THOMAS MILLER INVESTMENT

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Investment Strategy Overview

Data released over the past quarter provided mixed signals on the state of the global economy. While reports on the Japanese and US economies continued to indicate improving growth momentum, data on the major emerging markets, UK and the Euro-zone have been weaker than expected.

In China, recent data releases have raised concerns that the economic rebound may be faltering as growth in both industrial production and retail sales slowed in the first two months of the year. Also, data showing further increases in developers' inventories of unsold property stoked investors' concerns about the Chinese property market.

In the UK, recent industrial and trade figures showed that the recovery continues to be patchy and there remains a risk of another contraction in GDP in the first quarter. In February, headline consumer prices rose 2.8% from a year earlier driven by higher energy bills and a weaker sterling. That marked the 39th month that inflation has been above the Bank of England's target. It is disconcerting that UK inflation pressures persist despite the backdrop of weak economic activity.

In the Euro-zone, in March, Cyprus became the latest casualty of the ongoing sovereign debt and banking crisis. The controversy surrounding the initial bailout package centred on the proposal of a one-off levy on deposits. That element of the package represented a marked departure from previous Euro-zone bailouts. For financial markets, the real issue is one of perception and confidence. The key question for investors is whether or not the EU-IMF proposal for Cyprus represents a special case or a new template for future bailout agreements. If viewed as a special case, arguably, there should be limited lasting implications for financial markets. In contrast, if it is seen as a precedent for future bailout deals then it raises serious questions about the credibility of Euro-zone policy and policymakers.

Economic reports from the US have been more upbeat. In addition to data showing ongoing rebound in the housing market, the labour market continues to recover—albeit at a slow pace. While short term risks remain, a more optimistic outlook for US economic growth over the next few years is justified for a number of reasons. These include the ongoing recovery in the housing market, improvements in the growth rate of broad money aggregates, the strengthening of the banking system and the related easing in credit conditions, the increasingly buoyant business investment climate; and ongoing monetary policy support.

Over the course of the first quarter, substantial variations were observed in regional equity markets. Japanese equities led the rally, fuelled by a radical shift in monetary policy under the new government while Euro-zone equities lagged on the back of the Cyprus crisis. Emerging Market equities suffered from a combination of rising US Dollar and waning regional growth momentum. In the fixed income markets, an inconclusive election in Italy and, more recently, investors' misgivings about the nature of the EU-IMF bailout package for Cyprus resulted in strong safe haven demand for government bonds in the US, UK and, in particular, Germany, where yields on 2-year bonds turned negative for a while in March.

The backdrop of improving global economic growth, moderate inflation, reasonable valuations, resilient corporate earnings and ample liquidity favours risk assets. From a relative asset allocation standpoint, these factors (versus expensive bond valuations) lead us to conclude that equities offer better long term value than government bonds.

In broad terms, our current investment strategy is to be overweight equities, underweight cash and neutral on fixed interest. Within the fixed interest asset class, we continue to favour corporate bonds over government bonds. Clearly, risk assets face a number of notable sources of downside risks. These include the ongoing Euro-zone crisis, the threat of geo-political crisis in Northeast Asia, the potential for another Spring-Summer US growth slowdown and the political risks surrounding discussions on the US budget, government spending cuts and debt ceiling. Any of these could result in a bout of short term risk aversion in the financial markets. However, our positive longer term views mean we will consider a correction in equity markets as an opportunity to increase our positions.

Abi Oladimeji
Head of Investment Strategy

TMI Asset Allocation Scorecard

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)			+			
Equity allocation by region	+	0	0	0	+	-
Bonds (overall)			0			
Corporate bonds	+	+	+	+	0	0
High Yield bonds	0	0	0	0	0	0
Govt guaranteed bonds	0	0	0	0	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives (including ARFs*)			0			

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.
* Absolute Return Funds

Market Overview

Stock markets have started the year on a positive note as optimism grows that the world will finally see some sort of economic recovery in the second half of 2013.

