2nd Quarter 2014

5 Key Issues Shaping Current Investment Strategy

1	**Sterling looks overvalued, but currency headwinds may continue for some time.**
2	**With markets close to fair value, long-short strategies can boost performance.**
3	**Referendum: “Should Scotland be an independent country?”**
4	**China – hard landing or managed slowdown?**
5	**Emerging markets – are bonds a better way to gain exposure than equities?**

Sterling Looks Overvalued, But Currency Headwinds May Continue For Some Time

- Sterling has rallied significantly and is close to a five-year high against the dollar, driven by higher growth forecasts and the expectation that the Bank of England may be the first major central bank to raise interest rates.
- Sterling looks overvalued on certain measures, but may remain strong if growth and geopolitical tensions continue.
- Concerns about deflation and the possibility of interest rate cuts to 0% or lower are making the euro less attractive to investors.
- Sterling strength is already having an impact and a number of companies have indicated currency headwinds when reporting results. Shares in mid-sized companies tend to outperform in periods of sterling strength because of their domestic bias.
- Dollar-denominated assets will be more attractive to investors who believe that sterling will weaken in the coming months. Overseas investors may not begin to discount the risks of the general election in May 2015 until the Autumn.

Figure 1
Sterling has rallied strongly and is close to a five year high versus the dollar.

Source: Rathbones, Datastream

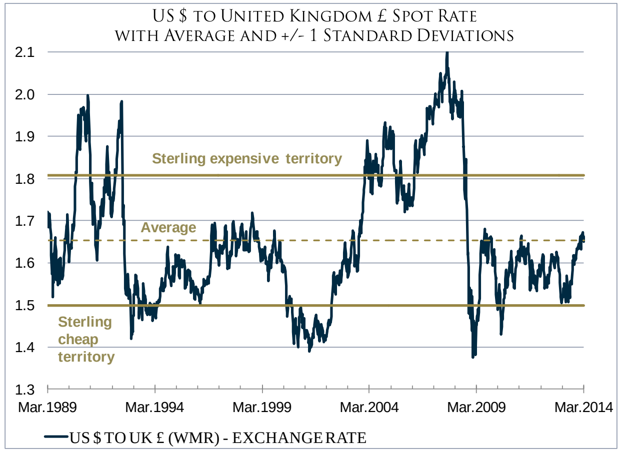
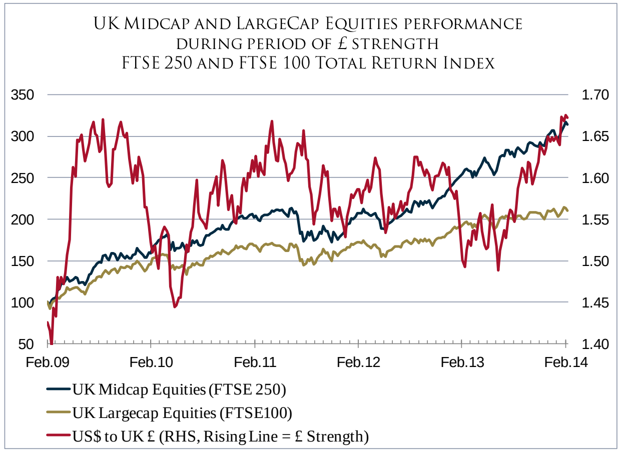


Figure 2
UK mid-cap stocks tend to outperform during periods of sterling strength because of their domestic orientation.

Source: Rathbones, Datastream



WITH MARKETS CLOSE TO FAIR VALUE, LONG-SHORT STRATEGIES CAN BOOST PERFORMANCE

- With equity and bond markets trading at or around fair value, attractive opportunities lie with hedge fund strategies that aim to identify winners and losers within these markets, rather than those that depend on market direction

- The Dodd-Frank Act in the US means that investment banks cannot now trade on their own account, so less capital is competing to exploit pricing anomalies amongst equity and credit securities.

- In the first quarter of 2014, a higher level of corporate activity, as well as downward earning revisions in the US, led to wider dispersion of stock price performance.

- Long-short managers are increasing their overall portfolio exposures while not betting on market direction – this reflects greater conviction in their ability to identify individual stock ideas and an increase in overall opportunities.

Figure 3
US and UK equities are trading close to fair value.

