



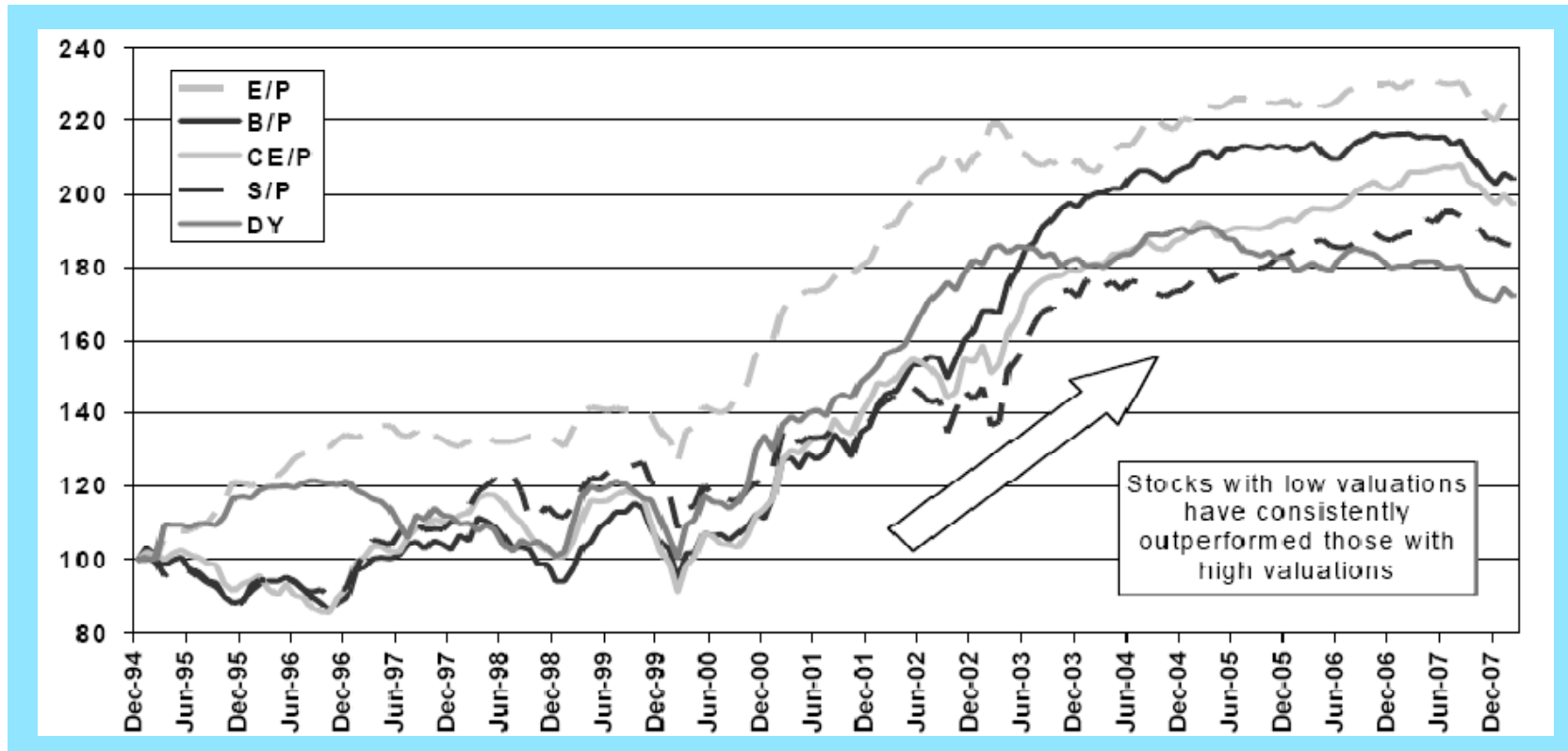
Value

Growth

... and the Future?

Europe style relative performance long term

Valuation factors have a superb LT record in Europe...

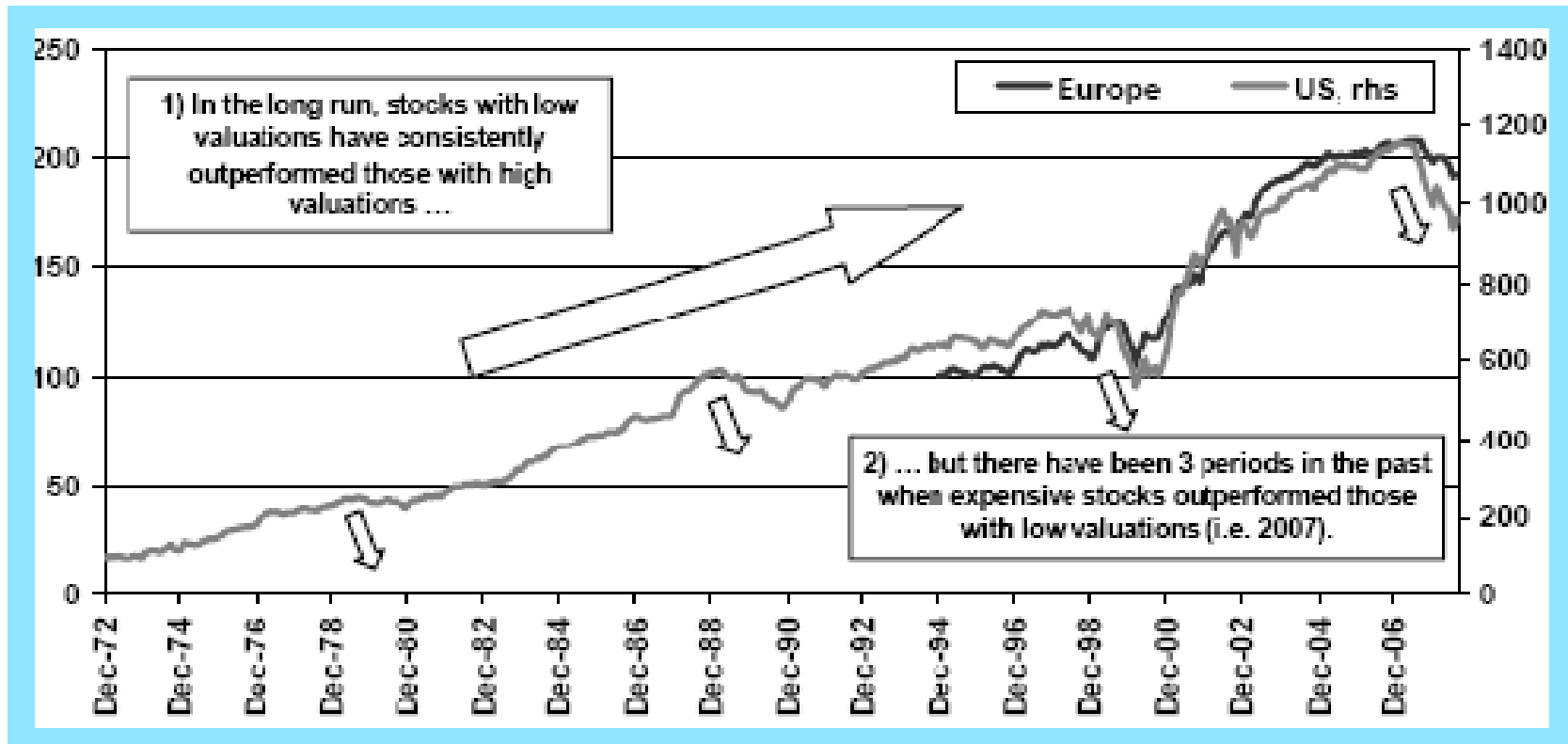


Source: Morgan Stanley Quantitative & Derivative Strategies, Morgan Stanley Research 28 March 2008 European Strategy

Note: Shows cumulative factor returns based on five valuation factors in Europe, using MSCI Europe as the universe

Long term investment v short term speculation

Valuation factors have a superb LT record in Europe & US, but they stopped working in 2007...

