Davy Asset Management

DAVY

SPRING 2014

Investment Outlook

From Davy Asset Management

Outlook 2014:
Beyond the Crisis

"...the global economy is now in a more healthy and sustainable position than it has been at any time since the eruption of the global financial crisis more than five years ago."

- ROBBIE KELLEHER, J&E DAVY

Global Economic Outlook, page 4

"What investors *want* and what investors *need* can often be two different things."

- JAMES FORBES, DAVY ASSET MANAGEMENT

Investment Outlook, page 16

INTRODUCTION & OUR OUTLOOK

In our Outlook last year, we predicted equities were the best positioned asset class to deliver the highest returns in 2013. This certainly came to pass and the strength of the rally surprised many. Global equities delivered the fourth calendar year of positive double-digit returns since 2009. This has understandably left some investors questioning how much longer this run can last.

In addressing this conundrum, this Outlook covers:

i. an overview of Davy Asset Management's view for 2014 and how we will look to position the funds for the year ahead;

ii. our colleagues in J&E Davy's outlook on what they believe will happen in the global economy and financial markets in the year ahead; and

iii. a preview of how portfolios might be positioned for 2014.

As we enter 2014, there is a lot of confidence about the prospects for another strong year in equities. Many of the conditions necessary for a continuation of the positive market environment we have experienced since late 2011 remain in place, namely:

- a continuation of very low interest rates and low inflation globally;
- encouraging economic data, suggesting global growth in 2014 may be in the 3% to 4% range;
- while global equity valuations have re-rated strongly over the past two years, they are still in line with the long-term average;
- after several years of outflows, positive inflows into equities and equity funds had only just commenced in 2013, and are likely to continue into 2014, which should put further upward pressure on equity prices; and
- bond yields globally are still very low by historical standards, and if 2014 global growth is in the forecasted range of 3% to 4%, then this could put further upward pressure on bond yields, encouraging investors to switch from bonds to equities.

Given all of the above factors, what is the mood in Davy Asset Management for 2014?

While we remain positive in relation to the outlook for equities, we also believe some caution is warranted. Why, you might ask?

Firstly, we have had two very good years for equity markets back-to-back in 2012 and 2013; in fact in each of these two calendar years the US stock market, as measured by the S&P 500 index, never went under its starting point, which is unusual.

Secondly, there is a strong consensus among the major investment banks we talk to that 2014 may be a good year for global equities, with the range from +10% to +17%. In our experience, a strong bullish consensus view is also unusual and has a good chance of not coming through - it suggests that there is significant investor complacency and a lot of good news priced into markets, which could easily be turned into nervousness on relatively insignificant poor news.

Even in Europe, where we have had a series of very worrying crises in recent times, the stock markets have recovered strongly in anticipation (correctly in our view) of better times ahead.

In our opinion, a continuation in 2014 of the double-digit returns we have experienced over the past two years requires good earnings growth. We believe we will get earnings growth in 2014, but will it be at a level high enough to propel equity markets significantly higher?

Our expectation is for a mid-to-high single-digit global equity market total return for 2014, with the risks skewed to the upside if we are wrong. Equities are still, in our opinion, the asset class of choice, and we believe any significant volatility/downside moves can be used by investors to increase equity weightings, where suitable.

Known unknowns

No doubt, as is the case every year, a number of 'known unknowns' will test the resolve of investors in 2014, such as the US debt ceiling debate, the ECB's bank stress tests and in particular the recent decision by the Federal Reserve to taper its Quantitative Easing ('QE') programme. While undoubtedly this could cause short-term market volatility, we think the stimulus will only be reduced because economic conditions are sufficiently strong.

As the cycle evolves, we will continue to tilt our funds' portfolios towards the stocks/themes where we see the best opportunities, and importantly away from those stocks/themes where we see unattractive risks.

We retain our conviction that monetary assets, such as bonds, will remain under pressure, while euro savers will continue to see deposit rates fall.

Whatever the future may hold, our commitment to our clients and belief in the Davy Asset Management investment process and funds are as strong as ever. I hope you find this outlook useful and if there is any aspect you would like to discuss further, as always we are available to answer your questions.

PRAMIT GHOSE
Investment Strategist,
Davy Asset Management

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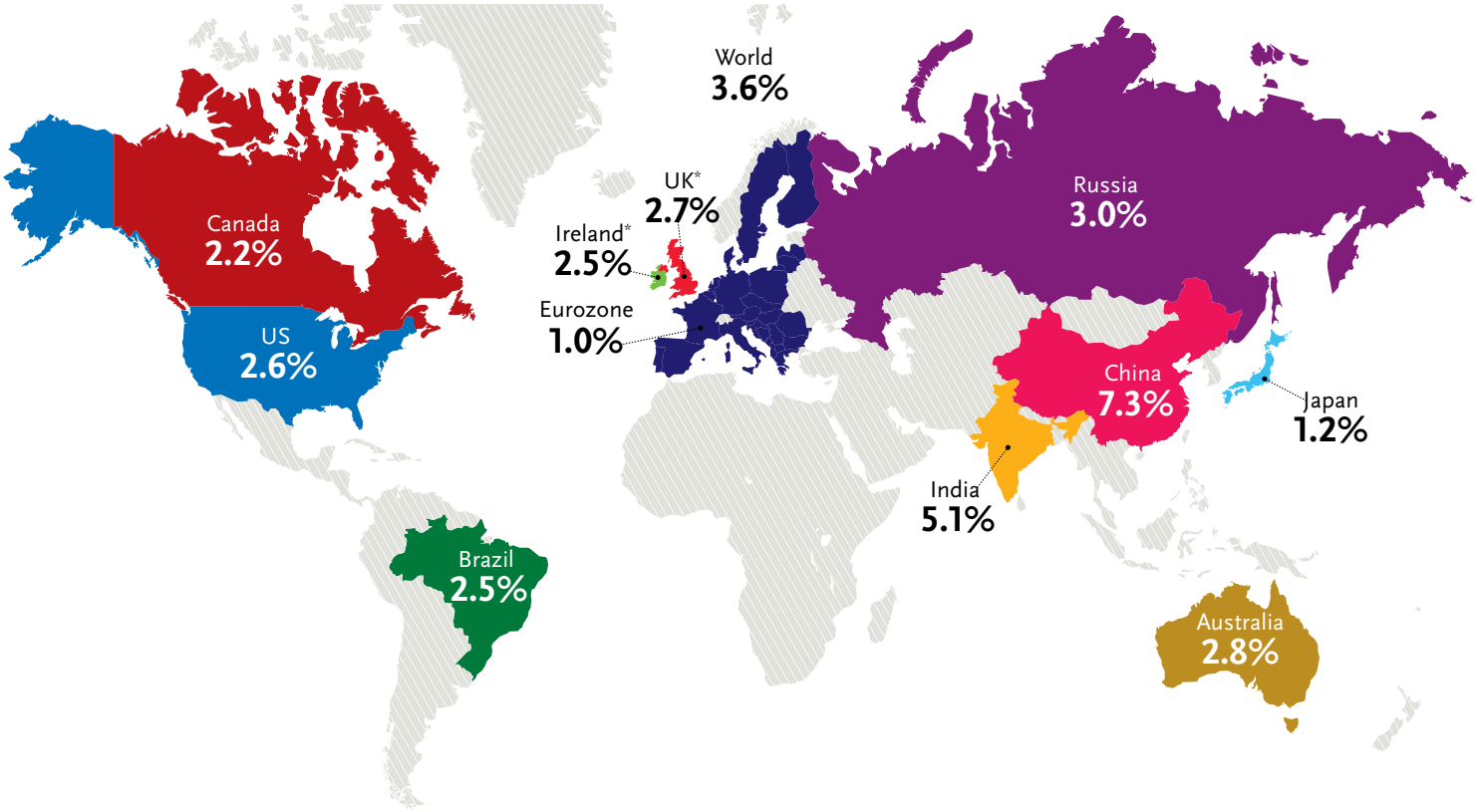
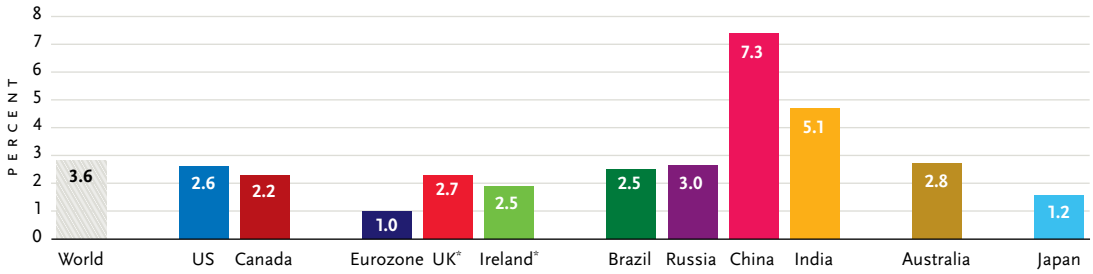


