Forum Finance Group

since 1994

January 2012

Investment Perspectives 2012

INVESTMENT PERSPECTIVES 2012

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EXECUTIVE SUMMARY

- In 2011, the ***crisis of sovereign debt in the Euro zone deteriorated***. Portugal became the third country to apply for financial support from the European Union and the International Monetary Fund. ***Government bonds issued by Italy*** and, to a lesser extent, ***Spain*** were sold off, leading to an ***increase of borrowing costs*** and a widening of credit spreads compared to those of German Bunds.

- The financial markets were characterized by ***elevated volatility, less liquidity and intraday swings well above average***. The best yearly performances were recorded by the assets considered to be the safest, including ***US Treasuries, German Bunds and gold***. Most ***equity markets*** ended the year with ***double-digit losses***, but ***U.S. equities were resilient*** and ended the year virtually unchanged. Volatility in foreign-exchange markets was also high, even though ***year-on-year variations were small for the main currencies***.

- The ***global economy should slow down in 2012***. Economic activity in the Euro zone will most likely contract and the United States should grow at a moderate pace. Faster-growing economies will also face lower growth than in the past year, but we do not anticipate a hard landing of the Chinese economy. The ***European banking sector is under severe stress*** and the ongoing deleveraging of the banks' balance sheets will negatively impact other economic regions.

- ***Monetary policies will remain very accommodative*** in the mature economies and the ***central banks of emerging countries*** are likely to ***loosen policies*** due to ***receding inflation pressures***. The Federal Reserve has clearly indicated its intention to maintain ***interest rates close to zero*** for an extended period while the European Central Bank is expected to take ***additional easing decisions***.

- We recommend a ***more cautious positioning*** of the portfolios at the beginning of 2012. The failure of the European political leaders to come up with a long-lasting solution has only ***increased the level of risk for investors***. Our inability to predict how the current crisis will unravel has led us to ***reduce our exposure*** to equities and adopt a more ***tactical approach***.

- Our attention will be more focused on ***assets providing income*** than on those which depend on price appreciation to generate positive returns. We continue to find little value in G-7 government bonds, but recommend ***increasing the exposure to investment-grade credit and high-yield bonds***, especially those issued by U.S. corporations.

- Our exposure to equities will favour ***high quality dividend paying stocks***. We also like the shares of ***international companies with strong brands***, especially those with ***increasing exposure to emerging markets***. From a regional perspective, our focus will mainly be on ***U.S. stocks*** and we believe that ***emerging markets' equities could fare better*** in 2012.

2011: 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*** produced mixed results. High-yield bonds and emerging market debt generated positive annual returns despite the severe correction during the third quarter, but our portfolios failed to benefit from the strong performance of the safest government bonds (US Treasuries and German Bunds). Our decision to ***avoid any exposure to peripheral sovereign debt*** was, however, fully vindicated by the dramatic widening of spreads relative to German Bunds.

- Our ***positive outlook on equities for 2011*** was detrimental to the performance of our portfolios. Even though companies produced overall strong results, the inability of political leaders on both sides of the Atlantic to resolve key issues negatively impacted market sentiment and the appetite for risky assets. Our exposures to European, Asian and emerging equities as well as gold mining stocks were amongst the portfolios' worst contributions; our preference for the ***shares of high quality international companies and those paying sustainable dividends within the developed markets*** proved to be correct and helped to compensate, on a relative basis, for the draw downs of the other equity positions.

- Concerning our exposure to ***Hedge Funds***, we expressed our hope that the environment would prove to be less challenging in 2011 and that certain strategies would produce positive returns. Unfortunately, the hedge fund industry has largely been unable to generate absolute returns throughout the difficult conditions of the past year and the correlation with long-only exposures has been higher than what we had anticipated.

- Our core ***5% allocation to physical gold*** produced another healthy contribution as the precious metal performed strongly until the later months of the year. The investment into assets considered to be the safest and protection against the debasement of the major currencies were the key supportive factors for the price of gold.

- 2011 turned out to be a difficult year for ***commodities*** as for the other cyclical assets. Whereas the price of ***oil was well supported*** by geo-political factors, in particular supply concerns in the wake of the Arab spring, the ***prices of other commodities suffered from the global economic slowdown and fears of a renewed recession***. Our commodity exposure through a certificate on a global commodity index produced a small negative contribution.

- In contrast to the previous years, the parities of the ***major currencies*** did not record significant variations in 2011 even though intra-year volatility was high. Our slight ***preference for the dollar over the Euro*** was the right choice due to the inability of European political leaders to resolve the sovereign debt crisis and the ECB's decision to lower interest rates. Our feeling that the Swiss National Bank could take ***unconventional measures to fight against excessive appreciation*** of the Swiss franc proved to be correct as it decided to fix a 1.20 floor under the Euro-Franc parity.

2011: ECONOMIC DEVELOPMENTS

The European sovereign debt crisis

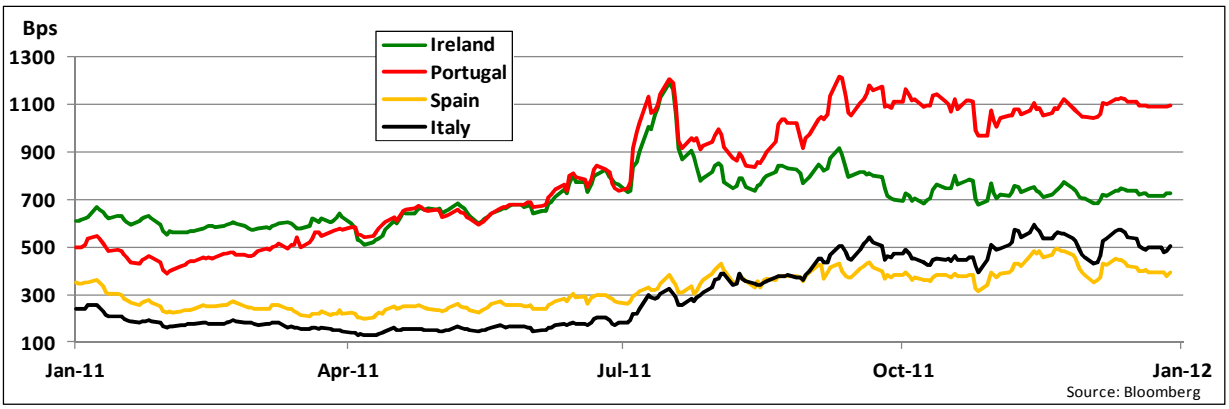
As for 2010, the past year was dominated by the sovereign debt crisis in the Euro zone. It is nearly two years since the Greek crisis broke out and that a bail-out package was provided by Euro zone members and the International Monetary Fund. This first aid program has been followed by similar financial support to Ireland in November 2010 and to Portugal in May 2011. As feared at the time, ***these bail-outs have only served to postpone the final outcome*** and ***have not prevented the crisis from spreading to larger countries*** such as Spain, Italy and, to a lesser degree, France.

Numerous summits between European finance ministers and heads of states were held throughout 2011 in order to define a meaningful solution to end the crisis. In a systematic manner, the initial hope resulting from these meetings was quickly followed by disappointment. This was mainly due to the ***failure of the latest plan announced to address the major issue of how to immediately reduce the soaring borrowing costs*** faced by the countries under the most stress.

The solution proposed during the latest EU summit in December insisted heavily on the need to implement more rigorous budget discipline and to converge towards tighter fiscal integration. While these proposals are fundamental to insure the survival of the Euro in the long term, they failed to have any significant impact on the markets and the ***yields of sovereign bonds remain at unaffordable levels***. At year-end, the 10-year yields of Italian, Spanish and French sovereign debt were respectively of 7.1%, 5.1% and 3.2%, compared to a level of 1.8% for 10-year German Bunds.

The fallout of the debt crisis in Europe and the lack of a political solution are having ***devastating consequences on the economy***. Borrowing costs for most countries have soared, governments have collapsed and the European banking sector remains under immense stress. The euro economies are facing recession and their decision to adopt severe fiscal austerity policies will bring a further contraction of economic activity. There is a clear risk that this situation could lead to growing social unrest and ultimately split the euro apart.

