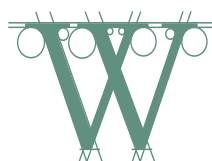


A broad opportunity set for an uncertain world

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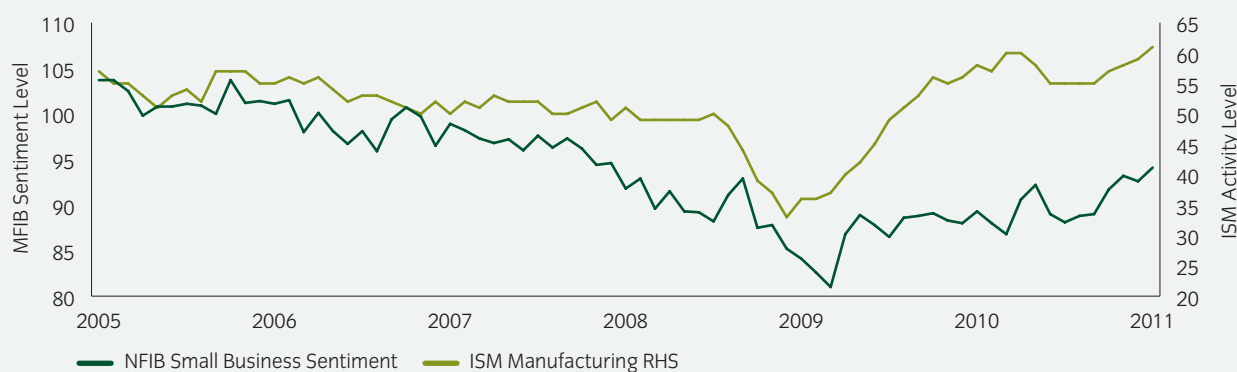


With the economic recovery picking up, investors are becoming increasingly optimistic on the outlook for risk assets. Yet investors would be well advised to maintain a dynamic approach to asset allocation given the potential road bumps that lie ahead. Using a broad opportunity set of potential investments also makes more sense than limiting your hand to traditional assets.

A cyclical recovery is underway

With economic data in the western world improving, a cyclical recovery is underway in the developed world. Data is particularly robust in the US, where manufacturing activity is strong and even unemployment levels have shown tentative signs of improvement now that the small business sector is participating in the recovery. In addition, the core of Europe is showing considerable strength, with high German consumer optimism being buoyed by strong exports of luxury goods to the Far East. Despite a weak Q4 GDP figure following severe weather conditions, the UK is also rebounding, with both services and manufacturing data improving. This provides a constructive environment for equities, although our exposure is currently skewed to the developed world as we remain wary of markets where we see crowded trades.

Chart 1: Small business sentiment is now picking up



Source: Bloomberg.

Not a normal recovery

In our view, however, we are not witnessing a 'normal' recovery and to an extent we are in uncharted territory, with no clear medium-term path being evident. There are significant structural imbalances at a country level, in the form of unsustainable budget deficits in Europe and the US, for example. The financial sector is also still in balance sheet repair mode, as are Anglo-Saxon consumers who do not have a large financial cushion to protect themselves from price rises. Signs of improving growth and the threat of inflation bring with them the prospect of policy normalisation as official interest rates begin to move

from their current near-zero levels. This is likely to prove a significant challenge in a world where western governments cannot afford higher interest rates and consumers are not well placed to withstand higher mortgage costs, for example.

Not a time for static asset allocation

Overall we feel that the after-effects of the financial crisis are likely to continue to result in a more volatile economic environment, with the coming decade being characterised by shorter periods of expansion and more frequent recessions than has been the case since the early 1970s. This reflects a more fragile environment in which a number of key stories are unfolding, with each one bringing both risk and opportunity. Given this, we are convinced of the benefits of a more dynamic approach to asset allocation which avoids traditional static asset allocation models or ‘buy and hold’ mentalities. By having access to a broad opportunity set, including equities, bonds, total-return strategies, real assets and opportunistic trades, and being ready to move swiftly between these asset classes, we are in a better position to take advantage of changes in the economic environment.

Three main acts in play

There are currently three major themes we see in financial markets. The first of these is focused on policy normalisation and deleveraging in developed countries. With growth picking up and inflationary pressures building, policymakers – particularly in the UK and mainland Europe – recognise that near-zero official rates are no longer appropriate. Interest rates are therefore likely to rise later this year. However, given high levels of government and consumer indebtedness, there is a need for structural debt repayment at a state, banking sector and a household level. This heightens the fragility of the recovery and is likely to limit the scope for significantly higher interest rates. Nevertheless, we currently have limited exposure to government bonds in our multi-asset portfolios as the short-ends, in particular would be vulnerable in the early stages of policy adjustment. We prefer corporate bonds with short to medium-term maturity where we have greater clarity on the prospect for company solvency.

The second theme is that of the rise of the emerging world. In recent years this has been a positive support for global growth while the Anglo-Saxon world was struggling. However, many emerging markets are currently experiencing inflation problems driven by food and energy. In some areas this has proved a catalyst for political tension as in the Middle East and this poses additional risks that are currently in the limelight. Elsewhere it brings the prospect of further policy tightening. In some countries, exchange rate appreciation is an option to help counter inflationary pressures and we retain exposure to a basket of emerging market currencies where we see the prospect of revaluation.

Lastly is the theme of sovereign debt problems, particularly in peripheral European countries. In our view, much of the problem in these countries stems from the fact that they have monetary union without sufficiently common fiscal policies. More closely aligned fiscal policy would require a much higher degree of integration between the core and periphery and whilst a new set of ‘rules of engagement’ are currently being devised, uncertainty is likely to persist with a number of key event risks likely in the coming months. Against this background, we have limited appetite for peripheral risk and prefer cyclical exposure to the core. Our European equity exposure, therefore, continues to be skewed towards Germany.

Chart 2: Germany outperforming Europe



Source: Bloomberg.

Flexibility and risk management are key

With considerable uncertainty continuing to cloud the investment horizon, we believe investors should remain flexible in their investment approach, and have the ability to move dynamically between asset classes should economic conditions change. Having a broad spectrum of investable opportunities increases the scope for investors to take advantage of a wide variety of market themes. Skilled downside risk management is also key, helping to protect portfolios from significant market falls.

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