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ASSET MANAGEMENT (C.I.) LIMITED

## Investment Memorandum

The latest quarter represents a solid one for investors, with modest gains cementing the recovery noted in earlier quarters. Currency movements significantly altered returns for international investors. International bond markets, as represented by ten year government bonds, were steady to firm. Our review discusses why we may have seen such performances in the light of such a poor economic background.

The tables below detail relevant movements in markets:

### International Equities 31.08.09–30.11.09

**Total Return Performances (%)**

| Country | Local Currency | £ | US$ | € |
|---|---|---|---|---|
| Australia | +5.8 | +14.1 | +14.9 | +9.8 |
| Finland | -4.9 | -1.2 | -0.5 | -4.9 |
| France | +1.0 | +4.9 | +5.6 | +1.0 |
| Germany | +2.4 | +6.4 | +7.1 | +2.4 |
| Hong Kong, China | +11.9 | +11.1 | +11.9 | +6.9 |
| Italy | -1.4 | +2.4 | +3.1 | -1.4 |
| Japan | -12.2 | -6.1 | -5.5 | -9.7 |
| Netherlands | +3.4 | +7.5 | +8.2 | +3.4 |
| Spain | +3.2 | +7.2 | +7.9 | +3.2 |
| Switzerland | +0.8 | +5.4 | +6.1 | +1.4 |
| UK | +6.4 | +6.4 | +7.1 | +2.4 |
| USA | +7.8 | +7.1 | +7.8 | +3.1 |
| Europe ex UK | +1.5 | +5.4 | +6.1 | +1.4 |
| Asia Pacific ex Japan | +6.0 | +10.9 | +11.7 | +6.7 |
| Asia Pacific | -3.2 | +2.3 | +3.0 | -1.6 |
| Latin America | +16.4 | +22.7 | +23.6 | +18.1 |
| All World All Emerging | +11.2 | +14.6 | +15.4 | +10.3 |
| The World | +4.3 | +6.2 | +6.9 | +2.2 |

*Source* FTSE World Indices

FT Government Securities Index All Stocks (total return): +0.8%

### International Bonds—Benchmark Ten Year Government Bond Yields (%)

| Currency | 31.08.09 | 30.11.09 |
|---|---|---|
| Sterling | 3.56 | 3.52 |
| US Dollar | 3.40 | 3.20 |
| Yen | 1.31 | 1.26 |
| Germany (Euro) | 3.25 | 3.15 |

### Sterling's performance during the quarter ending 30.11.09 (%)

| Currency | Quarter Ending 30.11.09 |
|---|---|
| US Dollar | +0.7 |
| Canadian Dollar | -3.0 |
| Yen | -6.4 |
| Euro | -3.6 |
| Swiss Franc | -4.2 |
| Australian dollar | -7.0 |

### Other currency movements during the quarter ending 30.11.09 (%)

| Other Currency | Quarter Ending 30.11.09 |
|---|---|
| US Dollar/Canadian Dollar | -3.7 |
| US Dollar/Yen | -7.0 |
| US Dollar/Euro | -4.2 |
| Swiss Franc/Euro | +0.7 |
| Euro/Yen | -2.9 |

### Significant Commodities (US dollar terms) 31.08.09–30.11.09 (%)

| Significant Commodities | 31.08.09–30.11.09 |
|---|---|
| Oil | +12.7 |
| Gold | +23.2 |

### Markets

Equity markets have consolidated the gains noted since the low point last March. The FTSE World Index, in local currency terms, returned 4.3% over the quarter, with returns in sterling, US dollars and euros being 6.2%, 6.9% and 2.2% respectively. In local currency terms, as so often in the past, Latin American and Emerging Markets have been the outstanding performers. The FTSE Latin America Index has returned 16.4% and the FTSE All World All Emerging Markets 11.2%. Of the major areas, the USA was the best performer with the FTSE USA Index returning 7.8%, followed closely behind by the FTSE UK Index with a return of 6.4%. As so often in recent quarters, Australia performed well with the FTSE Australian Index showing a very solid return of 5.8%. Asia ex Japan showed another excellent performance with the FTSE Asia ex Japan Index returning 6.0%. Lagging behind, was the FTSE Europe ex UK Index which returned just 1.5%. The only negative performance, apart from some individual countries in Europe, was Japan which returned -12.2%. Currency adjusted returns were somewhat different as both the US dollar and sterling weakened over the quarter. Sterling adjusted returns for Latin America, Emerging Markets and Asia Pacific ex Japan expanded to 22.7%, 14.6% and 10.9% respectively, whilst continued strength in the Australian dollar increased the sterling return to 14.1%. With European currencies strengthening against sterling, the return on the FTSE Europe ex UK Index rose to 5.4%, only slightly behind that of the UK and the sterling adjusted FTSE USA Index return on 7.1% which was slightly lower than its local currency return as the US dollar weakened slightly against sterling. A strong yen meant that the negative return on the FTSE Japanese Index was reduced to -6.1%.