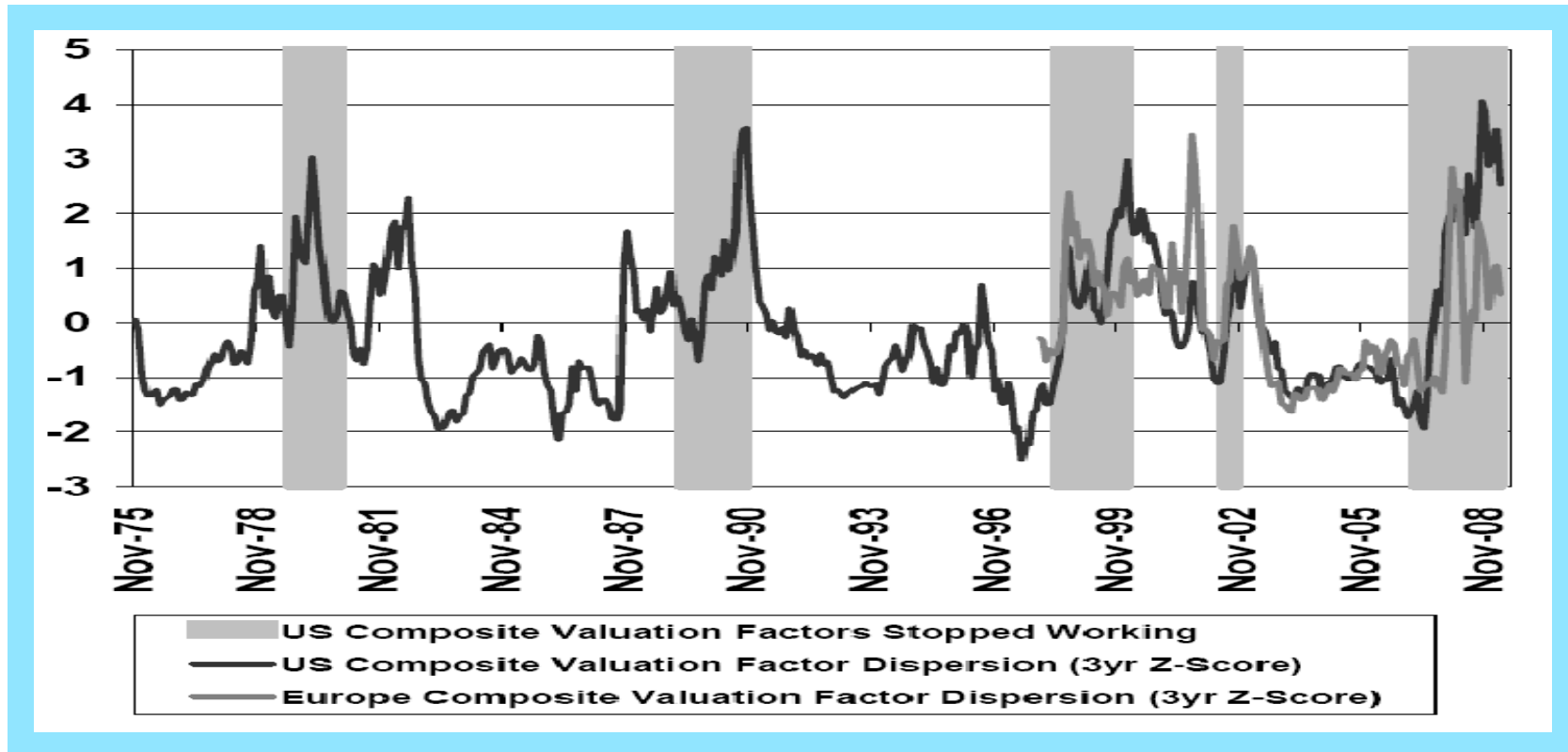


Source: Morgan Stanley Quantitative & Derivative Strategies, Morgan Stanley Research 28 March 2008 European Strategy

Note: Shows cumulative factor returns based on the composite valuation factor in Europe & US, using MSCI Europe & SPX as the universe

Value or growth ?

Valuation dispersion remains wider than usual, especially in the US, which means...



Source: Morgan Stanley Quantitative & Derivative Strategies, Morgan Stanley Research 14 April 2009 European Strategy

Note: What is the valuation dispersion? We rank fundamental values for a particular factor (eg E/P) across a sector. The difference between top & bottom quintile medians is the factor dispersion for that sector. The factor for the universe is the average dispersion of all sectors (ie sector neutral). The dispersion for Europe & US composite valuation factor is based on an equal-weighted average dispersion among E/P, B/P, S/P, CE/P & DY. We then expressed the composite valuation factor dispersions in z-scores (ie no. of standard deviation away from the 3 year rolling average)

Value or growth ?

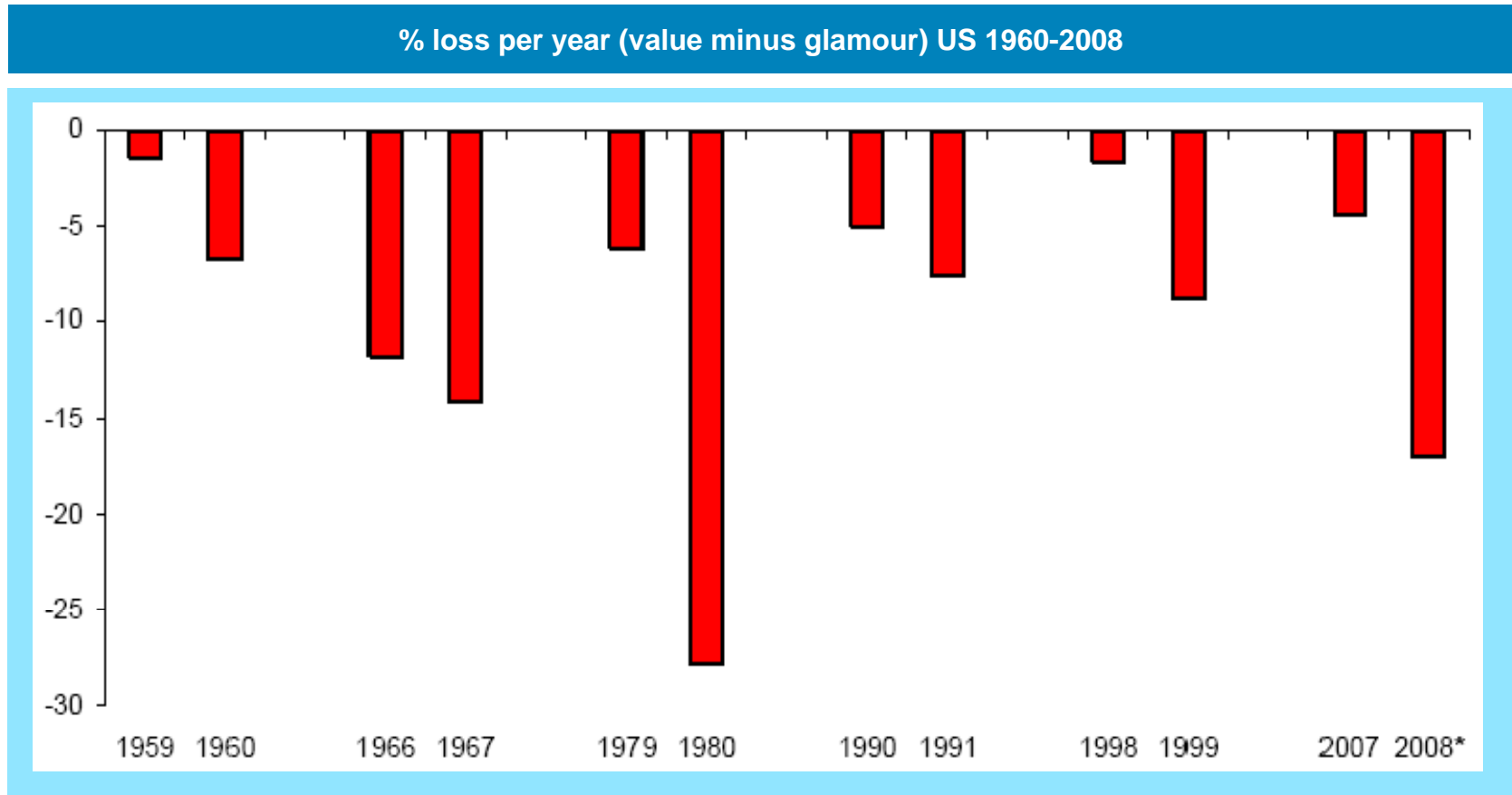
...stocks with lower valuations are likely to outperform expensive stocks in the next 12 months

US composite valuation factor dispersion (3y z-score)	Next 12mths valuation factor returns when dispersion is...					
	...Narrower than normal			...Wider than normal		
	< -2	< -1	< 0	> 0	> 1	> 2
1. Europe composite valuation factor						
Avg next 12 month factor return	2.0	1.6	3.4	8.5	10.6	12.4
Hit ratio	3 / 4	35 / 51	88 / 106	38 / 54	20 / 28	5 / 7
2. US composite valuation factor						
Avg next 12 month factor return	-0.6	6.4	6.1	6.1	10.9	13.6
Hit ratio	2 / 5	89 / 116	208 / 254	90 / 135	47 / 59	11 / 14

Source: Morgan Stanley Quantitative & Derivative Strategies, Morgan Stanley Research 14 April 2009 European Strategy



Value out of vogue!



