Barnett Waddingham
Private Clients

Investment Summary
Winter 2009/10

Investment Commentary

Looking Back

Happy New Year from us all at Barnett Waddingham Investments!

Regular readers might be waiting with bated breath for a pithy reference to 1697; the next year in our journey through the ages. 1697 saw the opening of a certain famous City landmark. If a building could have wisdom, this one would doubtless have plenty. In our view, plenty of wisdom (as well as plenty of luck?!) will be needed when making investment decisions in 2010 and beyond.

In our previous 2009 commentaries, we considered the UK's financial predicament in depth. We highlighted the indebtedness of the private sector and the lack of demand this has caused, as well as the 'solution' put forward by the Government known as Quantitative Easing (QE) - money creation in all but name. Whilst we have acknowledged the global reach of the credit crunch, it has been natural to focus on the UK since this is where the majority of our clients reside. The aftermath of the credit crunch has also revealed strategic flaws in the UK's economy such as excessive debt (leverage) in both the public and private sectors, trade imbalances and an over reliance on consumption (often funded by debt) which places both government, companies and households in a highly inflexible financial position when placed under strain.

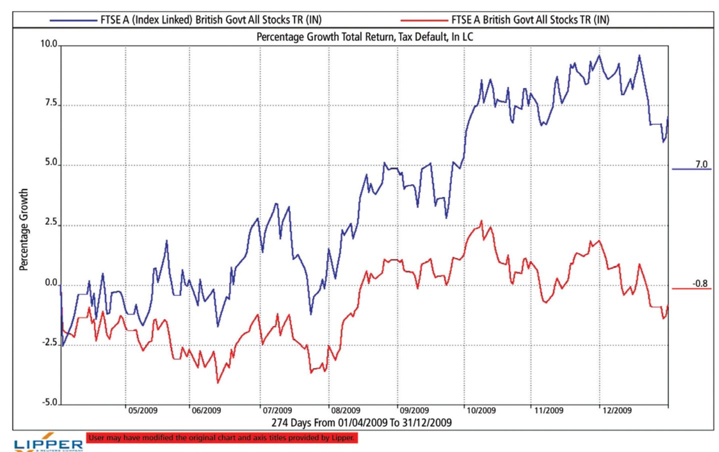
What's Happened Since?

Whilst it was a relief to see an improvement in equity markets since interest rates were cut to record lows early in 2009, we noted that the valuation surge experienced did not make up for the decline in value during 2008. Indeed, one could argue that with interest rates so low and QE so large, it is surprising that assets have not risen in value far more than they have done. Later in this commentary, we argue why this might have occurred (hint: it is to do with debt).

We are concerned about the long term consequences of current government deficits (which are huge) and those

forecast for the future (also huge) and the impact these could have on investments; particularly those most regard as 'safe' such as Government Bonds (Gilts) and cash deposits.

In our June 2009 paper, we identified the conundrum of deflation and inflation and indicated at that time that markets appeared to believe inflation would prevail. The graph below compares the returns on Index-Linked Gilts with those from Fixed Interest Gilts since and the trend seems to have continued, i.e. markets perceive an inflationary future.



Investment Commentary (CONTINUED)

The Case for Inflation

In the short term, a bout of inflation would likely ease the pain of the UK Government and those in the private sector with large debts since inflation devalues debt in real terms.

The Retail Price Index, which includes housing costs, soared from an annual 0.3% in November to 2.4% in December, the biggest month-on-month rise in the annual RPI rate since the Winter of Discontent 31 years ago in 1979.

Time will tell whether the market's expectation that inflation lies ahead is proved correct. Certainly the decline in the value of Sterling in the last 2 years has made many imports more expensive. Having said this, the domestic economy has been so poor that many suppliers have absorbed much or all of the increased costs so that turnover and market share is maintained as far as possible. We see little evidence of inflation sourced at a domestic level; as a result of wage increases, for example, and this could be as a result of the decline in organised labour (unions) and the UK's manufacturing sector.

Are the Economic Factors in Place to Allow Inflation to Become Reality?

Our economist, Dr Woody Brock, provides a set of jointly necessary and sufficient conditions required for monetary inflation to become reality.

