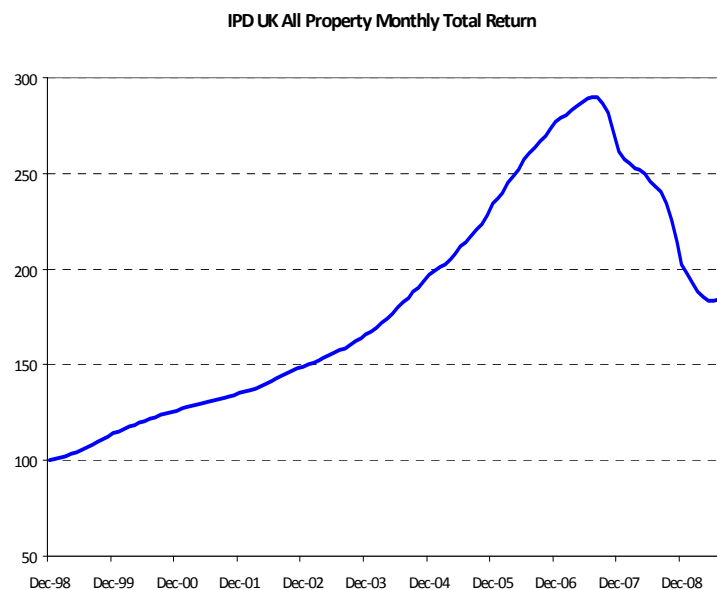


Property: Back to the first rung of the ladder

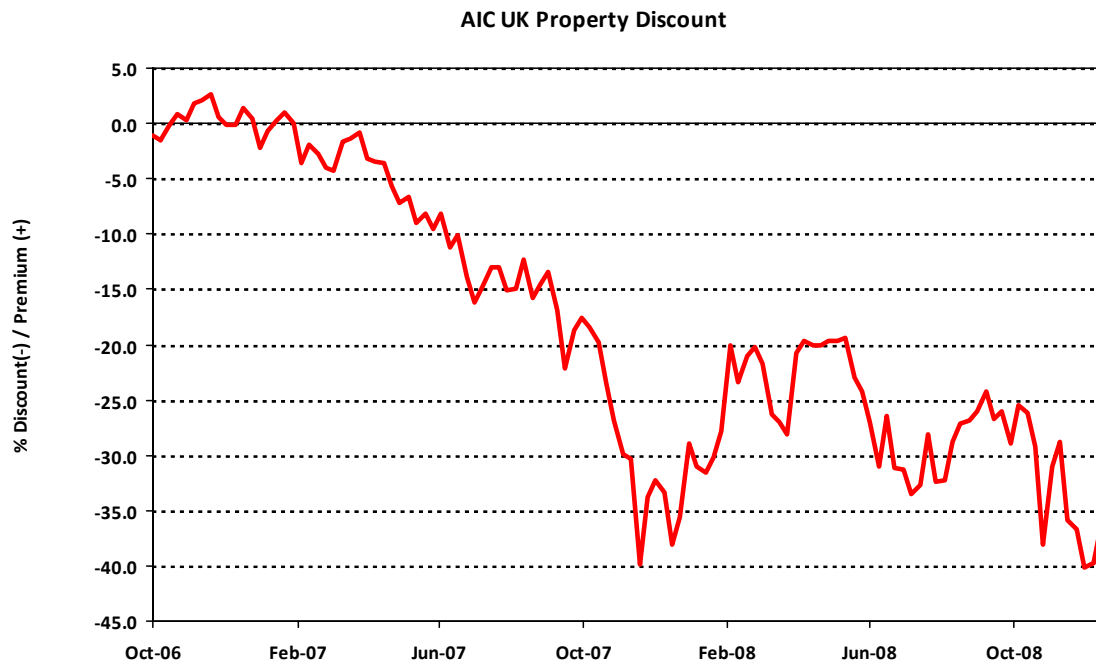
Over the years investing in commercial property has been seen as essential to providing diversification for an investment portfolio. This is an asset class that has traditionally provided investors with a good level of income and the potential for capital gains with relatively low volatility. However, for investors in UK commercial property it has been quite a different story over the last two years as capital values have almost halved since the peak of the market in mid 2007. With signs appearing that the global economy is now recovering, the outlook for property is now improving. Many believe that the property market is fast approaching the low point for this cycle. So is now the right time to start rebuilding property weightings in multi asset portfolios?



