Aston
Asset Management

Manager Insight

April 2011

INVESTMENT UPDATE ON INTERNATIONAL EQUITIES

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Much has been written in international circles about the shift in performance from growth to value stocks in January 2011. In terms of style, it appears that this was triggered by a bout of uncertainty on the part of investors on the outlook for growth and inflation across the globe, as well as the desire to lock in profits after a successful 2010 for international stocks. To be sure, the trend did not continue, and by March favor had returned to growth stocks, but it did highlight the need for investors to understand some of the nuances behind the performance of international equity markets.

Although we would describe ourselves as conviction-based stock-pickers rather than style investors, our search for unrecognized growth in companies where earnings growth prospects are better than consensus or where earnings growth is not fully discounted does produce certain style characteristics. Our strategy currently leads us towards growth and away from value factors, with a tilt towards the bottom 20% of the MSCI EAFE Index* by capitalization. In addition, the emphasis we currently have on "quality growth"—companies with strong balance sheets, for example—means that we have a slightly lower expected volatility than the market (as measured by the beta of the portfolio).

THREE BELIEFS

As we look across international markets at the moment, our current investment strategy is anchored by three beliefs. First, that the global economic recovery will continue. Secondly, that we will see weak growth among traditional Western countries as high levels of indebtedness force governments to pull back on quantitative easing, constraining consumers. In this environment, loose monetary policy is still an imperative. Third, that growth will continue in the East, with a sanguine approach to inflation from the authorities.

It is difficult to envisage a scenario, except in the very long-term, where growth rates in the Western world move back to the levels seen during the 1990s and 2000s. This leads us to favor companies with strong sales and revenue growth potential that are able to attract a premium in a low-growth environment, and towards firms listed or active in the Asia and Pacific regions, where economic conditions are likely to be more favorable.

With this in mind, the portfolio is structured around five long-term secular trends that we see, the first of which is Chinese wealth creation. This is well known, but no less powerful for it. In the last five years, we have gone from 10 million Chinese with annual incomes of more than $15,000 to 31 million today, and a projected 72 million by 2015. This has huge implications for global consumption and distribution patterns, and underscores investments in casinos in Macau, where we expect double-digit earnings growth for the next three-to-four years, as well as leading European luxury car makers, private banks—increasingly active in China—and China's leading Internet portal.

The second trend is Internet spending, which we expect to continue to grow at the expense of brick and mortar retailers. Unlike the heady days of 2000, valuations are now at sensible mid single-digit multiples. Among the companies we like is a leading UK online insurer and the dominant search engine provider in Korea, where we see strong potential for earnings surprise.

Third, we expect food prices to continue to rise. More than a temporary phenomenon, we see this as a long-term trend heightened by events such as the floods in Australia, but one fundamentally driven by growing populations, changing tastes, and increasing competition for arable land. This leads us towards producers of fertilizers and agrochemicals, which we believe should continue to do well throughout 2011.

*The Morgan Stanley Capital International (MSCI) Europe, Australasia and Far East (EAFE) Index is is a free float-adjusted market-capitalization index that is designed to measure the equity performance of developed markets, excluding the U.S. and Canada. Indices are adjusted for the reinvestment of dividends and capital gains. Individuals cannot invest in an index.

Fourth, we remain positive on the prospects for gold mining stocks. This has been a long-term theme across our international equity strategies for a number of years now, and we continue to see attractive opportunities for a number of gold mining companies. If inflation were to continue to rise and real rates turned positive, we would view that as the end of the gold trade. For the moment, however, we continue to see opportunities here.

Finally, we remain cautious on the prospects for the European banking sector in what has been another long-term theme for us. Consumer demand for European financial products peaked five years ago, and we expect the environment to remain weak for the next few years.

REGIONAL EXPOSURE

As a result of these long-term trends, we are maintaining a decent amount of exposure towards Emerging Markets, both directly and through companies with significant earnings in the region. This is behind a slight overweight to the UK market. The trends continue to lead us away from developed Europe, where we expect growth to remain low and away from the Japanese market, though we have started to narrow the extent of the underweight here by making selected acquisitions as valuations moved to remarkably low levels following the March earthquake and tsunami.

In terms of sectors, the largest overweight positions relative to the index are in Materials, where we are positive on precious metals and agriculture, and in Technology, our favored area for cyclical exposure. We expect a tailwind from enterprise spending in Technology, and recently increased exposure to the sector following an upgrade to its outlook from our Strategic Policy Group. We remain cautious on Industrials, Consumer Staples, and the previously mentioned European Banks where we think it will be difficult for companies to maintain profit margins given wage pressures and the difficulty of passing on higher costs.

In summary: In a weak global growth environment with low real interest-rates, growth stocks and companies with pricing power are our focus in 2011.

Note: Investing in foreign markets involves the risk of social and political instability, market illiquidity, and currency volatility.

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