1. A large increase in the monetary base (typically, bank reserves) due to central bank financing of a very large fiscal deficit
2. Banks ***able*** to extend lots of new credit
3. Banks ***wishing*** to do so
4. Customers ***able*** to assume more debt
5. Customers ***willing*** to do so
6. A central bank that is not aggressive in sterilising money creation.

The UK currently meets condition 1 and possibly 6 at the moment, although we cannot see how the other conditions are met. Remember that in Dr Brock's opinion, all 6 conditions need to be met in order for (perceived future) inflation to become a reality.

The Case for Deflation

Via his 1933 study "Debt-Deflation: Theory of Great Depressions" the celebrated US economist Irving Fisher came to a very different conclusion to that currently perceived by the bond markets. Dr Fisher's conclusion was that excessive debt and major contractions lead to a period of deflation (falling prices) rather than inflation (rising prices). With this thought in mind, it is consistent to sketch a situation where, despite QE and ultra low interest rates, the additional liquidity created is used by banks to repair their own balance sheets rather than lent out to the economy at large. Thus, the velocity of money in the economy slows in line with slowing economic activity.

Following a period of excessive debt, banks cannot or will not make loans whilst potential borrowers remain concerned about falling asset prices and are busy repaying existing loans or increasing savings levels. Countries and individuals must go through a time consuming and painful period of debt repayment once excessive debt has been accrued.

It strikes us that the situation since March 2009, where the Bank of England and UK Government have worked in cooperation via QE to buy UK Fixed Interest Gilts with freshly created cash, has obscured the real demand from real investors of these Gilts. In doing so, it has made it much more difficult to deduce the more likely outcome of the inflation/ deflation conundrum – a vital element to consider when making investment and asset allocation decisions.

Higher interest rates might be forced on the UK by investors as a 'risk premium' rather than as a result of the Bank of England raising rates to cool an overheating economy.

Barnett Waddingham
Private Clients

Summary

UK policymakers face daunting challenges now and in the future about whether to raise interest rates in an attempt to combat the threat of (perceived) inflation ahead and whether to continue with QE, which has been the lifeblood of the domestic economy during the last 9 months, but at the price of ballooning government borrowing and deficits. Ceasing QE could result in higher interest rates, as the 'real' interest rates required by 'real' investors in Gilts are revealed. Any rise in interest rates would present a stern test of the strength and sustainability of the underlying health of the UK economy. Maintaining interest rates at their current level (they cannot go much lower with Base Rate of 0.5%) runs the risk of leading the country and its finances at worst to an inflationary crisis or at best to another bout of boom and bust.

All such potential outcomes unsettle markets because they represent acute uncertainty.

What could be done by Government?

The underlying fundamentals of the UK economy have not really changed since the commencement of QE. The main aspect that has changed is the spectacular increase in Government borrowing and government deficits and a corresponding rise in equities, albeit one which has not restored January 2008 values. In order to signal real change and one which is likely to avoid the 'boom/bust' speculative bubbles we have seen in the past, 3 targeted policies are needed as part of the resumption of sustainable growth:

1. Policies that reduce the growth of public and private sector borrowings and deficits
2. Policies that increase productivity growth
3. Policies that increase workforce growth.

These policies are largely at odds with the UK Government's policies over the last few years.

What can Investors do?

We would urge readers not to overlook the profligacy of the UK's public and private sector borrowing binges over recent years and the potential impact these could have on investment portfolios in future. Not all countries have managed themselves with such bravado. A plethora of global investments is available to UK based investors.

- Focus on overseas economies that have different characteristics to the UK in terms of debt levels, resources, demographic trends and other factors
- Focus on UK businesses with a genuine global reach; particularly into economies referred to above. These are less dependent on the fortunes of the domestic economy.

