



IM Matterley Undervalued Assets Fund Outlook for 2012

Matterley

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Review of 2011

The Fund fell by 9.8%* during the year while the market fell by 3.5%*. We cannot claim to be anything other than disappointed by this outcome. We do however take some heart that if investors afford us a longer time horizon then the results suggest our process, and our implementation of it, has merit in a crowded market place. Over three years, for example, the Fund has risen by 61.9%* versus a 43.9%* rise of FTSE All-Share Total Return which puts us in the top decile of our peer group. For detail of our investment process please visit www.matterley.com.

Relative to the headlines that we have had to endure, the performance of the UK equity market is creditable. The more “exciting” investment avenues of China and Brazil, for example, have fared far worse, falling by 21.7% and 18.1% respectively. No sane person a year ago would have given you much chance if you had offered a prediction that the Icelandic and Irish Stock Exchanges would outperform these emerging giants, but that is indeed the case. That Iceland has risen by 4.4% this year is a valuable reminder that there is life after death in the world of floating exchange rates. That Ireland is the best performing index in Europe highlights that there is life after a shrinking public sector provided there is an aspirational, rather than expectant, private sector.

The headlines over the year were alarming and unpredicted in the main. January saw the first uprising against a dictatorial regime in Tunisia and this would later spread to Egypt and Libya. The Japanese tsunami in March caused such devastation that, when combined with a nuclear disaster, made us question the ability of the nation to return to any sort of normality. Added to this there was astonishing political paralysis in the US and the European political impasse which, while not totally surprising, has exceeded even the most bearish predictions of a year ago. If this all just seemed to be tales from a distant land, then the riots in London during August were a reminder that we are far from immune.

Looking to the year ahead, market commentators are uniformly bearish and, as a result, 2012 seems to be just too horrendous to countenance. It is true that bad news and awful headlines have now become a way of life but one would hope we don't have a repeat of this next year. However, even if we do our propensity to be shocked will be lower and as a result, the impact on consumer and business behaviour will most likely be more muted than we fear. Also from an equity stand point macroeconomic fears have resulted in a valuation that has only been seen on two occasions in the last 20 years, namely post Lehmans and in the early 90s.

*Source: Financial Express Analytics at 31/12/11

All figures not explicitly sourced are obtained from Bloomberg

Please refer to the Important Information at the end of this document

Review of 2011

Before we provide our thoughts for 2012 we think a detailed audit of our performance in 2011 is appropriate. As we look back at our outlook document for 2011 our standpoint at the time could be summarised as follows:

- Value did exist but we were acutely aware it was predicated on earnings and not asset support.
- Cash was rapidly accumulating on company balance sheets and this would act as a valuable support to UK Plc and drive attractive dividend growth and corporate activity.
- Asset allocation would finally play into the hands of equities, taking up the baton from bonds.

The risks as we saw them at the time were:

- Sterling strength acting as a drag on earnings.
- Bonds would at the very least struggle under the scenario of rising interest rates and might fare far worse owing to a financial scare which would be destabilising to financial balance sheets. The most likely source for this in our opinion was the Eurozone, resulting in a dash to cash rather than equities.
- And finally, we felt the European sovereign issue would dominate headlines but in reality, it was our view that enough money would be found to keep the system functioning. As a result, while we were happy to maintain appropriate cash balances, we were determined to buy when weakness asserted itself.

Twelve months on none of the above makes us wince with embarrassment although our prediction of a rise in interest rates has been laughably wide of the mark. Admittedly our statement regarding the value case for UK Equities implicitly went hand in hand with a prediction of positive returns for the year. This has of course proved to be wrong. Since the FTSE 100's inception in 1984 there have now only been eight years of negative returns. This year is far from the most negative in performance terms but it has set a new record in that this is the lowest starting PE (10.8x) that has achieved a negative return. The previous record from a valuation perspective was a fall of 11.5% in 1990 from a starting point of c12x.

However, allied with this statement of value we did highlight the importance that earnings momentum would have on equity performance. This has proved to be a valuable overlay. For example, Royal Dutch Shell has seen its 2011 earnings estimates revised up by c17% this year and the share price has risen by 16% before taking account of its 5% yield. On the other hand Lloyds has seen its earnings estimate for 2011 fall from 6.5p to 2.5p. This 61% fall is neatly matched by the 61% fall in the share price over 2011. While these two examples possibly overstate the significance of estimates momentum our focus on this remains intense for those shares trading above replacement cost.

