Forum Finance Group
since 1994

January 2014

Investment Perspectives 2014

INVESTMENT PERSPECTIVES 2014

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EXECUTIVE SUMMARY

- In Europe, ***the levels of stress have continued to abate*** and political events had a lower impact on financial markets than during the previous years. The ***spreads of peripheral sovereign debt continued to decline*** and ***European equities were much in demand*** over the course of the year. The main central banks confirmed their positions as being the ***most influential drivers of the markets***; in May, the talk of tapering by the Federal Reserve had a significant effect on bond yields and emerging market assets. In October, the ***ECB decided to cut its refinancing rate*** following an unexpected drop of inflation.

- In 2013, the financial markets were characterized by a ***large divergence of performances across asset classes***. The ***best performing assets were the equities of the advanced economies***, while emerging market equities lagged. It was a difficult year for fixed-income assets, with ***many market segments recording negative returns***, in particular emerging market debt; in contrast, ***high-yield bonds performed well***. The prices of most commodities ended the year lower, with ***gold losing more than a quarter of its value***.

- ***Global economic growth is expected to improve in 2014 led by advanced economies***. The headwinds represented by fiscal drags in the US and in Europe will dissipate and a higher level of economic activity should be supported by a ***certain degree of re-synchronization of growth*** across the different regions, including the Euro zone. The main risks are represented by the upcoming changes to the Federal Reserve's monetary policy, the fragility of the Euro zone recovery and the implementation of structural reforms in emerging economies.

- ***Monetary policies will remain very accommodative*** in the developed economies even if they will start to diverge as ***the Federal Reserve begins to reduce the size of its asset purchase program***. However, this change of policy does not represent a tightening of financial conditions but a ***normalization of interest rates*** in the context of more supportive economic conditions; the ***Fed will maintain short-term interest rates close to zero in 2014***. In contrast to the Fed, the ***European Central Bank maintains a bias to an easier monetary policy*** to contain the threat of low inflation and support the nascent recovery.

- At this stage, we will not be making major changes in terms of asset allocation, as ***we recommend maintaining the current overweight into equities*** and continue to trim our exposure to debt instruments with unrewarding characteristics.

- The allocation to investment grade bonds should decrease further but, for Euro based portfolios, we will be holding our core position in a fund investing into ***Euro-denominated investment grade credit with an active hedging of duration risk***. ***Conditions remain supportive for high-yield bonds*** as there is still room for some spread compression and as most technical factors are positive.

- The ***reduction of tail risks*** and the ***rich valuations of the safest debt instruments*** make equities the most attractive asset class. From a regional perspective, our ***allocation will continue to focus on developed markets*** despite the lower valuations of emerging market equities. Within emerging markets, we favour Asian equities over Latin American ones and maintain our current exposures to ***Chinese and to Asian equities***.

2013: REVIEW OF OUR INVESTMENT THEMES

- At the beginning of 2013, we recommended to adopt a more ***dynamic asset allocation*** based on an improving macro environment, receding tail risks and an improvement of market sentiment. We also emphasized the issues faced by investors that had an over-weight allocation to debt instruments. Our decision ***to exclude investing into any G-7 government bonds*** and to ***underweight the allocation to investment grade credit*** was vindicated by the ***rise of long-term yields*** that took place from May onwards. ***Our clear preference for high-yield corporate debt*** proved to be a rewarding trade, while our ***emerging market debt position denominated in local currencies was negatively impacted*** by the talk of Federal Reserve tapering.

- Our ***positive outlook on equities*** and our ***belief that the asset class would benefit from inflows*** led us to be overweight. Our ***preference for developed markets over emerging markets*** was the right stance, even if we did not anticipate such an outperformance of US equities, considering that their valuations were more expensive than those of European stocks. ***Chinese equities failed to produce a positive contribution*** while, once again, ***the performance of gold mining equities turned out to be extremely disappointing*** and detrimental to the performance of our portfolios.

- 2013 was a more encouraging year for the hedge fund industry. A certain degree of ***economic normalization*** and the ***greater importance of company fundamentals have improved the environment for hedge funds*** and contributed to a higher level of risk taking. Most of our hedge fund positions generated positive contributions and brought diversification to the portfolios. ***Market conditions were not very supportive for structured products***, mainly due to ***a regime of low volatility***, explaining our very limited activity within this space during the past year.

- Our core ***allocation to physical gold was reduced during the year*** as the prospect of higher real interest rates added to the various factors already negatively influencing the price of the precious metal.

- ***Global commodities*** produced negative returns in 2013. We had expressed our ***muted outlook for the asset class*** at the beginning of the year and initially ***been heavily underweight***. Our commodity exposure through a certificate on a global commodity index was sold during the second quarter, leaving us with ***no allocation to commodities*** (excluding gold for some portfolios) ***for the remainder of 2013***.

- With the exception of a depreciating yen, the parities of most of the major currencies ended 2013 with limited variations. This was in line with our expectations as our assessment was that ***the prospects for big surprises appeared limited***. As expected, ***the Swiss National Bank maintained the 1.20 Euro-Franc floor*** without having to expand its balance sheet. The major trend in the FX markets was the ***severe decline of several emerging market currencies***, mainly due to deteriorating current account balances and the prospect of FED tapering.

2013: ECONOMIC DEVELOPMENTS

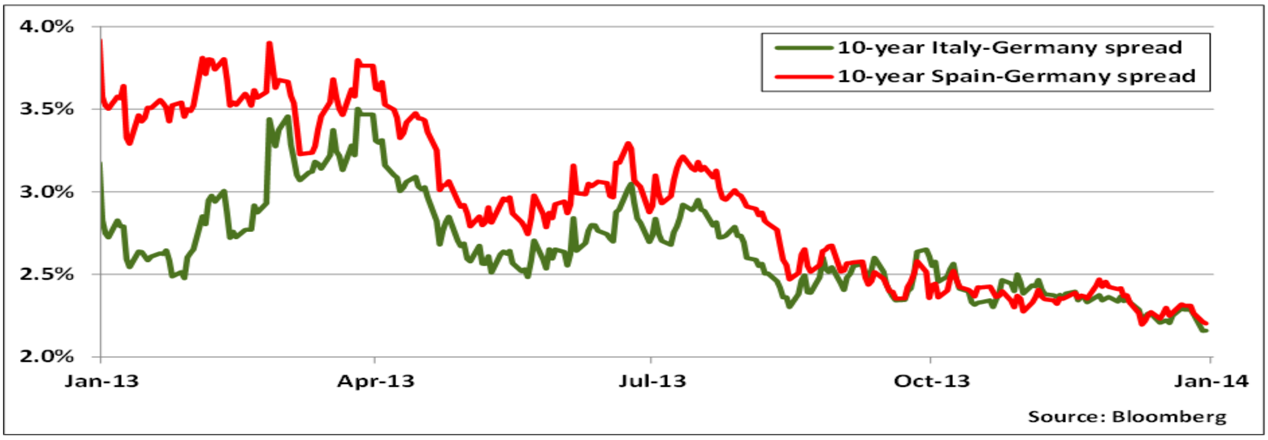
Improving financial conditions in the Euro zone

Throughout 2013, a certain degree of ***stability was gradually re-established in the financial markets of the Euro zone*** after a volatile first quarter. General elections in Italy that took place at the end of February failed to produce a clear result; this outcome triggered ***wider spreads on European peripheral debt*** and added to the downside pressure on the Euro. Additional political risk in the region came in the shape of a ***bailout request from Cyprus*** for its banking sector. For the first time since the beginning of the sovereign debt crisis, ***the EUR 10 billion agreement*** reached by the Troika (IMF, ECB and the European Commission) and the Cypriot government ***included a "bail-in" of depositors who had deposits of over EUR 100'000***.

From then onwards, market sentiment turned more positive on the back of ***improving economic conditions in the Euro zone***; rising consumer confidence and purchasing managers' indexes above the level of 50, indicative of an expansion of activity, contributed to the view that the ***region was returning to modest growth***. Another encouraging sign for the region was ***Ireland's formal exit from the bailout program*** funded by the International Monetary Fund and the European Union. If all goes to plan, Ireland will no longer receive any financial assistance and will be able to ***borrow in the financial markets at an affordable cost***; the yield on Ireland's 10-year sovereign debt ended 2013 at 3.5%, well below the yields on equivalent Italian and Spanish debt.

Finally, European Union finance ministers recently reached an agreement on ***how to deal with failing banks***. They pledged to create a ***55 billion-euro industry-financed resolution fund*** over the next 10 years, to ***back an agency to make decisions on handling failing banks*** and to agree on ***cost -sharing procedures***. This plan is now to be discussed by the European Parliament. **The European banking sector remains an area of concern** as many banks are still recovering from the crisis and adjusting to new capital requirements and regimes; ***bank credit growth has been inexistent*** in the Euro zone, due to both excess capacity in the economy and supply constraints.

