Investment Report No.21

Our aim is to protect investors' capital and to increase its value year on year.

Tricky times

The world has changed since we last wrote an investment report back in July. Since then we have witnessed a credit crisis and the first run on a UK retail bank for over 140 years. Not surprisingly a more volatile investment environment has ensued, although at the time of writing the UK stock market is only 5% off its recent high and is still showing a small positive return for the year to date. The overall direction in equities belies savage movements within sectors. Financials and UK domestic cyclical stocks, including house builders and property companies, have collapsed, with falls of over a third since the summer. These price moves have been offset, to some extent, by blue chip defensive sectors such as consumer staples, healthcare, oils and utilities - where we have significant investments. Last February we wrote *"…our contrarian and cautious instincts tell us to be aware that such a steady rise in markets, with relatively low volatility, will not last forever"*. We do not expect the current bout of instability to end soon.

'98 or '89?

Much has been written about the crisis in credit markets and we have little to add. Although we have been concerned about the growth of securitisation - the packaging up of debt by banks to be sold on to third party investors such as other banks, insurance companies and hedge funds - we must admit that we were not that familiar with the murky world of Collateralised Debt Obligations (CDOs) and Structured Investment Vehicles (SIVs) now making headlines on a daily basis. Our natural scepticism of the opaque led us to have a limited exposure to financials with balance sheet risk. A banking crisis is unfolding and it is doubtful that we have seen the full contagion impact on the debt markets. We are not out of the woods yet.

Many had hoped that the high volatility of stock markets since the summer was a repeat of previous financial crises, like the Asian crisis of ten years ago or the collapse of Long Term Capital Management in 1998. On these occasions equity markets regained their poise after a few months. It is different this time. There are signs of this crisis moving from Wall Street to Main Street, seeping out into the real economy. Although analysts and economic forecasters are pointing to a bounce back in 2008, growth is more likely to slow because bank lending is constrained by deteriorating capital ratios. The risks of a hard landing on both sides of the Atlantic cannot be ruled out. US house prices have already fallen by 5% year on year and are expected to fall until 2009 (*see Figure 1*). This is the biggest decline since World War II, eclipsing the collapse of the early 1990s. With commercial property prices also falling, this feels more like 1989, prior to the last recession, than 1998.

