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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The word "unbelievable" is much overused but it can quite properly be applied to the events of the last quarter in the financial world. The most disturbing point in the quarter was when it became quite clear that many depositors had become concerned about the safety of their bank deposits. That is about as serious as it becomes. Hopefully, we have passed that low point in the series of dismal events we have witnessed. In this review, we try to look ahead at some of the consequences of what has happened.

The tables below detail relevant movements in markets :

International Equities 31.07.08 - 31.10.08

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	-17.0	-28.6	-41.7	-28.3
Finland	-27.7	-28.0	-41.2	-27.7
France	-21.8	-22.1	-36.5	-21.8
Germany	-23.7	-24.0	-38.0	-23.7
Hong Kong, China	-39.3	-25.0	-38.9	-24.8
Italy	-22.2	-22.5	-36.8	-22.2
Japan	-33.5	-10.4	-26.9	-10.1
Netherlands	-28.7	-28.9	-42.0	-28.7
Spain	-23.0	-23.3	-37.5	-23.0
Switzerland	-14.6	-6.0	-23.4	-5.7
UK	-18.1	-14.8	-33.2	-17.8
USA	-23.2	-5.8	-23.2	-5.5
Europe ex UK	-23.7	-23.0	-37.2	-22.7
Asia Pacific ex Japan	-27.9	-27.0	-23.7	-26.7
Asia Pacific	-30.9	-18.6	-33.6	-18.3
Latin America	-32.4	-37.5	-49.0	-37.3
All World All Emerging	-34.4	-32.4	-44.9	-32.2
The World	-24.6	-14.8	-30.5	-14.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +2.5%

International Bonds – Benchmark Ten Year Government Bond Yields (%)

Currency	31.07.08	31.10.08
Sterling	4.81	4.53
US Dollar	3.98	3.96
Yen	1.54	1.49
Germany (Euro)	4.36	3.91

Sterling's performance during the quarter ending 31.10.08 (%)

Currency	Quarter Ending 31.10.08
US Dollar	-18.4
Canadian Dollar	-3.3
Yen	-25.8
Euro	+0.4
Swiss Franc	-9.1

Other currency movements during the quarter ending 31.10.08 (%)

Other Currency	Quarter Ending 31.10.08
US Dollar/Canadian Dollar	+18.6
US Dollar/Yen	-9.0
US Dollar/Euro	+23.0
Swiss Franc/Euro	+10.4
Euro/Yen	-26.0

Significant Commodities (US dollar terms) 31.07.08 – 31.10.08(%)

Significant Commodities	Quarter Ending 31.10.08
Oil	-47.3
Gold	-20.6

Markets

In the very disappointing performances of international equity markets over the last quarter, there has been a fairly uniform movement in markets in local currency terms. Those that held up relatively well (although a poor absolute performance) were Switzerland, Australia and the UK. However, with the enormous currency movement of the last quarter, the picture changes dramatically for investors based in the two weakest currencies, sterling and the euro. Thus, the local currency total return on the FTSE World Index was -24.6% but this reduced to -14.8% in sterling terms and -14.5% in euro terms. In sterling terms, the USA (-5.4%), Switzerland (-6.0%) and Japan (-10.4%) stood out as performing relatively well. There were relatively weak performances from Latin America (-32.4 in local currency terms and -37.5% in sterling terms) and emerging markets (-34.4% and -32.4%), both in terms of the relevant FTSE World Index.

Although corporate bonds have performed poorly in the current environment, high quality government bonds have benefited from the concerns about the banking system and financial markets. Measured by the gross redemption yield on ten year government bonds, these fell by 28 basis points on sterling bonds to 4.53%, by just 2 basis points on US government bonds to 3.96%, by 5 basis points to 1.49% on yen bonds and by 45 basis to 3.91% on German bonds.

Currency movements over the quarter were truly extraordinary. Sterling and the euro were particularly hard hit. Against a rampant US dollar, sterling fell by 18.4% against the US dollar and by 25.8% against the yen. The Swiss Franc was also strong with sterling falling by 9.1% against that currency in the quarter.