Source: Lipper Hindsight. Monthly sterling total returns 1st January 1999 to 31st August 2009.

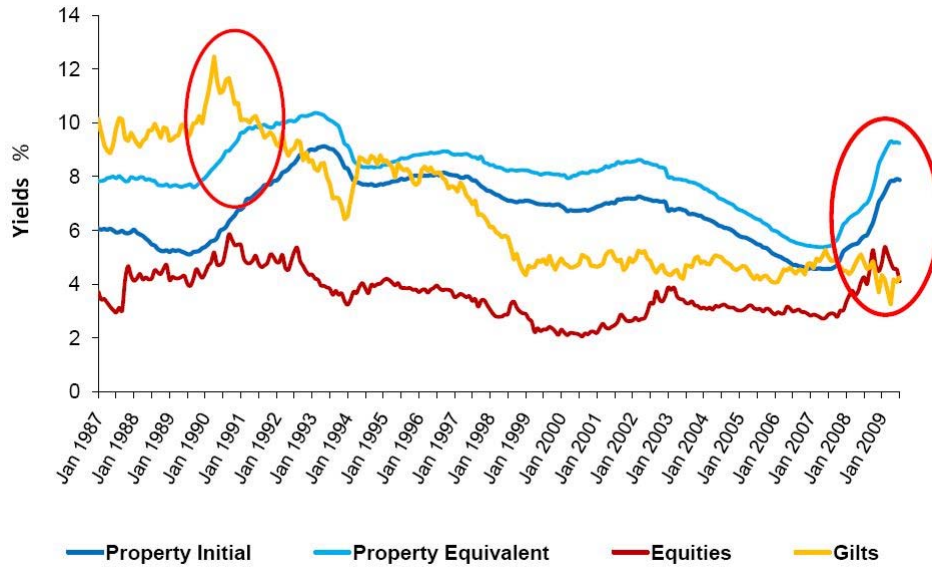
Investment in commercial property for most private investors is achieved via listed securities such as REITs (Real Estate Investment Trusts), property shares and closed ended funds. These provide investors not only with access to this asset class but also short term liquidity. Over the long term listed assets should deliver returns that are correlated to those an investor might expect from a direct investment in commercial property. However, short term, liquidity considerations may cause listed assets to act and behave in the same manner as the broader equity market and the share price of these vehicles may become significantly dislocated from the value of the underlying properties held within them. The global financial crisis in the last quarter of 2008 caused investors to dump all risk assets including listed property securities and we witnessed just such a dislocation, the average closed ended fund fell from a small premium in

January 2007 to a 40% discount by December 2008 as investors scrambled for liquidity at any cost.



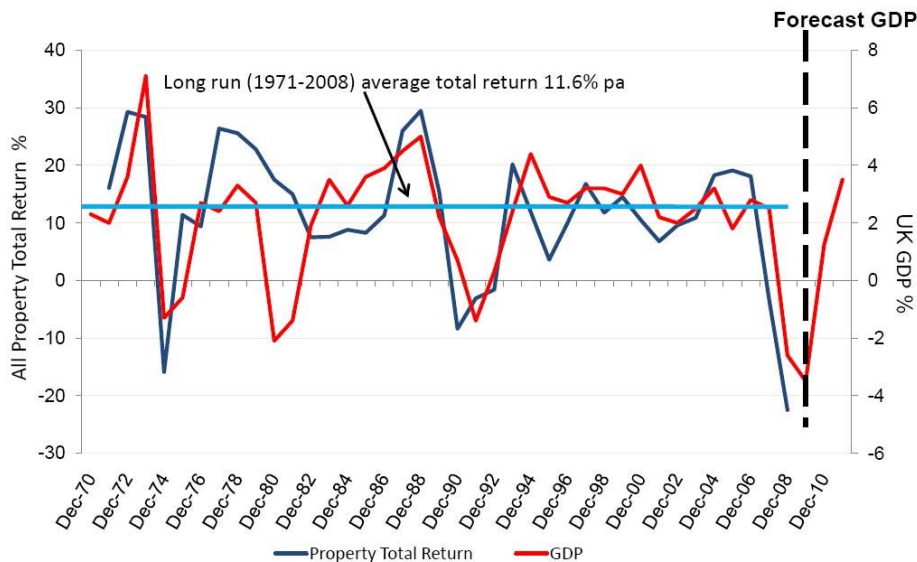
Source: Datastream/ Winterfloods. Weekly discount of AIC UK Property sector market cap weighted returns from 2nd October 2006 to 15th December 2008.