Some of the major markets made nearly double digit returns, with the Dow Jones Industrial index up over 11% and the S&P 500 up 10%. This represented the best first quarter for the Dow since 1998. On the final day of the quarter the S&P 500 broke through its previous all time high of 1567 set back in 2007, albeit that it is still a little short of its intra-day high of 1576, also set in October 2007.

To some extent the S&P 500 has been the laggard among the American indices, as the Dow Jones Industrial, the S&P 400 mid-cap, S&P 600 small-cap, Russell 3000, and the Russell 2000 mid-cap indices are all well into the territory of new highs. Dow theorists will be heartened by the fact that the DJ Transport index has been outperforming the DJ Industrial index, after underperforming it since mid 2011 and after trading sideways for over two years. However, the NASDAQ Composite trailed with a rise of 8%, weighed down by the poor performance of Apple, and the index remains well short of the records set 13 years ago in 2000.

The initial impetus to the rally came as the United States resolved the fiscal cliff issues that had hung over it last year. The deadlock that has concerned markets since mid 2011 was resolved in the early hours of New Year's Day as Republicans agreed to increase tax rates on income of over $400,000, and payroll taxes were raised. Most markets rose 2% on the first day of trading in relief, and went on to enjoy a stellar January with many up an astonishing 5%. The rally continued into February with average major market gains of some 2%, and then extended further into March, albeit that the march in European markets was halted by the bail-out of Cyprus in the middle of the month. The FTSE All Share rose just 1% over the month, after peaking on March 14th.

It is significant that the biggest rallies have occurred in 'devaluation' currencies, Japan and the UK being the most obvious examples. Both lost almost as much in currency terms as they gained in stock market appreciation, with local or hedged investors being the only ones to fully benefit. The US stands out in this regard, with its stock market rallying despite a rising Dollar.

The UK's FTSE 100 index of leading shares finished up just over 9%. Interestingly, the larger companies have tracked the gains of the broader market more closely this year than last, when larger stocks underperformed significantly. The Mid-250 index rose 12% and the Small Cap index 11%.

The rally in UK stocks was fairly broad based. The industrial engineering and defence sectors rose 16.8% and 22%, while food producers rallied 17%. Consumer discretionary sectors also benefited, with media up 13.7% and leisure up 15%. Bank stocks rose 7.5% and life insurance stocks rose 11%, but non-life insurance performance was more muted at 6.4% as both RSA and Aviva cut their dividends. During March, health care stocks took up the leadership of the market – both here and in the US – and the sector finished up 14%.

The main laggard was the mining sector, which fell 19% over three months. Mining stocks staged a strong recovery from November through to mid-January as share prices discounted a rebound in the iron ore price to $120 per tonne and a clear out of senior management at Rio Tinto, BHP and Anglo American, with Tom Albanese, Magnus Kloppers and Cynthia Carroll all leaving. However, March saw this confidence evaporate as sluggish growth in China continued.

Eurozone markets struggled, with the EuroStoxx 50 index falling. However, broader European markets (including Switzerland and Sweden up 14% and 8.5%) were up 5%. Spain fell 3% and Italy fell 6%. Emerging Market performance was also disappointing, with China, Korea, India and the Hang Seng all down, though Thailand, Indonesia, New Zealand, Australia, the Philippines and Taiwan made positive returns.

Bond markets climbed back after a poor start to the year. By the third day of trading the FT Government All Stocks index had dropped 2.3%, but clawed back these losses to post a positive 0.71% return for the quarter. This was driven by recovery in longer dated issues, with the FT Over 15 year index returning 6.75% since its low point on February 13th, and the yield on these bonds dropping from 3.38% to 3%. More Bank of England Gilt purchases could occur later in the year, after Governor Mervyn King voted in both February and March to increase the Bank's £375bn "asset purchases" limit. He was outvoted on both occasions, the first time this has occurred during his tenure. There remains an appetite for Gilts despite the downgrading of the UK from AAA to AA+ by Moody's credit rating agency in February, with overseas investors increasing their holdings of Gilts in February for the eighth successive month. Index-linked Gilts had a strong bounce after the Office of National Statistics decided not to change the method of calculating the Retail Price Index. UK investment grade corporate bonds returned 1.6%.

