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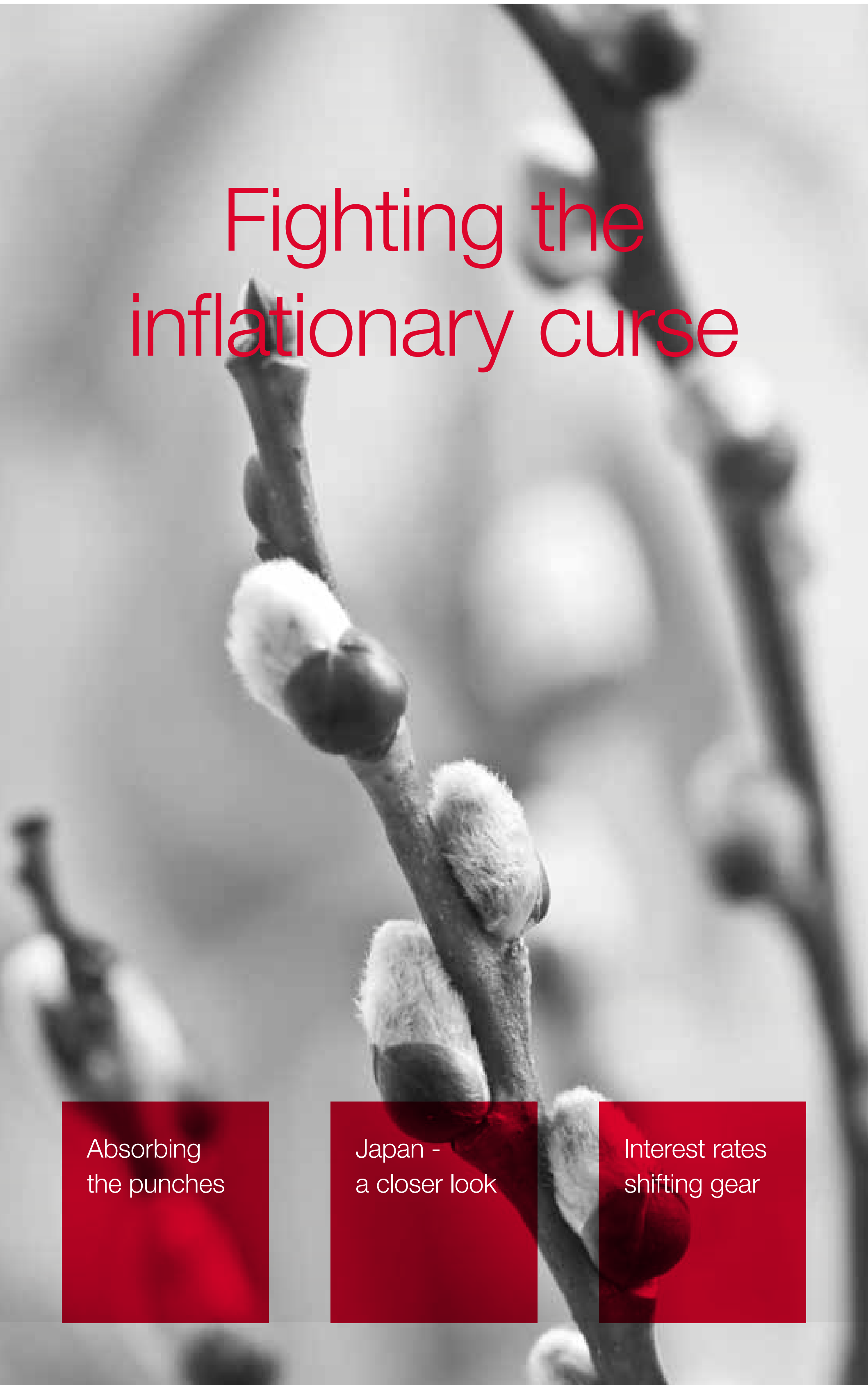
Investment Update

Spring 2011



Fighting the inflationary curse

Absorbing the punches

Japan - a closer look

Interest rates shifting gear

Absorbing the punches

The first quarter of 2011 has seen some significant global events that will change the political, human and topographical landscape of certain countries for a long time. The list of key events seems endless: in the space of three months we have witnessed conflict in the Middle East and Africa, a devastating earthquake and tsunami in Japan, rising oil prices, higher global inflation, further strains within the eurozone and profit-taking in emerging markets.