The cash flow story in UK Plc continues to be the one bright spot from a balance sheet perspective when set against that of the Government and the consumer. The number of companies that find themselves in a net cash position rises with metronomic consistency and now stands at slightly over 1 in 3**. Management actions as this status is achieved have in the main taken the form of share buy-backs and accelerated dividend growth. The former is a crucial support in times of low liquidity and the latter is a valuable source of income in a world of almost none. The one avenue that has not

** Source: Matterley

been explored as much as we would have expected is M&A and the buyer of last resort, that was so in evidence in 2004 and 2005, has not been as prevalent at a corporate level.

Asset Allocation

With asset allocation in mind our preferred, but admittedly far from perfect, source of information comes from the Investment Management Association. Monthly buying trends are highlighted in the table below. To some extent the frenzied buying of bonds seen in 2010 has ceased. The vogue investment has shifted to Cautious Managed which is ultimately a partial foray in equities, albeit a nervous one! Our overriding feeling however is that financial circumstances have resulted in our short-term fear being realised of cash being accumulated on the sidelines. We stress this is only a short-term fear as with no rate rise on the horizon this is not an entirely sustainable situation in our view.

Date	Best Selling Net Retail	Worst Selling Net Retail
Oct-11	£ Strategic Bond	UK All Companies
Sep-11	£ Corporate Bond	Asia Pacific Excluding Japan
Aug-11	Global	European Smaller Companies
Jul-11	Cautious Managed	UK All Companies
Jun-11	Global	European Smaller Companies
May-11	£ Strategic Bond	North America
Apr-11	£ Strategic Bond	Europe Including UK
Mar-11	Cautious Managed	Asia Pacific Excluding Japan
Feb-11	Cautious Managed	£ Corporate Bond
Jan-11	Cautious Managed	£ Corporate Bond
Dec-10	Cautious Managed	£ Corporate Bond
Nov-10	Cautious Managed	Europe Excluding UK
Oct-10	Active Managed	UK All Companies

Source: Investment Management Association. Note: As of 01/01/2012 the Cautious Managed Sector has been re-named as "Mixed Investment 20-60% Shares".

Eurozone

The Eurozone situation has of course provided us with events that are materially worse than our wildest nightmares of a year ago. While this has not had a direct impact on the Fund it has undoubtedly caused investor sentiment to favour safety above all else. Stylistically this has not been to our liking as it has caused material reratings in shares that in our opinion did not offer the best relative value in the market. There has also been a focus on those shares with high initial yields rather than those shares that offer the best combination of yield and dividend growth. In our view, it has also put on hold many M&A decisions. Given a proven by-product of our process is benefiting from periods of corporate activity, this has not provided us with the boost we would have anticipated.

Economically, the way ahead in the Eurozone, for now at least, is taking the form of common sense, accountability and no small dose of central bank intervention. First and foremost we want to stress the word 'economically' here, as there is still an element of political inertia that stems from a determination by leaders to postpone tough decisions until after they are re-elected next year. Our view is that if tough actions are not taken now, à la Ireland, then there may be little to be re-elected to. Recent political change in Italy and Spain is a key milestone in achieving this. It is also

important to realise that, in contrast to Greece, both these countries are capable of achieving a balanced budget based on recent history.

Moving to bottom up analysis, we think it is crucial to stress the enormously positive impact of the recently announced 3 year Long Term Refinancing Operation (LTRO) auction by the European Central Bank (ECB). This facility offers an almost unlimited amount of money to financial institutions at 1% for a 3 year period. A month ago people were bemoaning the ECB's reluctance to act as the lender of last resort, but through the LTRO the ECB has now stepped up to the plate in quite some fashion. With this, money banks have three obvious options available to them: deleverage by buying in their own debt at below par, conduct a carry trade on higher yielding sovereign debt, or lend to the real economy.

As to which of the three options the financial institutions will ultimately choose is an interesting debate. We suspect they will go for deleveraging via bond re-purchases. The carry trade then on Italian ten year debt, for example, will look appealing and most likely lending to the real economy will take third place. This may disappoint some but refinancing debt on incredibly attractive terms will materially improve core tier one ratios. Achieving a 5% net interest margin in sovereign bonds will be enormously enhancing to earnings. Given capital ratios and earnings power have been two overriding concerns of investors this year, we are baffled that people can say this is anything other than a resounding positive to the banking sector. It is also not a huge leap of faith to say it will improve market sentiment and who knows, it may even ultimately benefit the wider economy.

In short, we think that the Euro project is at last starting to have leaders with an economic background that have the right agenda of common sense and accountability. This is bridging an admittedly wide credibility gap but when this is combined with the significant injection of liquidity there is a growing feeling that time is being bought to return these economies to somewhere closer to their potential.

Performance Attribution in 2011

Moving the analysis to our portfolio we set out below how the portfolio has been positioned at a sector level and how this had fed through into relative performance over the year. The blue bars signify our active over or underweight and the yellow bars show performance.

