Forum Finance Group
since 1994

January 2011

Investment Perspectives 2011

INVESTMENT PERSPECTIVES 2011

Table of contents | Pages

EXECUTIVE SUMMARY

- In 2010, the epicentre of the financial crisis moved from the global banking sector to the public sector in Europe. Several countries in the Euro zone were unable to meet their fiscal financing needs in the capital markets and had to depend on bail-outs financed by the European Union and the International Monetary Fund. The central banks of the G-7 countries expanded their unconventional programs to boost the economic recovery.

- 2010 was characterized by choppy trends in the equity markets until they took on a more sustainable positive direction during the last four months of the year. The yields on US Treasuries and German bunds reached record lows before experiencing a severe reversal from October onwards. The dollar and the Euro recorded extensive depreciations of their values against other major currencies.

- The economic recovery should extend into 2011 and the level of growth should remain above its long-term average. The global economy is still facing headwinds such as weak job and housing markets in the advanced countries, inflation concerns in emerging ones and the ongoing crisis in the European Monetary Union debt markets. Corporate balance sheets are in pristine shape and prospects for higher GDP growth in the U.S. have improved recently.

- Our view is that the major central banks cannot afford to modify their monetary policies during the next two to three quarters. The Federal Reserve has clearly indicated its intentions to reflate asset prices and boost the level of inflation. Other central banks also remain in accommodating mode and, as such, the conditions are still supportive for risk assets.

- We recommend adopting a slightly more dynamic positioning of the portfolios. A large number of strategists have been increasing their allocations to risk assets over the last quarter or so, meaning that our current allocation is now quite similar to the consensual view. This was clearly not the case during most of 2009 and 2010, when our recommended positioning was much less defensive than the one recommended by most financial advisors.

- We remain optimistic on the outlook for equities on a six month perspective and therefore recommend increasing the allocation to this asset class. Equity prices should be well supported by low interest rates, the growth of earnings, compelling relative valuations and supportive corporate actions.

- Our overall outlook on fixed-income remains one of caution. We find little value in G-7 government bonds and recommend reducing the exposure to investment-grade credit. Our favoured fixed-income segment is high yield bonds. We view our allocation to emerging market debt in local currencies as a way of hedging the portfolios against the depreciation of the dollar and Euro.

2010: REVIEW OF OUR INVESTMENT THEMES

- Our preference for ***high-yield bonds and emerging market debt*** over ***G-7 sovereign debt and investment grade corporate bonds*** proved to be rewarding trades. Both of our favoured segments in the fixed-income space produced strong returns as they benefited from supportive inflows and an ongoing improvement of the credit markets. Our cautious stance towards ***G-7 sovereign debt*** was due to its unattractive risk/reward profile and the fear of a sudden trend reversal.

- Our ***optimistic outlook on equities during 2010*** was often put to the test during the year due to the negative impact of the European sovereign debt crisis and the mid-year concerns over the possibility of a double-dip recession. However, ***our assessment ultimately proved to be correct*** as companies consistently produced strong quarterly earnings and equity markets rallied from September onwards. Furthermore, ***the vast majority of the equity funds selected for our clients' portfolios comfortably outperformed their respective benchmarks***, bringing significant positive contributions. We had been hopeful for a good performance of Japanese equity markets, particularly due to the anticipation of a weaker yen. Unfortunately, this was prevented by the currency's strong appreciation and it was not until November that a positive trend in Japanese equities finally emerged.

- Concerning Hedge Funds, we wrote in January that hedge fund strategies would offer ***valuable contributions to the portfolios, in terms of performance, reduced volatility and diversification***. Whilst the overall performance of Funds of Hedge Funds and certain strategies has fallen somewhat short of our more optimistic expectations, we are pleased to report that hedge fund managers have paid particular attention to the control of risk and liquidity and still managed to produce positive returns by avoiding deep draw downs. Furthermore, most of our selected single managers outperformed their peers and enhanced the performance of certain portfolios.

- We had a positive view on commodities in January, as we stated that ***the economic recovery would gather pace***. 2010 has turned out to be another good year for commodities in terms of performance due to robust industrial and financial demand. The ***5% allocation to physical gold***, in addition to the gold mining equity fund, produced another healthy contribution as dollar weakness and ongoing momentum trades supported the pursuit of the rally of the precious metal during most of the year.

- The selection of these investment themes, added to our resolve during the more testing periods of the year, allowed the portfolios to take advantage of positive market trends throughout 2010 and to end the year with very respectable returns. It is, however, very important to highlight the impact ***of currency movements in 2010***. For unhedged portfolios based in Swiss francs, the ***strong depreciation of both the Euro (- 16%) and the U.S. dollar (- 10%)*** meant that it was extremely challenging to be able to produce positive returns in Swiss franc terms.

2010: ECONOMIC DEVELOPMENTS

The European sovereign debt crisis

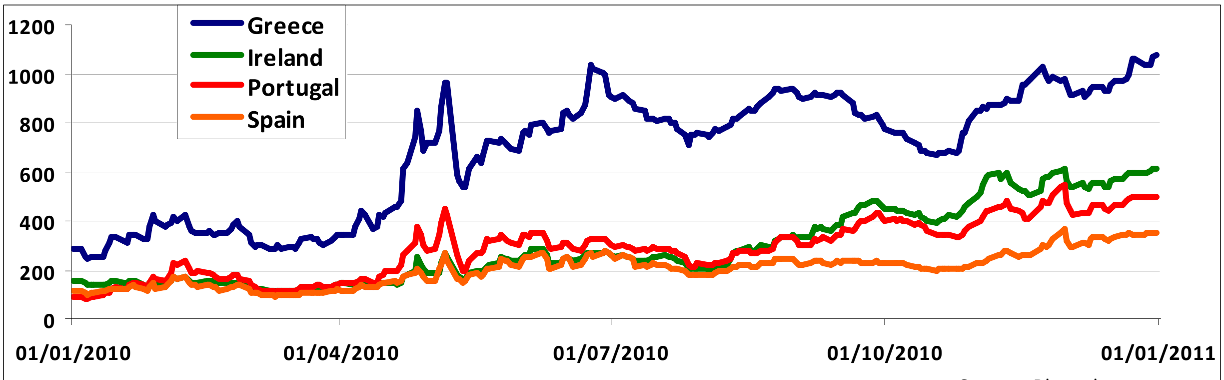
If the banking sector had been the main source of market stress since 2008, risks related to European sovereign debt took over in 2010 and were the main drivers of market corrections. Greece, during the spring, and Ireland, in November, were the main culprits as they had to rely on bail-outs funded by the IMF and the European Union (***European Financial Stability Facility***) for their financing needs.

At the beginning of May, Euro zone members and the IMF provided Greece with a 110 billion-Euro bail-out package to prevent it from defaulting on its massive debt. This amount was the equivalent of 47 percent of the country's gross domestic product. Six months later, Ireland also requested emergency international aid and accepted 85 billion euros worth of financial support, more than 50 percent of its GDP. The facility will include up to 35 billion euros to support the country's banking system, which had been suffering from important deposit outflows.

While the size of these aid packages is far from insignificant, the market fears were more due to the risks of contagion to other countries such as Portugal and particularly Spain. If the cost of a bail-out on the Irish scale for Portugal, seen as the next weakest link among the EU's high-deficit countries, would be affordable and cost around 100 billion euros, it would amount to more than 550 billion euros for Spain. This threat on government bonds represents a big risk for the balance sheets of the banking sector. This largely explains the ongoing tensions in the European sovereign debt bond markets and the need for multi-year fiscal austerity to win back market confidence.

The rescues for Greece and Ireland do not appear to have solved that much and have most likely just kicked difficulties further down the road. The key conclusions to be drawn from the current situation are that ***sovereign debt in Europe can no longer be considered as risk-free*** and that the ***final outcome of this crisis is still impossible to predict***. What is certain is that Europe's fiscal problems are far from over and that they will continue to cause stress to global financial markets.