The other notable factor to affect UK investors has been the weakness in Sterling. This has been gathering pace since the height of the Eurozone concerns last summer, when the pound was seen as a safe haven, but accelerated over the quarter. Sterling has traded as low as $1.49 and €1.145, but rallied to $1.51 and €1.18 by the end of the quarter. Gold dropped -3.6% and silver -6.4% in Dollar terms.

James Penn
Senior Portfolio Manager

Historic Market Rates

As at 31st March 2013

	Close	3 month % Change	6 month % Change	1 year % Change	3 years % Change
FX					
GBP/USD	1.5198	-6.43%	-5.99%	-5.06%	0.05%
EUR/GBP	0.8436	-2.86%	6.05%	1.31%	-5.31%
EUR/USD	1.2819	8.77%	-0.32%	-3.93%	-5.28%
USD/JPY	94.2200	-0.33%	20.86%	13.70%	0.83%
USD/CNY	6.2102	3.82%	-1.19%	-1.40%	-9.02%

	Close	3 month Change	6 month Change	1 year Change	3 years Change
BOND YIELDS					
US 10 YR	1.849	0.091	0.215	-0.360	-1.977
UK 10 YR	1.768	-0.060	0.041	-0.436	-2.171
GERMANY 10 YR	1.289	-0.027	-0.153	-0.505	-1.803
JAPAN 10 YR	0.551	-0.240	-0.227	-0.438	-0.849
SWISS 10 YR	0.716	0.190	0.175	-0.150	-1.167

	Close	3 month % Change	6 month % Change	1 year % Change	3 years % Change
EQUITIES					
S&P 500	1,569	10.03%	8.92%	11.41%	34.18%
Dow Jones	14,579	11.25%	8.49%	10.34%	34.28%
NASDAQ	3,268	8.21%	4.86%	5.69%	36.26%
FTSE 100	6,412	8.71%	11.66%	11.15%	12.89%
FTSE ALL-SHARE	3,381	9.29%	12.73%	12.58%	16.17%
DAX	7,795	2.40%	8.03%	12.21%	26.68%
NIKKEI	12,336	18.67%	39.07%	22.34%	11.24%
Hang Seng	22,300	-1.58%	7.00%	8.48%	4.99%
COMMODITIES					
GOLD	1,596.82	-4.69%	-9.89%	-4.29%	43.44%
CRUDE OIL - WTI	97.23	5.89%	5.47%	-5.62%	16.08%
S&P GS Soft Cmd	710.82	-3.91%	-13.63%	0.37%	40.68%
S&P GS Ind Metals	1,457.22	-7.10%	-10.22%	-11.42%	-18.30%

Source: Bloomberg

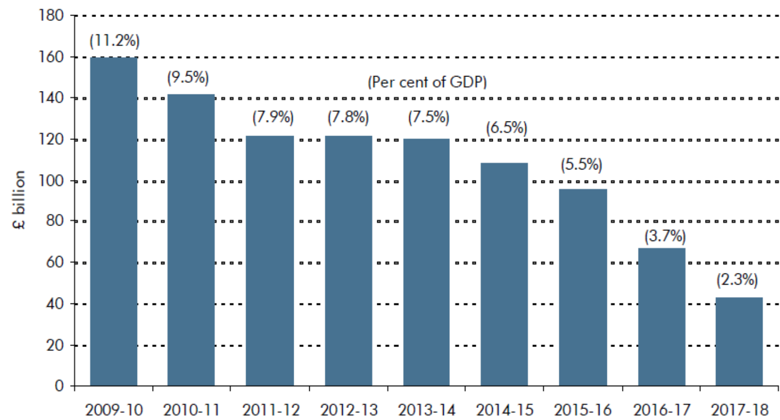
How do we get out of this situation? Well, I wouldn't start from here...

