

PRESS RELEASE

The Widening Fan of Uncertainty

London, Guernsey, Isle of Man, Jersey and Geneva – 18th August 2010:

Paul Meader, Head of Guernsey Portfolio Management and a new member of Collins Stewart Wealth Management's Asset Allocation Committee, sums up the committee's thoughts on the current markets situation:

- **"The odds seem stacked against a double dip this time around"**
- **"This continues to be a remarkably normal recovery in an abnormal cycle"**
- **"Economic growth should continue, equities are cheap, corporate earnings are strong"**
- **"... and we perceive excellent opportunities in many markets"**

It's been a busy ten days for central bankers, with a blizzard of press conferences and statements. Normally such matters would not merit much attention outside of the arcane world of economists but an interesting theme began to develop as the meetings unfolded: a note of caution on the global economic outlook. Until a couple of years ago, central bankers used to speak a language all of their own which required a codebook to decipher but today they speak clearly and, on occasions, are forthright. We've heard nothing quite so explicit for a while and so it is worth taking note of their words. In reality, they told us little that we didn't already know from observing the data. And anyway, central bankers have an even more rotten record of successfully predicting economic activity than private sector economists. But the mere fact that Ben Bernanke, the Fed Chairman, discussed a slowdown of growth and Mervyn King, Bank of England Governor, announced a downgrade to UK growth forecasts is significant.

Investors had already noted that economic growth was once again softening. With a few notable exceptions, such as Germany which is now benefiting from a weaker Euro, the softness has been evident across a broad range of global statistics. To be clear, this is a deceleration in the pace of growth, not an actual contraction in the economy. However, it has led to inevitable chatter about a "double dip" in global growth.

Having been firm believers in the reflation of the global economy since mid 2009, this change of tone has caused us to prick up our ears. It's not the first time we've heard such talk during this cycle – there were similar concerns as recently as January this year before economies reaccelerated, and the markets with them. This time though, there is clearer evidence that the pace of growth is slackening. However, the reality is that double-dips are pretty rare phenomena in economics, even though it is entirely usual for economies to have a mid term softening. This is usually a temporary wobble as the first stage of economic recovery wanes (that first phase being triggered by the initial stimuli and the rebuilding of stocks) and the second phase (of self-sustaining growth underpinned by business investment and employment gains) takes over. A double dip is usually only triggered when this hiatus is accompanied by an external shock (such as the oil crisis of the 1970s) which is sufficient to tip the economy back over the edge.

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The odds seem stacked against a double dip this time around. Not only is there no external shock, the impressive recovery we've seen is based on the massive stimuli applied globally by governments and central banks and it is clear that these authorities stand ready to apply yet further stimuli if required – witness the introduction by the Fed in recent days of what has been dubbed “QE-lite”, whereby they will recycle the Quantitative Easing to date back into further bond purchases. Further, an element of softening right now is no surprise whatsoever because one of the most effective measures taken by governments in early 2009 was to seek to “front load” the recovery by subsidising consumers to buy new cars and houses. Those subsidies have recently expired and so, understandably, consumers are catching their breath.

“This continues to be a remarkably normal recovery in an abnormal cycle.”

So at the risk of sounding like a scratched record, this continues to be a remarkably normal recovery in an abnormal cycle. Our central case remains that growth is entering the self sustaining phase, that policy actions will remain successful but that interest rates will have to remain low for a long time, reflecting the fragility of the Western capital markets. Against such an outlook, equities are becoming an increasingly cheap asset class both in an historical context and against the alternatives such as bonds.

“The reality is that the central case may remain the same but the risks, having once been skewed to the upside, are now more “symmetrical”.”

But what if we're wrong? Every double dip starts with a gentle slowdown. Perhaps this time it is not an “external shock” that triggers a second recession but the deep fiscal retrenchment that some governments, like that of the UK, are starting to implement. We are not so naïve as to dismiss recent economic evidence and the statements of the central banks. The reality is that the central case may remain the same but the risks, having once been skewed to the upside, are now more “symmetrical”. Some people describe this in terms of a “fan of uncertainty”. As you peer into the future there is always a range of possible outcomes, a range that inevitably widens into the future. In normal circumstances it is possible to predict a relatively narrow “outer band” of outcomes around your central case. But these are not normal times. For a while we have been faced with a fan of uncertainty that is wide (i.e. the possibility of fairly extreme positive and negative outcomes is uncomfortably high). Now, however, it is both widening further and has also become quite symmetrical to the downside versus the upside. This means that careful portfolio construction is more important than ever. The job of the investment manager is to take controlled risks, and generate return as a result. I've never known that to be an easy job, but it really is very tricky right now. This means that it is essential to fully understand where the risks lie in portfolios, to manage these stringently and to be properly diversified. Using a gambling analogy, one of the keys to our success has been to ensure that we “don't put all the chips on red” because if black turns up you're in trouble.

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It might appear surprising then that we have not simply reduced equity risk in client portfolios in light of these evolving circumstances. The reason for this is simple - our central case remains exactly the same: economic growth should continue, equities are cheap, corporate earnings are strong and we perceive excellent opportunities in many markets. Rather, our response recently has been to bolster the most efficient portfolio counterweight: the fixed interest allocation. We have done this not by allocating additional monies to bonds but by reducing credit risk and tilting towards government bonds, so ensuring that we have sufficient fixed interest duration to give us “bang for our buck” if we need it. Our credit exposure has served us well over recent months and, we believe, offers less obvious value than outright equity risk. Therefore we're in the pleasant position that it's painless to reduce this exposure and in so doing, our portfolio construction is purer: taking risk where it is most efficiently expressed and ensuring an adequate counterbalance if we're wrong.

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The good news is that it should become fairly apparent fairly quickly whether this growing downside economic risk is real and sustained. So our approach is tactical rather than strategic. Having been nimble we should be in the enviable position of capturing upside whilst bolstering our defences. And whether we're right or wrong in our central case, greater clarity should soon return and the widening fan of uncertainty should narrow once again. Whoever said that markets go quiet in the summer?

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Notes to Editors

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¹ as at 30/06/10

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¹ as at 30/04/2010

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*** AWARDS FOR COLLINS STEWART WEALTH MANAGEMENT****Discretionary Portfolio Management****Daily Telegraph Wealth Management Awards**

Best Discretionary Service	2009 Winner 2008 Runner-up 2007 Winner
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Money Marketing Awards

Best Discretionary Adviser	2009 Winner
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Financial Times/ Investors Chronicle Wealth Management Awards

Best Investment Manager	2008 shortlisted
Best Charity Manager	2008 shortlisted
Best Cautious Fund Manager	2008 shortlisted

Charity Times Awards

Best Investment Manager	2009 shortlisted, 2008 shortlisted
Best Professional Services	2007 shortlisted

Private Asset Managers (PAM) Awards

Best Investment Performance: Absolute Return	2008 shortlisted
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Advisory Stockbroking**Financial Times/ Investors Chronicle Investment Awards**

Best Advisory Stockbroker	2009 Winner
Best for Advisory	2008 Winner (Gold)
Best for International Shares	2008 Winner (Gold)

Shares Magazine Awards

Best Advisory Stockbroker	2008 Winner
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Customer Service & Communication**Financial Times/ Investors Chronicle Investment Awards**

Best Stockbroker for Customer Service	2009 Winner 2008 Winner (Silver) 2007 Winner
Best for Communication	2008 Winner (Silver)
Best Advisory Stockbroker Cost	2007 Winner

Daily Telegraph Wealth Management Awards

Best Marketing Materials	2008 Winner
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