

## IVEAGH WEALTH FUND MONTHLY COMMENTARY

The Iveagh Wealth Fund posted a performance of 3.27% in December.

For the best part of the 4<sup>th</sup> quarter of 2009 we were highlighting that our inputs were uniformly positive and that as a result of that we increased portfolio risk to a volatility target of around 17%. This certainly was a contributing factor to performance in December. However, we do see a number of risks ahead in 2010 and will be very nimble in re-adjusting portfolio risk exposure during the year.

Market exposure at month end was as follows: Major Market equity 33.6%, Small Cap and Tech equity 5.9%, Emerging Market equity 6.4%, Far East ex Japan equity 14.7%, Private Equity 5.9%, Natural Resources 3.9%, Gold and Precious Metals 3.8%, Real Estate 3.9%, Absolute Return 16.9%, Cash 4%.

Since this is our last report for 2009, we have produced a lengthier version than is usual and titled it "Out with 2009 and in with 2010". This report appears below:

### Out with 2009 and in with 2010

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Financial markets will enter 2010 with a degree of trepidation and for good reason. After all, the structural debt problems that created the meltdown of 2008 and the near collapse of the global banking system have only been partially addressed. In particular, leverage in the financial system has certainly come down and banks have raised enormous amounts of capital through share issues both of which are a positive and global credit markets have rallied allowing for higher valuations of assets on banks' balance sheets. However the response to the greatest economic contraction in the post war period in most regions has been extremely high government deficits and zero interest rates. Both of these will need to get addressed at some stage and only then will we know how fragile or robust the current recovery is.

2009 certainly ends with solid annual returns in all equity markets. Major market equities have posted returns ranging from 17% in Japan to around 25% in the case of the US, Europe and the UK. Much more stellar performance has come from emerging market equities

with China A shares up 80% and Brazil rising by no less than 140%!

It must however be borne in mind that major market indices lost about half of their value in 2008 and thus a rally of around 25% puts an investor who invested 100 dollars at the beginning of the 2008 still around 30% down. We highlight this because investors should in our opinion, look at the returns on their portfolios and from their specific managers over the two years 2008 and 2009 and not at just one year in isolation of the other.

The Iveagh Wealth Fund did protect investor downside in 2008 with a loss of 1.5% and ends 2009 with a gain of around 5% and thus investors would have seen a positive return on their money over the two years, itself no mean feat! However, that now lies in history and the key question is what can we expect in 2010?

With regards to this the answer, according to our inputs is rather positive, at least in the near term. Our models suggest a positive outlook for global growth in the first quarter with the risk being that growth surprises to the upside rather than the downside. This is likely to occur in an environment of benign inflation but more importantly one in which the threat of deflation has been fully dissipated. Given the low inflation outlook and the large output gap that persists in major economies, zero interest rates policies in countries such as the US and the UK are unlikely to be changed early in the year. However, it is important to note that the factors that will drive monetary policy have all reversed. In the first phase that is good news as it means that the threat of deflation has gone, that house prices have finally stabilised and may rise somewhat, that unemployment has peaked and that we may see it fall somewhat during the year and that credit conditions remain on a positive trend of improvement. Eventually as these trends accelerate, they may trigger a monetary policy response, but in our view that may not occur in 2011. In the market's opinion, however, US rates are likely to rise by August of this year.

Market positioning suggests that retail flows into riskier assets have been slow and that there is still strong pent up demand for equities from investors who switched into

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cash in 2008 and early in 2009 whilst hedge funds have increased their net and gross exposures through the year.

Valuations for equity markets are at around historical averages which in turn poses the question as to whether the glass is half full or half empty. We see it as half full given that analyst earnings forecasts may prove too conservative and given the economic fundamentals of strong growth, low inflation and zero interest rates mentioned above. Thus, we would not be surprised to see an expansion in market PEs in 2010.

Finally all global equity markets broke out of their bear trends during the second half of 2009 and enter 2010 with firmly established uptrends. For these uptrends to be broken the recovery would have to fizzle out or policy errors would need to occur.

Thus our recommendation is to focus on the above inputs early in 2010. However, we do see risks ahead. First and foremost, it is important that the global economic recovery be sustained. Any sign of a renewed downtrend would be very negative. Secondly, it is important that the threat of inflation does not emerge as that would impact valuations negatively and may force a policy response through higher interest rates earlier than it is warranted. Third, we are wary of rising inflation later in the year in countries such as China and the possibility of a policy response there that has a broader implication of global equity markets.

Most importantly of all, we are extremely concerned about the risk of a policy error by governments on the fiscal side. This situation is best illustrated by the UK where the government has failed to take any deficit reduction measures whatsoever ahead of a mid-year election. This decision could prove extremely reckless for a government running a deficit that stands at 14% of GDP, an extraordinarily high number, and that needs external funding for its debt. The risk here is that government bond yields rocket up in order to attract inflows of capital to fund the deficit and that a currency crisis takes hold as well. The markets could, in such an environment, punish other sovereign entities that have failed to address their fiscal position, including the US.

In conclusion, we enter 2010 encouraged by our econometric inputs and the recovery that has taken hold since the middle of 2009, but wary of the “tail risk” that exists in government bond markets as well as the risk that the recovery itself may not be sustained later in the year. As a result, we will use our forward looking inputs as an important guide with regards to whether portfolio risk should be reduced at some stage in 2010. In the absence of these two key risks, however, 2010 should post another positive year for equity market returns.

The Iveagh Team

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