Mark Robinson
Director
Head of Investment

Remarkably, markets have ended the first quarter in reasonable shape. As this is written, the FTSE 100 Index has recovered to a level above 6,000 points, having fallen close to 5,500 points in mid-March, and the Dow Jones Industrials Average has pushed through and sustained a level well above 12,000 points.

This resilience of stockmarkets and their seeming ability to recover over short periods is perhaps explained by the fact that investors still have very few investment options, unless they are willing to accept a negative real return on their cash. Officially, consumer price inflation in the UK is now running at 4.4%, but for most of us day-to-day living costs seem, and probably are, much higher: the cost of a first class stamp, for example, has just risen by 12% - it may be a small outlay, but it all adds up. We've come a long way from the Penny Black – it's almost ten shillings now in old money!

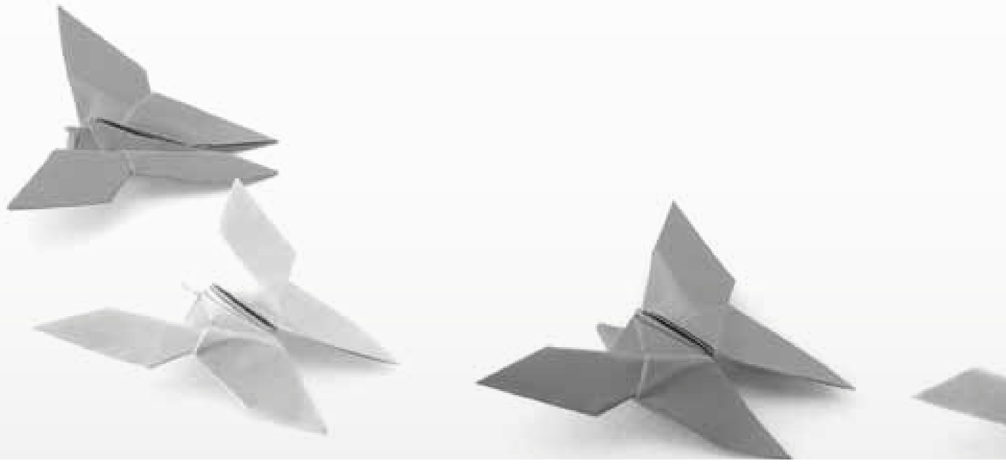
Having cash in the bank may seem reassuring but it shouldn't be: inflation is now eroding savings in real terms (and not forgetting tax), by anything between 3% and 5% per annum. That is neither a pleasant space to be in, nor a recipe for longer term preservation of wealth, let alone handing over greater wealth to the next generation. It therefore explains why, when windows of opportunity are blown open by the periodic storms of market uncertainty, they shut so quickly as surplus liquidity is invested.

Mark Robinson
4 April 2011

Japan – a closer look

Stockmarkets tend to be very bad at both predicting and dealing with low-probability, extreme events, and invariably overreact as a consequence. They also have little respect for the human tragedy that is so often the by-product of such catastrophes. Japan's stockmarket fell by around 16% in the two days immediately after the earthquake and tsunami, but has since staged a reasonable recovery as the full extent of the tsunami and nuclear situation has become slightly clearer. The memories will last a lifetime, but in the near term Japan will rebuild and probably emerge from this crisis with a stronger political and economic framework, something that has dogged it for so many years.

In the short-run disruptions to supply chains are not just likely to impact Japan's economy, which could easily now tip back into recession this year, but the wider global economy too: gone are the days of stockpiling, with manufacturers now relying on the just-in-time delivery of components. With many supply chains temporarily broken in the Japanese automotive and electronic goods sectors, other firms will need to pick up the slack, possibly providing a temporary boost to Japan's Asian neighbours. Some industries, however, may just have to wait for production lines to restart. But this breakdown is not expected to last long and the reconstruction of North East Japan could galvanise a country that, before the disaster, was still very much on its knees.