European sovereign debt CDS USD spreads



Source: Bloomberg

The sovereign 5-year CDS spreads of Greece, Ireland, Portugal and Spain respectively widened from 283, 158, 92 and 113bps at the end of 2009 to 1'026, 619, 497 and 348bps at year-end. These considerably wider spreads reflect investors' reluctance to continue lending to these nations and the need for alternative refinancing solutions.

G-7 central banks

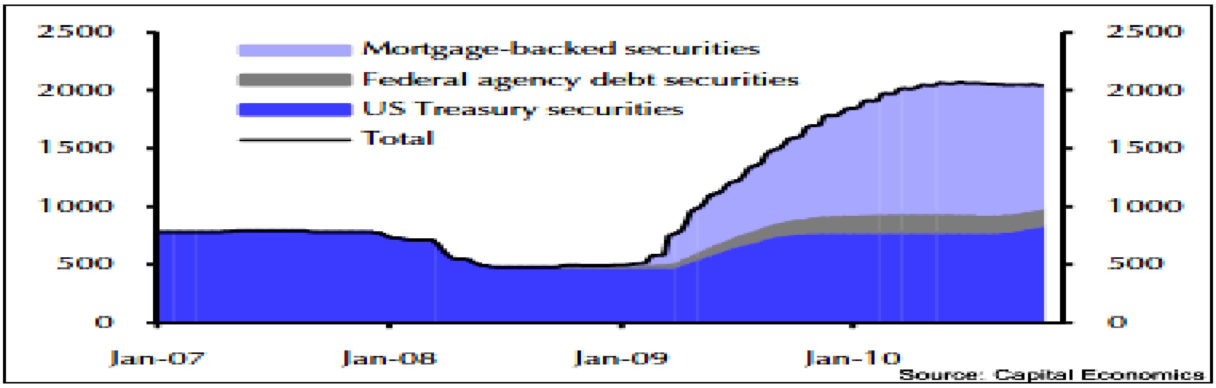
The monetary policies of the major central banks remained extremely supportive throughout 2010. In a world of zero interest rates, the banks undertook more unconventional stimulus measures such as the additional purchases of assets. These measures have contributed to boost the prices of financial assets and also increased expectations that key policy rates will remain low for longer than previously anticipated.

The Federal Reserve

In August, the Federal Open Market Committee voted to reinvest the principal payments in its portfolio of mortgage-backed securities into long-term Treasury securities in order to keep the size of its balance sheet constant. These purchases amounted to about $35 billion per month. At its early November meeting, the FOMC announced that it would maintain its existing policy and purchase an additional $600 billion in long-term Treasuries by the end of June 2011 ("QE2"). The total monthly purchases by the Fed amount to about $110 billion per month, which is large relative to the amount of debt the government is issuing.

The Fed's asset purchase plan is not only meant to lower long-term interest rates but also to create asset price inflation. The Fed's Chairman, Ben Bernanke, has made it clear that the extremely low levels of inflation recently recorded in the U.S. (less than 1%) increased the threat of deflation, hence the Fed's decision to target an inflation level of around 2%.

The Federal Reserve Bank's balance sheet ($bln)



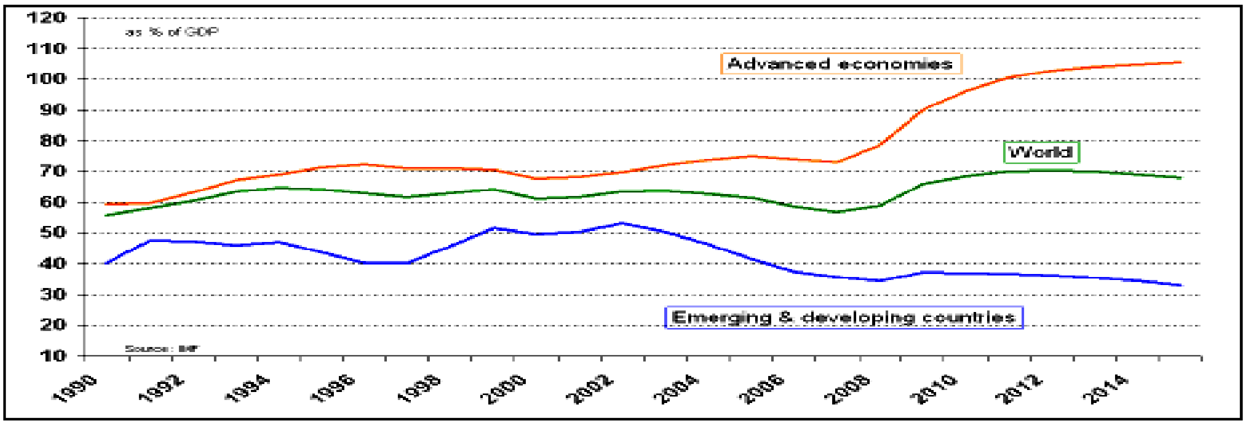
The European Central Bank

The European Central Bank has not been as straightforward as the Fed in terms of communicating its intentions, but has still remained in supportive mode. The Bank's President, Jean-Claude Trichet, has repeatedly insisted that the ECB was not engaged in "quantitative easing" as it has withdrawn liquidity from the financial system equal to the amounts it has spent on bonds, neutralizing any inflationary risks. The ECB does not identify whose bonds it buys but it is widely believed its focus has been on debt issued by Greece, Ireland and Portugal. The ECB has also been active in providing funds to banks to meet their liquidity needs. Many European banks remain dependent on the ECB through its emergency-liquidity measures and 270 of them asked for access to its unlimited funds at the end of 2010.

A diverging world economy

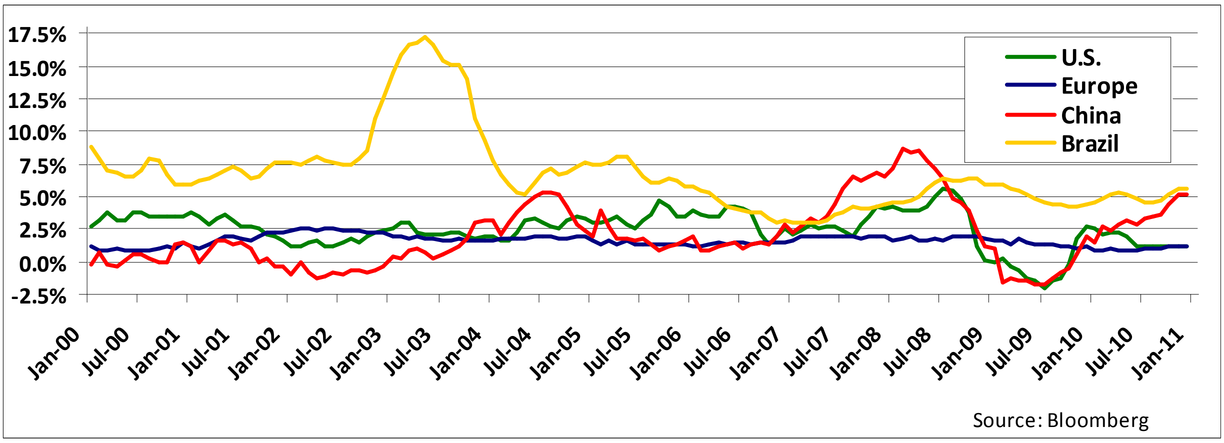
Global economic growth rebounded strongly in 2010 and was above its long-term average of 3.25%. However, this recovery was far from being uniform and was clearly driven by faster growing regions such as Asia and Latin America, while the Euro zone and the U.S. were lagging. GDP growth is not the only indicator of an increasingly diverging world economy. While major developed countries are hindered by huge fiscal deficits, mountains of public debt and high unemployment, developing economies are benefiting from healthier fiscal balances, high savings rates and an expansion of domestic consumption.