European sovereign debt CDS USD spreads



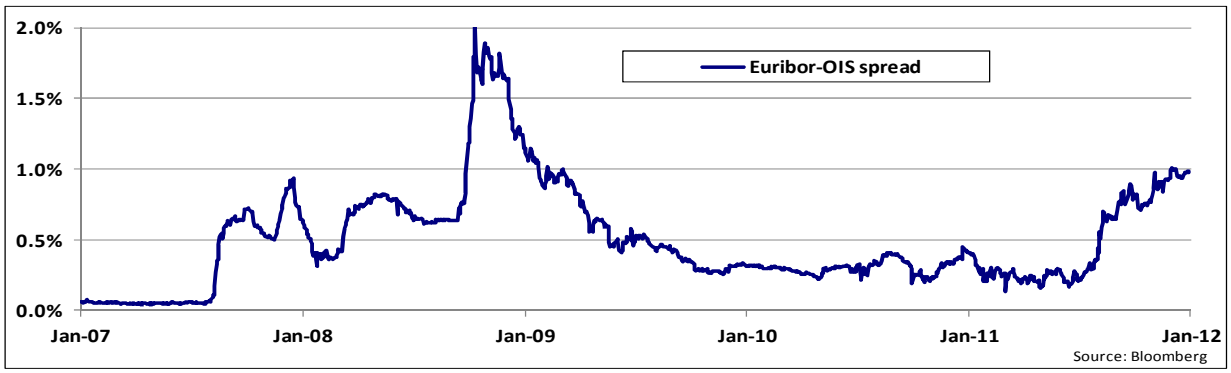
The chart above shows that the sovereign 5-year CDS spreads of Ireland and Spain ended the year with relatively modest yearly increases. In contrast, those of Portugal and Italy have respectively widened from 497 and 242bps to 1'093 and 503bps. These considerably ***wider spreads reflect investors' general lack of confidence and the liquidation of sovereign debt holdings by banks***.

The European banking sector

As already mentioned, the ***European banking sector finds itself under severe stress*** and the shares of European banks had a torrid time throughout 2011. The Bloomberg Europe Banks and Financial Services Index dropped by 32% last year, nearly twice the decline of the Euro Stoxx 50 Index, leaving bank stocks trading well below their book values. At a time when banks are under great pressure to meet new capital requirements decided by European regulators, this decline in the value of their shares are making them ***reluctant to raise equity*** and leading them to ***shrink their balance sheets*** by selling assets. This ***deleveraging of the European banking sector*** will not only have negative effects on consumer and corporate lending in Europe but it ***will also impact activity in other regions*** as European banks are reducing their presence in Eastern Europe and Asia.

Banks in Europe have also had to face major difficulties in terms of access to funding. Since July, the ***markets for bank bonds***, which are an important source of long-term funding for banks, ***have almost completely frozen up***. A second vital source of funding is borrowing through short-term interbank markets or tapping money markets. Both of these have also been drying up. ***American money-market funds***, which were a big source of dollars for the European banking system, ***have reduced loans by more than 40%*** during the second half of the year, while ***banks have been reluctant to lend to one another***, except for the shortest possible time.

The Euribor-OIS spread



The Euribor - Overnight Index Swap (OIS) spread, a key measure of the willingness of European banks to lend to one another, ***is on a risk-averse trend***, as shown in the chart above. This reluctance has been at work since the middle of 2011 and is reflected by the widening of the spread from 0.2% to 1% during the second half of the year.

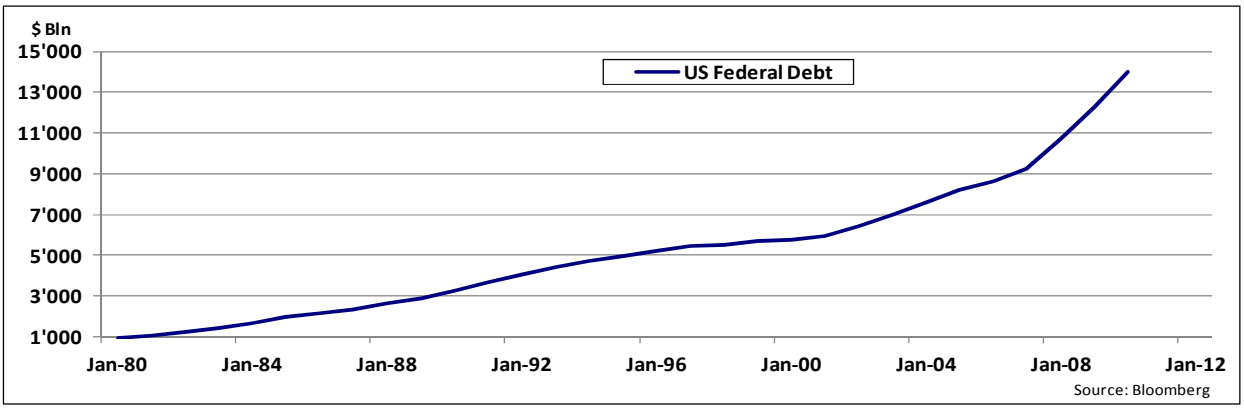
The intervention of the European Central Bank

Due to the issues mentioned above, the ***European Central Bank decided to intervene to provide funding to European banks***. On December 21st, it made EUR 489 billion available in three-year loans to more than 500 banks across Europe. This means that the banks have borrowed enough cash to refinance almost two-thirds of the debt they have maturing in 2012, amid concern that bond markets will remain closed. This operation should go a long way towards easing some of the funding pressures and also extend the average maturity on ECB loans to about 21 months from a mere ten weeks before the offer of the central bank.

The U.S. government debt

In comparison to the debt crisis in Europe, the issue of sovereign debt issued by the United States was less of a topic during 2011, except during fierce political debates and when the country was hit by a downgrade of its credit rating. Despite a last-minute agreement on the U.S. debt ceiling in August, financial markets were heavily impacted by ***Standard & Poor's historic decision to downgrade the country's sovereign AAA credit rating to AA+***. This decision was not only based on the prevailing level of debt to GDP and the size of the budget deficit, but also on the unsustainable path of the U.S. fiscal outlook. The level of U.S. debt is now above 100% of GDP, compared to an average of 80% in the Euro zone, while the budget deficit has reached 10%, which is much higher than the 6.4% average in Europe. This credit rating downgrade triggered a flight to the assets considered to be the safest, in particular, paradoxically, U.S. Treasuries.

Total amount of U.S. Federal debt

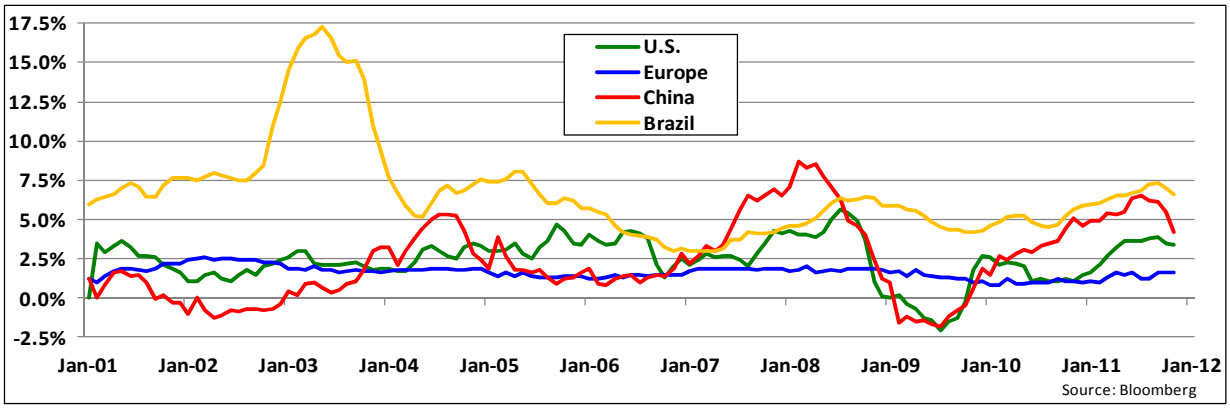


Whereas European nations are taking stringent measures designed to reduce their levels of debt, the United States have chosen to stimulate economic growth through reflation policies. The chart above shows the ***explosion of the amount of debt issued by the U.S. over the last 30 years*** and the acceleration of the pace of this issuance over the last four years. Despite this trend, ***yields on U.S. Treasuries have continued to decline*** and only time will tell whether the audacious stimulatory measures taken by the Federal Reserve will contribute to a contraction of the budget deficit or push the U.S. economy on the brink of a disaster.