Figure 1: IM Matterley Undervalued Assets Fund Sector Weightings (blue) and Performance (yellow) Relative to the FTSE All-Share (2011)



Source: Bloomberg

Given our performance a natural reaction from our investors is that we must have misjudged financials badly. However in reality this has been far from the case and indeed it has been our biggest positive contributor to returns. We have been heavily underweight the banking sector and despite having made the case for increasing our banks holdings in our half-year document, it has taken us until the dying days of December to do so. Elsewhere within financials we have been fortunate to be the holder of both Evolution and Collins Stewart which were bid for in August and December respectively. Our rationale for the investment in these names was that we felt both businesses had adequate operating businesses with material net cash balances that were being ascribed little or no value.

Our biggest negative contributor has been energy. This is a combination of both being underweight Royal Dutch Shell given its size (although it has been a top ten holding for the entire year) and disappointing performance from Enquest and Dragon Oil. Enquest found itself on the receiving end of what has tacitly been admitted to be a poorly thought-out raid on North Sea oil revenues by the Exchequer. The shares have fallen by a third but now trade on little more than one year's cash flow. Given their reserves suggest a life of far longer than this we are confident this can correct. Dragon Oil has provided nothing but good news during the year on production and reserves. This has manifested itself in 2011 earnings estimates being revised up by 35%. The shares have however fallen by c15% and now trade on 5.5x earnings with half its market capitalisation in cash. We are always happy to be challenged on our views on value but in this instance any argument against this holding will be met with a robust and passionate defence.

Another key sector that has contributed to our underperformance has been an underweight in Consumer Staples. While we have held Imperial Tobacco and Associated British Foods the sector as a whole typifies the rerating we have seen of perceived safety but in many cases earnings trends struggle to justify this billing. Unilever for example has seen its earnings estimates downgraded by over 15% but the shares have risen by just over 10%. The company now stands at a c175% premium to the market and this is illustrative of the valuation of many of the sector constituents. It is our view that these shares will struggle to rerate further and are susceptible in an environment where risk appetite is reappraised.

The final sector we think appropriate to mention is IT. Here we have to own up to a stock specific error in the form of PV Crystalox. The position in this solar manufacturer was initiated well below the value of their plant and net current assets at a time when the business remained extremely profitable. However, in recent months Chinese manufacturers have adopted predatory pricing in an attempt to win greater market share and this will cause the company to incur losses and inventory write downs. Deteriorating balance sheets such as this are a key sell discipline of ours and accordingly we have exited the position.

Outlook for 2012

The value case for equities has strengthened over the year as the price falls have occurred at a time of c16% earnings growth. This combination means that the UK market has been derated from 10.8x to 8.8x. The earnings stream has in the main flowed through in cash and as result the asset backing, that to some extent we were lacking at the start of last year, has increased. A year ago for example we felt value on a par with March 2009 was attained at c 5000 on the FTSE 100 and even in the darkest days of the year this proved to be a good floor. This figure today on our analysis has been revised up by over 200 index points and given the lower starting point we feel the downside support for the market is considerable.

This cash flow is also facilitating attractive dividends and the added attraction of dividend growth. Below we show the dividend yield of the FTSE 100 expressed as a ratio of UK 10 year gilt yields.

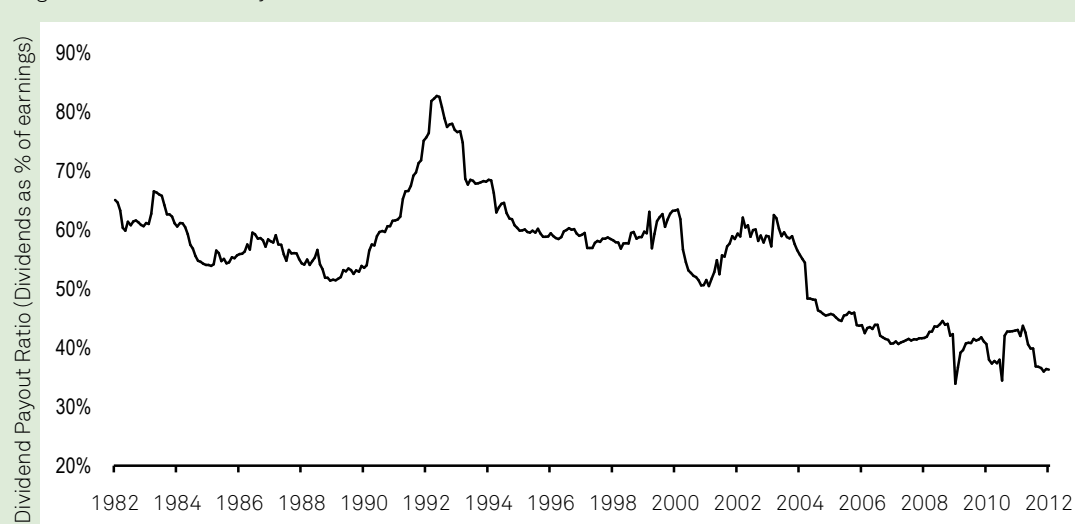
Figure 2: FTSE 100 UK Dividend Yield Relative to the 10 Year Gilt Yield (2000-2011)



