investment update

4th quarter 2005

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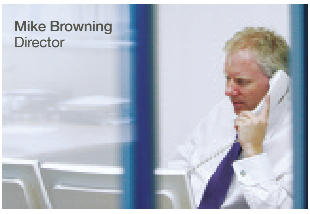


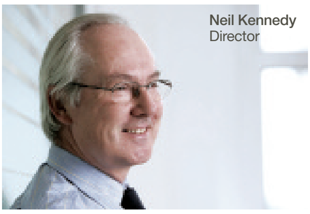


## Equity markets have generally performed much better than expected over the course of this year, and this does give us some mild concerns for the quarter ahead. If anything, some of the risks have increased over the past few months rather than eased, particularly those that revolve around economic impact of higher energy prices. With three quarters of the year now gone and with equity markets generally having delivered more than twice our expected return, it is time for a modest reappraisal.

Although we are firm believers in the long-term benefits of equity investment, we also acknowledge the importance of banking profits when stockmarkets have become a little detached from economic reality. We are therefore inclined to be reducing our overall commitment to equity markets on a short-term basis, and increasing exposure to more defensive instruments such as fixed interest securities and cash.

For new investors, there is plenty of scope to be introducing alternative asset classes into a portfolio and building equity market exposure more gradually as opportunities arise and the economic coastline becomes a little clearer.

In this quarter's Update, Mark Robinson takes a closer look at Japan. There have been so many false dawns in Japan that remarks about the land of the rising sun are wearing a bit thin. This time, however, it really may be different.

October 2005

# Japan – a nation undergoing change

**While the focus of attention in recent months has been on hurricanes, oil and its impact on global growth, something slightly less newsworthy has being going on in Japan. September 11th marked the fourth anniversary of the atrocities in America, but it also marked the day on which Japan's reformist prime minister, Junichiro Koizumi, was re-elected. Whilst the rest of the world has been preoccupied, Japan has quietly been trying to get back on track after the economic derailment that has plagued it for the past decade.**

The past was a country saddled with debt, corruption and inflexible labour policies: companies owned each other through a complex web of cross-shareholdings, and were lent money based on fragile or non-existent business models by banks which were barely viable themselves; corruption both at the political and corporate level was rife; and the 'job for life' culture created a corporate culture that had little room to manoeuvre when times got tough.

Slowly but surely, however, things appear to be changing. Banks' bad debts have more than halved in the past four years as non-performing loans have been written off and companies have 'admitted' failure; labour laws have been relaxed to allow more flexible working practices, reducing the cost of production and improving corporate profitability; Japanese individuals are slowly starting to rebuild their personal balance sheets as employment and wages recover and property values begin to stabilise.

"…it could offer a safer haven from some of the troubles elsewhere."

There have been many false dawns on Japan's economic recovery over the past few years, but the present recovery does seem to have some real substance. Koizumi's win is certainly good news and provides continuity for his economic recovery strategy. It is not all good news, however. There is still much work to be done to reduce the overall level of corporate debt, which is still high by international standards. The country's economic growth rate, which the OECD forecasts will be 1.8% this year, is also low in comparison to other developed markets. That said, Japan's high-end technological edge over the rest of the world has remained throughout its troubled past, and there is hope that it can work with, rather than against, some of the low-cost powerhouses of China and India to maintain its strong competitive position with America and other developed economies.

The future for Japan does look much brighter and it could offer a safer haven from some of the troubles elsewhere. It is likely that we will be increasing our exposure, where appropriate, in the near future.

# US – leading or trailing Europe

**If we were to allocate capital based on the market value of companies and stockmarkets, then America would be the largest allocation with more than 50% of our exposure. The fact that our commitment to the US market, other than for dollar-denominated investors, has been nowhere near this figure has been driven by various factors, including concerns over America's twin deficits and the plight of the dollar.**

However, one of the strongest influences has been the heady valuation at which the US equity market has traded versus other developed stockmarkets. This decision to be underweight US equities has paid off in 2005: the S&P 500 Index of leading US companies has made no gains this year in dollar terms, contrasted with the UK, European and Japanese markets which have risen by around 16%, 21% and 19% respectively in local currency terms.

We should not forget that having some exposure to the world's largest economy, no matter how stretched valuations may seem, is still important, particularly if companies are capable of delivering greater profitability than international equivalents. It is interesting to note, for instance, that the average earnings growth for S&P 500 companies is expected to be around 13% for 2005, compared to around 9% for FTSE 100 companies (Source: Reuters Estimates). The US estimates are much higher than expectations earlier this year. If they achieve this, then it will only be the third time in the past fifty years that the S&P 500 companies will have delivered more than 10% earnings growth for ten or more quarters in a row. After the previous two occasions, the US equity market delivered some solid gains.

All this suggests that the US market may not be as overvalued as many commentators have thought and that there may be some catching up to do relative to European markets in particular. However, we should not forget that the US is probably still the most vulnerable of all big economies to a slowdown, which could be accelerated by a further spike in energy prices linked to a harsh winter. This may cause US households to re-examine their borrowing and spending habits, which have kept the economy afloat for so long.

"…the US is probably still the most vulnerable of all big economies to a slowdown."


# The year so far

**For much of this year global stockmarkets have worried about the impact of higher energy prices and the impact on inflation, raising further concerns for the direction of interest rates. At times, the upward pressure on energy prices has been fierce: leaving aside the massive humanitarian impact, the devastation caused to the Gulf Coast's infrastructure by hurricanes Katrina and Rita has caused significant disruption to oil production at a time when domestic demand was already at a peak.**

This has come at a time of continued strong demand for energy and commodities from Asia. The price of oil stopped short of $70 a barrel, largely due to the release of oil from strategic reserves, but this may only be a temporary solution for a commodity which is still seeing strong global demand and suffering from supply restrictions. After some initial concerns, it now seems that the long-term economic impact of the hurricanes will not be as great as first feared, with the negatives possibly being neutralised by the growth brought about through reconstruction and regeneration in the region.

"…it now seems that the long-term economic impact of the hurricanes will not be as great as first feared."

# A shift in market sentiment

**As we write there seems to be a shift in market sentiment from one which fears higher global inflation (and higher interest rates), to one which is acknowledging the brake on economic activity caused by, amongst other things, higher energy prices.**

> "…and respond soon to weaker economic growth, and a severe slowdown on the high street."

In the UK, for example, there is a real possibility that the Monetary Policy Committee will have to modify its inflation forecast and respond soon to weaker economic growth, and a severe slowdown on the high street, by reducing interest rates further. This should provide a more benign backdrop for bond markets, which have been looking overvalued in some areas. In continental Europe, the chances of an interest rate cut are less likely given the European Central Bank's firmer approach to controlling inflation.

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