% Gross Domestic Product ('GDP') Growth Forecasts for 2014



Source: IMF, World Economic Outlook Database, October 2013

**Davy forecasts*

2014 ECONOMIC FORECASTS

ROBBIE KELLEHER
Global Investment Strategist, J&E Davy

Global GDP is expected to expand by 3.6% in 2014, up from 2.9% in 2013 according to the latest IMF forecasts.

Of the world's major economies, the fastest growing nations remain in Asia. Despite experiencing a slowdown in recent years, China and India, driven by their massive populations, are expected to record the fastest growth rates of 7.3% and 5.1% respectively.

Commodity producing nations like Australia, Russia and Canada, which benefited from continued strong demand from emerging economies during the crisis, have slowed of late. But, if achievable, growth rates of 2-3% for these economies are still respectable.

In the troubled Eurozone, economists expect a return to growth in 2014, albeit at a more subdued 1% pace. While there still remains a lot of work to be done in Europe, we find it encouraging that many of the peripheral economies, including Ireland and Spain, should exit recession this year.

However, the strength of the global economy is still dependent on the United States. Although the US faces a number of challenges in 2014, most notably the reduction of the Federal Reserve's Quantitative Easing programme, in the absence of the fiscal drag which hampered its progress last year, economists expect growth in the region of 2.6%.

ROBBIE KELLEHER
Global Investment Strategist, J&E Davy

2014

GLOBAL ECONOMIC OUTLOOK: BEYOND THE CRISIS

The global economy now appears to have expanded by just under 3% in 2013, a slightly slower rate than in 2012. However, momentum gathered pace in many regions as the year came to an end. The US economy picked up strongly in the autumn months, while Japan continued to benefit from the 'Abenomics' initiatives. Perhaps most surprising was the strength of the recovery in the UK, which is now the fastest growing of the G7 nations. The Eurozone has finally exited recession, albeit at a muted pace, and the Chinese economy expanded by close on 8% in 2013.

We expect this momentum to be maintained into 2014 and, in many ways, the global economy is now in a more healthy and sustainable position than it has been at any time since the eruption of the global financial crisis more than five years ago.

- The recovery, although slow in places, is now broad-based. All of the major economic blocs in the developed world (US, Eurozone, UK and Japan) are expanding again.
- Some further fiscal consolidation is required, but the most significant of the budgetary adjustments have been completed.
- All four of the world's major central banks are committed to maintaining strongly stimulative monetary policies until the recovery becomes self-sustaining and banking systems have been repaired.
- Personal sector debt ratios, although still high, have been lowered.
- Systemic risks have eased significantly, most notably in the Eurozone. Many of the peripheral economies in Europe have performed ahead of expectations and markets' estimates of the risk of financial dislocation have been greatly reduced. This has been most clearly demonstrated in a very significant reduction in government bond spreads in those countries.
- Although the pace of expansion in China has slowed, the new political regime appears to have successfully navigated the Chinese economy away from an unsustainable growth path of 10% to a much more sustainable medium-term trajectory of between 7% and 8% per annum. A 'hard landing' in China was seen by many in recent years as a significant risk to the recovery of the global economy.

Looking to 2014, we expect global growth to accelerate by 3.6%. Higher growth rates are likely to be achieved across a number of regions. A significant acceleration is anticipated in the US and UK, while the Eurozone should return to positive, albeit modest, growth again. Growth in China should remain within the 7% to 8% range.

UNITED STATES
Still the leader in the developed world

Growth in the US economy in 2013 is estimated at just a little over 1.5%, down on the 2.8% recorded in 2012. A number of factors weighed on performance over the past 12 months, including a tighter fiscal policy which resulted from the resolution of the so-called 'fiscal cliff' that faced the economy in early 2013; the uncertainty which surrounded the wrangling in Washington over the debt ceiling and agreement on a new budget; as well as fears that the Federal Reserve ('Fed') was about to reduce, or 'taper', the amount of liquidity support it provides to the economy.

Nevertheless, the US remains the locomotive of recovery in the developed world. The recovery in the economy, although below the historic norm for the US itself, has been more even and sustained than in any of the other major economic blocs.

In addition, more recent evidence suggests that the recovery gathered pace as the year ended. The economy grew at an annualised rate of 2.8% in Q3 and recent employment data show job creation running in excess of 200,000 per month again. Net job creation now exceeds 7 million over the past three and a half years. This, combined with the wealth effects of a rising stock market and a housing market in which prices have risen by more than 20% in 18 months, should support an acceleration in consumer spending.

The economy faces a number of challenges in 2014, most notably the impact of the recent decision by the Fed to taper its asset purchases and the fact that the agreement on the debt ceiling has not been fully resolved. However, the Fed has made it clear that it will only reduce monetary stimulus when it is confident the underlying momentum in the economy is sufficiently strong to do so.

The politicians in Washington have also shown on a number of occasions they will eventually come to an agreement rather than allow the economy go over the brink.

All in all, we expect US GDP to grow by 2.6% in 2014 and we remain particularly positive on the longer term prospects for the US, given its flexibility and innovation and the impending transformation of its energy sector.

Tapering Begins

The Fed announced in December that it would reduce the size of its Quantitative Easing ('QE') programme by $10 billion, from $85 billion to $75 billion. We think this reduction in stimulus will be one of the main issues the US economy will have to contend with in 2014.

During the depths of the crisis, the Fed embarked on what has been described as the most expensive experiment ever undertaken – QE (the process of creating new money and pumping it into the economy in the hope of getting things moving again).