Source: Bloomberg

We are back at levels not seen since the Lehmans fall-out, but what this chart fails to capture is that the prospective dividend yield of 4.3% is slightly over twice that on offer from gilts. In a world of low growth the prospect of dividend growth perhaps looks optimistic. However, when the cash that is on balance sheets is combined with a low payout ratio in the context of history it continues to look eminently achievable.

Figure 3: UK Dividend Payout Ratio (2000-2011)



Source: Credit Suisse

This year is an interesting case study in underlining the credentials of the UK market when it comes to dividend growth. Year on year dividend growth is now set to be 21% and has been repeatedly revised up during the year. This impressive growth has also occurred in a year when boards have undeniably been cautious owing to the fact that 2008/09 is still fresh in the memory and they read the same depressing newspapers as us.

Further to these generic comments about the asset class, we also think it is important to highlight that, at the outset of last year, the market valuation was skewed by several large cap stocks trading on cheap PEs. In contrast today, we can see opportunities at all ends of the market capitalisation spectrum, many of which are not just cheap, but are intriguingly cheap.

Within the FTSE 100 Cairn Energy, for example, at the time of writing has c\$5.5bn** of cash, a product of cash flow and the partial sale of their holding in Cairn India, which equates to c250p a share. Further to this the company still retains 22% of Cairn India which at current prices and exchange rates is a further 130p** of value. While there are further exploration costs to be taken in Greenland the current share price of c265p looks bizarre to us given the intention of the company to return c160p to shareholders and the potential for exploration success. As a result we have increased this to a top ten position in the Fund.

Within the FTSE 250, Millennium and Copthorne has seen its shares fall by over 30% over the last year despite recording over 10% earnings growth. The price to book is now just 0.6x** and recent asset sales suggest their carrying values are conservative. The proceeds from these sales combined with cash flow have also seen the business move to net cash and the value case is also complimented by a PE of 11x, a yield of over 3%.

Elsewhere we think Aer Lingus deserves a mention, as having fallen by close to 40% over the last year it now trades at a 5% discount to its net cash balance. Negative enterprise values such as this are usually reserved for loss-making businesses with little additional asset support. However, in the case of Aer Lingus the company has recently revised up its profits estimate for the year and its fleet and other assets are over 300%** of the current market cap.

Is There Any Good News?

While we believe that a moderation of bad news from the Eurozone will have a key bearing on sentiment, we do think it is important to highlight the improvement in economic data from the US given it represents c25% of global GDP. There are many data points we could give you but perhaps the best is improving employment data that has driven the unemployment rate to the lowest in three years.

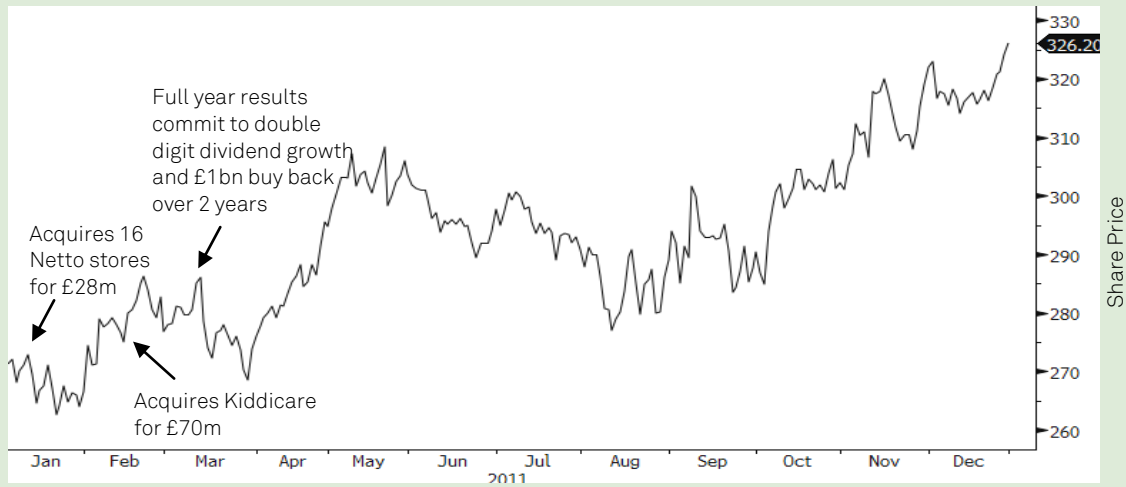
There has also been a notable improvement in house prices in most major cities in the US. Orlando, for example, which is particularly close to the author's heart (please see our Findings from Orlando piece written in January last year) has seen the median value of a housing transaction rise from \$95k to \$115k (Source: Orlando Regional Realtor Association). While price rises such as this do not make headlines in the same way that price falls do it undoubtedly has a positive wealth effect on the US consumer. It also provides crucial support to the banking system.