In the international bond markets, as measured by ten year government bonds, yields fell. In the case of sterling bonds, the gross redemption yield fell by 4 basis points to 3.52%. The fall was greater for US bonds, with the yield declining by 20 basis points to 3.2%. For yen bonds, the fall was 5 basis points to 1.26%. For German bonds, the decline was 10 basis points to 3.15%.

In the currency markets, sterling rose by 0.7% against the US dollar but fell by 7.0% against the Australian dollar, 6.4% against the yen, 4.2% against the Swiss franc, 3.6% against the euro and 3.0% against the Canadian dollar.

In the commodity markets, oil rose by 12.7% and gold by 23.2%, the latter perhaps telling us something about inflation and the currency markets, something we will discuss in this review.

### Economics

Notwithstanding the recovery in international equity markets from their March low point, the international economic situation remains poor with a high degree of risk, although not as bad as the position towards the end of 2008. The worries of bank depositors have been largely addressed and the absence of that uncertainty has removed a major negative from stock markets. Some major financial institutions remain dependent upon official support but a way of managing the position has been found. Insofar as stock markets do not like uncertainty, this represents an improvement on the situation a year ago. Furthermore, the worst of the recession appears to be over internationally. Extraordinary stimulative measures, both monetary and fiscal, have been used in a sometimes unorthodox way to avoid a recession becoming a depression and these measures appear to be succeeding, albeit that they come at a high price which will have to be repaid at some stage.

What are these extraordinary measures? On the fiscal front, budget deficits have been allowed to balloon as no offsets have been made to the fiscal problems caused by the recession which, apart from the help given to financial institutions, has seen tax revenues coming under pressure and government spending rising, for example, on social security benefits to put the problems of recession caused to government finances at their most basic. These are the automatic stabilisers of an economy which help to counter the worst effects of a recession. The other side of the equation is that, in times of boom, the money received from extra revenue or saved in social security must be saved. Unfortunately, politicians are not very good in observing this part of the policy which is why so many countries face serious debt problems both of a current and an overall debt level nature. To put this into context, we show an excerpt from a table in the IMF's World Economic Outlook of October 2009, which shows the magnitude of the problem

**General Government Fiscal Balances as a % of GDP - G 7 countries**

| | | 2008 | 2009 (estimate) | 2010 (estimate) |
|---|---|---|---|---|
| USA | actual balance | (5.9) | (12.5) | (10.0) |
| | structural balance | (3.4) | (5.1) | (5.3) |
| Germany | actual balance | (0.1) | (4.2) | (4.6) |
| | structural balance | (0.6) | (2.2) | (2.7) |
| France | actual balance | (3.4) | (7.0) | (7.1) |
| | structural balance | (3.3) | (4.0) | (4.1) |
| Italy | actual balance | (2.7) | (5.6) | (5.6) |
| | structural balance | (2.7) | (3.7) | (3.8) |
| Japan | actual balance | (5.8) | (10.5) | (10.2) |
| | structural balance | (5.2) | (7.6) | (8.0) |
| UK | actual balance | (5.1) | (11.6) | (13.2) |
| | structural balance | (5.5) | (9.0) | (9.6) |
| Canada | actual balance | 0.1 | (4.9) | (4.1) |
| | structural balance | 0.4 | (2.2) | (1.6) |

*Source* : International Monetary Fund - World Economic Outlook - October 2009 ( excerpt )

