



# WITH PROFITS FUND

## Investment Report

Second Half 2007 and Outlook for 2008

**L V =** LIVERPOOL VICTORIA

# WITH PROFITS FUND

## Investment Report

### Second Half 2007

This report provides information on the performance of the Equities, Property and Fixed Interest investments held in the Liverpool Victoria Friendly Society With Profits fund, for the period 30th June 2007 to 31st December 2007. These investments are managed by Liverpool Victoria Asset Management Limited (LVAM). The performance of each of the investment types is measured against an external benchmark, which our fund managers are targeted to beat. Our fund managers have also provided a commentary on each investment type together with their personal outlook.

This information does not constitute investment advice and we recommend you to speak to a suitably qualified financial adviser before making any investment decision based upon this, or any other, information.

### OVERALL COMMENT

Over the second half of 2007 the LV= With Profits fund performed well despite difficult market conditions. It benefited from strong performances in UK, European and Asian equities, where we performed better than the local market average (or benchmark index). Since our investments in these markets make up around 85% of the total equity portfolio, their strength more than offset disappointments in our US and Japanese investments. Our property portfolio performed well compared to its benchmark index, despite a fall in property prices. In contrast, our portfolio of fixed income investments did not rise as much as the benchmark index against which it is measured.



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Head of Fixed Interest,  
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## EQUITIES

	LV=	BENCHMARK
3 months	0.8%	-0.4%
6 months	0.8%	-2.1%
12 months	8.6%	5.3%

These figures measure the growth of our equities portfolio against the FTSE All Share Total Return Index. The figures are measured at 31st December 2007.

### Standardised Performance

These figures show the percentage growth each year since the fund was launched.

Yr to 31st Dec 2003	20.5%
Yr to 31st Dec 2004	10.9%
Yr to 31st Dec 2005	24.0%
Yr to 31st Dec 2006	14.1%
Yr to 31st Dec 2007	8.6%

12 months total return % (mid price to mid price basis) gross income reinvested. Source: LVAM.

This table complies with the Financial Services Authority's regulations to compare different products from different providers.

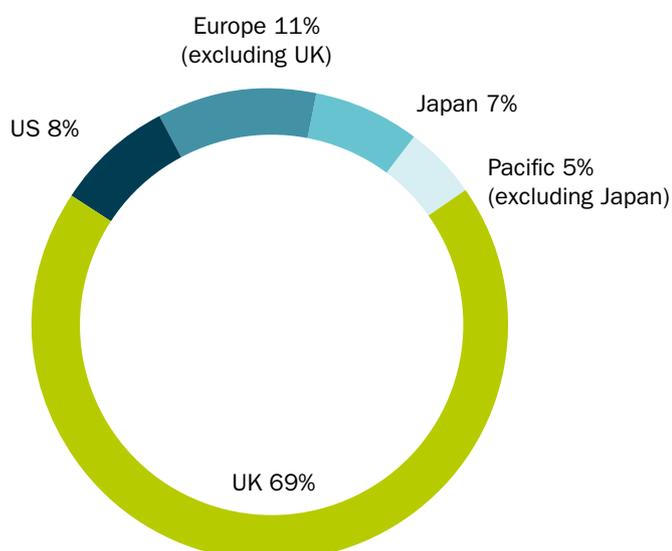
Past performance is not a guide to future performance.

## TOP 10 HOLDINGS

as at 31st December 2007

1 Royal Dutch Shell	6 Tesco
2 BP	7 BG Group
3 Vodafone	8 Rio Tinto
4 HSBC	9 Royal Bank of Scotland
5 GlaxoSmithKline	10 Anglo American

Equity Country Weightings as at 31st December 2007



## MARKET REVIEW

**UK equities** had a disappointing second half of 2007, in the face of the so-called 'credit crunch'. Shares of companies in the Financials sector were especially weak. International banks such as Barclays and Royal Bank of Scotland were impacted by their exposure to complex investment vehicles which came under intense criticism. UK mortgage banks, notably Northern Rock, suffered as the ensuing credit crunch drove up interest rates on loans between banks. Growing fears of a US recession caused consumer-related and economy-sensitive shares to fall, while defensive sectors and oil-related companies proved more resilient.

**European equities** were volatile over the six-month period. Having fallen at one point by over 9%, European share prices ended the period almost 4% higher on average, close to an all-time high. Initially investors were concerned over the possible outcome of the US sub-prime crisis and the potential effect that this could have on global economic growth. However towards the end of the year these worries ebbed as central banks continued to cut interest rates in the face of rising inflation, and pumped funds into the money markets, easing fears of a year-end funding crisis.