European sovereign debt spreads



The chart above shows the ***contraction of 10-year Italian and Spanish sovereign debt spreads*** over 10-year German Bunds from the end of March onwards. Compared to the end of 2012, these spreads respectively contracted by 98 bps and 173 bps, signalling a much ***improved sentiment in the Euro zone bond markets*** and ***more affordable refinancing costs*** for peripheral countries.

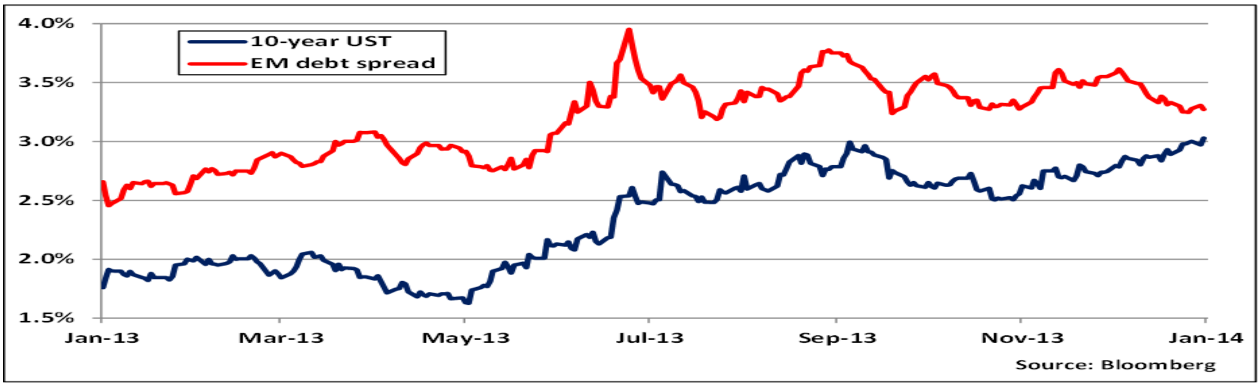
The Federal Reserve's shift of policy

The overwhelming influence of the Federal Reserve's monetary policy on financial markets was highlighted by two key events in 2013. Following years of extremely accommodative monetary policies, the ***Federal Reserve announced in May that it was approaching the time when it would start scaling back the size of its bond-buying program***. The effects of this unexpected message were very detrimental to the values of certain assets.

Following this shock announcement, the central bank's members spent months trying to convince the markets that ***a tapering of the pace of asset buying was not a tightening of its policy***. On December 18, they reached this objective after announcing that the bank would ***reduce its monthly asset buying by $10 billion*** in January 2014 and committed to ***keep interest rates at record lows***, likely beyond the point at which unemployment reaches its 6.5 percent threshold.

Markets reacted very positively to this decision; the shift of the Federal Reserve's policy towards a gradual decrease of its support reflects a ***higher level of confidence in the recovery of the US economy*** and the first step to get policy back to a more normal direction.

The impact of tapering talk on financial assets



The initial mention of tapering by Ben Bernanke in May triggered a ***correction of the prices of most financial assets***. As shown above, the uncertainty over the effects of a scaling back of the Fed's massive monetary stimulus pushed ***bond yields higher*** and sparked ***outflows from emerging markets assets***. By contrast, the decision announced in December triggered only ***very limited rises of bond yields*** and a ***rally of global equities' prices***.

The expansive policies in Japan

Japan has been experiencing a ***radical change of monetary and fiscal policy*** since Shinzo Abe became Prime Minister after the LDP's victory in the December 2012 general election. Abe's policy has been based on a ***three-pronged approach***: an ***annual $670 billion expansion of the monetary base***, a ***boost of government spending*** and ***structural reforms*** to make Japanese businesses more competitive.

So far, the main effects of these policies have been a ***significant depreciation of the yen***, a strong ***rally of equities***, ***improved corporate profitability*** and ***an end to 15 years of deflation***. The Bank of Japan will extend its unprecedented easing in 2014 as it targets an inflation rate of 2%.

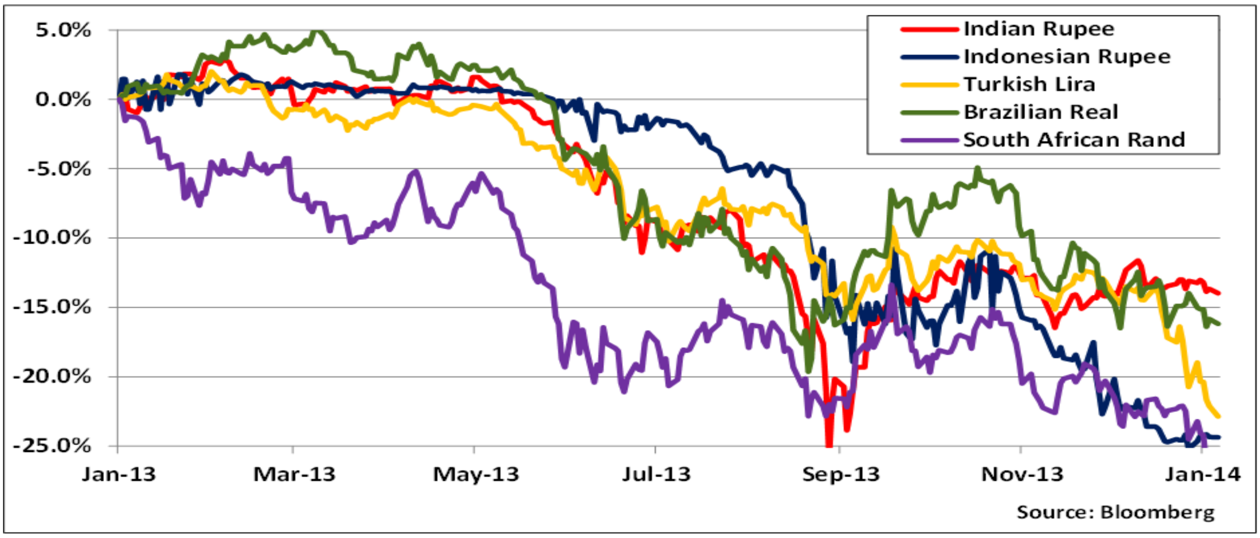
A challenging year for the BRIC economies

In contrast to older economies which have benefited from improving economic developments during the past year, ***the BRIC*** (Brazil, Russia, India & China) ***economies have had to face an increasing number of challenges***. A ***lack of structural reforms*** and the ***struggle to transit to a model less reliant on external demand*** have contributed to a mix of slower economic growth, financial stress, inflation and severe currency depreciation.

For example, Brazil's economy has been hurt by weaker iron ore prices due to lower demand from China. The country's ***failure to invest enough into highways and ports*** during the years of high growth has also driven up freight costs and resulted in long delays of loading times for exports such as soybeans; this situation has even led to large foreign orders being cancelled. Meanwhile, ***Brazil's central bank has been fighting against rising inflation*** due to the decline of its currency and a widening budget deficit; ***the benchmark Selic rate has been raised by 275bps*** since April 2013 to a rate of 10%. All these issues have significantly impacted the pace of economic growth, which stood at a ***modest 2.2% year-on-year rate*** for the third quarter of 2013.

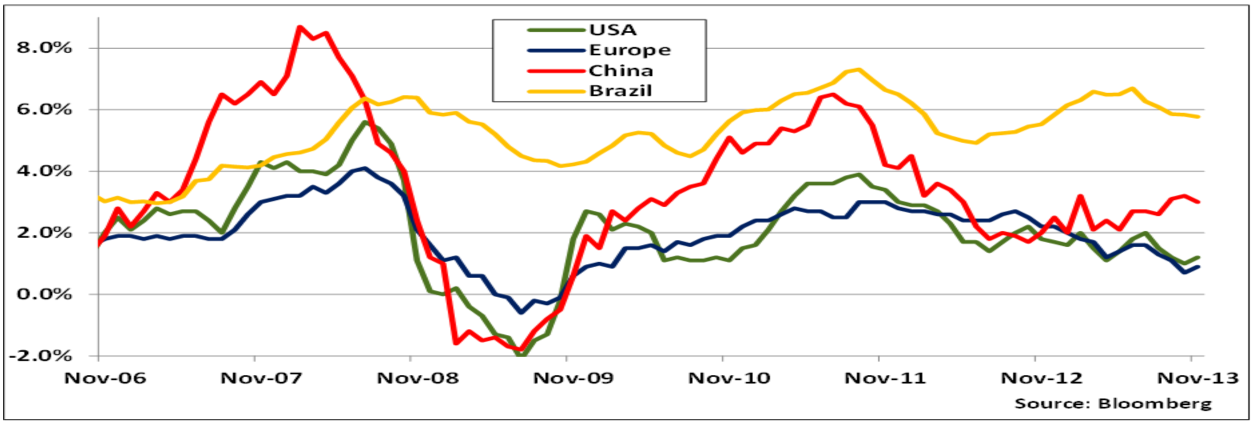
The problems facing the Chinese economy are of a different nature; the yuan continues its ascension while inflation at 3% remains under control and well below the official target rate of 3.5%. One of the main concerns for the Chinese economy has been the combination of a ***declining structural growth rate*** with a ***significant accumulation of private and public sector leverage***. This excessive increase in credit extension and the misallocation of capital are some of the key issues that the Chinese authorities have targeted in their third plenum reform agenda. The main objectives of the new policy approach are to achieve a ***more balanced growth model*** over time and to ***reform the financial system*** so that ***risk can be priced much more effectively***.

