

We continue to expect Equities to outperform Bonds and Cash.

Under a scenario we have called “Globalization at Work”, investors still face a combination of high and growing corporate profits, still low interest rates and reasonable valuations. We will once again base our presentation on “the 4 fundamental pillars of the investment scene”.

These four pillars are:

- 1. The economy and corporate profits**
- 2. Inflation and interest rates**
- 3. Investor sentiment and the required returns**
- 4. Asset valuations and the expected returns**

1. The economy and corporate profits

The world economy is still growing, notwithstanding the clear and present slowdown in the USA.

In 2006 and for the third year in a row, world GDP has grown by more than 4%. It will actually, most probably turn out to be closer to 5% for 2006.

CapitalatWork has been arguing for years that Europe would sooner rather than later start to grow at a faster pace and possibly, at some point, grow even faster than the US. We have reached this point now and just as the US is slowing down, Europe is picking up.

We are still convinced that Europe’s growth is healthy and based on very strong fundamentals. Private and corporate balance sheets are very strong after years of under-consumption and the EU enlargement (27 countries now) creates a huge, young and dynamic internal market.

Whether the US is going into a soft landing (the majority view) or a hard landing (the minority view) will not be unimportant but other economies, such as those of China, India, Brazil, Russia have become large enough and hopefully self-sustaining to keep the world growing especially if Europe and Japan continue to recover.

We still expect the US economy to land softly, especially if commodity prices in general and energy prices in particular were to come down further, but certainly do

not rule out a hard landing. That is why we are cautious with regards to everything related to the US, first and foremost with regards to the US Dollar.

We remain very sceptical with regards to the political will (although Mr. Hank Paulson seems to be a smart and very determined guy) to tackle the looming fiscal, pension and healthcare deficits.

Beyond the US slowdown, we still don’t see many reasons why global growth will not continue in 2007 and beyond.

Of course there are problems. Yes, there are always problems, even when the economy is growing. Often because the economy is growing.

2005 and 2006’s main worry was the price of oil (still above 60 Usd/barrel) which supposedly raises costs, raises inflation, raises interest rates and lowers growth.

Well, the global economy’s resilience in the face of higher commodity prices in general and higher oil prices in particular is another surprise of the past two years. Excluding energy, inflation has remained under control, interest rates have stayed low, companies have lowered some other cost items and growth has continued unabated.

One overriding fact stands out: companies, all over the world, are very profitable.

In 2003 and 2004, priority had been given to deleveraging (debt reduction), including off-balance sheet items like pension-fund liabilities.

In 2005, 2006 and our expectations for 2007 are that money continues to go back to shareholders in the form of dividends and share buy-backs or is being put to productive use through increased capital spending and acquisitions. 2005 and 2006 are record years for corporate transactions and, again, we see no reason why this trend could not go on in 2007.

So, our best judgement is that companies will continue to generate huge cash-flows, based on normal, healthy and sustainable developments!

2. Inflation and Interest Rates

The picture is basically as follows:

- Central banks all over the world have been tightening monetary policies. Some central banks are basically done (US & UK), some are still busy (Europe), some are only getting started (Japan).
- Bond investors have stayed relatively calm during that tightening process, with long rates in fact still close (+ - 1% above) to multi-decennia lows!

