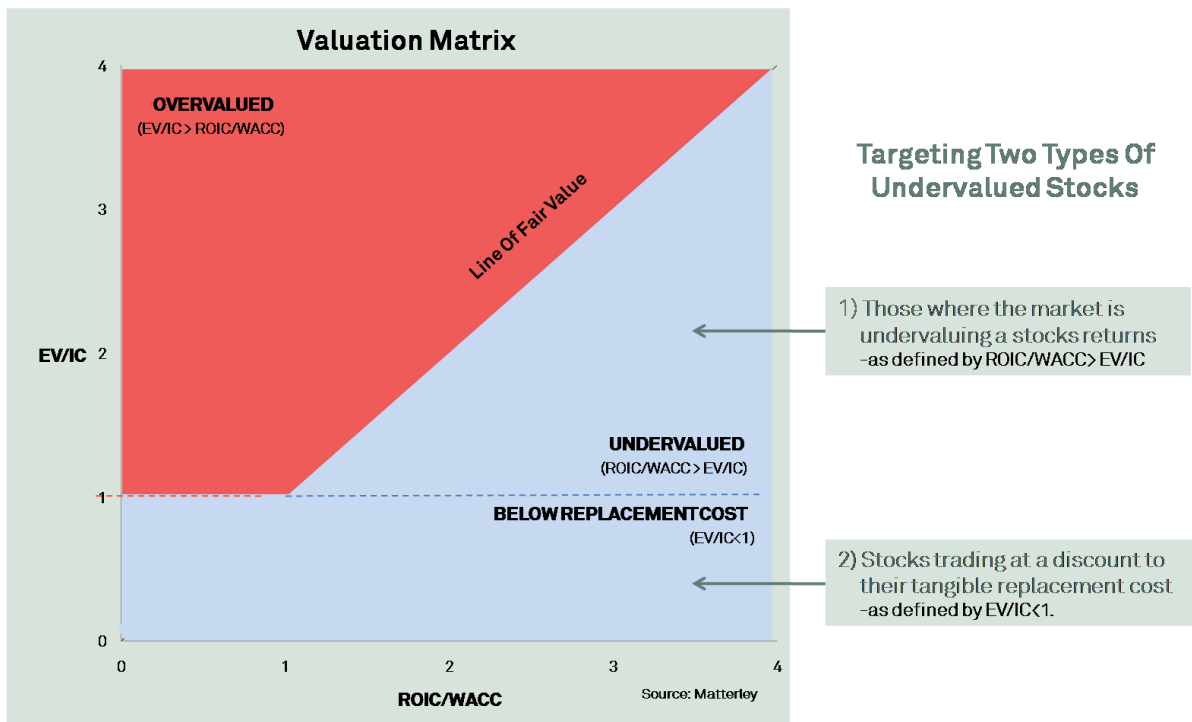


There was rarely a dull moment in 2009. A 20% fall in the FTSE All Share Index by early March has given way to more than a 50% bounce. This has resulted in a 25% move over the year representing the best performance for the Index since 1989. The fund has had a decent year rising by 39%.

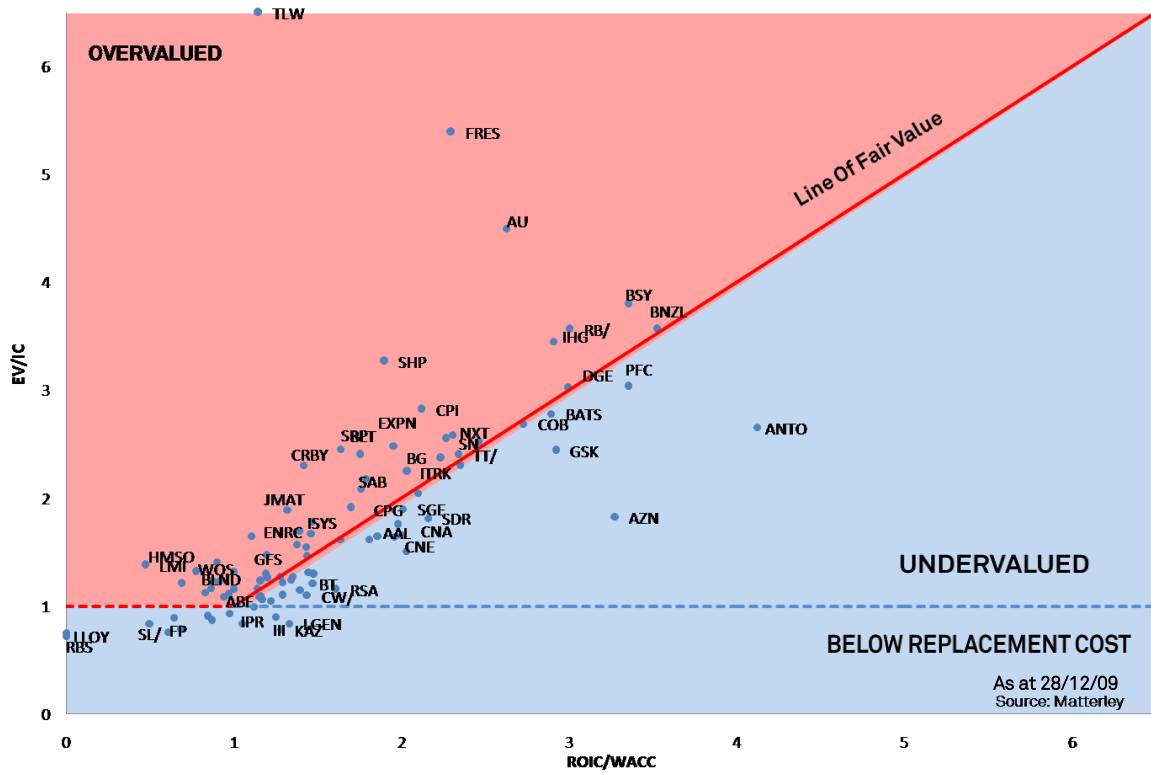
The rise in the market is all the more impressive given the weight of rights issue activity. Within the FTSE 100 twelve companies had to own up to their shareholders and raise money, £50bn to be precise. To put this number into context, it represents c1.5x the current market capitalisation of Tesco. From a sector perspective the main culprits fell into the Banking, Mining and Real Estate sectors. In the main, these rights issues proved to be the event investors were waiting for. The notable disappointment has however been Real Estate as the sector continues to make new relative lows. This is perhaps a function of remaining scepticism among investors as to whether enough has been raised. It is also a useful reminder that sectors that have been so aggressively overvalued in the past can take more than just one market cycle to perform again. Technology for example has only just started to perform after close to ten years in the doldrums and we will touch on this in more detail later.

