

# Six-Monthly Investor Newsletter

for the six months to 30 September 2011



T.BAILEY

## Market Overview

At the start of the last six-month period the world was absorbing the news from Japan, having recently witnessed the devastating Tōhoku earthquake, tsunami and the subsequent nuclear disaster that continued to unfold. As the proud nation began the process of picking itself up, more successfully than many commentators of the time would have had us believe, effects were nonetheless felt globally, not least through disruptions to modern supply chains.

In recent months market commentary has turned once again to Japan but for an altogether different reason: whether the developed nations of the West are following a similar weak economic trajectory to that which Japan found itself on a decade ago.

Government policy makers have struggled to generate growth post the Great Recession amidst the problems besieging weak financial institutions that continue the process of strengthening their balance sheets and as consumers similarly look to de-leverage following many years of spending on credit.

The rising of such fears coincided with the ending of the US Federal Reserve's second series of quantitative easing, a policy which this time around met with limited success, and the downgrading of the US's credit rating by Standard and Poor's following much political jostling over the nation's debt-ceiling. Both of these suggest there is little room for policy makers to intervene to improve the situation.

However, the more serious immediate concern for financial markets has been closer to home. The consequences of low

growth, indebtedness and a lack of political will have all met in the European Union and, more specifically, the structural problems facing the members of the Euro currency. Indeed, with peripheral countries at significant risk of defaulting on their debts, aspects of the situation in Europe are quite reminiscent of the banking crisis of 2008.

As a result it has been the traditional safe assets like UK gilts and US Treasuries that have surged in value in recent weeks. However these look thoroughly unappealing for longer-term investors offering nominal returns of around 2% per annum on a ten year term. With inflation running around 5% p.a. - and for those in the UK unlikely to see it return to the official target of 2% in the very near future - investors in these assets are enjoying negative real returns. And if Western sovereign debt returns look dismal, consider the risk that continues to evolve through the interaction between the heavily indebted European nations and the region's fragile financial institutions.

However, despite the corporate world looking to be in the stronger position having learnt the lessons of the Great Recession, such an overbearingly poor macro picture has seen risk assets in the short term struggle greatly - despite many companies continuing to report strong results, the majority beating earnings estimates.

The conclusion is that risk assets will remain challenging and unpredictable in the near term, until there are convincing economic plans put forward that are backed up by sufficient political will to deal with this latest crisis. For the longer-term investor, equity markets are more bearishly priced and look more attractive.

## T. Bailey Growth Fund

Greater emphasis has been placed on fund selection during the period with a reduction in the number of index tracking funds and ETFs within the portfolio. Markets have been very volatile over the past three years but we feel in many ways the picture is clearer than in 2008. In particular, this is the time when good active managers come to the fore and we can exploit our strengths and resources in identifying these managers. Over the last six months the passive exposure in the fund has been reduced from 30% to 16% with plans for further reductions to follow. To date we have added the Franklin UK Mid Cap Growth Trust, Aberdeen Emerging Markets Fund, Wells Fargo All Cap Growth Fund and the Aberdeen Asia Smaller Companies Fund to our stable of active funds.

In conjunction with this we sought to take smaller, short-term tactical asset allocation calls. Tactical asset allocation is perhaps the hardest part of our investment process to get right constantly and can take a great deal of time while contributing least to longer-term performance.

Finally we have reduced the weightings in some of our larger holdings, as we work towards introducing a principle that no more than around 5% should be invested with any one fund manager. This reduces manager specific risk within the portfolio and provides a natural mechanism to take profits when funds have excelled.

With regard to asset allocation, concerns over peripheral sovereign debt in the Euro-zone and the high probability of a Greek default mean we remain underweight the region. The lack of political resolve to address the crisis only adds to the frailty of the situation.

Throughout the last six months we have stuck with our overweight position to Japan. The country has shown incredible resilience and determination following the earthquake and its equity markets

have rebounded strongly. Companies in the region still look good value, however the current strength of the Yen during this period of volatility is a cause for concern so we are cutting our position back to neutral.

We held an opening underweight position to emerging markets at the start of the period. This was based on fears that equity valuations had become stretched and that the region was exhibiting signs of overheating, which proved correct. Now, following the events of the period, we have moved to a neutral position with the inclusion of the Aberdeen Emerging Markets Fund in the portfolio.