The depreciation of the « fragile five » currencies



The assets of emerging economies had to face difficult market conditions throughout 2013; the chart above shows the ***depreciation***, in dollar terms, ***of the currencies of India, Indonesia, Turkey, Brazil and South Africa***, labelled the "fragile five". These economies proved to be particularly vulnerable due to their ***large current account deficits*** and a ***lack of domestic reforms***.

Inflation across the world (2006-2013)



Inflation rates in the United States and in Europe have fallen to levels well ***below the 2 percent target of their central banks***. For that reason, the European Central Bank decided to cut its refinancing rate to a record low of 0.25 percent after an ***unexpected drop in euro zone inflation to 0.7 percent*** in October. ***Inflation around the world will stay tame***, except in some emerging economies hit by higher prices of imported goods due to their weaker currencies.

Conclusions

The past year was challenging for the larger emerging economies and the ***implementation of in-depth structural reforms will take time***, meaning that they are unlikely to benefit from any significant pick-up of growth in 2014. For certain countries, the deterioration of their current accounts will continue to weigh on the value of their currencies. On a more positive note, exporting countries will profit from ***stronger demand from the US and Europe***.

Even if the Federal Reserve has announced that it will start reducing the size of its asset purchase programme at the beginning of 2014, ***the monetary policies of the major central banks remain accommodative*** with ***short-term interest rates to be kept at levels close to zero in 2014***. This stance is supported by the distinct ***absence of inflationary pressures*** and ***unemployment that remains at elevated levels***, particularly in the Euro zone. In the US, the recent announcements by the Federal Reserve have been well received by the markets and ***reduced the concerns over potential policy mistakes***. In contrast to the Federal Reserve, ***the European Central Bank might need to expand its balance sheet*** and provide additional liquidity to support the fragile recovery.

The levels of stress in European financial markets have continued to decline, reflected by much ***tighter spreads for the sovereign debt of peripheral countries*** and ***strong demand for European equities***. The risks of a flare-up of the debt crisis have not totally disappeared, but ***steady progress continues to be made*** and an agreement over how to handle failing banks would represent another important step forward. In conclusion, ***financial and economic conditions have generally improved for the most developed economies in 2013*** and ***this positive trend should extend into the year ahead***.

2013: THE FINANCIAL MARKETS

The change of financial market regimes

In contrast to the previous year, ***2013 turned out to be much more discriminating*** in terms of the returns recorded by the different asset classes and across the different regions. This outcome is in part due to risk-on/risk-off market regimes progressively giving way to an environment where investors focus more on the fundamentals at a micro level. However, the ***most influential driver of price movements***, in particular for debt instruments, ***was the Federal Reserve's announcement in May that it was considering reducing the size of its purchases of financial assets***.

2013 performances

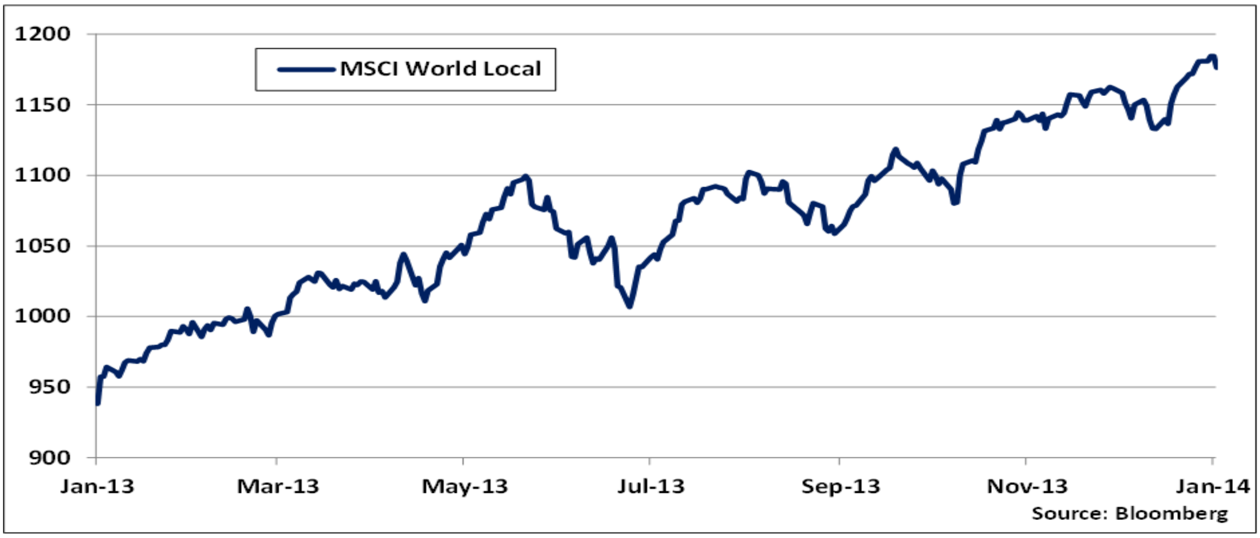
	End 2012	End 2013	2013 performance
Equities			
S&P 500	1426.2	1848.4	+ 29.6%
Euro Stoxx 50	2635.9	3109.0	+ 18.0%
MSCI EM	1055.2	1002.7	- 5.0%
Yields			
UST 10-year	1.76%	3.03%	+ 127bps
Bund 10-year	1.32%	1.93%	+ 61bps
BBB EU	2.98%	3.42%	+ 44bps
Currencies			
EUR/USD	1.319	1.374	+ 4.2%
USD/CHF	0.915	0.893	- 2.4%
GBP/USD	1.626	1.656	+ 1.9%
USD/JPY	86.75	105.3	+ 21.4%
EUR/CHF	1.208	1.227	+ 1.6%
Commodities			
CRB Index	295.0	280.2	- 5.0%
Oil, WTI	$ 91.8	$ 98.4	+ 7.2%
Gold	$ 1675	$ 1206	- 28.0%

Equities

When looking back at the behaviour of global equity indexes during the past year, ***one could be tempted to conclude that it was an easy year for equity investors***. However, the strong performance of these global indexes conceals the ***wide range of regional market returns***. The countries with the largest weightings (US 54% & Japan 9%) produced the strongest returns, thus ***skewing the performance of the global indexes to the upside***.

