

**Ian Kernohan**, RLAM's Economist, gives his reaction to the Brussels Agreement and its wider implications.

**Robert Talbut**, RLAM's Chief Investment Officer, discusses the growing impact that policy makers have on financial markets, the resulting uncertainty of this trend and why this demands a change in approach for stock selectors and asset allocators.

**Derek Mitchell**, UK Opportunities Fund Manager, shares his view on a potential return of the "Nifty Fifty" and reveals which companies he believes are the ones to watch.



**Ian Kernohan**  
*Economist*

While investors have been focussed on developments in the Eurozone, economic news from the US has improved a little, and there are some signs that China may be ready to ease policy, after a long period of tightening. Assuming the European problem is contained for the time being, attention now will turn to developments in these two economies. If recent trends in US data continue, then share prices can move higher from here.

The broad outlines of the Brussels agreement were well flagged in advance, including bank recapitalisation and the setting up of a Special Purpose Vehicle, to act as a conduit for capital from surplus economies such as China and the OPEC countries. This SPV will operate alongside the EFSF, which is to be leveraged, although details on this are still not clear. All economies, not just in Europe, have a strong interest in containing this problem.

In short, we have avoided a messy Greek default at this stage, the ramifications of which threatened to tip the global economy over the edge. This is why equity markets have rallied in anticipation of the agreement and in the immediate aftermath. However, while the short term risk of financial armageddon may have diminished somewhat, this agreement is not a silver bullet that solves the fundamental problem: namely, that the Eurozone is not an optimal currency area, with an active lender of last resort and a co-ordinated pan-Euro approach to fiscal policy.

In the longer term, the big question is whether the Eurozone can survive as a collection of individual democracies, or whether some sense of pan-Euro democracy can evolve. However, that is a question for another day. For now the focus will be on managing the Greek writedown, recapitalising the banks and ensuring that Spain and Italy are not drawn into the circle of woe.



**Robert Talbut**  
*CIO*

Irrespective of the outcome of the latest Euro crisis summit, we will not be returning to a period of sustained healthy growth for a considerable time. This is not to be seen as a persistently pessimistic stance, but rather a realistic assessment of the scale of our current problems and the uncertainties over how they will be addressed.

The biggest change that all market participants are starting to appreciate, post the economic crisis of 2008, is the degree to which the market backdrop and financial returns will be determined not solely by fundamentals such as asset class or company valuations but instead by the action of policy makers. It should be clear to all that the degree of imbalances that exist within the global economy, including the impaired functioning of the banking sector, will necessitate far greater engagement from policy makers.

It is this greater dependence on politicians and central bankers that will make the outturn far more uncertain, and it is this added uncertainty over events that will shape market participants views and actions within markets themselves. For instance, it helps to explain the ultra low government bond yield in 'safe' sovereigns, the low levels of market

participation and also the skittish and volatile trading in many assets including corporate credit and equities. It also explains the general degree of risk aversion that exists overall.

My view is that these issues will persist for an extended period and that the strong emphasis upon fiscal consolidation in an increasing proportion of the globe will pose further challenges to the growth outlook. Once this is accepted I believe that it should lead investors to adjust their approach to stock and asset selection. Corporate bond investors should improve their understanding of the security of their holdings in the event of corporate distress. Equity investors should emphasise sustainable and growing dividend payments as indicators of attractive companies. Using these criteria it should be no surprise that I see bank paper as uninvestable – the capital structure is increasingly seen as fungible by regulators and dividends are restricted, meaning that this a poor home for clients' assets.

Furthermore, asset allocators should shift from using point forecasts to determine relative attractiveness and instead build uncertainty into their forecasting. The heightened degree of uncertainty means that investors cannot hold views on investments with a very high degree of conviction, and therefore asset allocators should be factoring this into their portfolios. Instead of trying to build optimal allocations based upon a certain expected outcome, we should be recognising the high degree of uncertainty by building scenarios of potential outcomes and then positioning portfolios that can both benefit on the upside, but also provide greater protection on the downside. It is by recognising that we don't know for certain what will occur, that we can best position investors' funds for a reasonable outturn. It should not be seen as a failure to build into your expectations the wide range of potential outcomes that the increasing dominance of policy makers brings, but instead as a realistic response to a changed environment which is likely to persist.



**Derek Mitchell**  
*UK Opportunities  
Fund Manager*

Are we about to see a return of the Nifty Fifty? That was the name given to a group of stocks that outperformed the US market for eight years in the late 1960's and early 1970's. Morgan Stanley believes so, and in a recent research piece laid out the rationale for a recurrence of this phenomenon. The deleveraging process that both sovereigns and corporates need to go through will lead to a prolonged period of low growth. This is an ideal environment for companies that can deliver sustainable growth to outperform. The Nifty Fifty grew their earnings

consistently faster than the market despite falling GDP growth. Their ability to deliver also led to a huge valuation re-rating, with the average P/E reaching 45x at the peak. I believe that this is something that we will need to get used to in the UK market.

In today's world, what sort of company would be able to deliver this sustainable growth? Companies with a decent yield that will deliver a better total return? Companies with emerging market exposure that can capture the superior growth offered by this region? Companies with strong balance sheets? All are likely criteria for deciding constituents in a new Nifty Fifty.

To a certain extent we have already seen the emergence of a group of companies that could constitute a Nifty Fifty in the UK. Companies like Babcock, Shire, BG, Experian, Aggreko, Imperial Tobacco, and Compass have already outperformed the UK market through the difficult conditions witnessed this year. These are all quality companies with a defensive bias, but there is also room in portfolios for high quality cyclicals with strong franchises and attractive long term prospects such as Weir Group or Petrofac.

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Source: rlam as at 27 October 2011 unless otherwise stated.

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