Investment Bulletin

SAUNDERSON HOUSE

10 July 2009

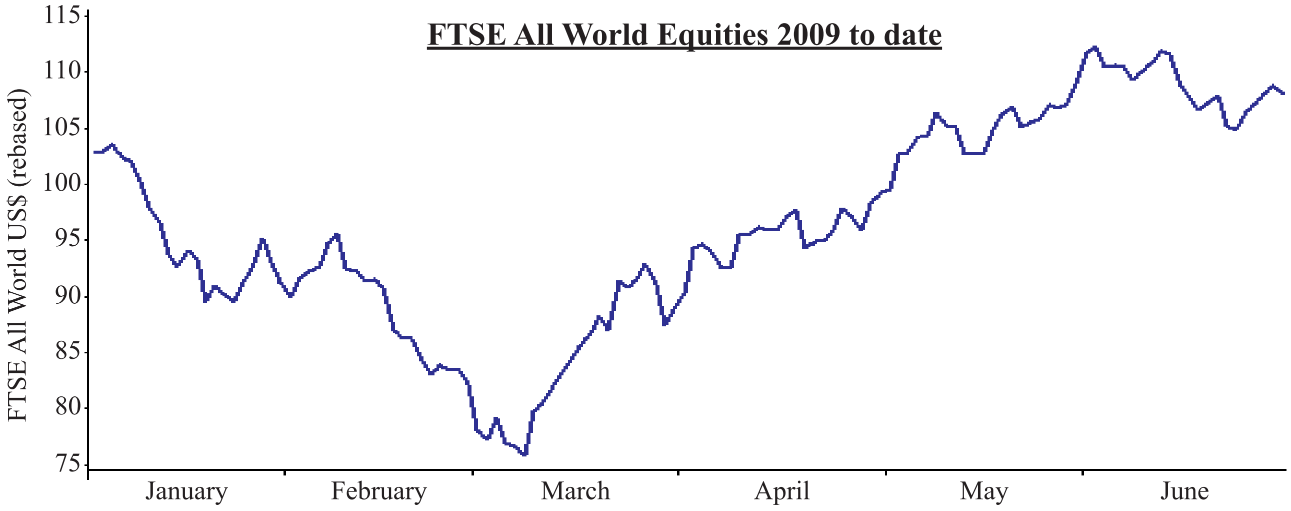
FOCUSED FINANCIAL ADVICE

KEEPING YOUR BALANCE

As we move into the second half of the year, equity investors might be forgiven for breathing a sigh of relief that 2009, thus far at least, has proven less traumatic than 2008. While the first half was by no means memorable in terms of investment returns, concerns that the financial system was on the brink of collapse have eased.

Share prices did plumb new depths for this bear market in early March, but some recovery since has left them slightly higher over the first six months of the year (see chart below). In fixed interest markets, government bond prices declined from their elevated levels at the year end, taking yields higher. However, yields have not risen far enough to raise alarm about whether the government's yawning budget deficit is financeable. Corporate bonds, an area where we have focused a good deal of our attention this year after their dire performance in 2008, have recovered some poise.

One area where there has been little movement in recent months has been interest rates. The UK's Bank Rate fell from 2.0% at the start of the year to a record low 0.5% in March and has remained firmly rooted at that level since. Completing our brief tour of the core asset classes, commercial property yields have started to look more attractive, especially given record low interest rates. However, we believe that the weakness of the economy may continue to exert downward pressure on rental values, thereby delaying any recovery. Unless property assets can be purchased at prices already discounting further weakness, we remain wary.



Source: Reuter's Ecowin

Looking forward, our view is that economic growth will not recover quickly from the body blows inflicted by the financial crisis. However, the rapid and sizeable response from governments and central banks does seem to have headed off the worst case scenario - a complete breakdown in the global financial system. Equity prices have, rightly in our view, recovered somewhat to reflect this. Nevertheless, the longer term issues, such as impaired credit markets, consumer and government indebtedness and rising unemployment are still very much with us. These factors will, we believe, hamper both economic and corporate profits growth for several quarters to come. Consequently, interest rates are likely to stay low for a prolonged period.

Our recent asset allocation switches - increasing corporate bond allocations in place of both UK government bonds and cash where implemented - mean that portfolios are, in our view, now better positioned for continued low interest rates and only a gradual economic recovery. Overall allocations to lower risk cash and fixed interest assets remain substantial while equities remain, for now, skewed largely towards developed markets and larger, more defensive stocks.

In short, we are maintaining our balance between the possible inflationary and deflationary scenarios for the economy, though with a slightly reduced emphasis on the latter. With the Bank Rate set to stay lower for longer in our view, returns comfortably above the 0.5% to 1.0% available on current accounts and liquidity funds may be obtained by putting some cash to work in term deposits without unduly increasing risk.

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We are often asked for our opinion on commodities and precious metals and, in particular, why our models do not include allocations to these. Our response is straightforward. Commodities are raw materials used in business and/or for consumption. They do not ‘earn their keep’ by producing a flow of payments or services like those from a property, a bond or a share. Instead, any investment return comes purely from rising prices. Investing successfully in commodities, therefore, depends on judging when to buy and when to sell and, crucially, judging when others are going to buy or sell, rather than from the value derived from the flow of payments or services.

Gold provides the perfect example. India’s recent announcement that it would double import duties on gold should have had a marked negative impact on gold prices, given that the Indian jewellery industry is by far the largest user of gold in the world. However, the increasing popularity of gold funds which offer investors a simple and inexpensive way to gain gold exposure and are backed by physical holdings of the metal (such as exchange traded funds), has meant that the price of gold is increasingly influenced by investor sentiment, rather than supply and demand fundamentals. This, in our view, is cause for concern. As we saw with commodity prices last year, investor sentiment can drive prices a long way from ‘fair’ value i.e. that justified by fundamental supply and demand. For example, the price of a barrel of oil climbed from $50 in 2007 to $145 in mid-2008, before falling all the way back to $30 before the end of that year. It is now $60.

Our preference is to invest in businesses and other assets (mainly through funds) that generate cash flows. These businesses may well earn their cash flows from areas such as processing or mining commodities - but they should be adding significant value above that achieved simply by owning the commodity.

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Finally, the recent, well-publicised demise of structured product provider Keydata Investment Services has served to reinforce our conviction that an in-depth understanding of risk and reward is fundamental in achieving investment success. Keydata’s Secure Income Bonds failed to live up to their name, with £103m in assets disappearing from Luxembourg-domiciled SLS Capital, which was holding the assets. The matter has now been referred to the Serious Fraud Office. You will be pleased to know that Saunderson House has avoided recommending esoteric structured products such as these on the basis of too much complexity and counterparty risk.

This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 10 July 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.