It certainly has been a torrid time for investors in commercial property but there is now reason for renewed optimism. Firstly, as a result of the significant falls in capital values the yield on commercial property has now risen to previous peaks. The yield now compares very favourably to the 10 Year UK Gilt yield, a key valuation measure for property investment. Historically, as the chart below shows, the yield on commercial property has traded at a 2% income premium over gilts. Inevitably gilt yields will have to rise as the Government seeks to fund the growing national debt, however, with property currently yielding around 8% and gilts ranging between 3.25% to 3.75%, this income premium is currently twice the long term average.



Source: Clavis Walden, IPD UK Monthly Index to 31st July 2009.

Another reason for optimism is the correlation of commercial property values with the growth of the economy. The daily news on the economic recovery continues to improve with nearly all of the major economies approaching the end of a short, sharp recession. Governments and their Central Banks have provided unprecedented levels of monetary and fiscal stimulus to stave off a downward deflationary spiral. Their goal of avoiding a deep depression is showing signs of being achievable and they appear to remain committed to a loose policy to defeat deflation and sustain the recovery. The chart below shows that historically the best time to invest in commercial property has been just as the recession is ending, a period when yields are peaking and investor sentiment is beginning to turn.



Source: IPD UK Annual Property Index to 31 Dec 2008 & HM Treasury April 2009

However this optimism should be tempered by a level of caution. Whilst we maybe close to or, at the bottom of the capital value cycle for property, the rental value cycle may still have further to fall. In a recession rental values typically decline as insolvencies rise, leases expire without renewal and break clauses are enacted. Furthermore, in this cycle landlords are being forced to lower rents on some properties to attract new tenants to occupy empty buildings which have had their relief from rates dramatically cut. Property specialists tell us that whilst the rate of decline in rental values has slowed, the vacancy rate could continue to rise.