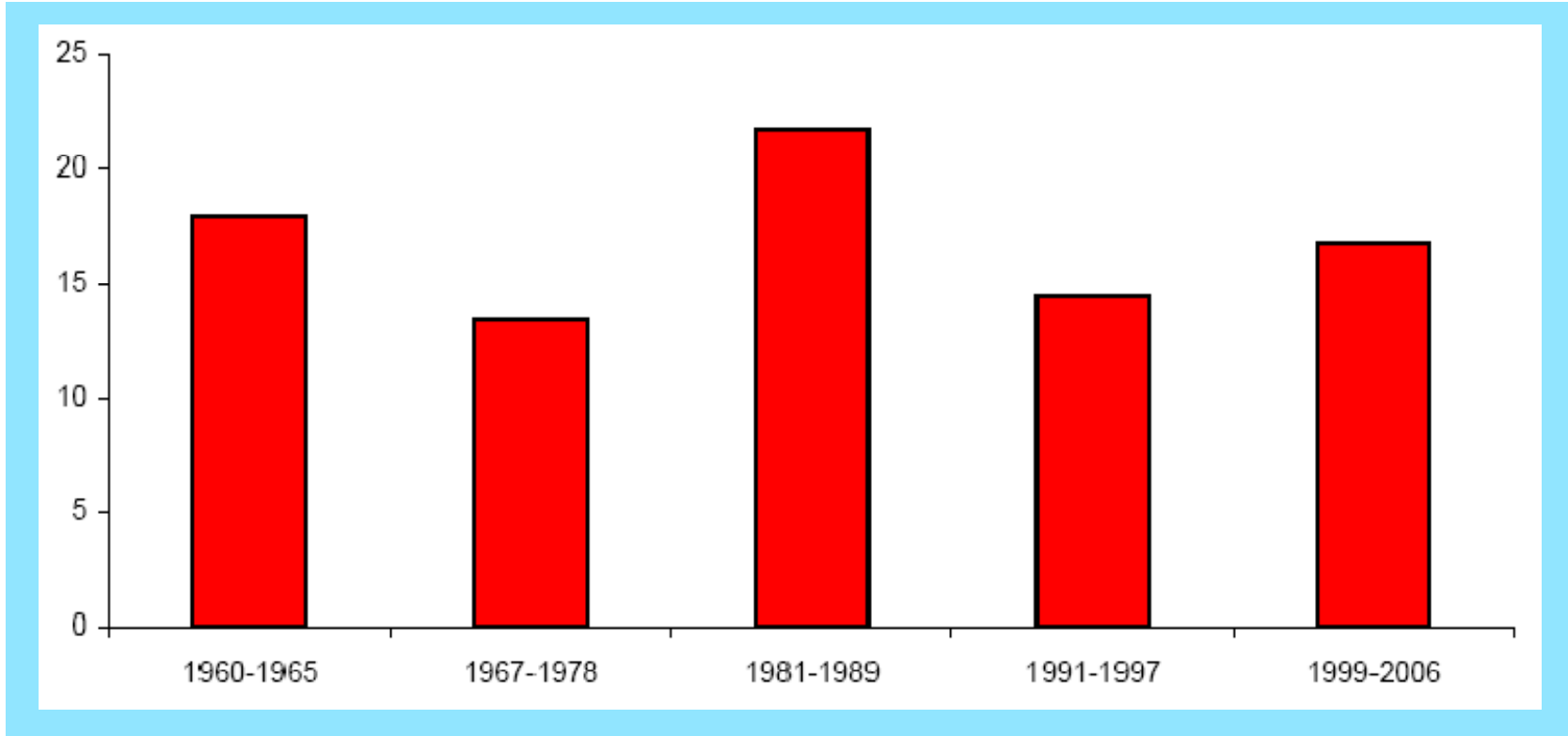
Source: SG Equity Research,*YTD
30 July 2008

Value: *High cash flow to price*
Glamour: *Low cash flow to price*



Value when in vogue!

US value minus glamour (% pa)



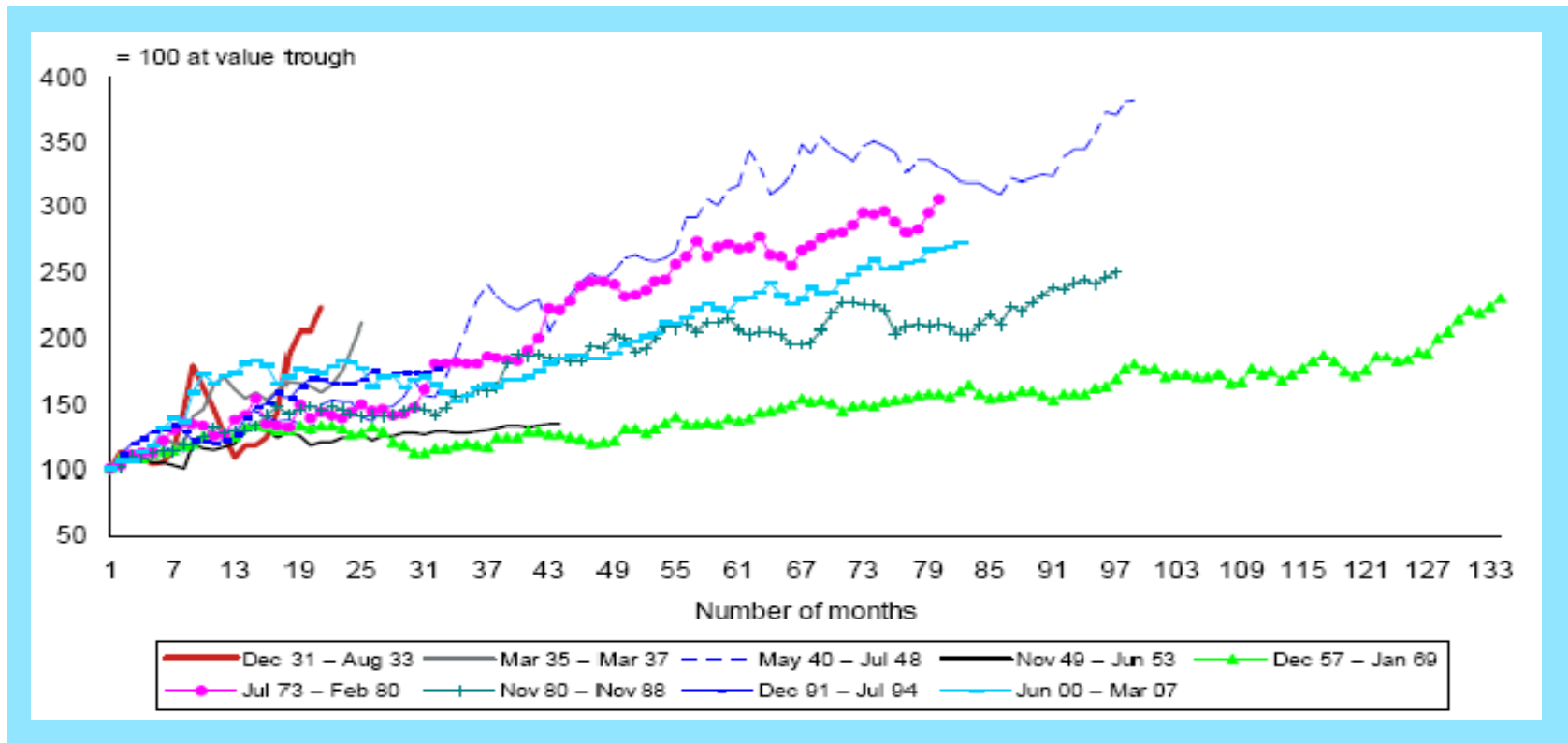
Source: SG Equity Research
30 July 2008

Value: High cash flow to price
Glamour: Low cash flow to price



Value when in vogue!

Figure 6: Previous value rallies



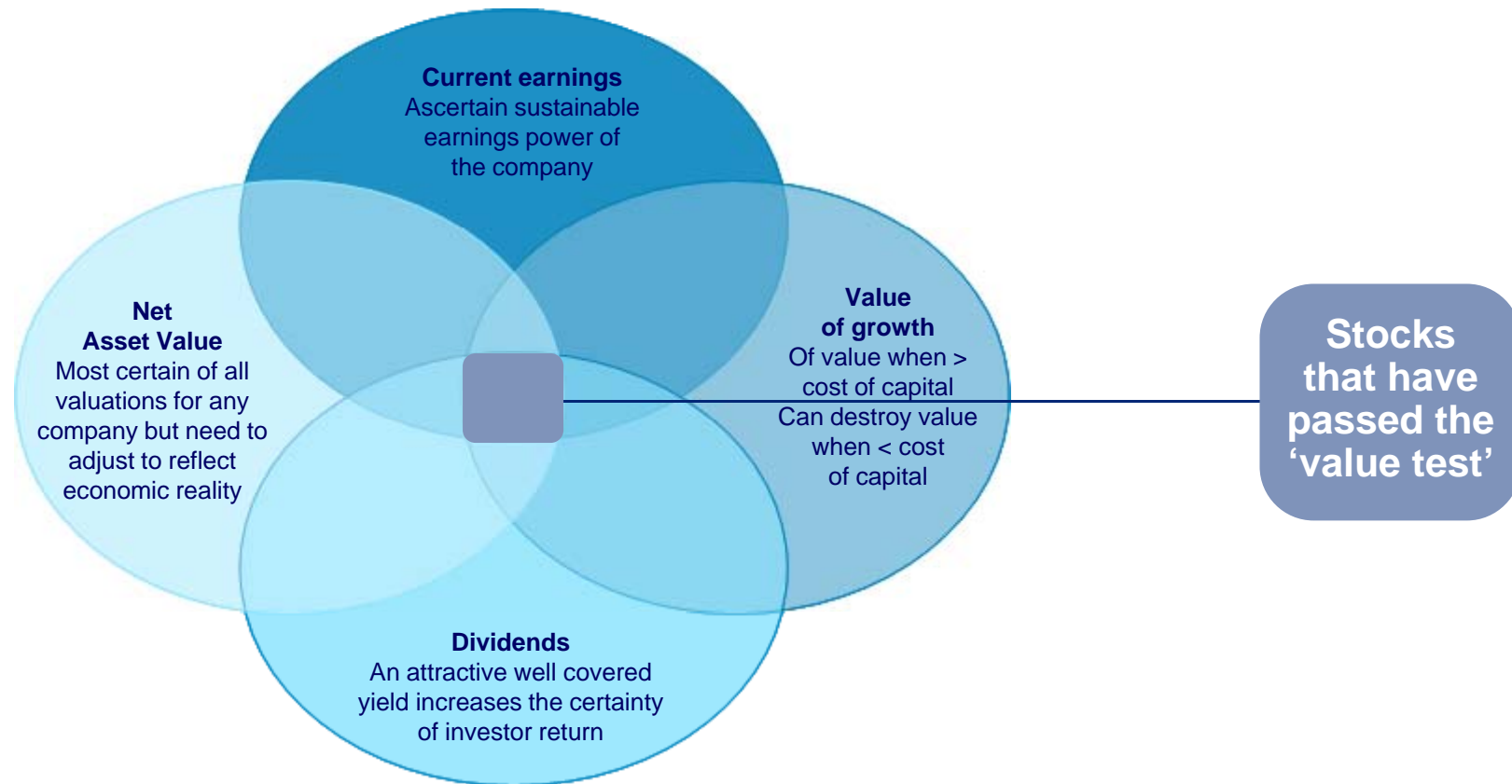
Source: Kenneth French Data Library, Nomura Research

Note: Chart shows the relative performance of top and bottom value quintiles in the US screened on price/book. Performance is based at 100 at the trough of each value cycle. Portfolios are value weighted.

