

## Investment Summary

Spring 2010

### Investment Commentary

#### A strange state of affairs?

We noted in our September 2009 Commentary that the equity market could be buoyant for some time due to the short term advantages bestowed on the economy by the Quantitative Easing (money creation) programme. The rationale behind this opinion was simply that investors might favour the intrinsic value of companies and their assets over Government bonds and Sterling both of which were integral parts of the financial engineering administered at such a vast scale. Looking back, equities have performed well since then although it has sometimes been difficult to understand why. In the words of one fund manager we work with, the position has felt similar to "The Phoney War" of early World War II when the lack of major military operations meant that life in the UK felt normal even though war with Germany had been declared months before.

With politicians swamping the airwaves with the constant noise of lobbying and electioneering it has been too easy to overlook the precarious realities of the financial position that the UK finds itself in. In short, the UK has a dependency on deficits but Government itself is in a precarious position when administering the spending cuts and/or increases in taxation needed since over 50% of UK GDP is now sourced from public sector activities and the UK already has some of the highest tax rates of any G20 economy.

Markets are looking for the UK Government to admit the extent of the problem and put in place a clear recovery plan. Clearly debt cannot continue to be accrued at the current rate. Either the UK Government takes clear steps to get finances in order or the markets will do so.

The General Election result appears to be popular although it is probably fair to say that we are still in the Honeymoon period. In any event we should all wish the new Government well. Difficult decisions lie ahead. There are no easy options.

Elsewhere, there is a 'them and us' situation starting to appear between EU member states. Our economist Woody Brock



addressed this issue over two years ago and, in our view, has to some extent accurately predicted the situation in which the EU now finds itself. A recent German poll indicated that 86% of Germans see no need for Germany to participate in any rescue package for Greece. Understandably, a number of Eurozone member states (and their populations) are beginning to question the benefits of the EU club.

## Investment Commentary (CONTINUED)

### OK, but where is this going?

Intuitively, many of us realise the importance of compound interest and the benefits of preserving the real value of our assets. By 'real value' we mean the value of the assets concerned based on their purchasing power measured globally factoring in inflation and the value of Sterling against a basket of other currencies.

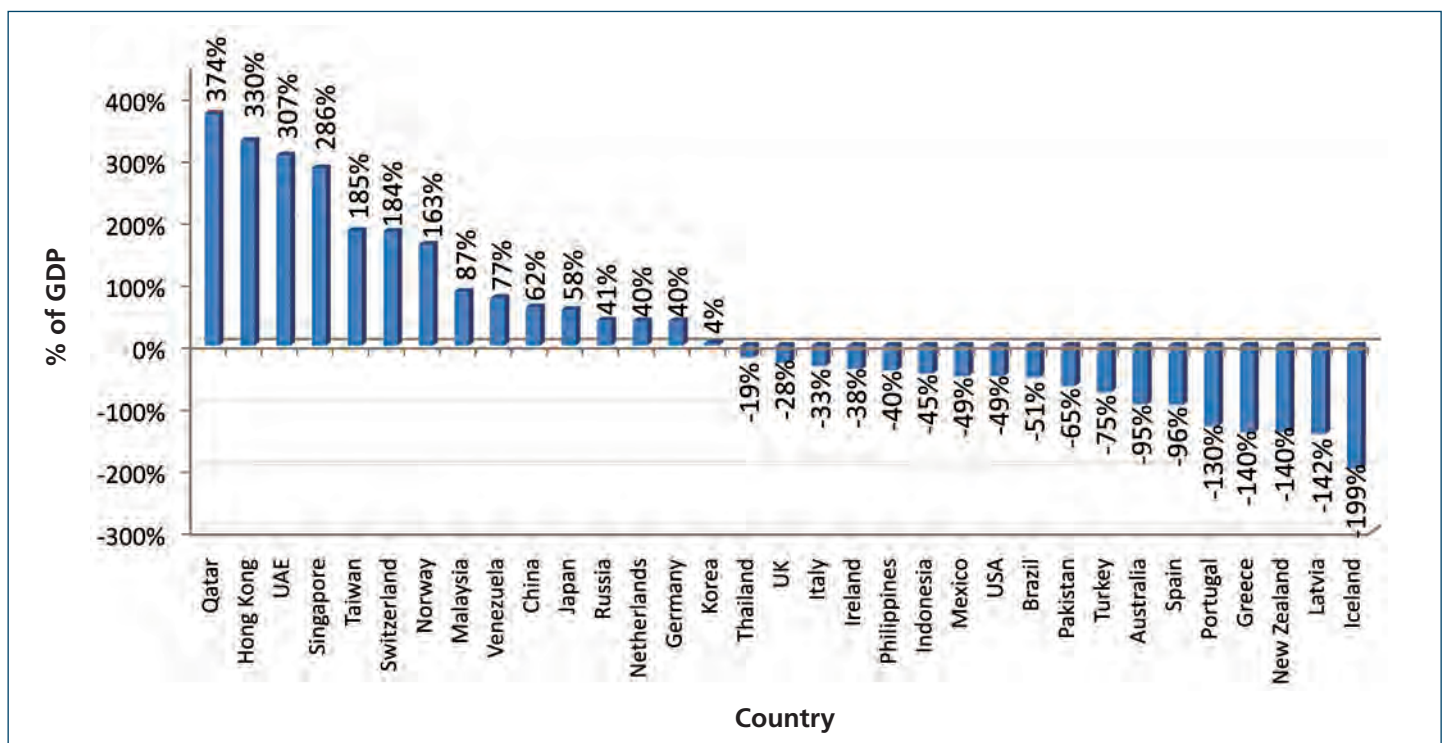
A number of our clients may remember the famous words of the then British Prime Minister Harold Wilson in November 1967 when he announced that 'from now the pound abroad is worth 14% or so less in terms of other currencies. It does not mean, of course, that the pound here in Britain, in your pocket or purse or in your bank, has been devalued'. When an economy such as that of the UK features the combination of a heavy dependency on imports along with a small manufacturing base, some might question the practicalities of Mr Wilson's remarks. Although the rampant inflation experienced by the UK in the early 1970's had much to do with the OPEC oil embargo of 1973 it was nevertheless the case that our weakened currency and the market's perception of this were contributory factors in importing inflation and the subsequent increase in interest rates as well as the need for the International Monetary Fund (IMF) to bailout the UK in 1976.

