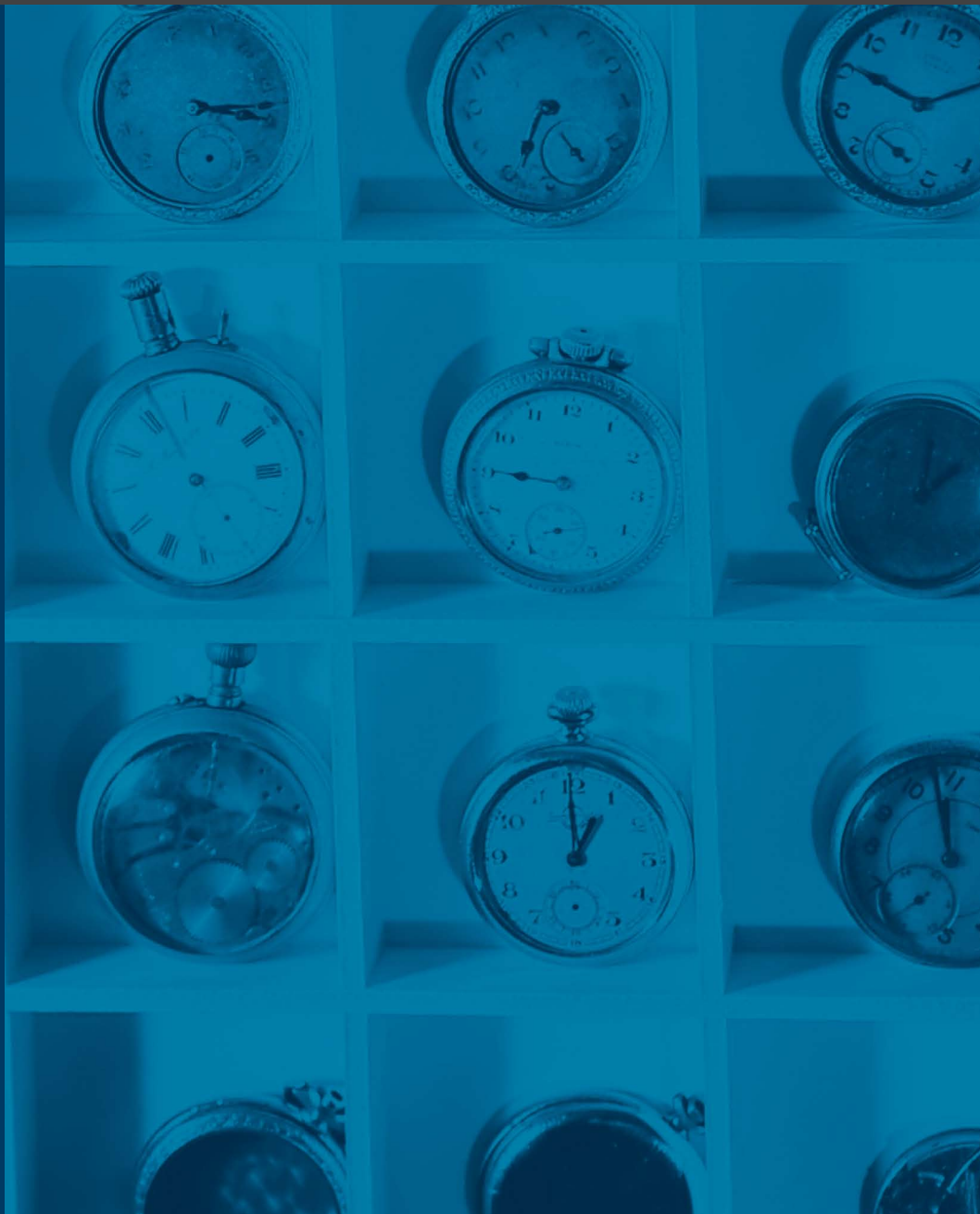


Investment Brief

Economic Outlook	1
House View	2
Fund Review	3
Commercial Property	4



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Registered in England number 2146006;
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Economic Outlook

Equity markets rallied in the final quarter of 2011, going some way to repairing the damage done in the previous period, but still leaving most major indices down for the year. Investors will not look back on the year with any fondness as almost unprecedented levels of volatility made for very difficult markets, regardless of asset class.