The scale of the stimulus is unprecedented. Since the programme began back in 2009, the Fed's balance sheet has swelled to almost $4 trillion – one quarter the size of the entire US economy. At the current run rate of $75 billion per month, the Fed is essentially creating the equivalent of a new Ireland every three months.

The good news is the experiment appears to be working; the bad news is that this liquidity will be gradually reduced as we move through 2014, and market participants will need to wait and see how the economy performs without this extra stimulus.

Having successfully steered the economy through the great recession, Ben Bernanke is stepping down as Chairman of the Federal Reserve, which leaves this delicate transition to be managed by Janet Yellen, who is due to formally take over in January.

Yellen's track record suggests that she is fully aware the Fed needs to be careful not to derail the recovery, but she also needs to be careful that she is not remembered as the person who allows liquidity to get out of control and thereby sowing the seeds of the next crisis.

The changing of the guard. *Federal Reserve Chairman Ben Bernanke (left) will be replaced by Janet Yellen (right) at the end of January.*

"The economy [in the US] faces a number of challenges in 2014, most notably the impact of the recent decision by the Fed to taper its asset purchases..."

Ireland: Returning to Growth Again

The Irish economy returned to growth again in the second quarter of last year and expanded again in the third quarter. In those two quarters, the economy grew at an annualised rate of more than 5%. Encouragingly, the recovery was mainly driven by a bounce back in domestic demand with both consumer spending and, particularly, investment spending expanding again.

More recent indicators suggest the recovery was sustained into the latter months of the year and that was evident across a range of sectors. Employment is growing strongly again, the unemployment rate is at its lowest level for four years, consumer confidence is back to levels last seen in 2007 and tax revenues have been ahead of budget targets.

Even the hard-pressed construction sector is growing again as the very low level of activity in recent years has led to severe shortages of supply in parts of both the residential and commercial sectors.

Our growth forecasts of 2.5% for 2014 envisage a more broad-based expansion than has been the case for a number of years. Some modest recovery is expected for consumer spending and a more significant recovery is forecast for investment spending. As a result, overall domestic demand in the Irish economy is expected to increase again for the second year in a row after falling for five consecutive years after 2007.

We expect Irish GDP to grow by 2.5% in 2014

UNITED KINGDOM

The surprise packet of 2013

Of the major global economies, the one to surprise most on the upside in recent times has been the UK. It is not so long ago that many forecasters were talking about the possibility of a 'triple-dip recession' and none other than the Managing Director of the IMF was warning that fiscal policy was too tight. Now revised data show that not only has a 'triple dip' been avoided but that the economy never even suffered a 'double dip' recession. The pace of recovery in the economy has been accelerating since the final quarter of 2012 and the economy grew at an annual rate of 3% in Q2 and Q3 of last year. In fact, more recent indicators suggest the economy continued to perform strongly into the final quarter of the year. Some of the Purchasing Managers' Indices ('PMI') are at their highest levels since 2007.

The performance of the labour market has been particularly encouraging, with employment levels at record highs and the unemployment rate at a relatively low (by European standards) 7.4%.

The commitment by the new Governor of the Bank of England, Mark Carney, to maintain low interest rates for several years has helped confidence and the 'Funding for Lending' and 'Help to Buy' schemes have supported a recovery in the housing market. This momentum is likely to be maintained into the current year and we expect GDP growth of 2.7% in 2014.

EUROZONE

Growing again but subdued

After six consecutive quarters of declining GDP, the Eurozone economy expanded again in Q2 and Q3 of 2013, but by only 0.3% and 0.1% respectively. Moreover, unlike the US and UK, the more recent monthly indicators suggest the pace of recovery remained very modest in the latter part of the year.

It is encouraging that many of the peripheral economies (Italy, Spain, Portugal, Ireland and Greece), which suffered very severe recessions in recent years, should exit recession this year. However, growth in the overall region will be restricted by further fiscal consolidation in many countries and the unwillingness of Germany to undertake any offsetting actions in its own budgetary stance. Private debt levels remain high and further deleveraging will continue to bear down on growth prospects.

We do expect GDP to expand in the Eurozone in 2014 after two consecutive years of decline but the growth rate is unlikely to be more than 1% - well below what is likely to be achieved in other parts of the developed world.

JAPAN

The great policy experiment

The boldest policy experiment amongst the major global economies has been in Japan following the election of Shinzo Abe as Prime Minister in December 2012. His policies, known as 'Abenomics', are focussed on reversing the prolonged period of low growth and falling prices which have dominated Japanese economic performance since the collapse of the

equity and property bubbles in the late 1980s. Abenomics has three main elements or 'arrows': an easier monetary policy, a more flexible fiscal policy and structural reform aimed at reducing the many rigidities which exist in the Japanese labour and other markets.

The most aggressive implementation to date has been in monetary policy where a programme of QE, almost the equivalent in absolute terms of that in the US, has been introduced, even though the Japanese economy is only some 40% of the size of the US economy.

Not surprisingly, the biggest impact so far has been in the financial markets. The dollar has appreciated by more than 35% against the yen and the equity market has rallied by more than 80% since October 2012. There have also been noticeable impacts on the real economy. Real GDP growth was running at an annualised rate of 4% in the first half of 2013 and the annual rate of consumer price inflation is now a positive 1% year-on-year.

However, the ultimate success or otherwise of the policy depends crucially on the implementation of the third arrow, i.e. structural reform. Progress to date has been slow and many are sceptical about the extent of its eventual implementation. In the short-term, however, the economy should continue to benefit from the looser monetary and fiscal policies.

CHINA

Adjusting to a more sustainable growth path

For more than 30 years after the economic reforms of the late 1970s, the Chinese economy grew at an annual rate of almost 10%, with real GDP rising more than 20-fold over that period. In the process, China became the second largest economy in the world after the US with a level of GDP that now equates to roughly half of that in the US.

Inevitably, such growth rates generate fears of inflationary pressures and the creation of asset bubbles. The new political regime, under Xi Jingping, has targeted a slowing of the growth rate to a more sustainable rate of between 7% and 8% per annum, as well as rebalancing the composition of growth away from exports and investment and more towards consumption. This commitment to reform was evident after the recent Third Plenum, a high-level meeting of policy makers, where a comprehensive roadmap for economic reform was published and where the focus was on the introduction of more market-oriented policies.

The introduction of such policies should improve the long-term productivity and composition of the Chinese economy but may be restrictive in the shorter-term. Nevertheless, we expect growth in China to remain in the 7% to 8% range which it has occupied for the last two years ■

"...the global economy is now in a more healthy and sustainable position than it has been at any time since the eruption of the global financial crisis more than five years ago."

WARNING: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. Returns on investments may increase or decrease as a result of currency fluctuations.

Table 1: *GDP 2010 - 2014 (please note, 2014 figures are forecasts)*

GDP (% change)	2010	2011	2012	2013	2014F
World	**5.2**	**3.9**	**3.2**	**2.9**	**3.6**
Developed economies	**3.0**	**1.7**	**1.5**	**1.2**	**2.0**
US	2.5	1.8	2.8	1.6	2.6
Eurozone	2.0	1.5	-0.6	-0.4	1.0
UK*	1.7	1.1	0.2	1.5	2.7
Japan	4.7	-0.6	2.0	2.0	1.2
Emerging economies	**7.5**	**6.2**	**4.9**	**4.5**	**5.1**
China	10.4	9.3	7.7	7.6	7.3
India	10.5	6.3	3.2	3.8	5.1
Brazil	7.5	2.7	0.9	2.5	2.5
Russia	4.5	4.3	3.4	1.5	3.0

Source: IMF, World Economic Outlook Database, October 2013

**Davy forecast*

2013: THE YEAR IN REVIEW

JANUARY

Stock markets get off to a strong start

Equity markets began the year at a blistering pace, rising 5% in January. This set the tone for what was to follow for the rest of the year.

