Investment Report N°·23

August 2008

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

A return to normal?

'We are in the midst of the worst financial crisis since the 1930s. In some ways it resembles other crises that have occurred in the past 25 years, but there is a profound difference: the credit expansion based on the dollar as the international reserve currency. The periodic crises were part of a larger boom bust process; the current crisis is the culmination of a super boom that has lasted 25 years."

George Soros, The New Paradigm for Financial Markets: The Credit Crisis of 2008 and what it means

The unanswered question for investors and the reason for the huge volatility in share prices in 2008 is; will the period enjoyed for the last 25 years - known as 'the great moderation' - featuring low inflation and credit expansion continue? Alternatively is George Soros right; are we looking at a whole new era of investment parameters where inflation remains a stubborn problem and credit growth continues to reverse? The combination of rising prices and declining lending is a worrying combination for asset prices whether bonds, property or stocks.

We have two concerns. First that profit growth driven by ever higher levels of debt is now over. Second, as we have said in the past, higher inflation is not good for valuation multiples of all asset classes. The 'de-rating' of equities that began in 2000 has taken a further step down since markets peaked last summer. Profits are also coming under pressure. In the 1970s price earnings ratios bottomed in single digits – we are now not too far away from those levels (see Figure 1).

This de-rating is rarely appreciated by the investment community which is preoccupied with share price momentum and short-term profitability. Company management is usually no different as share price valuation is used as a measure of success. We recently witnessed a prima facie example of this when a retailer came to visit us. The company has been well managed and is regarded highly by investors. Profits have grown steadily over the past ten years and yet the Finance Director bemoaned the fact that rather than increasing the valuation, the multiple had fallen from 20 times earnings to 12 times earnings since 1998. This is no reflection of the quality of the company or its management, merely how the market has chosen to value such businesses over that period. One day, price earnings ratios will expand again, as they did for the two decades to 2000, but until then the process of contraction continues.

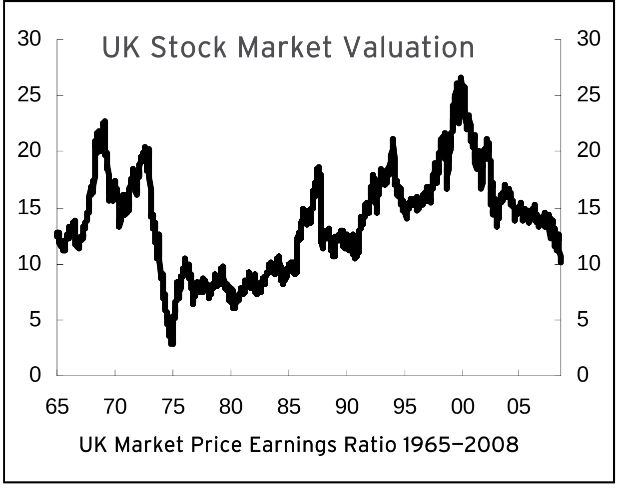

Figure 1 *Source: Datastream & MF Global*

Brace position

The news coming from the UK economy remains grim. The number of mortgage approvals for house purchases fell by 68% year on year in June, the lowest level since records began in 1993. Personal lending is also falling sharply. It would appear that we are six months to a year behind the US where there are few signs of the housing market stabilising. American home prices, according to the Case Shiller index, fell by a record 17% in the year to May. We are told that the most dangerous phrase in investment is "it's different this time". George Soros is hinting that it may be. Many look back to the recession of the early 1990s for a steer as to how to value companies in current conditions but, if the US is any guide, this UK housing bubble was far more excessive than the late 1980s boom. There were no buy-to-let investors back in 1989 and 125% loan-to-value mortgages were a glint in the eye of Northern Rock executives. In 2008, affordability is low and the availability of credit (very few people buy property without a mortgage) is falling – hardly the preconditions for a recovery.

As interest rates are reduced the cost of mortgages should fall but since last summer the cost of borrowing has actually risen and until lower interest rates are passed on to borrowers the predicament will continue. Credit oils the wheels of the modern Anglo Saxon economies and without it the machine is not functioning properly.

Investors have, so far, been caught out by trying to call the turn in cyclical parts of the stock market where Troy has had minimal exposure. Shares in house builders, property, banks and retailers have been savaged in the last year. To date, there are no signs of turn as the current downturn is steeper than in previous cycles. Many value and income investors have been particularly caught out by high dividend yields which appeared to offer a bargain but proved unsustainable.