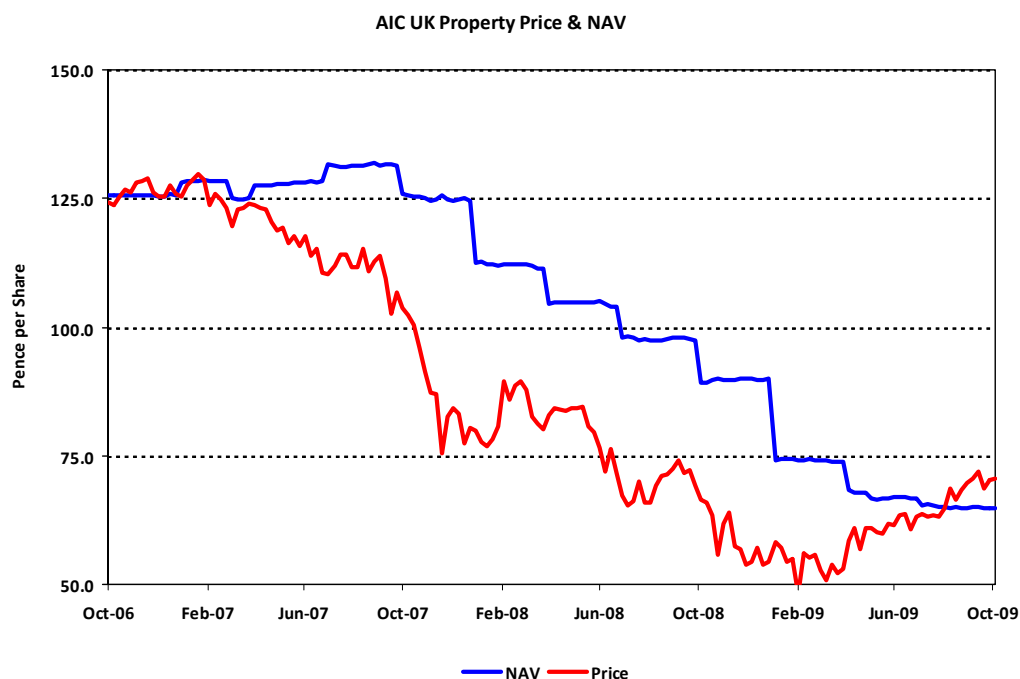
The belief that we have reached the bottom of the capital cycle is based upon the assumption that the economy will continue to improve. As we have already mentioned, the UK Economy has been saved from Armageddon by unprecedented amounts of monetary and fiscal stimulus. There is now an expectation that the economy will resume growth in the next few quarters but this will come at a considerable cost. Government spending has increased and our nation debt, through the introduction of Quantitative Easing, has literally exploded. The traditional way to reduce the Nation's real debt burden has been to inflate the economy and devalue the currency. This in turn will lead to sluggish economic growth over the next five years and the effect will be a slow recovery in property capital values. A final concern is of course the lack of bank lending. All of that being said, the potential upside that commercial property can offer investors at the moment does seem to outweigh the downside risks I have outlined above.



Source: www.ipd.com

The recent buyers of commercial property have been overseas investors. They have been tempted by a capital correction in the UK that has been far greater than anywhere else in the developed world. These depressed valuations coupled with Sterling weakness have seen a whole

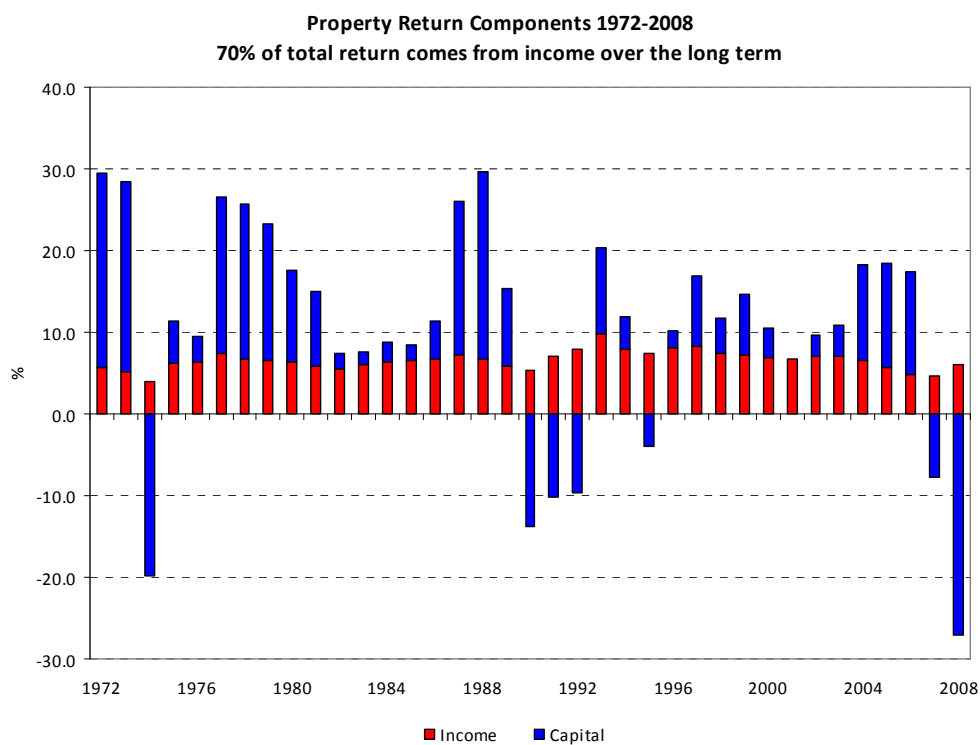
host of international buyers knocking at the doors of UK property managers. The obligatory upward only rental review clause together with longer leases can create quasi bond type investment assuming the properties are let to quality tenants. There has also been renewed interest from UK institutions wanting to re-enter this asset class seeking to benefit from the wide yield premium over gilts. But as yet there is little evidence to suggest the retail investor is buying.