China

China had to face a series of issues which contributed to a ***gradual slowdown of its economic activity in 2011*** as GDP growth dropped from 9.7% in the first quarter to 9.1% during the July to September period. The People's Bank of China ***tightened its monetary policies*** to fight against an acceleration of inflation, which reached a three-year high of 6.5% in July compared to less than 3% a year earlier, and a rise of property prices. The Central Bank imposed higher reserve requirement ratios on the major banks, thus reducing the amount of new loans and the supply of money. Chinese authorities have made it clear they will be ***steering economic growth to a more sustainable long term pace*** and most forecasts are projecting growth of around 8% in 2012.

Inflation across the world (2001-2011)



As shown in the chart above, ***inflation across the world is trending downwards***, in particular in the faster growing economies such as China and Brazil. This will give the central banks of emerging countries more flexibility to stimulate their economies if they deem it necessary. In the U.S., inflation seems to have peaked due to the recent appreciation of the dollar, whereas inflation in Europe is still well below the 2% ceiling monitored by the ECB.

Conclusions

In conclusion, the ***public sector will continue to present the most important risk factor in 2012***. Market participants are still waiting for a resolution of the debt crisis in Europe and will be waiting for signs that the European Central Bank will play a more decisive role. At this stage, it appears that the most obvious solution would be for the central bank to take quantitative easing measures and accelerate the pace of government debt purchases. One thing is sure; the ***current borrowing costs for many countries are prohibitive*** and, unless they decline to more affordable levels, they will only add to the ***difficulties of balancing fiscal budgets in the years ahead***. In the US, the fiscal outlook is grim and it is unlikely that any progress will be made in tackling the ever widening budget deficit in 2012 as the political focus will clearly be on electoral issues.

The ***European banking system represents a major concern*** due to the sector's shortfall of capital and its exposure to the sovereign debt of the peripheral countries. Without a revaluation of these assets, the banks' balance sheets will remain at risk and that is why the ***banking crisis is so closely intertwined with the debt crisis***. Now that European banks have received funding from the ECB, there is also a big worry that they will tend to hoard the cash rather than lend it out to companies or households. This means that, even in the best case scenario, one can only anticipate a ***weak expansion of credit***.

World economic growth should slow down in 2012, but not collapse unless the debt crisis in Europe spirals out of control. There are signs that the economic activity is stabilising in the emerging economies and the ***threat of inflation has significantly decreased***. These conditions will mean that ***policy is likely to ease significantly in a number of those economies***.

2011: THE FINANCIAL MARKETS

Political and macro uncertainty drive the markets

During most of 2011, the trends of financial markets were closely tied to the outcome of the latest European summit or to the debate about how to reduce the budget deficit in the United States. As to be expected, the ***durations of these trends were very brief*** and ***volatility remained elevated during unusually prolonged periods***. This increasingly unstable environment meant that a traditional investment approach, based on fundamental analysis and a medium to long term view, was largely brushed aside in favour of ***extremely short term and reactive investment decisions***.

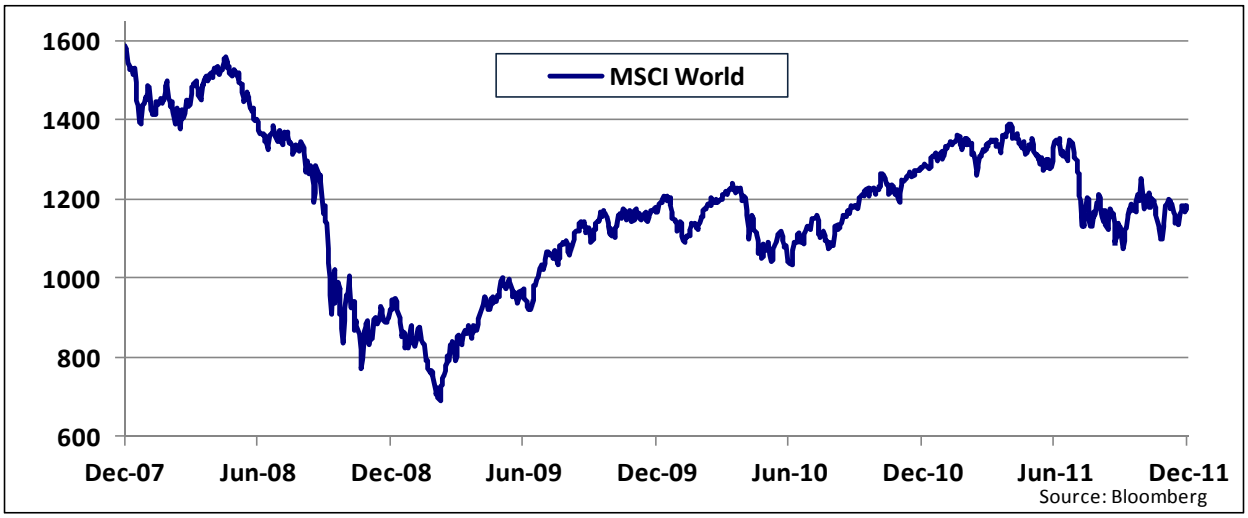
2011 performances

	End 2010	End 2011	2011 performance
Equities			
S&P 500	1257.6	1257.6	0%
Euro Stoxx 50	2792.8	2316.6	- 17.1%
MSCI EM	1151.4	916.4	- 20.4%
Yields			
UST 10-year	3.30%	1.88%	- 142bps
Bund 10-year	2.97%	1.83%	- 114bps
BBB EU	4.88%	4.80%	- 8bps
Currencies			
EUR/USD	1.338	1.296	- 3.1%
USD/CHF	0.935	0.938	+ 0.3%
GBP/USD	1.561	1.554	- 0.4%
USD/JPY	81.12	76.91	- 5.2%
EUR/CHF	1.251	1.217	- 2.7%
Commodities			
CRB Index	332.8	305.3	- 8.3%
Oil, WTI	$ 91.4	$ 98.8	+ 8.1%
Gold	$ 1421	$ 1564	+ 10.1%

Equities

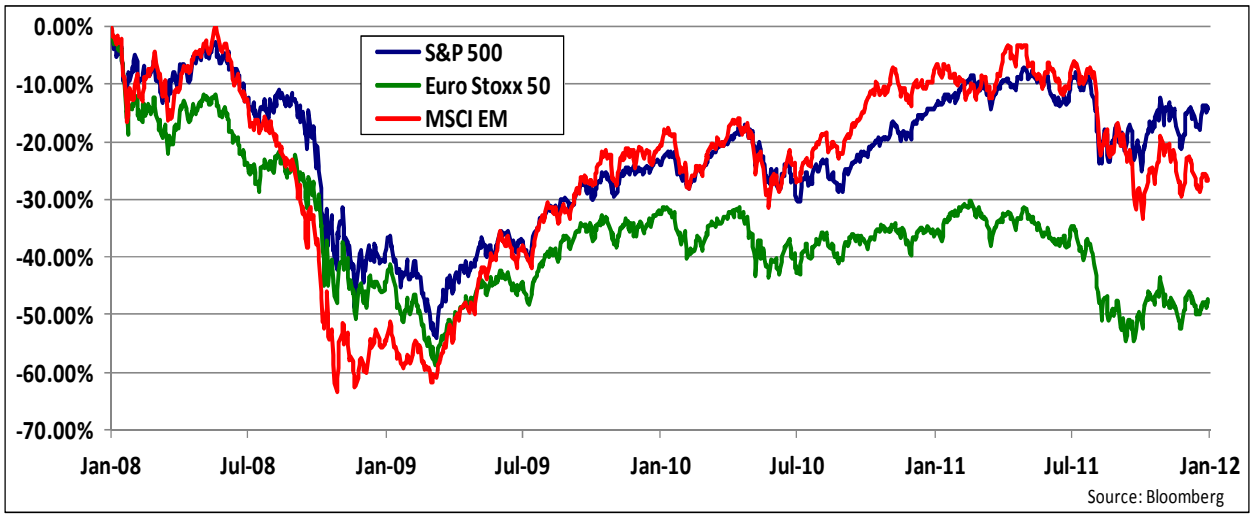
Equity markets proved to be very resilient during the first third of the year. Despite having to face steeper oil prices, renewed stress on peripheral European sovereign debt, rising inflation concerns and the risk of a nuclear disaster in Japan, equities managed to record modest single-digit gains until the end of April. From then onwards, markets started to drift lower and, by the end of July, they had given up all the year-to-date gains. ***August and September were dramatic months for equity markets***, with the S&P 500, Euro Stoxx 50 and MSCI Emerging Markets indices recording respective losses of 13%, 18% and 22% over the period. Markets were badly hit by Standard & Poor's historic decision to downgrade the sovereign AAA credit rating of the U.S. to AA+, a global deterioration of economic data and the spreading of the European sovereign debt crisis to Italy and Spain. A strong rebound in October was followed by a much weaker end to the year due to yet another disappointing EU summit outcome and poor conditions for sovereign debt in Europe.

