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ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

Following the very difficult stock market conditions of 2008 and the early part of 2009, it is a relief to note some modest recovery during the quarter just ended. Whilst this might seem strange, given the present very poor economic background internationally, our review discusses, amongst other things, why this might be happening.

The tables below detail relevant movements in markets:

### International Equities 31.01.09 – 30.04.09

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+9.2	+22.7	+26.1	+22.0
Finland	+17.5	+18.3	+21.6	+17.5
France	+7.8	+8.4	+11.4	+7.8
Germany	+10.6	+11.3	+14.4	+10.6
Hong Kong, China	+15.0	+11.9	+15.1	+11.3
Italy	+6.3	+6.9	+9.9	+6.3
Japan	+7.8	-4.3	-1.6	-4.9
Netherlands	+0.1	+0.7	+3.5	+0.1
Spain	+6.7	+7.3	+10.3	+6.7
Switzerland	+2.6	+1.8	+4.6	+1.2
UK	+4.4	+4.4	+7.3	+3.8
USA	+7.0	+4.1	+7.0	+3.5
Europe ex UK	+8.1	+8.6	+11.6	+7.9
Asia Pacific ex Japan	+16.8	+21.6	+25.0	+15.4
Asia Pacific	+11.7	+6.7	+9.7	+6.1
Latin America	+16.2	+19.9	+23.2	+19.2
All World All Emerging	+21.8	+24.1	+27.5	+23.3
The World	+8.1	+6.3	+9.2	+5.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +2.6%

### International Bonds – Benchmark Ten Year Government Bond Yields (%)

Currency	30.01.09	30.04.09
Sterling	3.71	3.51
US Dollar	2.84	3.12
Yen	1.29	1.43
Germany (Euro)	3.31	3.17



### **Sterling's performance during the quarter ending 30.04.09 (%)**

<b>Currency</b>	<b>Quarter Ending 30.04.09</b>
US Dollar	+2.8
Canadian Dollar	-1.5
Yen	+12.6
Euro	-0.6
Swiss Franc	+0.9

### **Other currency movements during the quarter ending 30.04.09 (%)**

<b>Other Currency</b>	<b>Quarter Ending 30.04.09</b>
US Dollar/Canadian Dollar	-4.2
US Dollar/Yen	+9.5
US Dollar/Euro	-3.3
Swiss Franc/Euro	-1.4
Euro/Yen	+13.3

### **Significant Commodities (US dollar terms) 30.01.09 – 30.04.09 (%)**

<b>Significant Commodities</b>	<b>30.01.09 – 30.04.09</b>
Oil	+10.7
Gold	-4.1

### **Markets**

Equity markets performed very badly in January and February but have recovered sharply from the beginning of March. This means that investors with an April quarter end have generally seen a modest recovery in portfolio values. For the quarter, the total return on the FTSE World Index was 8.1% in local currency terms, 6.3% in sterling terms, 9.2% in US dollar terms and 5.7% in euro terms. Within the major markets in local currency terms, there was not a significant variation in performance. The FTSE USA Index returned 7.0%, Europe ex UK 8.1%, Japan 7.8% and the UK 4.4%. The outstanding equity market performances came from the FTSE Asia ex Japan Index which returned 16.8%, the FTSE Latin American Index which returned 16.2% and the FTSE All World All Emerging Markets Index which returned 21.8%. The major difference in performance in sterling adjusted terms came from Japan where the weakness of the yen after a stellar performance in 2008 caused the FTSE Japanese Index to show a negative return of 4.3%. In sterling terms, the FTSE World Index returned 6.3%, the FTSE USA Index returned 4.1% and the FTSE Europe ex UK Index returned 8.6%. The return on the FTSE Asia Pacific ex Japan Index rose to 21.6%, on the FTSE Latin American Index to 19.9% and on the FTSE All World All Emerging Markets Index to 24.1%. Australia is also worthy of a mention. Following a strong recovery in the Australian dollar, a very satisfactory local currency return on the FTSE Australian Index of 9.2% rose sharply to 22.7% in sterling terms.