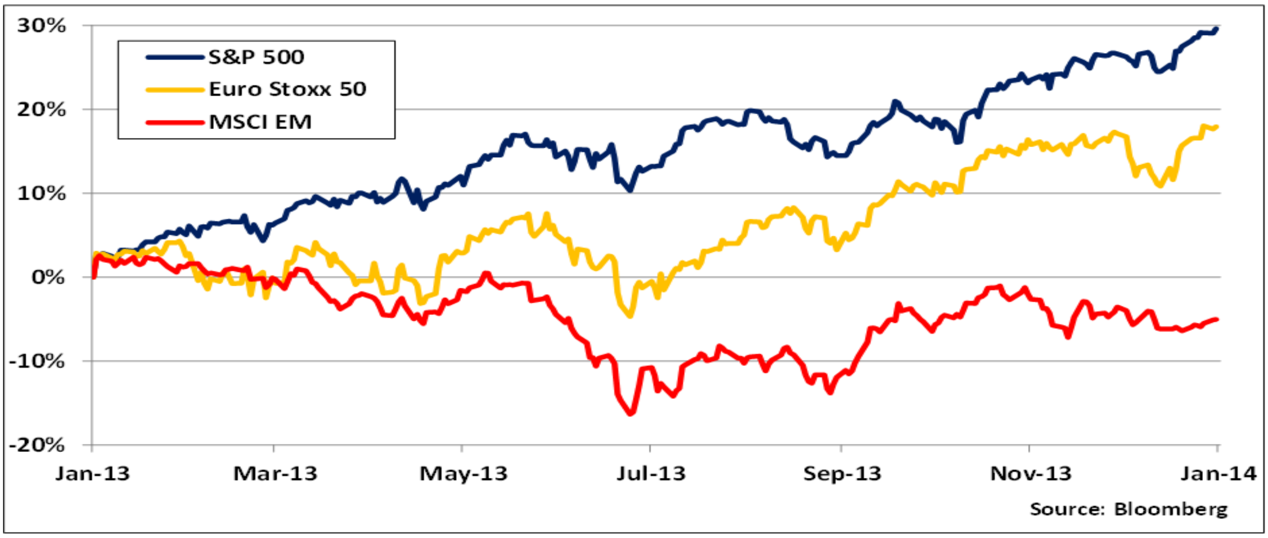
The ***volatility of equity markets remained well below its long-term average*** and the largest drawdown for the MSCI World Index was inferior to 10%; this correction was triggered by the unexpected ***talk of FED tapering at the end of May which impacted emerging markets the most*** at a time when they were already lagging. Overall, ***equity markets proved to be very resilient to political risks*** in Europe and in the US in comparison to the previous years.

MSCI World Local



The global equities index in local currency terms recorded a 26.2% gain in 2013 due to a strong performance from the end of June onwards. From a regional perspective, ***US equities continued to outperform European ones***, while many emerging markets struggled to produce positive returns.

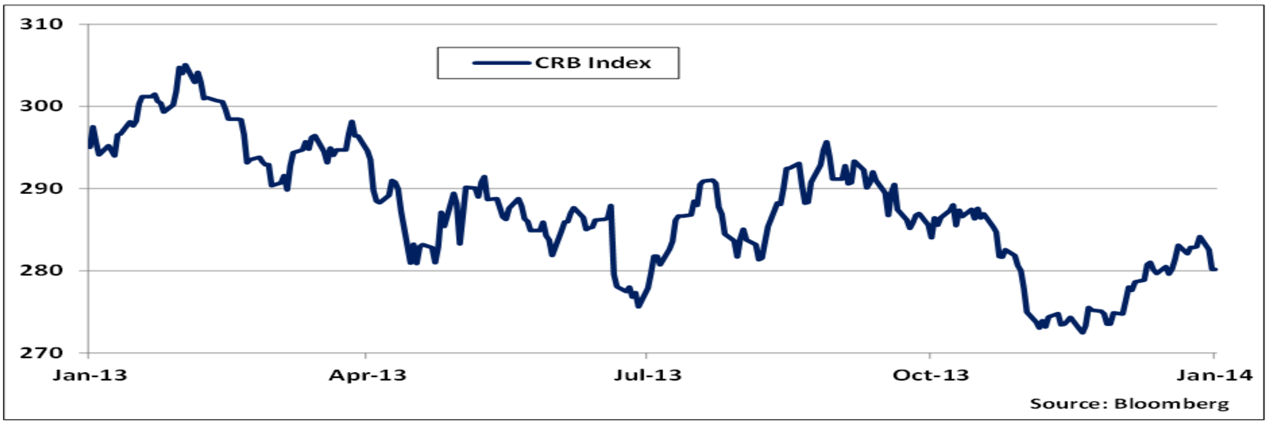
S&P 500 - MSCI Emerging Markets - Euro Stoxx 50



As already mentioned, ***the performances of the major equity indices***, in local terms, ***turned out to very heterogeneous.*** The highest return was produced by Japanese equities, with a ***51.5% gain for the Topix***, while US equities also performed well as ***the S&P 500 climbed by 29.6%***. In Europe, all the indices ended in positive territory; out of the major European indices, the best performance was recorded by the German DAX Index, up by 25.5%, while the UK FTSE 100 Index and the Italian MIB Index produced smaller respective gains of 14.4% and 16.6%. Global emerging equity markets had a disappointing year, reflected by a ***5% drop for the MSCI EM Index***. Once again, the ***Chinese equity market underperformed***, with a 6.8% decline for the Shanghai Composite Index.

Commodities

CRB Index

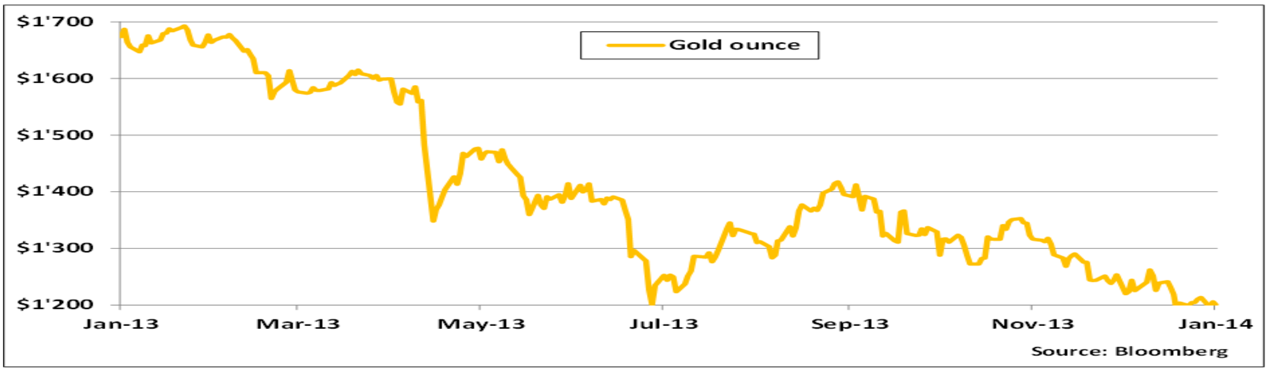


Global commodity indexes recorded negative performances in 2013. Following an initial rise, the ***prices of most commodities dropped sharply during the second quarter.*** The ***impact of slowing emerging market growth was felt on commodity prices***, in particular those of metals. The fall in metal prices can also be explained by a ***continuing rise in metals mine supply*** from large investments in recent years and some signs of a ***slowing real estate sector in China***.

The price of oil held up well on a year-to-year basis but volatility was quite high, reflected by the steep drop of the price of WTI oil during the last quarter due to a glut of supplies.

The prices of many commodities have been capped by high levels of supplies and by ***extremely low rates of inflation*** in the developed economies. These conditions are unlikely to change much in the near term, hence the rather muted expectations for the asset class in 2014.

Gold

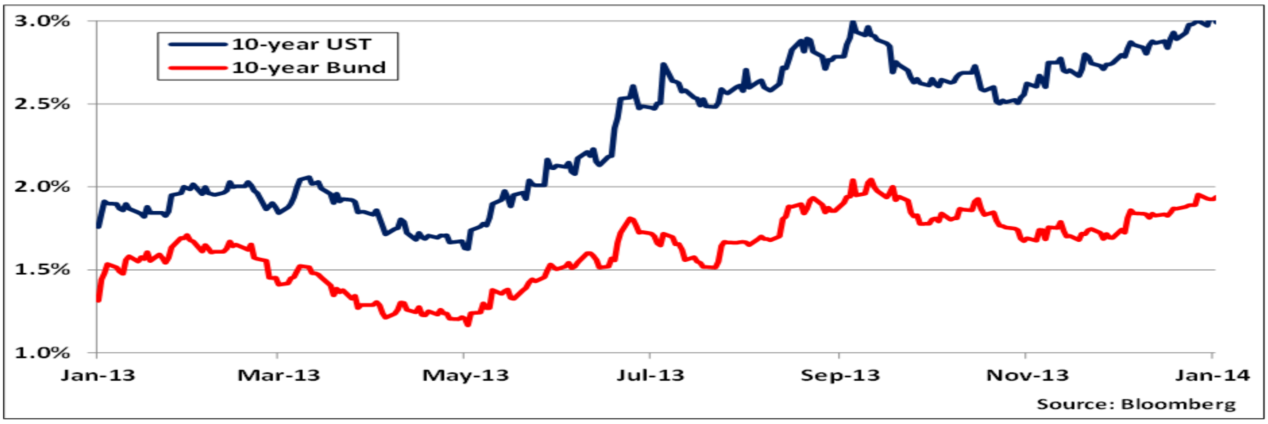


The price of gold depreciated by 28% in 2013 as ***the precious metal recorded its first annual loss since 2000***. The steep drop of the price of gold was due to the ***unwinding of "short-term" speculative index-tracking exposures*** taking precedent over the "***long-term" buying of physical gold in Asia***. ***Holdings in the SPDR Gold Trust***, the biggest exchange-traded product backed by bullion, ***contracted by close to 40 percent*** in 2013 (the equivalent of 517 tons). More recently, the prospects of a reduction of the Federal Reserve's quantitative easing policies and the ***rise of real interest rates*** have added further pressure on the price of gold.