**US equities** ended the period just into negative territory. Initially, the failure of several key players in the mortgage market battered investor confidence and reduced expectations of future consumer spending - a key driver of the US economy. However, investors' appetite for risk recovered somewhat following co-ordinated support from five central banks, three interest rate cuts and a falling dollar, which helped the shares of US exporters. Towards the end of the period, evidence of mounting problems as a result of the sub-prime crisis and signs of a slowing US economy once again undermined confidence, leading to renewed share price volatility going into the New Year.

**In Japan**, equities followed the global pattern of volatility, fluctuating with announcements relating to the sub-prime crisis, and its potential impact on the global economy. Closer to home, Japan's domestic economy deteriorated during the second half of the year, which added to the difficulty for equities. In addition, investor confidence in the key construction and financial industries deteriorated following a series of policy blunders, which exacerbated the weakness of the Japanese market compared to its global peers. For investors in the UK, there was some comfort in the fact that currency movements protected them from the full impact of share price falls in Japan.

**Asian equities** bucked the global trend and delivered strong returns over the period, approaching 20% in some markets. In part this reflects the growing demand for equity investments in the emerging Chinese and Indian markets, and also the region's

insulation from the developed economies. Healthy economic growth in Asia is in stark contrast to the slowing economic environment among OECD\* countries. All of this was evident in market performances within the region - while China, Hong Kong, India, Indonesia and Malaysia performed well, markets more dependant on the US consumer, such as Taiwan and Korea, lagged their neighbours.

\* The Organisation for Economic Co-operation and Development is an international organisation of 30 countries. It provides a setting where governments can compare policy experiences, identify good practice and international policies.

## PERFORMANCE

**Our UK portfolio** performed well relative to the market, thanks to our small exposure to Banks, (notably, having no exposure to Northern Rock) and other interest rate sensitive and consumer sensitive sectors. The fund also added value through holding shares with solid defensive growth stories such as Unilever and Reckitt Benckiser, which performed well. Stock choices such as Babcock International and Serco were also positive as company shares such as these, with clear long-term profit outlooks and exposure to government expenditure, were favoured by investors during the period.

**In Europe**, the major contributor to our better-than-market performance was our low exposure to Banks, which suffered due to the sub-prime crisis, and our overweight position in Telecommunications (notably Telefonica) which benefited as investors sought out companies with clearer outlooks in terms of their profitability.

In a difficult market environment, **the US portfolio** trailed its local market index during the period. Our underweight exposure to the (relatively strong) Energy and Utilities sectors more than offset the benefit of our underweight position in the weak Financials sector. At the stock level, Google, Occidental Petroleum, Procter & Gamble and Fannie Mae made positive contributions to our performance. In contrast, Countrywide Financial, E\*TRADE, Capital One and Comcast were major detractors.

**In Japan**, our investments fell further than the local market. The latter half of 2007 has been challenging for investors with sharp market falls in August, early September, November and early December. Under such volatile market conditions both our sector allocation and stock selection strategies - which are based on a medium- to long-term outlook, rather than short-term market direction - were unable to add value.

**In Asia**, the portfolio outperformed thanks to our market positioning. Our bias towards markets which are more insulated from the US economy, namely India, HK/China and Indonesia, and away from export-orientated Taiwan, was a strong positive.

This was partially offset at the individual stock level. In Taiwan, our preferred Technology stocks struggled to perform whilst in India, Bharti Telecom, previously a strong performer, suffered from regulatory concerns.

## OUTLOOK

The **UK market** outlook for 2008 remains uncertain. Most economic forecasts suggest slower growth but opinion is divided as to whether the key US economy goes into recession. Global banks continue to struggle against poor borrowing conditions and further write-offs. To help combat this, Central Banks have cut interest rates and further aggressive cuts, especially in the US, are forecast. Markets are likely to remain volatile in the coming months and it may not be until the latter part of the year - when the impact of lower interest rates begins to feed through - that the outlook will become clearer.

**European equity markets** continue to show signs of nervousness due to the US sub-prime crisis, high oil prices and a weak dollar, all of which have increased the probability of a US economic slowdown that could negatively impact European exporters. In addition, rising inflation casts doubt on the European Central Bank's willingness to lower interest rates should economic growth disappoint in Europe. Investors are likely to remain cautious for some while.

**In the US**, an economic downturn in 2008 will be pronounced but brief, in our view. Economies outside the US are expected to hold up better, and the weak US dollar will provide some relief for export-oriented industries. We expect interest rates to be cut decisively over the course of 2008, heralding an economic recovery in 2009, even though it might not feel like one.

**For Japan**, given the degree of uncertainty arising from the turmoil in the US housing and financial sectors, the record high level of crude oil prices, and upward pressure on the yen, we expect the equity market to remain volatile for some time to come. We will probably have to wait for signs that the US economy is stabilising before we see a meaningful recovery in equity prices.