From a valuation perspective, with our returns-based matrix in mind, the number of stocks in the FTSE 100 that represent value to us has fallen. We still however believe there are certain stocks offering considerable value and this underlines the importance of stock selection in 2010. By way of reminder, we like to value businesses according to the returns they are achieving on their capital and then seeing what price you are being asked to pay for this capital.

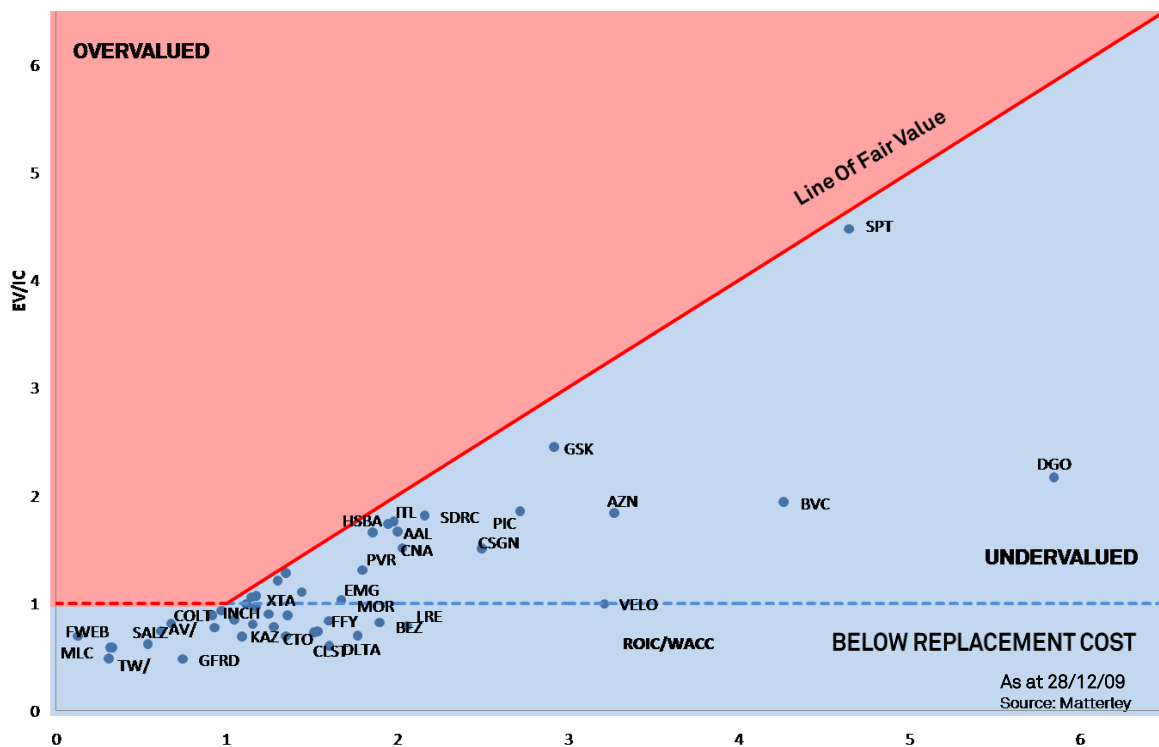
## Our Investment Process



# FTSE 100 Matrix



# S&W Matterley Undervalued Returns Fund



As we look at the portfolio versus the FTSE 100 we see a clear valuation arbitrage and within this framework the following themes dominate our thoughts for 2010.