Debt instruments

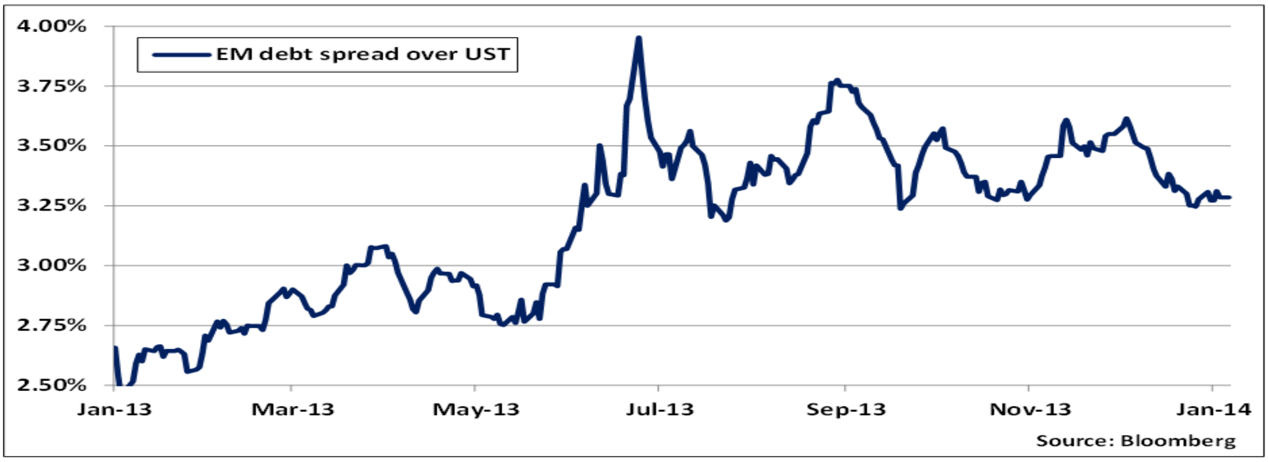
2013 is likely to be remembered as the year when the ***long-term bull market for G-7 government bonds finally ended.*** 10-year yields were drifting lower until May when the markets were shook out of their torpor. During his testimony to the US Congress, the Federal Reserve Chairman Ben Bernanke said that ***the central bank could consider reducing its purchases*** within "the next few meetings" if a sustained improvement in the labour market was to be observed. The impact of this announcement was for ***yields to rise steeply and for credit spreads to widen***; even if Fed members attempted to talk down the likelihood of an immediate change to the Fed's policy, new trends within the bond markets had clearly been established.

10-year US and German government bond yields



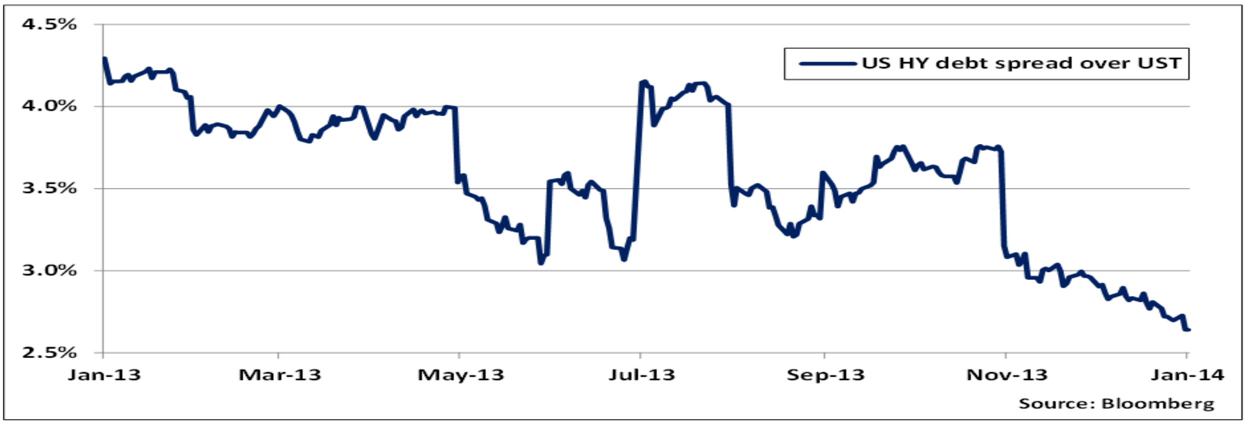
The yields on the benchmark 10-year U.S. Treasuries and German Bunds initially dropped from 1.76% and 1.32% at the end of 2012 to ***year-lows of 1.63% and 1.17%*** in May; from then onwards ***these trends have clearly been reversed*** as the Federal Reserve moves closer to start scaling back its monetary stimulus; ***the respective 10-year yields ended 2013 at 3.03% and 1.93%***.

Emerging Market Debt spread



During the past year, ***the spread of emerging market debt yields over U.S. Treasury yields*** (JPMorgan EMBI Global Spread Index) ***has widened from 2.7% to the current level of 3.3%*** after having reached a year-high of 3.9% in June. This wider spread is the consequence of ***important outflows from all emerging market assets*** during the summer months.

U.S. High Yield spread



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, ***narrowed from 4.3% to 2.6% in 2013***. The prices of high-yield bonds were impacted by the ***talk of Fed tapering during the second quarter*** and spreads widened significantly from 3% to 4.1%. In Europe, this move was even more pronounced as the spread of the Itraxx Crossover index increased by 162 basis points from 367 bps in May to 529bps, before ending the year at a much tighter level of 286bps.

The ***investment-grade credit space was negatively impacted by the rising interest rates*** even though credit spreads continued to tighten. This was reflected by a decrease 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 117bps in January to 70bps at year-end, while the equivalent US Index tightened from 95bps to 62bps.

Debt instruments' market performance in 2013 (USD)

World Government Bond Index	- 4.0%
U.S. Credit AAA	- 1.6%
U.S. Credit BBB/BB	- 2.6%
Global Emerging Market Sovereign	- 6.2%
U.S. High Yield	+ 7.2%

Currencies

The main trends observed in the foreign-exchange markets throughout 2013 were for ***commodity -related currencies and those of emerging markets to depreciate*** quite significantly against the currencies of the developed nations. Amongst the majors, ***the dollar ended the year 4.2% lower against the Euro*** and ***appreciated by more than 21% against the Japanese yen***, due to the aggressive monetary policy of the Bank of Japan to create inflation and boost exports. The EUR-CHF parity remained within a relatively tight range (1.208/1.258) as the Swiss National Bank reaffirmed its policy of ***capping any appreciation of the Swiss franc beyond 1.20 per Euro*** despite signs of overheating in the domestic economy.

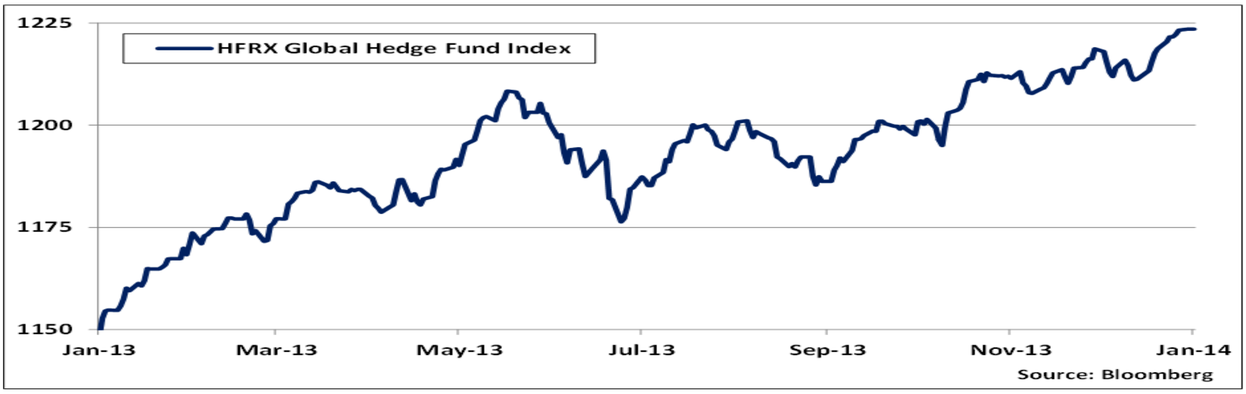
Hedge funds

2013 was an encouraging year for the hedge fund industry. Most strategies produced positive returns and, according to HFR, investors allocated ***$53 billion of net new capital to hedge funds*** in the first nine months of the year, compared with $34 billion for the whole of 2012. While the average returns of hedge fund strategies ***have lagged those recorded by global equity indexes,*** it is also important to take account of the ***lower levels of risk*** that they have used to generate returns. ***Long/short equity*** and ***event-driven*** strategies have performed well on the back of a ***decreasing correlation*** within equity markets as well as a ***higher level of corporate activity***.