FEBRUARY

Deal done on promissory notes

Ireland managed to secure a favourable deal on the Promissory Notes, and became the first nation to exit its bailout later in the year.

FEBRUARY

Italian elections - hung parliament

The Italian elections ended in a stalemate as no single party won enough votes to win a Senate majority. Silvio Berlusconi was later ejected from the Senate after being convicted for tax fraud.

MAY

Bernanke signals QE tapering

On 22nd May, Ben Bernanke hinted the Federal Reserve may consider scaling back on its QE programme later in the year if economic conditions continued to improve.

JUNE

Taper tantrum

Bernanke's comments on QE tapering triggered widespread panic in the market with over $1 trillion wiped off global equities and $3 trillion wiped off global bonds.

JULY

Mark Carney joins the BOE

Canadian Mark Carney became the first foreigner in over 300 years to take over as Governor of the Bank of England when he replaced Mervyn King.

JULY

Irish commercial property

US investor Kennedy Wilson completed its purchase of 16 Irish commercial properties for €306 million.

OCTOBER

Irish house prices rise

Strong gains in Dublin property were reported with prices 12% higher than the same time last year.

OCTOBER

Yellen confirmed as Bernanke's successor

Janet Yellen was announced as the first female Chairperson of the Federal Reserve, replacing the outgoing Ben Bernanke.

NOVEMBER

Record levels on Wall Street

On 22nd November, the S&P 500 closed at a record high of 1,800, surpassing the pre-crisis peak.

NOVEMBER

ECB cuts rates

Mario Draghi took the market by complete surprise when he cut interest rates to a record low of 0.25%.

MARCH

Depositors hit in Cyprus

The bungled bank bailout in Cyprus, where depositors' money was targeted, sparked fears across Europe that it could be used as a template for future bank bailouts.

MARCH

New Leaders in China

Xi Jinping (President) and Li Keqiang (Prime Minister) were formally appointed as the new leaders of China at the annual meeting of the National People's Congress.

APRIL

Abenomics pressures the yen

Japanese Prime Minster Shinzo Abe and BOJ head Haruhiko Kuroda kick-started 'Abenomics' by announcing a massive $70 billion per month Quantitative Easing ('QE') programme.

APRIL

Gold crash begins

Gold suffered its largest decline in over 30 years as prices fell 14% in two days in April. Gold continued to fall as the year progressed and finished 28% lower.

AUGUST

Syria - Crossing the red line

Bashar al-Assad came in for widespread criticism from the international community after allegedly using chemical weapons on his own people.

SEPTEMBER

Lehman Brothers - five years on

September marked the fifth anniversary of the collapse of Lehman Brothers.

SEPTEMBER

Merkel re-elected in Germany

Angela Merkel became the first European leader to be re-elected since the euro debt crisis began, when her CDU party romped to victory in the German general election.

OCTOBER

Stalemate on Capitol Hill...again

Republicans and Democrats once again failed to compromise on extending the $16.7 trillion debt ceiling.

DECEMBER

Fed finally tapers

At the December FOMC meeting, the Fed announced it would taper the amount of QE from $85 billion to $75 billion per month.

DECEMBER

Ireland exits bailout

Ireland became the first country to exit its EU/IMF bailout. The return to financial sovereignty helped push Irish borrowing costs even lower.

DECEMBER

Bank of Ireland raises capital

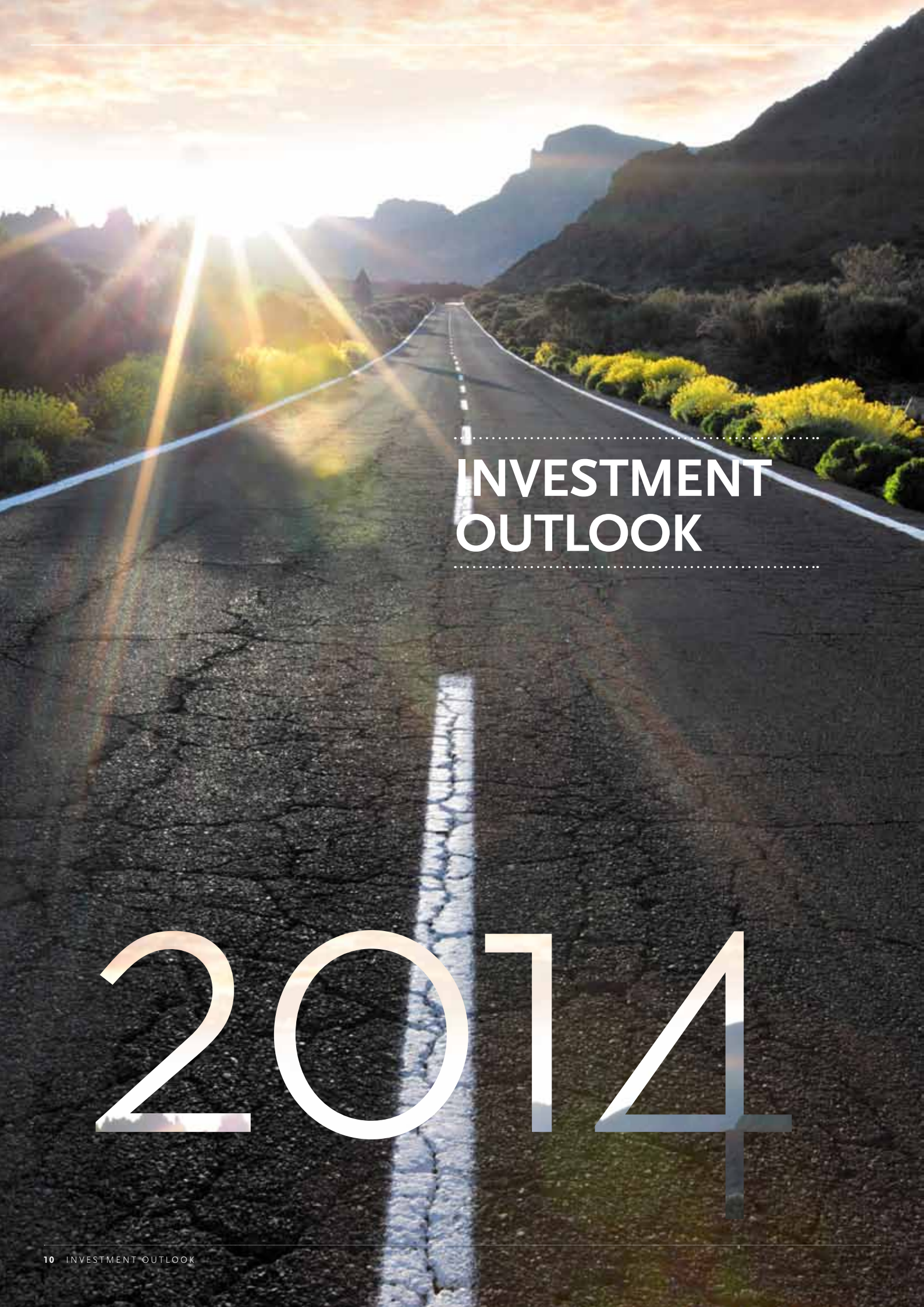
Bank of Ireland raised €1.8 billion in a joint equity and bond issuance, allowing it to pay off the government preference share.

