Investment Review

For

Third Quarter 2010

Third Quarter Investment Briefing

The Third Anniversary of the Credit Crunch

Equities

Another quarter of mixed messages, good returns July, poor returns August, good returns September, at least the quarter was positive in total returns!

This is going to be a continuing theme of mixed returns, but overall being in the market is better than remaining on the outside as good fund managers continue to make money for us in these markets. Whereas, global equity markets year to date have returned only 0.9% despite the rally in September. Although shaky to say the least we are in a slow recovery period and as mentioned in our last bulletin I do not think we are heading for a double dip, a message backed up by some good managers as stated below.

Fidelity star manager Anthony Bolton has once again reassured investors the global economy can escape the dreaded double dip.

"We are returning to a low growth world in the West and not a double dip. I am not expecting economies to go back into reverse," he said.

"From early on I felt we were in a multi-year bull market. Most bull markets are more than one year in my experience. We always were going to have a decent consolidation phase in the bull market and this is what we have seen."

Investment guru Warren Buffett has ruled out a double dip recession in the US and says the businesses owned by his Berkshire Hathaway vehicle are expanding.

Speaking to the Montana Economic Development Summit, Buffett says he remains confident of a American economic rebound, Bloomberg reports.

"I am a huge bull on this country. We will not have a double dip recession at all," Buffett says. "I see our businesses coming back almost across the board."

In terms of a potential double dip, Citywire Selection-selected Gibbs admits to have been previously 'a bit more worried than he is now' but he thinks that if western economies do 'stagger through it' then equities might ultimately do quite well.

The trend of growing economies in the developed world is coming to an end? Or most certainly slowing considerably, the developed world has a number of issues, not least one we see on our own doorstep, the final salary pension liabilities.

See below:

FTSE 100 companies with large pension deficits have been flagged as stocks to avoid at all costs if the UK becomes stuck in a deflationary quagmire, managers have warned.

The issue was brought to the fore last week when a report by Pension Capital Strategies (PCS) revealed several UK companies have pension liabilities which are more than double their market value, such as BT at £43 billion, British Airways at £16.8 billion and Invensys at £5.4 billion.

The top 10 largest pension liabilities in the FTSE 100

1. BT - £43,293m

2. Royal Dutch Shell - £39,381m

3. Royal Bank of Scotland - £30,830m

4. Lloyds Banking Group - £27,073m

5. BP - £23,281m

6. BAE Systems - £20,488m

7. Barclays - £20,486m

8. National Grid - £19,598m

9. HSBC - £18,869m

10. British Airways - £16,826m

What is the way forward? We have mentioned previously that the emerging markets offer attractive returns, obviously these markets have their own risks, but they are different risks to what they once were. These economies are no longer debt ridden, or politically unstable, but will be the future powerhouses of the world.

Emerging Markets

Not just for Christmas but for life!

Plus, not just equities but bonds too!

China
Re-emergence of China is one of the largest investment opportunities of our time

- Developing with unprecedented scale
- Underpinnings are sound and many
- Urbanisation, industrialisation, high savings levels, capital markets opening
- Areas of Focus
- Consumption v Investment
- Infrastructure spending
- Go West policy

Brazil
Resilient in recent downturn

- Political and macroeconomic backdrop relatively stable
- Continue to find new investment opportunities
- Areas of focus
- Infrastructure bottlenecks
- Will labour productivity and structural reform continue to improve?
- Presidential elections in October 2010

India

Demographic Dividend

- Median age of the population 25 years; growing workforce and aspiring consumers
- Domestic Orientation
- Limited reliance on exports combined with structural growth drivers
- Rural Empowerment
- Real income growth and credit availability
- Areas of focus
- Removal of capacity constraints
- Rural India in transition

Russia

Dependency on hydrocarbons

- Post-Lehman hangover severe given the importance of oil and gas
- Strong fiscal position
- Used its massive reserves to lessen the downturn
- Political and institutional weakness a 'wildcard', which can create opportunities
- Areas of focus
- Consumer spending
- Presidential elections 2012
- Governance