Systematic and global macro strategies have continued to struggle to produce attractive returns. CTA and trend-following strategies were heavily impacted by the ***reversal of the big upward trend for bonds and short-term interest rates*** in May. In contrast to other hedge fund strategies, systematic/CTAs and commodity-focused ones have suffered from net outflows in 2013.

The global economic conditions are likely to change significantly in the years ahead. Higher real interest rates, decreasing intervention by central banks, higher volatility and lower correlation between assets should provide a ***more supportive backdrop for hedge funds*** and improve their chances of ***outperforming traditional asset classes***, in particular the fixed-income asset class.

HFRX Global Hedge Fund Index



Hedge Fund strategies' performances in 2013 (end of November, USD)

HFRX Global Hedge Fund Index	**+ 6.1%**
HFRX RV FI Convertible Arbitrage Index	**+ 9.2%**
HFRX Multi-Emerging Markets Index	**+ 7.4%**
HFRX RV FI Corporate Index	**+ 6.0%**
HFRX Equity Hedge Index	**+ 9.8%**
HFRX Macro Multi-Strategy Index	**+ 3.3%**
HFRX Event Driven Index	**+ 13.5%**
HFRX Equity Hedge Short Bias Index	**- 9.9%**
HFRX Macro Systematic Diversified CTA Index	**- 1.8%**

2014: ECONOMIC OUTLOOK

The global economy has been showing signs of improvement over the last quarters. We expect this positive trend to continue and for ***global growth to increase in 2014***. One of the more encouraging aspects of this outlook is that a higher level of economic activity should be supported by a ***certain degree of re-synchronization of growth*** across the different regions.

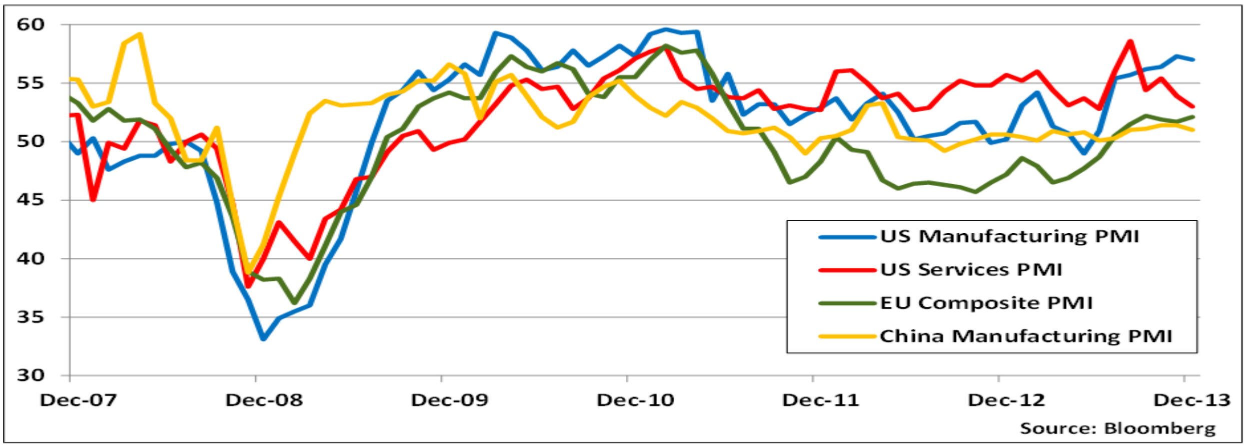
In Europe, ***the levels of stress have continued to abate*** and political events have had a lesser impact on financial markets than during the previous years. ***Stronger economic activity*** and ***more competitive labour costs*** added to ***the dwindling impact of fiscal drag*** are significant positive factors for the region. On the negative side, ***credit growth is non-existent*** due to the breakdown of the usual transmission mechanism, meaning the European Central Bank's ***lower interest rates and extra liquidity have not been passed through to smaller firms and households***. Other areas of concern are the ***threat of deflation*** and ***an appreciating Euro***.

The ***economic outlook is also looking more positive for the larger emerging economies*** after a year of disappointing growth. Stronger demand in the US and in Europe should also contribute to ***higher growth for exporting countries*** such as Korea and Mexico.

Finally, ***the recovery of the United States is underway***, reflected by the latest manufacturing PMI survey at its highest level since April 2011. The prospects for US growth are underpinned by the ***diminishing impact of fiscal drag*** and a ***slowly improving labour market***.

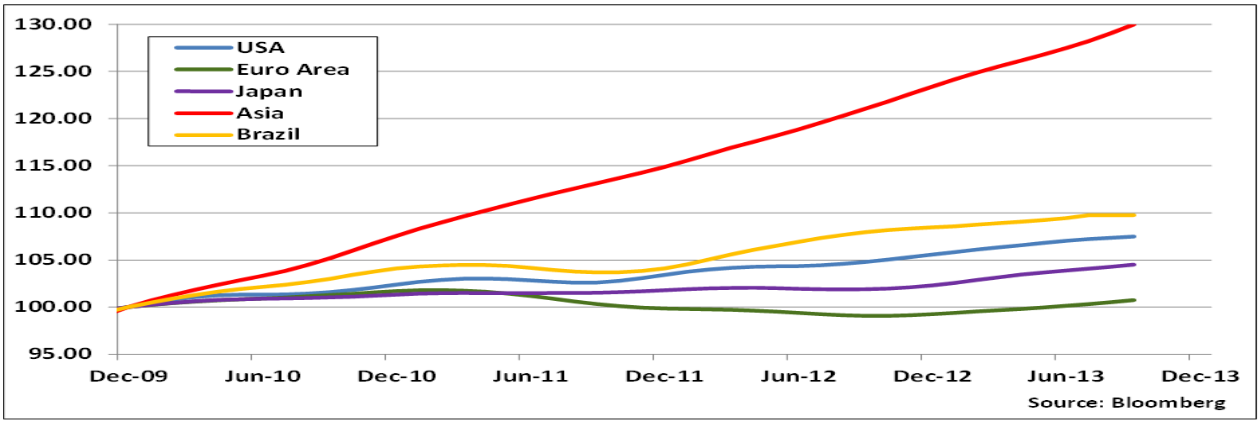
Leading economic indicators

Purchasing Manager Indexes



The ***positive trend of Purchasing Managers Indexes*** is indicative of an improving global economic outlook. The latest data in the ***U.S.*** and in the ***U.K.*** have been particularly strong with readings reaching multi-year highs. In ***Europe***, the services and manufacturing composite index bottomed in March at 46.5 and ***the latest data at 52.1 indicates an expansion of activity***. Finally, ***growth in emerging markets is slowly gaining momentum*** and ***China's manufacturing index has also been trending modestly higher*** with the latest data at 51.

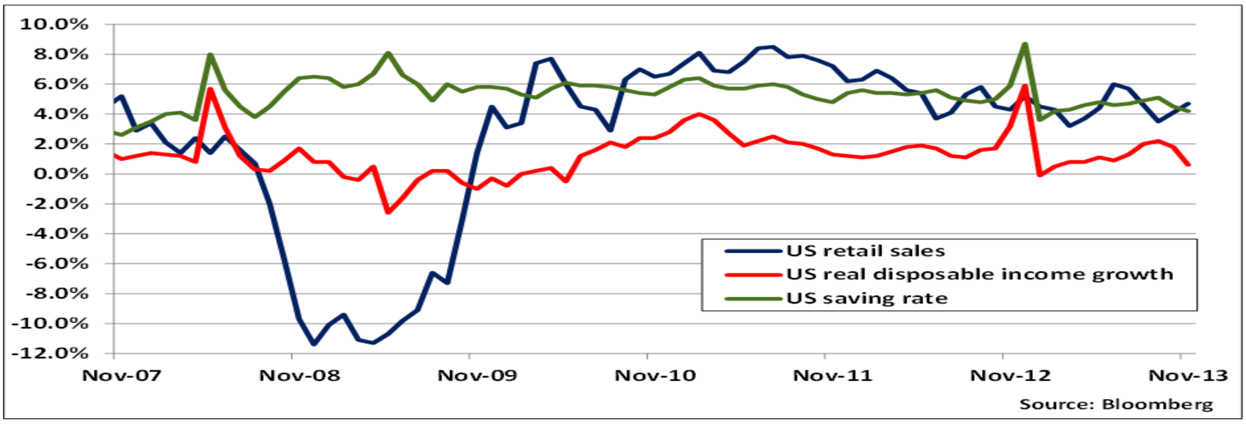
OECD Composite Leading Indicators



The chart above shows that, in contrast to the previous years, ***the Leading Indicators are signalling that the outlook appears to be improving across all the regions***. This is particularly true for the economic conditions in ***Europe and Japan***, reflected by the significant steepening of the curves. ***Conditions for the US, Asia and China remain stable*** while the ***slowdown of the Brazilian economy*** is reflected by a flatter slope of its Leading Indicator.