For a number of countries, the figures are frightening. Whilst the forecasts will never be exactly accurate, the order of magnitude is not really in doubt. The IMF forecasts an actual balance and, within that, the structural balance, and it is this latter figure which is so disturbing for many countries. Deficits come in two forms, cyclical and structural. Cyclical deficits one would expect in the current environment. These are the deficits which arise as a result of the recession. In a boom, these should be cyclical surpluses. It is the structural deficits which are the worry. As their name implies, these deficits are built into the economy with a chronic excess of government spending over government revenues. It is these which must be addressed. Why ? Because, if they are not, the financial credibility of a country will become in doubt. Increasing the overall level of public debt and the annual servicing costs will put into doubt a country's creditworthiness which, if unchallenged, will eventually lead to a financial and economic collapse as creditors and potential buyers of debt take fright. For a number of countries in the IMF table, and others which are not, the situation looks very serious.

It is self-evident that, in these countries, credible plans have to be drawn up to address these deficits so that these countries can continue to retain their creditors' confidence and be able to sell new debt at acceptable interest rates relative to their peers. This will not be easy and, if they are to succeed, politicians will need a strong resolve in the face of what are bound to be very unpopular measures needed to restore public finances. If they fail to put forward credible plans, the markets will pass judgement in the form of relatively higher interest rates, a credit downgrading or a refusal to buy government debt. At that stage, there will be no choice but to act. The forecasts for government borrowing contained in those IMF tables would scarcely have been believable two years ago. Getting the balance right between tightening too early, too late or at the right time will be a difficult judgement. Tightening too early could prejudice any economic recovery, but tightening too late could result in a financial and economic crisis as detailed above. The balance is probably in favour of risking the former because the financial position of many countries is very fragile at present and the presence of these large deficits is a potential cause of a financial crisis at any time.

Measures to correct these severe fiscal imbalances will, for most countries, be twofold, cuts in public spending (in nominal or real terms) and rises in taxation. Generally, the former will be preferable. Both actions will affect economic growth but rises in taxation are likely to have more damaging long term effects since they will stunt entrepreneurs and risk takers and, in this increasingly mobile world of business, cause companies to relocate business. These negative consequences will reduce a country's long term potential growth rate. However, tax increases may be more palatable for some politicians. In the current febrile atmosphere, it is easy to attack bankers' pay and bonuses and seek revenge by taxing them more, but one has to be careful what one wishes for, because the negative consequences could be far greater in financial terms. Apart from companies and individuals moving to countries with a more benign tax regime, the management of financial institutions which have problems and may be in government hands or rely on government support, requires skilled individuals to achieve as good a work out of the problems as possible. There is no point in cutting off one's nose to spite one's face because it is in everyone's interest to achieve the best result for these companies, including the taxpayer where they are involved.

However moves to restore public finances in the worst affected countries are achieved, they are going to bear down on growth prospects and these countries will almost certainly show lower growth than those countries which have stronger finances.