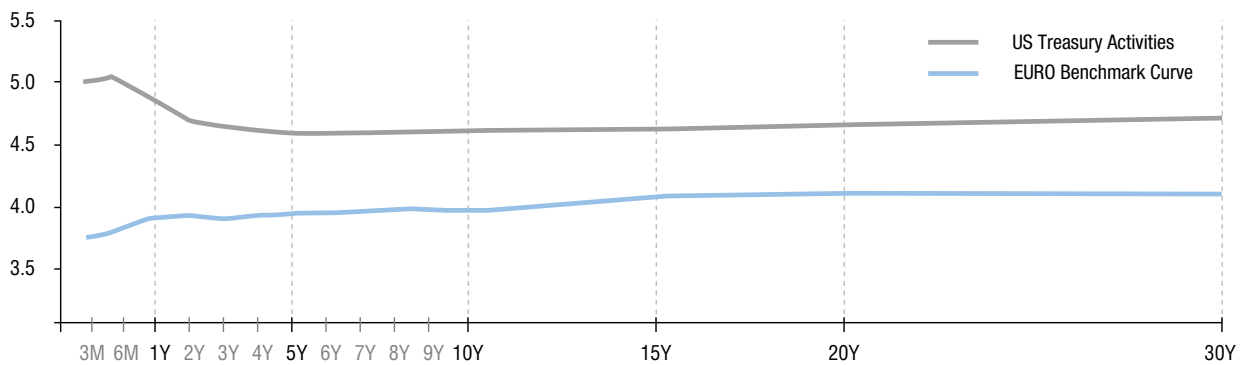


Fig.1: Usd & Euro Yield Curves. The result of the above two trends is, of course, a flattening of the yield curves.

In contrast to widespread views, we still don't see this flattening as a leading indicator of economic hardship, certainly not for Europe. Please note that risk-free short rates at 3% to 4% in Europe and 4% to 5% in the US are the first meaningful competition to equity returns in a long time.

The trillion-dollar question is and will always remain: what future levels of inflation are we to expect?

- At CapitalatWork, we have had the tendency over the years to stick to our "low-inflation" view of the world, in sharp contrast to the huge swings in consensus expectations, which have regularly gone from fears of inflation to fears of deflation and back again. During 2006 we have again witnessed quite a reversal in fears. In synch with oil prices, we went from anxieties on the inflation front in H1 to confidence in H2.
- Our low-inflation scenario was and still is based on an unwavering faith in the benefits of free and competitive markets for capital, labour, services, goods and increasingly also for taxes.
- What future inflation are interest-rate markets currently discounting?

Europe - Euro			
	Nominal Bond Yields	Real Infl.-linked Yields	Discounted Inflation
5 years	3,90%	1,90%	2,00%
10 years	3,90%	1,85%	2,05%
30 years	4,40%	2,10%	2,30%

USA - USD			
	Nominal Bond Yields	Real Infl.-linked Yields	Discounted Inflation
5 years	4,60%	2,40%	2,20%
10 years	4,60%	2,35%	2,25%
30 years	4,70%	2,20%	2,50%

Inflation expectations have come down (because of higher real inflation-linked yields) and converged in the course of 2006, with expected US inflation barely 0,25% (0,5% one yr ago) higher than in Europe. Also, expected inflations are now in line with CapitalatWork's low-inflation expectations.

- We stick to our view that there is little value left in the government bond-market, but we do discover pockets of value here and there.

We own selective bonds in emerging markets like

Turkey Government	Turkish Lira (after 20% sell-off)	at 18% nominal yield
Poland Government	Polish Zloty	at 2,6% real yield + inflation
Brazil Government	Brazil Real	at 7,5% real yield + inflation
Mexico Government	Mexican Pesos	at 3,5% real yield + inflation

We own great corporate bonds like

Vinci	Euro	perpetuals	at 6,34% nominal yield
Bayer	Euro	perpetuals	at 6,12% nominal yield
Linde	Euro	perpetuals	at 6,64% nominal yield
Solvay	Euro	perpetuals	at 5,68% nominal yield

Through hard and selective work we manage to have a 6% running yield for a 6 year duration in our Bonds at Work fund, and a 2,80% running real yield (+ inflation) for a 8 year duration in our Inflation at Work fund.

3. Investor sentiment and required returns

Obviously investor psychology is an important aspect of the overall problem and not the easiest to harness as humans are diverse, complex and changing. At CapitalatWork we have the advantage of meeting a lot of investors, both amateurs and experts, and, so doing, we get a good sense of their current state of mind.

In 2005 and 2006 we hinted at gradually changing sentiment towards the asset-classes; a change for the worse for bonds and a change for the better for equities. This is exactly what has happened but we think there is further to go.

Again, this is basic human nature at work. People always tend to extrapolate past trends into the future. It was our take that it would take at least three years of equity-outperformance for perceptions of a trend to kick in.

In practice ?

- In a flat yield curve environment, asset allocators (ALM-committees) are almost uniformly reducing the duration of their bond holdings, bracing themselves for potential higher long rates.
- Asset allocation intentions towards equities are clearly on the rise, but investors haven't yet put all their available money where their mouth is!