Combining European Value Factors

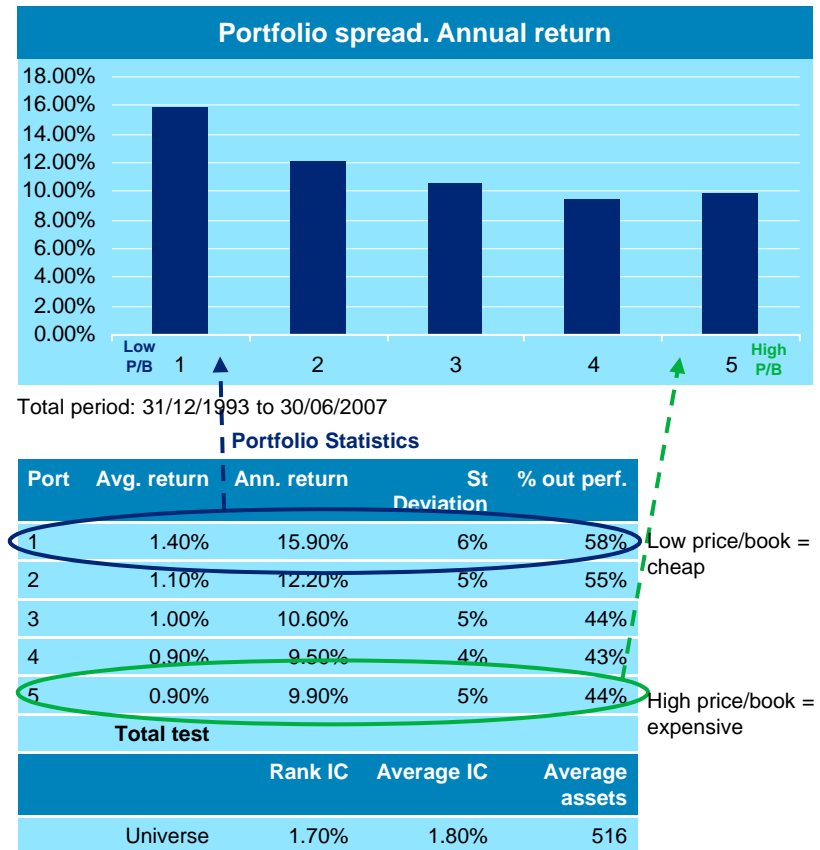
Investment process - four major components

- **The aim:** identifying attractive valuations and prospects



Investment process - net asset value

- We look for cheap stocks as measured by price/book ratios
- Equities with high asset backing and therefore low price/book ratios generally have a higher margin of safety relative to other companies.
- If existing management are unable to raise the rate of return on the existing assets this may attract predatory attention. If all else fails, the company may be broken up in order to realise the value within the company.
- By comparison equities with high price/book ratios are dependent on maintaining a high growth rate.

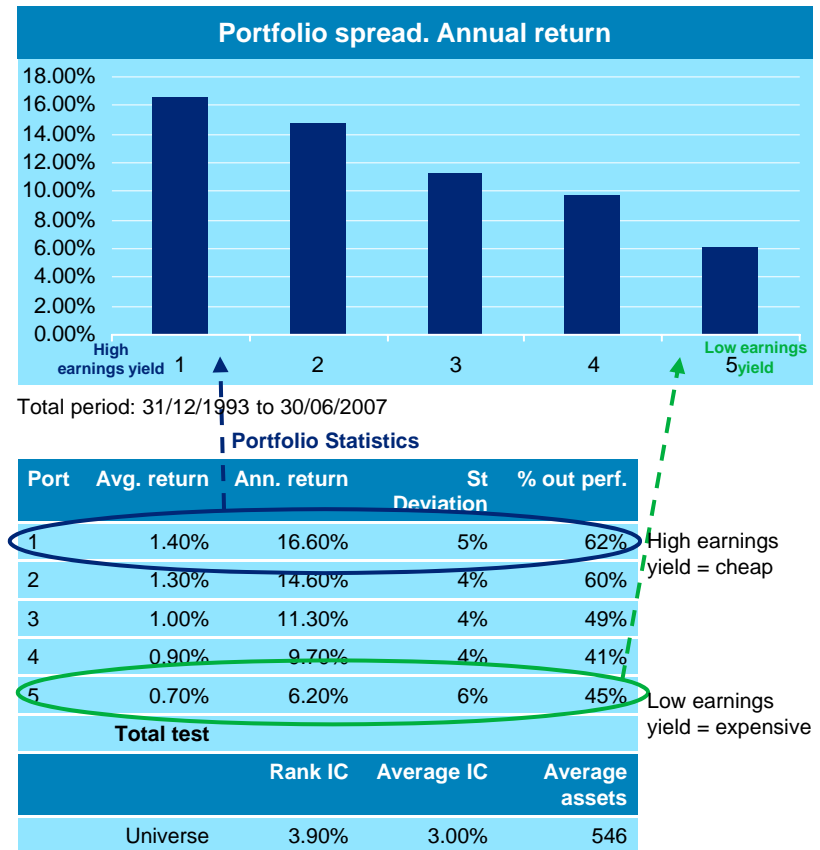


Source: R/ME8, FactSet, JPMorgan, Barra
Historical price/book value ratio in Europe, rebalanced every month; for illustration purposes only



Investment process - current earnings

- We look for cheap, high earnings yield stocks
- Equities with high earnings yields generally outperform, reflecting the low expectations underlying their rating.
- In reality reversion to the mean together with the capital cycle and probable reorganisation generally lead to earning surprises. Once this becomes apparent re-rating takes place.

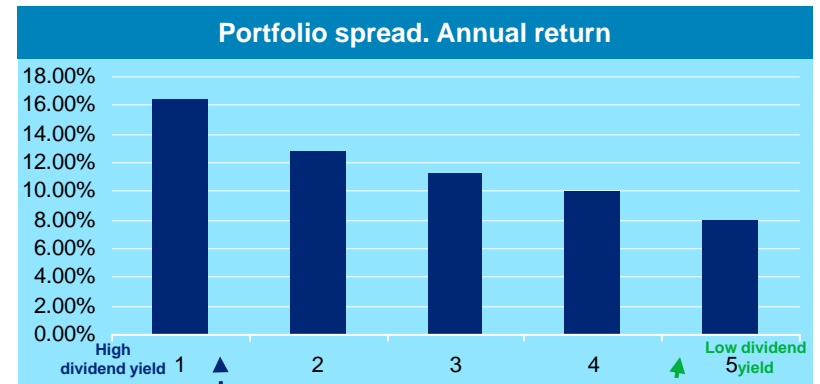


Source: R/ME8, FactSet, JPMorgan, Barra
Historical price/book value ratio in Europe, rebalanced every month; for illustration purposes only



Investment process - dividends

- We look for high dividend yield stocks
- A high initial dividend yield (assuming a reasonable level of cover) allows investors to immediately lock in an attractive level of return.
- If an investor requires a return of 8% and is able to attain a dividend yield of 5% then capital or income growth only has to average 3% over the holding period to achieve this return.
- An investor buying a stock with no or little yield is totally dependent on growth to achieve the required return.