Source: Rathbones, Datastream

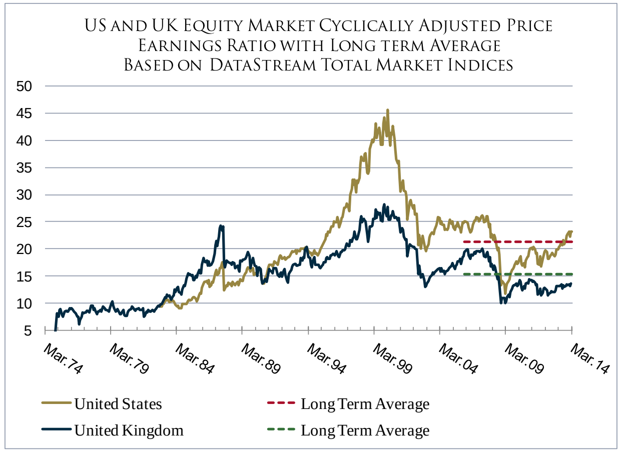
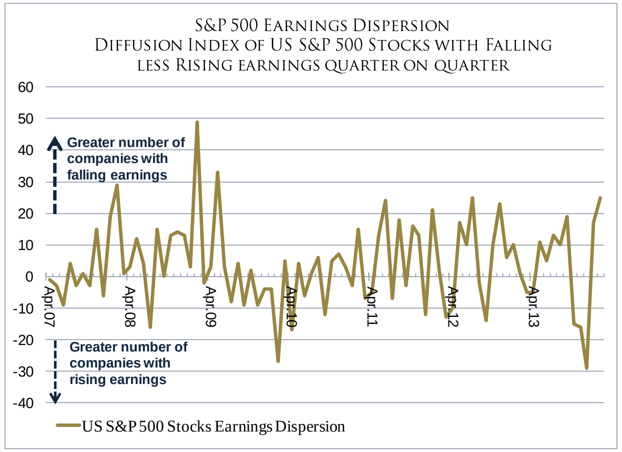


Figure 4
A greater number of US companies are revising down their earnings, leading to greater dispersion of stock price performance.

Source: Rathbones, Datastream



REFERENDUM: "SHOULD SCOTLAND BE AN INDEPENDENT COUNTRY?" (18 SEPTEMBER 2014)

- The 2012 Scotland Act will come into effect in 2015, regardless of the referendum, introducing a new land, property and income tax regime.
- An independent Scotland would face a budget deficit due to higher public spending. Oil revenues only partly fill this gap and long-term production is in decline. The deficit could be offset by higher taxes or lower spending.
- Keeping sterling would minimise "the border effect", but could be unpopular due to the resulting restrictions on monetary and fiscal policy.
- Investors will scrutinise the Scottish government's macroeconomic policy. Strategists estimate that an independent Scotland would pay an interest rate premium of 0.7% to 1.85% over the UK 10-year gilt.
- Scottish residents and the remainder of the UK may need to move liquid assets such as SIPPs and ISAs if these assets are located in a foreign domicile and in breach of EU cross-border rules.
- Financial services firms could face higher regulatory costs. Food and energy prices could rise for Scottish consumers.

Figure 5
It remains uncertain how the North Sea oil revenues will be divided if Scotland becomes independent.

Source: Rathbones, The Scottish Government

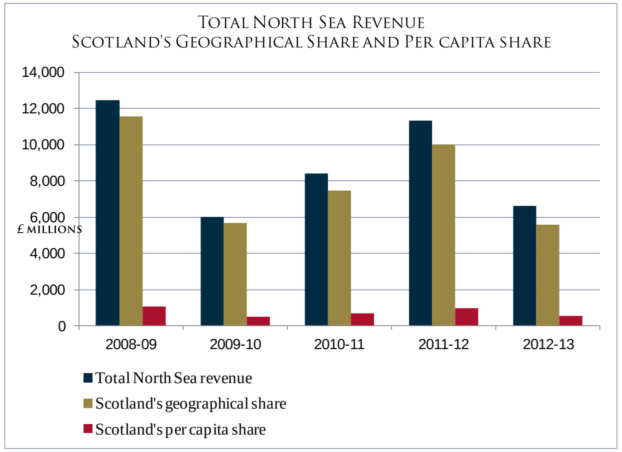
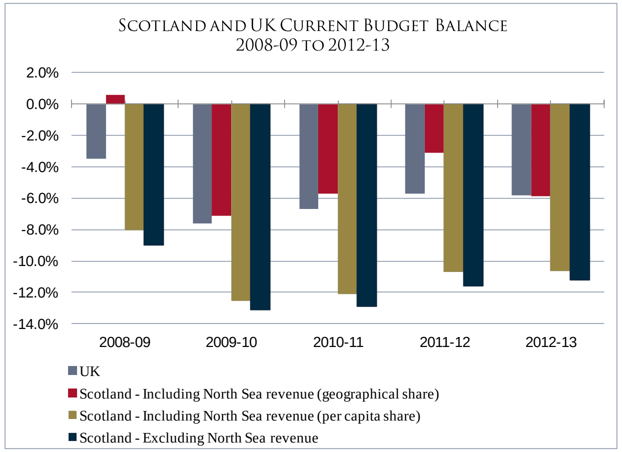


Figure 6
Depending on how the North Sea Oil revenues are divided, there could be a significant impact on the Scottish Government budget.