Asia

The 21st Century will be the Pacific Century

- Low labour costs
- High Asian savings
- Re-investment increases capacity
- Further lowering costs
- Economies of scale
- Cheaper production
- Improved quality (i.e.) Samsung started as a cheap white label goods, look at it now

Commodities

Philip Gibbs: Gold will climb higher on Western currency 'crisis' Jupiter's star financials manager Philip Gibbs thinks the gold price could continue to climb because of an 'ongoing crisis' in the major western currencies, despite the asset testing record highs in the last few weeks.

Other commodities will also continue to perform on the back of the growth from the emerging economies.

China, for example, is the largest consumer of every commodity except oil, devouring a huge percentage of the global demand for base metals. All of this is to meet rapid urbanization and the needs of the mushrooming middle class: the stainless steel for their new kitchens, the lead in the paint for their walls, the fuel for their cars and power stations – it's all based on strong, tangible demand, not hype.

Fixed interest

Western Government bonds should be kept at arms length with historically low yields backed by a return of your original investment, they are not attractive.

The corporate bonds with reasonable yields of circa 6% compare favorably with Government bond yields at 2%.

We think the lower investment grade or strategic fund managers offer the best prospects in the western markets. However, this is where it becomes interesting and ties in with all as above the emerging market bond yields have always been very attractive (double figure returns) but with a high level of risk of default by the government in question.

This risk has reduced considerably with more stable government, lower debt than the developed economies (they were bitten badly in the late 90's and have learnt to save)! So this sector of bonds/fixed interest is an exciting proposition with good potential returns.

Interest Rates

Despite the Bank's official forecasts pointing to an acceleration in growth next year, Mr King has taken every public opportunity since the financial crisis to make clear a recovery will be long and slow.

The Bank's decision to keep interest rates at a record low of 0.5pc for the last 18 months has been credited with limiting the scale of repossessions and encouraging what business lending from banks there has been.

Mr King, however, has signalled his intention to keep interest rates at a low level as the Government's cuts in public spending - which will start next year - provide another drag on the recovery. A survey from Nationwide Building Society showed today that many UK consumers are more fearful about the economic outlook than at any time for more than a year.

Ernst & Young's economic forecast, published last month, suggested that the base rate will remain at the historic low of 0.5 per cent until the end of 2013.

Commercial Property

Another of our favoured investment sectors, although there has been some growth in this area during 2010, it is still heavily discounted from its mid 2007 valuations. With the ongoing economic slowdown there has been some reduction in rental yield, but this has shown to be more apparent in lower quality secondary property. In prime and good quality secondary property this has stabilised and in respect of London actually increased.

We like commercial property funds producing good net rental yield of 4.5 – 5%, as this will be the main growth driver for the time being, but in the not to distant future we will see capital value growth, probably sooner from the London area, as sterling continues to weaken allowing foreign investors great value for money property.

Home Front

Locally, the residential property continues to be a tough sector, with some fabulous potential buys on the market, but only if you are cash rich and not looking to sell!

I have to say that we have some major concerns over a particular waterfront residential development. In regard to residential mortgages and buy to let mortgages for this development, the banks are being very stringent, even to the point of taking into account any incentives and asking the purchasers to not only pay a substantial deposit but also pay for the incentive.

We expect to see many of these units unsold and people losing substantial deposits that have been handed over, we wait with baited breath!

Best mortgage deals:
Tracker rates from 2.49%
2 year fixed rates 2.99%
5 year fixed rates 4.49%
10 year fixed rates 5.49%

In August the States of Jersey went through the process of voluntary redundancies, as many companies have done so this year, sorry to any of you who have been caught up in these spending cuts. Our immediate fear is that in real terms due to the redundancy payouts there will be no saving in the short term when required. By the time the saving starts to come through they will undoubtedly have sanctioned additional funds to employ new staff. So has it been a pointless exercise?