Performances in international bonds were mixed, distorted for a while in the USA and UK by the announcement of quantitative easing. Taking ten year government bonds as the benchmark, gross redemption yields on sterling bonds fell by 20 basis points to 3.51% and on German government euro denominated bonds by 16 basis points to 3.17%. On the other hand, yields on US government bonds rose by 28 basis points to 3.12% and on Yen bonds by 14 basis points to 1.43%.



In the currency markets, changes were relatively mild except in the major currencies for the yen against which sterling rose by 12.6% during the quarter. Elsewhere, in the equity movements noted above, we commented on the sharp recovery in the Australian dollar.

In commodity markets, oil rose by 10.7% as OPEC output production curbs began to take effect but gold fell by 4.1%.

## **Economics**

Although it is pleasing to see that shares have started to make a modest recovery, some may puzzle as to why this has happened given that the economic situation remains dire. Although we cannot yet be sure that the world equity markets have hit their low point in this cycle, we can feel fairly confident that they will, at some stage, anticipate economic recovery and this may be happening now. By definition, the economic cycle will turn up. There are certain things which will cause this to happen. One is that the stock cycle will turn. Initially, in a downturn, or when things look as if they may deteriorate, companies will draw down stocks to meet part of the demand. This will reduce working capital needs. Lower production may involve redundancies or shorter time working. Replicated throughout the economy, lower economic activity results. This is where we are now. But, at some stage, stocks become dangerously low, levels at which companies may not be able to service their customers and therefore lose business so manufacturing output is either stabilised to maintain stocks at a given level or it might increase if it is felt prudent to build up stocks. If replicated throughout an economy, it will give it an uplift. In its recent interim report, the OECD cites a negative contribution from stockbuilding in five of the G7 economies this year with a recovery to a neutral position next year. That, of itself, implies some impetus to growth next year because things are not forecast to get worse.

Crucial to, and the start of, the present economic and financial problems is the situation in the housing markets, particularly in the USA, UK and some European markets, such as Spain and Ireland. We all know what has caused the problems here and what is prolonging the problems but, at some stage, a market clearing rate for houses will be reached, i.e. prices at which supply and demand are in balance. If this is temporarily below the replacement cost of houses, housebuilders will hold off building more houses and a shortage will develop pushing up house prices again. Stronger house prices, although generally some way off, will engender more confidence. For this reason, various indicators of the housing market are watched closely.

In the financial sector, signs of a stabilisation in the banking sector are crucial. We can probably tick one box, that of security of bank deposits. Worries probably peaked last autumn when fears of a run on some banks were very real. Governments and central banks seem to have worked out a way of dealing with depositors' worries about the security of their deposits whether it be through guarantees, nationalisation, part nationalisation or stronger banks acquiring weaker ones. The alternative, a major bank failure, did not bear thinking about and the threat seems to have been averted. We hope that we are not premature in suggesting that this worry can be removed from investors' and depositors' minds.

After a dreadful year for financial stocks, some tentative encouragement may be drawn from the recent dramatic recovery in many financial stocks. This suggests some lessening of risk aversion on the part of investors. It is very difficult to generalise about the sector but here, as elsewhere, it is time to say that the strong will get stronger. The demise, or weakening, of competitors gives the opportunity for increasing market share and improving margins. We have seen some quite strong results from some banks in the first quarter. Even those which have required government support and investment have shown strong rises from very low levels. Ultimately, the US and UK governments do not want to be owners of banks and, though they will not say it, it is in their interests that they should show a substantial level of profits in the future so that the relevant governments can sell their shares in the banks. A successful conclusion to the programme of stress testing the banks will be necessary in this respect.



Linked in some way with this point, because it is relevant to the financial sector, is the stimulus given to share prices from signs of a resumption of merger and acquisition activity. We said in the previous paragraph that the strong will get stronger as a result of the world recession. There are still plenty of companies with financial strength which will be looking to take advantage of the fall in share prices or relatively strong rating of their shares or the weakness of the target company to make acquisitions which would not have been so easily possible prior to the economic crisis. When one moves, others will follow, and we may expect to see an increasing pace of merger and acquisition activity which should be positive for markets.