MSCI World (2008-11)



As shown in the chart above, ***global equities recorded a 7.6% drop in 2011*** due in particular to the important draw downs in August and September. From a regional perspective, the equities of emerging markets did not benefit from their countries' better fundamentals and higher growth.

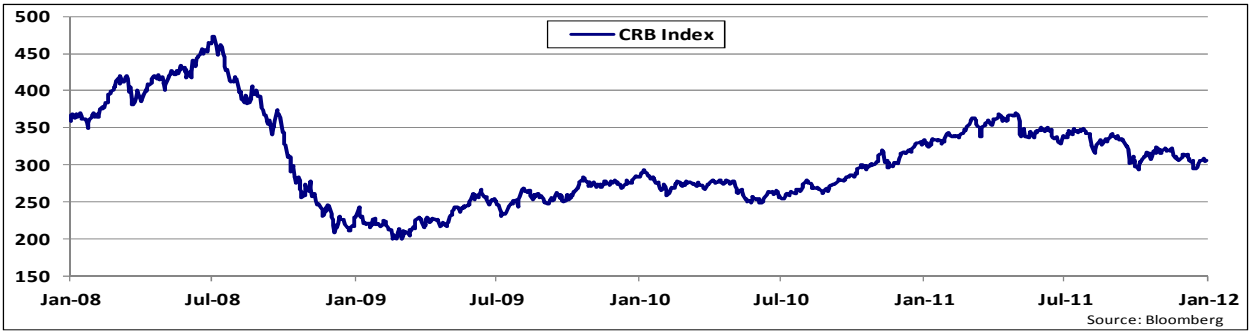
S&P 500 - MSCI Emerging Markets - Euro Stoxx 50 (2008-11)



In 2011, the ***best performing*** amongst the major equity indices, in local terms, ***were those of the United States***, with the Dow Jones Index posting a 5.5% annual gain and the S&P 500 Index ending the year unchanged. Despite the much healthier state of their economies, ***emerging markets' equities performed poorly***, with the MSCI EM Index dropping by some 17%. In Europe, all the indices ended in negative territory, but regional performances varied considerably, ranging from a decline of 52% for the Athens Stock Exchange Index, - 17% for the CAC 40 Index, - 15% for the DAX Index, - 8% for the Swiss SMI Index to - 6% for the UK FTSE 100 Index.

Commodities

CRB Index (2008-11)

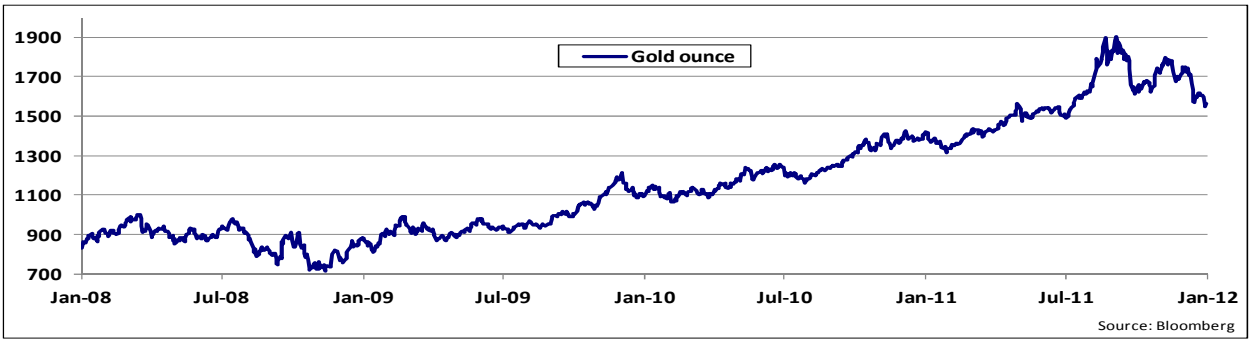


Global commodity indexes performed well until the end of April. During that period, the best performing commodities were precious metals, with silver rising by over 50%, and crude oil. The ***initial rise of oil prices*** was essentially due to ***supply concerns*** as unrest in the Middle East spread to Libya, a significant oil producer. This was compounded by the impact of a massive earthquake and hugely destructive tsunami in Japan on energy prices due to the extensive damage sustained by a vital nuclear plant in Fukushima. This disaster prompted a ***rethink of nuclear energy policy*** in many countries, adding to pressure on the prices of other power producing energies.

From the end of April onwards, the prices of most commodities started to weaken as ***concerns about global growth*** and the ***deepening of the debt crisis in Europe*** negatively impacted demand for industrial metals and oil.

The price of WTI crude oil gained 8.1% in 2011 and ended the year at a price of $ 98.80, a level well below its April year-high of $ 114, but significantly above its lowest level of $ 75.70. Despite concerns over the global economy, ***oil prices remained relatively high*** due to ***resilient growth in Asian economies*** and ***instability in producing countries*** such as Iran and Libya.

Gold price in $ (2008-11)

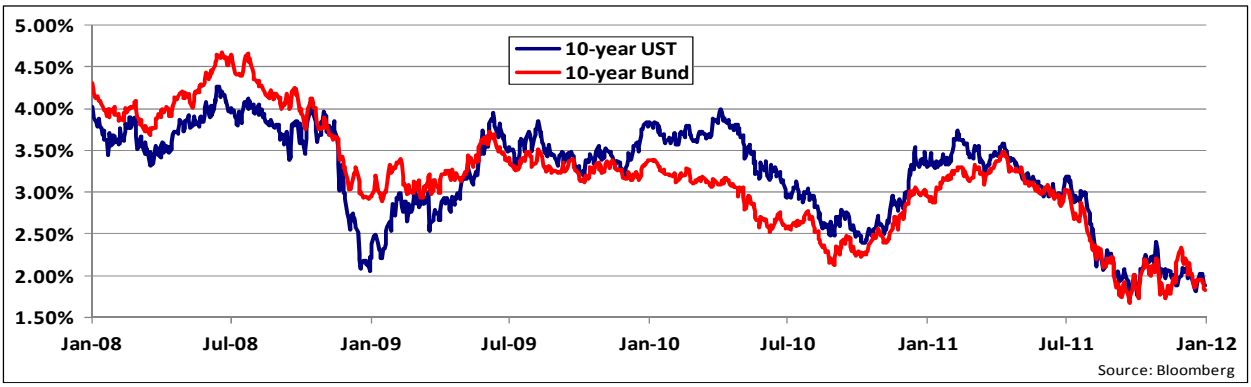


In 2011, the evolution of gold prices can be split into ***two very distinctive periods***. During the first one, lasting between January and the beginning of September, the ***price of gold appreciated*** in a virtually uninterrupted way from $ 1'421 to reach a ***year peak of $ 1'900***. The main drivers of this performance were the weaker dollar and the search for safety. From then onwards, prices started to slide and the behaviour of gold became increasingly volatile, particularly due to the ***appreciation of the dollar*** and an ***increase of the correlation with risky assets***.