### **Corporate activity:**

The move by Kraft for Cadbury for us is the start of a recurrent consolidation theme in the UK for two key reasons. Whilst there has been an extremely rapid rise in economic indicators, it would be hard to argue that we will return to the peak of economic growth seen in the 2004 - 2007 period. Given that cost cutting stories have largely run their course we think the next big synergy to be realised is from intra-sector M&A. The ability to cut cost and deliver synergies for the acquiring company will prove to be a very significant and a relatively sure foundation for future earnings.

Secondly, the weakness of our currency is also a key factor in our forecast for further consolidation. Both European and US companies will look at their UK comparator and muse with interest their increased buying power.

While that is the basic theory behind our forecast of increase M&A activity, we are acutely aware of the need to pass the practical. As we look back at the M&A activity of 2003/2004 the recurring characteristic of the companies that fell to takeovers was that they were trading below their replacement cost (RMC, Aggregate Industries, Corus and Pilkington to name but a few). We therefore hope our focus on this metric will serve us well in the coming year and as it stands today the portfolio has just over half its constituents trading below their replacement cost. This is compared to c10% for the market as a whole.

### **The importance of financial strength:**

While we are of the view that cash is a poor investment we do believe that investing in companies with net cash represents an attractive risk reward. Downside you would hope is limited and casting one's mind to the upside there is interesting optionality. Given the environment in which we find ourselves there is an opportunity for the financially strong companies to address any strategic shortfalls they may face. Crucially, given that there is less competition to buy these assets than in years gone by, they should also be able to transact at a price that is right for them and not just the target company. If smaller rivals can be bought for below their book value and cost efficiencies are achieved then they should be able to enhance their competitive position. This will not go unnoticed by the stock market in our view and to benefit from this we have c 60% of our companies trading with net cash on their balance sheets.

## TMT:

In connection with Real Estate we mentioned that those sectors that have been aggressively overvalued, as this sector was in 2007, take more than just one market cycle to perform again. Probably the best example of gross overvaluation in living memory was the Tech sector in 1999. As can be seen from the chart below the sector has had close to ten years in the doldrums.

### FTSE Tech relative to FTSE All-Share



The recent move from the lows however, while visually unimpressive, represents a c 40% outperformance of the FTSE All Share this year. The sector has been one of our largest overweights owing to net cash balance sheets and modest valuations and we continue to be positive on its prospects for 2010. We do however note with interest how much the Telecoms and Media sector have lagged. This is not dissimilar to what happened in '97 and '98 but should history repeat itself then these sectors will follow where Tech has led.

In our factsheets during the year we have written on a couple of occasions that we see the enormous volume pickup in fibre optic networks, driven by increased broadband usage, ultimately feeding through to improved pricing. In time we also believe the widespread take up of smart phones will bring about better pricing in mobile. We therefore believe that the Telecoms sector has every chance of being the surprise growth story in 2010. Coming from a starting point of 9.5x earnings this is not a widely held view and we think that share prices within the sector could be materially higher in 12 month's time.

Within Media we have had limited exposure during the year, preferring other cyclical areas of the market. However, as a result of the poor relative performance of the sector this year combined with improving earnings trends, in no small part helped by the strengthening dollar, we are starting to build positions in certain names who trade on modest PE ratios (c10x) and whose returns on capital are being quantifiably undervalued by the market.

## Conclusion:

We have not known a year where there is such a divergence in people's views on the outcome for the year. In this country the macro picture is further complicated by the upcoming election which will make forecasting an even more thankless task. We have therefore decided to concentrate all our efforts on putting together a portfolio that is fundamentally cheap and are heartened by the amount of investible opportunities we are finding. We hope this will serve us well in the coming year and draw comfort from Warren Buffet who once said, "Why scrap an informed decision because of an uninformed guess?".

To illustrate the informed decision we have made for the year ahead we have put together the following table. For both the FTSE 100 and our fund we have tried to articulate exactly what you are getting for every £1 you have invested.

<b>What do you get for every £1 invested</b>		
	<b>FTSE 100</b>	<b>Matterley Fund</b>
Sales	49p	74p
Earnings	7p	10p
Net Assets	31p	62p
(Net Debt) or Net Cash	(22p)	7p

Source: Matterley. Bloomberg consensus data for full year 2010e quoted on 28/12/09. Excludes Banks and Insurance stocks.

That the portfolio is cheap on an absolute basis as well relative to other asset classes and has materially more sales, earnings, assets and cash (as opposed to debt) than the FTSE 100 gives us confidence in its prospects for 2010.

## Disclaimer:

The information contained in this document does not constitute advice or a personal recommendation, nor does it constitute an invitation to purchase units. Investment should be made on the basis of the Prospectus and Simplified Prospectus, available on request. You are recommended to seek advice concerning suitability from your investment adviser.

The information in this document is based upon sources we believe to be reliable, but its accuracy cannot be guaranteed.

Please note past performance is not a reliable indicator of future returns. The value of investments, and the income from them, can go down as well as up and may be affected by exchange rate variations. The levels of taxation and their respective treatment depend on your individual circumstances and the applicable law, which may be subject to change in the future.

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