In macro terms, investors must consider the effects of the vast amounts of money being thrown at the problems by governments and central banks throughout the world. Monetary and fiscal measures were aimed at stabilising the economic position and seeing off deflation. Quantitative easing, as practised in the USA and UK, the modern day equivalent of printing money, is aimed at causing some inflation on the basis that a prolonged period of deflation is too awful to contemplate. As outlined before in these reviews, deflation can have devastating economic effects. We have been used to worrying about the malign effects of inflation but have not had to consider deflation, a problem that, apart from in Japan where it had been a problem, did not seem to be a realistic prospect. We are not talking here about a short period of falling prices, which would please many people, but a persistent change in trend which could alter the financial habits of individuals and businesses. Policy makers are fearful that a period of deflation could turn a recession into a depression. If we remind ourselves about the malign effects of deflation, one is that the real value of debt rises, placing a further unwelcome burden on businesses and individuals where borrowings are in place. A second is that, for businesses, whilst the prices they charge customers are not sticky downwards (in a deflationary environment customers would challenge businesses which are not cutting prices), wage costs are sticky downwards. It may be that the current recession challenges this proposition quite hard because, in the private sector, there is anecdotal evidence of pay freezes and some pay cuts but it is still likely to be true that it is more difficult to cut costs than preventing prices being reduced. A scenario like this paints a bleak picture for many businesses. A third, very unwelcome, consequence is that the prospect of continually falling prices creates a vicious circle of falling demand as buyers hold off non essential purchases in the hope of buying more cheaply. This is a scenario for a depression.

At present, there is a significant output gap in most economies which argues for subdued prices for a while. An output gap measures the difference between an economy's potential output and its actual output. If, as at present, actual output in most countries is below potential output, pricing power is weak because competition is stronger on the assumption that most companies have an output gap themselves. They will try hard to cover fixed costs by raising volumes, albeit at depressed prices, provided the extra production does not actually lose them money.

Quantitative easing is trying to prevent the deflationary scenario from occurring by stimulating activity in the relevant economy. By buying a bond from the private sector it creates a deposit in a bank for a seller—it might be bank. If that cash is hoarded the purpose of quantitative easing is defeated but, if it is spent or lent, it has the chance of creating a money multiplier and stimulating economic activity and, eventually, modest inflation. The other route by which it aims to boost borrowers is by driving down interest rates on bonds and making it cheaper for companies to borrow, thus helping to keep down their financing costs.

One might ask why one wants to see a little bit of inflation given that the experience of most of us is that the aim of economic policy in the past has been to keep it down. If one looks at the main central banks, a range around 2% is generally the desired inflation target but, why, one might ask, aim for inflation at all? Partly, it is to give a margin of safety against the deflation scenario developing with all its unpleasant side effects. It is also helpful at chipping away at the real value of liabilities whether they be in the government sector or the private sector. In terms of keeping economic activity rising steadily, the prospect of modestly rising prices encourages consumer activity while falling prices, which discourage it, leading to the possibility of depression. Inflation of around 2% suits most requirements.



It sounds easy but, of course, it is not. Quantitative easing is being tried in the USA and UK because the scope for further easing of conventional monetary policy is exhausted. In most major countries, interest rates are close to zero. In the scheme of things, the attention of politicians has been centred on those who have borrowed money, whether they be individuals or businesses. Very little attention has been paid to those who have money on deposit. In the UK, for example, it is estimated that there are seven times as many savers as borrowers and these people are feeling the pain. It will hit pensioners particularly hard and the lack of income from, say, bank deposits will affect aggregate demand in the UK economy and this will be replicated elsewhere.

The aim of quantitative easing is to boost the money supply, raise asset prices and stimulate demand. If it was as easy as just printing money to achieve this, everyone would be happy. But printing more money to chase a limited supply of goods and services obviously leads to inflation. The trick, therefore, is to reverse the process as soon as it can be done without reverting to the previous situation. This means selling back the bonds, if they were the assets purchased, under “quantitative easing” and withdrawing from the banking system the money originally created. This is not as easy as creating the money in the first place. It is doubly difficult if the relevant economies are drowning in a sea of debt, as the US and UK economies are at present, as it would threaten to push up interest rates as central banks sought bids for their bonds.