Public debt



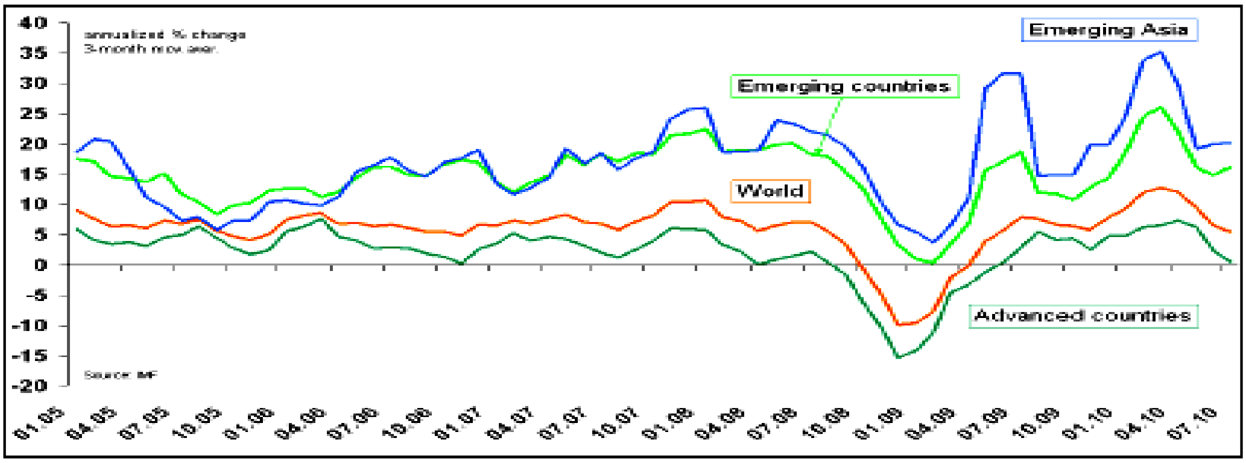
As shown in the chart above, the percentage of public debt to GDP is exploding in the advanced economies, while emerging and developing countries are less and less dependent on capital markets to finance their fiscal balances.

Inflation across the world (2000-2010)



Strong growth and sustained demand for commodities in emerging countries have resulted in much higher levels of inflation, leading to interventions by central banks. In contrast, inflation measures in Europe and the U.S. are well below their long-term averages and have led to concerns about potential deflation.

World retail sales



The chart above shows how emerging countries, in particular Asian ones, are boosting the level of domestic consumption and reducing their dependence on exports to the advanced economies. At the same time, consumers in the Western world are taking the opposite direction, as they wean off credit and increase their saving rates.

Conclusions

In conclusion, the public sector will still represent the most important risk factor in 2011. The cost of the deterioration of public finances will be felt for years to come and the severe austerity measures undertaken by European nations to repair their finances will heavily dampen the growth of their economies over the next years. Unanswered questions remain as to whether other European countries will also need to tap the 750 billion Euros European Financial Stability Facility set up in May as a financial lifeline. So far, the markets' focus has been on European debt, but, at some stage, investors might start to turn their attention to the issues related to the size of U.S. government debt.

G-7 policymakers are still facing the difficult task of correctly timing the withdrawal of their loose monetary strategies and avoiding the creation of asset inflation. It clearly appears that the U.S. Federal Reserve has chosen to take the risk of over-stimulating its economy rather than face the threat of deflation. In contrast, the major risk facing central banks in emerging countries is the underestimation of inflation. Therefore, economic policies will continue to be a source of risk and will be less synchronized from one region to another.

World economic growth should continue to improve in 2011, but the world is become increasingly unbalanced. Emerging and developing economies are benefiting from the ongoing improvement of their fiscal balances and the decrease of public debt as a percentage of GDP, whereas it will take a long time before advanced countries can return to a healthy fiscal position.

2010: THE FINANCIAL MARKETS

A testing year for investors

2010 will be remembered as a very challenging year for investors due to choppy trends and the significant difference of regional performance within the same asset classes. The positive factors such as resilient corporate earnings and strong global growth finally gained the upper hand over concerns related to European sovereign debt and high unemployment levels in developed economies. This helped to end the year with positive equity trends, strong gains in commodity prices, a sudden rise of bond yields and an ongoing depreciation of the dollar and the Euro.

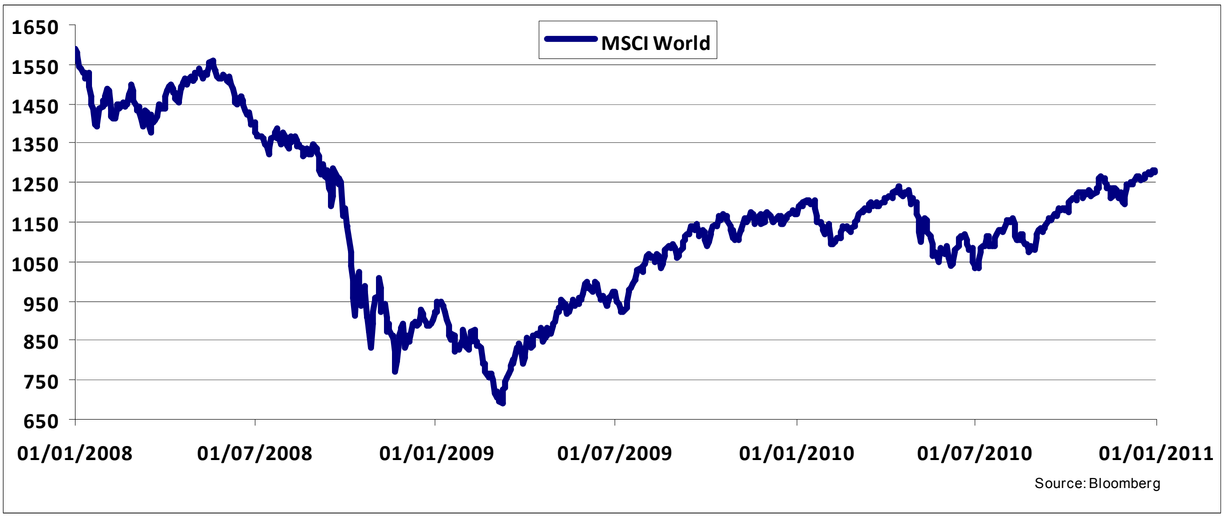
2010 performances

	End 2009	End 2010	2010 performance
Equities			
S&P 500	1115.1	1257.6	+ 12.8%
Euro Stoxx 50	2965	2792.8	- 5.8%
MSCI EM	989.5	1151.4	+ 16.4%
Yields			
UST 10-year	3.84%	3.30%	- 54bps
Bund 10-year	3.39%	2.97%	- 42bps
BBB EU	5.41%	4.88%	- 53bps
Currencies			
EUR/USD	1.432	1.338	- 6.6%
USD/CHF	1.035	0.935	- 9.7%
GBP/USD	1.617	1.561	- 3.5%
USD/JPY	93.02	81.12	-12.8%
EUR/CHF	1.484	1.251	-15.7%
Commodities			
CRB Index	283.4	332.8	+ 17.4%
Oil, WTI	$ 79.4	$ 91.4	+ 15.1%
Gold	$ 1097	$ 1421	+ 29.5%