Sentiment is supposed to be a contra-indicator. Positive sentiment towards an asset or an asset-class being an indication of positive newsflows already being discounted (it's in the price) and obviously vice versa for negative sentiment.

If this is true (and it certainly is partly true) current improving sentiment is less bullish for equities than it has been over the last three years - but - we think a lot of money still has to come into equities and valuations must be much higher before we can talk of "fully discounted bullishness".

4. Asset Valuations and expected returns

For the broad averages, remarkable growth in earnings and a benign long rates environment, make for still very reasonable valuations as illustrated by the above of the expected returns on European equities and available yields on nominal and inflation-linked government bonds.

At CapitalatWork, we spend a lot of time and efforts valuing company stocks and bonds, through our specific “Entreprise Value” & “Free Cash Flow” comparisons.

If we look at our “Core” and “Own” stocks,

- The average expected FCF-return on equity is 10,98% (11,75% last year), based on current market price for equity, the current FCF generation and future FCF-growth of +- 3%.
- Were we to require an average 10,5% return on our equity investments, which is a 6% to 7% risk-premium above govt bond yields, based on the same current FCF and future FCF growth, the undervaluation of above stocks would amount to an average of 14,6% (20% last year).
- Our companies don’t need to grow spectacularly to justify owning them. The implied future growth rate of the current FCF stands at 1,76% (1,00% last year), were we again to require an average 10,5% return on our equity investments at current market prices.

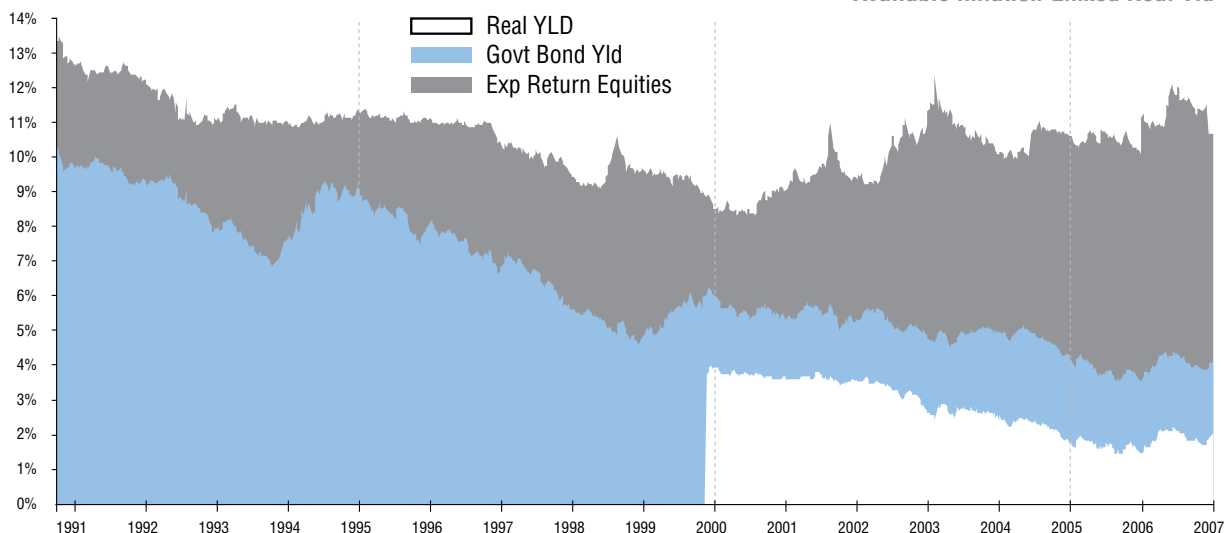
Two more views:

- The average current FCF to remunerate total Entreprise Value (Equity + Debt) at market prices stands at 5,6% (6,0% last year).
- The average current FCF, after debt service, to remunerate the Equity part of Entreprise Value only also stands at 5,95% (6,45% last year).

In our best judgement, these are still attractive propositions.

CONCLUSION:

With interest rates still near multi-decade lows, discounting low inflation and low default rates, bond valuations are generally not very attractive. Value is in extreme selectivity. With company FCF at all-time highs, equities are where the value still lies.