Whilst there was no specific event, like Lehman Brothers in 2008, to pinpoint for the year's troubles, it was a confluence of unrelated events and failed political initiatives that caused sudden lurches in sentiment. The Arab Spring, Japanese Earthquake and the US debt ceiling brinkmanship and subsequent downgrade dominated the first half of the year, but it was the European debt crisis that dominated the second half, and will continue to do so into 2012.

Whilst the European summit in December edged the Euro countries closer to fiscal union, it did little to fix the solvency issues of the periphery, and until that starts to happen, it will weigh heavily on market sentiment. The "Merkozy" plan is to apply fiscal rules to balance budgets, keep debt to GDP at 60% and apply automatic sanctions on those countries that break the rules. However, most members are already in breach, and whether the sanctions are enforceable is highly debateable.

Europe's political deadlock has eroded confidence and will tip the Eurozone into recession, possibly a deep one. However, such a situation will force Germany in particular to accept a more aggressive European Central Bank (ECB), and allow some quantitative easing, which should stave off a collapse of the banking sector and therefore boost markets. Unfortunately for the UK, its dependence on Europe for exports means a recession there will have a large impact on growth at home as well, and a UK recession will at least be flirted with during 2012.

Aside from Europe, it is China and the US that will have the greatest impact on the investment landscape over the next year. The prospects for the latter are reasonably positive after a series of consensus-beating economic data releases over the last few months that have alleviated concerns about a double-dip recession. Markets have so far given the US an easy ride on its fiscal situation compared to the treatment of Europe, but eyes will certainly be on November's election as then there will finally be some potential for consensus on how to tackle their debt mountain.

Anxiety over the Chinese slowdown is still running high and a "hard landing" is possible, though at this stage still unlikely. However, the property bubble is bursting and the collapse of such credit fuelled manias would have an impact on an economy, even a carefully stage-managed one such as China. Consensus still suggests more than 8% growth for China in 2012 however, keeping its place as the engine room of the global economy.

The slowdown in China coupled with a recession in Europe suggests a potential theme for 2012 is deflation, driven by lower commodity prices. This would be positive for importing nations and consumers alike, but would likely spark developed country central banks into more quantitative easing, as interest rates are already at their floors. Emerging country central banks however are able to cut rates, and indeed China and Brazil already have.

The outlook for 2012 therefore continues to look uncertain, with the potential for disaster not insignificant, and a roadmap for tranquillity hard to foresee. A global "double-dip" recession should be avoided, and a resolution in Europe is likely to be found in some form, but the road will be rocky and the wild swings in investor sentiment we saw in 2011 are likely to feature again in 2012.

House View

We used October's market rally to trim back on risk, creating a tactical cash balance by removing some of the more risky equity and bond funds. Whilst we felt the sell-off in August and September to be over-the-top, we equally felt the rally in October was built on hope rather than anything more concrete. With the likelihood of the European debt crisis dragging on well into 2012, we felt it prudent to reduce risk levels until a clearer picture emerges.

With the prospect of a solution looking further away, we established a position in short-dated Gilts in December using part of the cash balance built up during October and November. Whilst we have made our negative view on Gilts clear in the past, we see the largest dangers in longer-dated Gilts, where yields have reached levels that only the prospect of a prolonged Japan-style deflationary environment could justify. At the short-end, the yields are still better than interest on cash, and there is the optionality of capital appreciation should market sentiment turn negative.

Having a tactical cash balance allows us to take advantage of better entry points in the future, and also helps to weather any more falls, such as those we saw in August and September. According to industry surveys most institutions are also overweight cash, and in a world of near-zero interest rates, they will eventually be forced into risk assets, as the pressure to find a return grows ever more acute. In the fixed income world, the yields on Investment Grade credit, High Yield and Emerging Market debt all look attractive, and could well be the first home for the cash piles built up around the world.

