Investment Bulletin

SAUNDERSON HOUSE

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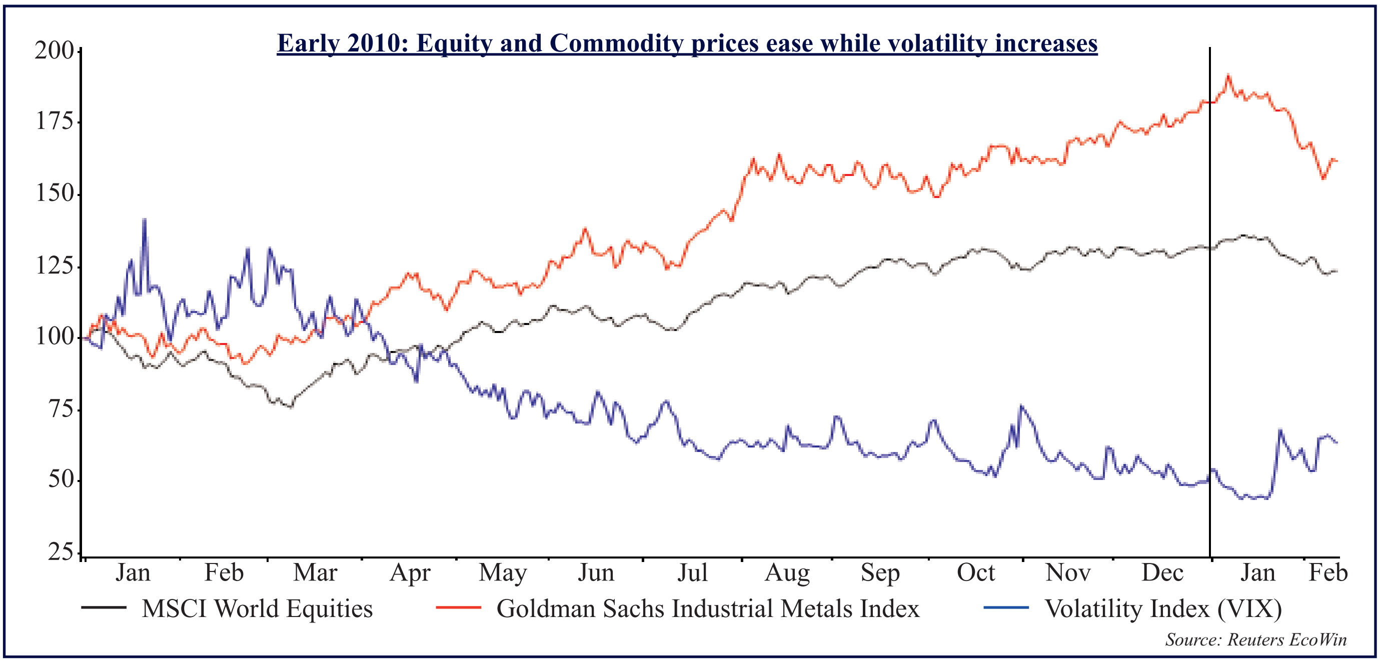
CONFLICT-FREE FINANCIAL ADVICE

WITHDRAWAL SYMPTOMS?

The new decade has ushered in a more challenging environment for investors. In quick succession, Chinese monetary tightening, the Obama administration's assault on the US commercial banks and the ominous tremors in the Greek government bond market have all served to undermine some of the certainties that investors enjoyed in 2009. As a result, equity prices have eased, commodity prices have come under pressure and volatility, which had declined through 2009, has begun to increase once more (see chart).



While the three catalysts mentioned above might appear unconnected, they are all, as set out below, early signs of a gradual change in economic policy as governments and central banks begin to reverse some of the steps taken in 2009 to support their economies.

(i) By increasing bank reserve ratios, the Chinese authorities are signalling that their chief concern is now the threat of high inflation rather than too little economic growth.

(ii) President Obama's announcement of restrictions on the activities of commercial banks indicates that the concerns regarding the survival of the US banking sector have now given way to action to ensure that taxpayers are never again asked to bail out the banks.

(iii) The sharp fall in the price of Greek government bonds is the result of the ECB ending its provision of unlimited emergency liquidity that allowed banks to borrow against collateral at an interest rate of just 1%.

Subsequently, we have seen the Bank of England announcing a pause in its programme of quantitative easing – another plank of policy support being removed.

Do the developments over the past few weeks change our view on asset allocation?

No. Our recommended asset allocations have been constructed with one eye on a more testing investment landscape. That this more testing landscape is now with us is no surprise. After all, many of the causes and consequences of the financial crisis have yet to be addressed. Trade imbalances are still large, governments are heavily indebted and taxes in many western economies will need to rise sharply, despite the fact that many household balance sheets are already in a parlous state.

Our view in early 2009 was that 2010 and beyond would bring a more difficult environment for investors. We therefore only increased allocations to risk assets very cautiously, paying close attention to quality and the sustainability of yield support. Similarly, while allocations to cash and conventional gilts were reduced, this was carried out in a deliberately measured fashion. Our thesis then, as now, was that equities and other risk assets were floating up on a flood of central bank-created liquidity. While we were, of course, pleased to see asset prices recovering we suspected that, sooner or later, the flood of liquidity would begin to drain away.

Our allocations to risk assets within portfolios are, therefore, largely skewed towards the equity of blue-chip, international companies rather than smaller more economically sensitive domestic companies. We also have relatively light allocations to emerging markets equities while our preference within fixed income is towards investment grade bonds rather than lower quality high yield bonds. This positioning means that recommended portfolios should prove resilient to the coming challenges. In short, we have resisted the temptation to ride the tidal wave of liquidity that buoyed asset prices in 2009.

A more challenging investment environment may also bring opportunities. As well as being relatively defensive, our recommended portfolios of highly liquid assets should give us the flexibility to take advantage of further value opportunities as and when they arise. At present, we are researching fixed income funds that have the flexibility to make gains, even in a rising interest rate environment. We are also looking closely at where and when better value may be on offer in overseas equity markets.

The world economy and financial markets are gradually recovering from deep recession and the effects of the credit crisis. Progress thus far is encouraging but there are likely to be many more bumps in the road ahead. We believe that portfolios are reasonably well positioned at present but will contact you with recommended changes as and when appropriate.

ANTHONY BOLTON'S NEW FUND - A SPECIAL SITUATION?

Our late January seminar at Plaisterers' Hall with Anthony Bolton and Angus Tulloch produced fascinating differences of opinion on the short-term outlook for Chinese equities. To view a recording of the seminar please go to our website.

Since the seminar, more details of Anthony Bolton's new fund have been released. Fidelity China Special Situations plc will be a £630m investment trust listed in London. If Anthony can apply his exceptional stock-picking skills to China, this will be an exciting investment. However, four issues give us pause for thought: (i) Anthony has only committed to run the trust for two years, (ii) the closed ended nature of the trust means there must be a risk that it will trade up to a premium to net asset value at launch, only to languish later (perhaps after Anthony has stepped down) (iii) by investing only in China and China-related stocks, the trust will lack the flexibility to make allocations elsewhere, for instance if China is perceived to be over-priced, (iv) with a 1.5% annual management charge and a 15% performance fee, investors are paying a full price for Mr Bolton's investing prowess.

Our full note will be issued after the publication of the prospectus on 26 February.