The UK Chancellor was in sombre mood when he delivered his Budget last month. Nearly five years on from the banking collapse of 2008, the UK economy remains becalmed, with few signs that a meaningful recovery is underway. A similar picture exists across the Eurozone, whether in the shape of stagnation, recession, or outright crisis. In contrast, the US economy is showing some signs of improvement (although major challenges remain) and growth is still reasonable in Latin America and in the Asia Pacific region.

The problems faced by the UK are fairly typical of what is being experienced elsewhere. Fundamentally, there is too much debt and not enough growth. These problems were highlighted by the Office for Budget Responsibility in its March 2013 "Economic and Fiscal Outlook". The OBR provides independent analysis and forecasts, and two extracts from its report pointed to the scale of the problem. First, and as Chart 1 alondside shows, UK Government borrowing remains at historically high levels, and will not return to more normal levels for five years. Even this outcome depends on continued spending cuts and faster economic growth. The UK is in for a long haul.

Next, there is the outlook for economic growth. Again, Chart 2 shows an unexciting picture. The "fan" highlights the range of possible growth outcomes over the next few years, the central case being for 0.6% this year, 1.8% next year, and then a wait until 2017 until we see a more meaningful growth level of 2.8%. Growth helps generate the tax receipts which reduce the deficit, and so it is clearly going to take a long time to get the economy back on track.

Chart 1: Public sector net borrowing excl. Royal Mail and Asset Purchase Facility transfers



Source: OBR

Chart 2: GDP Fan Chart

Source: OBR

So, it is all rather dismal. We are experiencing a period of financial repression, one where interest rates are held below inflation for a sustained period. This eases the pressure on those who are in debt and ensures that the Government can issue its own debt at lower yields than would normally be the case. One effect is that savers are seeing their cash balances generate negative returns after inflation, and annuity rates have tumbled. So, savers and pensioners are in effect paying to ensure that those with debts benefit from low interest rates. They are also being driven to invest in equities, bonds, and property rather than leaving their funds on deposit. A depreciating currency is a further drain on their resources. For many investors, repression is of course boosting the value of their investments, but for others, there is a heavy price to pay.

Is there an alternative approach? The UK Government has four other ways it could go. It could embark on a policy of real austerity, along the lines of what happened in Latvia, shutting down chunks of its activities in an effort to balance the books. Such a "shock therapy" policy would trigger a major recession but might lead to faster growth in the longer term. This would be hugely risky and divisive. Perhaps the Government could simply default on part of its debts, as part of a globally-coordinated move to reduce the level sovereign debts. Inconceivable, surely. Or what about a dose of inflation, to erode the real value of the debt? To an extent, this is already happening, but again, it is inconceivable that the Bank of England would countenance a return to 1970s-style inflation, with its inevitable impact on living standards.

Finally, the Government could go all out for economic growth, whether through more "demand side" spending (thus gambling that the markets will accept a higher short term deficit) or through such "supply side" measures as changes to incentives, labour laws, and business regulation. To a limited extent, this is happening already, but there is much more that could be done, and confidence is still low.

The markets are right to be worried about the economic prospects in the UK and elsewhere. As Keynes wrote in his 1936 "General Theory", "If the animal spirits are dimmed and the spontaneous optimism falters .... enterprise will fade and die". It is in these much-talked of "animal spirits" that the best hope for recovery and escape from repression lies. Here, equity markets have an important role. Shares have delivered remarkable returns since their low point four years ago. Yes, part of the gain can be attributed to Central Bank support, but even so, robust equity markets are good for confidence. Rising share prices trigger corporate activity, as business people want to invest, believing that markets are telling them that better times lie ahead. Buoyant markets also boost consumer spending, which combined with rising business investment provides a welcome boost to profits, and hence to share prices – and thus, a virtuous circle sets in.

Fanciful? Perhaps. However, equities are often a leading indicator of how an economy is going to perform. Valuations remain supportive, and equities are still an attractive asset class, not least from an income perspective. Further gains could help the UK and other economies escape from their current troubles faster than some of the forecasters expect. Otherwise, financial repression might be with us for a very long time.

