds with moderate perceived risk. Heavy redemptions may force many other funds to close over the coming months. It has been disappointing to see so many hedge funds fall over 2008, albeit by less than stockmarkets, when they were meant to be uncorrelated. We continue to avoid them during this period of shake out. We expect many to conclude that the 2% plus 20% fee model can no longer be justified.

Private Equity - General outlook deteriorating for operational, financial and sentiment reasons. Risks to this view are more on the side of weaker private equity returns if slowing growth un.masks unsustainable loadings of debt. The Credit Crunch means far less gearing in private equity deals, lower returns and poorer exit prices. It is still too early to buy into private equity.

Commodities - It is now emerging how much speculative money went into oil and metals over the last year and how quickly it was withdrawn. We are looking at the current depressed prices and asking ourselves when it would be appropriate to start investing again. There will need to be a clearer view of how long and deep the recession will be before we will commit to this asset class.

Cash - The sharp move down in interest rates on both sides of the Atlantic makes cash much less attractive despite its safe haven status. We are looking to commit more cash to better yielding opportunities. We have entered a dangerous era in foreign exchange markets where many countries would like their own currency to be lower even though they cannot all achieve this.



Christopher Aldous has been involved in wealth management since joining Cazenove in 1981. He has since been a Director of Barclays de Zoete Wedd, an Executive Director of UBS and a Managing Director of Robertson Stephens, the US technology investment bank. He co-founded Absolute Fund Management in 2001, where he managed a fund of hedge funds and was Chief Executive Officer until 2007.

If you would like to know more about our portfolio construction process using index-tracking Exchange Traded Funds or gain an up-to-date view about investment trends and opportunities please visit our website:
www.pan-asset.co.uk

Time to review your Charity's Investments

With the average charity investment portfolio declining by approximately 20% in 2008 and interest rates near zero, many charity trustees will be wondering what to do next. How does our asset allocation overview translate into a sensible investment policy for a charity?

The introduction of the Trustee Act 2000, with the abolition of the narrow and wide investment restrictions, has meant that charities can be more diversified with their investment policy. Moreover, the Charity Commission in its guidance CC14, encourages charities to regularly review their investment policy and to diversify their investments, having considered their suitability as part of the trustees duty of care.

Many charities carried out a strategic review of their investment policy in light of the change of legislation and in the aftermath of the so called 'dot-com crash' in 2001. In reality, most charities have tended to tread a cautious path on asset allocation. Many still have a very high percentage of their investment assets in UK assets, be it bonds, equities or even physical property (see chart). Meanwhile, while past performance is no guide to future performance; having such a high percentage of the portfolio in UK equities has meant that charities have missed out on considerable gains in overseas markets, notably Asia.

Over the last few years, charities have begun to adopt a policy of diversification, investing in a variety of asset classes, with the aim of reducing volatility. The idea has been that as some assets fall in value, others will appreciate, thus smoothing out the overall performance of a portfolio. The lesson from 2008 has been that in extreme conditions, nearly all asset classes have fallen together at a time when income has also become harder to find.

It is generally accepted that diversification is a prudent long term investment policy, but it has encouraged trustees to invest into less liquid investments such as hedge funds, private equity or structured products. Sadly during 2008, the more diversified charities, typically

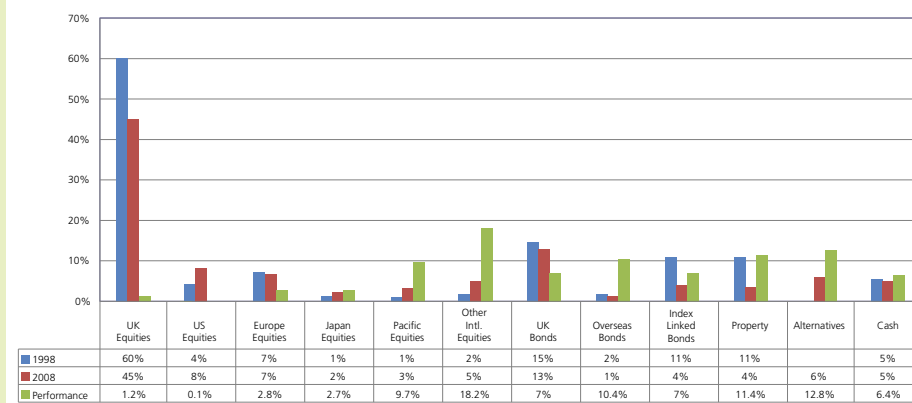
US foundations and more forward looking UK charities, have had a cash-flow squeeze and been forced to sell liquid assets in order to maintain their core grant making activities.

We are not suggesting that these illiquid assets are unsuitable for charities. What is vital to the relative success of any investment policy is the relationship between real assets, such as equities, property and commodities and monetary assets, typically cash and bonds. The monetary assets can be attributed to a tactical reserve that a charity may have, set aside to cover any unforeseen cash-flow needs or any near term capital expenditure that trustees may be planning. The remaining funds should then be invested strategically into real assets that represent a stake in economic progress, providing a rising income stream. They should produce significantly higher returns over time than monetary assets, which are at the mercy of inflation.

We explore these fundamental issues when discussing an appropriate investment policy with trustees. By offering a detailed analysis of each asset classes, their return and risk characteristics, and their suitability to a particular charity, we begin to construct a portfolio to match their objectives. At Evercore Pan-Asset, we remained in cash for most of 2008 and will only invest a client's cash into an asset class if that asset class is likely to beat the return on cash over a one year (tactical) or five year (strategic) period.

We believe that the events of 2008 have been a reminder to most investors that financial markets can offer some nasty surprises. As trustees review portfolios and the impact of recent investment performance, it is vital that an appropriate asset allocation is set to take advantage of market recovery when it comes, be it Asian equities, corporate bonds or whatever is suitable for the charity. Diversification is important and this is a good time to take a fresh look at investment policies. We would be delighted to assist trustees with this process and help charities develop successful investment policies for the future.

UK Charity Asset Mix 1998 vs 2008 and Annualised Total Returns



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Source: WM Total Charities as at 30.09.08. Thomson Reuters as at 31.12.08.

About Evercore Pan-Asset

We are an independent firm providing an asset allocation advisory service to pensions, charities and private wealth. This can be part of an integrated investment management service or as a stand-alone consulting service. We use Exchange Traded Funds extensively to implement our asset allocation views. Apart from our PanCONSULT service we offer six contrasting investment strategies, each of which can be tailored to the needs of the individual client.

- PanBALANCED
- PanCASHPLUS
- PanGROWTH
- PanPACIFICSHIFT
- PanOPPORTUNITIES
- PanALTERNATIVES

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