30th July 2013

Our Ref: MK/RD/Q213

Mr & Mrs A N Other
123 ACB Street
London
NE1 2BA

Dear Mr & Mrs Other

Re: MPL Portfolio Valuation – 123456789.1

Market Review

Recently we have experienced improving economic fundamentals in the United States, slowing growth in China, benign growth in Europe and increased quantitative easing (QE) from global central banks, which has further inflated prices across all asset classes.

The question posed by many participants within global financial markets has been "when will this excess liquidity be reduced by global central banks, in what circumstances, and how?" As we approached the end of May 2013, a statement made by Ben Bernanke, Chairman of the US Federal Reserve, and relating to a tapering of the $85 billion Quantitative Easing bond purchasing programme, sent the majority of markets across all asset classes into a tailspin.

Many bond market participants took this as a signal that US interest rates would be increased as early as September 2014 as QE is reduced in the midst of a continued US economic recovery. Global bond markets, which are far larger and more sophisticated than global equity markets, immediately priced in this implied US interest rate rise, resulting in increased bond yields, and lower bond prices. The effect of this signal was that the fixed interest segments, namely global and government bonds, of all client portfolios were adversely affected.

As US mortgage rates are linked to US Treasury bond yields, the increase in yields of the latter was matched in tandem by an increase in US mortgage rates. This gave investors cause to worry about the impact of this mortgage rate increase upon the US consumer. As the US housing recovery is still in its infancy, any increase in mortgage rate at this stage could potentially choke off this recovery and with it any further improvement in US economic prospects.

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US 10 Year Treasury Bond (R1) vs. the S&P 500 Index (R2) vs. the FTSE 100 (R3) Index
<u>May 2013 – July 2013</u>

Global equity markets duly took direction from the bond markets, falling from recent multi-year highs. Investors weighed the impact of the removal of excess liquidity, which has inflated asset prices, as potentially contributing to a halt of the US economic recovery.

Owing to the brutal bond market response to the Federal Reserve Chairman's statements, in some quarters there is a belief that Chairman Bernanke has been forced to retreat on his timetable for QE tapering after only two months. He recently said "it was too soon to judge if recent mixed signals from the US economy would prompt the central bank to delay plans to trim its bond buying later this year". As I write, this view has seen US equity markets recover all of the falls suffered at the end of May with many global equity markets also not too far behind. The second quarter US earnings season which is currently underway has, encouragingly, begun with quite reasonable company results announced thus far, leading to further market gains.

However, at this juncture every investment manager is faced with the conundrum of what course of action should be taken in an environment where Quantitative Easing is being gradually removed, the global economic recovery is gaining traction, and fixed interest yields are starting to return to the higher levels you would expect to see in a normalised economic environment.

Looking ahead to the end of 2014, we are still positive on the prospects for forward US corporate earnings, and we consequently are remaining overweight in this area of investment. However, the events of the last two months remind us that almost five years after the onset of a financial crisis which shook the global economy to its core, markets remain volatile.

We continue to try and achieve the investment planning required to fulfill our clients' financial planning goals along as smooth a path as possible. However one must accept that this road will continue to be a bumpy one, along the uncharted journey we face together.

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Fixed Interest

Prior to the recent pullback in global financial markets, we took profits on our tactical overweight position in South East Asian emerging market sovereign debt, as this had reached the top band of its five year trading-range.

We have also reduced our exposure to the Australian Index-linked government bond market. Whilst we have seen price appreciation and good coupon receipts in the period that we have held this asset class, we have been exposed to a negative Australian Dollar/UK Sterling move, which along with the impact of events in May upon global fixed interest markets discussed above, had a negative effect upon the valuation of these securities.

Looking ahead a couple of years, if the US economy continues to improve with the UK economy potentially following suit, we have to consider the impact of these events upon UK Treasury bond yields as this could prompt new Governor of the Bank of England Mark Carney and the Monetary Policy Committee (MPC), to consider a reduction or cessation in the level of QE that the Bank could otherwise commit itself to. This will be a fine balancing act as not only will UK bond yields increase with a resulting negative impact upon prices, but a similar upward move in UK mortgage rates could also occur which would be negative for the UK consumer, albeit within an improving economic climate.

In this circumstance, bonds with a longer dated maturity (greater duration) over five years would be most affected as they are more sensitive to interest movements than bonds with shorter maturities, hence tactically we will be looking to concentrate our UK government index-linked bond holdings in this area of shorter bond maturities, as we wait to see whether or not bond yields potentially normalise to their historic levels seen in conventional economic cycles.

Global Equity

During the recent market pullback, advantage of this was taken by increasing holdings in the global equity section of MPL client portfolios with a risk rating of Below Average Risk and above. We felt at this time that the global equity market pullback, in the US and South East Asia in particular, was overdone and that this was a good opportunity not only to increase our strategic longer term positions in these areas, but also do this in conjunction with a shorter-term overweight tactical weighting.