In the commodity markets, movements were also dramatic with oil falling by 47.3% over the quarter and gold by 20.6%.

Economics

Usually, in our reviews, we cover issues of general interest in the world economies and financial markets and then move on to discuss news from individual countries or regions as they may relate to investment matters. Because events are moving so quickly in the economic and financial world, this would not be a particularly rewarding exercise at present so, instead, we think that there will be more value to be gained from trying to look ahead and speculate on the consequences of what has happened and what it might mean for investors. Of necessity, this will be a very broad exercise, and with new developments each day, any tentative conclusions might quickly be proved irrelevant or just wrong. Nevertheless, we think the exercise worth undertaking because, in the present frenetic atmosphere, it is easy to become carried away with the mood swings of the day, mostly negative, rather than try to concentrate on more fundamental issues, difficult though that is.

The current severe problems are a function of the extreme dislocation in the financial system. Prior to that, reasonable economic growth had been forecast, notwithstanding what was then a very high oil price although growth had been slowing down. However, when the international banking system seizes up and major institutions have to be rescued or supported in one form or another, that introduces a completely new and dangerous element into the equation. With banks refusing to lend to one another and hoarding cash, the supply of credit to businesses and individuals dried up. In these circumstances, significant decisions are taken by businesses and individuals which reduce economic activity. Companies may collapse or place a strict cap on spending. These effects permeate throughout the economy. Individuals reduce their spending, perhaps because they are made redundant or just feel more cautious and risk averse. The resulting decline in consumer confidence makes the lives of retailers much harder. Many will go out of business. We can see how many retailers are struggling at present. The situation will worsen these difficulties as it feeds through into the supply chain. The difficulty of obtaining mortgages because of the problems in the banking system is having a dramatic effect on the housing market. There has been a sharp fall in the number of transactions, estate agencies are closing branches and, of course, house prices are falling in many countries. The great property bubble is bursting. The spectre of negative equity is looming for many. Confidence will decrease further.

Good quality assets, depressed in price by current market conditions, will recover and move ahead again in due course. But many assets have experienced permanent diminution, if not elimination, of value and the size of wealth destruction has been enormous. Banks have borne a large part of this and, although many are recapitalising in one form or another, their ability to lend or their desire to do so will be much reduced in future. Some of the wealthy individuals who, in normal circumstances, could ride out bad economic times more or less unscathed, have suffered from the problems some hedge funds have experienced or are experiencing now. The problems in the hedge fund industry will also affect those who have run them and done very well out of doing so. The industry is sure to contract significantly and a source of conspicuous consumption is likely to be much diminished.

As well as finding out some financial institutions and hedge funds, this global financial storm is finding out some countries. Iceland is perhaps the most high profile country because of the banking problems, which have been so well documented in the UK, but others have been hit. Hungary and the Ukraine have received IMF loans. The UK has not been immune. The sharp fall in sterling is testament to the particularly difficult problems facing the UK.

Desperate times call for desperate measures and, hoping not to give any hostages to fortune, it does seem, at the time of writing, that governments and central banks have found a method of propping up banks which have suffered heavy losses or a run on deposits. The stress in the inter bank markets, caused by banks being unwilling to lend to each other, which led to inter bank rates settling at rates way above what would normally have been expected in relation to official interest rates, seems to be easing as government guarantees gain more credibility. Whilst it is early days, there is room for cautious optimism on this front.

One of the major problems which arose from the seizing up of the money markets and the resulting elevated interest rates was that monetary policy became rather ineffective as a policy tool. Extremely stressed levels in the inter bank market meant that monetary policy was inadvertently tightened so cuts in official rates were rendered relatively ineffective. As inter bank markets move away from their extremely stressed levels towards more normal levels (they are still well away from this position) so monetary policy can become more effective, as the transmission mechanism from a reduction in central bank rates to a reduction in costs for the end borrower becomes more effective. One realistic conclusion from what has happened is that now banks' balance sheets have, to some extent, been repaired or are about to be repaired (by governments and private investors) and some semblance of confidence is appearing in money markets, central banks will cut interest rates, in some cases aggressively, to boost their economies. If the transmission effect is effective, then that will help individuals and businesses as their finance costs decline and disposable income increases.