Debt instruments

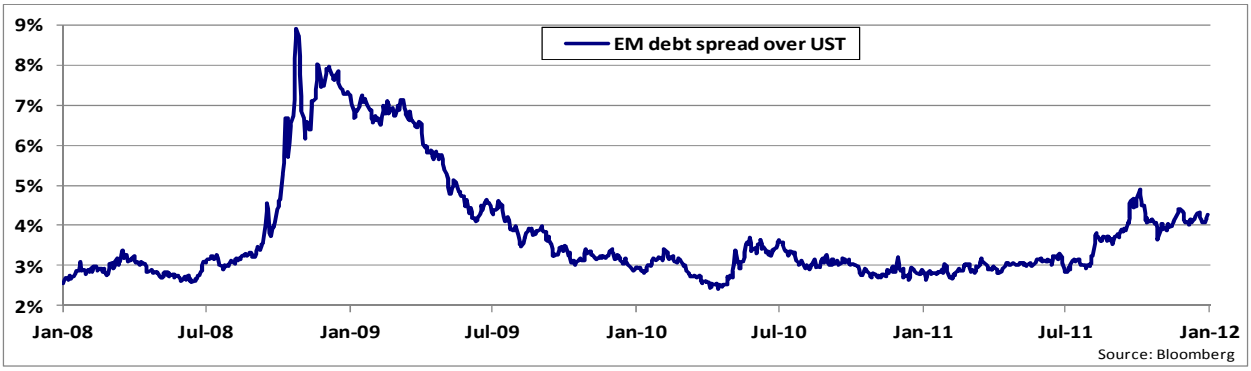
The ***bull market for G-7 government bonds extended into 2011*** as investors piled into assets considered to be the safest. The ongoing saga of the European sovereign debt crisis evolved into an even deeper crisis, as political leaders were unable to produce any real solutions during their numerous "last chance" summits. The ***little confidence shown by investors towards risk assets*** at the beginning of the year ***quickly evaporated***, leaving investment grade and high-yield bonds under huge pressure during August and September. Since then, these assets have recovered to various degrees but are still pricing in a very negative economic outlook.

10-year US and German government bond yields



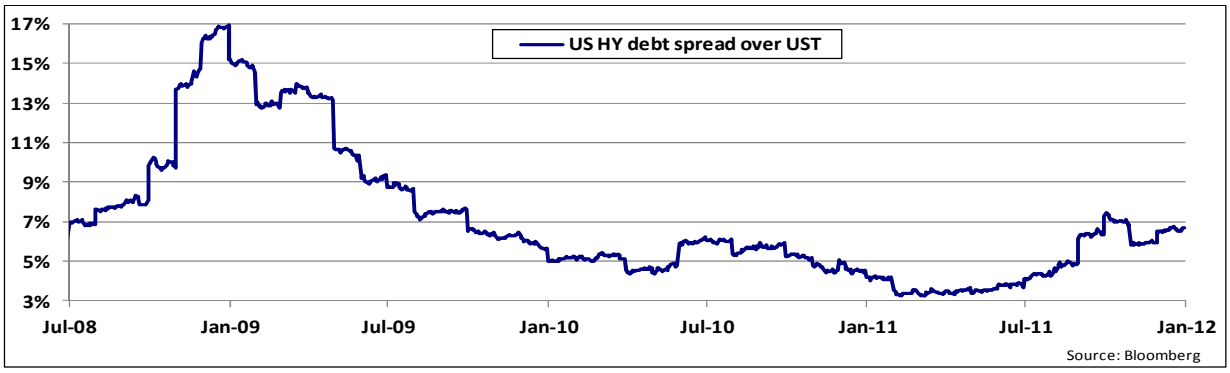
The yields on the benchmark 10-year U.S. Treasuries and German Bunds initially climbed from 3.30% and 2.97% at the end of 2010 to ***year-highs of 3.74% and 3.49%*** before regularly declining to ***year-lows of 1.72% and 1.67%*** on the 22nd of September. Since then, yields edged somewhat higher but ended the year below 2%, meaning that ***inflation-adjusted real yields were in fact negative***.

Emerging Market Debt spread (2008-11)



Since the end of 2010, the spread of emerging market debt yields over US Treasury yields (JPMorgan EMBI Global Spread Index) has widened from 2.9% to the current level of 4.3%. This ***wider spread is more due to the collapse of the yields on US Treasury bonds than weakness in demand for emerging market debt***. Strong fundamentals and the beginning of looser monetary policies by the Central Banks of emerging economies since the end of the summer have been supportive factors for this asset class.

U.S. High Yield spread (2008-11)



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, expanded from 4.2% to 6.7% in 2011. The prices of high-yield bonds were impacted by ***heavy selling during the summer*** and spreads widened significantly to reach a year-high of 7.5%. In Europe, this move was even more severe as the spread of the Itraxx Crossover index expanded by over 500 basis points from the year's lowest level (352bps in May) to 875bps, before ending the year at a level of 754bps.

The ***investment-grade credit space proved to be a resilient asset class throughout 2011***, even if credit spreads widened. This was reflected by an increase of the Itraxx Europe A to AA 5-year Index, which measures the performance of the most liquid credit default swaps for investment grade credits, from 105bps in January to 174bps at year-end, while the equivalent US Index widened from 85bps to 120bps.

Debt instruments' market performance in 2011 (USD)

World Government Bond Index	+ 6.4%
U.S. Credit AAA	+ 6.8%
U.S. Credit BBB/BB	+ 9.0%
Global Emerging Market Sovereign	+ 8.5%
U.S. High Yield	+ 5.5%

Currencies

Even though ***volatility remained high*** in the foreign-exchange markets throughout 2011, the major parities ended with ***limited year-on-year changes***. The Euro appreciated from 1.34 to 1.48 against the dollar during the first four months, before losing ground to end 2011 at a parity of 1.30, a drop of 3.1%. An even more spectacular movement was observed in the EUR/CHF parity as the ***Swiss franc climbed from a level of 1.25*** per Euro at the end of 2010 to an ***intra-day parity of 1.0*** in August. Market interventions by the Swiss National Bank contributed to stabilize the exchange rate until the Central Bank decided to set a ***1.20 floor*** on the EUR/CHF exchange rate. At year-end, the parity was of 1.22, representing a yearly decline of only 2.7%.

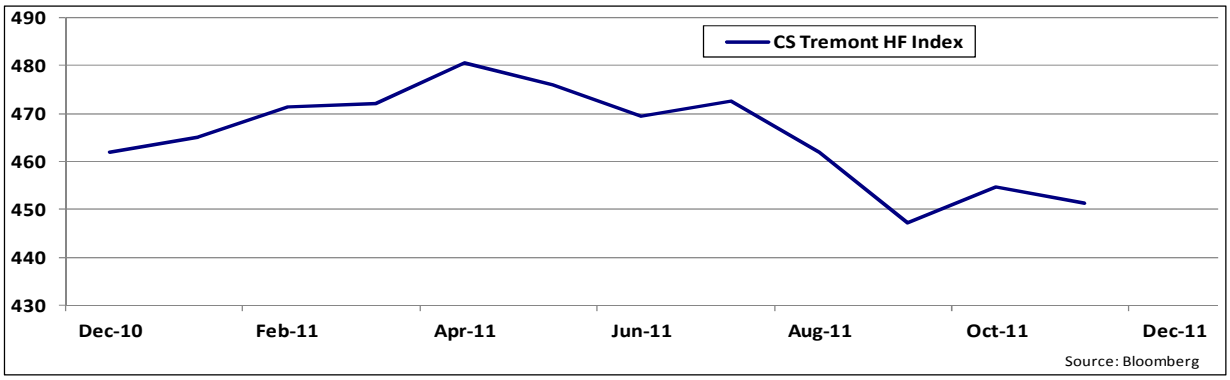
Hedge funds

2011 was a very tough year for hedge fund managers as sustained periods of high volatility and increasingly correlated assets made for a challenging investment environment. Hedge funds are on track of recording their ***second-worst year on record***, as they have been unable to cope with the ***frequent and violent reversals in the markets***, despite cutting their level of risk.

As an example of these frequent reversals, the swings between intraday highs and lows in the Dow Jones index averaged ***126 points*** until the end of July. Since then, they have averaged around ***260 points***, a clear indication of the unstable environment and low market conviction. Hedge funds have also been impacted by the ***deterioration of liquidity in the markets*** and a significant ***reduction in equity-trading volumes***, reflected by an average volume of 7.9 billion shares traded in U.S. equity markets in 2011 compared to 8.5 billion last year and 9.8 billion in 2009.

