FORUM FINANCE GROUP

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Investment Perspectives 2010

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INVESTMENT PERSPECTIVES 2010

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EXECUTIVE SUMMARY

- The vast amounts of money spent by the governments on banking and fiscal stimulus packages contributed to avert a financial meltdown and conditions in the financial markets improved significantly throughout 2009. Nevertheless, some very serious issues such as the deterioration of public finances and the severe contraction of lending activity by the banking sector still need to be resolved.

- 2009 was characterized by a strong recovery of the prices of equities and commodities, while investment grade credit, high-yield and emerging market debt experienced a huge amount of spread contraction. 2009 also turned out to be a much better year than expected for the hedge fund industry.

- In many ways, 2010 could prove to be a very challenging year for the economic environment as several conditions need to be met before one can consider the recovery to be sustainable without the help of fiscal stimulus. In particular, a solution to reduce the high levels of unemployment in the developed world needs to be found, while consumer spending without the help of government subsidies is critical.

- We do not expect the major central banks to modify their monetary policies before they are convinced that the economic recovery is on a sustainable path. We assume that the current conditions within the financial markets will be maintained for at least the next two quarters and consider that they are still supportive for risk assets.

- We are looking to take further advantage from our current exposures to equities and fixed-income as it appears too early to implement any major changes within the portfolios.

- Equities should continue to benefit from low interest rates, strong earnings per share growth, compelling relative valuations, sceptical investor positioning and high levels of liquidity. Furthermore, we anticipate a significant increase of M&A activity, which should generate additional support for the equity markets.

- Our overall outlook on fixed-income is one of caution. At this stage, we find little value in G-7 government bonds and recommend holding a limited exposure to investment-grade credit following its strong gains recorded in 2009. Our favoured fixed-income segments are high yield bonds and emerging market debt.

- We view hedge funds and structured products as being genuine alternatives to traditional assets and fully expect them to play an increasingly important role in terms of de-correlation and capital preservation, especially at a time when the holding of cash is so unrewarding.

2009: REVIEW OF OUR INVESTMENT THEMES

- Our preference for ***corporate credit over sovereign debt*** at the beginning of the year proved to be a rewarding trade and contributed to stabilize the portfolios during a challenging first quarter. From June onwards, we recommended to also invest into ***other segments of the credit space, such as local currency emerging market debt and high yield bonds,*** as they appeared at that stage to offer ***more potential than investment grade corporate credit.*** We also ***reduced the overall allocation to fixed-income in favour of equities***; the prevailing supportive risk-taking environment for these asset classes until the end of the year meant that all these trades brought ***strong positive contributions*** to the portfolios.

- Our ***cautious positioning towards equities in January*** helped the portfolios to withstand the intense downwards pressure experienced on equity prices until early March. However, the pace and the strength of the rebound initiated in March came as a surprise for us, as for most of the investment community. However, ***by the middle of the year, we had already increased the allocation to equities*** and we wrote in our mid-year outlook review that ***the potential for further appreciation was still on offer.*** Furthermore, we recommended selecting ***cyclical stocks and emerging markets over defensive stocks,*** a recommendation that produced telling returns for the portfolios.

- Concerning Hedge Funds, we wrote in January that we remained ***constructive towards hedge funds as we believe that, despite all its critical aspects, a crisis is always a source of new opportunities. While we recognize that redemption pressure will subsist for some time, Hedge Funds have demonstrated in the past their ability to recapture the return path earlier than other market players.*** In terms of performance, 2009 turned out to be one of the best years on record for the Hedge Fund industry and investors have shown a renewal of confidence by committing new funds to Hedge Fund managers since the end of the summer.

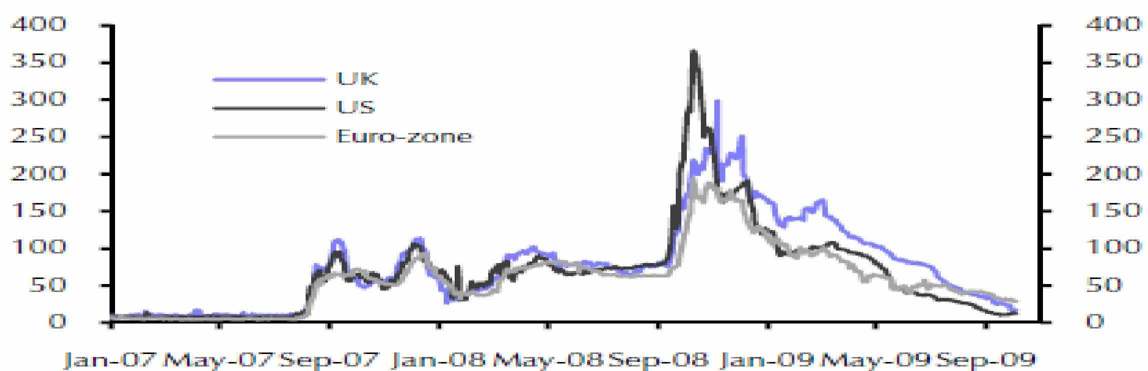
- We had a cautious view on commodities in January, as we stated that ***the current economic environment is likely to generate ongoing negative pressure, at least during the first half of 2009.*** In fact, commodity prices started to rebound just before the prices of equities and produced strong returns in 2009. The ***allocation of 5% to physical gold*** produced a healthy contribution as dollar weakness and momentum trades triggered a strong rally of the precious metal.

- The selection of these investment themes, combined with an appropriate timing of their implementation, allowed the portfolios to take advantage of powerful market trends throughout 2009 and to end the year with very respectable returns.

2009: THE END OF THE FINANCIAL CRISIS?

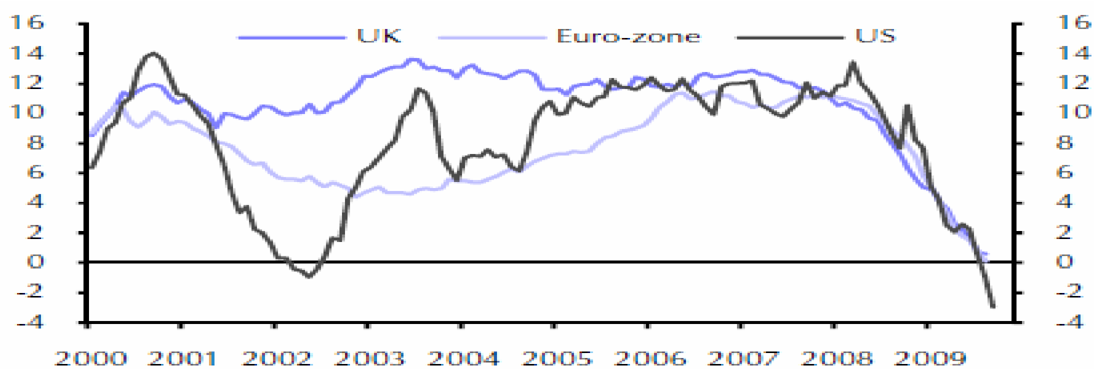
Even though certain market conditions had started to improve during the last quarter of 2008, the financial crisis was continuing to weigh heavily on a deteriorating economy and a brittle global financial system at the turn of the year. The numerous and widespread measures put in place by the Central Banks and the governments to support their banking sectors and economies had contributed to lower the cost of lending between banks, but were still proving to be ineffective in allaying the fears relating to their health.