Harry Morgan
Head of Private Investment Management (UK)

Regulation may be considered far from exciting, it is also far from irrelevant…

Regulation isn't usually considered a topic of discussion that causes much excitement perhaps other than in a roomful of *"industry-related fee earners".*

Regulation, however, impacts on us in all aspects of our daily lives whether it's in relation to "keeping to the legal speed limit", "turning up to work on time", or "not being subject to the offside offense". There is no escaping the fact that our lives are governed by Rules and Regulations with the good objective of trying to "mitigate an undesirable outcome". So while Regulation may be far from exciting, it is also far from irrelevant.

Financial regulation, both locally and internationally has become increasingly complex over the past few years predominately as a result of market and financial failures. The challenge of keeping abreast of these changes and how they affect us and our clients is no simple "walk in the park". However, whilst we at TMI may not be able to assist you in avoiding the perils of the "offside rule", we can assist you in keeping up-to-date with regulatory change and how this may affect you and the investment management service which we deliver.

In this publication we have provided some information in relation to current "hot topics" which are current headline grabbers.

Retail Distribution Review ('RDR')

Effective from 31 December 2012, in the UK and 31st December 2013 in the Isle of Man.

The RDR applies to all advisers in the retail investment market, regardless of the type of firm they work for. This means that any regulated firm, ranging from a bank to a small independent financial adviser (IFA), is captured. Our UK private investment business comes under the scope of RDR, and we welcome the letter and spirit of the changes. Although pure discretionary management and execution-only business is outside the scope of the RDR on the Isle of Man (IOM), and therefore Thomas Miller Investment in the IOM is not captured by RDR, as a business we always strive to meet the highest standards of excellence and client service. So we have decided that all front line staff involved in making investment decisions will be RDR-compliant from the respective deadlines.

In simple terms the Retail Distribution Review targets the quality and standard of advice available to consumers in the financial services sector by ensuring that clients

- are offered a transparent and fair charging system for the advice they receive;
- are clear about the service they receive; and
- receive advice from qualified professionals, and the advice is suitable for their needs.

To achieve this, regulated firms must explicitly

- disclose and separately charge clients for their services;
- clearly describe their services as either independent or restricted; and
- ensure that individual advisers adhere to consistent professional standards, including a code of ethics.

The purpose of the RDR was principally to address perceived "persistent problems" in the retail market, such as the widely publicised misselling of investment bonds and payment protection insurance (PPI). The RDR is intended to increase the numbers of customers who feel confident enough to purchase retail investment products.

FATCA and Isle of Man Disclosure

In a time where transparency and accountability are becoming ever more important and with continued focus on 'everyone paying their fair share', the IOM and UK Governments recently announced they are developing an automatic exchange of information agreement, similar in style to the widely publicised US FATCA regime. When it comes into force the agreement will require IOM financial institutions, including banks and investment managers including TMI, to provide a range of information to HMRC in relation to UK residents. UK resident but non-domiciled persons would not be included but the likelihood is that they would be subject to a separate arrangement.

A separate IOM Disclosure Facility ('IOMDF') has also been announced. The IOMDF will allow individuals and companies to bring their UK tax affairs up to date in a structured way. Some of the headline features are:

- anonymous discussion with HMRC, prior to making a disclosure;
- liabilities arisen before 1999 are not subject to tax;
- limiting penalties up to 10% for periods up to 2009; and
- where 'innocent error' has occurred, no tax will be payable for a period ending more than 4 years before the disclosure.

Full details of both arrangements are yet to be announced, but we will keep you updated.

UK Regulatory Structure

On 1 April 2013 the Financial Services Authority (FSA) was replaced by the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA).

The PRA will be responsible for the prudential regulation of banks, insurers and major investment firms.

The FCA will supervise the conduct of all firms along with the prudential regulation of 23,000 firms. The FCA has been tasked with ensuring markets operate with integrity, promoting competition and ensuring firms put consumer outcomes at the core of their business.

Thomas Miller Investment Ltd will be regulated entirely by the FCA.

Sue Preskey
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