2011 will also be remembered as the year when several highly-rated hedge fund managers, with outstanding long term track records, decided to retire from the industry. The decisions of star managers such as Stanley Druckenmiller, Bruce Kovner or George Soros to retire reflect in part an increasingly frustrating regulatory and trading environment, which is largely driven by macro issues and much less based on fundamental valuations.

CS Tremont Hedge Fund Index (2011)



Hedge Fund strategies market performance in 2011 (end of November, USD)

CS Tremont Hedge Fund Index	- 2.3%
CS Tremont Hedge Fund Convertible Index	+ 0.5%
CS Tremont Hedge Fund Emerging Markets	- 6.0%
CS Tremont Hedge Fund FI Arbitrage	+ 4.3%
CS Tremont Hedge Fund Long/Short	- 6.5%
CS Tremont Hedge Fund Multi-Strategy	+ 1.7%
CS Tremont Hedge Fund Event Driven	- 8.4%
CS Tremont Hedge Fund Short Bias	+ 2.2%
CS Tremont Hedge Fund Futures	- 4.9%

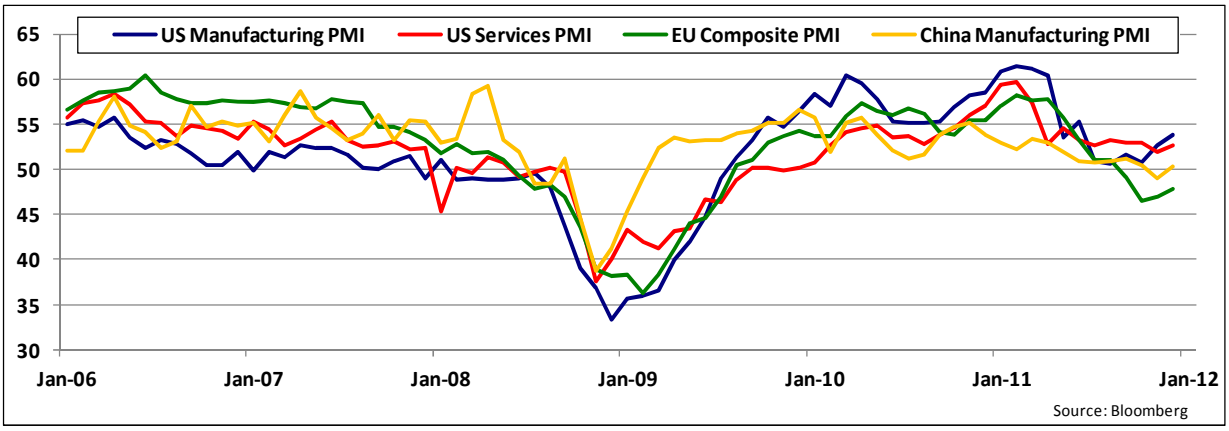
2012: ECONOMIC OUTLOOK

The story of 2011 has been one of a gradual slowdown. The year has ended with a pattern of diverging growth among the major economies and we expect this trend to persist and for the ***global economy to grow at a slower pace in 2012***. The stringent austerity measures imposed on the economies in the ***Euro zone*** will drag the region into a ***recession***, while US growth will remain below its long term potential. ***Activity in the more dynamic economies will continue to decelerate***, but we ***are not anticipating a "hard landing" in China***. Solutions to key issues such as the debilitating borrowing costs for over-indebted countries in Europe and the structural deficit of the US fiscal budget still need to be found. The resolution of these issues will not be made any easier by upcoming ***presidential elections in the United States and in France***.

The world economy is facing serious headwinds, but several factors should contribute to allay some of the surrounding risks. A ***fall in the levels of inflation*** is already beginning to come through; this should have a positive impact on household real incomes and support consumer spending. The ***strength of the corporate sector*** is another supportive factor. Companies have built up huge reserves of cash on the back of strong profits and a reduction of debt. Finally, ***monetary policies are very accommodating*** and ***interest rates are going to remain very low*** throughout the whole of 2012. The Federal Reserve has signalled there would be no changes before mid-2013, while the European Central Bank has begun to reverse rate rises and central banks in the faster growing countries are also lowering rates as inflation pressures diminish.

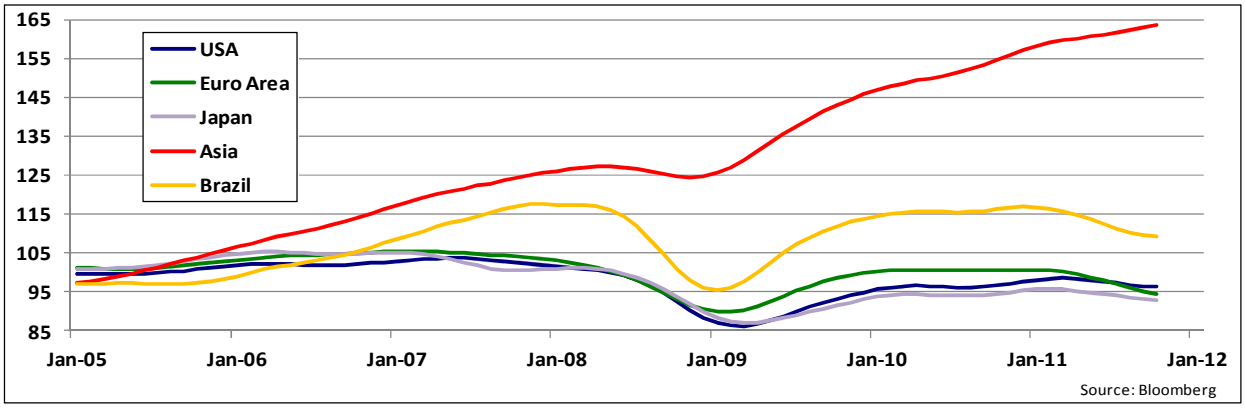
Leading economic indicators

Purchasing Manager Indexes



Purchasing Managers Indexes are showing ***weak signals*** across the different regions. The latest data in the ***U.S.*** are showing a slight improvement of the manufacturing index from its summer lows, but ***service industries***, which account for 80 percent of the economy, are expanding at the ***slowest pace since January 2010***. In ***Europe***, the services and manufacturing composite index has dropped well below 50, indicating an ***economic contraction***. Finally, ***China's manufacturing index*** has just returned above 50, indicating a ***modest expansion of activity***.

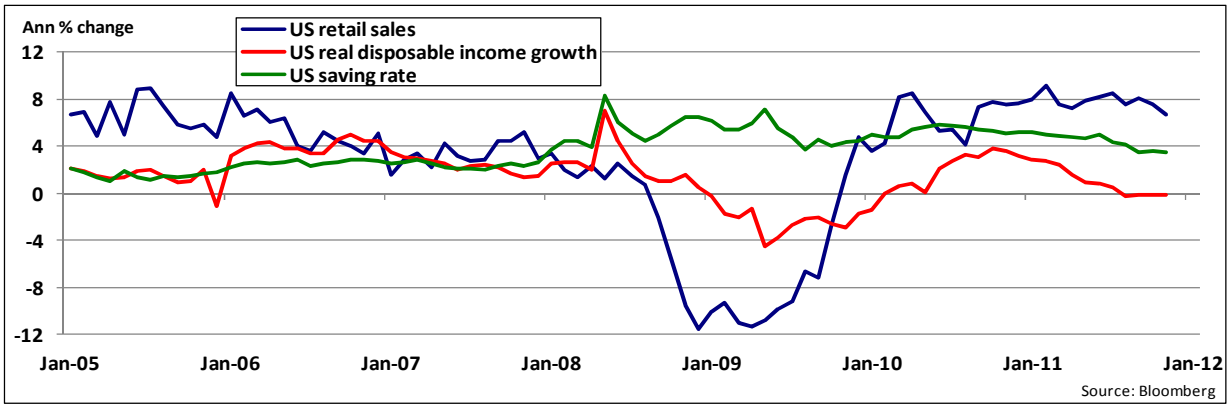
OECD Composite Leading Indicators



The chart above shows the ***divergence of economic conditions*** in the various regions. The ***resilience of Asian economies*** is reflected by a continuous rise of the region's OECD Leading Indicators throughout 2011. In contrast, the Leading Indicators for the United States, Europe, Japan and Brazil ***peaked during the first quarter of 2011*** and are signalling that the ***deceleration of economic activity is likely to persist throughout 2012***.