DECEMBER

Strong year for equities

Global equity markets ended the year on a high, up 26% on the year. Gains were led by Japan (+54%) and the US (+32%).

WARNING: Past performance is not a reliable guide to future performance.



INVESTMENT OUTLOOK

2014

WHAT CAN INVESTORS EXPECT IN 2014?

BRIAN O'REILLY
Head of Global Investment Strategy, J&E Davy

Investors enjoyed another positive year in 2013, but with several stock markets now at all-time record highs and the Federal Reserve recently announcing the start of Quantitative Easing ('QE') tapering, what can investors expect in 2014? Brian O'Reilly, Head of Global Investment Strategy, provides his views on the outlook for the major asset classes.

The financial crisis that has been raging in one form or another for almost six years now finally looks to be losing its grip. Led by the recovery in the US, but supported by stabilising conditions in Europe and China, economic activity is steadily improving right across the world.

In normal circumstances, this should be unequivocally good news for investors, right? Stronger economic activity should translate into higher sales and profits for companies, and ultimately push asset prices higher. But we should not forget that the recovery would not have been possible had it not been for the massive amounts of liquidity pumped into the system in recent years.

Between them, the Federal Reserve, Bank of England, ECB and Bank of Japan have injected almost $5 trillion into the system in the form of QE and other liquidity measures. How fast this liquidity is withdrawn will play a major role in determining the strength and direction of financial markets in 2014 and beyond. Withdraw the stimulus too quickly and there is a risk of choking the recovery, leave it in too long and there is a risk of creating the next bubble.

What is clear is the ability of savers to generate income in a zero interest rate world is becoming increasingly difficult as both cash deposit rates and bond yields are already at multi-decade lows. The good news is that strong equity markets have compensated investors for mediocre returns elsewhere. However, after another strong year, questions are being asked about how much longer the equity bull market can last. Although we think the easy gains are behind us, we still believe equities can deliver positive returns, but those returns now need to be driven by earnings growth.

"... savers are under pressure from all angles, as low interest rates and higher tax rates, such as the recent increase in DIRT, eat away at their hard earned savings."

What does 2014 hold for investors?

Cash is not king

Undoubtedly, the single biggest frustration we come across in our conversations with investors is the inability to generate a decent level of income in their portfolio. As recently as 2012, banks offered attractive deposit rates in excess of 3%, and as such, investors could take relatively little risk and still generate a decent level of income. However, as evidenced by the recent ECB rate cut with central banks lowering base rates towards zero, unfortunately those days are now gone and deposit rates of anywhere between 1-2% are now the norm.

In fact, savers are under pressure from all angles, as low interest rates and higher tax rates, such as the recent increase in DIRT, eat away at their hard earned savings. This can be thought of as a transfer of wealth from savers to borrowers. While low interest rates are good for those on tracker mortgages, for savers more often than not this return does not even match the current level of inflation, and as a result investors may be locking in negative inflation-adjusted returns.

Unfortunately, this situation is unlikely to change anytime soon. As central banks try to spur on growth, we think rates will be kept low for an extended period of time. In a European context, the earliest the ECB could possibly entertain raising rates is 2016. In the interim, even the possibility of negative interest rates - where banks charge savers for holding cash on deposit - is apparently being discussed. We believe this would be too bold a move to make but it highlights the extent that policy makers can go to get people spending again.

Bonds have reached an inflection point

The situation in bonds is similar with yields also close to historically low levels. As investors scrambled for safety during the financial crisis, they moved away from equities into the relative safety of both government and corporate bonds. This pushed bond prices higher and yields lower,

to such an extent that yields have reached a level not seen since the Second World War. We still see reasonable value in certain corporate bonds, particularly in the high yield space, but here the spread has also compressed, and in some cases multi-national blue chip companies can borrow at lower rates than their governments.

Although inflation does not appear an apparent threat right now - in fact the ECB is struggling to fight off some deflationary tendencies - at current low yields, the prospect for bonds looks weak at best. For the past 30 years, yields have been moving lower and prices higher following the high inflation period of the 1970s. But since Ben Bernanke hinted back in May that the Federal Reserve ('Fed') would consider tapering its QE programme, yields have moved higher. We think his speech marked an inflection point in the bond cycle, and if, as we expect, improving economic conditions lead to higher yields, we cannot rule out that investors may find themselves nursing capital losses in bonds. This was the case in the US Treasury and UK Gilt markets last year.

Equities – will the bull market continue?

Fortunately, investors have been compensated for low returns in nominal assets by very strong stock markets. Equity markets have been higher in four of the last five years, and after last year's 26% gain, global equities are now up 150% since their March 2009 lows. Regionally, gains were led by Japan (+54%) and the US (+32%) last year, but even in Europe (+24%), after a slow start, returns picked up in the second half of the year. Understandably, after these strong gains, some are beginning to question how much longer this bull market can last. We believe it can last for a while yet as we still think we are more mid than late-cycle (See the text box opposite, '*What Next for Equities?*'), but we do think that investors should factor in more normal returns from here.

Valuations – more fair value than cheap

The big question now is: are equities expensive? For sure, it appears that a lot of the 'low hanging fruit' has been picked, and certain defensive segments of the market do look overstretched. Essentially, what took place last year was a significant re-rating of the equity market, which pushed up the price investors were willing to pay for every unit of corporate earnings.

This is not uncommon when conditions stabilise following deep downturns. Coming into 2013,

WHAT NEXT FOR EQUITIES?

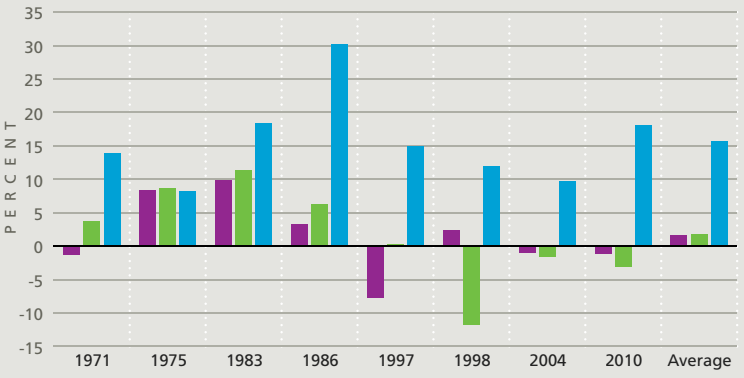
OLIVER SINNOTT
Investment Strategist, J&E Davy

Global equities have had a phenomenal run and some are questioning how much longer they can continue their upward ascent. To help understand where the market may go from here, we examined similar episodes over the last 40 years when global developed market equities were up over 30% in the preceding 12 months.