Equities

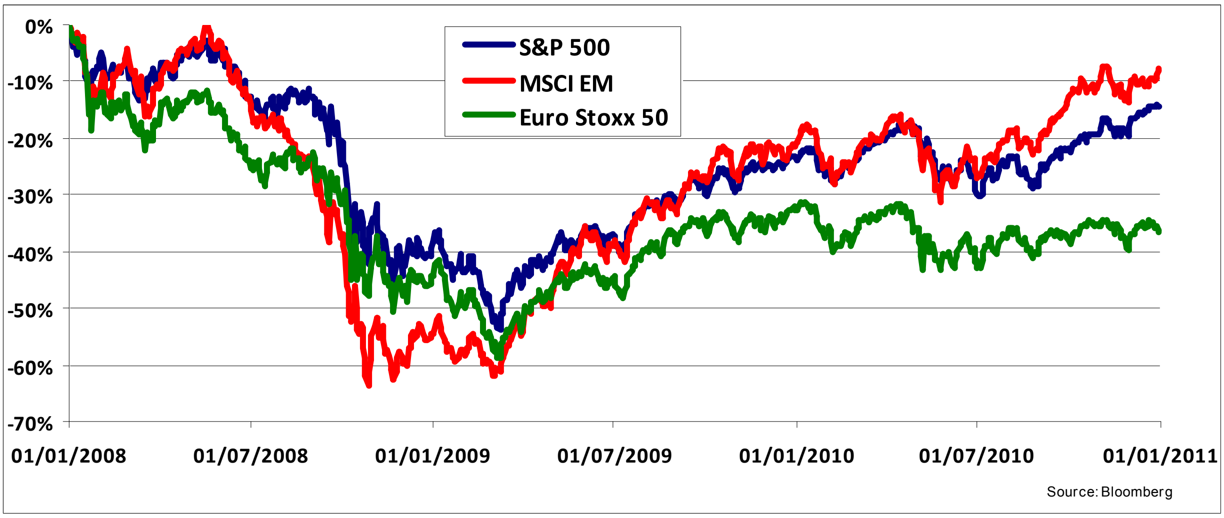
Equity markets had to overcome an early correction in January before moving higher. The strong growth of companies' earnings within a low interest rate environment contributed to enhance the prices of equities until markets turned lower towards the end of April. Concerns over fiscal deficits and the ability of troubled European countries to meet their debt obligations triggered a reduction of investors' exposures to risk assets, in particular to equities of the regions under scrutiny. Equity prices dropped until the beginning of July, then staged a one-month rebound before falling back again. From the end of August onwards, stocks entered into a very favourable period. Investors felt less threatened by a return to recession due to improving economic data and were also encouraged by resilient corporate earnings. This supportive environment lasted until November when markets were once again hit by the European sovereign debt crisis. While global equity markets showed resilience, European equity markets were badly impacted. However, this correction proved to be only temporary and equities rebounded strongly in December.

MSCI World (2008-10)



As shown in the chart above, global equities (MSCI World Index) recorded a double-digit return in 2010 as equity markets performed strongly during the last third of the year. From a regional perspective, the performances from one country to another turned out to be very divergent.

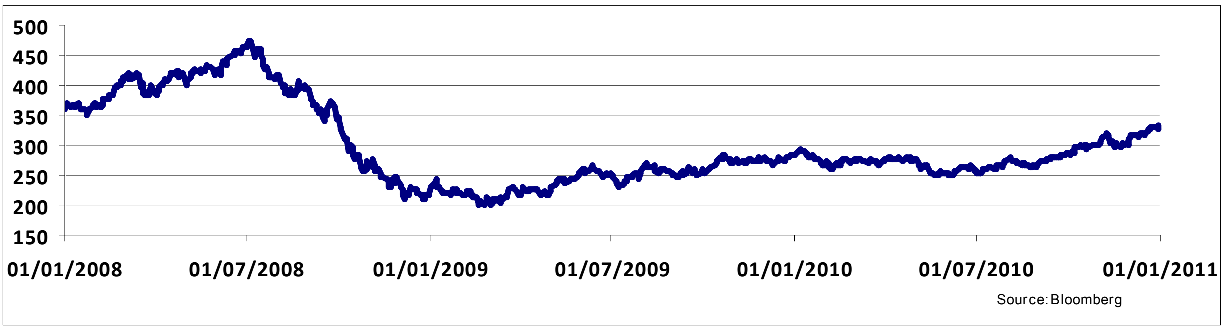
S&P 500 - MSCI Emerging Markets - Euro Stoxx 50 (2008-10)



As in 2009, the best performances in local terms belonged to emerging countries such as Mongolia (+ 138%) and Sri Lanka (+ 96%). Global emerging markets (MSCI EM Index) returned over 16%, while the S&P 500 also ended the year with a decent return of 13%. In Europe, regional performances varied considerably, ranging from - 36% for the Athens Stock Exchange Index, - 17.4% for the Spanish IBEX Index and -3.3% for the CAC 40 Index to + 16% for the DAX Index and + 21.4% for the Swedish OMX 30 Index.

Commodities

CRB Index (2008-10)

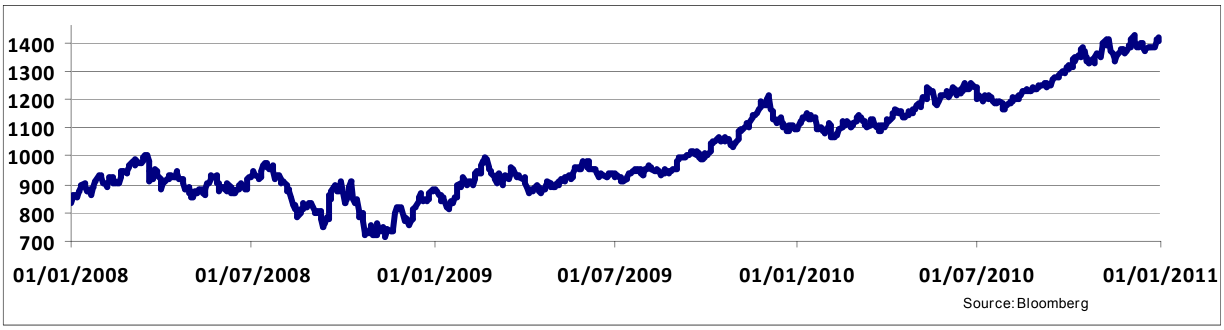


With the exception of gold, the prices of most commodities dropped during the first half of the year. Investors elected to stay away from real assets and took refuge in nominal ones such as government bonds and corporate credit. From July onwards, commodities recorded significant gains. A weaker dollar, increased appetite for risk and supply issues for agricultural commodities were the main drivers of these steep price gains.

Following their recent strong gains, the prices of industrial metals and agricultural commodities have already returned to the pre-crisis levels of 2008. This recent move does not only reflect sustained demand from growing emerging countries such as China and India and supply issues due to weather-related and political factors. It is also due to financial demand via investments into instruments such as Exchange Traded Funds (ETFs) which have attracted new investors into the asset class, especially due to concerns over the dollar and the need for an inflation hedge. The total year-end holdings in gold ETFs stood at a record 2’138 metric tons.

The price of WTI crude oil gained 15% in 2010 to end the year at a price of $ 91.40, a level below its May year-high of $ 93.50, but significantly above its lowest level of $ 73.80. This rise has been mainly supported by the signs of a global economic recovery and the decrease of inventories.

Gold price in $ (2008-10)

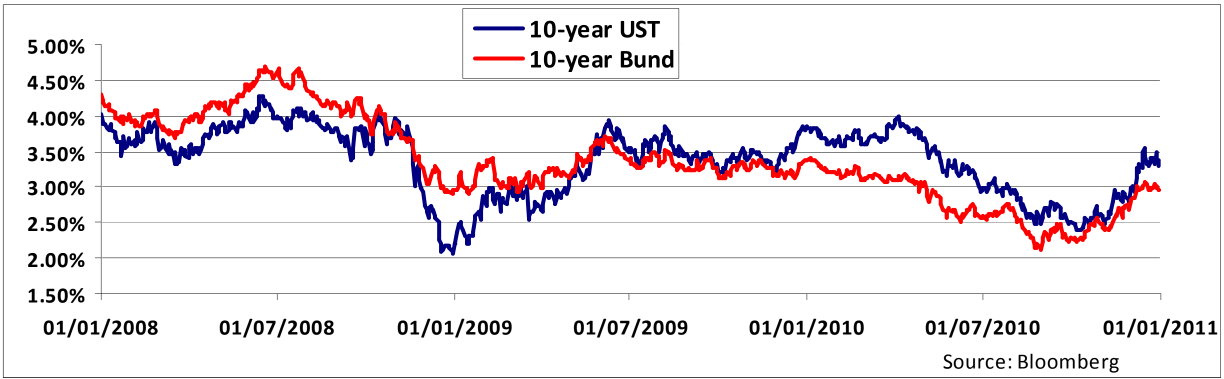


The investment into the gold theme did not lose any supporters during 2010. On the contrary, the reasons for holding gold were reinforced by China’s decision to relax certain rules related to investments into gold. This largely explains why China’s gold imports jumped almost fivefold to 209 tons in the first ten months of 2010 compared to the entire amount of 45 tons shipped in 2009. The price of gold soared 30% in dollar terms last year (39% in Euros), on concern that the value of currencies is being debased due to the injection of trillions of dollars into the global economy.