From a stock market perspective the prospect of a US recovery has fed through into good performance of certain shares exposed to the grass roots of the economy. For example, the portfolio has benefitted from Ashtead, the plant hire specialist, which rose by 70% in 4th quarter alone as earnings have continued to come in ahead of expectation. We continue to build positions in certain shares that stand to benefit in similar fashion and pleasingly in many cases we are able to do this at close to their share price lows.

Despite our optimism about a US recovery we do not want to overstate the economic growth potential of western economies. However, under the scenario of low, or perhaps no growth, attractive equity returns are still very much achievable in our view. The starting point to attain this has to be a strong balance sheet and then three avenues are afforded to a company in order to differentiate itself: namely, attractively priced in-fill acquisitions, dividend growth and share buy-backs where appropriate. Morrisons, for example, is a company that last year carried all three of these actions and the shares rose by over 20%, which was material outperformance versus both the market and its sector.

**Source: Matterley

Figure 4: Morrisons Share Price Graph (2011)

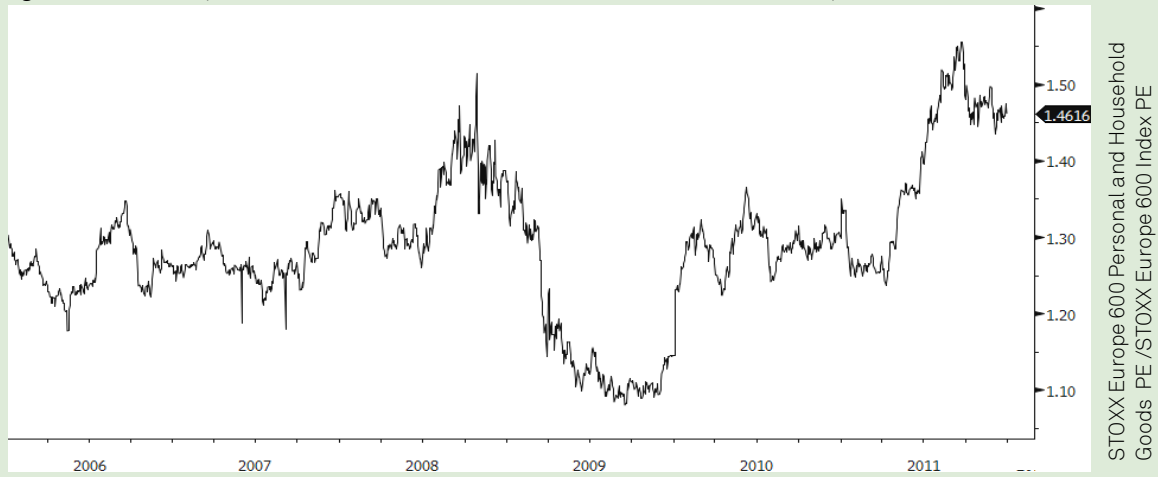


Source: Bloomberg

How Are We Positioned for the Year Ahead?

As mentioned we think the value proposition for equities is now in evidence at all ends of the market capitalisation spectrum. At a sector level, we struggle with Utilities owing to high levels of debt and nonexistent free cash flow, and Consumer Staples where we see the record PE relative being poorly supported by earnings trends.

Figure 5: STOXX Europe 600 Personal and Household Goods PE relative to STOXX Europe 600 Index PE (2006-2011)



Source: Bloomberg

Elsewhere we see good value in most sectors and as a result we are happy to normalise some of our weightings. Our underweight in banks, for example, which served us well last year, has been reduced in recent days. This is a function of our positive view on the ECB 3-year LTRO as well as our analysis in the improvement in gearing levels in aggregate. The nature of their capital backing is also crucial as the abundant Contingent Convertible capital that exists for both Lloyds and RBS provides equity investors with a unique opportunity. Specifically this “unique” opportunity takes the form of ranking superior to debt holders. By way of explanation RBS has £8bn^{***} of contingent convertible capital that will convert into equity at 50p if their tier 1 capital ratio breaches 5%. Lloyds have £9.2bn^{***} of capital with professional investors which will convert to equity at 59 p in the

^{***} Source: Credit Suisse

event their tier 1 ratio breaches 5%. In short, should these two banks need a rescue rights issue they are in the fortunate position of being able to access significant capital from bondholders at well over twice their current share prices.