Bank accounts and National Savings

Speculation is mounting that Santander could be set to launch a £20bn stock market listing of its UK business as the Spanish bank looks to raise new money after a spate of acquisitions.

Santander UK, which comprises the former businesses of Abbey, Alliance & Leicester, Bradford & Bingley, could be floated on the London market as early as this year, according to some observers.

Arturo de Frias, banks analyst at Evolution Securities, said now was a good time for Santander to float its UK operations and said a listing could come "sooner rather than later".

"The profitability is good and Santander has done a very impressive job of turning around the performance of these businesses," he said.

Mr de Frias estimates Santander UK is currently worth £20bn, but said that a flotation would likely require a 15pc to 20pc discount to this valuation.

This followed the purchase in August of 318 Royal Bank of Scotland branches, which will give Santander the fourth-largest branch network in the UK, overtaking HSBC.

Best Deposit Interest rates

3.25% -3.75% 18 month fixed deposit
2 % – 2.5% immediate access to 90 day deposit

Ashburton and Ermitage, Orchard and Spearpoint

Our local fund management groups of Ashburton, Orchard and Spearpoint have provided positive returns over the last quarter and year to date, with the Ashburton stable of funds being most prolific in their returns. Once again the Chindia fund being a great performer.

Ashburton Strategy

Equity exposure has been increased across our multi-asset funds, largely by opportunistically closing out options strategies introduced to protect against short-term weakness. Across these funds, equity weightings are approaching the permitted maximum levels. A shift in equity weightings towards China was outlined in July's Fact sheets. Bond strategy continues to evolve around finding relative value from a market that offers little value overall. We believe the environment is favourable to corporate bond spreads, although the potential for rising government bond yields poses a risk to returns. High yield corporate bonds remain attractive in our view.

Ermitage Strategy

As market volatility continues and global economies begin to implement the measures required to bring balance sheets back under control, we at Ermitage are being proactive in our asset allocation decisions.

For our longer term strategic positions we are utilising the services of long/short managers looking to generate alpha by benefiting from the re-emergence of price dispersions. We also continue to allocate to short term trading managers as the current volatility witnessed in markets is better suited to their strategy. Outside of our direct Gold holding we prefer long/short managers for our commodity exposure, as direct exposure to this sector carries too much risk for us.

In relation to Ermitage we have kept up an open conversation with Andy Whelan MD in relation to their lack of performance, I am afraid that although the Ermitage funds have provided a positive performance for the month of September it is time to sit down with each of you that hold one of these funds and discuss the options available.

Orchard Strategy

We 'agree' to buy top quality, highly liquid, dividend paying global companies that meet strict criteria, below their intrinsic worth. The portfolio earns a positive cash flow from these agreements and interest income from our cash holdings.
Rationale:
Orchard's investment strategy has the potential to deliver positive performance whether stock markets are going up, moving sideways or modestly downwards. 'Agreeing' to buy companies below their intrinsic worth avoids the associated risk of buying over valued assets.

Spearpoint

Manager review:
Equities have continued their recovery during September thanks to improving sentiment that at least two of the three main obstacles facing the global economy are abating, namely the risk of a double-dip US recession and China's slowdown. Meanwhile, both risk assets and bonds have also drawn strength from increasing speculation that the Federal Reserve (the Fed) will provide another dose of liquidity via Quantitative Easing (QE). Whilst there are divisions amongst policymakers about the likely wisdom and effectiveness of additional stimulus, any further weakness in the economy or renewed decline in inflation would likely prompt action.

Summary

We expect to see further sideways trading for the rest of this year, with some money being made by good managers. Our areas of focus are the Emerging Economies, Asia and Commercial Property, we cannot condone placing every penny in these areas, even with a strong conviction as this would become a high risk strategy, but they should definitely be part of all portfolios. We look forward to discussing this and more with you soon. If we can be of any assistance in the meantime please do not hesitate to call or recommend friends, family or colleagues to our services.