Source: Datastream/ Winterfloods. Weekly returns of AIC UK Property sector market cap weighted returns from 2nd October 2006 to 5th October 2009.

As investor sentiment has improved so has the trading environment and more importantly the liquidity conditions. Listed property securities have rallied strongly in line with the broader equity markets showing the same level of correlation that they did on the downside. The dislocation between share price and the underlying capital value is rapidly disappeared. The chart shows how the market weighted AIC UK Property sector has moved in terms of both share price and NAV (net asset value.) Share prices have bounced reflecting a sea change in sentiment whereas NAVs or capital values have merely stabilised. This bounce in share price is to be expected short term given that this sector has, over recent years, been more volatile and shown little correlation to direct commercial property. However, longer term we do expect the AIC UK Property sector to revert to displaying similar characteristics to those of the commercial property asset class once more.

Open ended funds, the traditional destination for most retail monies, have seen redemptions slow this year and the managers of these funds are no longer forced sellers looking for liquidity to pay exiting unitholders. The chart at the back looks at the funds ranked in the IMA Property Sector over two time periods: the period covering the fall from peak to trough of the cycle and the period covering the recovery to date. There is a clear division of returns between those funds invested in listed securities and non sterling assets versus those funds wholly invested in direct property.



Source: M&G Property Fund Presentation/ IPD Annual Index as at end 2008

Over the long term, property tends to be invested in for income rather than capital growth. Indeed, it is generally accepted that the majority of the long term gains are attributable to income rather than capital gains. It is hard to imagine that capital values can fall much further in a developed economy such as the UK, therefore, looking ahead the return on property will be dominated by income with a starting yield of around 8% but little capital gain in this rather sluggish economic growth environment. To maximise returns it is therefore important that private investors should review how they can most efficiently invest in this asset class. The introduction of REITs in January 2007 gave smaller investors a more tax efficient vehicle to access commercial property. REITs focus on property assets and do not pay capital gains nor income tax on the proviso that the majority of income generated is paid out to shareholders who then pay tax on their dividends. More recently we have seen the introduction of PAIFs (Property

Authorised Investment Funds) which levels the playing field in terms of tax efficiency for open ended funds. Our understanding is that many existing open ended funds will consider converting to this more tax efficient structure.

So, we believe commercial property values are close to or at the bottom of the cycle. The change in investor sentiment is rapidly closing the distance between listed property securities and direct property assets. Those that fell the hardest in price have, generally speaking, recovered the quickest as liquidity conditions have improved over the last six months. What investors must ensure is that they select the right vehicle and the right manager to maximise their returns in the next stage of the cycle as there will be considerable dispersion of returns between the winners and the losers. Gearing which was the enemy of returns in a falling market will now magnify the gains in a rising market. There is an expectation that capital values will begin to rise and a vast amount of money has already been raised ready to invest in this asset class. We do not expect to see a rapid rise in capital values but investors should be attracted by the total return potential, driven predominantly by the yield, which significantly exceeds the current yield on government bonds and cash.