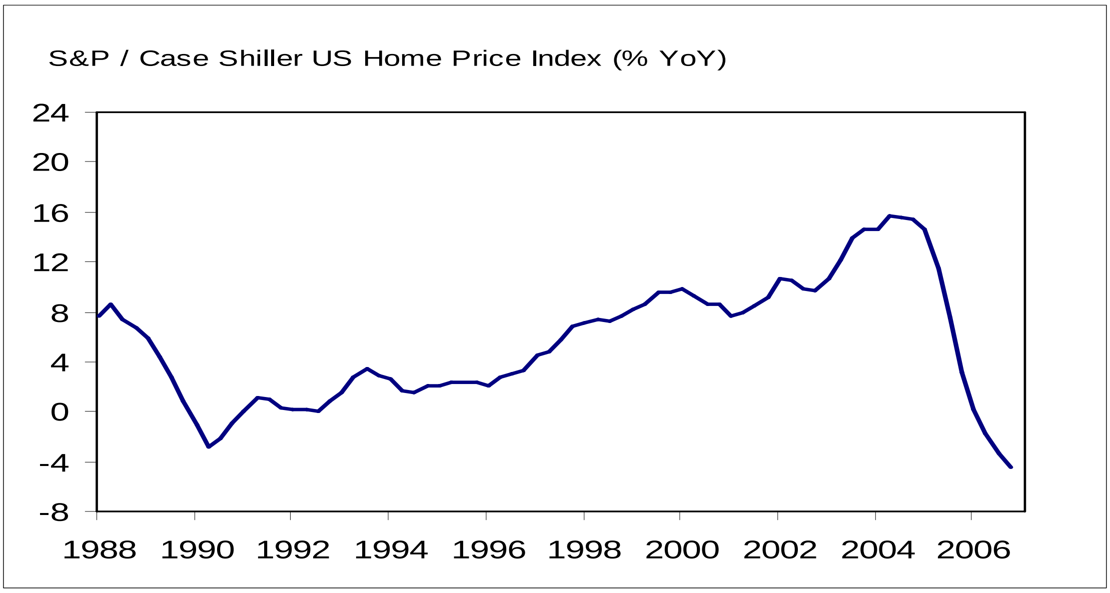

Figure 1 *Source: Bloomberg*

The First Cut

Last July we suggested that interest rates would remain higher for longer. The Bank of England's reluctance to cut rates immediately in the wake of the Northern Rock debacle speaks volumes. While the Bank has now made its first base rate cut to 5.5%, market credit conditions remain tight. The inter bank rate (LIBOR) should track the base rate closely but has remained stubbornly over 1% in excess of base rates – money is therefore still tight because *markets* have raised interest rates since the summer (see *Figure 2*). These are crisis levels despite the best efforts of the central bankers to provide liquidity to the system. The UK economy is now experiencing a serious slowdown while the banking system is clearly in deep trouble. A meltdown has only been avoided thanks to the biggest financial bail-out of a quoted company by any government. That none of Northern Rock's conventional banking competitors have stepped forward to buy the business says as much for their own predicament as that of 'the Rock'.

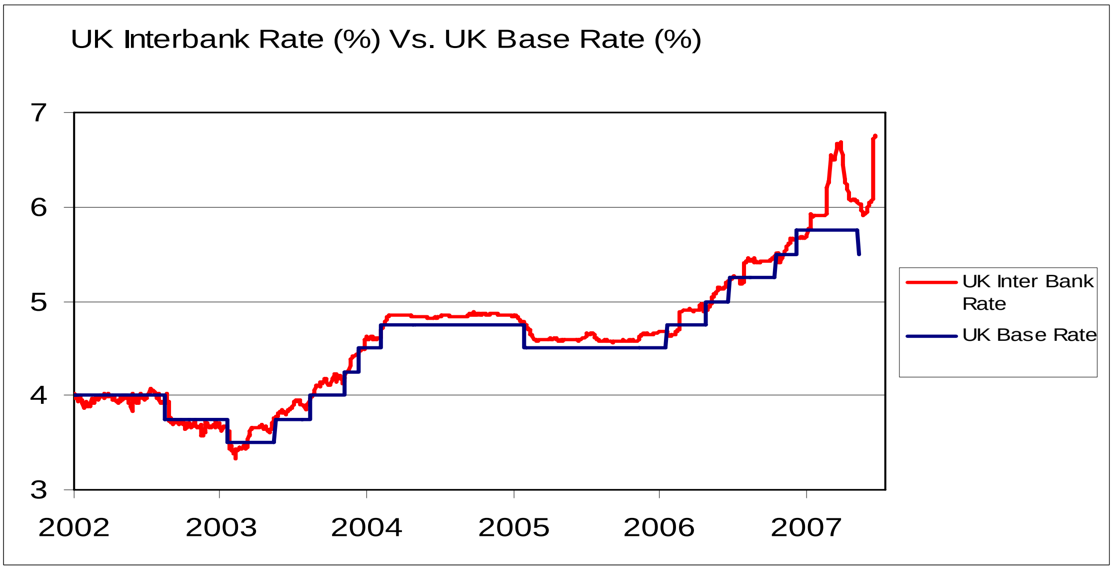

Figure 2 *Source: Bloomberg*

This rising cost of credit makes the UK economy more structurally vulnerable than the US. In recent years, growth has been driven by residential and commercial property values combined with a buoyant financial services industry and a burgeoning public sector. Sterling looks vulnerable. Five years ago we decided to hedge our US dollar exposure, when the rate was in the mid-£/$1.40s. With the rate well over £/$2 we have taken off the hedge with the view that the risks are now on the downside. The fundamentals for the two currencies are similar: they both have balance of payments and budget deficits, deteriorating economic performance, falling personal disposable incomes and declining cash available from home equity. The UK's current account deficit has been financed in recent years by inward foreign direct investment, until this year. Sterling is now reliant on hot money for support and with the Bank of England cutting interest rates, the pound is likely to fall. US dollar earners, such as GlaxoSmithKline and BP, should then begin to perform. At the same time, UK domestic companies will struggle.

We have warned that too much faith was being placed in central bankers' abilities. They are now in an invidious position: cut rates too quickly and inflationary concerns and currency pressures will mount, cut too slowly and they risk causing a recession.