3M Inter-bank rates – 3M OIS rates



The spreads between inter-bank interest rates and risk-free rates had started to contract from October 2008 onwards and are now back to normal levels.

Bank lending (% Y/Y)



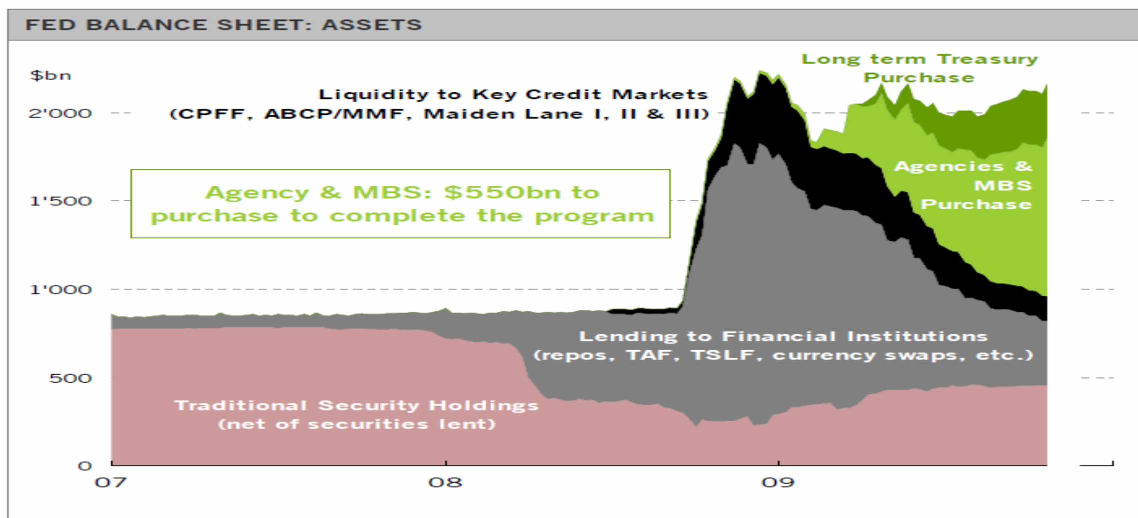
Despite having benefited from massive capital injections, banks remained extremely reluctant to risk any new lending as the value of the toxic assets held on their balance sheets continued to depreciate while their share prices reached new lows during the first months of 2009.

The contraction of lending activity has been fierce and, as of today, there is still no material pick-up in bank lending to households and companies. In fact, lending continues to slow (see previous chart), at least in part because of constraints on the supply of credit, but also because commercial banks need to reconstitute their capital while they still face further considerable losses associated with the conventional effects of the economic downturn.

As the banking system had totally seized up following the collapse of Lehman Brothers on the 14th of September 2008, the U.S. government explored the possibility of a bailout for their banks. The initial proposal for the Troubled Asset Relief Program (TARP), presented by the U.S. Secretary Hank Paulson, was to allow banks, brokers and insurance companies to sell their troubled assets, thus establishing a floor for distressed asset prices. However, this plan was soon to be replaced, following a meeting between Paulson and British Prime Minister Gordon Brown.

In fact, European countries were facing similar issues with their own banking system and the solution they chose was to directly inject capital into banks via preferred stock in order to improve their balance sheets. The U.S. Government decided to adopt the same plan and also to extend the use of the TARP funds to support other sectors, such as the auto industry. Additionally, Central Banks initiated large-scale purchase programs to revive commercial paper and other credit markets through an impressive increase of their balance sheets. These purchase programs, also referred to as Quantitative Easing (QE), targeted securities such as long-term government bonds or mortgage-backed securities. All these measures combined with zero interest rates policies contributed to significantly reduce the levels of long-term interest rates and to allow the credit markets to re-open.

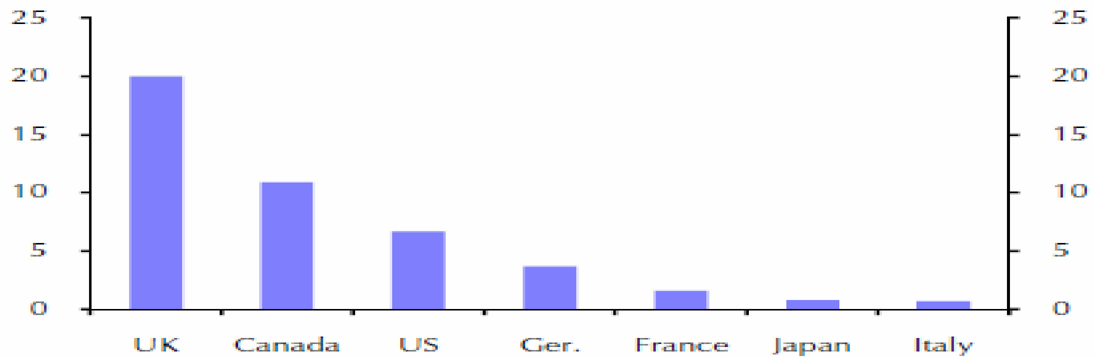
Increase of the Federal Reserve balance sheet



The size of these programs is without precedent, as the U.S. TARP plan amounted to $700 billion while the Federal Reserve has more than doubled its assets to over $2 trillion. As shown above, the purchase of long-term securities has surged over the past 6 months, but this has been more or less offset by a fall in the lending to financial institutions as they have returned part or all of the TARP money.

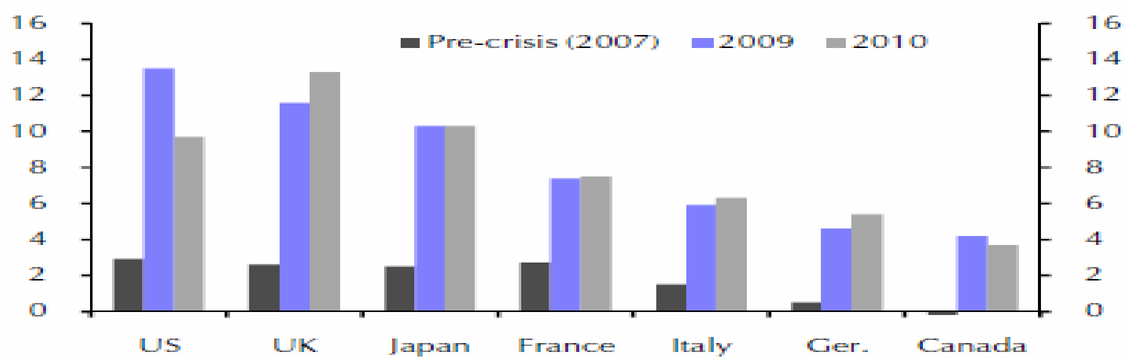
Similar programs were implemented by other countries. As an example, the Bank of England's QE program reached a total of £200 billion ($320 billion), while the cost of supporting the U.K.'s banking sector reached a total of £117 billion ($187 billion).

