

ASSET ALLOCATION ASSESSMENT: TRIPLE A-RATED?

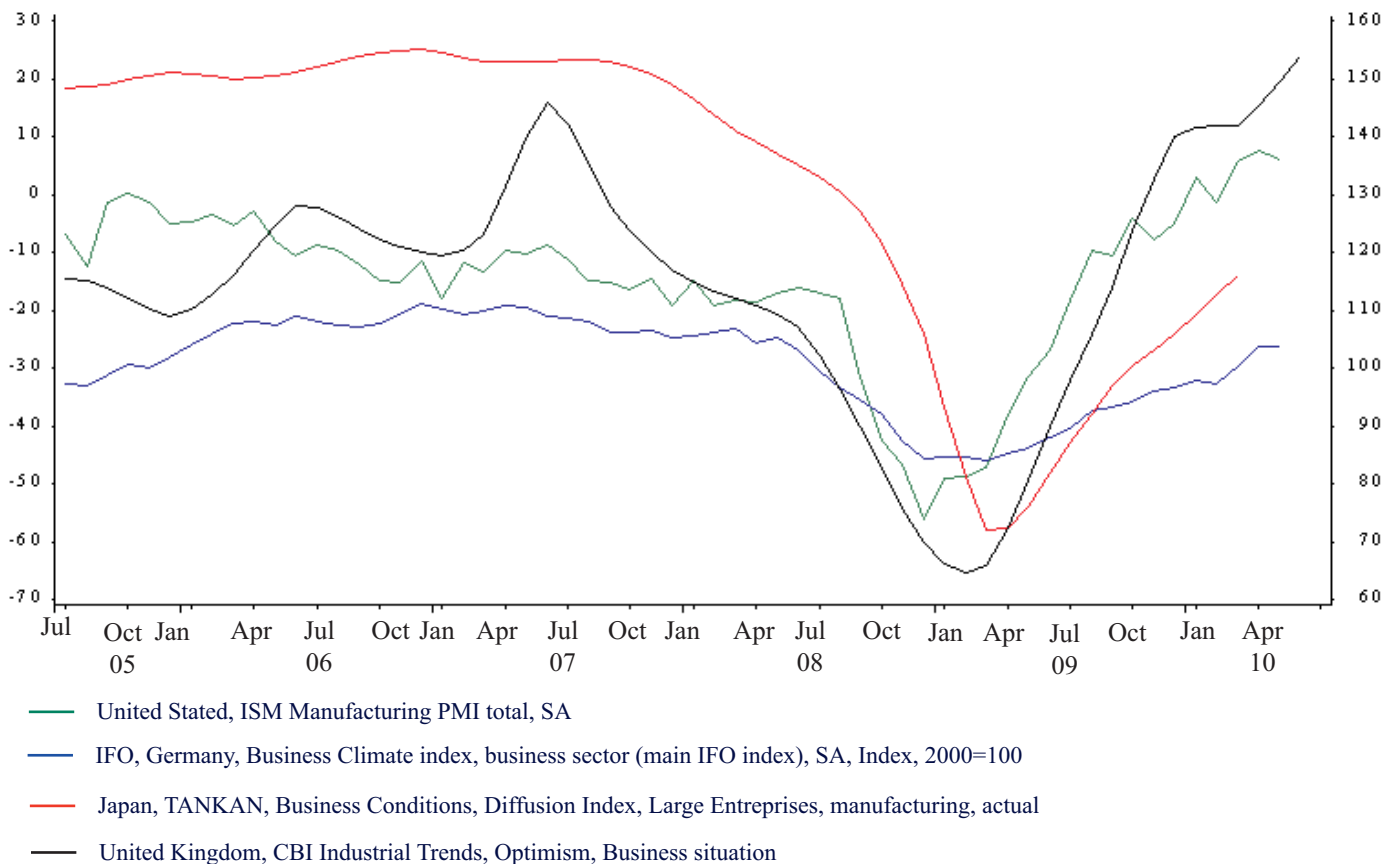
Appropriate diversification across asset classes, fund managers and securities is at the heart of Saunderson House's investment philosophy. The unfortunate situation in which BP finds itself serves as a timely reminder of the importance of diversification for our long term savings. It will be some time before BP's total liabilities are known and, until then, the value of the entire business is highly uncertain. This update contains a brief assessment of our current asset allocation together with some comments on Capital Gains Tax ("CGT"), which will be a much watched feature of Tuesday's emergency Budget.