Total period: 31/12/1993 to 30/06/2007

Portfolio Statistics					
Port	Avg. return	Ann. return	St Deviation	% out perf.	
1	1.40%	16.40%	5%	60%	
2	1.10%	12.80%	4%	53%	
3	1.00%	11.30%	4%	43%	
4	0.90%	10.10%	5%	45%	
5	0.80%	8.00%	6%	49%	
Total test					
		Rank IC	Average IC	Average assets	
		Universe	2.60%	2.50%	466

High dividend yield = value/cheap

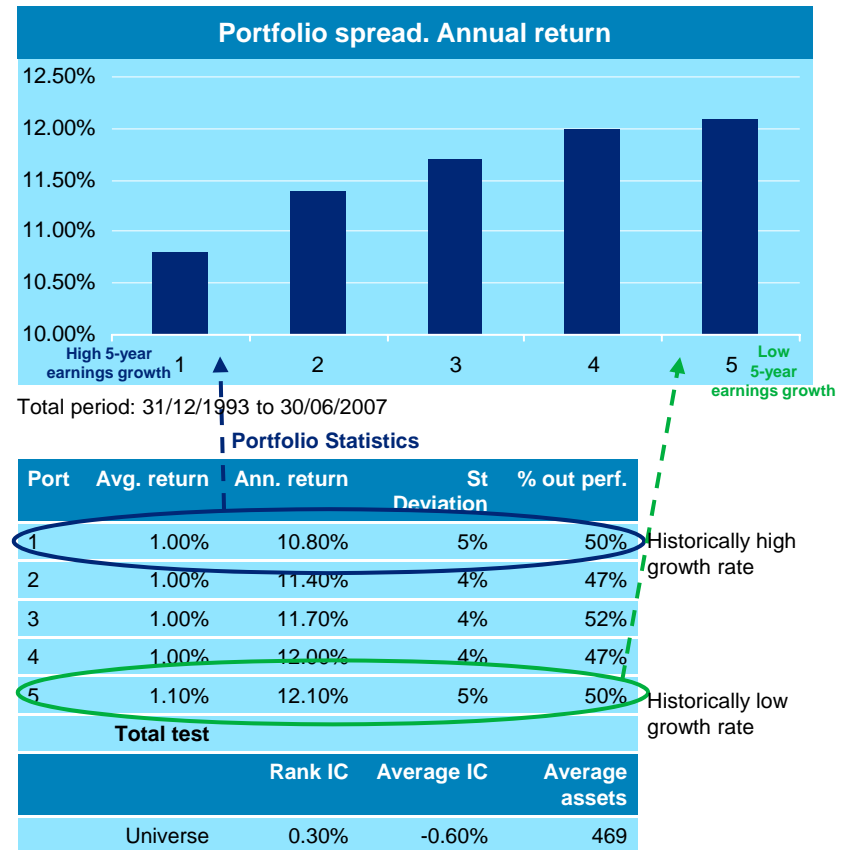
Low dividend yield = expensive

Source: R/ME8, FactSet, JPMorgan, Barra
Historical price/book value ratio in Europe, rebalanced every month; for illustration purposes only



Investment process - value of growth

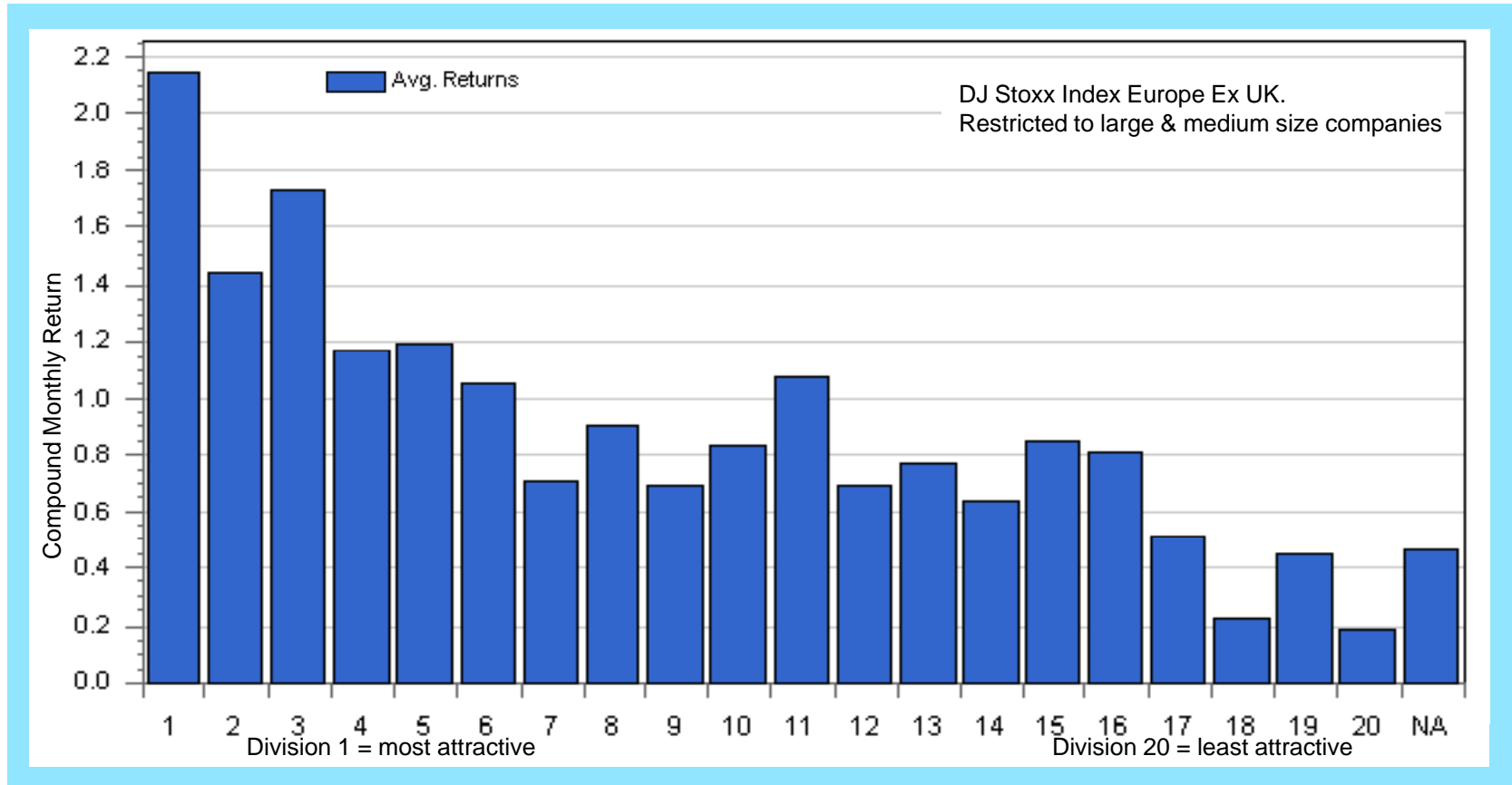
- We look for sustainable growth rates
- High growth rates attract not only envy but, if barriers to entry are low, competition. This dissipates the available returns reducing aggregate levels of profitability.
- Low growth rates generally lead to capital being redeployed to more attractive areas. This with the almost inevitable industry consolidation allows margins to be rebuilt. Hence earnings are strongly mean reverting!



Source: R/ME8, FactSet, JPMorgan, Barra
 Historical price/book value ratio in Europe, rebalanced every month; for illustration purposes only

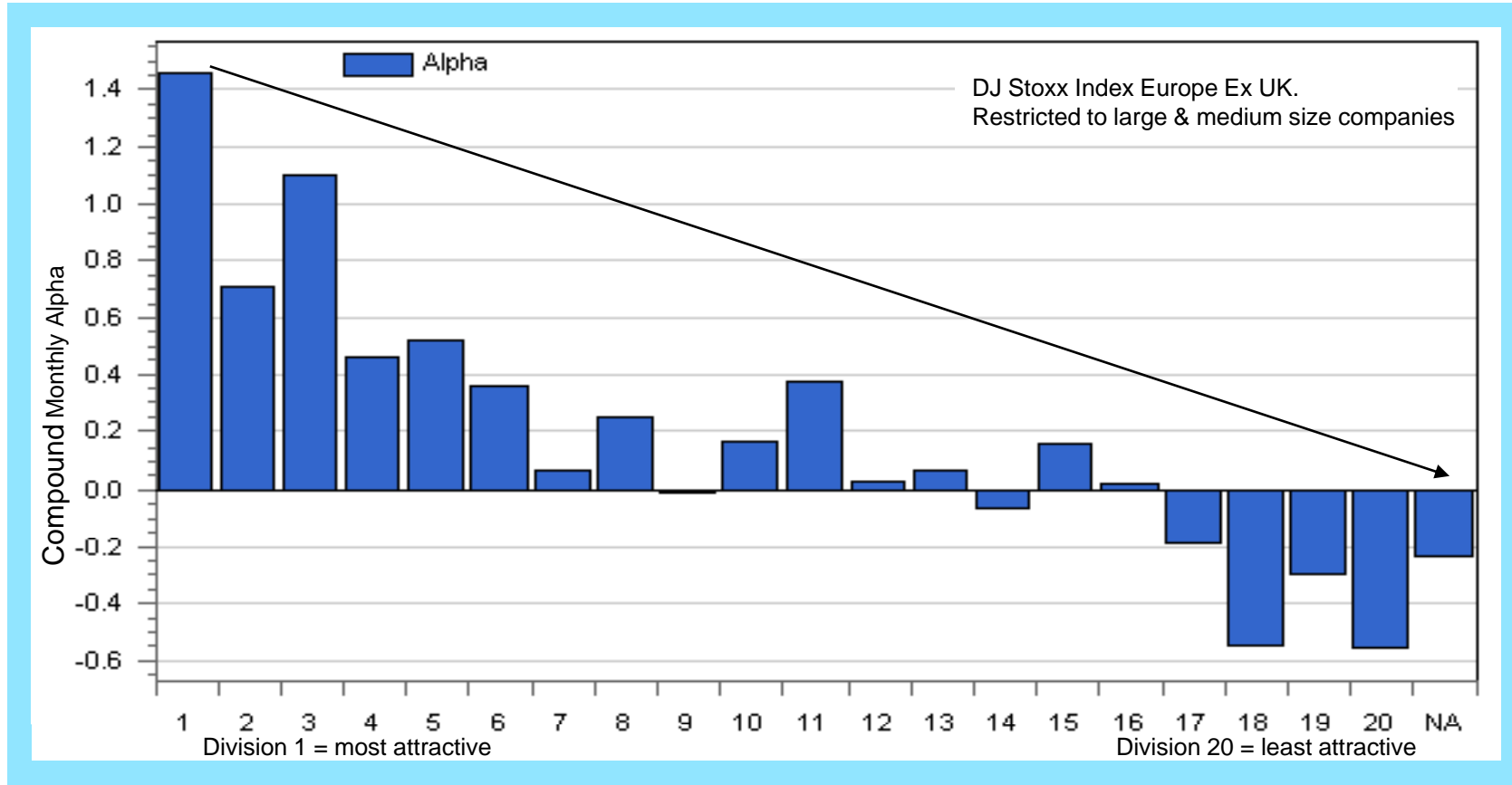


Back test results



Back test Source: FactSet Alpha Testing, Total Return, stocks equally weighted, no account is taken of any associated dealing or management costs. Period June 94 – March 05. For illustration purposes only.