Government spending on banking measures (as a % of GDP)



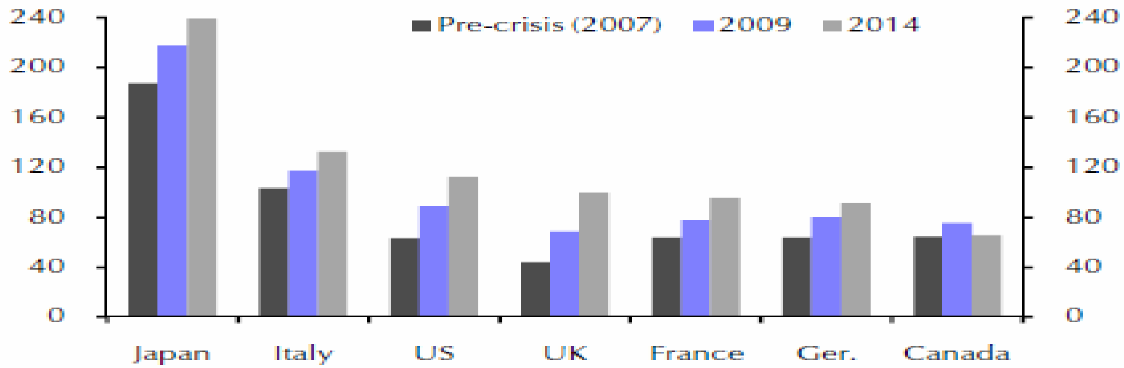
The measures put into place by governments to support their banking sectors and economies helped to avert an economic depression, but have come at a huge price (see chart above). The main consequence for governments has been a severe deterioration of their fiscal positions and the cost of these measures will be felt for years. This had led many to question whether the banking crisis has not simply been transformed into a fiscal crisis.

Yearly Government borrowing (as a % of GDP)



In order to finance these measures at a time when tax revenues are collapsing, G-7 governments have had to significantly increase their borrowing. Receipts have been falling at rates of around 10% per annum in the U.S. and the U.K. and cyclical elements of Government spending, such as unemployment benefits, have surged. In 2009, Government borrowing is widely expected to head towards 10% of GDP in many countries from previous levels of approximately 3% (see chart above).

Public sector debt (as a % of GDP)



This surge of spending combined with a collapse of tax revenues in response to the steep downturn in economic activity has had a significant impact on the level of outstanding public debt. The chart above shows the huge increase of accumulated public sector debt for the G-7 countries until 2014. U.S. public debt looks set to reach 100% of GDP, while it is likely to rise above 80% in the U.K., a level which is double the 40% ceiling previously considered to be prudent by the Government.

Conclusions

In conclusion, it now seems likely that the vast amounts of money spent by the governments on banking and fiscal stimulus packages have contributed to avert a financial meltdown and an economic depression scenario similar to the 1930s. A certain degree of confidence has been restored to the financial system and economic activity appears to be recovering much sooner than originally forecasted.

Nevertheless, the end of the financial crisis has left the financial system with some very serious problems. While conditions in the inter-bank lending markets have considerably improved, it could take years for lending activity in the banking sector to return to more normal levels. Also, the cost of the deterioration of public finances will be felt for years to come and, most likely, the major developed economies will have to undergo a sizeable fiscal tightening as governments attempt to repair their finances.

Finally, policymakers will be facing an increasingly difficult task as they attempt to prevent persistent deflation and continued de-leveraging pressures on one side while taking the risk of creating inflated assets on the other. While zero interest rates are adequate for the U.S. economy and some other G7 countries, they could well prove to be too stimulative for other parts of the world, suggesting that policymakers have limited room to manoeuvre and have no allowance for any major policy errors.

2009: THE FINANCIAL MARKETS

Risk assets make a strong recovery

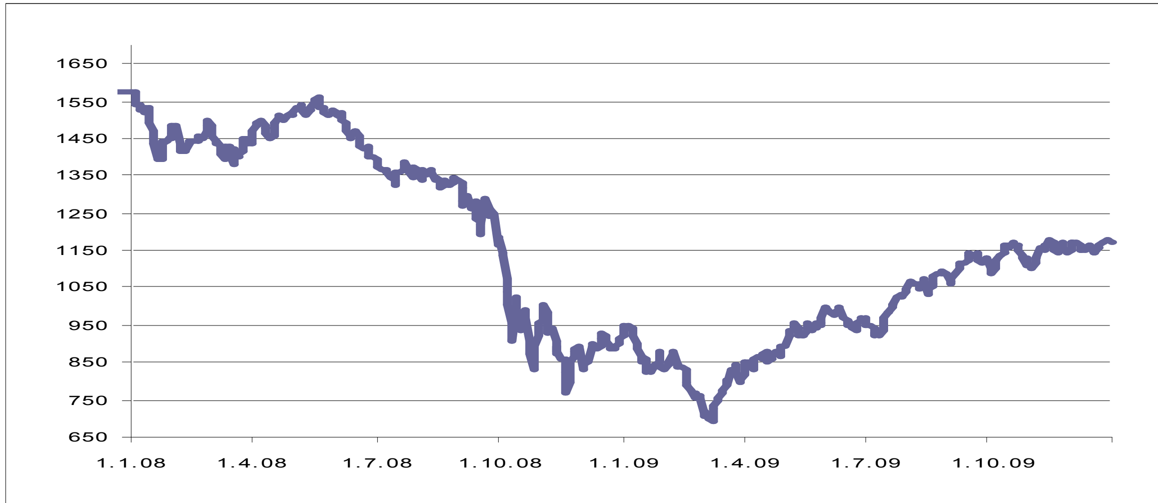
Despite overwhelming expectations for another painful year, which appeared to be confirmed by the ongoing bear market slide during January and February, risk-orientated assets staged a spectacular comeback in 2009. As fears of a "depression" scenario receded, investors regained some of their appetite for risk and assets such as equities, commodities, emerging market debt, investment grade corporate and high yield bonds rallied. An environment of record low interest rates, huge fiscal stimulus programs and numerous monetary policy initiatives provided the back-bone for a massive "reflation" trade.

Equities

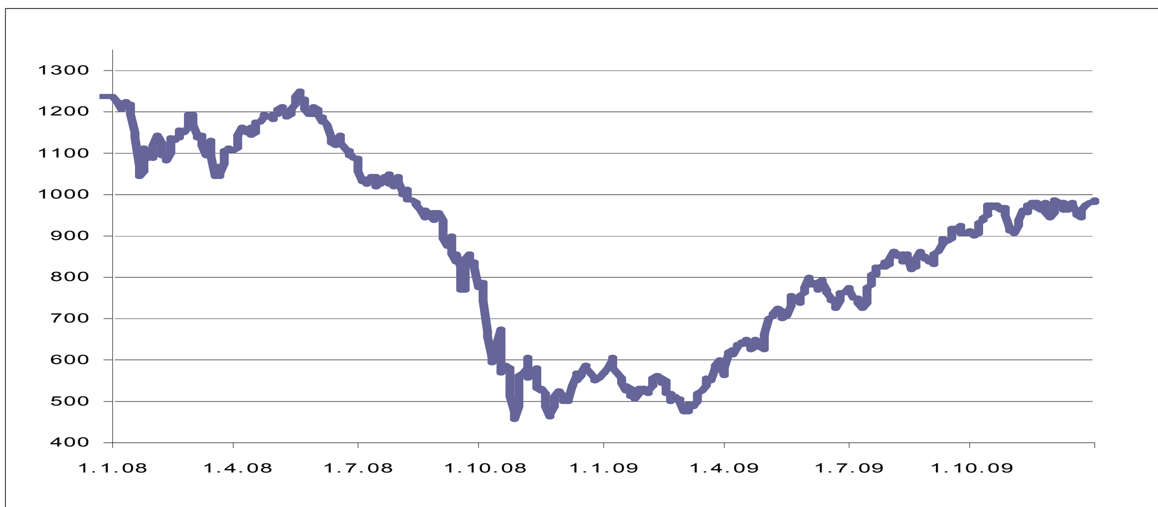
Stocks began the year under severe pressure until they reached what turned out to be the trough for 2009 on the 6th of March. An initial 28% drop of the MSCI World Index was swiftly followed by a powerful rally, with the index regaining 22% within a period of three weeks. The rebound came in part from some clarity on the U.S. government's strategy for addressing "toxic" loans at troubled banks, as well as some preliminary evidence that the rate of decline in economic activity was easing somewhat. After a brief pause towards the end of March, the rally gathered steam and continued well into the month of June. "Less bad news" and "green shoots" were often cited as being the main reasons for the resurgence of the stock market as investors regained some of their appetite for riskier assets and the fears of a "depression" scenario began to fade away. An improvement in the banking system and credit markets, measured by decreasing options volatility and narrowing spreads, also contributed to increase investors' confidence even though inflows into equities remained extremely limited compared to inflows into fixed-income assets.