The politics of reversing quantitative easing may be difficult even for normally independent central banks. Creating money to buy back bonds from the private sector may be easy but the reverse, tightening policy, risks unpopularity with business and the public who would not be exposed at the time to the unpleasant consequences which would follow in the form of inflation. Although we have an output gap at present, it will eventually disappear if attempts to boost the money supply and raise economic activity are successful. That is when the danger signs will appear and pre-emptive action will be necessary.

The danger is that some governments may not be averse to a period of inflation provided it does not get out of hand but, by that stage, the chances are that it will be on its way to doing so. Inflation helps to erode the real value of debt and if, as is probable, in its early stages it is accompanied by strong economic growth it may make governments’ finances appear in a better state than they are in terms of current government deficits, as opposed to the overall level of public debt against GDP. However, there are many malign consequences of inflation and one that would bring governments suddenly to face reality would be the reaction of the international bond markets. We consider it very likely that inflation will be a problem later on and this is informing our investment policy.

In recent reviews, we have generally not concentrated on individual items of economic news because events were moving so fast and economic data was rapidly being overtaken by events. As data seem to be settling down somewhat at its very depressed levels, we will introduce some individual data, at present just that indicating that the rate of dealing may be slowing down or that things are stable or even the odd “green shoot” of recovery. But, firstly, it would be a good idea to try to get a view of the big picture and, in this respect, we show below extracts from recent forecasts for growth, inflation and government borrowing in major economies taken from the recent IMF World Economic Outlook of April 2009 and the recent interim report from the OECD.



### Expected growth %

G7 Countries	2009	2010
Canada	-2.5	1.2
France	-3.0	0.4
Germany	-5.6	-1.0
Italy	-4.4	-0.4
Japan	-6.2	0.5
UK	-4.1	-0.4
USA	-2.8	0.0
Brazil	-1.3	+2.2
China	+6.5	+7.5
India	+4.5	+5.6
South Korea	-4.0	-1.5
Mexico	-3.7	+1.0
Russia	-6.0	+0.5

Source: IMF

Also, at the end of March, is an interim report from the OECD. Its forecasts are as follows:

### Changes in real GDP against previous year %

	2009	2010
USA	-4.0	0.0
Japan	-6.6	-0.5
Germany	-5.3	0.2
France	-3.3	-0.1
Italy	-4.3	-0.4
UK	-3.7	-0.2
Canada	-3.0	0.3
Euro area	-4.1	-0.3
Total OECD	-4.3	-0.1



### Consumer prices – changes against previous year %

	2009	2010
USA	-0.4	0.5
Japan	-1.2	-1.3
Germany	0.6	0.5
France	0.4	0.6
Italy	0.7	0.7
UK	2.0	1.7
Canada	-0.6	0.5
Euro area	0.6	0.7

### General government financial balance ( surplus / deficit as a % of nominal GDP )

	2009	2010
USA	-10.2	-11.9
Japan	-6.8	-8.4
Germany	-4.5	-6.8
France	-6.6	-8.3
Italy	-4.7	-5.9
UK	-9.3	-10.5
Canada	-4.4	-6.2
Euro area	-5.4	-7.0
Total OECD	-7.2	-8.7

Source: OECD

We will not go into individual details in the forecasts but rather make some general observations. Firstly, it goes without saying that 2009 is going to be a dire year. A serious recession is taking hold but, although lower than previously, there will be levels of economic growth in China and India which will be the envy of the major industrialised economies. Next year, although bad by historical standards, is expected to be much better. Although inflation is expected to be very low and negative in some countries, general deflation is not expected, and fears of this happening seem to be diminishing although they have not evaporated. Thirdly, the long toll which the recession and banking crisis have taken on governments' finances are apparent in the OECD's figures. It is this latter issue which we now wish to dwell upon.