We had been cautious about the prospects for interest rate decreases before the full force of the financial storm became apparent because of the level of inflation which had been driven up by rising food and energy prices. However, the extent of the financial crisis is such that some central banks may feel, apart from the need to give emergency help to their economies, that the disinflationary consequences of what has happened in the world economy justify some pre-emptive move on interest rates because they can have increasing confidence that inflation will be falling because of what is happening to food and energy price levels. It is therefore likely that the recently co-ordinated emergency cuts in interest rates will be followed by non-coordinated individual country reductions. This course of action is not without danger for countries with weak currencies. The disinflationary influences will arise because, for example, of lower commodity prices (we have seen a sharp fall in the oil price) and increased competition for business. Price wars are likely to develop in the retail sector. The economic effect for those with regular incomes will be an improvement in disposable incomes which, in some countries like the UK, have been squeezed in recent times by tax and price increases.

So, we can be reasonably confident that interest rates will be reduced further where it is possible. With the Federal Reserve having reduced the target for the federal funds rate to 1% and Japanese rates now at 0.3%, there is little or nothing further that these central banks can do on the interest rate front, although they have taken very significant measures to try to free up money markets and get banks lending to each other again. Elsewhere, the ECB and Bank of England do have further room for cuts, judged solely by the level of nominal official interest rates.

In terms of what governments can do to fight recessionary influences, the name of the world famous British economist, Lord Keynes, has been frequently mentioned. In very general terms, as it has been interpreted in the present economic situation, it means that governments should raise public expenditure to try to counter recessionary influences. A "Keynesian" approach is therefore recommended by some economists and the UK government, for one, seems attracted by the idea. Automatic stabilisers in an economy provide some counter cyclical balances. For example, in times of strong economic growth, tax revenues from direct and indirect taxes are buoyant and government spending on certain areas like unemployment benefit falls or is restrained. The government's budgetary position in such circumstances should be strong and, ideally, it should be running a cyclical budget surplus. The opposite happens in difficult economic times. As profits and incomes come under pressure, corporate and income tax receipts are weak, as are those from indirect taxes. As unemployment rises, benefit payments increase and public finances move into deficit. These are the stabilisers which help to iron out fluctuations in economic activity. In the extreme economic circumstances of the present, it is suggested that the automatic stabilisers are given the support of programmes of additional public spending and / or tax cuts, depending upon the country involved. This is tempting for politicians in trouble with their electorates, but there are risks. If we take the UK, for example, which has seen a long period of seemingly good growth, the automatic stabilisers were not allowed to work in the good times. Rapid growth in public spending, way above the potential growth rate of the UK economy, resulted in a structural budget deficit - i.e. one that was not the result of economic cycles. The UK, for some years, has consistently underestimated the size of public borrowing, at a time when it should have been running surpluses. The result is a large deficit with structural and cyclical components. The gap between government revenues and expenditures is the result of differences between two very large figures and an unexpected result is that one can magnify the difference significantly. So, for example, in the UK, the profits collapse in the important financial sector and a reduced stamp duty take on housing transactions will hit the revenue side hard. Piling a stimulus on to the economy, financed by increased government borrowing, can make the borrowing level look very ugly. If it is in an economy which is already borrowing heavily, the markets might take fright. They might demand higher coupons on the increasing amount of bonds which a government has to issue or foreigners might refuse to finance the deficit at what they consider an inappropriate exchange rate given the economic risks which they believe to exist. The problems which investors face in these circumstances is that politicians have short term horizons. Whilst they may pay lip service to the need for discipline later on when it is necessary to reverse the process and rein in government borrowing, politicians know that they will probably not be in office when the difficult decisions have to be taken. This is why it is right to be sceptical about politicians' claims that an additional boost to their economy now will mean tough policies later on. It may be someone else who has to deal with the problems. There are also questions about the most effective way to boost an economy. What might broadly be defined as public works programmes have to be effective in that they have to relate to something which will benefit an economy rather than a "make work" scheme. Secondly, they have to be activated quickly to meet the immediate economic need. Public works programmes take time to get under way. Tax cuts do have some more immediate advantages because they can be activated more quickly. However, with individuals feeling very uncertain about their own circumstances, the difficulty is that they may save the money rather than spend it, especially if politicians tell them that they are going to have to reverse the process in future.