Fixed-income

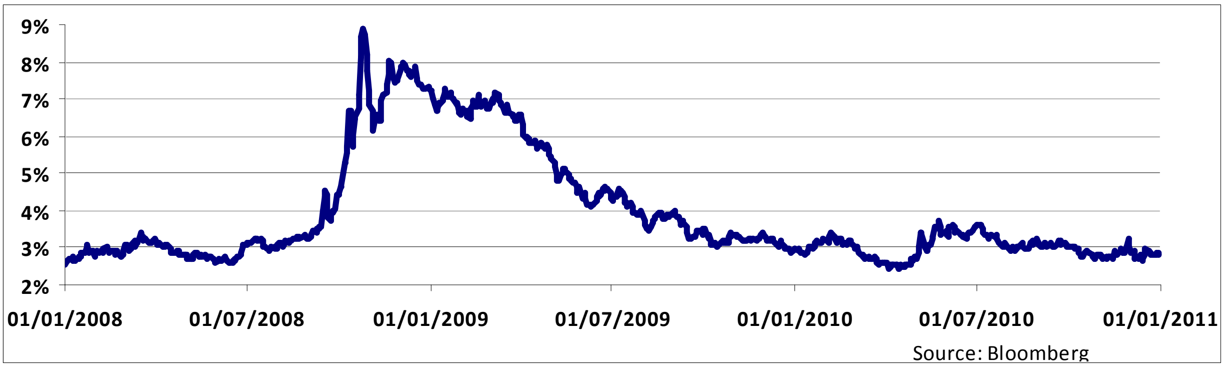
2010 might be remembered as being the year which marked the end of the bull market for G-7 government bonds. Until the fall, yields of US Treasuries and German Bunds consistently declined as investors favoured defensive assets over more risk-orientated ones. Investors were spooked by the events unfolding in European sovereign bond markets during the spring as yields of peripheral sovereign debt soared and Greece needed a 110 billion euros bailout. This positive trend for the major government bond markets lasted until October, when improving confidence in the equity markets led investors to reduce their allocations to US Treasuries and German bunds.

10-year US and German government bond yields



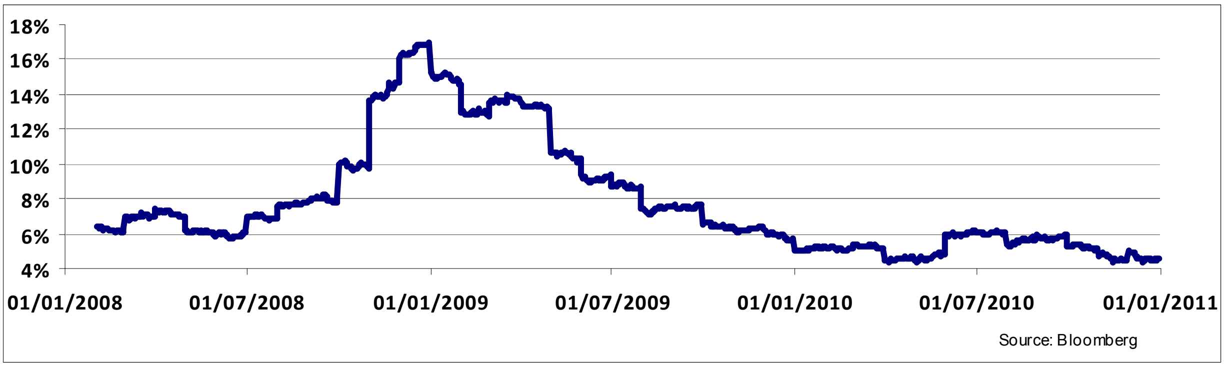
The yields on the benchmark 10-year U.S. Treasuries and German Bunds dropped respectively from 3.84% and 3.39% at the end of 2009 to year-lows of 2.39% and 2.12%. Even if the lowest yield on German Bunds had already been reached at the end of August, it wasn't until mid-October that these bond markets really turned. Within two months, 10-year yields had soared around a full percentage point to over 3.5% on Treasuries and 3% on Bunds.

Emerging Market Debt spread (2008-10)



Since the end of 2009, the spread of emerging market debt yields over US Treasury yields (JPMorgan EMBI Global Spread Index) has barely moved as it ended the year at a level of 2.9%. Despite the recent spike of US Treasury yields, demand for emerging market debt has remained resilient and the current spread is well below the 3.7% level observed in May at the height of the European sovereign debt crisis.

U.S. High Yield spread (2008-10)



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 5% at the end of 2009 to 4.6% on the last day of 2010. High-yield bonds were under selling pressure between April and August and spreads widened significantly. However, this proved to be only temporary. The asset class continues to benefit from the ongoing improvement of credit default rates and positive inflows as investors switch into assets offering higher returns.

Following its record-setting performance in 2009, the investment-grade credit space produced more modest returns in 2010, but these were still above their historical average. The amount of new issuance remained healthy and was met with solid demand from investors. Bond funds continued to benefit from considerable levels of inflows until the latter part of the year, when investors started to shift part of their bond allocations into equities.

Fixed-income market performance in 2010 (USD)

World Government Bond Index	+ 5.2%
Credit AAA	+ 6.0%
Credit BBB/BB	+ 14.6%
Global Emerging Market Sovereign	+ 12.0%
High Yield Local Currency	+ 14.3%

Currencies

2010 was another dramatic year for currency markets. Volatility remained extremely high and the world's largest reserve currencies, the dollar and the Euro, ended the year with steep losses against other currencies such as the Japanese yen and the Swiss franc. The USD/CHF parity climbed from 1.035 in January to over 1.16 in June before dropping by 19 percent to a year-end parity of 0.94. Apart from a rebound in September and October, the EUR/CHF parity plummeted all through the year from a starting level of 1.48 to an ending price of 1.24. These major movements directly impacted portfolio performances which diverged significantly, depending in which currency they were reported, unless they were hedged.

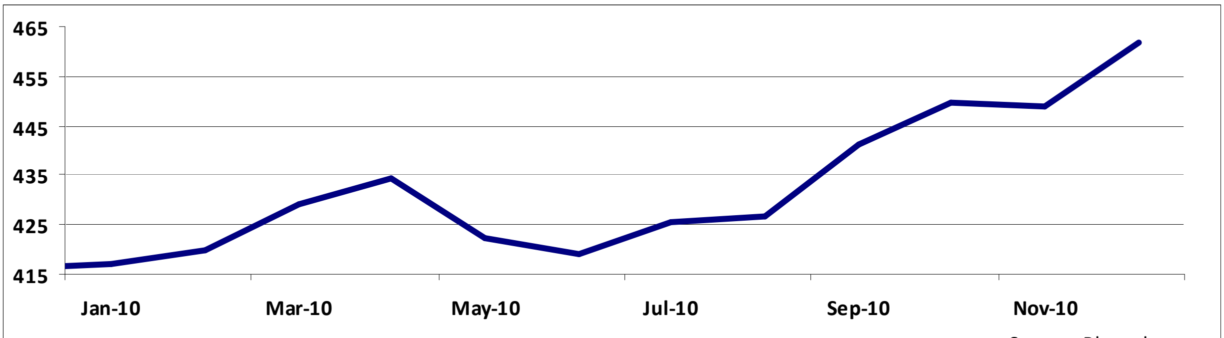
Hedge Funds

2010 was a demanding year for hedge fund managers as volatility and high correlation among asset classes made for a challenging investment environment. Pronounced market swings and massive monetary stimulus contributed to disrupt certain trading strategies, which are based on fundamental analysis and are better suited to longer trends.