Alpha generation



Back test Source: FactSet Alpha Testing, Total Return, stocks equally weighted, no account is taken of any associated dealing or management costs. Period June 94 – March 05. For illustration purposes only.

Backtest returns

Division	Equal Wgt. return	Univ. Med. return	Sharpe ratio	%> bench	%> up bench	%> down bench	Xs vs bench
-1-	2.15	1.94	0.26	66.15	60.24	76.60	1.39
-2-	1.45	1.22	0.17	63.08	60.24	68.09	0.71
-3-	1.73	1.47	0.26	64.62	57.83	76.60	0.93
-4-	1.16	0.91	0.14	56.15	60.24	48.94	0.40
-5-	1.19	0.95	0.16	60.00	53.01	72.34	0.40
-6-	1.05	0.71	0.12	51.54	51.81	51.06	0.28
-7-	0.71	0.52	0.08	53.08	44.58	68.09	-0.09
-8-	0.91	0.96	0.11	53.08	39.76	76.60	0.12
-9-	0.69	0.42	0.06	50.77	49.40	53.19	-0.07
-10-	0.83	0.66	0.09	53.08	50.60	57.45	0.04
-11-	1.07	0.78	0.14	53.08	49.40	59.57	0.29
-12-	0.69	0.57	0.07	47.69	44.58	53.19	-0.10
-13-	0.77	0.57	0.08	50.77	50.60	51.06	0.00
-14-	0.63	0.53	0.07	49.23	42.17	55.32	-0.14
-15-	0.85	0.41	0.10	49.23	45.78	55.32	0.07
-16-	0.81	0.67	0.07	46.92	46.99	46.81	0.08
-17-	0.51	0.43	0.04	45.38	42.17	51.06	-0.27
-18-	0.22	-0.10	-0.02	37.69	38.55	36.17	-0.53
-19-	0.44	0.55	0.02	40.77	44.58	34.04	-0.31
-20-	0.19	-0.01	-0.02	43.85	40.96	48.94	-0.56

Stocks we focus on

Stocks we avoid

Back test Source: FactSet Alpha Testing, Total Return, stocks equally weighted, no account is taken of any associated dealing or management costs. Period June 94 – March 05. For illustration purposes only.



Value of growth 2

Returns split by earnings performance (developed markets 1985 -2007)

% per annum	Highest growth	2	3	4	Lowest growth
Value	19.8	21.6	17.7	15.9	11.9
2	20.6	18.0	13.7	11.0	10.9
3	17.8	14.0	11.6	9.9	8.1
4	15.7	10.5	8.6	6.7	6.1
Glamour	7.90	5.04	4.42	2.77	2.18

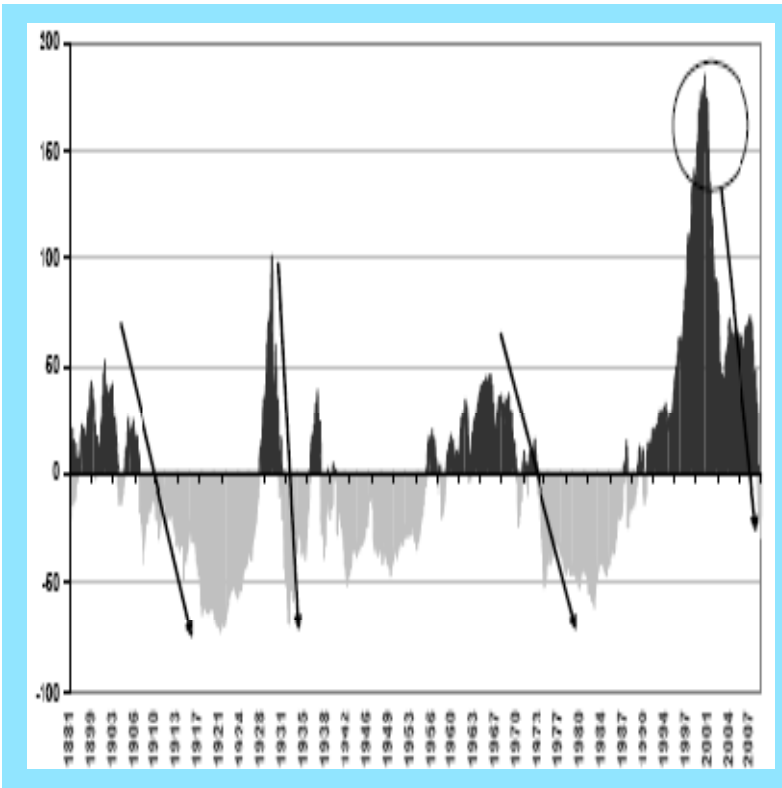
Source: SG Global Strategy, as at 27 October 2008



Where are we now ?

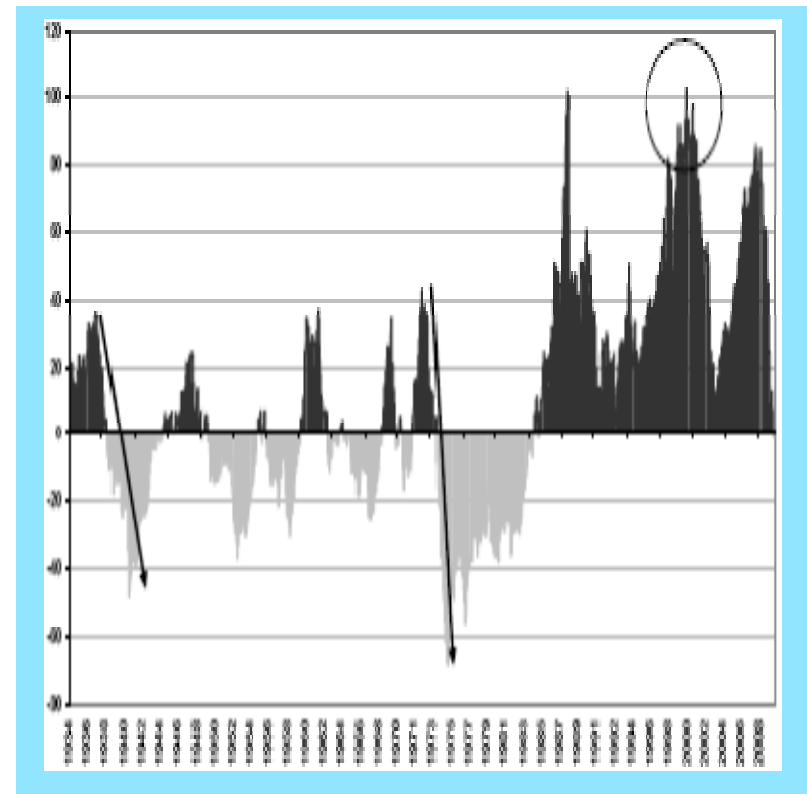
Undershoots normally follow overshoots!

% above/below long term average:
S&P 500 Shiller PE



Source: Shiller, Dow Jones, Global Financial Data, BLS, Morgan Stanley Research
30 March 2009 European Strategy
Note: Shiller PE = Inflation adjusted price to 10Y average reported EPS

% above/below long term average:
FTSE All-Share Shiller P/Div



Source: Global Financial Data, Morgan Stanley Research 30 March 2009 European
Strategy
Note: Shiller P/div = Inflation adjusted price to 10Y average reported DPS

Tobin's Q

In the US, Tobin's Equity Q - a ratio of market value to net worth - is currently 0.53x. That is 33% below average but still suggests 57% downside to trough levels. A version of the Q ratio for aggregate value to total assets is 41% above trough levels (or 33% using tangible assets.)

There are two main Tobin's q ratios, 1) Tobin's q ratio (or Tobin's Average q ratio) which looks at aggregate value and 2) Equity q ratio (or Tobin's Equity q ratio) looking only at equity value.

Tobin's q = Market value of Equities & Liabilities / Total Assets

Equity q = Market value of Equities / Net Worth

For Tobin's average q, there are two alternative measures of calculations, using either tangible or total assets (the difference being that when looking at tangible assets, the financial assets are excluded from liabilities and total assets). The data is only quarterly, but for the latest value of equity q we have used the approximation that the market value of equities has moved in line with the S&P 500.