Challenges for investors are in abundance. Sovereign debt issues within Europe's 'olive belt' first arose in April and the bearish mood that resulted has since been augmented by a stream of other unhelpful developments. These include oil spills in the Gulf of Mexico, rising tension in the Korean peninsula, concerns surrounding monetary tightening in China and, most recently, disappointing employment data in the US. Under the weight of such news flow, the uptrend in equity markets has been interrupted and share prices have fallen by about 10% in the last two months. Such a correction raises the question, is it right to persist with allocations to risk assets or should we be battenning down the hatches in anticipation of further bad news?

To answer this, we should first put the 10% correction into context. Equity markets had enjoyed a very strong run up to mid-April 2010 with share prices, as measured by the MSCI World Index, rising by more than 80% from the low point in early March 2009. This recovery was sparked by increasing conviction that dislocation within the global financial system would prove temporary and an extended economic downturn would be avoided. Improving economic data helped shares to further gains through to April. The recent bout of weakness has served to temper the optimistic mood by highlighting the many challenges still to be addressed.

These challenges include huge public sector deficits in many developed nations (such as that which triggered the crisis in Greece), stubborn unemployment and over-indebted consumers. They will not be solved any time soon. However, we regard the recent problems in the eurozone as aftershocks of the credit bubble and the subsequent financial crisis. Similarly, monetary tightening in China is part of a process of addressing the side effects of the crisis. In our view, unless mismanaged by the authorities, these issues are unlikely to lead us back into recession or into a second leg of financial crisis. Assuming both of these scenarios are avoided, risk assets should recover their poise in due course. Our reasons are as follows:

- As shown in the chart overleaf, closely watched surveys of business confidence, such as those carried out by the ISM in the US and the CBI in the UK, have recovered sharply since the financial crisis. They are not turning down in response to the current, unhelpful, news flow. This indicates that the economic recovery has achieved a degree of momentum, which should be sustainable.

Business Outlook Surveys - US, Germany, Japan and UK

Source: Reuters EcoWin

- A second cause for confidence in continuing economic recovery is that the economies of the emerging markets remain very strong. For example, China recorded economic growth of 11.9% in the first quarter. We do not believe it likely that developments in the eurozone could knock Asian growth off course.
- Finally, relating specifically to the eurozone crisis, our view is that central banks and governments have learned valuable lessons from the crisis – hence the aggressive nature of the ECB’s response in throwing a €750bn ‘iron curtain’ around Greece. The lessons learned should see appropriate policy measures put in place to avoid a second leg to the crisis.

In conclusion, we believe that the global economy is developing momentum, supported by strong growth in the emerging markets. This growth should allow the aftershocks of the economic crisis to be addressed in an orderly manner over an extended period. We therefore remain confident that our current recommended allocations to risk assets are appropriate.

CAPITAL GAINS TAX – COMMON SENSE MUST PREVAIL!

With Tuesday's emergency Budget, we should get a first glimpse of how the new government intends to address the UK's unsustainably large public sector deficit. Spending cuts are likely to form an important element in the deficit reduction programme, but it is likely that the Budget will also usher in the biggest fiscal squeeze since the Second World War. An increase in capital gains tax (CGT) is one potential source of much needed funds, though its inclusion in the programme appears to be a concession to left-leaning members of the coalition government, rather than a well thought through tax raising policy. It is by no means certain that the suggested move to more than double CGT rates, from the current 18%, will raise meaningful additional revenue, though it is likely to provoke further misallocation of capital as the savings industry structures new products in an attempt to mitigate the impact of the increase. We therefore continue to lobby energetically for common sense to prevail. If there is to be a rise in CGT, it must, in our opinion, be accompanied by the reintroduction of taper relief for investments held over a period of years. Without this, investors may find that post-tax returns from higher risk investments, such as equities, unacceptable. This would make funding more expensive and harder to find for all businesses. The government is, therefore, in danger of destroying the incentive for long-term savings at a time when the economy needs to rebalance away from consumption and back towards investment.

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This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 18 June 2010. 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.