The economic cycle from 2000 to 2007 combined huge fiscal expansion and credit growth. Both will be absent from the next cycle. Business models will need to change to reflect this. Individuals can no longer tap in to home equity to top up spending. Instead, the savings ratio will need to recover. The same principle follows for private equity investors whose key method of growth is refinancing – the same principle as mortgage equity withdrawal. There is little room for either. Successful businesses will be self sufficient and self financing.

Lean years

Back in November last year, Francis Brooke warned of value traps in the UK Equity Income sector. In an article for the Daily Telegraph (still available on the website www.telegraph.co.uk - **Investing for income: better judgements needed for the year ahead**) Francis said that a number of UK banks were on yields that may well be unsustainable. "*The search for consistent income growth may be more challenging (in an) environment where dividend growth is harder to come by".* Over the past year the sector has performed very poorly returning -23%, with a number of funds falling by as much as 35%. The Trojan Income Fund, although down 13% over the same period, is ranked second in the sector (as at 17th July 2008). Francis continues to favour companies that can provide steady dividend growth that are not highly indebted. Thereby providing investors with income growth in real terms and seeking to avoid permanent capital loss.

In our view, it is too early to buy for recovery when the downturn is only just beginning to take shape. When it comes to the financials, most of the pain has been taken on sub-prime mortgages with $500bn written off worldwide. Yet, UK banks have barely started to take account of their non-performing loans. The recent rights issues are not adequate for the banks to re-capitalise themselves. These companies are unlikely to be taken seriously until dividends are cut and management teams are changed.

Browned off

Where did prudence go? According to Matthew Parris of *The Times* she was abandoned by Gordon Brown many years ago. During the Labour government's second term prudence was replaced with extravagance as government spending was ramped up, in part to avert recession in 2001. The result; government finances are looking tatty. The golden rule is being rewritten as demands on taxpayers' money is rising at a time when they can least afford tax increases.

Politics has been of little importance for investors in recent years. The global backdrop has been more influential than domestic issues. Northern Rock changed that. Months of dithering culminated in the approval of allocating £100bn of taxpayers money to bail out the bank. Further decisions along these lines, seeking to avert systemic risk, are likely to increase scepticism towards the UK economy. Lame ducks in the UK and US are likely to lead to public policy fudge as witnessed recently with the bailing out of US mortgage providers Fannie Mae and Freddie Mac.

Sterling has held up in recent months but looks increasingly vulnerable as a result. We continue to seek to diversify overseas, where appropriate, in order to protect our predominantly sterling based investors from the effects of a falling currency.

Too optimistic

We are always happy to receive feedback on our investment reports. One investor described our last report in April (N°. 22) as "*very interesting, albeit somewhat depressing".* We do not go out of our way to be gloomy but aim to give an objective, if cautious, assessment of the investment environment. With the benefit of hindsight, it would appear our assessment was too optimistic, at least in the short term. Equity markets rallied briefly until mid-May and then plunged 20% until the middle of July – the poorest period for stocks since 2002 and the worst June since 1930. This move provided confirmation, if it were needed, that we are in a bear market.

Positive thinking

What can go right? Markets are beginning to discount a hard landing. It may seem perverse but the best time to invest is when the outlook is bleak. Are we there? No, but we are getting there.

The picture is murky – if we can somehow return to the great moderation there is potential for markets to rally, if the system is broken and lending does not return to normal, there is more volatility to come.

It is easy to be optimistic when markets are high. The opposite follows when markets have fallen. Equities are one of the few commodities that people want less of the more they fall in value. Of course one can rationalise why stocks have collapsed in the last year but as counter intuitive as it feels, we must become more optimistic and more willing to invest over the next few quarters. We would encourage our investors to think the same way. Those under-invested should think about gradually increasing exposure however uncomfortable this may feel.

In 1974, stock markets fell steadily over the year. The fundamentals were not dissimilar to today - rising inflationary pressures, weak economic growth and poor leadership from central bankers and politicians. When markets eventually rallied, in early 1975, the rise was so fast that anyone not in before the turn found it almost impossible to get money into the market. We believe that at some point in the next year or so, patience and courage will be truly rewarded.

Sebastian Lyon

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