Monetary policy has been both unorthodox and loose. Interest rates at extraordinarily low levels and the policy of quantitative easing, where applied, have been the manifestation of this. The purpose of very low interest rates has been to relieve the pressure on borrowers, whether corporate or individual. There are, of course, far more savers than borrowers and their purchasing power has been adversely affected. The purpose of quantitative easing, where applied in its various forms, has been to raise economic activity and stave off a depression. This could happen in a number of ways. One was to reduce the level of bond yields for corporate borrowers. Central bank buying, such as, in the UK, of gilts and a small amount of corporate bonds, was meant to push down yields in the bond market, making it cheaper to borrow. The creation of money, for that is what it is, is meant to stimulate the economy in two ways, firstly by increasing the money supply to cause increased economic activity and, secondly, to raise asset prices. In the UK, certainly, it has been more successful in the second case. More money chasing a limited number of assets will raise the price of those assets and the distortion in the financial system caused by ultra low interest rates is spilling over into asset values. The danger of this is that bubbles will develop, the pricking of which can be very painful. Money has been moved away from cash to assets which provide an income. This provides one clue as to why equity prices have been so strong. In comparison with cash and high quality bonds, yields on equities, notwithstanding dividend cuts, have appealed. It is evident that quantitative easing has pushed down bond yields, and here we think that there is a definite bubble. Government bond yields, for example, as shown in the table at the beginning of this review, look far too low for the risks involved in some countries. The risks are the sheer size of certain governments' borrowing requirements and the inflationary risks being run with ultra low interest rates and quantitative easing where it has been applied. It is very noticeable that talk of deflation, which these monetary measures were to stave off, has subsided considerably. At a time of recession, it is easy to be lulled into believing that inflation will not be a problem further out. The size of the output gap, the difference between the productive potential of an economy and the current output level, is cited as a reason for being sanguine about the prospects for inflation on the basis that companies' pricing power would be weak in these circumstances. But the recession will have taken its toll on investment and some capacity will have been lost and we think that inflation could become a problem in some countries. Oil, for example, has already moved up sharply off its low point. Bonds are often considered to be safe stabilising investments in some portfolios, and sometimes they are, but they can also detract severely from portfolio returns if bought on the wrong yield and take a long time to recover. An extreme example is that in the 1960s, a long dated UK gilt was issued with a 5.5% coupon and, in the next decade, another was issued with a 15.5% coupon. That may be an extreme example, but moves on interest rates on medium and long dated bonds can have very serious effects on values. If countries suffer a ratings downgrade, and there will surely be more to come, the effect can be compounded. We feel confident that there is a bubble in bond markets which is why we would avoid anything but short dated issues.

It has undoubtedly been a factor in the recovery of equity prices which do not, we think, look overextended. On dividend yield and price/earnings ratio grounds, they do not look dear although, after such a strong rise, they are likely to be more volatile as they react to positive and negative news and there is bound to be some of the latter. As our tables on the international economic outlook from the IMF and OECD show, the economic outlook is improving, albeit from a very depressed level. Growth next year will be slow by recent standards but, at least, the international economic position is likely to be less bad than this year. Stock markets look ahead and the modest level of international economic growth which is expected is what share prices have now factored in to some extent. In the property market, it also looks as if the spillover effects from low interest rates and quantitative easing are being seen selectively. However, the high level of personal debt means that housing markets in the UK and USA remain susceptible to bad economic news. It is difficult to know how much of the expected economic recovery has been factored into international equity markets but, undoubtedly, the recovery in international equity prices, which we have noted, has been based on the view that, in many countries, things will get better. Below, we show the latest forecasts from the IMF made in October and the OECD in November.

## Real GDP Growth ( % )

| | 2008 | 2009 (estimate) | 2010 (estimate) |
|---|---|---|---|
| Advanced economies | 0.6 | (3.4) | 1.3 |
| USA | 0.4 | (2.7) | 1.5 |
| Eurozone | 0.7 | (4.2) | 0.3 |
| Germany | 1.2 | (5.3) | 0.3 |
| France | 0.3 | (2.4) | 0.9 |
| Italy | (1.0) | (5.1) | 0.2 |
| Japan | (0.7) | (5.4) | 1.7 |
| UK | 0.7 | (4.4) | 0.9 |
| Newly Industrialised Asian economies | 1.5 | (2.4) | 3.6 |
| China | 9.0 | 8.5 | 9.0 |
| India | 7.3 | 5.4 | 6.4 |

*Source:* International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

## Consumer Prices (%)

| | 2008 | 2009 (estimate) | 2010 (estimate) |
|---|---|---|---|
| Advanced economies | 3.4 | 0.1 | 1.1 |
| USA | 3.8 | (0.4) | 1.7 |
| Eurozone | 3.3 | 0.3 | 0.8 |
| Germany | 2.8 | 0.1 | 0.2 |
| France | 3.2 | 0.3 | 1.1 |
| Italy | 3.5 | 0.7 | 0.9 |
| Japan | 1.4 | (1.1) | (0.8) |
| UK | 3.6 | 1.9 | 1.5 |
| Newly Industrialised Asian economies | 4.5 | 1.0 | 1.9 |
| China | 5.9 | (0.1) | 0.6 |
| India | 8.3 | 8.7 | 8.4 |

*Source:* International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

Excerpts from Economic Outlook No. 86 issued by the OECD in November are as follows :

