Manager Insight

Prospects for the year ahead

January 2011

"After a volatile - albeit a positive - 2010, this year is unlikely to be any different. There will be more twists and turns in the markets and investors will find themselves juggling between the "risk on" and "risk off" trade, with the former favouring the more cyclical, higher beta asset classes (emerging markets, commodities-related trades and industrials), and the latter the defensive ones (USD, treasuries? and gold). Uncertainty over government and central bank policies, evolution of the European debt crisis, and inflation in emerging (and developed) markets are just some of the headline concerns that will add to the volatility.

On the whole, our managers are positive about prospects for the year ahead, but do note the potentially bumpy ride that awaits us. It is noteworthy that they continue to focus on the fundamentals and try to add value in the medium to long term. Although we have high conviction in all the incumbent managers, as ever, we will be keeping a close eye on them to ensure they remain so in their respective space. *Faisal Rahman, CFA, Portfolio Manager, Russell OpenWorld®*

Fund: OpenWorld India Focus Equity
Manager: Quantum Advisors Private Limited

Russell overview: The managers observe that after investors have had an opportunity to price in uncertainty (inflation, corruption, politics and global events) in the coming few months, the market will revert to focussing on the earnings power of Indian companies. Although they admit Indian valuations are not as attractive as they were twelve months ago, they continue to find stocks with good upside.

Manager insight: The "India story" in terms of GDP growth is not at risk. While the US and German policy makers slug it out to see who the bigger fool is, the near term data points suggest this round belongs to Ben. Though the US and global economies are apparently seeing a strong recovery, any slip into a downward path will not directly affect the Indian economy. But there will be the pressure on share prices – and the currency – if capital moves back to "risk- less" assets like the USD. With a capital account to GDP deficit of 3.5%, India is vulnerable to mood swings from portfolio investors. A patient, value-based approach to investing allows us to stay away from what is fashionable and assess - and price - risks over longer term horizons in order to give you sensible risk-adjusted returns over market cycles. With all the noise over inflation, corruption, and global uncertainty, patience will be needed. Just as it is has been handy when everyone rushes in to "buy India" and valuations tend to look frothy. Valuations in India are not expensive, but they are not cheap either. By July 2012, we see a +50% potential upside for the portfolio based on a combination of earnings growth and demand for Indian equity shares, reflected by a higher PER. While we do not focus on short-term movements in the stock markets, it is likely that the Indian markets could slip in the first few months of CY 2011 and then recover later in the year. We continue to buy (or sell) stocks based on our proprietary valuation criteria and ignore the shifting sell side estimates. Our focus on the management of businesses we invest in, and their respect for ethics and minority rights, is a constant.

Hermes Sourcecap

Fund: OpenWorld Europe Focus Equity
Manager: Hermes Sourcecap Ltd

Russell overview: The portfolio manager, James Rutherford, remains positive on European equities despite headline issues that investors seem to be obsessed by and they continue to see many areas of opportunity at the stock level. Furthermore, he notes that the market remains attractively valued, with the possibility of a reallocation of funds back into equities, supported by stronger real growth. He maintains his pro-inflationary positioning with exposure to franchise (pricing power) and growth stocks.

Manager insight: We remain positive on Europe despite the headline issues that most investors seem to be obsessed by and we continue to see many areas of opportunity at the stock level. European markets also remain attractively valued. The very real chance of a reallocation of funds back into equities, combined with stronger economic growth will support equity prices. Significant inflationary trends remain in play that augurs well for the outperformance of equities relative to bonds. Corporate profitability tends to benefit most when inflation ranges from 1 to 4% and we anticipate a move towards the top of that range this year. The biases in portfolios throughout 2010 were to pro-inflation stocks and themes. Little has changed as we enter 2011 and the first weeks of 2011 have immediately highlighted the significance of some of these structural issues, such as food prices. We are at the beginning of a secular bull market in agricultural commodities based on factors that are unlikely to dissipate any time soon: water shortages, climate change and rising food demand from rapidly expanding developing economies. Strong earnings momentum is set to continue with many European companies well exposed to the growth areas in the world. Balance sheets remain healthy, dividend yields are attractive relative to cash and equity-retirement may well come back into vogue alongside an improvement in M&A activity. As we have long said, in an environment such as today “the strong will get stronger”, hence why the emphasis on franchise value and growth companies remains in place.

MT LUCAS

Fund: OpenWorld Commodities Long Neutral
Manager: Mount Lucas Management LP

Russell overview: Although the strategy managed by the manager is strictly following a disciplined momentum algorithm, as professional investors and traders in the commodity markets since the mid-80s, their understanding of the markets and their outlooks can not be dismissed. In that regards, they remain very positive on the agricultural commodities and to a lesser extent energy-related ones.