In total, we found eight similar occasions: '71, '75, '83, '86, '97, '98, 2004 and 2010, and examined what happened in the subsequent 3, 6 and 12 months after similarly strong rallies. As Figure 1 illustrates, returns are muted in the following 3-6 month periods, but looking out over a 12-month time horizon, global equities delivered 15% on average. Even more impressive is that returns were positive in every single 12-month period.

Obviously, looking at the past to predict the future is fraught with risks, but history suggests that just because markets have had a good run, it does not automatically mean that they will not deliver further gains. In fact, investors have done rather well following strong momentum.

Figure 1: How do markets perform after strong rallies?
3, 6 and 12-month total returns following 30% rallies, in %

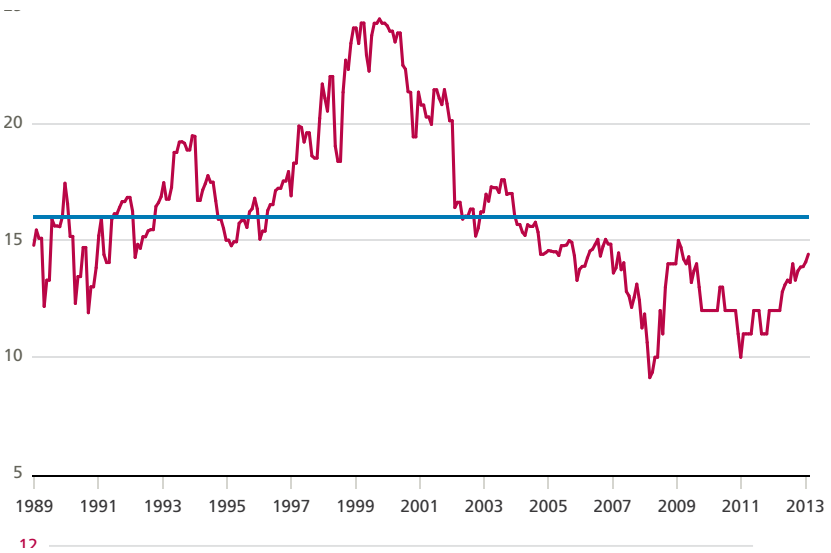


+3-month +6-month +12-month

Source: MSCI, Bloomberg

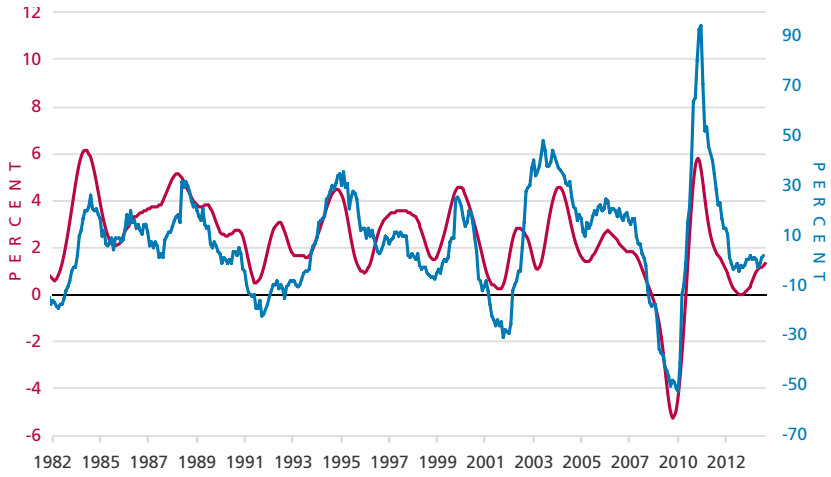
WARNING: Past performance is not a reliable guide to future performance.

Figure 2: MSCI World 12-month forward P/E multiple



Source: IBES, Davy

Figure 3: OECD G7 leading economic indicator & global earnings growth



Source: OECD, MSCI, Bloomberg

WARNING: Past performance is not a reliable guide to future performance.

equities traded at 12.2 times forward price-to-earnings ('P/E') estimates, and are now at 14.4 times. However, as Figure 2 illustrates, even after this move, the market P/E is still not expensive compared to history which suggests equities still offer reasonable, if not the exceptional value they did 12 months ago.

Earnings to drive returns from here

Profits have been growing strongly in the aftermath of the crisis as companies have managed their businesses very well and have right-sized for the lower growth environment, and we think that further equity market gains will need to be driven by earnings growth. The good news is that, against a backdrop of accelerating global economic growth, we expect companies to deliver another year of solid earnings.

How much now is the question. Analysts are forecasting 11% global Earnings per Share growth for 2014. Although we believe that this may prove overly optimistic, we still think high single digits are achievable, and as Figure 3 shows, rising earnings are consistent with an improving global economy, as indicated by the relationship between earnings and the OECD leading economic indicator. Factoring in the return from dividends and buybacks, this could push the total returns on equities into double digit territory for another year, without any further valuation re-rating. If the latter did happen (which we think unlikely but not impossible), it is not inconceivable that equities could deliver similarly impressive returns as 2013.

Property and hedge funds back in favour

The lack of yield is forcing investors to once again look at alternative assets for returns. Property has been a major beneficiary of this trend. As we know, demand for prime assets in prime locations in cities such as London and New York has been rising for some time now. However, interest is now spreading to other markets, including Ireland, where the involvement of foreign investors attracted by the high yields available has been vital in kick-starting investment (See the text box on page 14, '*Irish Property: The Recovery Continues*').

Also in the alternatives space, hedge funds are gaining traction. Hedge fund managers have come in for a lot of criticism in recent years as strategies such as 'trend following' have failed to deliver in what have been strong markets. The ability of managers to successfully short stocks has also come into question and, as always, investors are sceptical

of their high fee structure. However, we believe the virtues of holding long/short managers in a portfolio could add value if volatility increases due to Fed tapering, as was the case last June when hedge funds were the best performing funds ■

"We expect the Irish economy to continue on its path to recovery in 2014, and believe demand will stay high for Irish assets, particularly for real estate."

IRISH PROPERTY: THE RECOVERY CONTINUES

ROBIN POTTER COGAN
Property Investment Manager, J&E Davy

There is a new found sense of optimism in the Irish commercial property market. Over the course of 2013, investment activity surged and a significant proportion of this was carried out by foreign investors. Completed investment sales totalled €1.06 billion in the first three quarters of 2013, an increase of 91% on 2012, and the total for 2013 is expected to be in the range of €1.5 billion to €2 billion.

Foreign investors accounted for approximately 75% of the total investment, which has been vital in taking up the supply that has been brought to the market at a time when Irish investors and banks have been slow to participate. Institutional investors such as Blackstone and Kennedy Wilson have been very active in the market. This has now triggered renewed interest from domestic investors, such as IPUT and Irish Life, as well as more institutional foreign investors as evidenced by Green REIT quickly raising its initial cash target and listing on the Irish Stock Exchange in June and July.

We expect the Irish economy to continue on its path to recovery in 2014, and believe demand will stay high for Irish assets, particularly for real estate. Capital values remain 60% below prior peak levels, and yields of 6% for prime Dublin offices are high relative to other assets.

We believe demand for Irish real estate will stay high in 2014

WARNING: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. Returns on investments may increase or decrease as a result of currency fluctuations.

WHAT DO PROFESSIONAL INVESTORS THINK?