**Real GDP Growth ( % )**

| | 2009 (estimate) | 2010 (estimate) | 2011 (estimate) |
|---|---|---|---|
| USA | -2.5 | 2.5 | 2.8 |
| Japan | -5.3 | 1.8 | 2.0 |
| Eurozone | -4.0 | 0.9 | 1.7 |
| Germany | -4.9 | 1.4 | 1.9 |
| France | -2.3 | 1.4 | 1.7 |
| Italy | -4.8 | 1.1 | 1.5 |
| United Kingdom | -4.7 | 1.2 | 2.2 |
| Canada | -2.7 | 2.0 | 3.0 |
| Brazil | 0.0 | 4.8 | 4.5 |
| China | 8.3 | 10.2 | 9.3 |
| India | 6.1 | 7.3 | 7.6 |

*Source:* OECD Economic Outlook No. 86 - November 2009 (excerpt)

The two forecasters point roughly in the same direction with the OECD's slightly later forecasts being more optimistic. The OECD, in most of the above countries or regions, sees growth accelerating in 2011 against 2010.

Although we invest internationally with no bias in equities towards the UK, given that we have the freedom to invest internationally, most of our clients are sterling based and it would be right here to articulate our particular concerns about the UK which we believe to hold a high level of risk if action is not taken soon to rectify public finances.

Before the financial crisis, we had often remarked in our reviews of the dangers of the explosion in public spending which was taking place with a rate of increase well above the growth in the productive potential of the UK economy. Growth in the UK and world economy tended to mask this issue, although many were well aware of it, and the unsustainable growth of public spending was always going to leave a problem with public finances. In good times, wise governments prepare for bad times so they have some firepower to deal with adverse economic developments. The UK, having allowed public finances to deteriorate so badly in seemingly good times, was particularly ill prepared for the financial and economic storm which developed in 2008. The problems were exacerbated by the importance of the financial sector to the UK economy.

The crunch point for the UK economy could come shortly. With the General Election due to be held no later than 3 June, there is plenty of time for the UK's poor economic and financial fundamentals to catch up with it before then in the form of pressure on the pound and gilt-edged market. Foreign exchange and bond markets are unpredictable. But, if investors are suspending judgement until the General Election, they will want to be convinced that, whatever the complexion of the next government, a credible plan to restore the UK's public finances exists. This is best done if one party has a decisive majority. The nightmare scenario is a hung parliament where horse trading and compromises take place, which will not satisfy the UK creditors, and there is severe pressure on the pound and sterling bond market. The UK is the weakest of the G7 countries, being the only one still in recession, and its current finances are probably in the worst situation of all.

Whilst hoping for the best investors have to be prepared for the worst and it is hardly possible to over-exaggerate the risks to the UK economy if any further liberties are taken with the UK's public finances. For this reason, sterling based investors in international equities are likely to be best placed. This is partly by default, given the serious risks which we see in the sterling bond market (but also others). Cash would only be suitable if all other possibilities looked so unappealing as to make the negligible rates of interest earned on deposits worthwhile. However, there is also a positive reason for being invested in international equities. Whilst we do not invest in non UK equities for currency gains but, rather, for diversification, if the pessimistic scenario for the UK prevails then it is highly likely that sterling will be weak. As for 2008, when the pound fell heavily, this will represent some kind of insurance policy. As the economic forecasts, shown earlier, highlight, other areas of the world are going to perform better or less badly economically and exposure is already there. So, with uneven economic growth, some areas will offer superior investment opportunities and sterling based investors are able to diversify to take advantage of them.

In passing, we should also note that there are severe tensions within the eurozone. Although the euro has been strong, some members such as Ireland, Spain, Portugal and Greece are facing very difficult economic conditions. Unlike the UK, they do not have the luxury of being able to devalue their currencies and a steady loss of competitiveness is sapping the strength from their economies. To restore competitiveness they have to experience a significant cut in real wages to bring costs back into line, something which would surely cause social unrest, stirrings of which we have already seen. This, too, may be next year's story.

So, in conclusion, investors have to factor in some very unusual economic circumstances into their thinking when deciding on asset allocation. For the reasons mentioned above, in long term growth portfolios we believe that equities have the edge but, it goes without saying, that investors must be particularly nimble as events unfold.

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