Source: Rathbones, The Scottish Government



CHINA – HARD LANDING OR MANAGED SLOWDOWN?

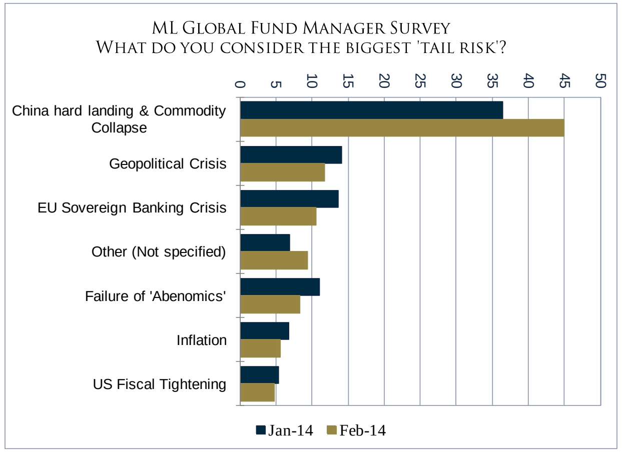
- The first corporate bond defaults have caused investors to question the health of the banking system after explosive growth in lending in recent years.
- There are some concerns that China may experience a credit crunch and short-term borrowing rates (Shibor) have risen sharply at certain points in recent months.
- The re-orientation of the economy away from infrastructure spending towards domestic growth has caused weakness in commodity prices.
- Lower growth in China will affect the global economy and Asia. Slowing growth is being priced into Chinese and Asia stocks – hence our underweight position.
- There is optimism over the possibility of a targeted package of stimulus measures – as ever, the key will be in the details.
- Longer term, investors should be wary of the risk of rising geopolitical tension between China and Japan

Figure 7
The Chinese economy has been slowing down as the new administration has been focusing on rebalancing the economy towards more balanced domestic growth.

Source: Rathbones, Datastream

Figure 8
Whilst rebalancing is necessary to create the foundation for more stable long-term economic growth, it is keeping investors on edge in the short-term as the economy continues to slow down.

Source: Rathbones, Merrill Lynch Global Fund Manager Survey



Emerging Markets – Are Bonds A Better Way To Gain Exposure Than Equities?

- Following concerns about the tapering of the US Federal Reserve's monthly asset purchase programme and the slowdown in Chinese growth, emerging market debt (EMD) has fallen sharply and is now offering substantial yields in dollar terms.

- Local currency-denominated EMD offers a material yield premium to this and, with the prospect of some currency appreciation in emerging markets currencies, some EMD may offer double-digit returns.

- EMD may be an interesting alternative to equities *on a risk-adjusted basis* for investors looking to increase their exposure to emerging markets – equities are likely to remain volatile until there are clear signs of a sustained recovery.

- This approach is not suitable for all, but may attract investors with a higher risk appetite and a long-term investment horizon.

- We would suggest gaining this exposure through a specialist EMD fund or a balanced debt/equity fund.

Figure 9
Emerging market debt has fallen sharply and is now offering substantial yields in dollar terms.

Source: Rathbones, Datastream

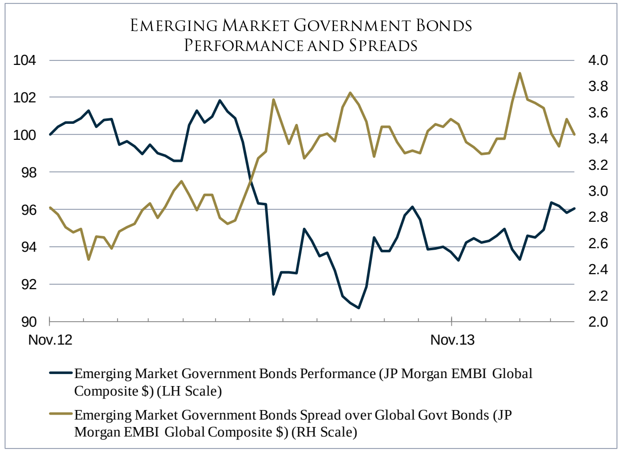


Figure 10
Emerging market debt provides investors with less volatile exposure compared to emerging market equities.

Source: Rathbones, Datastream