

## Introduction

The first quarter of 2008 was clearly a reminder to investors that, in order to achieve long term gains, we may have to expect some short term down periods. Indeed, we can add to that by observing that it was an exceptionally unusual quarter for many reasons: We have seen the first nationalisation of a British company for decades, one of the oldest investment banks in the US sold for a pittance, oil at over \$100 a barrel and gold breach \$1000 an ounce. In addition, all major asset classes (i), excluding commodities fell at the same time. The question that one has to ask is: are markets nearer the bottom or nearer the top? As we do not possess foresight we cannot know for sure, but probability tells us that we may have seen the worst and that there may be opportunities to be had as a result of the recent volatility. Either way we are continually developing processes to reduce our reliance on traditional approaches to investing, as developments in the Exchange Traded Fund (ETF) market and elsewhere allow us to do so. In this edition, we will examine what has been happening to the various asset classes by type and what action we have been taking during the quarter.

## Global Equities

The global credit crunch has continued to wash around the world's financial markets and equities have continued to struggle to make progress. Central banks have continued to provide large amounts of liquidity in the shape of increased loan facilities to the banks and the US Federal Reserve and the Bank of England have reduced interest rates in an attempt to calm the financial markets. Our investment processes have continued to focus on resource related markets and the higher growth regions of the world.

Our investment processes are designed to reflect the reality of the equity markets and attempt to try to control some of the volatility within the markets, not to try and predict what the markets will do. Throughout the quarter we have maintained high levels of cash within the Global Growth fund and have used an inverse ETF (price moves up when market moves down) in order to reduce some of the volatility. We continue to see economic areas that have large mineral and oil reserves and agricultural capability outperform their more financially based economies. Therefore, Latin America, Russia and Asia have a superior risk to return profile to markets such as the UK, USA and Japan whose economies are much more service sector based and have a much greater exposure to the problems surrounding the banks.

## Global Equity Income

During the quarter we unwound positions in individual ETFs, moving the proceeds into the latest of our OEIC's sub funds, the MFM iFunds ETF Global Income fund. This allows us to take advantage of more of the globally listed range of equity income ETFs that have recently been launched.

We continue to see a similar picture in the equity income sector as with global growth, with stock markets not traditionally perceived as being areas for high dividend payments consistently moving to the top of our investment selection criteria. Emerging markets and the Asia Pacific region now have a considerable number of companies that are highly profitable and distribute significant dividends to their shareholders. We are able to access these companies through a significant range of ETFs and we have been using the market volatility to increase our investment exposure to these areas of the market, as both fund prices and dividend yields continue to look attractive.

An area that has been previously significantly reduced within portfolios has been the property sector, which has been badly hit by the credit squeeze. However, we are again starting to see a distinct change in relative performance between the west and the east as the Asian Pacific real estate sector has started to improve and moved in to the portfolio asset allocation model. Again this sector provides an attractive yield and is less associated with the problems of the western banking crisis.

## Fixed Interest/Bonds

Worries over the global economy and the fact that many fixed interest securities are issued by companies in the financial sector saw some of the poorest performance from the sector since 1998. Indeed, many corporate bonds performed as badly as their equity counterparts. However, it should be remembered that bonds are different to equities in that they are redeemed, usually at a set price (ii), in the future and, in the interim, they pay high levels of interest to the bondholders. Many corporate bonds are currently trading below their issue price, which means that, providing the company is able to pay back the bondholders, there are capital gains to be had. This cannot be said for equities, which do not have this feature. In the meantime we are benefiting from receiving yields of up to 9%. We use managed funds to gain exposure to the corporate bond sector, as we are reliant on the manager's ability to do due diligence on a company's ability to pay its interest and repay the principle. We have exposure to the whole of the corporate bond sector, but have reduced our exposure to loans issued by financial companies, such as banks.

We managed to dilute the volatility in the bond markets by holding index-linked bonds (iii) issued by the government. These rose during the quarter as a result of the deteriorating inflation environment.