Equities have had a tough year, but at least having half of the allocation in the UK has meant overall returns have been better than being purely

Global, as the FTSE All Share outperformed all major indices bar the US. Corporate earnings have performed well, but market sentiment has been terrible with the second half of the year feeling very 2008-esque: little liquidity and markets going up or down on the utterances of politicians. What it means though is that equities look very cheap, especially in comparison to Government Bonds. Subtracting the UK 10-year government bond yield from the FTSE100 dividend yield produces a spread last seen during the crisis of 2008, a situation that reversed sharply in 2009, which was a great year for equities.

We have recently made a change to the definition of the Absolute Return sector, splitting the allocation into Multi Strategy and Long / Short. Clients and industry professionals alike have been confused and even bemused by the term "Absolute Return". Our objective is to better explain what the funds within these asset classes are trying to do.

Multi Strategy refers to a fund that uses a variety of asset classes, both long and / or short to express their investment view, typically derived from a top-down investment process (an example is featured in the Fund Review overleaf). A Long / Short fund runs both long and short positions in a single asset class, using a bottom-up investment process, taking none or very little

market risk. An equity market neutral fund such as Absolute Insight UK Equity Market Neutral would be a typical example, as it has as many long positions as short, meaning that it is unaffected by whether the FTSE All-Share falls or rises each day, instead relying on the fund manager's ability to go long outperforming stocks, and short the underperformers. In both cases we want these funds to provide returns that are not correlated to equity markets, providing diversification and protection particularly at times of stress.

We feel that the changes made in the last quarter mean that our clients' portfolios are in a stronger position should there be an event that triggers a sell-off, but are still sufficiently invested to benefit from an improvement in sentiment, and the cash balance enables us to take advantage of either situation.

House Tactical Positioning

Asset Class	Current Position
Cash	Overweight
Fixed Interest	Underweight
UK Equities	Neutral
International Equities	Neutral
Property	Neutral
Alternatives	Overweight



CF Eclectica Absolute Macro Fund



Fund Managers:	Eclectica Asset Management
Fund Size:	£54m
Asset Class:	Multi Strategy
Tenure:	December 2009

When putting together multi-asset portfolios, the aim is to blend strategies that can independently make money, but do so at different times. One style that is consistently uncorrelated to other asset classes is known as Global Macro, essentially investing using fiscal, monetary and even political analysis.

One of the UK's best macro investors is Hugh Hendry, co-founder of Eclectica Asset Management. His UCITS III CF Eclectica Absolute Macro fund aims to preserve capital and generate absolute returns using a top-down approach to allocating between Global Equities, Commodities, Global fixed income, Currencies and Credit on both a long and short basis.

Hugh's best returns have come at times when there are shocks to the global economy, and equity markets struggle. The fund returned +9.14% for 2011, a year when the total return of the FTSE100 was -2.18%, and the MSCI Emerging Markets index was down -17.82% (see Figure 1). Eclectica's offshore fund, which follows a very similar strategy, did particularly well in 2008, which was one of the worst ever years for equity markets.

Eclectica's central view is that the current problems surrounding European and US debt, the state of the economic recovery (or lack thereof) and austerity measures being placed on most economies mean that interest rates will remain at depressed levels for a long time to come. He therefore has short positions on both European and Australian rates, the latter being a play on Chinese growth as much as Australian given their dependence on resources. The market has a floor of 3% for Australian rates; a barrier which Hugh thinks is irrational.

Hugh is naturally contrarian but acknowledges that investors can be intellectually right about something, but still lose money if the market does not agree. This is why he puts great emphasis on price trend analysis to back up his top-down macro analysis and fundamental research. Capital preservation is of great importance to him, and he will reduce the risk in the fund if he feels the market environment is not likely to support his view.

Figure 1



31/12/2010 - 30/12/2011 Data from FE 2012

Commercial Property

One of the few areas to make positive returns during 2011 was UK Commercial Property, with the benchmark FTSE ALL Property index showing a positive total return of 5.37%.

The UK Commercial Property market was historically measured against the IPD UK Monthly Index. The data within this index is taken from 71 monthly valued funds, with a total value of £25bn. However one of the drawbacks of this benchmark is that the monthly data is often not available until thirty days after month end. A further disadvantage of this benchmark is that many of the underlying long term property funds are geared. This was fine when we and many other investment managers used popular geared property funds in the early 2000's.