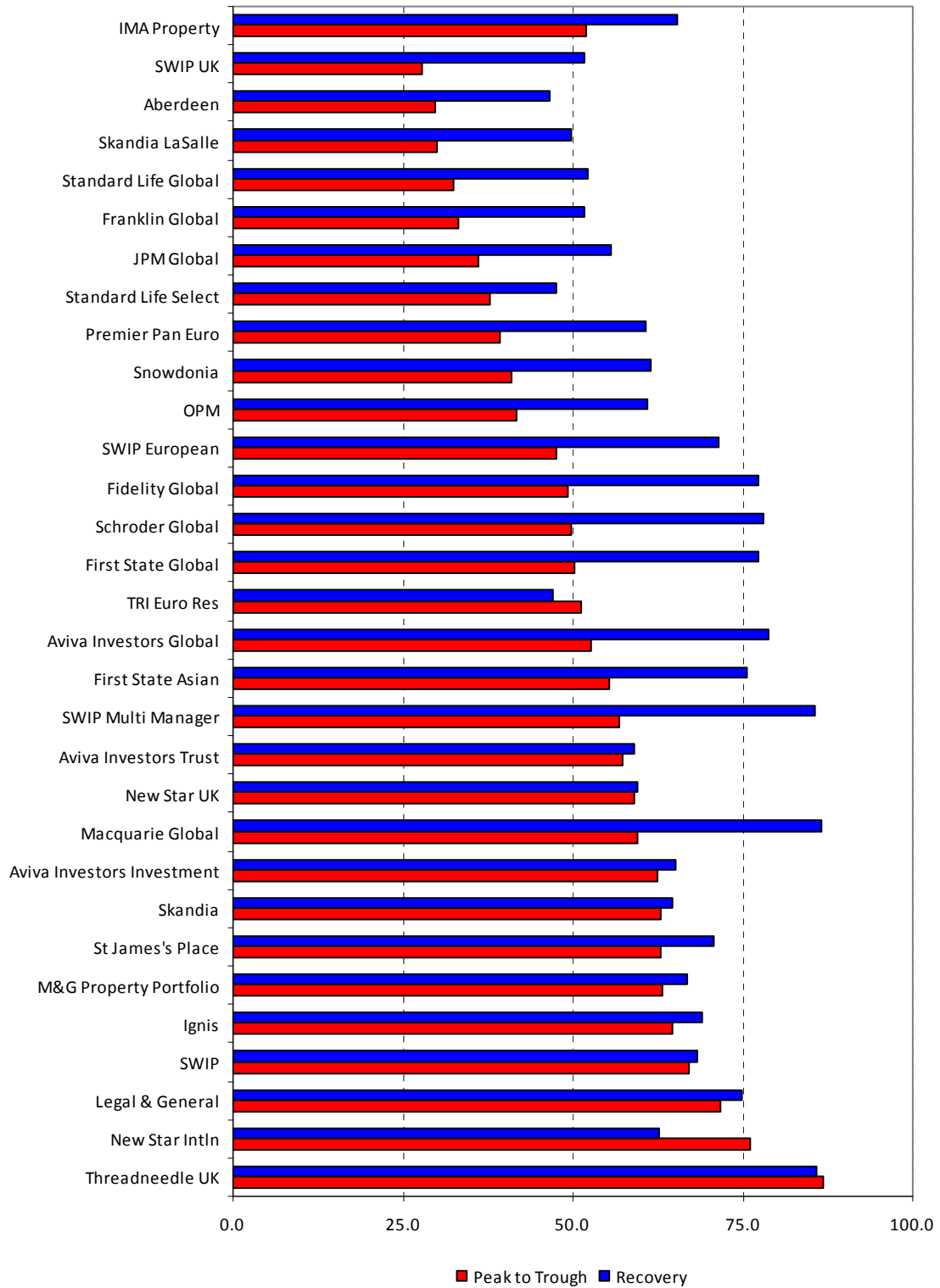
John Husselbee

North

5th October 2009

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IMA Property Sector - £100 invested 1st July 2007



Source: Lipper Hindsight. IMA Property Sector, £ returns, income reinvested. Periods 1st July 2007 to 31st March 2009 & 1st July 2007 to 30th September 2009.