



Date: 5th November 2009

Reducing Cash position to 40% from 45% to investing a little cash on weakness.

With the market falling sharply, our recommendation to have a very high cash allocation has clearly paid off. With the benefits of the high cash allocation, our key recommendations model portfolio has recorded a loss of only 2.2% compared to a market fall of 5.4%. The equity portion of the portfolio has seen a fall of 4.3% and thus even without the benefits of the cash allocation, our equity picks have continued to outperform.

Stock	21st October price	5th November Price with dividend	
LWL	47	44.75	-4.8%
HAYL	154	150	-2.6%
DIAL	7.25	7	-3.4%
NHL	3.2	3	-6.3%
NDB	188	172	-8.5%
LLUB	179.75	180.75	0.6%
RCL	50.75	49.25	-3.0%
BHR	65	62	-4.6%
HHL	125	123.5	-1.2%
OSEA	15.5	14.25	-8.1%
DFCC	152.25	143	-6.1%
ASPI	3018.6	2854.82	-5.4%
MPI	3391.26	3207.73	-5.4%
Average of Equity 55% of portfolio			-4.4%
Cash Return 45% of Portfolio			0.4%
Total Portfolio Return			-2.2%

Market Valuations not very attractive, on weakness specific stock buying opportunities are opening up.

Given the risk factors previously outlined, we still think overall market valuations are unattractive to reduce our cash allocation significantly. However we feel some new buying opportunities on a stock specific basis have cropped up. Particularly given further sharp downward movements in the market, buying on significant weakness and reducing cash positions a little, would be an appropriate strategy as such opportunities arise.

Double weight to HAYL and inclusion of TKYO voting shares in Key recommendations portfolio.

With recent results coming above expectations, we are even more bullish on the prospects of HAYL and are now recommending that clients have a double allocation to it. We are also now including TKYO voting shares in our core portfolio. Being relatively illiquid buying into them, during a period of weakness as the market falls may be the way to get a significant exposure to them. To make room for this increased position, we are reducing our Cash allocation by 5% to 40% and removing LLUB from our key picks recommended portfolio. However the 40% cash allocation remains very high, and reflects our view that overall market valuations have not yet come back to attractive levels.

Latest Recommended Portfolio (valid as of pricing of 5th November)

Cash Allocation	40%
Equity Allocation -	60%
Stock	5th November Price
LWL	44.75
	150
HAYL- Double Allocation	150
DIAL	7
NHL	3
NDB	172
TKYO-Voting	201
RCL	49.25
BHR	62
HHL	123.5
OSEA	14.25
DFCC	143
ASPI	2854.82
MPI	3207.73

Recap of previous views on reasons to have a very high cash allocation.

Raising the Cash allocation progressively has been a key part of our portfolio strategy in the last few weeks.

Either way, regardless of the actual cash position investors were able to take, having a very high and continuously rising cash position has been a key part of our portfolio strategy in the recent past. This we stress is not a strategy based on the impact of the Galleon insider trading scandal. We also stress on the actual next round of global economic turmoil which we believe is a high possibility, and has not even been factored into the correction due to Galleon.

7th September 2009

Global worries lead us to suggest a 15% cash allocation in our recommended portfolio.

10th September 2009

Raising Cash Allocation to 25% of our recommended portfolio.

18th September 2009

Maintaining Cash Allocation of 25% despite the drag on portfolio performance.

28th September 2009

Raising cash allocation slightly to 26% from 25%, and starting to favour liquidity and big caps as a means to mitigate risk.

“Cash position built up to take into account the risk of at least a 10% market fall.

The correction seen last week, could be termed a small technical one, and as before markets can clearly resume their bull phase this week and rise sharply given the level of liquidity and interest seen in equities by investors.

However this was a very minor correction we had was not, was not the level of correction we had recommended a raising of cash allocation to 25% for. The cash allocation we have built up is a risk mitigation strategy in the medium term if the market falls at least 10%, or more likely a 20% fall. Such



Capital Alliance –Equity Strategy View

sharp falls could happen, if for instance another period of global financial turmoil hits and impacts Sri Lanka.

China Economic risk is highlighted, but risk could be from anywhere.

On an indicative basis over the next three months, we believe the probability of such a significant global financial turmoil is in the region of 20-30%. On a simplistic basis, understand our cash allocation, it could be said that the probability of financial turmoil is matched by the level of cash we recommend that most clients to hold in our indicative portfolio. In reality, the level of cash we recommend in our portfolio reflects a combination of factors but largely reflecting our views on the probability of such risk, and the current level of valuations in the market (which suggest the degree markets have priced in that risk and the level of downside)

While in recent months we have moved away from liquid Big Cap stocks in our recommendations, and provided a series of mid and small cap counters for clients to invest in, we are again highlighting some liquid Big Cap counters in our core portfolios. Valuations of many of the small caps and Mid caps, we liked earlier are no longer as favourable. Furthermore in the context of the risk we are highlighting, in our view exit options from the more liquid stocks will be better, if the decision to cash out further occurs, if and when turmoil hits, at which point liquidity in some of the smaller stocks could completely dry out.”

2nd October 2009

Raising cash allocation further to 27% from 26% to protect against rising downside risk as the market rises above 3000.

20th October 2009

Raising cash allocation sharply to 35% with news flow turning negative in an overvalued market.

“Almost to prove that the risk that can actually hit you is the one you could not predict, the market fell yesterday on the potential repercussion of the Galleon Group insider trading case on Wall Street. This was a source of global financial risk with strong Sri Lanka impacts that no one could have predicted. A Black Swan Event for Sri Lanka.

Low market returns from now to reach fundamental two year forward fair value of 3500

Furthermore, though we set an index target of 5000 in 2011 based on an overshoot of fair value, we have always maintained and continue to maintain that actual fundamental fair value for the market two years in the future would be around 3500. Thus on a fundamental value basis for the market to reach 3500, it requires a rise of only 13.5% return over a two year period.

On an annualised basis, even with dividends included this would be 6.5%. Thus the total return for the market as a whole would just be a little above the risk free rate and much less than the 18%-20% total annual return investors should expect from Sri Lankan Equities given the higher risk in equity. “

22nd October 2009

Cash allocation raised up to 45% from 35%, with overvaluation persisting as reflected in our existing bottom up stock recommendations.

Thus continuing our defensive strategy and considering that the likelihood of significant falls has increased on news of Galleon’s liquidation, we recommend investors further raise their cash position to 45% from the 35% earlier advocated.

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