Courtesy of **Bloomberg**

Our colleagues in J&E Davy were recently asked to participate in a poll conducted by Bloomberg which surveyed over 750 global professional investors, representing an elite group of decision makers in financial markets. The Bloomberg Global Poll attempted to gauge the 'mood of the market' for 2014 and assess where investors see the greatest opportunities and, importantly, the greatest risks.

Here, they provide an overview of the results.

Which of the following do you think poses the biggest risk to the global economy in 2014?
When asked what the greatest risk is for 2014, investors seemed to be most concerned about political gridlock in Washington. 35% of respondents highlighted this as their main concern. The poll indicated that investors foresee the second biggest risk as a slowdown of the Chinese economy. Although the market has reacted well to the Communist Party's recent reforms laid out at the Third Plenum, obviously some are still concerned about a property bubble and a hard landing in the world's second largest economy. Interestingly (and good for Ireland), a flare up of the European debt crisis is the main concern for just one in five investors, while investors now assign a relatively low tail risk to geopolitical tensions between Israel and Iran, South and North Korea, and the situations in Syria and Iraq.

Issue	%
Political gridlock in Washington on fiscal matters	**35**
A slowing Chinese economy	**26**
Europe's debt crisis	**19**
None of these	**14**
Hostilities between Israel and Iran	**3**
Terrorism	**2**
Have no idea	**1**
The regional instability and nuclear threat from North Korea	**0**
Escalating violence in Iraq	**0**
The civil war in Syria	**0**

Source: Bloomberg

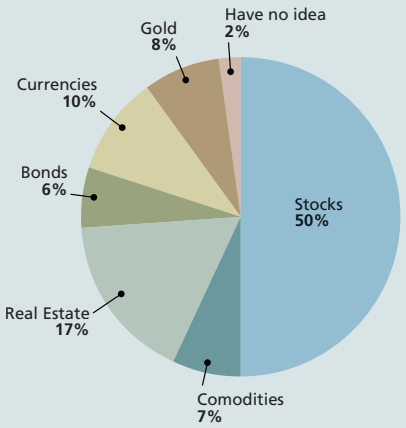
Economics: What is your view of...
When asked their view of the major global economies, 54% of respondents thought the US economy was improving, compared to just 33% for Europe and the world in general. Japan faired second best with 44% of respondents stating that its economy is improving on the back of Shinzo Abe's economic reforms. Perhaps more worrying is that 35% believe China's economy is deteriorating, while ahead of World Cup 2014, 43% believe Brazil's economy is deteriorating which could lead to further civil unrest.

What is your view of	Improving %	Stable %	Deteriorating %	Have no idea %
The economy in the U.S.	**54**	**32**	**13**	**1**
The economy in the Eurozone	**33**	**39**	**27**	**1**
The global economy	**33**	**49**	**17**	**1**
The economy in China	**19**	**44**	**35**	**2**
The economy in Japan	**44**	**38**	**14**	**4**
The economy in Brazil	**10**	**27**	**43**	**20**

Source: Bloomberg

What asset class do you think offers the highest return over the next year?
Turning to investments, despite the strong gains for equity markets in 2013, exactly half of respondents think that equities will once again deliver the strongest returns in 2014. This is followed by real estate, with 17% believing property prices will continue rising. Combined, over two-thirds of those surveyed think these two 'real assets' are the place to be in 2014. Interestingly, only 8% of respondents think gold will offer the highest return, while just 6% of investors think that bonds will deliver the best returns.

What asset will deliver the highest return in 2014?



Source: Bloomberg

WHAT INVESTORS "WANT" AND WHAT INVESTORS "NEED" CAN OFTEN BE TWO DIFFERENT THINGS

JAMES FORBES
Director – Distribution & Investment Solutions, Davy Asset Management

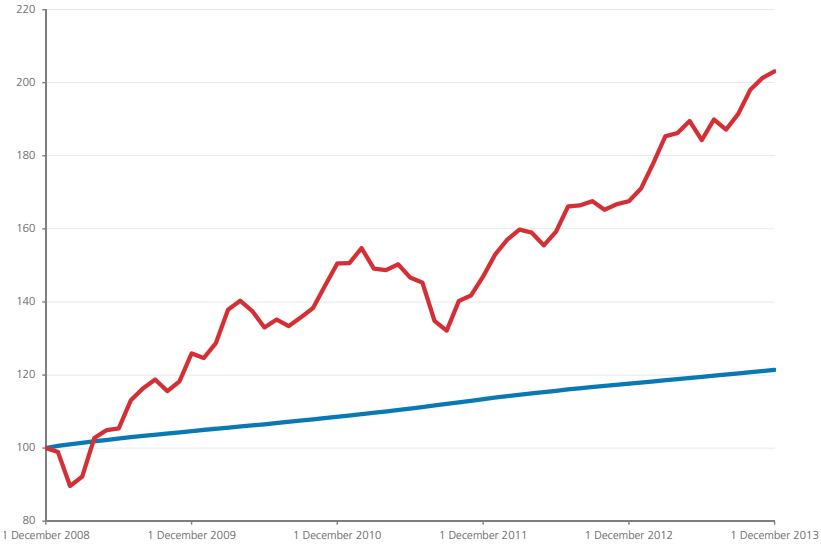
Irish investors have endured a roller coaster ride in investment markets since the financial crisis began in 2007. Throughout this period, many investors have endured a "double whammy":

- Firstly, many investors were highly exposed to one particular asset class (such as property or shares). In many cases these positions also involved gearing (borrowing). The mantra of '*don't put all your eggs in the one basket*' is one of the cornerstones of modern portfolio theory but unfortunately this strategy is often lost in the midst of bull markets; and
- Secondly, following significant losses in some of the major assets classes, many investors became very risk averse and moved into "low risk" products. Modern portfolio theory suggests that lower risk equates to lower returns. Hence, many investors over the last five years have missed some very strong returns from equity markets.

Lower risk products often target a benchmark of cash plus X%. Figure 1 shows the performance of Euribor plus 3% per annum versus the MSCI World Index (total return in euro) in the five years to the end of 2013. The annualised return from the low risk index is approximately 4% per annum whilst the annualised return from world equities is over 15% per annum.

The painful event experienced during the financial crisis has impacted investor sentiment, and in recent years many investors have been telling advisors they are risk averse. Demand for these lower risk products increased significantly, but many investors are now realising that lower risk typically results in lower returns. However, the financial goals of these same investors may not be satisfied by these lower risk products alone. For example, a return of 4% per annum on €100,000 over 20 years would yield €219,000 whilst a return of 7%* would yield €387,000 over the same time period.

Figure 1: Performance of Euribor plus 3% p.a. versus MSCI World Index (total return in euro)



MSCI World Index **3-month rolling Euribor plus 3%**

Source: Davy Asset Management, MSCI

WARNING: Past performance is not a reliable guide to future performance.

Core and Satellite

Recently there has been a significant trend in the introduction of multi-asset funds which have volatility targets. These are a welcome addition to an investor's armoury but perhaps not the "be all and end all". We would suggest that advisors can use these types of funds as forming the 'core' part (c50%-60%) of an investment solution but should also consider adding more specialised funds as 'satellites' (40%-50%).