The exceptionally high correlation of equities within the main equity indices, which lead to less differentiated performance, made it more difficult for certain hedge fund strategies to perform throughout the year. This rise in equity correlation appears to be closely linked to the increasing use by investors of index-tracking strategies such as ETFs, as opposed to trading in the underlying equity index constituents themselves.

Other issues facing hedge funds was the frequent reversal of trends and the need to keep risks under control. As an example, the S&P 500 gained or lost more than 3% during ten of the twelve months of the year. This risk-on, risk-off year meant that many big hedge-fund firms such as Paulson, Brevan Howard and Moore Global failed to match their performance of previous years and only produced modest returns.

CS Tremont Hedge Fund Index (2010)



Source: Bloomberg

Hedge Fund strategies market performance in 2010 (USD)

CS Tremont Hedge Fund Index	**+ 10.9%**
CS Tremont Hedge Fund Convertible Index	**+ 10.9%**
CS Tremont Hedge Fund Emerging Markets	**+ 11.3%**
CS Tremont Hedge Fund FI Arbitrage	**+ 12.5%**
CS Tremont Hedge Fund Long/Short	**+ 9.3%**
CS Tremont Hedge Fund Multi-Strategy	**+ 9.3%**
CS Tremont Hedge Fund Event Driven	**+ 12.6%**
CS Tremont Hedge Fund Short Bias	**- 22.5%**
CS Tremont Hedge Fund Futures	**+ 12.2%**

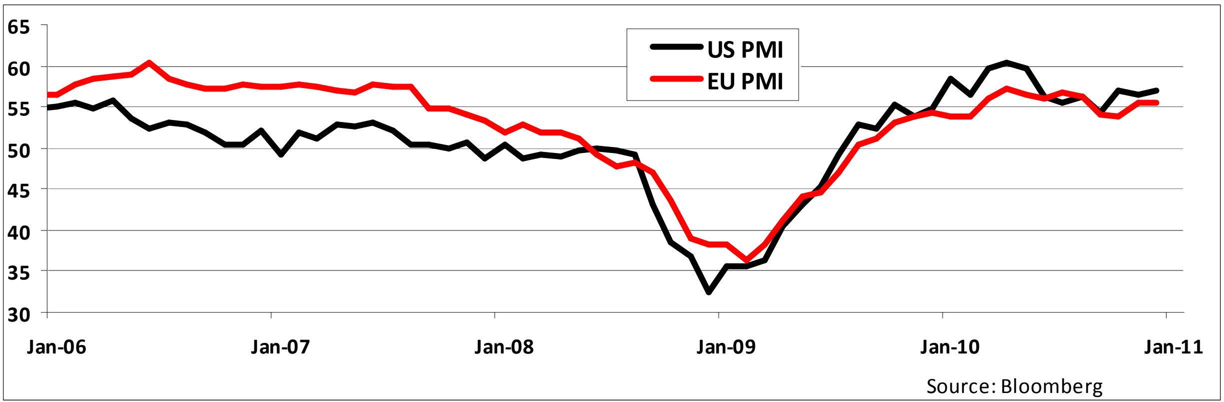
2011: ECONOMIC OUTLOOK

We expect the economic recovery to continue in 2011 even though there are still a number of headwinds. As described in a previous section, the European debt crisis is the major ongoing issue and its impact on the markets will largely depend on how well Portugal and Spain can match their fiscal targets and restore investor confidence. The housing sector remains a constraint on consumers in the Western world even if prices have largely stabilized. A recovery in the housing market is dependent on a recovery in the job market, which has yet to take place. The withdrawal of stimulus measures in the Western economies will also have a diminishing impact on the economic growth in 2011, while the threat of higher inflation across developing economies could lead to policy mistakes.

Despite these genuine concerns, it is also important to point out that the economy is benefiting from positive forces which should prove to be the dominant ones. Even if there is a tendency to focus on the problems facing Europe and the United States, global economic growth remains resilient, in large part due to the developing economies. In the U.S., the positive impact of the recent tax agreement should boost GDP growth, while monetary policies are supportive throughout the advanced economies. Finally, the balance sheets of the corporate sector are in a very good shape and it is widely expected that higher levels of business fixed investment and takeover activity should boost economic growth.

Leading economic indicators

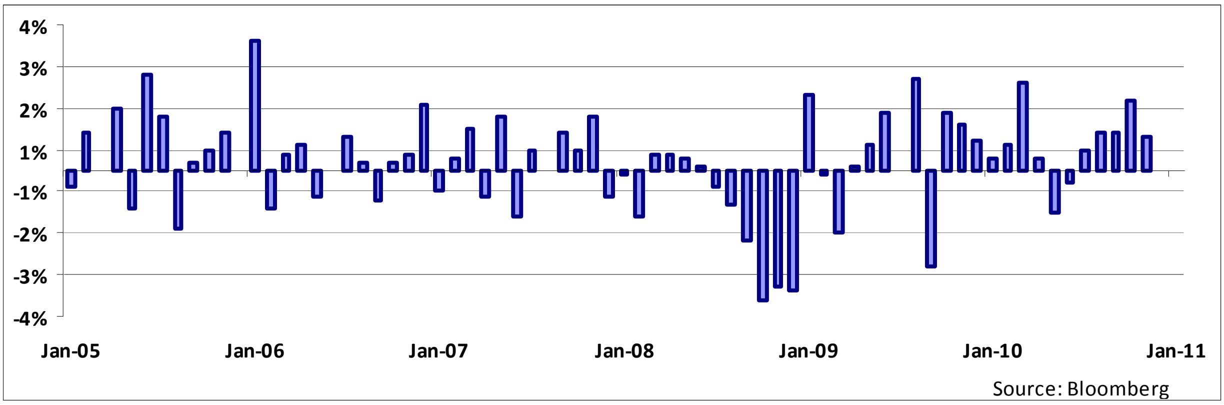
Purchasing Manager Indexes



Purchasing Managers Indexes remain at levels which clearly indicate an expansion of the economy. The latest data in the U.S. and in Europe showed that the economic recovery is gaining momentum and broadening beyond manufacturing. In the U.S., the ISM non-manufacturing measures of new orders and business activity increased to the highest levels since August 2005, while the strong health of Germany has contributed to support Euro zone economic activity.

Consumer spending

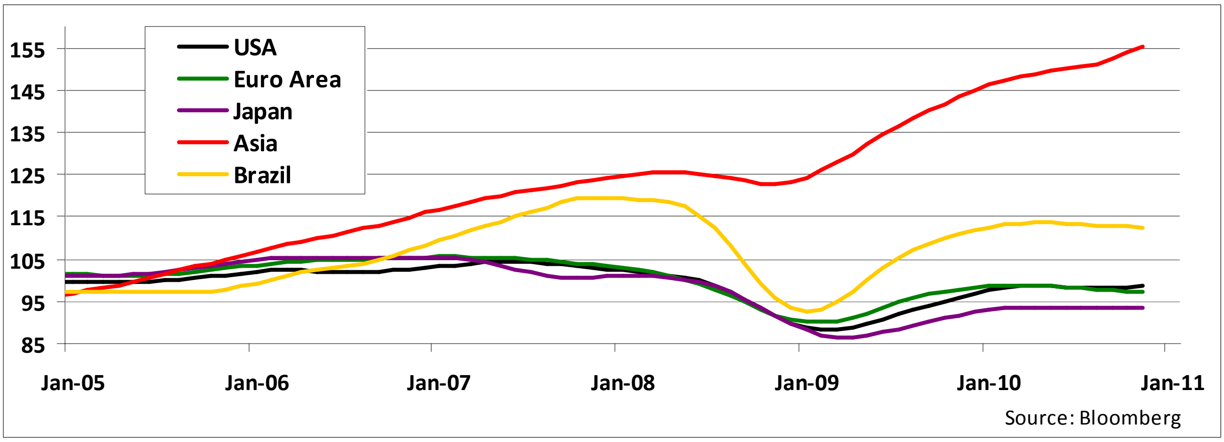
U.S. retail sales (month on month net change)



Asia and other emerging regions are benefiting from a structural growth in consumer spending (see page 6). Global retail sales in the advanced countries have been declining, as households have increased their level of savings in order to repair their balance sheets. Nevertheless, consumer spending in the U.S., which accounts for 70 percent of the economy, has remained resilient throughout 2010. This trend should extend in 2011, helped by modest job growth and boosted by the reduction in payroll taxes.