## Property

After the poor performance of property funds over the previous quarter, some stability returned during the last. As I mentioned in January most of the unusual volatility was caused by redemptions of property funds resulting in the managers being forced to mark down their fund prices. Many managers have now imposed restrictions on redemptions and this has helped the market to steady. Commercial property is not a bad long term investment, as business will always need premises from which to operate, but in the short term the sector is suffering from poor sentiment. Meanwhile yields have returned to the levels normally associated to this type of investment, residential property is a different matter, but we have no exposure to this market.

## Commodities

We hold commodities as they have a history of providing returns that are not normally reliant on the performance of other asset classes. Indeed, over the longer term they tend to do well when equities, in particular, don't. They have also been a good hedge against rising inflation. They certainly lived up to this reputation in the first quarter and prices have been very strong, as investors have continued to be attracted to the sector by the view that global demand will continue to outstrip supply in most sectors of the commodity market.

Demand for energy has been very supportive of energy prices aided by the oil producing cartel of OPEC being unwilling, or unable, to increase production levels. Precious metals have been very well supported by the weakening US dollar and as a safe haven from perceived future inflation. We have unwound some of our very overweight positions in the agricultural sector as this area was becoming increasingly overbought. In addition, we have taken some profits in the precious metals area of the market. The energy sector has been building a base from which it would appear a break upwards is possible and we remain close to normal weighting in this area. Following the heavy falls seen in industrial metals over the previous months, we have started to move from very underweight positions back towards neutral, this scenario also applies to the soft commodities such as cotton coffee and sugar.

Towards the end of March we have seen some of the froth blown off the top of the commodity sector as profit taking took place across most sectors and we are moving back in to areas such as soya beans and heating oil, which remain in long term upward trends.

## Absolute Return

The iFunds ETF Total Return Fund was renamed the ETF Absolute Return Fund during the quarter. This is to reflect its stance of trying to deliver a positive return over different market cycles and the inclusion of all the available asset classes traded as ETFs.

When comparing all major investment asset classes against each other on risk versus return basis we continue to see superior characteristics from the commodity related areas of the market. These include Latin America with its huge mineral/mining, oil and agricultural resources and the physical commodities themselves such as oil, precious metals and grains. Not unsurprisingly, we see good relative strength in related equity sectors such as oil service and oil exploration companies and agricultural related companies such as fertilizer and seed distributors. We have built positions within these sectors and given that the global fundamentals should continue to be very supportive of these themes and whilst equities in general have had a very difficult quarter we would expect to see these areas to make strong progress when the markets become less volatile and we will be in a strong position to deploy our high cash reserves in to purchasing additional exposure.

We have significantly reduced our exposure to the European sectors of the equity market and have only retained a reduced exposure to utilities and basic resources, which continue to demonstrate good relative out performance. An area we are starting to detect a subtle improvement in is the UK and European small company sector, which is currently providing the best risk return profile, when compared to both large and medium sized companies and we have a small position in this area.

Currencies continue to impact on the investment themes the iFunds processes highlight. The weakness of the pound against most major currencies means that exposure to the UK market as a whole is very low as the strength of the euro and most Asia Pacific currencies make these a superior alternative.

## Conclusion

The last quarter has been one of the toughest investment environments that even the most seasoned investment professional can remember. However, despite the huge amount of media exposure it has generated we continue to see certain long term investment themes and trends hold good and it is these areas that will provide the strong performance during periods of investment stability. It is during these periods of dislocation within the global investment markets that the best opportunities often occur and, given that we have an adaptive investment process and high levels of cash, we remain confident moving forwards.



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Investment Director, April 2008

- (i) Asset class is the term used to define investments by their type e.g. equities or fixed interest.
- (ii) Bonds are loans taken out by companies and are usually issued at, say, a pound and interest is paid to the holders. The bonds usually have a fixed life and will pay back that pound at the end of the agreed loan period. It can be likened to an interest only mortgage in so much as you borrow a fixed amount, pay interest and pay the loan back at an agreed point in the future. Indeed, some corporate loans are secured on property owned by the company.
- (iii) Index linked gilt returns are linked to retail prices, so holders benefit from rising inflation.

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