Consumer spending

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



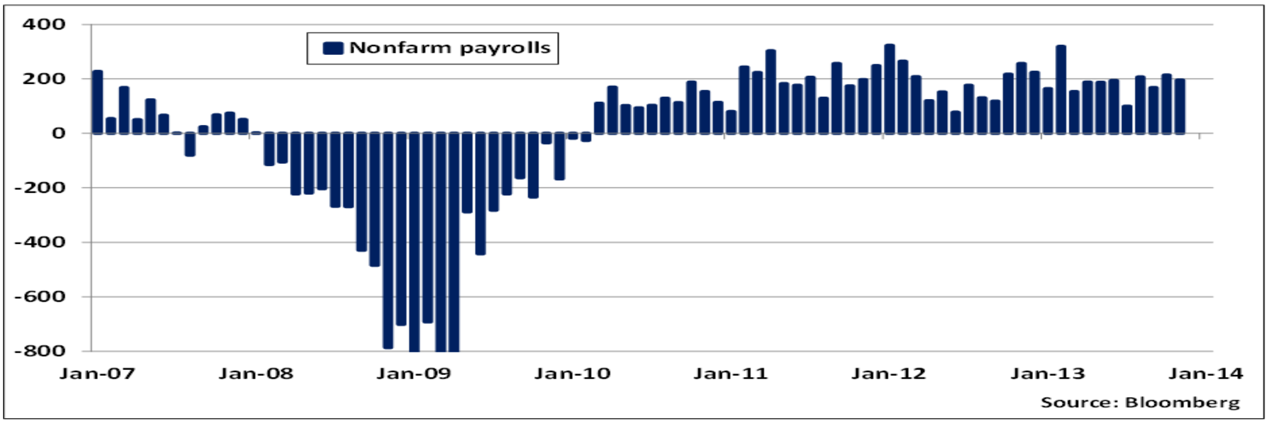
The chart above shows that ***consumer spending in the United States has remained resilient throughout 2013*** and has been ***rising during the last quarter*** following a third-quarter lull. US consumers have had to absorb a series of financial blows this year as the federal government ***boosted payroll taxes*** and ***cut spending***. However, ***consumer confidence is improving*** on the back of a slightly stronger labour market and higher prices of stocks and homes. Another positive factor is that there are signs that ***another government shutdown in 2014 appears unlikely***.

The prospects of higher levels of consumer spending appear favourable. The likely agreement on the U.S. fiscal budget will add to the tailwinds already represented by ***lower fuel prices, a higher wealth effect and an acceleration in wages***.

Job markets

Unemployment in the Euro zone rose at a slower pace in 2013, from 11.9% at the end of 2012 to a record of 12.2% in September. The most recent data has showed a slight drop of this rate to 12.1% and it is likely that ***the more positive outlook for the Euro zone should translate into slightly lower rates of unemployment for the coming year***. In the United States and in the United Kingdom, the ***unemployment rates have respectively decreased by 0.5% and 0.4% to 7.3% and 7.4%.*** In the U.S., this is largely the result of a ***decline in the share of working-age people in the labour force*** from 63.6% to 63%, a level not observed since the late 1970s.

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 stagnated*** over the course of the last twelve months. An average addition of 190'000 jobs per month in 2013 was in-line with the average recorded in 2012.

Conclusions

We expect the ***global economy to improve*** in the year ahead. ***Major fiscal headwinds will continue to dissipate*** and, in most cases, the ***central banks will remain supportive***. 2013 was a much less stressful year for the European region and confidence indicators have greatly improved; ***labour markets appear to be stabilizing*** and declining interest rates have brought some relief to the countries of the periphery. ***A recovery in the Euro zone economy has got under way*** even though it is fragile, in particular due to the strong Euro, a lack of credit growth and the ***many issues still facing the peripheral countries***.

The massive fiscal drag that weighed on the US economy in 2013 will decline sharply in 2014, enabling ***economic growth to accelerate to a level of around 3%***. The economic outlook will also benefit from the early agreement of a budget deal, which ***removes some fiscal policy uncertainty.*** The December decision of the Federal Reserve to ***start reducing its buying of assets*** coupled with a ***stronger commitment to keep interest rates at record lows*** is also positive for the economic outlook as it ***allays some of the uncertainty on monetary policy***.

The outlook for emerging countries points to a moderate recovery of growth. China should profit from better growth in the advanced economies but ***the government's on-going focus on structural reforms*** should limit any substantial pickup of economic activity.

2014: FINANCIAL MARKETS' OUTLOOK

The ***levels of stress within financial markets have continued to decline***, reflected by investors' increasing demand for equities and lower spreads of peripheral sovereign debt. With the background of an improving outlook for global economic growth and confidence indicators, ***the equity asset class should remain the main driver of portfolio performance in the year ahead***. Considering the expectations for rising long-term interest rates, ***the selection of the most appropriate debt instruments will also be one of the key issues to be addressed throughout 2014***.

At this stage, we will not be making major changes in terms of asset allocation, as ***we recommend maintaining the current overweight into equities*** and have been reducing our exposure to debt instruments with unrewarding characteristics. ***Duration risk will continue to be closely monitored*** and ***our exposure to the currencies of emerging markets will be reduced***. Taking account of a more supportive environment for hedge funds as well as the issues facing fixed-income assets, it is likely that we will be adding to our existing hedge fund positions.

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 2013***. These investment decisions have been explained in detail in our monthly Newsletters.

Debt instruments' outlook

In our opinion, ***G-7 government bonds continue to present a very unappealing risk/return profile*** in an environment where long-term interest rates are trending higher. We have been reducing the allocation to investment grade bonds but, for Euro based portfolios, ***maintained our core position in a fund investing into Euro-denominated investment grade credit with an active hedging of duration risk***. The overall conditions of below-trend growth and low default rates are still supportive for credit, which is why we are also exposed to ***sovereign and corporate IG bonds of the most credit-worthy nations*** offering a yield pick-up compared to debt with equivalent ratings in developed countries.

High-yield corporate debt remains one of our ***favourite exposures within the debt instruments asset class.*** This segment offers a more compelling risk-return profile than investment-grade. The current ***spreads are pricing in default rates well above projected ones*** and the yields on offer should be able to absorb the negative impact of rising interest rates, especially if this trend was accompanied by higher growth, a supportive factor for high yield. We have cut our exposure to ***emerging market debt denominated in local currencies*** and feel very ***comfortable with our allocation to senior secured loans***, in part due to the very limited duration risk of the asset class and healthy primary activity.

We remain ***positive on convertible bonds*** and are holding on to our current positions in European convertible bonds and emerging market ones. The returns of convertible bonds should be driven by ***underlying equity returns, income and some spread compression***. Convertible bonds should also benefit from the ***ongoing shift into equities from credit***, given their upside participation and the universe's majority composition of high-yielding bonds.

Equity outlook

The prevailing economic and market conditions remain supportive for the equity asset class. The improving outlook for global economic growth should ultimately translate into ***top-line growth and higher earnings***. Companies have benefited from low financing and labour costs to maintain margins at record levels; this situation can not last eternally, but is unlikely to deteriorate much in the near term. From a valuation perspective, ***equities can no longer be deemed inexpensive*** following the expansion of price-to-earnings ratios in anticipation of better results. Equities should also benefit from the lack of alternative investments, particularly within the fixed-income space.

A year ago, we wrote about our assessment that ***inflows into equities would increase at a faster pace than those into safe haven assets***. Recent data has confirmed that this trend is clearly under way and most likely to continue as ***investors reduce their relatively high levels of cash*** and ***their exposure to fixed-income assets*** in general.