A mid-year correction pushed equity prices approximately 7% lower on concerns that rising unemployment, weaker consumer spending and huge government deficits would prevent any meaningful economic recovery once the impact of fiscal stimulus plans began to recede. However, the correction proved to be only temporary as the more optimistic outlook prevailed and the equity markets' rally regained traction from the middle of July onwards. For the remainder of the year, the trend of equity prices remained largely positive as the major economies returned to positive growth and companies produced stronger than expected earnings, essentially the result of cost-cutting measures. Equity markets took into their stride limited corrections of around 5%, which took place towards the end of September and October, and ended the year on a strong note. In terms of performance, emerging markets provided the strongest returns, with a 74.5% gain for the MSCI Emerging Markets Index in dollar terms, while the mainstream U.S. S&P 500 Index returned 23.5% and the Euro Stoxx 50 Index 21%.

MSCI World (2008-09)



MSCI Emerging Markets (2008-09)



Commodities

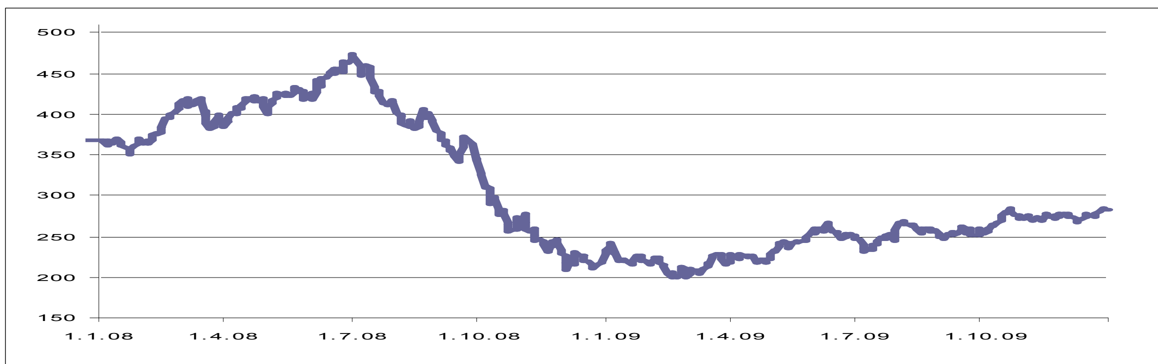
The prices of most commodities continued to depreciate during the first months of the year, adding to the steep losses experienced during the second half of 2008. As for equities, the turning point came at the beginning of March and from then onwards, commodity prices recorded spectacular gains. The main drivers of these higher prices were the exceptional monetary and fiscal policy stimulus, renewed institutional and sovereign wealth fund inflows and bouts of U.S. dollar weakness, attracting investor interest into “hard assets”, such as oil, industrial and precious metals.

Despite the deep global recession in early 2009, China's imports of many key base metals and iron ore quickly moved to record highs, reflecting strategic stockpiling by China's State Reserve Bureau at depressed prices and re-stocking by manufacturers. The strong recovery of China's industrial activity contributed to propel base metals, such as lead, copper and zinc, as the best performing commodities in 2009 as their prices more than doubled.

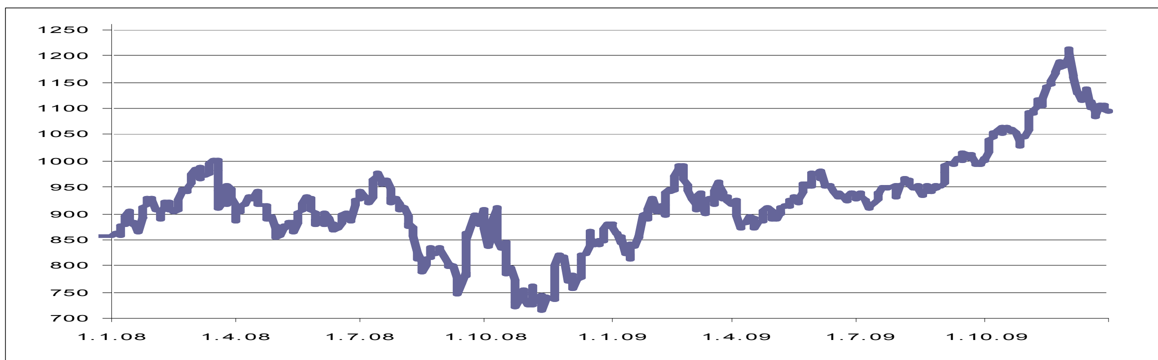
The price of WTI crude oil moved up from a $34 low in March to end the year at a price of $79.40, a level close to its October 23 peak of $82. Despite a steep drop in G-7 demand during the first half of 2009, consumption in China and India continued to increase, reflecting a surge in auto sales in both countries.

The purchase of gold was one of the most common investment themes throughout the whole of 2009. Initially, investors mainly bought gold as a protection against market shocks and potential future inflation, before increasingly considering it as a hedge against a falling dollar and the declining purchasing power of paper money. The shift of Central Banks from being net sellers to net buyers for the first time in more than 30 years also strengthened the interest in the precious metal, while hedge fund managers built important positions, both for fundamental and momentum purposes.