Bang to Rights

For equity investors, banks' reduced appetite for lending turns things on their head. In recent years we have written of the trend labelled 'de-equitisation' – increased leverage leading to a decline in the supply of equity, whether from companies being taken private or increasing borrowings to buy back shares. This process is clearly over and for the first time since the bear market of 2000-2003 we are beginning to witness the return of equity issuance. Last month SMG, the owner of Scottish television channels and Virgin Radio, reduced its excessive debts via a highly dilutive two-for-one rights issue. We expect to see many similar deals in the coming year. Those offering new capital, which may include Far Eastern and Middle Eastern investors, will set the terms while existing holders may be heavily diluted. Balance sheet strength and liquidity will be critical to performance and explains our bias towards well-financed larger stocks. After a prolonged period of underperformance they are showing signs of life.

An Unsuitable Home

We have been concerned by the very high property valuations in the UK that have prevailed for many years. Prices have been way in excess of the affordability ratios reached at previous peaks, such as 1989. While many commentators could explain the relentless rise - lack of supply, changing demographics and the emergence of buy-to-let investors - the sums never seemed to add up. We became more concerned when private investors started adding to their property exposure at the wrong stage in the cycle. Disillusioned and distrustful with the equity market following the dotcom bust and forgetting their exposure to residential property, they embraced commercial property funds instead, investing £4bn into the sector in 2006. The alarm was raised in Investment Report N°·19 in which we highlighted the rush into such funds was becoming a bubble. We have been around long enough to recall the great unwind of property funds in 1990-1992. It was ugly! The inherent illiquidity of the asset class makes it poorly suited to open-ended funds. When everyone dashes for the door at the same time the first move is to charge a penalty to exit. If that doesn't work, and it usually doesn't, the only solution is to slam the door shut and ban redemptions until market values settle down at lower levels. In the last few weeks a number of managers have refused to return cash in order to protect the remaining investors, some threatening to withhold cash for up to a year. With the property funds' sector far greater in size than in the last down cycle, expect more headlines of distressed sales in the near future.

Our natural aversion to property in the portfolios is for what we feel is an obvious but unconventional reason. We would never say 'never invest in property'. On occasion, exceptional returns can be made, but in seven years we have only ever held two property company shares. One was fortunately bid for in 2002, making a healthy profit. The other is a property fund that invests in Germany, a country that has not benefited from strong markets and where we feel valuations are low. Our reluctance to invest in real estate is due to the quaint belief that we feel most people have more than enough personal exposure and should diversify away from the asset, not add to it. This includes commercial property which is highly correlated with residential. In our view, the idea of '*diversifying'* into commercial property is an oxymoron.

UK residential appears to be following commercial property once again. Although it is too early to tell, Halifax's UK index is down for three months in a row and mortgage lending fell 20% year on year in October. Recently, we came across an interesting commentary from *Property Vision*, the buyers' agent. Until their latest report they had been more optimistic on the outlook. They accept that the primary drivers for residential property values in recent years - city bonuses, easy credit (including 130% mortgages) - are gone for the time being and confidence is fragile. Even the very top of the market, the exclusive world of Russian and Middle Eastern buyers, is waning. *Property Vision* say, "Confidence is a funny thing: even the richest buyer doesn't want to be seen as the patsy that bought at the top".

The Age of Turbulence

Now is not the time to be brave. The current unpredictability of markets is an indication of confusion. Investors are unclear as to how to value assets. These sharp price movements may be heaven (or hell) for volatility hungry traders but for long term investors there is little reward for considerable risk.

In October we attended a presentation by Alan Greenspan, erstwhile Federal Reserve Chairman, who was launching his biography, 'The Age of Turbulence'. Renowned for his Delphic comments when Chairman, he is more forthcoming now, relieved of his responsibilities as a central banker. Greenspan noted with some prescience in the book: "If interest rates start to rise and asset prices broadly fall, excess liquidity will dry up, possibly fairly quickly…something far short of doomsday - say, a dollop more uncertainty added to the mix of our future outcomes - and market participants will value real assets less." In the interview he added that the progressive disinflationary forces that came about as a result of the end of the cold war are beginning to wane. Inflationary pressures are starting to re-emerge. This has huge implications for asset prices whether equities, bonds, property, commodities or currencies. The current instability is thanks to that lack of liquidity he describes. This will provide investment opportunities but as ever we will endeavour to protect investors from the air-pockets we anticipate in the year ahead.

We would like to wish all our investors and friends a very merry Christmas and a happy New Year. We will not be sending out Christmas cards this year but will be donating the equivalent cost to the charity Childhood First (www.childhoodfirst.org.uk). We appreciate your continued support.

Sebastian Lyon

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