In an economic recession, so called "automatic stabilisers" come into play which, as their name implies, should theoretically help to stabilise an economy. As government revenues suffer and expenditure rises, for example on social security payments, the ability of government finances to deteriorate helps to provide an economic cushion as governments do not seek to deal with the deterioration in government finances by raising taxes or cutting expenditure, moves which could exacerbate the problem. However, this statement needs heavy qualification





because it depends upon the starting point in terms of government finances and the nature of the deficits which they have been running. Government deficits come in two forms, structural and cyclical. The situation which we have described above is a cyclical one in that deficits can be run in bad economic times, offset by surpluses in good economic times. That is perfectly sensible and a proper use of the stabilisers. What is dangerous is the running of structural deficits, deficits which are ingrained in the economy even in good times. Over the long term, and the short and medium term in some cases, this is an unsustainable position. The USA and UK are economies with significant structural deficits, for example. Whatever one might think about the merits of monetary union in Europe, it does at least theoretically entrench the position of budget discipline through the Stability and Growth Pact. In practice, the discipline of that Pact has been shattered by the recession but the thinking behind the limits on eurozone members' budget deficit is correct.

Whilst not for this review, the issue for countries with entrenched structural deficits has to be the level of public spending and taxation. In the short term, countries have to look at the interaction of these issues with the depth of the recession and what short term measures are needed to try to address current difficult problems. Economic recovery will be slow, which will affect the rate of improvement of countries' finances. The big question is as to how easy it will be to finance these large deficits. There are two issues here, we think. Firstly, there is the sheer size of countries' borrowing needs and, secondly, there is the issue of the inflationary consequences of monetary policy now being followed. We touched upon this when discussing quantitative easing. Dealing with the latter point first, we think that bond yields (we will use as a proxy here top quality ones such as those detailed in the table at the beginning of this review) are inadequate for the risks which we see for inflation later on. Also, with the sheer volume of issuance, yields seem totally inadequate. Yields were driven down by extreme risk aversion and, assuming the early signs of investors becoming slightly less risk averse continue, we might expect top quality bond yields to continue to rise. Although quantitative easing, where practised, is supposed to push down bond yields, we think that investors will become more wary of bonds as they realise that the modern day way of printing money is not painless as far as future inflationary consequences are concerned unless they can feel absolutely sure that the measures will be reversed.

The excesses of parts of the financial system and the resulting damage that it has inflicted on the world economy has exacted a big price on the capitalist system and we should note that certain governments have been ratcheting up the anti-business rhetoric and becoming more protectionist. Nobody should doubt that the new Administration in the USA is much more hostile to business. Tax proposals for US based companies with overseas interests, just announced by President Obama, will, if enacted, raise taxation for business and, with one rationale of trying to make sure more work is carried out in the USA, have an unwelcome protectionist tone. In the UK, the sharp increase in taxation on high earners has a strong political element to it. Investors, whilst naturally preoccupied with the serious economic position of the world economy, should not take their eye off the more hostile political environment for business and, by extension, investors.

Although we have discussed more general issues rather than review individual countries and areas of the world, we should make a brief comment on the UK as most of our clients are sterling based. Even before the financial crisis erupted, we had expressed serious concern for a long time about the state of the UK's public finances. The rate of increase in public spending was unsustainable, being well above the potential growth rate of the UK economy, and budget deficits, which were consistently in excess of the level the Treasury had forecast, were quite inappropriate for the levels of growth being observed in the UK economy. There was always going to be a problem when the economy turned down, though, of course, we had no idea of what was eventually to happen. As a result of the financial crisis, the UK's public finances are in a dire state. The situation is made worse by Treasury economic forecasts which look unrealistically rosy. The forecasts for economic growth and borrowing contained in last November's pre budget report were, at the time, regarded as unrealistic and they have duly been torn up in the Budget. Again, the economic and financial forecasts made in the Budget have been greeted with



derision by most independent forecasters. Indeed, most embarrassingly for the Treasury, the House of Commons Treasury Committee, with government majority membership, has questioned the Budget's forecasts and tactics. The danger with forecasts which are widely believed to lack credibility is that they will do damage in the financial markets. As it is, the forecast of public borrowing of £175 billion this year, 12.4% of GDP, is almost unbelievable, whilst, realistically, it is likely to prove to be an underestimate. Although sterling has recovered from its low point, it remains very vulnerable to a loss of overseas confidence. About one third of gilts are owned by foreign investors and, at a time when there is enormous competition for funds from sovereign borrowers, credibility in the UK's creditworthiness has to be maintained. If the UK were to lose its top credit rating, there could be serious consequences. Because of the above average risks associated with the UK economy, important overseas diversification, which we have always espoused, is more important than ever.