CRB Index (2008-09)



Gold (2008-09)

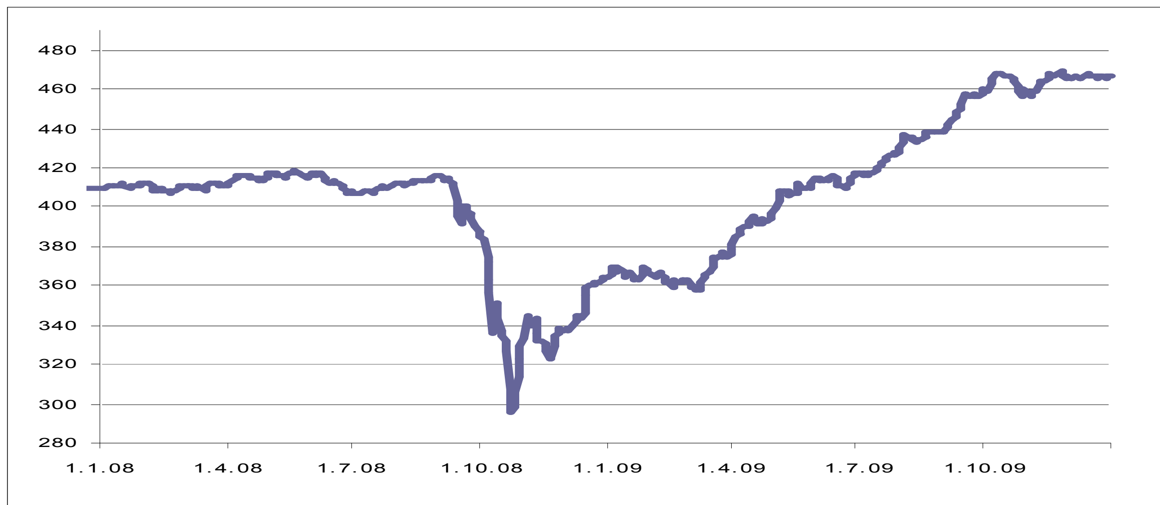


Fixed-income

If the 2008 bond market will always be remembered for the extreme widening of spreads and a collapse of liquidity, 2009 can be largely characterized by the considerable amount of spread compression and the unprecedented level of demand for fixed-income assets. Effectively, investors overwhelmingly selected fixed-income assets over equities as a way of reintroducing risk into their portfolios as they reduced their exposure to safe haven assets such as cash and Government bonds.

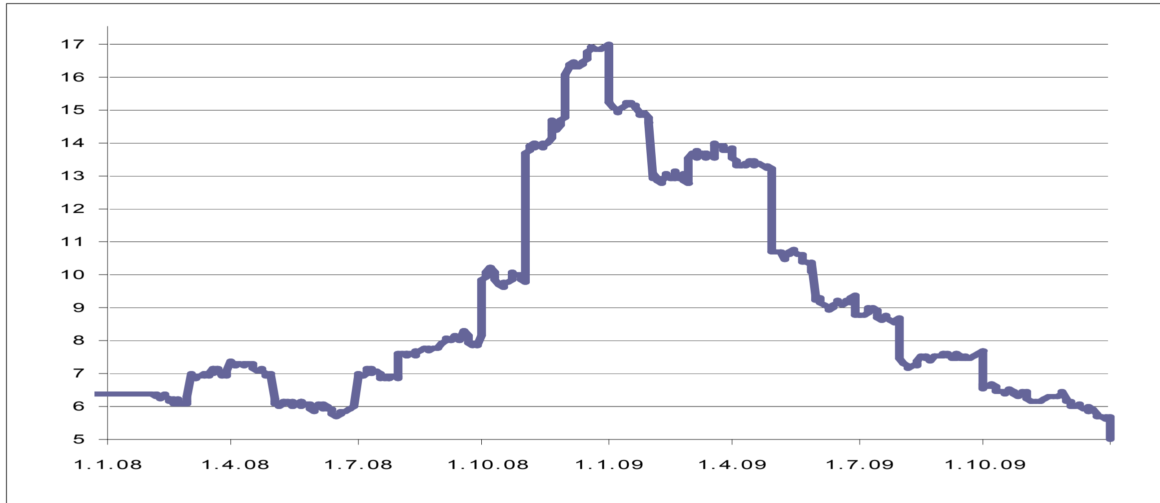
Despite the Federal Reserve's plans to purchase U.S. Government debt, yields on U.S. Treasuries started to rise from the middle of January onwards, as investors became increasingly concerned about the level of new Treasury issuance to fund new stimulus and bailout initiatives. The yield of the 10-year Treasury note climbed from a January 14 low of 2.2% to reach a year-high of 3.95% in June before declining somewhat during the mid-year correction of equity markets. The remainder of the year proved to be less volatile for U.S. Treasury yields as the Federal Open Market Committee reassured investors that the levels of the federal funds rate would remain low for a prolonged period and that certain purchase programs would be extended. The 10-year Treasury note yield remained within a 3.2% to 3.6% range from mid-August to the end of November, but then moved significantly higher during December to end the year at a yield of 3.84%.

Emerging Market Debt (2008-09)



While most bond sectors performed well throughout 2009, the higher risk ones, such as high yield and emerging market debt, benefited the most from investors' increasing appetite for risk assets. The strong performance of these sectors was partially due to a return of liquidity and the ebbing of selling pressure, which had pushed valuations to extreme levels, but also due to improving economic conditions and better access to capital markets.

U.S. High Yield spread (2008-09)



The spread of U.S. high yield debt over risk-free debt, as measured by the difference between the Citigroup HY Index and U.S. Treasuries, contracted from 16.9% at the end of 2008 to 5% on the last day of 2009. Similarly, the spread of emerging market debt yields over US Treasury yields (JPMorgan EMBI Global Spread Index) has narrowed from 8.9% in October 2008 to a 2009 end-year level of 2.9%, reflecting strong demand as economic fundamentals of emerging countries continue to improve.

Investment-grade credit added on to gains recorded during the last quarter of 2008 and a record amount of new issuance was met with huge demand from investors. Bond funds benefited from record levels of inflows throughout the whole year and spreads of investment-grade debt over government debt have largely returned to normalized levels.

Fixed-income market performance in 2009 (USD)

World Government Bond Index	+ 2.55%
Credit AAA	+ 4.00%
Credit BBB/BB	+ 32.4%
Global Emerging Market Sovereign	+ 27.5%
High Yield Local Currency	+ 55.2%

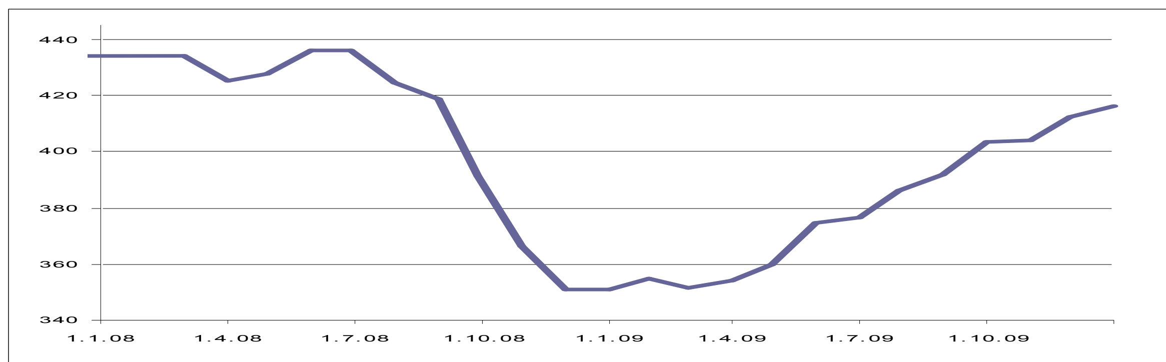
Hedge Funds

The Hedge Fund industry began 2009 under a huge amount of pressure as managers struggled to find a balance between honouring large pending redemptions and lifting gates or suspensions, while simultaneously insuring their funds would survive and produce satisfactory performances for the remaining investors.

