investment update

3rd quarter 2005

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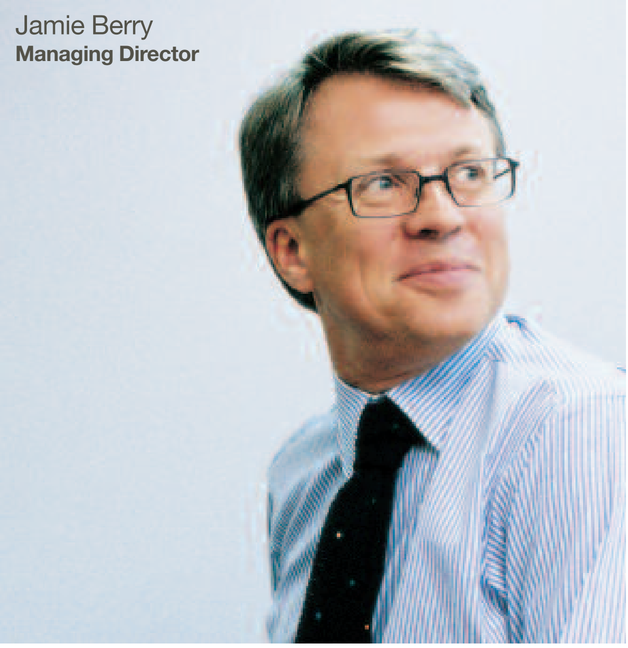


There have been some encouraging moves in global stockmarkets during the second quarter of 2005, which is somewhat surprising given the rather uncertain economic backdrop that has been unfolding. Most stockmarkets had embarked upon a downward path from mid February, and by mid May it seemed as though we would be entering the traditional late spring period of malaise that so often lingers throughout the summer months.

However, there was a swift reversal in sentiment during May, with markets testing and then moving ahead of their February highs. Of the major markets, the UK and continental Europe provided the best returns in local currency terms, whilst the US market was broadly unchanged. The FTSE World Index rose by around 6% in sterling terms during the second quarter, although returns were flattered by a strong US dollar.

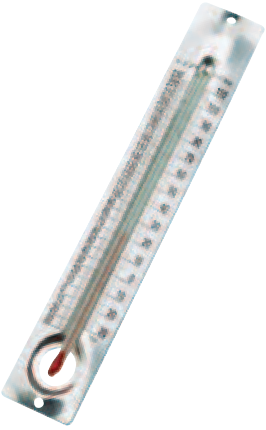
We are half way through the year and most asset classes have provided solid returns in excess of cash in the past six months. Retaining and building upon these returns during the next six months will prove a challenge, but we believe the prospects for making further gains will be enhanced by accessing both active stockpicking funds and a diverse asset mix.

In this quarter's Update, Mark Robinson comments on the effects of currency movements on markets this year, and also on important changes afoot in the FTSE 100 Index. Much of what is happening with the FTSE 100 reminds us of the late 1990s, when this index started its journey of losing the plot as a sensible measure of UK equity market behaviour.

This Update was written in the first few days of July, just prior to the terrible events in London on 7 July. As terrorist attacks increase in their frequency and atrocity, so the resilience of markets to such events also increases; as a result, markets fell sharply but recovered their poise within days.

London, like its population, will move forward, but terrorism is likely to remain an ever present threat for the foreseeable future.

July 2005



The FTSE 100 – an increasingly off track benchmark

One reason for markets to have risen in recent months whilst the general economic backdrop has softened can be explained by sector and stock dominance in market indices. For instance, in recent weeks, the rise in the UK market's main barometer, the FTSE 100 Index, can be largely attributed to the very strong increase in oil and gas shares.

However, a new dynamic is also coming into play: currently, BP and Shell are respectively the largest and the sixth largest companies listed in London, although are likely to occupy the top two positions later this month when Shell and Royal Dutch begin trading as a combined entity.

"…are likely to occupy the top two positions later this month when Shell and Royal Dutch begin trading as a combined entity."

Shell's weighting in the FTSE 100 Index is expected to double to around 8% and the sector's exposure will rise to around 20%. In scenes reminiscent of the late 1990s, when Vodafone represented around 11% of the FTSE 100 Index (and just four telecom stocks accounted for over 20% of the UK market), fund managers will be faced with a similar dilemma – do they bring their portfolios into line with what the Index is telling them, or do they follow their instincts and fundamental investment tenets, which tell them that such high concentrations carry a high level of risk? Running against the crowd is difficult, but we would rather pick managers who own stocks for the right investment reasons, than those that own something purely because of its weighting in a benchmark index.

