



This month we welcome back Richard Champion, after allowing him a few months break from writing! In September's issue, Richard details the recent changes to Principal's investment process and structure, outlining the reasons behind the change, the challenges faced and the advantages of a structured and rigorous system. We have lived through heady economic times and Principal's adjustments are the best course of action looking to the future.

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Richard Champion, Head of UK Equities

Richard has worked in the investment industry since 1985, initially in stockbroking and then in institutional asset management. He has wide experience of managing both UK and continental European equities. He joined Principal in 2004 and is based in the London office.

Investment Process

Investment philosophy, approach, structure and process; what do they mean and what are they for?

The last two years have been a period of momentous challenge for investment managers across the world. It has also been a time of very significant change for Principal. The sale of a majority stake in the business to our new owners eighteen months ago has given us the opportunity to take a close look at the way we do things, invest in new resources and refocus and improve our service.

This issue of PIMview therefore spends time detailing some of the improvements we have put in place and outlines how our investment process works for our directly invested clients. A future issue will look at our process for managed funds clients.

However, 'investment process' is an oft-misused term and it is important to distinguish between four components that form the core of what this means. These concepts, which are often mixed up together are; philosophy, approach, process and structure.

An investment philosophy is the investor's root stance on how markets work and function. Typically a philosophy will start with the words 'I believe'.

In Principal's case, our investment philosophy is quite simple: we believe that investment markets can be inefficient in the short-to-medium term, but that in the longer term they are efficient. In other words, that asset classes, sectors and stocks can be mispriced for a variety



Peter Finnigan
Director



Robert Doresamy
Senior Investment Manager

of reasons but that this mispricing, over time, tends to be noticed and corrected by investors. As we are active, not passive, investors we seek to identify and exploit those instances of mispricing on behalf of our clients.

An investment approach is the style any given investment manager might adopt to take advantage of their philosophy.

Principal's investment approach is value oriented. We believe the best way to achieve long-term superior returns is through purchasing investments that are cheap compared with their history, their peers and the market in which they are listed. However, we are pragmatic about how we identify that relative value, acknowledging that at various points in the economic cycle, differing metrics will be appropriate to measure it.

There is a wealth of academic material that supports the validity of value-based investing and some of the world's best-known investors are themselves overtly driven by the value style. Perhaps foremost of these is Warren Buffet, often cited as the world's most successful investor and richest man.

An investment structure is the means by which investment managers organise their investment process.

We have set up a structured investment hierarchy. At the top sits the Asset Allocation Team. This comprises the most experienced and senior investment managers at Principal. The team examines global economic and market conditions, looking at indicators such as forecast GDP growth, inflation, unemployment, currencies, politics (where appropriate) and fiscal and trade balances. The team's remit is to cover all asset classes and geographies, and to set asset allocation policy across the group, so that it is implemented consistently across all typical investment mandates, where applicable.

To provide a uniform body of econometric data on which to base our decisions, we use external sources and specifically seek out views that directly challenge our own. This is an invaluable benefit, for it stops us from becoming too set in our thinking and increases the rigour of our discussions.

One area where we have deliberately added to our resources is in fixed interest. Historically we have tended to use our own expertise in this area. However, although many of us have direct experience in the fixed interest asset class, we recently took the step of recruiting a specialist manager in the field, to add more sophistication to what we do.



Craig Veysey
Senior Investment Manager
(Fixed Interest Specialist)

Beneath the asset allocation come the two sides of Principal's conventional investment business. One of these is the directly invested team, the other our managed funds team.

On the directly invested side we have established a Stock Selection Team, which again comprises some of our more experienced investment managers and whose job is to translate the broad top-down asset allocation decisions consistently into portfolios across all investment mandates. So if our decision is to be overweight US equities, this is reflected across balanced, growth and corporate clients. The team populates reference portfolios for all investment mandates using the methodology described below, so that we have consistent views on the underlying equity investments.

Beside the Stock Selection Team sits a highly experienced and dedicated team of senior investment managers who are charged with handling client relationships and implementing the ideas generated by the Stock Selection Team in a way that is consistent with their clients' requirements. This group has an integral role in providing

feedback from our IFAs and intermediaries, in generating new investment ideas and in challenging the reasoning behind the work of the Stock Selection Team.



