



Guy de Blonay, manager of the New Star Global Financials Fund, comments below on the earnings challenges banking stocks are facing and explains why the fund will maintain its bias towards defensive stocks while taking advantage of certain areas of opportunity. The New Star Global Financials Fund is rated 'AA' by Standard & Poor's and the manager is 'AA' rated by Citywire*. Lipper, the performance group, ranks the fund as the top specialist financial fund in its global database over five years#. The fund returned 148.98% in sterling terms over the five-year period compared to the MSCI World Financials Total Return Index of 43.69%#.



Central bankers and bank chief executives have grown increasingly confident that the worst of the financial market crisis is over. JP Morgan's Bear Stearns rescue with Federal Reserve backing in March and other Fed measures helped to ensure continued functioning of the financial markets and led to a recovery in banking stocks until early May, with credit spreads shrinking significantly.

More recently, however, banking indices in Europe and the US have surrendered the bulk of their gains as investors have focussed on the earnings challenges facing the banks. While the mark-to-market writedowns could be nearing an end, new business flows are under pressure while potential returns are under threat from higher funding costs and lower leverage. The real economy, meanwhile, continues to deteriorate, undermining credit quality. In particular, investors are concerned about rising bad debts, especially in the US mortgage market, with expectations of higher provisions that will probably not recede until US house prices have bottomed, possibly not before 2009. In Europe, credit quality is expected to continue to deteriorate, notably in Spain and the UK.

Banks have responded to the combination of writedowns, the impact of off-balance sheet assets being brought on balance sheet and de-leveraging within a tougher operating environment by improving their capital positions. Some €70 billion of capital has been raised in Europe alone this year, most in April and May, helping to generate the improved sentiment towards financial stocks. Royal Bank of Scotland and HBOS, which are raising £16 billion between them, could provide interesting opportunities. Both have been punished by investors for their mistakes and are among Europe's cheapest banks on many valuation metrics. The question now is whether low valuations offer a sector-wide buying opportunity or whether greater selectivity is needed in the face of longer-term uncertainties.

*At 30.04.08

#Source: Lipper, performance data in sterling, NAV to NAV, net income reinvested to 30.05.08

RBS and HBOS share prices punished



Source: Datastream, total return in sterling, 31/07/2007 – 30/05/2008

While raising capital, many financial institutions are also putting their non-core businesses up for sale. This could boost takeover activity as well-capitalised banks pick up solid businesses at cheap valuations. HSBC, Standard Chartered and Banco Santander are seen as potential bidders.

Areas of opportunity

The current focus of the New Star Global Financials Fund is on companies with no sub-prime structured products, diversified income streams, strong franchises and exposure to emerging markets. The fund has largely avoided Ireland and Spain and UK mortgage banks due to concerns that credit quality will deteriorate further. Stocks with emerging market growth potential, such as Standard Chartered, are favoured. Financial stocks in the BRIC countries – Brazil, Russia, India and China – now trade on more compelling valuations because they ultimately suffered in the sell-off alongside their western rivals.



NEW STAR GLOBAL FINANCIALS FUND

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On a geographical basis, prospects are improving in Japan. After many years of underperformance, the threat of deflation appears to be over, with wholesale prices starting to reflect Japan's stronger economic growth. The country's financial companies are well positioned to benefit from Asian economic buoyancy while having limited exposure to losses from US sub-prime structured products. Domestic loan demand is increasing and banks are also focusing their attention on expanding overseas with the aim of tapping into Asian growth. Equity valuations, interest rates, liquidity and corporate profits also support the investment case.

In Europe, favoured stocks include Baloise, a multi-line insurance company with operations in Switzerland, Germany, Benelux and Austria. It recently announced new initiatives to grow its non-life business and attract new higher margin clients. With a strong balance sheet, Baloise can continue its share buyback programme while contemplating growth through acquisitions or strategic partnerships. Man Group, the hedge fund manager, remains a key holding for the fund as a result of the structural growth in alternative assets and its strong performance record in volatile markets.

Investment banks, such as Merrill Lynch and Goldman Sachs, have been avoided. The key issue for these companies is not necessarily whether more writedowns will be revealed but whether they can write new business over the next few years. There has been a fundamental shift in institutions' desire to embrace risk. Some profitable business lines may, therefore, be closed for months and perhaps years.

Until there are clearer indications as to the severity of the US economic slowdown and its impact elsewhere, it is prudent to maintain a bias towards defensive companies. Over the next few years, western banking profitability is at risk from rising bad debts, liquidity and capital market pressures, de-leveraging and regulatory pressures. There are areas within the financial sector that should cope with the expected trading conditions better such as emerging markets, where there are structural growth themes although rising inflation is now a concern.



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