investment update

1st quarter 2005

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Welcome to the first edition of our new look Investment Update

In the past, we have published this internally, in a quest for speed of despatch to you. However, advances in printing over the years means that we can now write something here and publish it professionally in a much shorter time period than used to be the case.

Although the look is different, our style of writing is largely unaltered. We want to give you a brief update of what's happened, coupled with our thoughts for the future.

In this edition, we focus on a brief round up of last year, and make comments on some of the key areas in 2005. We also have a postcard from Shanghai: Mark Robinson, who heads the investment team, visited China in late 2004, and summarises his thoughts on the region, and its impact on the financial world.

January 2005

A look back

2004 was a busy twelve months for several financial indicators, each one on their own normally having a major influence on economic activity and sentiment: we experienced, inter alia, soaring oil and other commodity prices, rises in interest rates, continued conflict in Iraq, political uncertainty (US election, India, Ukraine), a significant slide in the US dollar, and moderating growth (allegedly) in China. Most recently, of course, the world is coming to terms with the devastating Asian tsunami, the human and economic cost of which is still too early to determine.

“One unexpected ‘wobble’ during 2004 came from hedge funds.”

As always, there were a number of unexpected events to deal with during the year, although the returns that were achieved from various asset classes were broadly in line with our expectations of a year ago. Major stockmarkets generally made steady progress and have slightly exceeded our expectations, due to an unexpected improvement during the final quarter: returns were ahead of deposit interest, but generally not more than twice the cash (risk free) return. In the current climate of still low inflation and interest rates, we feel that a total return on UK shares (including dividends) should be above 5%, but not more than around 10% per annum.

One unexpected ‘wobble’ during 2004 came from hedge funds, which were impacted by reduced market volatility and worries about Chinese growth in the earlier part of the year. By mid year, it did not seem as though returns from hedge funds would creep above those of cash returns, but the final quarter in particular has seen a good pick-up in fortunes, with returns from the more diversified funds of funds vehicles that we use delivering around twice the equivalent cash return for the twelve months, in line with our expectations.

Looking ahead

Looking ahead, we expect 2005 to be not too dissimilar from 2004 in terms of investment return. However, a lot still depends on the extent to which the global economy begins to slow: latest figures suggests that global GDP growth peaked at 5.3% in the first quarter of 2004, but had fallen to 4.6% by the end of the third quarter (source: IMF; The Economist). If property markets cool down and consumers begin to rein in spending, it could mean that we are near the end of a very short period of interest rate tightening. Overall, we feel that there will be opportunity to generate investment returns ahead of cash, although with equity markets not looking particularly cheap, we may need to rely more heavily on alternative asset classes and income to deliver a greater proportion of return.

Property

Commercial property encountered a year of contrasting periods. The early part of 2004 saw some strong rises in asset values in most sectors, enabling most commercial property funds to enjoy returns well ahead of those from stockmarkets.

> "We remain confident that commercial property can deliver attractive returns in the coming year..."

Recent numbers point to a more selective commercial property investment environment, in terms of both sectoral and regional expectations. We remain confident that commercial property can deliver attractive returns in the coming year, but expect the vast majority of total return to come from income rather than capital gains. Commercial property is still one of the best income-producing asset classes available to us today, and should be viewed principally from that perspective, not one that will also deliver handsome capital gains. It behaves very differently from residential property (the behaviour of the two is largely uncorrelated) and can reduce the overall risk in a diversified investment portfolio. Many private investors and smaller pension funds have little, if any, exposure to commercial property, and the launching of new property funds is generally in response to a growing investor appetite. We welcome more choice, but do not want to see another 'TMT style' bandwagon emerging, which could undermine the integrity of this viable asset class. Care must therefore be exercised in the choice of property manager and investment structure. We also hope that the launching of new funds raises awareness of this asset class but does not create an environment of unsustainable exuberance which would undoubtedly lead to disappointment.

> "We welcome more choice, but do not want to see another 'TMT style' bandwagon emerging."

Mark Robinson
Director
Head of Investment

Postcard from Shanghai

Pick up the business section of any newspaper these days and it is hard not to spot an article commenting on the rapid pace of growth in China. Overseas research visits are an important part of our research process, and last month our Head of Investment, Mark Robinson, visited Shanghai to see what all the fuss is about. Here he provides some facts and figures of which we should all take note...

"Whether you need a real or fake Gucci handbag, a pair of Levi jeans, a Big Mac or a Starbucks coffee, Shanghai has it all."

The 20 mile journey from Pudong International Airport to the heart of Pudong, Shanghai's business district, takes just 7 minutes using the world's fastest commercially operated train. Fourteen years ago Pudong was marshland, but today it boasts the world's highest hotel and 350,000m^2 of building space (with much more planned) to accommodate a permanent population of 3.5 million by 2020. Shanghai's entire population is already approaching 20 million and is expected to reach 30 million in another ten years, despite China's enforcement of a one-child policy: the huge migration of people from rural to urban areas accounts for most of this increase. Clothing, feeding and accommodating this vast demographic shift is not a problem: whether you need a real or fake Gucci handbag, a pair of Levi jeans, a Big Mac or a Starbucks coffee, Shanghai has it all. Already, Shanghai has 2,800 twenty-plus storey buildings, with more being built. Hardly surprising, then, that around 50% of the world's tower cranes are believed to be in Shanghai.

As China's largest port, Shanghai's importance can be measured by the intensive motorway of traffic, often five abreast, moving in both directions along the Huangpu River, carrying both raw materials and finished goods into and out of China. The energy and pace of growth in Shanghai is intense, yet the environmental cost is high, creating a physical smog of success which pervades across the city. Whilst its huge potential is obvious, Shanghai is still a city which is short of clean water and power (air conditioning must be turned off in the summer months), and where the average wage for white-collar workers is less than £2,500 per annum.

continued overleaf

“The Chinese authorities have the complex task of transforming the economy from being the workhorse of the West to the largest consumer-driven economy of the world.”

The experience of Shanghai is being replicated across China, where around 15 million people are moving each year from the country to cities. Already, there are 17 cities in China with more than 20 million inhabitants and around 170 with more than 1 million people (contrast this with the whole of Europe, which has just 15 cities with a population of the same magnitude). But China is still an emerging market: of the 600 Chinese cities with a population of more than 500,000, only around 100 have piped gas and just eight households in 1,000 own a car, compared to 900 in the US.

“China is an investment opportunity, but timing is critical.”

The Chinese authorities have the complex task of transforming the economy from being the workhorse of the West to the largest consumer-driven economy of the world. This they will undoubtedly achieve, but the challenges faced by an economy growing so fast are wide-reaching: with urbanisation comes a rapid increase in the working age population and extra demand for energy and raw materials, not to mention an environmental nightmare; the transition to a consumer-led economy brings significant social change and pressure for political reform; greater wealth means major restructuring of the banking and savings industry, whilst at the corporate level the need for greater accounting transparency intensifies.

China is an investment opportunity, but timing is critical. For those with a 20 year or more time horizon, having some money in China is likely to be a sound investment. However, after ten years of 10% per annum GDP growth, China’s economy is beginning to moderate, which in turn has implications for the world’s other major economies. For now, this is where our attention needs to be, but in the long run we ignore China’s growth at our peril.

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