One of the countries best able to react to current circumstances is China where, although growth is slowing down, it is still likely to reach rates that the major industrialised countries can only dream of. Furthermore, because of its strong financial position, internally and externally, it can take measures to keep its economy moving forward without the markets punishing it. The constraint on heavily indebted countries is that the market will punish it through the foreign exchange markets. We have seen that already with countries like Iceland, the Ukraine and Hungary, and it could also hit larger countries. Although we are generally not living in a world of fixed exchange rates and, therefore, valuable foreign exchange reserves do not have to be used to support a currency in a losing cause, a precipitous fall in a currency is obviously dangerous for the country involved. It is inflationary and, therefore, may necessitate an increase in interest rates which will depress the economy. If it has foreign currency borrowings, they become more expensive to repay and the same goes for citizens, as in Hungary, who may have borrowed low interest rate currencies such as Swiss francs to buy their properties but now face much increased payments if their currency weakens against the currency borrowed.

These are not theoretical risks. Even in the present position, where most countries are being adversely affected in one way or another, no country has carte blanche to take irresponsible policy measures to try to restore order to their countries. They will be found out and those which have been following imprudent policies, mainly in the area of excessive government borrowing, will find themselves constrained.

One area where we see clear problems, over and above the obvious ones, is the eurozone. We have often expressed the view that this is not an optimal currency area, rather it is a political project. Far from economic convergence, as was the plan, monetary union has accentuated differences and the countries are clearly diverging. The fundamental problem was, and remains, that the "one size fits all" interest rate regime is completely unsuitable. It was at the start of the project and remains even more so now. The problems are becoming worse. We have drawn our clients' attention in recent reviews to the widening differentials in bond yields in the eurozone government bond market.

The extent of the strain in eurozone bond markets is shown by the widening spread in the gross redemption yields on ten year government bonds. Taking Germany as the most highly regarded credit within the eurozone and where, at the time of writing, the ten year government bond yields 3.80%, we see that the equivalent Greek government bond has a yield 123 basis points higher and Italy 109 basis points higher. Even France, where one might expect a similar level of credit risk perception, sees its equivalent bond yielding 34 basis points higher than the German one. Given the low levels of yield, these are enormous percentage points differences, especially as there is supposed to be no currency risk. Effectively, the divergence means that a different interest rate policy is being applied within the eurozone and the credit risk is seen to be widening. It was not supposed to be like this.

Individual eurozone governments are having to tackle the present economic crisis with one hand tied behind their backs because they have no individual control over interest rates. If we take countries like Ireland and Spain where the property markets are in an especially bad state, one might feel that the central banks might arguably have wanted higher interest rates than the ECB applied at the time to control the property boom and, now, after what has happened recently, might want lower interest rates than the ECB has recently been setting. But it is out of their hands. Taking Ireland as an example, it has recently introduced an austerity budget to try to repair the hole in government finances caused by the economic downturn. Even with that, it is forecasting a budget deficit next year of 6.8% of GDP, way outside the limits of the eurozone's Stability and Growth Pact. What the EC makes of the budget deficit restrictions in the current environment remains to be seen but large deficits like this, for whatever exceptional reason, make the European Monetary Union a more unlikely currency zone than ever.

