COMMENTARY

October 25, 2013

Dear clients and colleagues,

UK economy

As was reflected in the latest Q3 numbers, UK recovery is on track in almost all segments of the economy. The service sector and construction orders are picking up nicely while retail sales achieved their fourth best quarter of the past 10 years. Thanks to a limited supply of properties and a relatively easy access to cheap credit, UK real estate activity is also very strong.

While we agree that UK is better positioned than most neighboring countries, we remain somewhat concerned in certain areas.

Recent growth has been concentrated in household expenditure rather than in investment. Investment intentions remain modest and UK productivity is still anemic. In the past 5 years, UK productivity has showed no gain.

Household real purchasing power remains weak. Personal borrowing is trending up while real wages are going down. Over the past year, the price of a house in London rose by £40,000 whereas the average annual wage before tax was £35,000. With house prices hitting record highs, London is becoming more unaffordable.

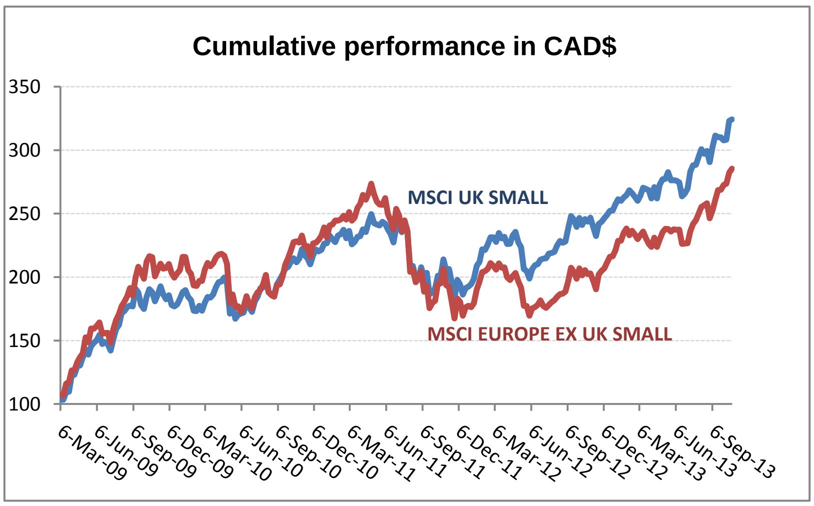
UK companies

UK small companies continue to deliver robust stock performance year to date with a return of 37%. Forward earnings estimates are trending up which bodes well for stock rerating. UK and European exposed stocks are performing well compared to those that rely more on emerging markets. In fact, we have noticed more downgrades on stocks with stronger emerging market exposure.

On the operational side, we noticed that several companies are still pursuing divestment of non-core assets. Companies continue to adjust to structural changes in their markets. In this context of weak revenues growth, capex programs have stabilized or even slowed. Companies are focusing on free cash flow generation and are increasingly vigilant on where they allocate their capital.

Markets are increasing the pressure on management teams to redeploy their cash by increasing the dividend payout or by announcing share buybacks. We see little signs that would suggest a strong pick-up in M&A activities in the very short term. With high valuation multiples and fiscal issues to cope with, we understand why management teams are hesitant to announce major M&A deals.

At this point we are neutral on UK small caps. As Eurozone economy improves, we believe that European small companies could close the performance gap with their UK peers. As we can see below, that could potentially represent an appreciation of 15%.



Source: MSCI, GACM

The Global Alpha Team