In these circumstances, and we are talking internationally, equities would appear to have the edge over other types of investment. We regard bonds as very risky for the reasons mentioned in this review. The returns on cash are minimal, although holding some gives flexibility. Shares and property (eventually), giving exposure to real assets in a potentially future inflationary environment, have appeal, especially with dividend yields attractive and ratings low. This point is made even though the environment for corporate profits is bad and dividends are being cut.

Finally, to emphasise the fact that it appears that the rate of decline of the world economy is slowing down, a prerequisite for an eventual improvement, here are a few signs of hope. It should be remembered that the stock market anticipates future events and that it may reasonably be expected to recover in front of economic recovery. Although most signs are negative at present, the following news in April lends credence to the view that the bottom of the economic cycle is in sight. Firstly, we will note some indicators from the USA. Figures from the Institute of Supply Management in the USA showed that the purchasing managers index for US manufacturing sectors rose to 36.3 in March from 35.8 in February. According to the IBD /TIPP economic optimism index, US consumer confidence rose in April to 49.1, from 45.3 in March. The National Association of Home Builders/Wells Fargo housing market index rose to 14 in April from 9 in March. This was the largest one month gain since May 2003. According to the Federal Reserve's Beige Book, five of its twelve districts in March and early April noted a moderation in the pace of the economy's decline and several saw signs of activity "stabilising at a low level". The Reuters/University of Michigan index of US consumer confidence rose to 61.9 in April from 57.3 in March, to be at its highest level since last September. The US Conference Board said that its consumer sentiment index had climbed to 39.2 during April from an upwardly revised 26.9 in March. If we now turn to the eurozone, Markit's purchasing managers index of eurozone activity in factories and service companies rose to 40.5 in April from 38.3 in March, according to the first estimate. The European Commission's economic sentiment indicator for the eurozone rose to 67.2 in April from 64.7 in March. In Germany, the ZEW think tank said that its gauge of German investor confidence rose to 13 in April from -3.5 in March, one of the first positive readings since July 2007. In Japan, the Cabinet Office's survey of sentiment index for general households was 28.4 in March, up from the previous reading of 26.9 in December. In the UK, the CIPS/Markit manufacturing purchasing managers index rose to 39.1 in March from an upwardly revised 34.9 in February. In the service sector, the CIPS/Markit purchasing managers index rose to 45.5 in March compared with 43.2 in February. The CBI said that businesses found it slightly less difficult to access credit between January and March, compared with the previous quarter, and small and medium sized enterprises expected it to become less difficult to renew existing credit and secure new credit in the coming quarter, according to the CBI. In the housing market, the RICS said that enquiries from prospective home buyers rose for a fifth month in a row in March. Its data also indicated that the pace of decline in house prices had eased recently. The Council of Mortgage Lenders said that the number of home loans taken out by people buying a home rose by 4% during February. It also reported a rise in the number of first time buyers. The CBI said that it expects the speed at which the economy is contracting to slow in the second half of this year with the recovery predicted to be "slow and fragile" with growth in GDP beginning again next year. The Council of Mortgage Lenders said that mortgage lending had risen by 16% during March. The CBI's distributive trades



survey balance rose to +3 in April from -44 in March, which is the highest reading since January 2008. The GfK NOP gauge of consumer optimism rose to -27 in April and the index of confidence in the economy over the next year rose to -15, the highest level since August 2007.

One might say that these items of news are not very exciting in terms of what they say about the relevant economies at present but the important issue is that they indicate that a change in trend could be imminent and this is what the stock market will be looking for.

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