In fact, most hedge funds managed to stabilize their situation sooner than expected and produce positive returns throughout most of the year and even during the testing months of January and February. Reduced competition amongst hedge fund and other active managers, opportunities generated from technical factors, rallying in the financial markets and renewed liquidity contributed greatly to this improvement. This return of liquidity enabled fund managers to re-rate the underlying positions, leading to higher net asset values of their funds. Some strategies benefited from recoveries from technical sell-offs, such as those in convertible or high yield bonds, or from excess volatility, such as high frequency and trading-orientated equity strategies.

Altogether, 2009 turned out to be much better than expected for hedge funds as they easily recorded their best performance of the decade, while starting to attract new money from the end of summer onwards.

CS Tremont Hedge Fund Index (2008-09)



Hedge Fund strategies market performance in 2009 (USD)

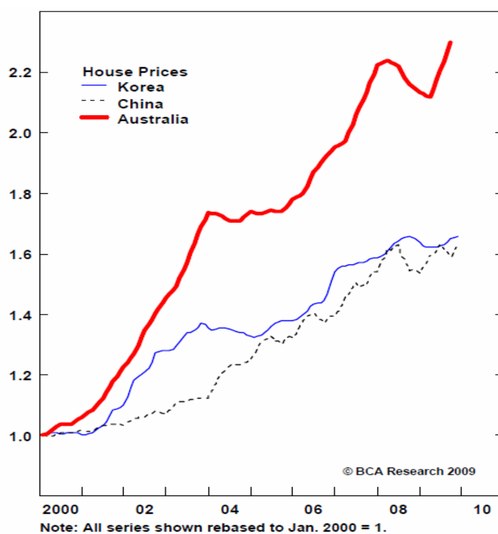
CS Tremont Hedge Fund Index	+ 18.6%
CS Tremont Hedge Fund Convertible Index	+ 47.4%
CS Tremont Hedge Fund Emerging Markets	+ 30.0%
CS Tremont Hedge Fund FI Arbitrage	+ 27.4%
CS Tremont Hedge Fund Long/Short	+ 12.9%
CS Tremont Hedge Fund Multi-Strategy	+ 24.6%
CS Tremont Hedge Fund Event Driven	+ 20.4%
CS Tremont Hedge Fund Short Bias	- 25.0%
CS Tremont Hedge Fund Futures	- 6.6%

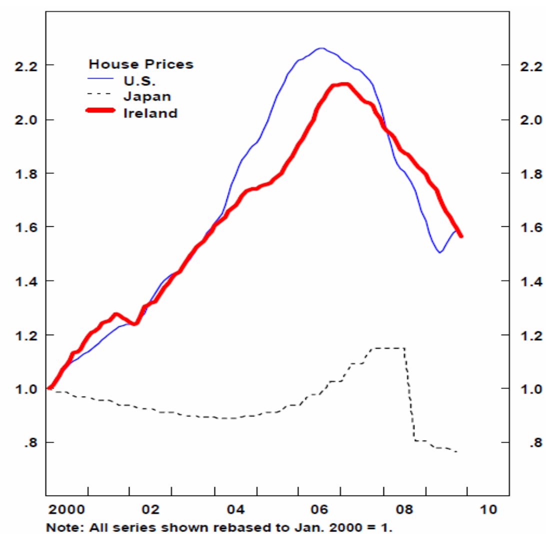
2010: ECONOMIC OUTLOOK

Going into the first quarter of 2010, we expect both economic and financial market conditions to become more complicated and challenging. This is mainly due to the fact that "reflation" assets, in particular equities, commodities and credit, have already risen sharply in anticipation of a global economic recovery and on the back of unprecedented policy stimulus. At the same time, economic growth has been very uneven and the recovery process is still unstable, meaning the environment could become more uncertain. Hereafter, we will highlight certain of the problems and issues that may adversely affect the stability of the world economy, making its recovery process more volatile and less stable than in the past.

Authorities across the world have done their utmost to reduce the effects of the global de-leveraging process, but the original cause of financial instability remains. The overall level of public and private sector debt throughout industrialized countries is very high (refer to chart on page 6) and ***any subtle changes in interest rate expectations could cause disproportionate economic and financial market responses***. As long as interest rates stay at extraordinary low levels, economic and financial conditions should stay supportive and continue to improve. However, economic and financial market stability will be tested whenever interest rates start to rise.

Central Banks of the major developed countries have taken drastic measures to stimulate an economic recovery and ***have brought down their interest rates down to zero***. ***While these rates are adequate for those countries, they are proving to be far too stimulative for other regions***, especially the emerging market universe, where GDP growth potential is much higher.

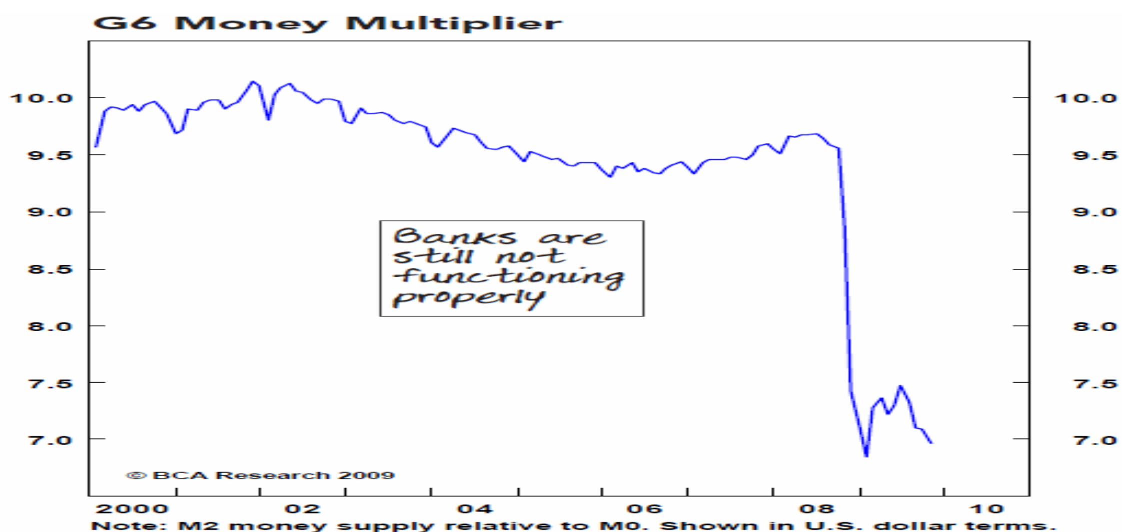




As an example, real estate prices throughout Asia have continued to climb while they are still declining in the Euro area economy and Japan (see chart above). Also, within the Euro zone, the widening of country sovereign CDS spreads for Greece and Ireland are reflective of significant divergent economic conditions.

All of these issues suggest that the policy environment will become extremely complicated and that ***the consequences of major policy mistakes could prove to be very costly for the global recovery process***.

Even if the collapse of the industrialized world's banking sector has been prevented by governments, ***banks remain in a precarious condition*** and it will take a long time for them to repair their balance sheets and to operate as before. ***Lending institutions are still extremely reluctant about extending loans***. Good quality credit is weak as businesses and consumers present unsatisfactory guarantees both in terms of asset collateral, which have collapsed in value, and in terms of their level of indebtedness, considered to be too high by lending institutions. It is difficult to know what impact the lack of financing will have on the sustainability of the ongoing economic recovery, especially as the weighting of the banking sector compared to the corporate bond markets varies from one country to another. However, ***it appears difficult to believe in a strong economic recovery without a properly functioning banking system***.

