



MARKET COMMENT

January saw a welcome respite from the volatility that has plagued markets over the last six months. Equities performed strongly as markets embraced risky assets. Global equities increased by 4.2% (MSCI World in euro terms) buoyed by reasonably positive economic newsflow and attractive equity valuations, while euro bonds also performed well (ML >5yr Euro Govt Bond Index up 2.2%). Regional equity performance differed significantly with the S&P 500 up 3.6% in euro terms while eurozone equities as measured by the MSCI EMU Index increased by 5.4%. However emerging markets were the stand out performer, generating a positive return of 10.4% in euro terms. On the currency side the euro finished the month broadly level with the US Dollar, having weakened mid month but strengthened towards month end on better sentiment towards the Euro area. Emerging market currencies

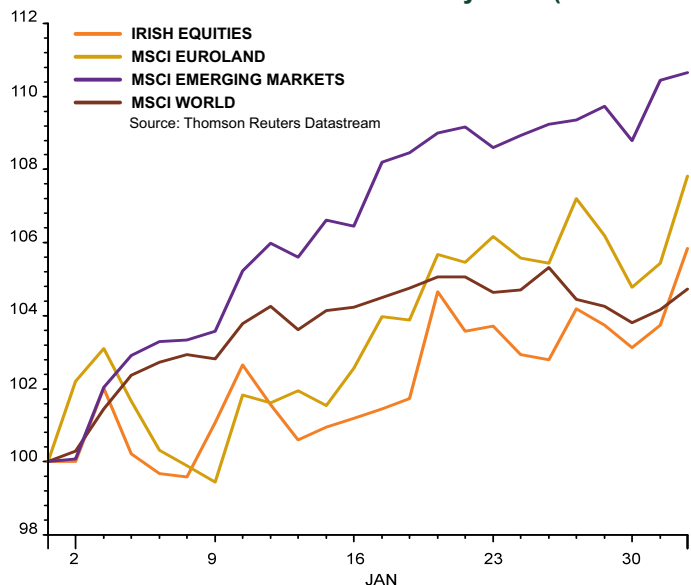
strengthened, not surprisingly given the interest in equities from that region. Middle East tensions over nuclear use in Iran and continued political unrest in Syria pushed oil prices upwards over the month.

The major news was the downgrading of 9 eurozone countries by S&P which included France losing its AAA status. The news was greeted with a whimper as equity markets posted positive returns post the announcement. From a style perspective banks and other cyclical stocks performed better than the defensives which were the stellar performers in the months when fear gripped markets such as August and September of 2011. Domestically the major news was that Ireland returned to the bond markets. The NTMA's bond switch offer of an existing bond at 4% due to redeem in January 2014 for a new bond at 4.5% to be redeemed in February 2015

was well received which is an encouraging sign that markets are rewarding the efforts made to stabilise the countries' finances. The end of the month saw another EU summit with broad agreement on the Fiscal Compact signalling another slow step towards ensuring further eurozone crisis would be averted.

Economic data released in January further reinforced the resilience of the US economy. While Europe languishes on the edge of recession recent economic numbers haven't been as bad as feared with some positive numbers coming through from Germany in particular. Chinese fourth quarter GDP results of 8.9% suggests that, while the economy is slowing down, a recession will most likely be avoided. Industrial metal prices which increased in January also reassure investors that China is engineering a soft landing.

Year to date returns to 31 January 2012 (in Euro terms)



Kleinwort Benson Investors Outlook versus Benchmark Positions - 6 Month Time Horizon

	Ireland	Euro zone	UK	Rest of Europe	US	Japan	Pacific Basin
Equities	□	↓	↓	↓	↑	↓	↑
Bonds	↓	↓	↓	↓	↓	↓	N/A
Property	↓	□	↓	□	N/A	N/A	N/A

↑ = overweight
 □ = neutral
 ↓ = underweight

VIEWPOINT

Based on current forecasts, the Irish debt to GDP ratio is expected to peak at ca. 120% in 2014. Commentators are now beginning to speculate as to whether we can sustain such a debt to GDP level. Pessimists point out that austerity measures to address the current budget deficit along with the impact of the economic slowdown in Europe will make it much more difficult for the Irish economy to grow its way out of the current predicament. This naturally brings with it the question of default.

Quite simply, default implies that Ireland doesn't pay its debt, and specifically does not repay outstanding government bonds, in full, when they mature. There are a number of scenarios where Ireland conceivably could default. Examples include not being able to return to the markets to borrow after the troika loans run out at the end of 2013, or a conscious political decision that not paying back is a preferable option compared to the implications of trying to meet the country's obligations.

If a default were to occur it could take two forms; orderly or disorderly. The former assumes entering into negotiations with bondholders and agreeing what is effectively some form of write down; either in the rate paid or by pushing out maturity or a combination of both. Greece is currently going through such a process of negotiations. Disorderly implies flat out refusing to pay back the bonds on their maturity date which would bring with it a deep distrust of Ireland by debt markets for future issues.

You can imagine that no politician wants to preside over a regime where the country defaults on its bonds so it would only be considered as a last resort. What would be the catalysts to bring about such scenarios? These could be a major deterioration in the country's finances, probably brought about by an economic collapse or the ECB no longer acting as a backstop for Irish banks or the eurozone core powers ditching peripheral nations. We believe such a set of circumstances are very unlikely, albeit not impossible.

As we look to see what could happen in two year's time we shouldn't ignore the encouraging "baby steps" of progress that we have seen recently, such as the switch of bonds with a 2014 maturity to bonds with a 2015 maturity. Clearly markets are separating Greece and Portugal from Ireland and this can only be considered positive. However we still have to continue to address our budget deficit in the face of a worsening external environment. The analogy that we are improving our house while the neighbourhood is simultaneously deteriorating seems apt!

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