Leading indicators

OECD Composite Leading Indicators

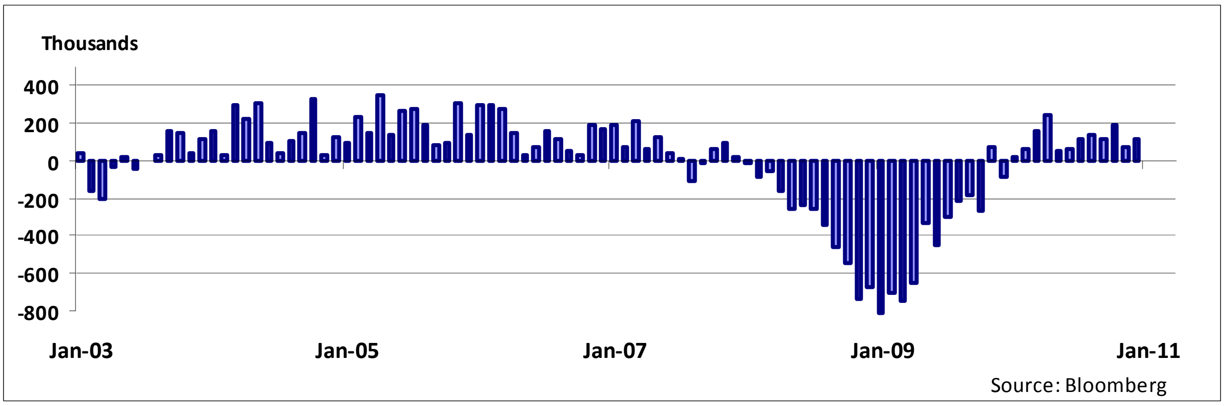


The economic strength of Asia is reflected by the OECD Leading Indicators, which point to the continuation of the prevailing trend at an elevated level. After the dip experienced during the summer, the Leading Indicators for the US have turned more positive. For Japan and Brazil, the trends are flat, while the trend has turned slightly negative in Europe.

Job markets

A sustainable recovery will only be possible if conditions in the labour markets improve in a significant way. So far, companies have been extremely reluctant to create new jobs or rehire workers. In the U.S., recent data have been more supportive, as indicated by the trend in jobless claims. However, the numbers are still far from levels that would be associated with a strong job market and the U.S. unemployment rate remains at an elevated level of 9.4%.

U.S. Nonfarm Payrolls (month on month net change)



In the U.S., conditions in the labour markets, as measured by the number of nonfarm jobs created by the private sector have clearly improved since the beginning of 2009. However, the pace of growth in nonfarm payrolls remains largely insufficient, as it would take about 250'000 to 300'000 additional jobs per month to regain the number of jobs lost during the economic downturn.

Conclusions

In the light of the above indicators, it is clear that there is still a long way to go before one can talk of a full recovery. Economic recoveries are never straight-line expansions and, even if the risks of a double dip recession scenario appear extremely low, an unexpected event could derail the prevailing positive trend.

It will take time for the real estate markets in the advanced economies to regain some strength. In several countries, the high level of inventories and a significant proportion of homeowners with negative equity has reduced the mobility of the workforce and dented consumer confidence. An acceleration in the pace of jobs' growth would contribute to restore some of the lost confidence, but it still feels too early to predict a significant improvement of the current trends.

To finish on a positive note, one should highlight the strength of corporate balance sheets and the expectations of strong growth in capital expenditure. Over the last years, there has been a near-record under-investment by the corporate sector in the G4 economies. Companies are currently benefiting from a strong financing ability and this should translate into an acceleration of investment.

2011: FINANCIAL MARKETS' OUTLOOK

We are of the opinion that the overall prevailing market conditions are still supportive for risk assets and we will be looking to take further advantage from our current exposures to equities and our more dynamic fixed-income assets. However, we are not complacent and are fully aware that 2011 will most likely present a certain number of unforeseen challenges. That is why we also intend to continue investing into assets which are less dependent on the direction of the markets or which offer a significant degree of protection against downside risks. Currency risk is another area which will require ongoing attention, especially for the portfolios based in a strong currency such as the Swiss franc.

The messages coming out from the G-4 Central Banks clearly indicate that measures taken to reflate asset prices aren't over yet. The Federal Reserve has signalled its concerns over the low level of inflation and the importance of higher prices of financial and real estate assets. While it is difficult to foresee a rapid re-rating of house prices, the prices of equities should be the main beneficiaries of the latest quantitative easing measures (QE2). The recent agreement between the Republicans and President Obama to extend the Bush-era income-tax cuts by two more years must also be considered as positive for risk assets as it should boost the prospects of higher GDP growth. While the message from the European Central Bank has been somewhat less direct, its recent actions indicate it will be pursuing its bond-buying program to contain the Euro-zone debt crisis. Finally, the Bank of Japan has also been taking measures to lower borrowing costs and counter the appreciation of the yen ,which should be supportive of higher equity prices.

Fixed-income outlook

Our negative outlook on G-7 Government bonds has not been altered by the recent upwards move of yields. We will continue to avoid holding any significant exposure to this segment of the fixed-income markets, as we see more value elsewhere. While we do not expect yields to continue rising at the recent pace, we clearly do not expect a return to the extremely low levels experienced during 2010. Our concerns about the outcome relating to the financing needs of peripheral European countries remain acute and we do not intend investing into their sovereign debt, as it appears extremely unwise to try predicting the future decisions of European politicians!

We still prefer segments that offer a yield cushion against rising government bond yields and US high yield corporate bonds are our favourite fixed-income investment theme for 2011. We believe that the ongoing rally will extend throughout 2011 as the global speculative-grade default rates are expected to drop well below the current level of 3.1%. In our opinion, emerging market debt in local currencies should remain well supported even if we do not anticipate a significant contraction of spreads. The exposure to debt denominated in local currencies should be seen as a hedge against the potential depreciation of the major currencies, in particular the dollar and the Euro. At this stage, investment grade bonds only offer limited value and we will not be replacing all of the positions arriving at maturity as we reduce the exposure to this area of the fixed-income space.

Equity outlook

Our positive outlook for equities in 2011 is based on relatively attractive valuations, loose monetary policies and the belief that companies will be able to maintain their profit margins and produce resilient results. In our opinion, companies have, to a large extent, taken advantage of the financial crisis to strengthen their balance sheets thanks to cheap re-financing and drastic cost control measures. While there is a genuine concern about the lack of growth in jobs across the mature economies, this situation allows companies to limit salary cost pressures and preserve their high profit margin levels. Globalisation of trade across the world has meant that companies have been able to compensate the weak growth of mature economies with an increasing exposure to countries with vastly superior levels of growth. Additionally, shareholders should continue to profit from the distribution of attractive dividends and supportive share buyback programs.