Inflation appears to be moderating in the region, so the tightening cycle appears to be at a late stage and unlike the West there is plenty of room to cut rates to stimulate growth. We have also added the Neptune Russia & Greater Russia Fund. We have been interested in Russia for a while and the recent sell off in commodities has provided an entry point. The rise of the Russian consumer makes for a compelling story, while the nation's commodity wealth and links with China should drive growth going forward.

## T. Bailey Growth Fund LITE

The T. Bailey Growth Fund LITE mirrors the long-term strategic and shorter-term tactical asset allocation of our long-established and successful T. Bailey Growth Fund. Here though we make use of low-cost passive instruments rather than active managers - this enables us to cap the total expense ratio of the leading unit class at 0.99%.

## T. Bailey Dynamic Cautious Managed Fund

This has been a challenging time for the more adventurous of our two cautious strategies. Concerns surrounding the sovereign debt crisis in Europe and weakening growth forecasts took a heavy toll on the price of risk assets central to the strategy of this fund.

One risk asset that did perform well though was gold and our allocation via the ETFS Gold Bullion ETF, returning 12.8% over the period. In equity markets a sizable allocation for the Japanese market also proved more resilient, particularly in Sterling terms. More disappointing was the performance of the strategic bond funds making up the fixed interest allocation within the portfolio which underperformed in the "risk-off" environment as they struggled, as we have, to see the value in mainstream sovereign debt, the main beneficiary of the flight to safety.

During the period we replaced a holding in the iShares FTSE 250 ETF and iShares MSCI Japan Small Cap ETF with Franklin UK Mid Cap Trust and Polar Capital Japan Fund respectively as we continue to favour opportunities for active managers to add value. In the same vein we reduced our holding in the HSBC Pacific Index Fund and invested the proceeds into the Newton Asian Income Fund. We also took the opportunity to reduce our exposure in the JPM Natural Resources Fund.

## T. Bailey Defensive Cautious Managed Fund

The 'groundhog day' uncertainty in global stock markets saw a flight to safety in the form of UK gilts, US treasuries and gold. But with these safe haven asset valuations stretched and equities appearing more compelling value, we took the opportunity to reduce the high cash position in the fund from 19.2% at the beginning of the period to 10.6% at the end of the period.

New funds that have been introduced include the BlackRock Gold & General Fund to take advantage of gold stocks which have lagged the underlying price of gold bullion significantly.

We have also continued to reduce our exposure to passive funds and ETFs in favour of active managers. We have invested in the Franklin UK Mid Cap Fund, Newton Asian Income Fund, and Aberdeen Emerging Markets Fund which all have strong consistent performance from robust and repeatable investment processes.

The continued focus will be to invest in asset classes that provide attractions for the medium to long-term via consistent fund managers, minimising the dangers of reacting to short-term volatility and noise in stock markets that we have witnessed in recent months.

Performance Table	Cumulative to last valuation point September 2011					12 months ended last valuation point September				
	3 mths	6 mths	1 yr	3 yrs	5 yrs	2007	2008	2009	2010	2011
Growth Fund Retail (Launch date 13 Dec 1999)	(13.09%)	(13.36%)	(6.59%)	12.44%	6.34%	19.07%	(20.58%)	11.59%	7.87%	(6.59%)
Growth Fund LITE 0.99% TER (Launch date 25 January 2010)	(13.50%)	(13.96%)	(6.91%)							(6.91%)
IMA Global Sector Mean	(14.11%)	(14.41%)	(4.90%)	15.66%	6.07%	13.64%	(19.30%)	11.98%	8.61%	(4.90%)
Dynamic Cautious Managed Fund Retail* (Launch date 2 May 2006)	(9.59%)	(10.55%)	(5.96%)	6.64%	(5.69%)	5.95%	(16.53%)	4.95%	8.06%	(5.96%)
Defensive Cautious Managed Fund Retail* (Launch date 20 July 2010)	(4.85%)	(5.34%)	(2.98%)							(2.98%)
IMA Cautious Managed Sector Mean	(5.65%)	(5.08%)	(1.59%)	13.69%	5.53%	4.70%	(11.35%)	7.56%	7.41%	(1.59%)

\* Performance shown for income unit classes.

Performance can be shown only for periods when the relevant funds were launched, hence blank cells for some periods.

**Source: Financial Express. Total Return (Bid to Bid, Tax UK Net). Past performance is not a reliable indicator of future results.**

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