Our portfolios and our funds at Work

In absolute terms we have had a good year but in relative terms only a mixed one.

- The equity part of our portfolios went up by 7% to 17% (see table below) over the last year.

In comparison, the MSCI World Index in Euro is up 8% in 2006.

- The fixed-income part of our portfolios basically broke-even last year with returns between -0,7% and +0,7%.

In comparison the JPM Global Government Bond Index (75% hedged / 25% unhedged) had a -0,4% negative return and the Barclays Global Inflation-linked Index had a -1,7% negative return.

These returns are completely in line with the expectations we had at the beginning of the year.

What worked for us?

1. Our asset allocation was again right on the mark.

We have been overweight equities vs. bonds and cash to the maxima allowed by our client and fund guidelines. We have kept our exposure to the US Dollar as low as possible.

2. With few exceptions, our stocks performed well, both on a operating basis and on a stock price basis.

Most of our companies managed to grow their top-line, did a good job of cost-containment, therefore managed to grow their bottom-lines and have been rational users of the generated cash. Our companies tend to be in economic-sensitive industries and to have a strong international exposure.

What worked against us?

1. On the bond side, obviously higher interest rates.

Although not spectacular, the rise from 50-year low interest rates over the last 2 years has hurt bond returns. Just like in 1994 and 1999, did the most defensive portfolios suffer most. After years of great bond returns, low to negative returns were inevitable.

2. On the equity side, a rising tide of “Global Growth” and “Global M&A”, lifted all boats and selectivity didn’t play as big a role as we generally like.

Our rigorous focus on superior businesses has always led to ownership of top-quality companies which ironically have NOT been the favoured targets of the M&A players over the last two years.

This phenomenon is likely to remain a fact of life for CapitalatWork and its clients as we are not going to change our discipline.

3. The international diversification of our portfolios sort of worked against us, relatively speaking, as our own Eurozone was very very strong.

This is even more ironic. In line with our outspoken positive stance on European growth and European stock prices, we have been overweight European stocks versus global benchmarks (which explains our strong outperformance vs the MSCI World Index) but ... underweight versus some of our local competitors.

It is not a new phenomenon that some of our competitors have played the investment game closer to home. It is unlikely to be because of vision but more because of old habits.

Under our “Globalization at Work” theme we continue to think that owning multinational companies which are able to profit from a globalizing world is the way to go.

4. In our Asia fund, a flat Japanese market and especially the 10% decline in Yen vs Euro, combined with a conservatively low exposure (8%) to Chinese stocks have led to unspectacular results.

CapitalatWork - Equity Funds	Asset Class		Return 2006 in Euro
European Equities at Work	European Equities	Euro	+17,09%
American Equities at Work	American Equities	Euro	+2,17% (13,81% in Usd)
Asian Equities at Work	Asian Equities	Euro	+8,40%
Contrarian Equities at Work	Global Value Stocks	Euro	+14,77%
Growth Equities at Work	Global Growth Stocks	Euro	+7,30%

CapitalatWork - Fixed Income Funds	Asset Class		Return 2006 in Euro
Bonds at Work	Global Bonds	Euro	+0,73%
Inflation at Work	Global Inflation-Linked Bonds	Euro	- 0,77%

CapitalatWork - Mixed Funds	Asset Class		Return 2006 in Euro
Global Markets at Work	Global Equities, Bonds and Derivatives Strategies.	Euro	+4,64%
Global Opportunities at Work *	Global Equities, Bonds, Derivatives and Long / Short strategies	Euro	+8,66%

* The Global Opportunities Fund is only registered in Luxembourg. For other countries, local regulations are applicable. For Belgium a minimum investment of 50.000 Euro is required.

If you have any questions regarding the above or any other matter related to economics and finance, don't hesitate to call upon us for a clear, honest, and interesting point of view.

CapitalatWork's strategic mission is to serve you and help you manage your investments in a rational, intelligent and fruitful way.

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22 years investment experience
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Between 1987 and 1994, Ivan worked for Lehman Brothers as an Institutional Business Developer. In 1994 he joined CapitalatWork where he holds the positions of CEO and CIO. Ivan also manages the Contrarian Equities at Work fund.