The outlook for **Asian markets** remains relatively positive. We believe the effects of the US sub-prime situation will be negligible in Asia, and there will be many beneficiaries of the region's continuing strong economic growth. We expect that this positive picture will be reflected in continued investment into the region by investors who are unnerved by volatility in equity markets elsewhere.

## PROPERTY

	LV	BENCHMARK
3 months	-5.6%	-8.6%
6 months	-7.3%	-9.5%
12 months	-1.2%	-5.5%

These figures measure the growth of our property portfolio against the IPD Annual Index. The figures are measured gross at 31st December 2007.

### Standardised Performance

These figures show the percentage growth of property in the fund for the last 5 years

Yr to 31st Dec 2003	13.2%
Yr to 31st Dec 2004	19.7%
Yr to 31st Dec 2005	20.5%
Yr to 31st Dec 2006	22.2%
Yr to 31st Dec 2007	-1.2%

12 months total return % (mid price to mid price basis) gross income reinvested. Source: LVAM.

This table complies with the Financial Services Authority's regulations to compare different products from different providers.

Past performance is not a guide to future performance.

## MARKET REVIEW

The summer months witnessed a significant reversal in trends in the UK commercial property market. The previous five years had seen unprecedented demand from investors which led to an acceleration in prices and yearly returns in the region of 15%. However, the credit squeeze and concerns over future performance prospects of the sector brought this run to an abrupt, if not unexpected, end. This turnaround has resulted in property prices falling back by around 10% in the second half of 2007 and a market characterised by considerably more sellers than buyers.

## PERFORMANCE

Exposure to London's strongly-performing West End and the secure nature of our leasing structure (primarily long tenancies and secure covenants) has led to outperformance in the second half of 2007. Lettings in the out-of-town retail and industrial sectors have also benefited our performance. The fund maintains a lower than average risk profile, with a low exposure to speculative development and unlet properties, and this has benefited returns throughout the recent decline in market conditions.

## OUTLOOK

Whilst interest rates remain relatively high and concerns exist over economic conditions, sentiment in the property sector is likely to remain subdued. A number of property funds face redemptions from investors seeking to withdraw their money, and many of those without cash in reserve have closed their doors to withdrawals. Activity in the sector is low although a number of investors appear to be positioning themselves to take advantage of the downturn, as recent falls in values now make property appear better value.

## FIXED INTEREST

	LV	BENCHMARK
3 months	4.7%	4.6%
6 months	8.9%	8.6%
12 months	3.7%	3.5%

These figures measure the growth of our fixed interest portfolio against the FTSE Actuaries Government Securities UK Gilts Total Return All Stocks Index. The figures are measured at 31st December 2007.

### Standardised Performance

These figures show the percentage growth of fixed interests in the fund for the last 5 years

Yr to 31st Dec 2003	2.9%
Yr to 31st Dec 2004	7.7%
Yr to 31st Dec 2005	9.7%
Yr to 31st Dec 2006	0.3%
Yr to 31st Dec 2007	3.7%

12 months total return % (mid price to mid price basis) gross income reinvested. Source: LVAM.

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## MARKET REVIEW

Many of the factors that created a volatile and weak environment for global equity markets boosted the performance of UK fixed interest stocks - or bonds - during the six-month period. Generally speaking, bonds perform better than equities in a period of weakening or weak economic conditions, and vice versa.

On the surface US economic growth remained moderate, with an improvement early in the period boosted by a recovery in exports, themselves helped by a weaker US dollar. However, there were underlying signs of a more significant economic slowdown in deteriorating employment indicators such as the number of jobless

claims. In the UK, unemployment remained low and inflation appeared to be well contained, climbing slowly back up to 2.1%. However, falling house prices started to impact consumer confidence negatively during the period - this was noticeable during a lacklustre Christmas shopping period.

For the six-month period, bond yields fell (and prices rose) as investors anticipated further interest rate cuts by both the Federal Reserve and the Bank of England, in an attempt to moderate the economic slowdown.

## PERFORMANCE

Our portfolio benefited from the favourable environment for bonds, rising sharply compared to the performance of the equity and property portfolios. However, we slightly trailed the performance of the benchmark index over the six-month period.

## OUTLOOK

Inflation remains a primary concern for central banks across the major economies, albeit to a lesser degree in the UK. The US housing market is likely in our view to continue to deteriorate, negatively impacting consumer confidence and, eventually, the wider economy. We expect to see house prices falling across the UK as lending criteria tighten. The earlier and bigger discounts offered during the Christmas season to keep consumers spending suggest that activity may struggle in the first half of 2008. In general terms, our medium term outlook for the UK fixed interest market view remains positive.

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