Commercial Property and Infrastructure

We remain positive on (direct) commercial property and infrastructure, on a global basis. Although we have recently reduced our tactical overweight position in UK Commercial Property Trust as it had reached the top of its trading range, property and infrastructure were relatively unaffected by the recent volatility in global equity and bond markets. Going forward, we will utilise these asset classes more extensively in the lower risk area of client portfolios as we anticipate the potential normalisation of government bond yields, within an improving economic environment devoid of QE.

Gold

Gold remains a very interesting area as we continue to hold and trade this asset class as a store of value. On the one hand, if QE remains in place and without any large-scale reduction, gold will remain a store of value as currencies are debased even further in an uncertain economic environment. The attractiveness of gold as an asset class may diminish however, if we see more certainty that the economic landscape is

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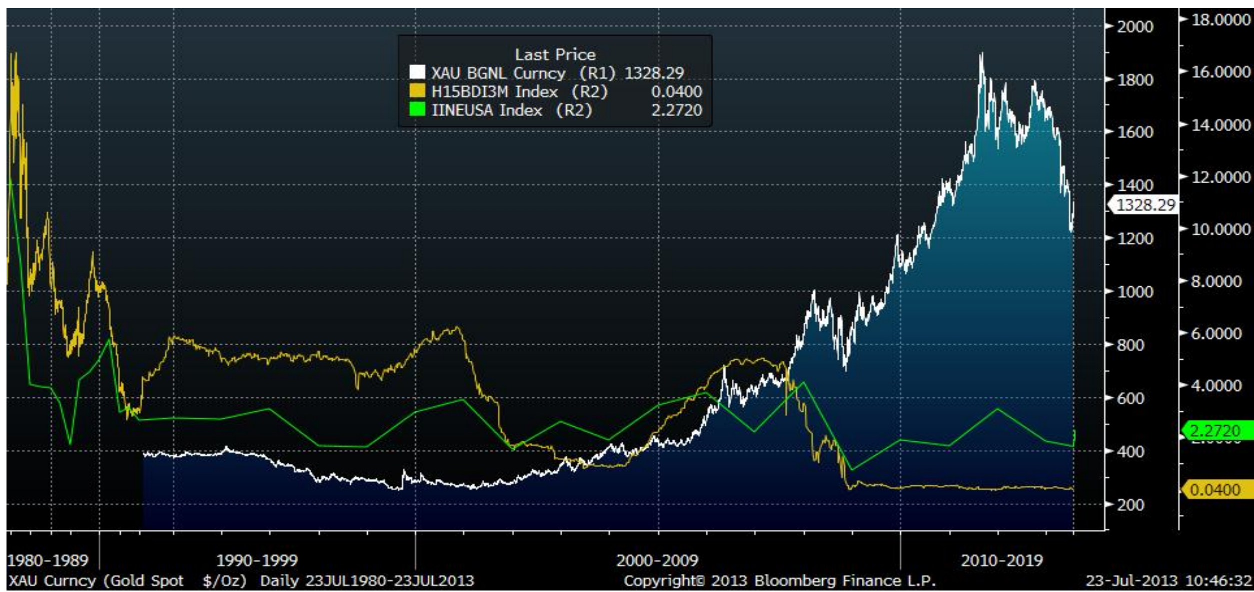
beginning to normalise in tandem with increased corporate profitability, and a subsequent rise in controllable inflation which will lead to an eventual increase in US interest rates. This is simply because other asset classes such as bonds with higher yields, equities of companies with pricing power which can withstand increased inflation, and real assets such as property may appeal more to some investors as they have a yield attached to them as well as capital growth prospects.

Spot Gold Price Vs. US Treasury Bill 3 Month Auction High Discount Rate
Vs. IMF US Inflation end of period consumer price percentage chart 1980 to Present



Source: Bloomberg

The chart above looks at the relationship between the gold price (XAU), US Treasury Bills (H15BDI3M), and US consumer price inflation (IINEUSA) since 1980. We can see that in the period 2001 to 2004, US interest rates fell resulting in a fall in US T-bill discount rates as inflation began to fall; the gold price increased by circa $100 dollars per ounce (or 30%) during this period as the dollar value was debased. Again, in 2008 following unprecedented steps taken by the US Federal Reserve to flood financial markets with liquidity in response to the global financial crisis, the discount rate fell following this action along with inflation in tandem with a sharp increase in the spot price of Gold.

Recently, muted US inflation expectations and investor perceptions of an improving US economy have diminished the attractiveness of gold in the eyes of some investors, who have sold the yellow metal down to under $1350 per ounce, however we note that the US Treasury Bill 3 month discount rate has remained static. We continue to hold gold assets however, we cannot be certain looking forward to the economic prospects for the US at this stage, that an increase in US interest rates (with a subsequent increase in the 3 month discount rate) within the next two years is warranted. Whilst the fall in the gold price has

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potentially been premature, we will have to keep a close eye upon that relationship described above, as other asset classes could come to be more attractive than gold if US economic prospects continue to improve.

With kind regards

AIDAN VAUGHAN
MANAGING DIRECTOR
aidan@mplltd.co.uk

MARK KITSON
INVESTMENT DIRECTOR
mark@mplltd.co.uk

RICHARD DAWES
INVESTMENT MANAGER
richard@mplltd.co.uk

*Figures courtesy of Bloomberg

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