Consumer spending

U.S. retail sales/income growth/saving rate (year on year net change)

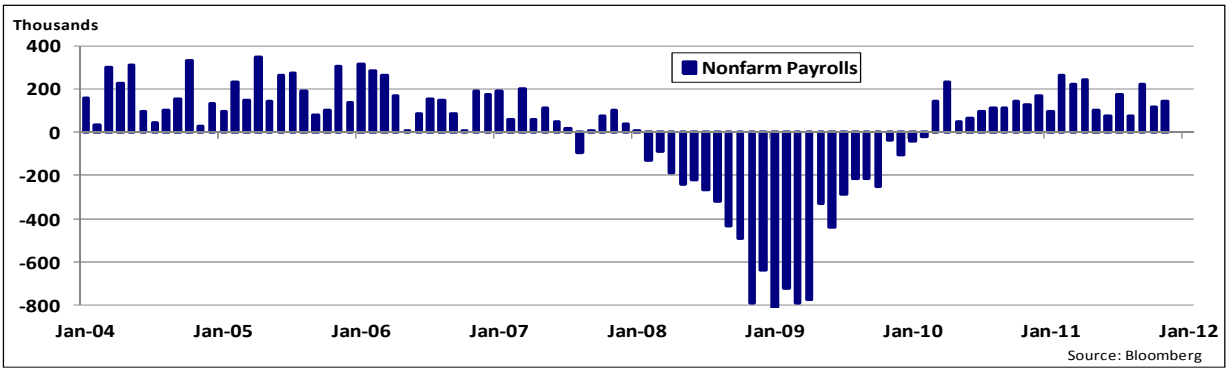


The chart above shows that ***consumer spending in the United States held up well*** during 2011, but this ***did not reflect a comparable increase of income growth***. As a result, the ***saving rate has been trending down***, falling from a high of 8.4% in May 2008 to a recent low of 3.5%. This fall in the saving rate took place despite a ***decline in household net worth***, which is contrary to the usual relationship between these series. It is likely that this is only a temporary deviation from a structural uptrend in saving as households try to repair their balance sheets. ***Ongoing consumer deleveraging will be a headwind for growth*** for some time, meaning that it will be difficult for the US economy to grow much above 2.5% in 2012.

Job markets

Overall conditions in the labour markets of the western economies ***have deteriorated*** throughout 2011. The latest numbers show that ***unemployment in the Euro zone and the UK has respectively risen*** from 10% and 7.9% at the end of 2010 to 10.3% and 8.3%. ***In the United States, the unemployment rate has decreased from 9.4% to 8.6%, but this is in good part due to people pulling out of the workforce***. At this stage, it appears premature to expect any significant improvement of job markets when taking into consideration the poor economic outlook.

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 ***slightly improved*** over the last twelve months. However, an average addition of 155'000 jobs per month in 2011 was below the 250'000 to 300'000 additional jobs per month required to regain the number of jobs lost during the economic downturn.

Conclusions

In the light of the above indicators, it is clear that the ***world economy will have to face serious challenges in the year ahead***. Developed economies are still a long way from recovery and the ***crisis in the Euro zone has deteriorated***. Additional austerity measures in the Euro zone will have a negative impact on the region's economic growth, while the western ***central banks*** are left with ***limited fiscal and monetary ammunition*** to stimulate economic activity.

The prospects of a ***recession in Europe*** and ***modest growth in the U.S.*** mean that the engine of the global economy has moved ever more decisively to large emerging economies. ***China*** accounted for more than ***40 percent of global growth in 2011***, which explains the concerns over the threat of a hard landing of the world's second largest economy. We do not anticipate this scenario as we believe that the authorities in China are well aware of the risks and will respond accordingly.

In addition to the uncertain economic outlook for 2012, one must also take account of ***important electoral considerations***. Negotiations related to the Euro zone crisis would clearly be impacted if a new President were to be elected in France, while the outcome of the US presidential election is likely to have a major influence on the behaviour of US corporations.

2012: FINANCIAL MARKETS' OUTLOOK

A year ago, the sovereign debt crisis in Europe was the most pressing issue facing the financial markets. Twelve months later, this is still the case and, unfortunately, the failure of the European political leaders to come up with a long-lasting solution has only ***increased the level of risk for investors***. Our inability to predict how the current crisis will unravel has led us to recommend a more ***cautious asset allocation*** and also adopt a more ***tactical approach***.

We expect ***volatility to remain elevated*** and, to a certain extent, act as a deterrent for investments into riskier assets. As long as markets are hanging onto the outcome of the latest "last chance" European Union summit to determine the trend of financial assets, it will be difficult to take ***rational investment decisions based on a fundamental approach*** and ***relative valuations between asset classes***. That is why we have been ***reducing the relation of returns of our portfolios to those of financial markets*** ("beta") and focusing more on ***income generating assets*** to the detriment of those dependent on growth.

It is important to stress that the recommended asset allocation takes into account the ***evolution of the portfolios' various assets*** since our mid-year review. It also reflects the ***changes*** that have already ***taken place within the portfolios during the second half of 2011***. These investment decisions have been explained in detail throughout our monthly Newsletters.

Throughout this document, we have highlighted the reasons behind our more cautious approach for the beginning of 2012. We are, however, aware that a sudden ***improvement of conditions in the European sovereign debt markets*** or the announcement of ***powerful quantitative easing measures*** by one or several central banks could immediately boost the level of confidence in the markets. This situation could lead to a ***significant change of our recommended asset allocation***.

Debt instruments' outlook

In our view, ***G-7 government bonds offer very little value*** and we will continue avoiding holding any significant exposure to this segment of the fixed-income markets, except maybe for tactical purposes. ***Investment grade bonds have become more attractive*** due to wider credit spreads, while the ongoing deleveraging keeps on strengthening already healthy corporate balance sheets. The tendency of risk-averse corporations to hold on to their cash rather than deploy it on new investment projects means that they have more money to service existing debt obligations and this reduces their need to issue new debt. We anticipate sustained demand for this asset class as we think that ***investors will target income over capital gains***. It has also to be noted that, from a historic perspective, an ***environment of low growth is supportive for credit assets***.

High-yield corporate debt, especially US, remains one of our ***favourite investment themes for 2012***. We think that the risks of a recession in the US are very remote and that forecasted growth of 2%, even if below long-term potential growth, should represent a good environment for high-yield bonds. The actual default rate in the US is below 2% and, even if this rate were to rise, we feel it is unlikely to reach the level currently discounted into prices. ***Emerging market debt is a core strategic exposure*** within our portfolios and we feel comfortable maintaining it at the same level as in 2011. This asset class should continue to be supported by the search for safe assets, demand for solid balance sheets and the anticipation of lower interest rates.

Equity outlook

Our more ***cautious outlook for equities*** in the first half of 2012 is more due to the ***uncertain macro -economic environment*** and the ***risks related to political decisions*** than to concerns over a deterioration of corporate fundamentals. Companies have, to a large extent, emerged unscathed from the financial crisis and have maintained profit margins close to peak levels. The ongoing deleveraging and cautious management of inventories have translated into ***stronger balance sheets*** and labour costs appear to be well under control. However, a deteriorating global growth outlook should, at some stage, ***negatively impact corporate earnings*** and it might prove difficult for companies to maintain their profit margins close to the current levels.

We have previously written about the potential for a reversal of the massive money flows that have been invested into the bond markets. While we do consider that bonds are expensive compared to equities, it is ***unlikely*** that we will observe ***strong asset allocation flows into equities*** and a ***re-rating of their valuations*** until the ***outlook on the Euro zone has improved***.

Another threat to the equity markets is represented by the difficulties facing the financial sector, particularly in Europe. Banks have no choice but to keep on shrinking their balance sheets as access to new capital is unavailable. There is a ***real risk of a credit crunch*** and, until this situation improves, ***banks will hoard the cash*** they have and put a halt to new loans. The effects of this sharp tightening of credit conditions are being felt far more widely than in the euro area and are inflicting ***strains on the global economy***.