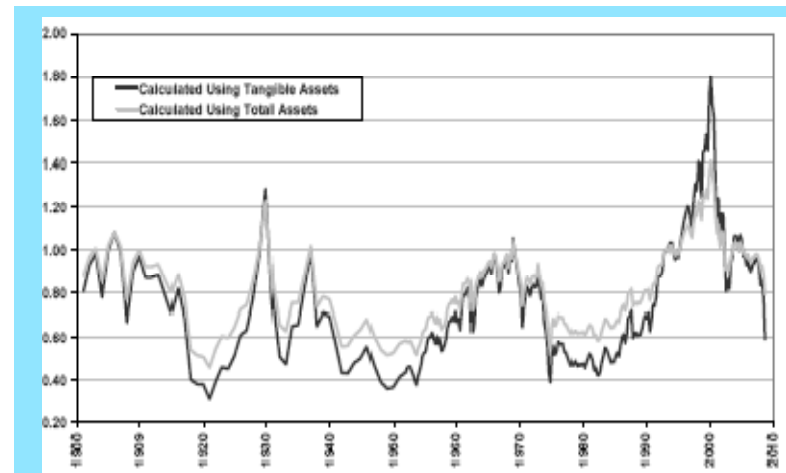
The long-term average value of q is below unity due to the overstatement of the replacement cost of company assets, largely due to the underestimation of the true economic rate of depreciation.

US Tobin's Equity q Ratio



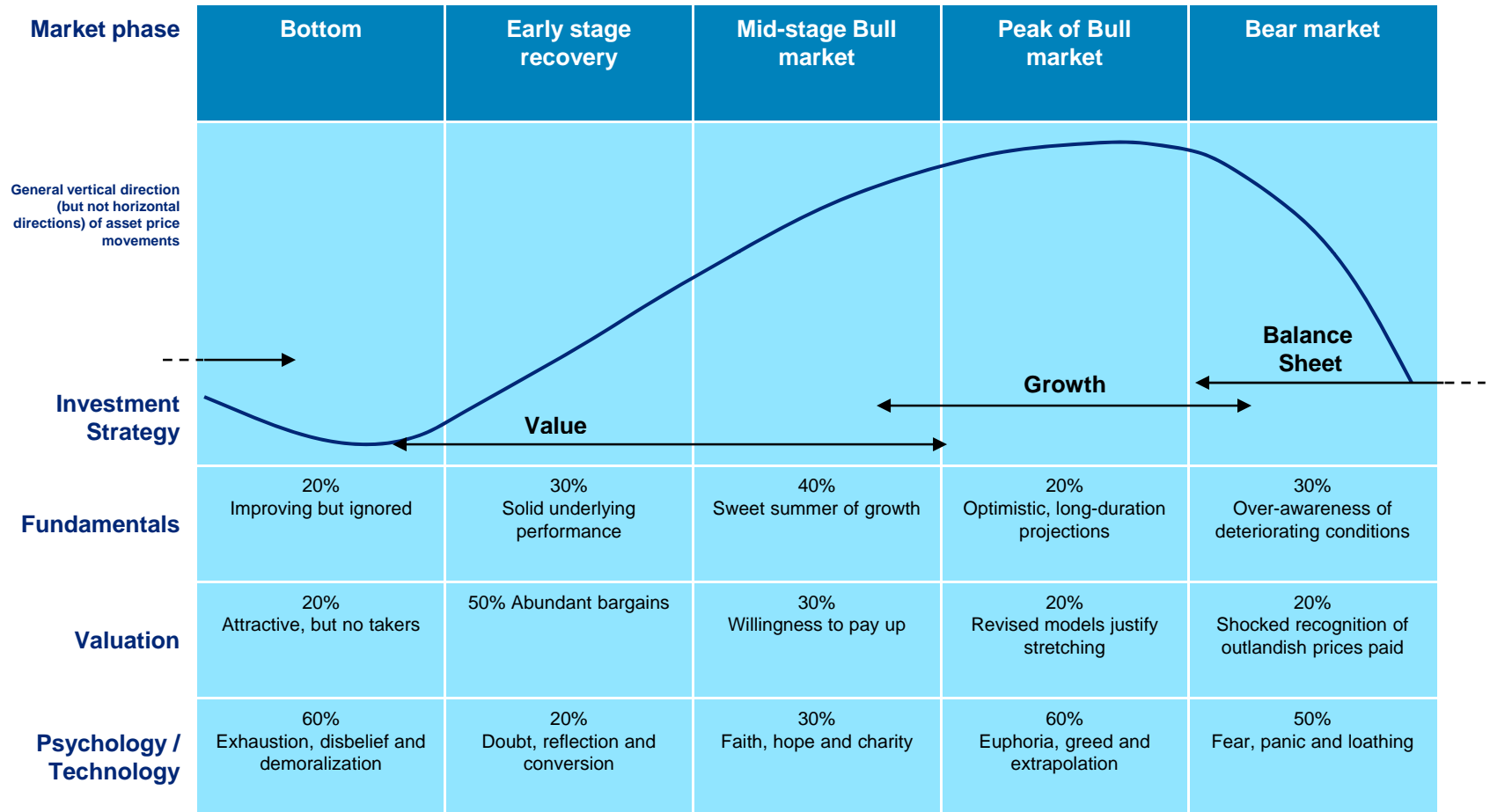
Source: Federal Reserve, Haver, Stephen Wright
 Note: Tobin's Equity q = Market value of equities / net worth
 (<http://www.econ.bbk.ac.uk/faculty/wright/>) Morgan Stanley Research 30
 March 2009 European Strategy

US Tobin's Average q Ratio



Source: Federal Reserve, Haver, Stephen Wright
 Note: Tobin's average q = Market value of equities + liabilities / total assets
 (<http://www.econ.bbk.ac.uk/faculty/wright/>) Morgan Stanley Research 30
 March 2009 European Strategy

