Rathbone Recovery Fund

Quarterly investment report, October 2009 to end December 2009

Market overview

Markets continued to rally in the fourth quarter, although their course was less than smooth. Investors worried about a potential default by Dubai World (and conflicting signals over a bail-out), as well as the status of sovereign debt in countries such as Greece and the UK. The former was downgraded, the latter was not, although these concerns are likely to reappear in the current year. Within this environment, the Rathbone Recovery Fund underperformed given its lack of large-cap defensives stocks and mining companies, and given the relative outperformance of the FTSE 100 index relative to small and mid caps (the latter having enjoyed a strong run in the previous two quarters).

Past performance should not be seen as an indication of future performance.

Performance and fund activity

During the final quarter, we created several new holdings, and took profits from some existing holdings that were looking up with events. We reduced *Clarkson*, *Cineworld*, *SAB Miller* and *Volex* – all of which had rallied strongly. On the buy-side, we created a holding in *Great Eastern Energy*, a coal bed methane developer and producer in India. The company has the reserves and the infrastructure to sell gas into West Bengal, a major industrial centre for steel and iron works. We also bought into the *London Stock Exchange* (LSE), where the new chief executive officer, Xavier Rolet, has outlined strategies for reclaiming market share and broadening the earnings streams. He has been replacing IT systems, creating efficiencies, and focusing on areas such as clearing and derivatives, where the company's competitive position can be improved. The LSE has recently announced the acquisition of Turquoise, which provides it with a pan-European platform in both dark and lit trading (non-transparent and transparent trading), and aligns it more closely with its largest broker-dealer customers. It will take some while for these efficiencies and any market share recovery to be realised in the numbers, but in our view, this has been more than discounted in the valuation. Another addition to the fund is *BBA Aviation*, a leading aviation services provider in the US and Europe. The company has cut costs, reduced debt, and with very strong positions in most of its markets, it should benefit from any cyclical upturn.

Outlook

The beginning of 2010 looks rosier than the same point in 2009 – the survivors are coming out the recession stronger than when they went in, and the macro news is becoming increasingly positive. In addition, there is still plenty of cash waiting on the sidelines, which is earning minimal or no interest whilst equity valuations are looking attractive relative to other asset classes. The issue for 2010 is likely to be one of things being too positive rather than the reverse. For example, it is quite likely in our view, that US GDP will wrong-foot consensus forecasts on the upside. This could well lead to a negative market reaction as investors factor in the prospect of liquidity being reined in earlier than expected, and an end to quantitative easing. In this environment, stock selection and a rigorous approach to balance sheet analysis is paramount, thus playing to the strengths of the Rathbone Recovery Fund.

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