"Nations are not ruined by one act of violence, but quite often, gradually, and almost imperceptibly, by the depreciation of their currency, through excessive quantity." Nicolaus Copernicus 1525

Cash Deposits

Given recent events in the global financial system, we have reviewed the selection of banks with whom Barnett Waddingham have established streamlined application processes for pension scheme bank accounts. We can also help with personal, corporate and charity monies and term deposits are also available over varying time periods:

Scottish Widows Bank Deposit Account: (no minimum deposit immediate access)	
£50,000 and over	**2.00% AER**
Under £50,000	**1.75% AER**
Scottish Widows Bank 1 Year Fixed Term Deposit Account: (minimum deposit £10,000, maximum £5,000,000)	**2.45% AER**
Bank of Scotland Deposit Account: (Minimum interest rate 0.20% above Base Rate)	**0.70% AER**
Bank of Scotland Current Account: (Minimum interest rate 0.20% below Base Rate)	**0.30% AER**

(Source: Barnett Waddingham Investments LLP Rates as at January 2010)

* Bank of England Base Rate 0.50%

Barnett Waddingham

Private Clients

Our Services

Investment Advisory Services

At Barnett Waddingham Investments LLP, we are constantly vigilant to the fact that investments in non-cash assets such as property, shares, fixed interest securities and other assets can go down in value as well as up. We also frequently remind ourselves and investors that an asset or portfolio which has decreased in value by, say, 50% then needs to increase in value by 100% in order to restore the original value. Estimations and forecasts are an inevitable aspect of the financial world but we believe it is wise to remember this simple yet incontrovertible fact. Losses hurt and whilst most investors like their portfolios to achieve attractive growth, it is also common to find that investors dislike losses more than they like gains. We believe that people make a difference to investment returns. To us, it is common sense that, as in any profession, there are good fund managers and bad fund managers. Our job is to find the winners to ensure that performance remains excellent compared to their peers. Our investment service is customised to the needs and requirements of each client. Only high quality, liquid assets are recommended. High charges and penalties are avoided and there is a real emphasis on transparency and simplicity. Combining these principles with an assessment of investors' propensity for investment risk forms the core of our investment service.

Self-Select Investment Services

For those clients who prefer to select their own investments without advice from Barnett Waddingham Investments LLP, we offer a service in conjunction with Selftrade, one of the UK's largest execution-only stockbrokers and part of the Société Générale Group. A wide range of listed investments including UK and international shares, gilts and investment funds are available via Selftrade.

Performance Review

Many of you will have held investments in bonds, shares and managed funds within your pension schemes for a number of years. Free of charge, we can provide you with a report showing how these investments have performed on both an absolute and relative basis versus similar funds or benchmarks such as the Bank of England Base Rate.

Retirement Options Services

The decisions made at retirement such as annuity purchase and income drawdown can have important ramifications in respect of death benefits and the level of risk to one's pension capital and income. There are also many pensioners utilising income drawdown who face the prospect of falling pension levels in the coming years because of falls in asset prices, gilt yields and interest rates. We believe that detailed advice on retirement options is crucial in order to improve the chances that expectations will be met. Amongst the services provided is a 'whole of market' annuity advisory service via which we are frequently able to facilitate substantial increases in annuity income compared with the rates available elsewhere.

Would you like to know more?

If you are interested in more details on any of the above, please contact your usual Barnett Waddingham consultant.

Chalfont Court
Hill Avenue
Amersham
HP6 5BB
Tel: 01494 788100
Fax: 01494 788800

Rigby Hall
Rigby Lane
Bromsgrove
B60 2EW
Tel: 01527 559111
Fax: 01527 559222

St James's House
St James's Square
Cheltenham
GL50 3PR
Tel: 01242 538500
Fax: 01242 538501

163 West George Street
Glasgow
G2 2JJ
Tel: 0141 243 4400
Fax: 0141 243 4432

West Riding House
67 Albion Street
Leeds
LS1 5AA
Tel: 0113 394 3700
Fax: 0113 394 3760

Port of Liverpool Building
Pier Head
Liverpool
L3 1BW
Tel: 0151 235 6600
Fax: 0151 235 6640

Cheapside House
138 Cheapside
London
EC2V 6BW
Tel: 020 7776 2200
Fax: 020 7776 3800

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office.

Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), Barnett Waddingham Investments LLP (OC323081), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at Cheapside House, 138 Cheapside, London EC2V 6BW.

Barnett Waddingham LLP is authorised and regulated by the Financial Services Authority and is licensed by the Institute of Actuaries for a range of investment business activities.
Barnett Waddingham Investments LLP and BW SIPP LLP are authorised and regulated by the Financial Services Authority.
Barnett Waddingham Actuaries and Consultants Limited is regulated by the Institute of Actuaries in respect of a range of investment business activities.

© Barnett Waddingham 2010