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MARKET EDGE

A view from the UK equity desk
October 2011



Key points

UK equities fell sharply with the FTSE® All Share Index down 13.5 per cent in Q3

Economically sensitive sectors struggled, while defensive sectors outperformed

Looking ahead we remain cautious from a macroeconomic perspective

Companies across a number of sectors are now in a better competitive position than before the economic downturn, with valuations below their long-term averages

We expect more UK-listed companies to become acquisition targets

Fears western economies may be heading back into recession sparked a slump in equities during Q3. Sentiment was further undermined by the growing sense of crisis enveloping the European Union as Greece teetered on the brink of bankruptcy and other governments struggled to convince markets they will agree the necessary measures to avert a default. Below we review the quarter in more detail and highlight our sector views.

Market review

UK equities fell sharply during the third quarter with the FTSE® All Share Index down 13.5 per cent. The ongoing European sovereign debt crisis and weaker global economic indicators, particularly in the US and Europe, were the key factors behind the sell-off.

Domestic economic indicators disappointed. August saw the largest rise in unemployment for two years, as job losses in the public sector outweighed gains in private sector employment. The weak labour market is taking its toll on the consumer, with retail sales reaching a 16-month low according to the CBI Distributive Trades survey. Although inflation remains above its official 2% target, speculation mounted that the Bank of England would soon sanction a further round of quantitative easing – printing money to increase the amount of credit in the economy.

Areas with greater sensitivity to the global economy performed badly – notably basic materials as industrial metal prices fell back sharply. Financials lagged, with banks lower on fears of sizeable write-offs on their holdings of euro zone government debt. The sector remained in the spotlight as the Vickers Report recommended banks ring fence their retail operations from investment banking. Defensive areas of the market, where profits tend to be less heavily swayed by the state of economic activity, were the strongest performers. The consumer goods, healthcare and utilities sectors all held up relatively well.

Outlook

We remain cautious from a macroeconomic perspective. Risks of euro zone debt defaults and economic recession still dominate investor sentiment.

In aggregate, UK equity valuations do not appear expensive in absolute terms and are particularly attractive when considered relative to other less risky asset classes, particularly when you consider the FTSE® All Share Index yields around 3.8%.

Furthermore, there are a number of sectors where companies are now in a better competitive position than before the economic downturn, with valuations below their long-term averages. This gives us scope for optimism. In addition, we believe that a subdued outlook for global growth, combined with the significant cash balances held by some larger companies, will result in further merger & acquisition (M&A) activity. The UK market is likely to feature heavily in this regard and we expect more UK-listed companies to become acquisition targets for larger competitors.

Key sector views

Oil & gas (underweight)

We continue to believe that oil majors face a challenging future, with existing productive assets in decline and access to new resources proving both difficult and expensive. The announcement by Conoco Phillips that it was splitting the business up is of wider interest as there have been repeated calls for the UK majors to follow a similar strategy. However, we remain

somewhat sceptical. We have sizeable positions in some exploration and production companies, such as BG and Premier Oil, where growth prospects are significantly stronger. Earlier in the year, we also participated in the initial public offering of Vallares, a cash shell founded by Tony Hayward and Nathaniel Rothschild investing in cheap oil & gas assets in emerging markets.

Banks (underweight)

While we believe the process of re-capitalisation is largely complete, in our view banks will continue to reduce the size of their balance sheets for some years yet, weighing on profits. In addition, we consider that stricter regulation, including greater capital requirements, will lower returns on a permanent basis.

In terms of individual stocks, we have been slowly building our position in Barclays, which offers a compelling valuation on a price to book basis. We also added to positions in Standard Chartered at the height of the recent panic about emerging markets.

Media (overweight)

Overall, we see media sector valuations as attractive, given that many companies have more robust cash flows than the market perceives. Pearson, Reed, DMGT and United Business Media all offer strong market positions and exposure to more resilient business-to-business expenditure. We are also exposed to recovering advertising trends through ITV, where we see positive operational gearing being underestimated. In addition, we own Aegis, which has benefitted from the disposal of its market research business and an

increasing focus on its core media business.

Mining (underweight) & Industrials (overweight)

We retain a bias towards industrials over miners but the relative position has shifted somewhat in favour of miners in recent months. We have taken advantage of share price weakness to increase our holdings in companies which we believe offer the best opportunities in the sector. Aggressive earnings forecasts in the industrial sector have started to come down but are likely to need to be cut further. Nevertheless, we remain upbeat on the long-term prospects of our holdings in the sector. Key holdings in industrials include Smiths and BAE Systems.

In the mining sector, significant progress has been made to reduce debt levels, enabling organic growth projects to be developed. Following a series of value destroying and poorly timed acquisitions at the peak of the cycle, we are hopeful there will be much greater capital discipline going forward. We remain focused on quality investments on companies with we expect to exhibit this. Lastly, analysis of the positioning of the majors on the iron ore cost curve has led to us to conclude that the returns in this specific commodity are substantially higher than we previously assumed. We hold Rio Tinto and Anglo American.

Support Services (overweight)

We have increased our exposure to higher quality companies and this has led us to an overweight position in the sector. Two companies that have proved extremely resilient through the global economic downturn

are Compass and Experian. We believe this record of delivery and future growth prospects, both organic and through acquisition, are under-appreciated. As the market has pursued more cyclical companies in recent quarters, we have established positions at attractive valuations, particularly on cash flow metrics. We retain our holdings in Rentokil and SIG, which continue to offer both 'self help', where management have the opportunity to improve business prospects, or companies with late cycle upside.

Smaller Companies

Smaller companies offer attractive valuations and are likely to benefit disproportionately from increased M&A activity. In this segment of the market, our funds are primarily focused on companies with international earnings and quality growth franchises. Significant underperformance has created valuation opportunities in domestically-focused franchises, and we have started to take advantage of this anomaly.

We remain focused on quality, growth at a reasonable price, special situations and businesses with sustainable and growing dividend yields.

Important Information

Source of all market data: Bloomberg

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