Outside of financials we think the best way to exhibit the value credentials of our portfolio is via our per pound analysis. We also show data for the FTSE 100 and for reference we give the comparable information of a year ago.

What do you get for every £1 invested? (Jan 2012)

	Matterley Fund	FTSE 100
Sales	189.0p	104.0p
Earnings	12.1p	10.2p
Tangible net assets	72.6p	31.3p
Net cash (Net debt)	12.6p	-12.4p

Source: Matterley. Bloomberg consensus data for full year 2012e quoted on 31/12/11. Excludes Banks and Life Insurance stocks and charges and expenses.

What you got for every £1 invested? (Jan 2011)

	Matterley Fund	FTSE 100
Sales	136.7p	87.2p
Earnings	9.6p	9.2p
Tangible net assets	58.4p	21.8p
Net cash (Net debt)	-4.3p	-15.5p

Source: Matterley. Bloomberg consensus data for full year 2011e quoted on 31/12/10. Excludes Banks and Life Insurance stocks and charges and expenses.

The year-on-year improvement in all the metrics above means the portfolio is the cheapest it has ever been at the outset of any year since its inception. The PE of c8.2x feels undemanding and it is important to highlight that this is built upon the foundation of net cash and significant asset support rather than excessive financial gearing. This heightened asset support has materially increased our confidence in the portfolio to withstand any shocks that we may see. Upside we believe is eminently achievable owing to the undemanding starting valuation and the well supported income stream which is increasingly being complemented by share buy-backs. This is an appropriate use of cash and cash flow in our view given the asset backing of so many of our portfolio constituents.

Conclusion

The crisis premium that exists owing to the Eurozone woes has manifested itself in an equity market that looks extreme value based on earnings and yield. This value also exists at a time of cautious positioning and bearish market commentary. We therefore believe that equities in aggregate can respond well to a moderation of bad news. Within this we hope that the portfolio will benefit disproportionately as it is demonstrably cheaper than the market as a whole, and the cheapest it has been at the outset of any year since its inception in 2008. While this is no guarantee of success it is a starting point that gives us a great deal of confidence in the year ahead.