In terms of the reaction of individual governments to what has happened, it seemed, at one stage, to be a case of every country for itself with individual announcements of what governments would do about their banks. France is leading a predictable race to more protectionism, floating the idea of a sovereign wealth fund to protect French industry from foreign predators including sovereign wealth funds. This has annoyed Germany, at least at government level, a more free market orientated economy.

The eurozone has been a casualty of the recent financial turmoil and, longer term, the maintenance of the eurozone in its present state looks increasingly doubtful.

So, can we draw these various strands and others together to see what the future holds for the world economy and, of course, relevant here, to investors? Clearly, many countries in the west and Japan are in or are likely to go into recession. Many companies will fail or go into retrenchment mode and there will be a significant increase in unemployment. Fiscal and monetary policy will be widely used to boost economies. But business will go on and the strong companies will become stronger. They may make cheap acquisitions of whole companies or parts of them and market share may increase. Although what has happened to the world economy has created a disinflationary environment, companies in this category may achieve greater pricing power later on. Therefore, investors in well placed companies like these may feel a degree of comfort about holding them and expect the benefits described above to be reflected in the relevant share prices. We have already seen some opportunistic purchases in the financial sector.

For two reasons, banks will change their business models towards more traditional banking as we knew it. One reason is natural caution. Financial institutions have had an enormous shock and will want to revert to traditional and, as we know it, much less risky banking models with the risks on, rather than off, balance sheet. Shareholders will demand this. Even if they did not, which is inconceivable in the current environment, government and regulators will. It is a political imperative. Most people are very angry at what has happened and the potential cost to taxpayers of putting it right. There will be massive increases in regulations which will require much stronger capital ratios and limits to the type of business which has proved so risky and nearly brought the financial system to its knees. In the particular sights of many politicians at the moment are hedge funds about which, at the time of writing, there is undisguised glee in many quarters at the magnitude of losses caused by their shorting of VW whilst Porsche was quietly and, unknown to them, acquiring a controlling stake. The high earnings and conspicuous consumption of many hedge fund managers, not to mention bankers, has left a bad taste in many people's mouth, particularly in Europe, and we can expect politicians to take their revenge. Capitalism has suffered a major crisis. Whilst it has bought many benefits to the economic system, it will have to fight hard to restore its reputation in many people's eyes.

Stock markets look ahead, and looking through the huge mood swings and volatility in markets just now, we can see how the economic recovery can start. With the banking system looking as if it has passed its worst crisis in terms of customer concern about the safety of their deposits and governments guaranteeing, in many cases, inter bank lending and other forms of borrowing, the inter bank market is gradually unfreezing. Aggressive cuts in official interest rates will eventually permeate through to borrowers as the transmission effect becomes increasingly strong. A reduction in the financial pressure on individuals and companies should help to stem the decline in economic activity in the first instance. For consumers, although not necessarily companies which face competitive pressures, the disinflationary environment should help to ease the pressure on incomes. A fall, if only temporary, in the price of petrol is such an example. For those companies and individuals who have the financial resources, and there are still many, the stirring of what Lord Keynes called "annual spirits" will provide business opportunities which will help to stimulate economies.

From the information which we have at present, the most likely trajectory for the world economy is some quarters of recession or flat or minimal growth followed by a gradual recovery. Growth is likely to be slower but of better quality than in the past and governments and regulators, having had such a shock, are likely to place severe restrictions on financial institutions' ability to become involved in the sort of assets which have proved so toxic. This will especially be the case where governments have provided financial support to banks and political hostility to some financial institutions will back this up.

Most big companies will survive the present crisis and some will prosper from it. Forced selling by hedge funds and others who are deleveraging will continue to cause volatility until this process eventually works itself out of the system. Given the modest ratings of many shares and attractive dividend yields (outside the financial sector many good quality companies will at least maintain their dividends), we think only those forced to sell will have reason to do so now if they are long term investors and we advise maintaining positions.

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