In the wake of disappointing performances recorded by the gold mining sector in 2012, the ***past year turned out to be even more painful***. The drop of the price of gold clearly contributed to a large part of the losses, but ***market sentiment towards the sector remained overwhelmingly negative***, despite the focus of companies to improve their profitability and distribute more dividends. ***Gold mining equities is one asset class where we do not have a consensual outlook*** due to conflicting opinions about valuations, reduced support for the price of gold and confidence in new managements to better allocate assets.

Alternative investments

Alternative investments add value to portfolios due to their ability to ***exploit market inefficiencies, reduce portfolio volatility, bring diversification*** and ***provide access to complex strategies.*** Some of our current focuses are on ***global macro and on long/short strategies*** which should benefit from the ***lower correlations*** between equities, sectors and countries.

For certain strategies, the ***economic and market conditions have evolved in a positive way*** and we think that ***the environment will generally be more supportive for hedge funds*** going forward. The changing trends of interest rates and the moving away from risk-on/risk-off market regimes are some of the reasons why ***hedge fund managers should be able to perform well in the year ahead***.

Our exposure to funds investing into other hedge funds (FoHFs) has remained relatively stable throughout the year and the ***performances produced have generally met our expectations***, especially when taking account of the amount of risk taken. Looking forward, it is likely that our allocation into this space will be maintained around the current levels.

Investments into structured products were limited in 2013 due to ***less supportive conditions*** for the type of products we invest into. If these conditions were to improve, with in particular a higher level of volatility, we would expect our allocation to this space to increase.

Gold outlook

Contrarily to most initial predictions by strategists, ***gold has consistently lost support during the past year*** due to decreasing tail risks, weaker demand for safe haven assets, subdued inflation and the prospect of rising real interest rates. The price of gold was heavily impacted by the unwinding of holdings in exchange-traded products and the ***momentum for the gold price remains negative*** at the time of writing.

The in-house views on gold are divergent, explaining why only a certain number of portfolios are still exposed to the precious metal. Gold could be considered as a ***long-term insurance against the more extreme scenarios*** and, under the current market conditions, should not be viewed as a likely contributor to portfolio performance in the medium term.

Currency outlook

The major currencies ended 2013 at parities close to those observed a year earlier but not without having experienced significant intra-year variations. Contrarily to expectations, ***the dollar failed to appreciate against the Euro and the British pound***. For 2014 we would expect ***the US currency to perform better*** in view of stronger economic growth and the start of FED tapering.

The Euro experienced a bout of weakness during the spring and its parity dipped below a level of 1.28 against the US dollar. From then onwards, ***the common currency has remained well supported,*** ending the year at a parity of 1.38. Our assessment is that any further appreciation of the Euro would be considered unwarranted by the European Central Bank and ***we expect the dollar to strengthen in 2014***. The higher pace of economic growth in the US, the reduction of asset purchases by the Federal Reserve and the gradual reduction of the budget and current account deficits should all contribute to push the dollar higher.

In 2013, the Swiss National Bank ***easily defended the 1.20 cap*** it has set for the franc against the Euro. Looking forward, it is likely that ***the EUR/CHF parity will remain in a tight range during 2014***. The central bank will continue to prevent the franc from appreciating above the 1.20 cap even though ***this policy is preventing it from raising interest rates to limit upwards pressure on domestic real estate prices***.

As widely expected, the Japanese Yen extended its decline, reflected by the 21% appreciation of the USD-JPY parity. This change in value was largely driven by the ***ultra-accommodative monetary policy of the Bank of Japan*** and the ***return of carry trades*** based on short yen positioning. It is likely that the ***value of the Japanese currency will erode further in the coming year***.

The past year saw ***significant changes in the values of some of the emerging market currencies*** due to massive outflows from the end of spring onwards. The talk of a reduction of the Federal Reserve's asset purchase program combined with deteriorating current account deficits were the main drivers of these trends. Looking ahead, ***investors will need to be much more selective*** and assess individual countries according to their specific fundamentals.

2014: ASSET ALLOCATION

Debt instruments

- As explained previously, we find ***little value in highly-rated sovereign debt*** on the basic assumption that its very low yield does not offer enough protection against rising long-term interest rates. The current economic cycle, characterized by slow growth and low default rates, is still supportive for credit but the risk of duration needs to be closely monitored. We are ***underweight investment-grade credit*** due to limited upside and low yields.

- ***Conditions remain supportive for high-yield bonds*** as there is still room for some spread compression and as most technicals are positive. Companies have extended the maturity of their debt and there is ***little reason for anticipating a rise of default rates*** considering an improving growth environment. A modest rise of interest rates should be more than compensated by the current yields and by the potential for tighter spreads.

- We recommend ***maintaining the current allocation to convertible bonds***. We believe that convertible bonds are likely to outperform fixed-income assets due to the rather low risk environment and expectations of higher equity markets. ***Convertible bonds are an optimal alternative to a direct equity exposure*** as they benefit from bond-like downside protection and a participation in the upside of equities.

Equities

- We recommend to remain ***overweight towards equities***. Even if equity valuations are nearer their long-term averages, the marginal improvement of the global economy provides a positive backdrop for the asset class. The ***reduction of tail risks*** and the ***rich valuations of the safest debt instruments*** make equities the most attractive asset class.

- ***Equity prices should continue to benefit from inflows*** as money moving out of cash and the fixed-income space will be looking for more rewarding returns. Ultimately, equities should benefit from the ***growth of earnings*** and also be supported by ***higher levels of M&A activity*** on the back of improving corporate confidence as well as ***high corporate cash levels***.

- ***We suggest to add an exposure to Japanese equities***. The ongoing reforms, a very loose monetary policy and the potential for a significant increase of demand by domestic institutional investors should push equity prices higher. Due to the weak outlook for the Japanese yen, we will ***hedge the currency exposure***.

- From a regional perspective, our ***allocation will continue to focus on developed markets*** despite the lower valuations of emerging market equities. Within emerging markets, we maintain our exposure to ***Chinese and to Asian equities***.

Commodities

- 2013 has been another negative year for commodities and ***the outlook for the asset class is underwhelming***. The prices of commodities have not benefited from the improving outlook for global growth and the ***demand/supply balances do not appear to be very supportive***.

- At this stage, ***we find it difficult to identify broad-based tailwinds for commodity prices*** in the next quarters. The inventory levels are generally quite high and our expectations for the dollar to appreciate do not provide a background for higher prices.

- The logic conclusion of the above is that ***we do not intend increasing our exposure to the asset class*** in the near term.

Gold

- We have decided to ***sell our remaining exposure into physical gold*** for our model portfolio. Client portfolios have benefited from ***decent returns from this position since our initial investment***, but ***we fail to find a likely catalyst*** that would alter the prevailing negative sentiment towards the precious metal in the short term.

- We still consider gold as a ***fundamentally good store of value over the long term***, but it is currently facing serious headwinds and its behaviour is also being influenced by speculative elements which, from a tactical perspective, make it highly unpredictable.

Hedge funds

- Hedge funds will continue to play a key diversification role in the portfolios, especially when considering the shrinking universe of attractive debt instruments. The ***active management approach*** of hedge funds contributes to the ***diversification of investors' portfolios*** and their ***returns are less correlated*** to those from traditional assets.

- With the progressive return to an environment where company fundamentals matter more than political decisions, we think that ***strategies such as long/short and global macro should be well positioned to generate attractive returns.*** Our search for high-quality hedge funds integrates the need to find those with the ***most appropriate structures and terms*** as to fit our requirements within an increasingly complex set of constraints.

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 risk profile*** and the ***chosen investment strategy***, 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***.

HEDGE FUND MANAGERS

- The Forum Finance Group invests into ***Funds of Hedge Funds*** and, for the clients that have approved this asset class in their mandates, into ***Single Hedge Funds*** .

- Funds of Hedge Funds offer ***diversification and low volatility***, while Single Hedge Funds focus on ***specialist strategies*** with an emphasis on ***risk management***. We consider Single Hedge Funds to be ***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 analyse 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 2014

For our balanced accounts, we recommend the following grid*:

	Allocation	January 2014
Short-term deposits	**0 – 20%**	**6%**
Debt instruments	**15 – 55%**	**28%**
Investment grade bonds	5 – 45%	7%
EM & high-yield bonds	0 – 20%	11%
Specialist bonds	0 – 15%	10%
Equities	**20 – 60%**	**50%**
Developed markets	15 – 50%	42%
Emerging markets	5 – 30%	8%
Commodities	**0 – 15%**	**0%**
Physical gold	0 – 5%	0%
Other commodities	0 – 10%	0%
Hedge funds	**0 – 25%**	**16%**
		100%

* *The ranges have been adjusted somewhat to be more in line with the updated mandates.*

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