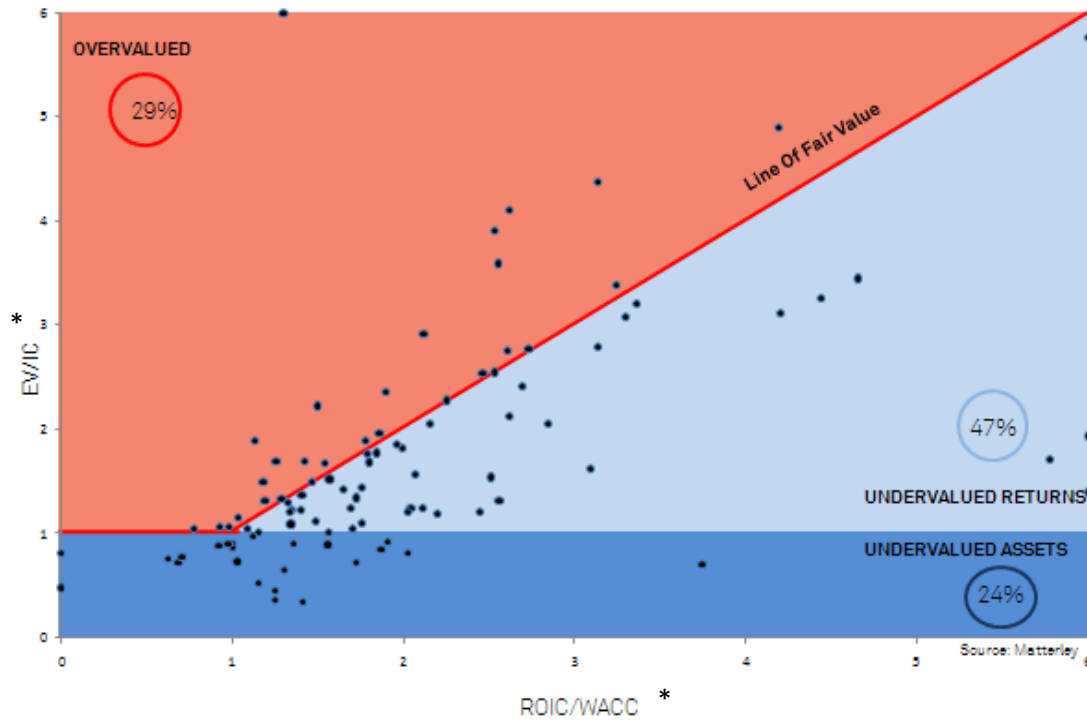
Henry Dixon

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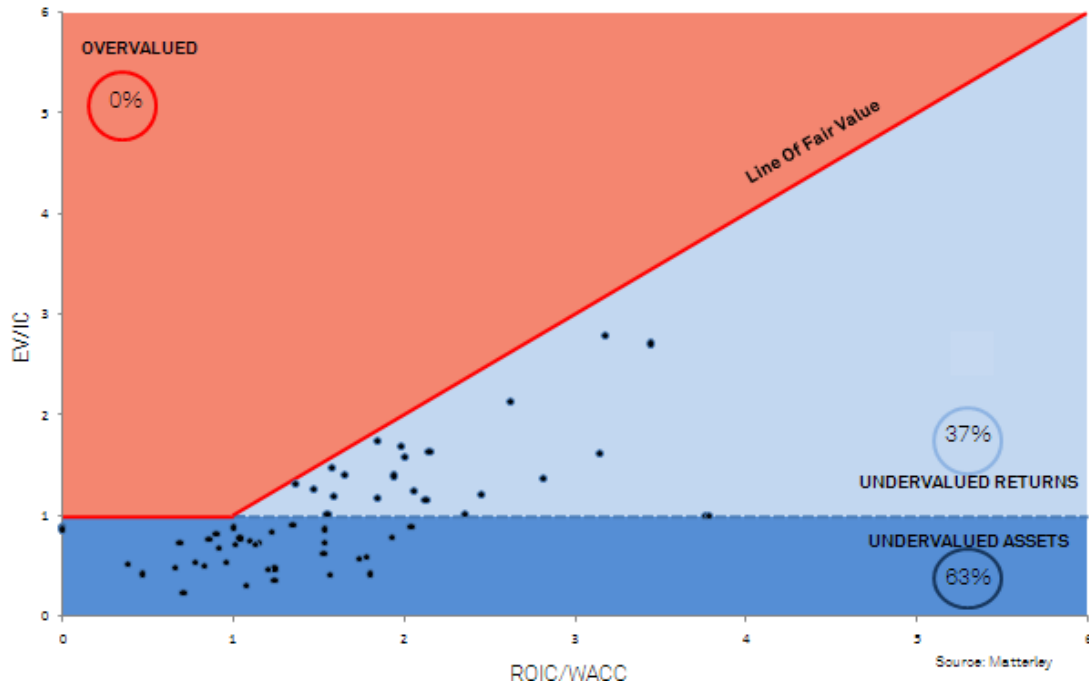
Appendix

- Valuation Matrices 31/12/11
- Valuation Matrices 31/12/10
- Important Information

**FTSE 100 Valuation Matrix
31/12/11**



**IM Matterley Undervalued Assets Fund Valuation Matrix
Holdings at 31/12/11**



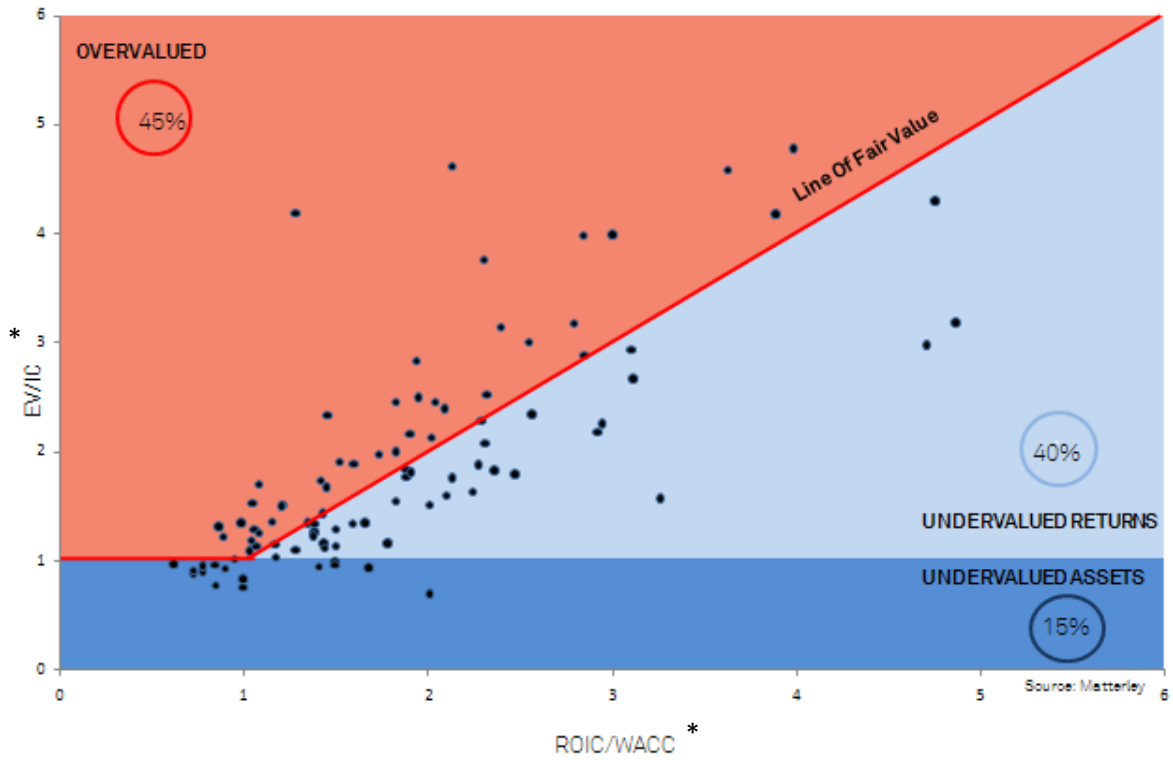
*EV/IC = Enterprise Value/ Invested Capital