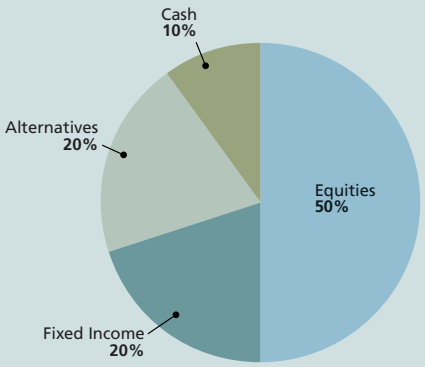
The core fund forms the cornerstone of the investment strategy and the fund often targets a level of return based on the investor's circumstances, such as their tolerance for risk, return requirements and, of course, time horizon. The satellites can be used to add more colour to an investor's portfolio and take advantage of opportunities that can present themselves in a more "active manner".

At Davy Asset Management, we endeavour to help brokers with investment solutions which incorporate our medium-term views of markets. We employ the knowledge of our investment team to produce suggested thematic investment solutions, and importantly, we take a more holistic approach to risk factors (many investors take a rear mirror view – i.e. what has happened). Figure 2 on page 17 outlines potential asset exposure for a moderate growth objective.

* *Society of Actuaries' maximum gross investment return for equities.*

Figure 2: Sample Portfolio Solutions - Moderate Growth

Objective	Moderate Growth
Risk Rating	4
Investment Horizon	Medium to Long Term (up to 10 years)



Source: Davy Asset Management

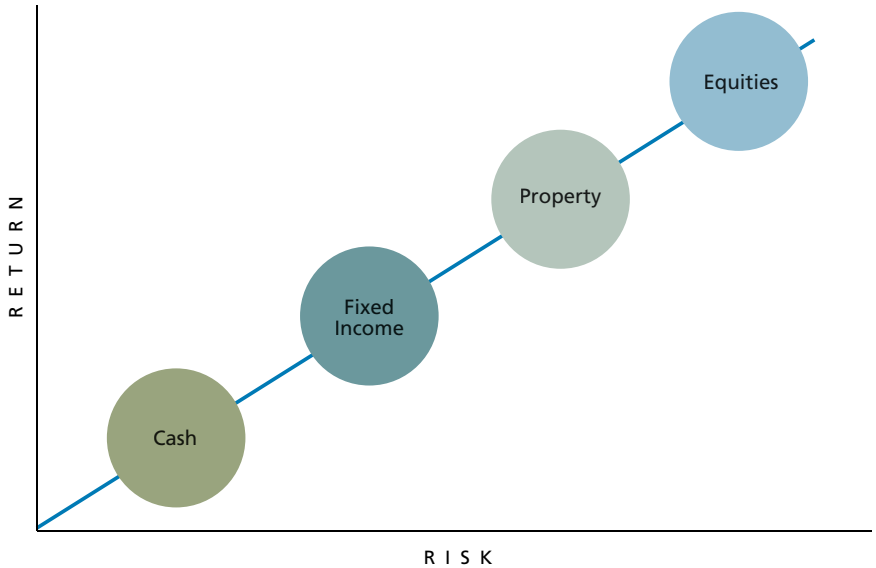
Risk Scale

Moderate Growth Fund	Fund Ranges	Strategic Asset Allocation*
Equities	35% - 65%	50%
Fixed Income	10% - 40%	20%
Alternatives	10% - 40%	20%
Cash	0% - 20%	10%

* *Strategic Asset Allocation represents the long-term target asset allocation assigned to each major asset class*

A sample portfolio is shown for illustrative purposes only.

Figure 3: Risk and return comparison



Source: Davy Asset Management

What investors say they want and what they actually need can often be two very different things. We would strongly advise starting at what the financial requirements are likely to be at a particular date in the future and then work back as to what might be an appropriate level of risk (and hence return). As the adage goes, '*there is no such thing as a free lunch*'. As Figure 3 illustrates, if investors need higher returns to meet their objectives, then they will generally have to accept higher risks – a key to meeting these objectives is understanding the risks and managing them accordingly.

For more information on our investment solutions, please contact your regional sales manager or call us on (01) 614 8874.

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MARKET DATA

Equity Markets Price Return (%)	2009	2010	2011	2012	2013
ISEQ €	27.0	-3.0	0.6	17.1	33.6
FTSE 100 £	22.1	9.0	-5.6	5.8	14.4
DJ EURO STOXX €	23.4	-0.1	-17.7	15.5	20.5
S&P 500 $	23.5	12.8	0.0	13.4	29.6
Dow Jones Industrial $	18.8	11.0	5.5	7.3	26.5
NASDAQ $	43.9	16.9	-1.8	15.9	38.3
Hang Seng HK$	52.0	5.3	-20.0	22.9	2.9
Nikkei 225 ¥	19.0	-3.0	-17.3	22.9	56.7
Topix ¥	5.6	-1.0	-17.4	18.0	51.5
MSCI Emerging Markets $	58.7	11.9	-14.9	13.9	0.9
MSCI All Country World Index €	26.2	8.3	-8.5	13.2	22.9
MSCI World Index	25.9	19.5	-2.4	14.0	21.2

10-Year Government Bond Yields (%)	2009	2010	2011	2012	2013
US	3.8	3.3	1.9	1.8	3.0
German	3.4	3.0	1.8	1.3	1.9
UK	4.0	3.4	2.0	1.8	3.0
Japan	1.3	1.1	1.0	0.8	0.7
Ireland	4.8	9.1	8.4	4.5	3.5
Italy	4.1	4.8	7.1	4.5	4.1
Spain	4.0	5.5	5.1	5.3	4.2
Portugal	4.1	6.6	13.4	7.0	6.1

Corporate Bond Yields* (%)	2009	2010	2011	2012	2013
European Investment Grade	4.0	3.8	4.4	2.0	2.1
US Investment Grade	4.9	4.1	3.9	2.8	3.4
European High Yield	10.2	8.3	12.1	5.6	4.9
US High Yield	9.2	7.9	8.5	6.7	6.4

Interest Rates	2009	2010	2011	2012	2013
3-Month Euribor €	0.7	1.0	1.4	0.2	0.3
3-Month Libor £	0.6	0.8	1.1	0.5	0.5
US Libor $	0.3	0.3	0.6	0.3	0.2

Central Bank Rates	2009	2010	2011	2012	2013
ECB	1.0	1.0	1.0	0.8	0.3
Bank of England	0.5	0.5	0.5	0.5	0.5
US Federal Reserve	0.3	0.3	0.3	0.3	0.3

Currency Rates	2009	2010	2011	2012	2013
EUR/USD	1.4	1.3	1.3	1.3	1.4
EUR/GBP	0.9	0.9	0.8	0.8	0.8
USD/GBP	1.6	1.6	1.6	1.6	1.7
USD/JPY	93.1	81.2	77.0	86.8	105.3
EUR/CHF	1.5	1.5	1.3	1.2	1.2
EUR/AUD	2.0	1.6	1.3	1.3	1.5

Commodities (%)	2009	2010	2011	2012	2013
Gold $	24.4	29.5	10.1	7.1	-28.0
DJ UBS Commodity Index $	18.9	16.8	-13.3	-1.1	-9.5

All data is sourced from Bloomberg as at market close 31st December 2013 and returns are based on price indices in local currency terms, unless otherwise stated.

* *Source: Bank of America Merrill Lynch*

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