Manager insight: Looking ahead to 2011, and the macro factors that drive the commodity markets, the tightness in the Commodity markets looks to be a long term problem. China’s demand for Commodities is growing at an accelerating rate. Crop production in the U.S. continues to grow linearly, failing to keep up with demand from China. Commodity markets have been saved so far due to the rapidly increasing yields in South America, namely in Brazil and Argentina. To date, these emerging agricultural economies have enjoyed rapid rises in acreage and yield per acre. The problem is, these now maturing industries are unlikely to maintain their current growth rate, and future yields will most likely achieve linear trend growth, much like the U.S. agricultural market. These growth rates will not be able to keep pace with Chinese demand. Supply is very tight for next year to meet global demands, record yields are needed just to keep up. We think grains, particularly Corn and Soybean will continue to move higher even from these levels. We think Gold is overbought, Sugar probably range bound here. We also think Natural Gas, while there is plenty of supply is a bit oversold and has some upside potential. We are bullish Crude Oil, but not to the degree we are bullish grains.

Fund: OpenWorld Global High Dividend Equity
Manager: Thornburg Investment Management

Russell overview: Cliff Remily, the portfolio manager, sees some reasons for optimism, including a cyclical recovery in earnings and reasonable valuations, supported by an accommodative monetary policy. He also cautiously observes that this could be the "year of the dividend".

Manager insight: Looking forward, we see some reasons for optimism, including a cyclical recovery in corporate EPS and reasonable valuations, supported by an accommodative monetary policy. Concerns that we face include rising oil and commodity price inflation and continued weakness in employment and the housing market. Deflation and or a double dip recession now seem unlikely. Quantitative Easing has provided a tailwind for asset prices in general, and for energy and materials stocks in particular, and we expect this trend to continue.

Fund: OpenWorld Global Climate Change
Manager: Impax Asset Management

Russell overview: The managers do not envisage any significant changes to the portfolio structure. They expect markets to continue to trend higher and will take some profits in the US and recycle the assets into Europe where they feel valuations are attractive and the sovereign debt risks are abating.

Manager insight: After a volatile year for equity markets, expectations for 2011 are positive, although downside risk remains over financial stress in the Euro area, stagflation in developed countries and over-heating in China. Although a handful of sub-sectors, particularly renewable energy, are struggling to recover, the outlook for environmental markets, in general, is encouraging, driven in particular by a strong Q3, anticipated cyclical recovery in construction markets, upward pressure on commodity prices and continued emerging markets growth. M&A activity continues to contribute to performance, with large multinationals paying rich valuations for companies with strong technology and good market positioning. Valuations remain at the low end of the historical range and portfolios are well positioned for sustained growth.

Fund: OpenWorld US Credit
Manager: Logan Circle Partners

Russell overview: We remain positive on investment grade credit. While fundamentals and technicals remain supportive, current valuations are less compelling. Individual credit selection will drive excess returns in 2011 as we anticipate bondholder-negative corporate actions accelerating in the coming quarters.

Manager insight: Additional stimuli (in the form of QEII, extended Bush era tax structures, a new payroll tax reduction, and unemployment benefit extensions) were all enacted in the 4th quarter of 2010 to provide a boost to economic activity over the next 6 to 12 months. We do however remain mindful of the unintended consequences that these initiatives could potentially bring about. Potential headwinds in the form of high commodity prices could put pressure on margins and effectively negate the positive impacts of tax policy for consumers. Congressional gridlock among policy makers along with heightened sensitivity to austerity and deficit spending makes further stimulus or QEIII a remote possibility. After an impressive two year run, we have tempered our expectations for total and excess returns from investment grade credit for 2011. While fundamentals and technicals will remain supportive, valuations are less compelling with high grade spreads at multi-year tights. In the case of industrials, credit spreads have returned to levels eclipsing, on the tight side, even 2006/2007 valuations. From a fundamental standpoint, investment grade credit metrics continue to show steady improvement as top-lines grow at a modest pace, interest expense resides at historic lows, and profitability expands. Technicals within investment grade credit

remain supportive. Demand for investment grade paper will be strong with higher all-in yields and anaemic non-corporate spread supply. The breadth of potential spread tightening will be concentrated within the financial, communications, and crossover spaces of the market as most industrials and utilities are unattractive at current levels. Individual credit selection will drive excess returns in 2011 as we anticipate bondholder-negative corporate actions accelerating in the coming quarters.

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