Alternative investments

Alternative investments have been playing an integral part in our clients' portfolios and this will still be the case in 2012. We consider ***investments into hedge funds as a way of reducing the volatility*** of the portfolios and ***gaining exposure to niche strategies*** into which we are unable to invest directly.

The ***hedge fund industry***, in particular the funds investing into other hedge funds (FoFs), is once again ***facing serious challenges***. The managers of these Funds of Funds will have to show that they are really able to preserve capital during the most testing market conditions in order to justify the level of fees they charge or face the risk of losing investors.

Structured products are also genuine alternatives to traditional assets, especially as they do not necessarily have to rely on positive performances of the underlying assets to generate positive returns. We will continue to invest into structured products that offer ***attractive levels of income coupled with strong protection against downside risk***. A volatile and uncertain environment has a positive impact on the pricing of such structures and our opportunistic approach is designed to benefit from these kind of situations. However, it is extremely important to emphasize that the ***most important decision*** related to ***structured products*** is the ***careful selection of the issuers***, based on the quality of their credit, and not just the focus on the product's potential return.

Gold outlook

The safe haven status of gold, within the uncertain prevailing environment, has recently been put to the test. The appreciation of the dollar over the last months, added to the liquidation of consequent gold positions, have meant that the ***volatility of the precious metal has increased***, as has its ***correlation to risky assets***. Also, for the first time in over three years, the technically important 200-day moving-average has been breached. This could mean that gold might be losing some of its potential, especially if the dollar were to remain well bid.

Despite all the above, ***gold still remains an integral part of most investment portfolios***. It should be supported by an environment of ***low interest rates***, ***the potential threat of inflation*** due to additional easing measures by western Central Banks and its traditional role as an ***insurance*** against the more extreme scenarios.

Currency outlook

2011 has been another eventful year in the foreign-exchange markets. While one could simply look at the annual returns of the main parities and conclude that very little happened, this could not be further from the truth. Once again, ***unpredictable measures taken by Central Banks*** have had a major bearing on currency trends and this is ***likely to persist in the year ahead***.

The situation in Europe remains extremely uncertain and the markets will still take a lot of convincing before one can expect to observe a more supportive environment for the European currency. ***A break-up of the Euro is still not our most likely scenario*** and we believe that the European Central Bank will have to expand its balance sheet at a faster pace, an action that could trigger ***further depreciation of the Euro***.

Even if the US dollar is a structurally weak currency due to the country's twin deficits, the recent improvement of US economic data and better prospects for growth relative to the Euro zone should ***favour the dollar over the Euro in 2012***. Furthermore, at this stage, it appears less likely that the Federal Reserve will implement a new round of quantitative easing, which could have negative consequences for the dollar.

The ***Swiss franc is no longer supported by its safe haven status*** and the Swiss National Bank has made its position very clear; it will take all the measures it deems necessary to avoid any breach of the 1.20 floor it has set against the Euro. At this stage, we do not expect the markets to put the determination of the SNB to the test and anticipate the ***Euro-Franc parity to remain stable***.

Over the longer term, we remain convinced that ***emerging market currencies*** should appreciate against the major currencies, in particular due to higher levels of growth and much stronger fiscal positions. However, in the shorter term, it might prove to be ***difficult for these currencies to appreciate*** due to the European debt crisis, the slowdown of China and expectations for lower interest rates in the emerging economies.

2012: ASSET ALLOCATION

Debt instruments

- As explained previously, we have become ***more constructive towards debt instruments***. We recommend ***increasing the exposure to investment-grade credit*** as we target more income generating assets. ***High-yield bonds remain one of our favourite asset classes*** and we intend to ***slightly increase this exposure***, while the allocation to emerging market debt will remain unchanged.

- High-yield companies have continued to focus on strengthening their balance sheets. Solid corporate fundamentals, lower leverage, higher cash balances and modest debt maturities over the next year are supportive factors. Furthermore, we believe that the current market valuations are pricing in what seem like ***excessively pessimistic future default rates***.

- For the allocation to emerging market debt, our focus will remain on bonds denominated in local currencies for FX diversification purposes. The fundamental reasons for an investment into this asset class have not changed: the demand for ***sound sovereign debt*** and a bias towards ***income generating assets***.

Equities

- Over the last months, we have progressively reduced the risk in our portfolios, which is reflected by the ***recommendation of a lower allocation*** to this asset class. At this stage, we feel that the extremely ***uncertain and highly volatile market conditions*** are ***not supportive of richer valuations*** and that macro-economic and political risks are likely to keep pressure on riskier assets.

- Equity prices could suffer from a further de-rating even if ***price-to-book valuations and other ratios are close to the low levels observed in 2009***. A lower growth environment and ongoing deleveraging could mean that equities will remain range bound and one must also expect more ***downgrades to profit expectations***. In the case of additional quantitative easing, equities should perform well as they offer protection against inflation.

- Under the current conditions, we like ***high quality dividend paying stocks***. We also like the shares of ***international companies with strong brands***, especially those with ***increasing exposure to emerging markets***.

- From a regional perspective, our focus will mainly be on ***U.S. stocks*** which should benefit from better prospects for corporate profit growth and demand for assets outside the Euro zone. Following a disappointing past year, ***emerging markets equities could fare better*** in 2012 and the ***expectations of lower interest rates*** should provide support.

Commodities

- In the short term, the ***prices of commodities*** are likely to continue to be driven primarily by ***macro sentiment***. At this stage, the risks appear to be more to the downside, in particular for industrial commodities, due to **lower growth expectations**.

- From an economic perspective, slowing demand and a recovery of supplies could lead to some downward pressure on oil prices. However, this ***downside risk should be contained*** due to ongoing political instability in the Middle East region and the standoff between Israel and Iran over the latter's nuclear programmes.

- We mainly invest into commodities through equities or hedge fund strategies, but have an ongoing exposure to a ***well-balanced commodity index*** with weightings of 20% in energy, 20% in precious metals, 20% in base metals and 40% in agricultural commodities.

Gold

- We ***recommend maintaining the current 5% allocation to physical gold*** due to its defensive nature. The main reasons for investing into gold are to protect against ***monetary debasement*** and to ***insure part of the portfolios against unpredictable events***.

- Furthermore, the low or negative real interest rate environment means that there is ***no opportunity cost in holding gold***. Finally, a contraction of the major central banks' balance sheets appears most unlikely. To the contrary, there is a ***mounting risk of Euro zone debt being monetized***, which should turn out to be supportive for the price of gold.

Hedge funds

- During most of 2011, hedge funds of funds struggled to cope with the volatile conditions and the frequent changes of trends in the financial markets. Their returns turned out to be ***more closely correlated*** with those of the other assets in our portfolios, even if their levels of volatility were much lower. We still consider that these alternative investments should play a key role, but they have to represent a ***genuine hedge*** to the remainder of the portfolios.

- In the prevailing market conditions, ***defensive strategies*** such as arbitrage trading and flexible ones such as short-term trading should have a prominent role. Systematic strategies based on trends and momentum such as Commodity Trading Advisors (CTAs) should also add diversification and bring protection to the portfolios.

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, debt instruments 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.

- ***Structured products are classified within the most relevant asset classes*** at any defined moment. This allows us to better analyze the overall levels of risk of each asset class than if structured products were classified separately. Structured products are, by nature, hybrid instruments and the evolution of their different components will determine whether it becomes necessary to ***reclassify*** a particular structured product into a different asset class.

ASSET ALLOCATION GRID 2012

For our balanced accounts, we recommend the following grid:

	Allocation	January 2012
Short-term deposits	**0 – 20%**	**7%**
Debt instruments	**15 – 40%**	**36%**
Investment grade bonds	5 – 30%	15%
EM & high-yield bonds	5 – 20%	11%
Specialist bonds	5 – 15%	10%
Equities	**20 – 50%**	**35%**
Developed markets	10 – 30%	25%
Emerging markets	10 – 30%	10%
Commodities	**0 – 15%**	**7%**
Physical gold	0 – 5%	5%
Other commodities	0 – 10%	2%
Hedge funds	**10 – 30%**	**15%**
		100%

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