*ROIC/WACC = Operating Profit on Invested Capital/Weighted Average Cost of Capital

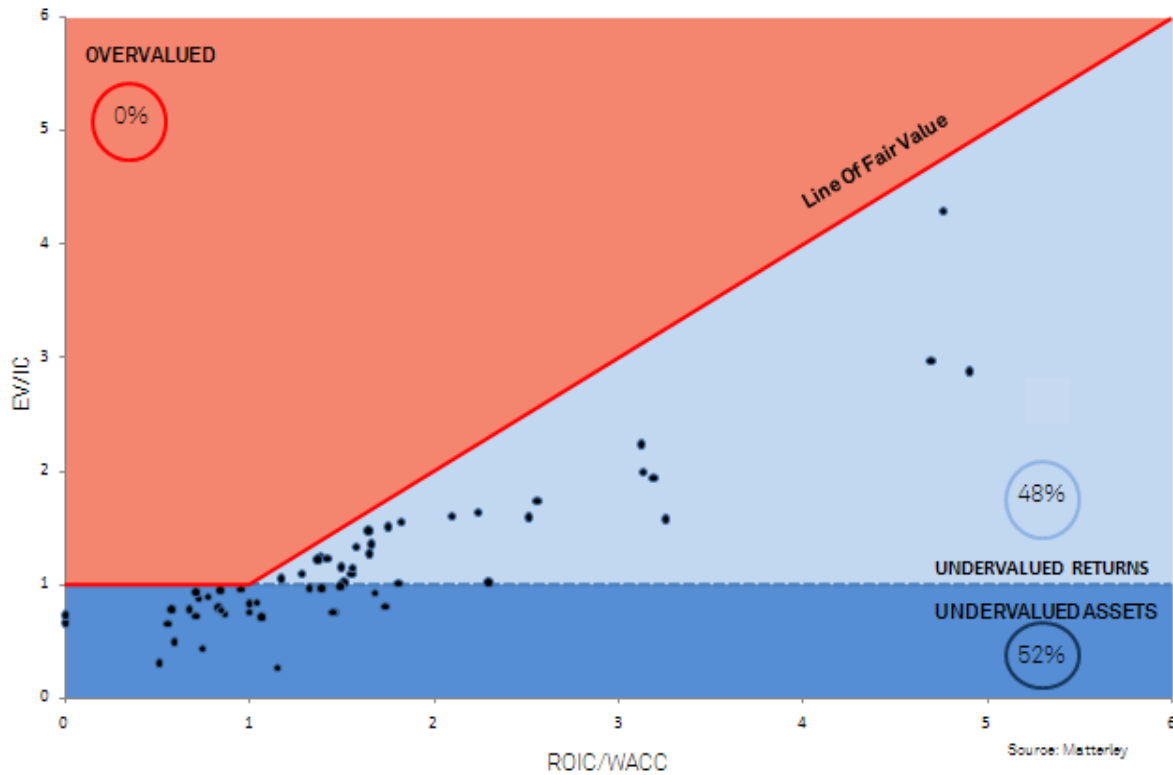
Enterprise Value: Market capitalisation and all calls on the business (debt + pensions + operating leases + contingent liabilities)

Invested capital: The book value of the fixed assets and working capital required to create the business

FTSE 100 Valuation Matrix 31/12/10



IM Matterley Undervalued Assets Valuation Matrix Holdings at 31/12/10



*EV/IC = Enterprise Value/ Invested Capital

*ROIC/WACC = Operating Profit on Invested Capital/Weighted Average Cost of Capital

Enterprise Value: Market capitalisation and all calls on the business (debt + pensions + operating leases + contingent liabilities)

Invested capital: The book value of the fixed assets and working capital required to create the business

Important Information

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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