Kathie Langfield
Senior Investment Manager

Importantly, we are specifically not going down the route of dividing the investment side of the business from the relationship side. All members of the Stock Selection Team also manage client relationships, and all investment managers are kept abreast of market developments and changes to our 'house' view through daily, weekly, monthly and quarterly in-house meetings. These ensure that there is a two-way flow of ideas between all managers, that client concerns are addressed right across the company and that best practice is shared amongst us all. In support of this we make a very significant investment in building research libraries covering the stocks we like and dislike and explaining the rationale for our investment decisions.

An investment process is the methodology by which we implement our investment philosophy and approach.

Our process is the mechanism by which we identify mispriced securities and exploit them for our clients. It is important to have a formal process, because what we are seeking to provide our clients and intermediaries is a clearly defined, consistent, rigorous and replicable investment service.

In the directly invested side of Principal's business, we screen our investment universe (the FTSE 350 index of the largest companies in the UK, excluding investment trusts) for historic and consensus future earnings, dividends, balance sheet strength and net assets. We aim to do two things with this data; firstly we assess whether our view of a company's prospects is markedly different from the consensus. If it is, we will use our own estimates. Secondly, we gauge where the resulting future valuations stand compared with the company's history, with other companies in its sector and with the general market. We then make a judgement on the appropriate relative valuation for each company based on, amongst other criteria; our view of company management; industry fundamentals; prospects for corporate change; and where we stand in the economic cycle.



Hugh Weston
Senior Investment Manager

Only then do we look at momentum and technical indicators. We are fundamental investors, and these tools are only used for confirmation of our fundamental analysis.

This process provides us with a list of attractive investments with which we populate portfolios. Typically these will have between 30 and 45 holdings, and are therefore relatively concentrated. However, because we are conservative investors whose aim is to generate incremental and gradual out-performance, we have imposed upon ourselves a set of portfolio construction rules. These prevent us putting all our eggs into one basket - and indeed preclude us from ignoring the largest sectors, even if we wanted to do so. We also have a set of rules limiting the size of any individual stock position, which is scaled to the size of the company involved.

The aim is for us to be benchmark aware, but not index trackers. We are not afraid of risk - this is after all where we hope to generate value - but we do seek to control it.

Having made our decision, we monitor our investments closely against relative target bands. It is crucially important that we retain a rigorous buy and sell discipline for our clients' holdings.

Conclusion

We are seeking to create sensibly constructed, risk aware portfolios of good value shares for our clients. We want to be nimble, adaptable and pragmatic, but also disciplined, thorough and consistent. From the point of view of our clients and intermediaries, the key is that we are conservative by nature, but open-minded in terms of the universe of assets and ideas we are happy to invest in for you.