Diversification across markets and sectors is particularly important in the current climate. The FTSE 100 Index is a poor representation of the UK economy, yet it continues to be one of the most popular yardsticks and most widely followed benchmarks by investment professionals, private investors and the media. An analysis of the Index highlights some of the imbalances and risks: just six sectors account for around two thirds of the Index; the top 10 companies account for more than 50% of its total market capitalisation; the bottom 40 companies (including some very familiar 'household names' such as British Airways, ICI, Next and Boots) collectively have just a 10% weighting, equivalent to the size of BP on its own.

From this it is easy to see that a small number of sectors and stocks dominate the UK market and are capable of moving it quite sharply both up and down. Currency is also a major influence. Many large UK companies earn a substantial proportion of their profits in dollars, so any move in the dollar has a significant impact on the market's direction. It is therefore quite possible for broad economic influences to be concealed and for markets to become detached, at least in the short term, from economic reality.

"The FTSE 100 Index is a poor representation of the UK economy…"

Just say 'non'

European markets seem to have taken the rejection of the EU constitution by France and Netherlands in their stride.

Shares have been boosted on hopes of improved export demand, led by the euro's weakness, whilst business confidence surveys from France and Germany suggest that conditions are not as poor as originally feared. However, the eurozone economy is still growing at a very slow pace compared to the other major economies, and could easily drift into recession territory. Whilst the economic picture is not particularly bright, the opportunities for stockpicking across the eurozone have possibly improved. Companies know they must rise to the challenge of international competition and seek out ways to innovate, restructure and form alliances.

Mark Robinson
Director
Head of Investment

Investment overview

Changes in interest rate expectations around the world seem to have been the primary influence for markets and have also been responsible for big currency fluctuations in the past quarter. Just a few months ago, most expectations were for a further rise in global interest rates this year, but in a swift reversal it now seems that the US is currently the only central bank considering such a move in an effort to control inflationary pressures.

The price of oil has again influenced sentiment and monetary policy, retreating to $47 a barrel in May and then testing new highs above $60 very recently. The US Federal Reserve is still sufficiently worried about higher energy costs and inflationary pressures that it has increased interest rates to 3.25%, its ninth consecutive move of 0.25% in the past twelve months. However, it may be persuaded soon to take its foot off the brake, particularly if oil demand growth in China begins to moderate further. It is also worth bearing in mind that the US is now much less dependent upon oil than it was in the 1950s and is still very cheap in real terms (a gallon of petrol is still cheaper than a gallon of milk in the US). However, oil remains an essential global energy source and a key influence on the inflation front.
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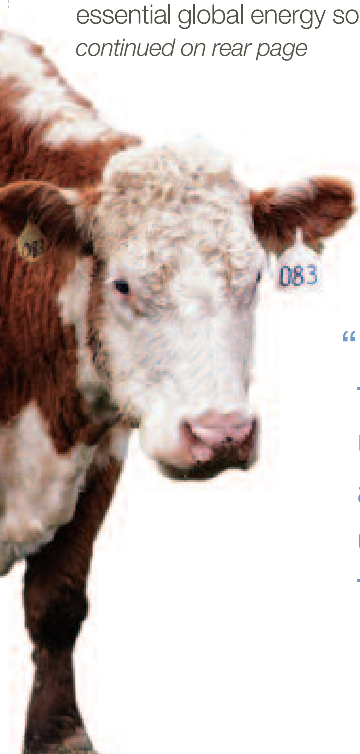

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It is interesting to note that equity market behaviour has become rather detached from economic growth rates, suggesting that corporate profitability is still moving along at a good pace. Many UK businesses have amassed large amounts of cash on their balance sheets and are busy buying in shares for cancellation or handing it back to shareholders. Dividend growth remains robust and is providing a strong underpin to the market.

Even in Japan, we are seeing evidence of a shake up in attitude towards investors. The big banks' incestuous cross-shareholding culture has gone and has been replaced by a new framework of corporate accountability. As external share ownership has increased, so the delivery of shareholder value has risen to the top of the corporate agenda. This is encouraging a new breed of Japanese company and bodes well for future investment opportunity.

"Many UK businesses have amassed large amounts of cash on their balance sheets."

Investors are becoming more discerning about the prices paid for shares, and as we flagged earlier this year a moderate switch away from smaller companies to larger entities seems to be underway in most markets. Smaller company fund managers argue that their part of the market offers superior growth rates and that higher valuations are justified, but after some very sharp increases there is now very little room for earnings disappointment in our opinion. We have been addressing our exposure to smaller companies in recent months, and will continue to move portfolios up the market capitalisation scale, where better value can be found.

"Better value can be found up the market capitalisation scale."

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