### How are other countries throughout the world doing?

Gordon Brown, Alistair Darling and other members of the Labour Government were extremely effective in presenting the UK's financial position as an inevitable consequence of 'The Global Financial Crisis'. The crisis situation in countries such as Greece certainly assisted this posturing.

We have been looking at how other countries around the world have fared. Rather than appraise countries on the ratings given by agencies such as Moody's, Standard & Poor's or Fitch, we have been considering information from the IMF as well as other sources and a different basis of assessment, Net Foreign Assets (NFA). NFA relates to the value of the assets a country owns abroad minus any debts owed to foreigners. A table of examples is shown below.

NFA analysis seeks to calculate whether a country's level of indebtedness and/or its indebtedness to foreigners implies a potential instability going forward. The importance of this analysis can be seen from the recent falls from grace of Iceland and now Greece. Many countries, be they "developing" or "developed", are getting into a lot of debt and we believe



Source: IMF Data, Stratton Street Capital LLP calculations, as at February 2010

## Investment Commentary (CONTINUED)



that this potentially has significant implications for investors both in bonds and in currencies and the role these assets have as 'stores of value'.

From a fixed income perspective, it is important to bear in mind that most bond funds are based on indices which allocate the greatest weight to the most heavily indebted, be they corporate or sovereign. This is arguably not ideal for the investor under normal circumstances and much less so now being that so many countries' finances are getting over-stretched. It would seem more sensible to invest one's fixed income monies with those who are best able to pay their debts. Many of the world's major creditors are now in the Far East and Middle East.

NFA analysis is also relevant for currencies. In order to ease/solve the global imbalances between debtors and creditors, it is necessary for the currencies of the major debtors to weaken versus the major creditors. For example, China has been running massive trade and current account surpluses for several years and now has amassed \$2.5 trillion in foreign exchange reserves. This cannot go on indefinitely. Logically, there should be major foreign exchange adjustments between the major creditors and debtors.

What is the impact of this for investors aiming to preserve the real value of their savings? If the status quo has indeed changed so that countries perceived as 'rich' are in fact not quite so rich as in the past, would that not have an impact on investment choices?

### Active Management

Among other things, the past three years have shown the limitations of many computerised modelling devices which produce asset allocations based on various assumptions and references to past return/risk characteristics. In our view, active management has become more important than ever, particularly if it transpires that we have indeed seen a paradigm shift in a number of aspects and relationships which were previously taken as 'given'. In addition, it has rarely been more important to remember that significant portfolio losses need to be followed by even larger percentage gains in order to restore the original value (if a portfolio of £100,000 falls by a third then it needs to grow by 50% to restore the original sum invested).

## Summary

Many clients based in the UK have inadvertently and unnoticeably had the value of their savings reduced significantly in real terms over the last 2 or 3 years due to the devaluation of Sterling against a basket of other major currencies and the impact of this on the price of products and services they buy. Whilst the UK stock market has bounced by about 50% since March 2009, it remains lower than its highest 2008 level and about 25% lower than as at December 1999.

As we have said on previous occasions, thinking globally is essential in order to preserve the real value of one's savings. Not all countries and markets have been so affected by the credit crunch as the UK and other EU countries and not all of them have such complex and structural domestic difficulties.

## Further Information

### Would you like to know more?

If you are interested in more details in this document, please contact your usual Barnett Waddingham consultant.

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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
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