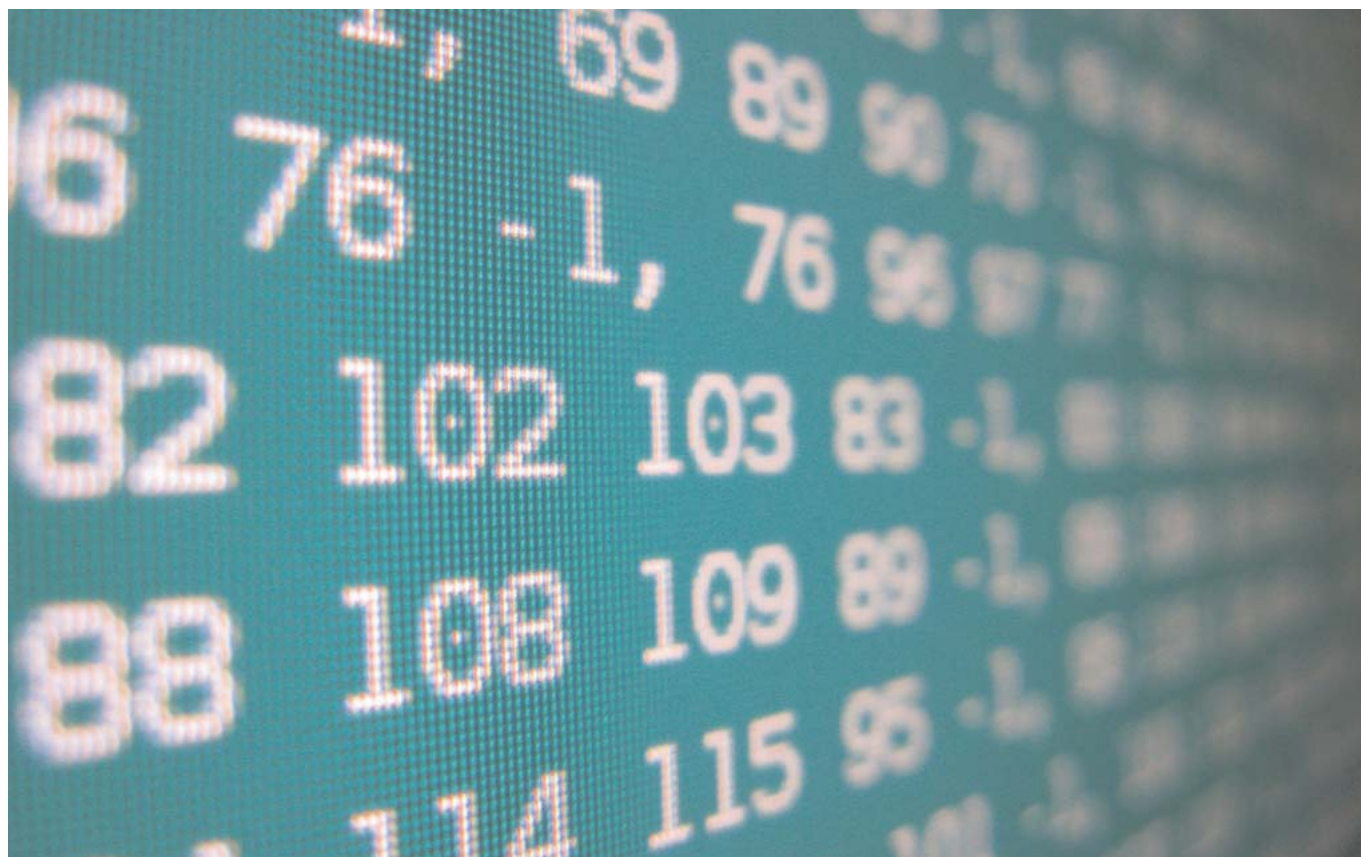
Neil Whelan
Investment Manager



Becca Davies
Assistant Investment Manager



Scott Robertson
Investment Manager



MARKET LEVELS AND MOVEMENTS TO 31 AUGUST 2009

UK Equities

	Index	vs Last Month %	YTD Total Ret %
FTSE 100	4,909	6.5	10.7
FTSE 250	8,818	10.2	38.6
FTSE SmallCap	2,704	13.1	45.8
FTSE All Share	2,521	7.1	14.1

Overseas Equities

	Index	vs Last Month %	YTD %	YTD (£) %
US (Dow Jones)	9,496	3.5	8.2	-4.5
Europe*	137	5.4	18.8	8.2
Japan (Nikkei)	10,493	1.3	18.4	2.1
Pacific*	323	-0.7	40.1	29.5

*based on FTSE All-World Indices Europe ex UK and Pacific ex Japan respectively

UK Valuation Yardsticks

Market P/E	16.6	(historic, FTSE All Share)
Index Linked Yield	0.7%	(over 5 years, 5% inflation)
Market Yield	3.5%	(net historic, FTSE All Share)
Base Rate	0.5%	

Bond Yields

	Now %	End 2008 %
UK	3.6	3.1
US	3.4	2.3
Germany	3.3	2.9
Japan	1.3	1.2

(based on ten year Government bonds)

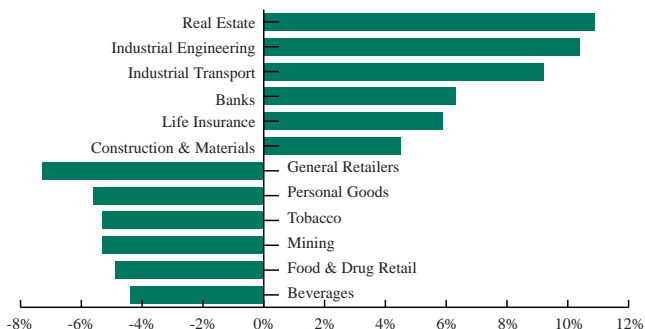
Currencies

	Current Rate	YTD %
£ vs US\$	1.6	13.4
£ vs Euro	1.1	9.8
£ vs Yen	151.2	16.0

Source: Datastream

Sectors of the Month

Best Outperformers



Worst Underperformers

Note: Percentage changes are relative to the FTSE All Share index

Source: Datastream

FTSE 100 Index

Last twelve months



Source: Datastream

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