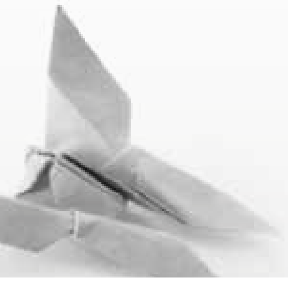


Time flies

It is now two years since the market lows of March 2009, when a recovery in asset values seemed way, way off and fear of a deep and prolonged global recession looked like the only scenario. Of course, we now know that the important steps taken by central banks to inject liquidity into, and restore confidence in, the financial system have averted a major meltdown. But we did come perilously close and many of the scars are still quite visible, not least in the European banking sector and peripheral eurozone economies where countries such as Ireland have come back for more money and Portugal is being stubborn in accepting that it needs to be bailed out.

So where does this leave us from an investment standpoint? Given its financial and structural problems, our strategy since mid-2008 has been to have little or no exposure to continental European markets. This decision has worked well given the underperformance of continental European markets relative to their western counterparts. But a lot of water has now passed under the bridge and we believe it is now time to re-examine our exposure. Whilst further challenging periods will undoubtedly surface in the months and years ahead, we believe that the problems faced by the eurozone's peripheral economies are now adequately factored in to share prices.

Furthermore, the market valuations of many large-cap, global businesses quoted on the core continental European market exchanges are perhaps being unfairly tarred with the same brush as those more exposed to the eurozone's problems. This situation provides opportunities for active managers, so we intend to dip a toe back into continental European markets, hoping to take advantage of the valuation anomalies and the attractive growth rates within several of Europe's stronger, core economies.



Interest rates shifting gear

Interest rates have remained on hold in the UK, US and Europe for over two years, but we are now entering a phase where tightening can be expected. As this is written, the European Central Bank is expected to be one of the first out of the blocks and UK and US authorities are expected to take action later this year, although the timetable has probably been put back following a knock on economic activity brought about by events in Japan, combined with more domestic consumption concerns. In Asia, a shift in monetary policy has already begun, with China raising interest rates to help combat rising inflation. This has unsettled Asian and emerging markets, where some very strong gains have been made in the post-financial crisis period. Although they have regained some composure in the past few weeks, the threat remains of some further shorter-term profit-taking.

Whilst we still regard Asia and many emerging markets as the primary drivers behind longer term global economic growth, their shorter term sensitivity to a sustained high oil price and breakdown in the commodity cycle is high. We therefore intend to rein in some of our exposure to these areas.

Although rates are not expected to rise significantly, a tightening phase, combined with curtailment and reversals of quantitative easing programs, will undoubtedly create a more nervous period for both bond and stockmarkets in the months ahead. A rise in interest rates has largely been factored into most government bond markets, but the timing and magnitude of rate increases is somewhat unclear. There is greater clarity, however, on the delicate path that policymakers must tread – a gentle and controlled tap on the brakes is what is needed, sending a general message of calm, rather than an aggressive movement that propagates panic and brings the global economy to a full-scale emergency stop.

“a gentle tap on the brakes rather than a full emergency stop”

The big question now is whether markets can cope with a more challenging economic period in the months ahead as monetary and fiscal policies are adjusted and the authorities attempt to bring inflationary pressures under some semblance of control. We may be entering more of a mid-cycle economic phase now, but nonetheless we believe that various asset classes still have the capacity to generate satisfactory returns in 2011. We believe that it is particularly important to stay invested in those assets that are capable of tackling inflationary pressures on the one hand and dealing with more challenging periods on the other. For us this still means as full a commitment to shares as risk tolerances allow, and also good exposure to investments such as inflation-linked bonds, gold, property and strategically-positioned bond funds which are also capable of delivering a real return. In our view, being out of the market is perhaps just as risky as being in it, given the corrosive inflationary environment that surrounds us.

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