In recent years we have used the FTSE All UK Property benchmark rather than the IPD. This benchmark is more akin to lower geared property funds although it includes a weighting in Real Estate Investment Trusts (REITS). REITS are listed companies that invest in property. Due to their stock market listing, the fluctuation in price is often more influenced by the volatility of the stock market rather than the actual underlying values of the properties within the fund.

Commercial Property is included in our clients' portfolios to diversify risk away from reliance on fixed interest and equities. Correlation with fixed interest and equities is typically low and this proved to be the case again during 2011. Our preferred Commercial Property holdings performed well on a relative basis to other asset classes.

2011 was a reasonable year for commercial property, particularly prime office space in the South East of England which witnessed a surge of interest from overseas investors. The definition of "prime" is important in understanding our preferred property managers. M&G under the leadership of Fiona Rowley is perhaps the most defensive that we hold; she considers that the key features of prime property are strong covenants, long leases and quality assets. Some of Fiona's top ten tenants include Tesco, B&Q, House of Fraser,

HSBC and J Sainsbury. This fund is ungeared and achieved a positive return in 2011 of 3.6%.

We are often asked why we invest in unit trusts rather than directly in REITS. As highlighted earlier REITS are stock market listed property companies. This means that during times of market stress these companies exhibit similar behaviour to markets like the FTSE 100 and therefore do not afford short term diversification within portfolios. A good example of this is Land Securities PLC which is a FTSE 100 company and the largest REIT in the UK based on market capitalisation. The company has a high quality tenant base with J Sainsbury as the largest retail client. Land Securities achieved share price performance of -2.2% during 2011 but the notable feature was the volatility and drawdown of the share price. The biggest period of drawdown for the share price in Land Securities during 2011 was between July and October at -28.9% against -5.3% for M&G Property. Similarly the twelve month volatility for Land Securities was an exceptionally high 28.2% (FTSE 100 = 21.0) against the FTSE All UK Property benchmark of 2.1% (source: FE Analytics). Correlation of markets and stocks is a critical factor in determining how we build portfolios for our clients, hence we favour funds with proven management that historically have achieved lower volatility and correlation to equities and fixed interest.

It is encouraging to note that 2011 witnessed a reasonable level of property transactions, comparable to the £35bn in 2010. This included an exceptionally quiet summer during the re-ignition of the European Debt Crisis. Land Securities,

Hammerson and British Land were net purchasers of property for the first time for some years. Overseas investors included private equity and countries like Norway at a time when there is a lack of capacity in the UK debt markets available for traditional investors.

Prime property rental growth showed a small positive during 2011. Our managers anticipate that quality property with long leases in good locations will continue to present attractive opportunities in 2012. The secondary market appears much less positive, particularly outside of the M25 where public sector spending cuts and general austerity in the regions could lead to more businesses struggling to pay their rents. There is a growing polarisation between regional towns such as Harrogate, Winchester, York and Brighton on the positive and Sunderland, Swindon and Rotherham on the negative. As such we favour managers with a more defensive style where they hold larger weightings in prime assets.

The outlook for UK Commercial Property is therefore mixed; our managers seek opportunities within the quality end of the market, attempting to avoid areas of concentrated public sector weakness. As we look to 2012 and beyond we are also questioning how such huge new London projects such as The Shard and 20 Fenchurch Street (Walkie Talkie Building) can find the necessary tenants with the traditional long leases. This is at a time of substantial upgrading of existing office space in London and when the Financial Services market continues to shrink. The Walkie Talkie Building at 509 feet tall and 680,000 sq feet is scheduled for completion in April 2014. This will house, amongst other things, the highest public park in London called the "Sky Garden". Such extravagance must surely be questioned.

This document does not constitute advice or a personal recommendation or take into account the particular investment objectives, financial situations or needs of individual clients. Clients are advised to contact their asset manager as to the suitability of each recommendation, for their own circumstances, before taking any action.

This research has been prepared with all reasonable care and is not knowingly misleading in whole or in part. The information herein is obtained from sources which we consider to be reliable but its accuracy and completeness cannot be guaranteed.

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It should be remembered that past performance is not necessarily a guide to future performance.