Value cycle

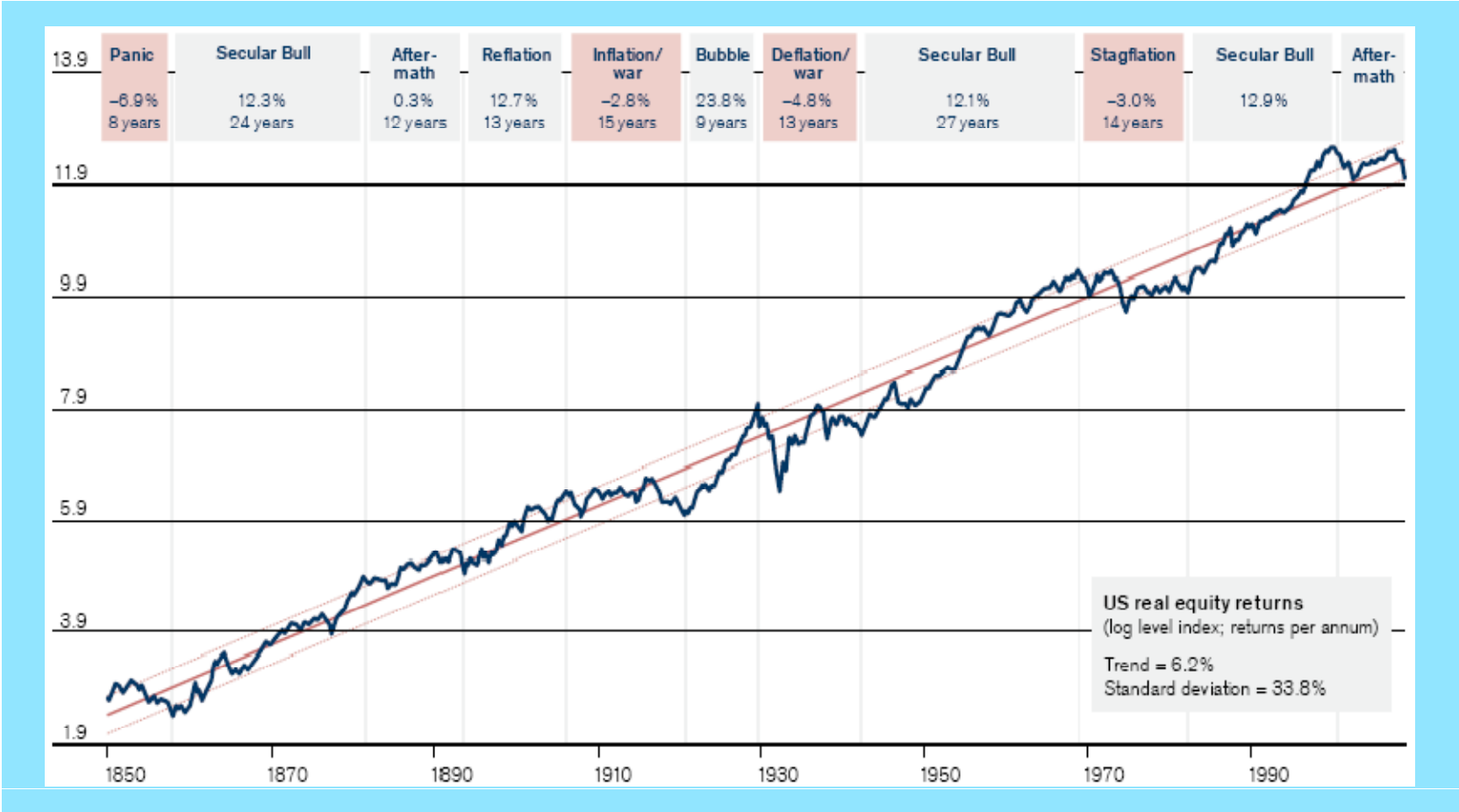


Source: Morgan Stanley Research 23 February 2009 European Strategy



USA

Figure 3: US real equity returns

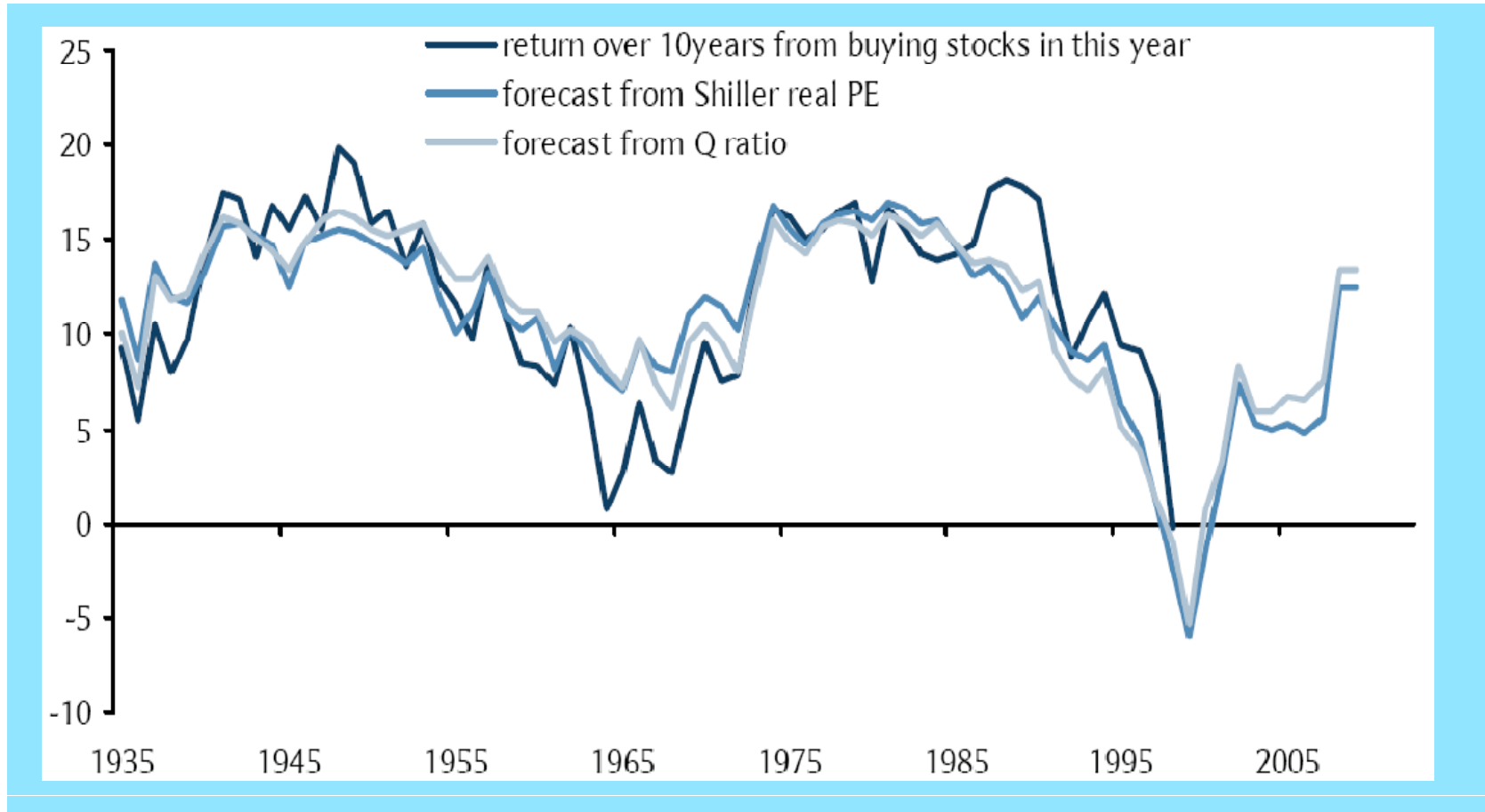


Source: Credit Suisse



The future 1 ?

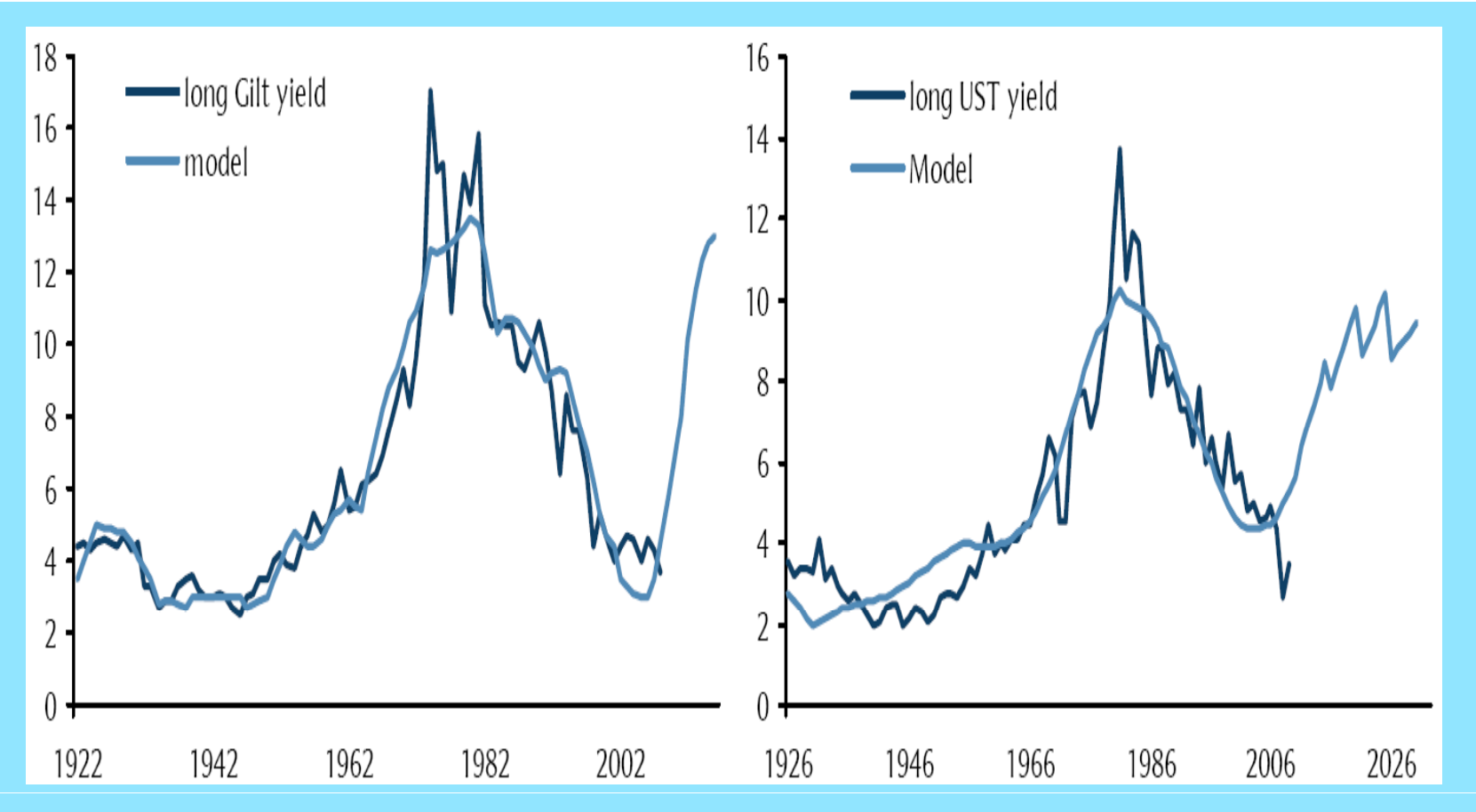
Figure 4: 10-year rolling annualised nominal returns from US equities, 1935-2008, actual and individually regressed from Q ratio and real PE ratio



Source: Shiller, Wright, Barclays Capital

The future 2 ?

Figure 8: US and UK long-dated government bond yield, actual and modelled from demographics



Source: Barclays Capital



Appendices

FactSet

FactSet is a leading provider of global financial and economic information, including fundamental data on tens of thousands of companies worldwide. Combining more than 200 databases into its own dedicated online service, FactSet also provides the tools to download, combine and manipulate the data for investment analysis.

With FactSet's Alpha Testing, Nick Sheridan can assess the relationship between one or more variables and subsequent returns over time. He builds a model specifying the factors that he thinks are related to returns, the groups or divisions he wants companies to be divided into, which companies he wants to consider, and the historical context in which he wants to test these factors. Alpha Testing does the rest by calculating subsequent returns for each group or division, the entire universe, and the selected benchmark in easy-to-understand reports that help him identify factors correlated with excess returns, or "alphas". These reports include CPU-intensive mathematical and statistical calculations. Nick Sheridan can also view return information in either overview charts and reports or in detailed reports for any specific fractile or time period. He can even see the underlying company constituents of any division at any time.

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