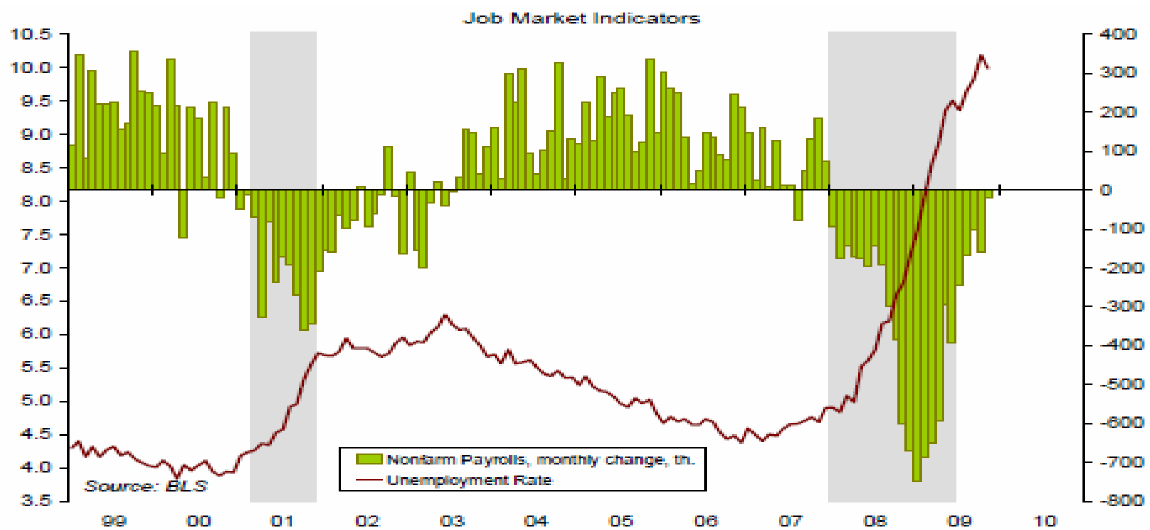


The chart above shows that the money multiplier for most of the major developed countries remains highly depressed, suggesting that the credit creation process is still not functioning properly.

Public-sector spending around the world has exploded upwards during the last year or so, creating a huge level of demand that has prevented the world from falling into an even deeper recession. Supportive measures such as public-sector infrastructure spending, subsidized purchases of consumer durable goods and tax credit for first-time home buyers, have clearly contributed to help economies return to positive growth. However, fiscal stimulus will not be sustained forever and ***large budgetary deficits***, resulting from public sector debt filling in for shrinking private sector debt, ***will need to be made up either by raising taxes or issuing new debt***. The eventuality of higher taxes at a time when households attempt to repair their balance sheets could clearly have a detrimental impact on private consumption, resulting in lower GDP growth.

A sustainable recovery will only be possible if conditions in the labour markets improve in a significant way and the unemployment rates drop to a lower level. Companies will need to feel confident enough with prevailing and anticipated consumer and business demand in order to create new jobs or rehire workers. Such a scenario would contribute to increase the level of consumer confidence and be supportive of consumer spending without the backing of subsidies.

U.S. Job Market



In the U.S., conditions in the labour markets, as measured by the deceleration of the pace of jobs destroyed, have clearly improved since the beginning of 2009. The next positive step would be for a creation of new jobs during the first quarter of 2010.

Conclusions

While it is widely recognized that a recovery is underway, certain conditions need to be met before one can consider it as sustainable. Banks in the industrialized world are still licking their wounds and a strong economy requires the support of a healthy banking system in order to be able to run smoothly. Additional signs that the residential real estate sector is picking up would add to the confidence of households and contribute to improve their quality of credit, while also reducing the collateral damages due to foreclosures. Finally, remedies to reduce the high levels of unemployment in the developed world need to be found, while consumer spending without the help of government subsidies is critical.

We consider that it is crucial to record an improvement of these issues by the end of the second quarter 2010 to avert any risks of a double dip recession scenario.

2010: FINANCIAL MARKETS' OUTLOOK

We are of the opinion that the prevailing market conditions are overall still supportive for risk assets and we are looking to take further advantage from our current exposures to equities and fixed-income as it appears too early to implement any major changes within the portfolios. However, we are fully aware of the current high levels of correlation between the different asset classes and that is why we will be looking to find additional uncorrelated positions to bring genuine diversification to the portfolios in order to reduce this specific risk. From this perspective, we believe that assets such as hedge funds and structured products will prove to be very valuable in 2010.

We expect the current conditions within the financial markets to be maintained for at least the next two quarters. Even if expectations of higher short-rates have been on the rise during the last months, we would be very surprised if the major Central Banks were to hike their interest rates before a confirmation that the economic recovery is on a sustainable path. Historically, policymakers have had a tendency to hike rates rather later than sooner after a period of economic weakness and, taking account of the severity of the recent recession, we do not expect any different outcome this time around. Furthermore, the effects of the huge fiscal stimulus should continue to lift economic activity during the beginning of 2010, with the objective of contributing to the creation of a self-sustaining recovery.

Fixed-income outlook

Our negative outlook on G-7 Government bonds has not changed and we continue to avoid holding any significant exposure to this segment of the fixed-income markets. As the economic recovery gathers pace, we anticipate that yields will come under increased pressure on higher short-rate expectations and as investors add to their exposures to risk assets. We are also concerned about the recent developments within the European sovereign debt markets, as the pressures on countries such as Greece, Spain and Ireland have led to a widening of yields. Compared to Germany's 10-year Bund end-year yield of 3.4%, the respective yields on the 10-year bonds for Greece, Ireland and Spain were of 5.8%, 4.8% and 4%.

Whilst we agree that the environment for interest rates is still supportive for corporate bonds, we believe that the value of investment-grade bonds is no longer attractive, hence our ongoing shift into high-yield bonds and emerging market debt. High-yield bonds should continue to benefit from a contraction of spreads as the anticipated default rate peaks and as companies are able to access the capital markets for refinancing purposes. Emerging markets' debt also offer higher yields than developed sovereign debt and should continue to benefit from improving financial market conditions, stronger growth and positive inflows.

Equity outlook

At this stage, we are of the opinion that equities remain in a sweet spot and that the current cyclical bull market has the potential to carry on. Even if valuations are no longer below their historical averages, equities should continue to be well supported by low interest rates, the ongoing recovery of economic activity, the growth of earnings and positive inflows. Surveys and sentiment indexes show that a majority of investors are still underweight equities relative to their benchmark and that the level of bullishness is not particularly high, leaving room for a significant increase of allocations to equities. Emerging markets have rallied explosively since March and have benefited from important inflows. In our opinion, these markets can no longer be considered to be undervalued compared to developed markets and, therefore, we recommend adopting a neutral allocation to this region as we prefer to focus on more defensive sectors.

After an initial phase of equity gains largely driven by liquidity and low interest rates, it is important that the bull market moves on to a second phase led by a sustainable recovery in profits and economic activity. That is why we will be looking for reassurance in the shape of top-line growth and an improvement of the labour markets. Without a confirmation of these signals at a time when the effects of the stimulus plans will be starting to fade, the equity market rally might well then begin to correct. However, this eventual outcome will most likely not take place before the middle of the year.