The last two years have seen net equity selling as investors have opted to invest into government and corporate bonds on a massive scale. We feel that there is now the potential for a reversal of this trend as bonds appear to be expensive compared to equities. Unless one forecasts a collapse of economic activity, we fail to understand why bonds should represent the asset of choice. This point of view is clearly put forward by an increasing number of strategists who are recommending to reduce the exposure to fixed-income to the benefit of the equity asset class.

Alternative investments

Alternative investments have been playing an integral part within our clients' portfolios and we expect this to remain the case throughout 2011. Investments into hedge funds allows the portfolios to be exposed to niche strategies into which we are unable to invest directly while structured products can offer rewarding returns with a significant downside protection. From this perspective, we view hedge funds and structured products as being genuine alternatives to traditional assets and expect them to play an important role in terms of de-correlation and lesser volatility, especially at a time when the holding of cash is so unrewarding.

Throughout the years, we have searched for high-quality hedge funds and have preferred to invest into hedge funds of limited size. The main reasons behind this choice is to be able to have access to the managers, to be invested into funds with maximum flexibility and to avoid managers who might have lost some of their edge due to the large size of assets accumulated.

It has to be noted that the risk attached to the vast majority of the portfolios' investments into structured products can be assimilated to an equity-type risk. Hence, one could argue that these structured products could just as well be classified within the equities asset class rather than under alternative investments.

Gold outlook

Gold has continued to perform well due to the extremely low level of real interest rates and its role as a valuable hedge against the debasement of G-4 currencies and the threat of potential future inflation. We observe that gold has become an integral part of most investment portfolios and expect this to remain the case in the longer term.

While it is difficult to make predictions on the future price of gold, we believe that the ratio of the Dow Jones to the price of an ounce of gold could further contract and move well below the current level of just over 8 (the long-term average is of 9.5). Gold is a store of value and offers protection against extreme scenarios and, in the current environment, most investors are likely to maintain a more cautious stance and opt to keep their allocation into the precious metal.

Currency outlook

Even during the less volatile periods, it is extremely challenging to try and anticipate the trends of currencies. Their parities are determined by a very wide range of factors and the addition of unprecedented stimulus measures by central banks and frequent political intervention has made it even more difficult to make forecasts. Nevertheless, we will highlight some of our beliefs hereafter.

We are convinced that the European Union will deploy all the required efforts to support the countries facing financing difficulties and that a break-up of the Euro is not the appropriate solution. There are some positive signs related to Spain's fiscal position and, if this were to be further confirmed, decreasing pressure on the EMU debt could help the Euro to regain some stability.

While the US dollar should remain structurally weak due to the twin deficits, recent upward growth revisions and cyclical factors should favour the dollar over the Euro in 2011. The Euro is overvalued against the dollar in terms of purchasing-power parity and the sovereign debt crisis is not over yet.

The Swiss franc has clearly benefited from its safe haven status and been driven higher by Euro and dollar outflows. Against the Euro, the franc has clearly become overvalued and Switzerland's dependence on the Euro zone has made this situation very uncomfortable. While it is hard to imagine that the Euro will experience a sustained appreciation against the Swiss franc over the coming months, we would expect the parity to evolve higher during the next quarters. Furthermore, we would not be surprised if the Swiss National Bank were to take unconventional measures to fight against excessive appreciation against the Euro.

Over the longer term, we remain convinced that emerging market currencies should appreciate against the dollar and the Euro. Higher levels of growth, strong fiscal positions and higher interest rates should be supportive and lead to currency gains.

2011: ASSET ALLOCATION

Equities

- We remain optimistic on the outlook for equities on a six month perspective and therefore recommend increasing the allocation to this asset class. At this stage, we feel that many of the reasons behind our positive outlook on equities last year remain valid for 2011.

- Equity prices should be well supported by low interest rates, the growth of earnings, compelling relative valuations against long-term bonds, sceptical investor positioning and high levels of liquidity. Furthermore, as a level of confidence returns, there is an increased likelihood that equity shareholders will benefit from the deployment of a portion of the record levels of cash held by companies. Increased momentum in M&A activity, stock buyback programs and capital expenditure spending should all help to drive shareholder returns.

- At this stage of the rally, we like the stocks of companies that offer sustainable high dividend yields, mainly for income purposes. We also like the shares of international companies with strong brands as well as small caps exposed to emerging markets.

- From a regional perspective, our focus will be more on developed markets as we fear that equities of emerging markets might face a higher risk of pressure on profit margins, mainly due to labour costs and the threat of steeper interest rates. Japanese equities have recently started to make up some of their underperformance and, considering their attractive valuations, should be able to sustain this trend especially during yen depreciation periods.

Fixed-income

- As explained previously, our overall stance on fixed-income is one of caution. At this stage, we have little to no exposure to G-7 government bonds and recommend further reducing the exposure to investment-grade credit. Our favoured fixed-income segment is high-yield bonds and, to a lesser extent, emerging market debt.

- High-yield companies have been able to refinance and extend the maturity of their debt at favorable conditions. Our view is that the bulk of high-yield bonds' performance will derive from the coupons on offer, even if they should also benefit from an additional contraction of spreads as default rates further decline.

- For the allocation to emerging market debt, we prefer investing into bonds denominated in local currencies as a hedge against the ongoing depreciating dollar and Euro. Due to higher inflation pressures in emerging countries, we expect to take advantage of the appreciation of their currencies via this exposure.

Hedge Funds

- Hedge funds benefited from positive inflows in 2010 as institutional investors increased their allocations. We anticipate an extension of this trend, in part due to the need for replacement solutions for a portion of the allocation to bonds. Hedge funds play an important role in the construction of portfolios as they offer valuable contributions in terms of alpha generation, reduced volatility and non-correlated returns.

- We are hopeful that hedge funds will face a less challenging environment in 2011 and be able to improve on their 2010 performance. Strategies such as Long/Short, Event-Driven and Global Macro should benefit from the prevailing trends, while an exposure to the CTA strategies plays an important role in terms of diversification and portfolio protection.

Commodities

- We expect demand for commodities to remain robust in 2011. While it is difficult to make any predictions about supplies, in particular those of agricultural commodities, the trends in final and financial demand should stay supportive for this asset class.

- Final demand from emerging countries will probably continue growing at a rapid pace and investors are likely to increase their exposures to physical assets over nominal ones. The need to protect portfolios against rising yields, depreciating currencies and inflation in developing countries will be a key issue going forward.

- Our preference is still to invest into commodities through equities or hedge fund strategies due to speculative froth and risks associated with financial demand.

Gold

- We recommend maintaining the current 5% allocation to physical gold. As long as real interest rates stay low and the major currencies continue to be impacted by previously untested policies of the major Central Banks, gold will remain a core portfolio asset. Gold should continue to be supported by demand for a safe haven from potential economic and financial shocks. Our other investment into gold, a fund of gold mining companies, has greatly contributed to the performance of our portfolios in 2009 and 2010 and will remain a core holding in 2011.

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.

- Since 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. 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 2011

For our balanced accounts, we apply the following grid:

	Allocation	January 2011	+/- (July 2010)
Short-term deposits	**0 – 20%**	**5%**	**-6%**
Fixed-income	**15 – 40%**	**21%**	**-1%**
Investment grade bonds	5 – 30%	6%	-4%
EM & high-yield bonds	5 – 20%	9%	+3%
Specialist bonds	5 – 10%	6%	-
Equities	**20 – 50%**	**37%**	**+7%**
Developed markets	10 – 30%	27%	+7%
Emerging markets	10 – 30%	10%	-
Alternative Investments	**15 – 35%**	**32%**	**-**
Funds of Hedge Funds	10 – 30%	20%	-2%
Structured Products	5 – 15%	12%	+2%
Gold	**0 – 5%**	**5%**	**-**
		100%	**0%**

Forum Finance Group
since 1994

CONTACT

The Forum Finance Group S.A.
6, rue de la Croix d'Or
C.P. 3649
CH-1211 Genève 3
Suisse

Phone : +41 22 311 8400
Fax : +41 22 311 8465
E-mail : info@ffgg.com
Web : www.ffgg.com