investment update

FASTEN YOUR SEATBELTS

Not the first crisis, not the last

SO WHERE DID IT ALL START

All was looking well until...

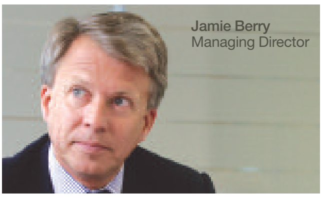
2001
2005
2004
1988

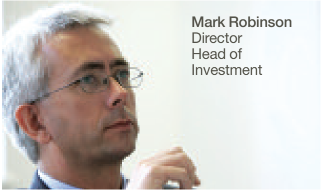
HEDGE FUNDS – IN THE THICK OF IT

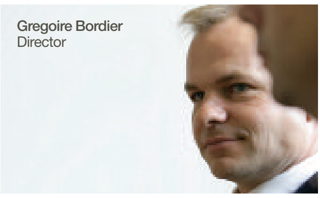
Black box meltdown

BERRY

FASTEN YOUR SEATBELTS







It is hard to recall a more turbulent quarter in financial markets than the one we have just experienced. Anyone who has been away throughout this period might be puzzled that UK savings rates appear to be a little better, yet interest rates have stayed the same, and therefore slightly sceptical about stories of savers with Northern Rock forming long queues outside its branches demanding their money back.

Did the Bank of England really step in as lender of last resort to the tune of several billion pounds, and was its Governor invited to answer questions about his action in front of a Treasury Select Committee? Unfortunately, it was all true. Overall, it has been a quarter where confidence in the financial system has been tested to its absolute maximum and at times reached, to pardon a pun, rock bottom. Serious as all these events have been, on reflection the news media has possibly played its part in exacerbating the alarm and panic that we have witnessed, and contributed to the extreme volatility in virtually every asset class.

This is not the first financial crisis the world has ever seen, and it will not be the last either, but we learn from each one and become a little more risk averse until the next wave of easy money and optimism overcomes rational thought processes. The financial system, stockmarkets and virtually every other class other than cash have been through several rounds in the ring and come away with bruises, some nastier than others. The healing process may take some time to reach all parts, but it has already begun and confidence is slowly returning to markets. This does not mean that we are out of the woods, but the fundamental backdrop for investment does appear to be a lot brighter than it did at the height of the summer.

Mark Robinson

October 2007

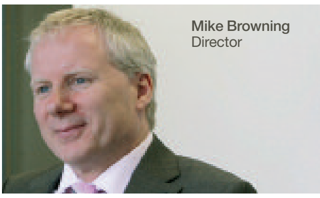
HEDGE FUNDS – IN THE THICK OF IT

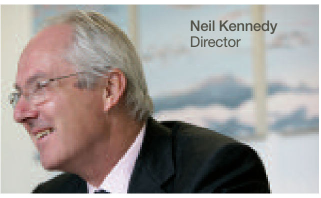
Several hedge fund strategies came unstuck during the summer downturn, with some quant-based managers falling victim to 'flaws' in their technical models, the output from which caused losses to be accentuated.

Similarly, those managers that were too highly geared and could not bear the pain any longer were forced to change tack mid-way through the period and did not benefit from the subsequent rebound. Those that were able to sit through the turbulence have fared much better and are now posting some better returns. Our exposure, via diversified funds of hedge funds rather than single managers, has seen some decline in value, but the funds we use in client portfolios generally did the job that they were meant to do whilst equity markets were tumbling, that is to provide a good level of protection from the sharp falls and to exhibit lower levels of volatility.

"Those that were able to sit through the turbulence have fared much better..."

SO WHERE DID IT ALL START





To find the origins of this crisis we need to look at the monetary backdrop over four years ago. In June 2003 the US Fed Funds interest rate had fallen to just 1%.

The technology-induced economic boom of the late 1990s had run out of steam and the terrorist events of September 2001 had caused an acceleration of the downturn. Low interest rates provided fertile ground for mortgage lenders to kick into action. Unscrupulous lending practices became commonplace, and so-called 'liars' loans', where both borrowers' income and assets were stated, but not independently verified, grew in number, as did a variety pack of other document-light loans designed to appeal to a broad church of potential US borrowers. These mortgages were bundled up into collateralised debt obligations (CDOs), were awarded a variety pack of ratings by credit rating agencies, and sold on (often in smaller chunks) to banks, institutional investors and hedge funds according to their risk appetite. All was looking well until US interest rates started to rise, mortgages went into default and the new structures around which this sub-prime debt had been repackaged needed to be valued. With no ready market in these securities, valuations became questionable and banks began to take a much closer look at all their credit risk, not just sub-prime related. Contagion set in and before we knew it they had closed off the avenue of cheap funding for private equity deals and leveraged buyouts which had been so instrumental in driving markets to new heights in the early part of the year. The rest, as they say, is history.

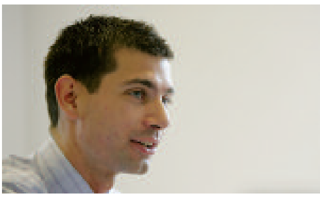
"Low interest rates provided fertile ground for mortgage lenders to kick into action."

2001 1990 1994 1998 2004 2005 1997 2002 2006 1985 2000 1988 1993 2003 1986

“...it reignites some of the fires that are still smouldering...”

Whilst the extent to which financial institutions were or are still exposed is becoming clearer by the day, there is still much uncertainty over the duration of the lending gridlock that has gripped money markets. To some degree, participants are playing each other at their own game, reluctant to extend credit for fear that borrowers have the same illiquid assets on their balance sheets. However, conditions have certainly eased, with UK 3-month lending rates between banks having fallen from their peak of around 6.9% in early September to below 6.25% now. But lenders are still being very choosy about whom they do business with and on what terms, and the longer this goes on the greater threat there is to the economy as a whole.

In common with the Fed, the Bank of England may need to reduce rates, but care is required to ensure that any action does not become so accommodating that it reignites some of the fires that are still smouldering, and causes a repeat of the situation that created all the trouble in the first place. On balance, this seems very unlikely, as financial institutions and many consumers have learned a hard lesson, that living beyond one’s means and relying on continued strength in asset prices are not comfortable bedfellows.



To summarise, markets are working their way through the characteristics of a typical cycle, where easy money leads to increased lending, asset price bubbles, speculation and greed, and is then normally followed by overheating, tighter credit conditions, defaults, and finally fear and panic. Something for everyone really.

"...easy money leads to increased lending, asset price bubbles, speculation and greed..."

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