Alternative investments

As mentioned above, we believe that it will be important for asset managers to be prepared to adapt the structure of the portfolios during the course of 2010 in order to reduce their dependence on risk-orientated assets. The correlation of these assets is at elevated levels and the risks of a synchronized correction are not to be taken lightly. From this perspective, we view hedge funds and structured products as being genuine alternatives to traditional assets and fully expect them to play an increasingly important role in terms of de-correlation and lesser volatility, especially at a time when the holding of cash is so unrewarding.

Gold outlook

In our opinion, the interest in gold will somewhat recede in 2010 compared to last year as investors shift their focus onto more risk-orientated assets. However, we recognize that more and more investors consider gold to be an essential component of their portfolio and we feel comfortable holding a core position as a portfolio insurance against market shocks and as a safer monetary asset than paper money.

2010: ASSET ALLOCATION

Equities

- We remain optimistic on the outlook for equities on a six month perspective and therefore recommend slightly increasing the allocation to this asset class.

- Equities should continue to be well supported by low interest rates, strong earnings per share growth, compelling relative valuations, sceptical investor positioning and high levels of liquidity. Furthermore, we anticipate a significant increase of M&A activity, which should generate additional support for the equity markets.

- At this stage of the rally, our preference goes to large cap stocks over small caps and to certain less cyclical sectors which have clearly lagged. From this perspective, we intend to pay a particular attention to the stocks of companies belonging to defensive sectors, such as telecoms, utilities, tobacco and pharmaceuticals that offer sustainable high dividend yields.

- From a regional perspective, our focus will be more on developed markets as equities of emerging markets now trade at a premium. We are hopeful that Japanese equities might finally be back on track as a shift of Government policy will most likely target a depreciation of the yen.

Fixed-income

- As explained previously, our overall outlook on fixed-income is one of caution. At this stage, we have little to none exposure to G-7 government bonds and recommend holding a limited exposure to investment-grade credit following its strong gains recorded in 2009. Our favoured fixed-income segments are clearly high-yield bonds and emerging market debt.

- High-yield bonds should be well supported by an ongoing improvement of financial conditions, a possible peak in default rates, potential outflows from investment grade corporate bonds due to attractive yield pickup and favorable issuance terms. We believe that there is still some room for spreads to contract, even though it appears unlikely that these spreads will return to the extreme lows experienced between 2004 and 2007.

- For the allocation to emerging market debt, we prefer investing into bonds denominated in local currencies. The healthy public finances and ongoing improvement of emerging countries' fundamentals and projected higher levels of growth than those experienced by developed countries should continue to be supportive. Therefore, we expect to take advantage of both the potential rating upgrades of emerging countries' debt and the appreciation of their currencies.

Hedge Funds

- Hedge funds have recovered some of the lost confidence by investors and are, once again, benefiting from positive inflows. We believe that this trend will prevail in 2010 and that hedge fund strategies will offer valuable contributions to the portfolios, in terms of performance, reduced volatility and diversification. Furthermore, we believe that hedge funds will be able to continue to generate value without needing to take on historical levels of market risk.

- Originally, hedge fund strategies were primarily designed to exploit market inefficiencies and to produce positive performances notwithstanding the direction of the markets. Additionally, certain strategies relied on the use of leverage to generate performance resulting from small spreads between opposing hedged positions. Unfortunately, during the recent period, this lead to an extreme dependence on access to leverage to produce performance as opportunities became less and less rewarding due to over-crowding competing funds. Furthermore, hedge funds also made the mistake of moving away from their original concept as they became increasingly correlated with market directionality, leading to the disastrous situation experienced throughout 2008.

- Fortunately, not all hedge fund managers made these mistakes and we will continue to have a bias towards those that managed their funds well during that testing period and who did not apply liquidity restrictions such as gates or suspensions.

Commodities

- Commodities should continue to be well supported during the first half of 2010 as the economic recovery gathers pace. However, we prefer to invest into commodities through equities or hedge fund strategies due to speculative froth and risks associated with paper demand.

Gold

- We recommend maintaining the current 5% allocation to gold.

FFG PORTFOLIO CONSTRUCTION

- The construction of an investment portfolio and the selection of its individual components are the result of a well-defined investment process. This process begins with the determination of the client's investment profile, which then leads to the tactical positioning of the portfolio within strategic asset allocation ranges for each asset class.

- The determination of the allocation to the different asset classes is the main driver of the portfolio's performance and serves as the keystone around which the other investment decisions are taken. The role of your investment manager at the Forum Finance Group is to build portfolios based upon all the relevant information and through the selection of investment products from a pre-determined investment universe.

- Each individual investment has a specific role to play and the selection of any product is based on both its inherent features as well as its complementary properties within the portfolio. It is necessary to fully understand each investment product in order to be able to predict to a large extent its behaviour depending on different market scenarios and to better evaluate its purpose in relation to the other assets.

- Therefore, the performance of any specific investment cannot be measured against its peer group without taking into consideration the remainder of the portfolio. Typically, the portfolios' risk budget will be spread across directional assets such as equities, commodities and high-yielding debt. The portion of the portfolios dedicated to the preservation of capital will be invested into assets less correlated to market trends, such as funds of hedge funds, highly-rated bonds and certain structured products.

SINGLE HEDGE FUND MANAGERS

- From a historical perspective, the Forum Finance Group investment managers have always invested into the hedge fund space via Funds of Hedge Funds, essentially in order to comply with mandate directives and for portfolio diversification purposes, but also to limit risks associated with single manager funds.

- More recently, following the June 2009 corporate merger with IWM Independent Wealth Management (IWM), investments into single managers are also taken into consideration for those clients having signed an appropriate mandate (in particular ex-IWM clients). We view these types of investments as genuine alternatives to the traditional asset classes, providing access to outstanding fund managers and improving the risk-return profile of portfolios.

- Whereas Funds of Hedge Funds will continue to be classified as a separate asset class, the majority of single manager hedge funds will be classified within the traditional asset classes. Therefore, as an example, the allocation to equities will not only include the direct equity positions and the investments into equity funds, but may also include strategies such as Long/Short equities or Event Driven equities.

STRUCTURED PRODUCTS

- From our point of view, structured products also provide an alternative way of investing into traditional asset classes such as equities, fixed-income and commodities. The different structures of these products vary considerably and the selection of a specific structure is not only a function of the prevailing market conditions and the outlook for the underlying asset, but also a function of the capacity of the product to mitigate risk within the global portfolio.

ASSET ALLOCATION GRID 2010

For our balanced accounts, we apply the following grid:

	Allocation	January 2010	+/-
Short-term deposits	**0 – 20%**	**3%**	**-2%**
Fixed-income	**15 – 40%**	**22%**	**-3%**
Investment grade corporate bonds	10 – 30%	10%	-3%
Investments in funds	5 – 25%	12%	-
Equities	**20 – 50%**	**38%**	**+3%**
Direct investments	10 – 30%	15%	-
Equity funds	10 – 30%	23%	+3%
Alternative Investments	**15 – 35%**	**32%**	**+2%**
Funds of Hedge Funds	10 – 30%	22%	+2%
Structured Products	5 – 15%	10%	-
Gold	**0 – 5%**	**5%**	**-**
		100%	**0%**

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