INVESTMENT UPDATE JANUARY 2008

The Investment team held a two day meeting at the beginning of January to consider the economic and financial market outlook for 2008. Given the current sharp movements in financial asset prices, and the considerable media coverage to current developments, we thought it timely to provide a summary of developments in the financial markets and the team's investment conclusions.

Summary of key events

- The crisis in US sub-prime asset backed securities has virtually closed the credit markets since last August. Efforts by Central Banks to ease credit conditions have only recently begun to take effect with the spread between Libor and official interest rates in the major economies normalising and issuance in asset backed security markets starting to pick up modestly.

- The sharp drop in equity markets since the start of 2008 indicated that investors were still fleeing risky assets as commentators warned that a certain recession in the United States in early 2008 would spread to the rest of the world. Investors were also worried by the assertion of a number of prominent writers that the US sub prime crisis marked the beginning of a process of financial de-leveraging that would threaten the survival of the financial system in its current form.

- The financial markets came under more pressure from the threat by the credit agencies (yes them again) to downgrade companies that insured bonds (monoliners). The monoliners, which are AAA rated, guaranteed the bond issuance of entities with a lesser credit rating which gave the issuer access to cheaper capital and a broader investor base. If the AAA rating of the issuers was downgraded the banking sector would be exposed to yet more losses on their bond holdings.

- Societe Generale, the French banking conglomerate, announced on 24th January 2008 that it had lost $7bn (two years of investment banking profits) due to unauthorised trading by a trader. It transpired that the losses were discovered over the previous weekend and this may have exacerbated the stock market plunge on Monday 21st January by the bank's need to sell equity to cover positions.

- With confidence already at a low ebb, the sharp decline in equity markets on Monday resulted in the Federal Reserve cutting interest rates by 75 basis points. The move was unprecedented as it took place just one week before a formal meeting of the Federal Open Market Committee and was therefore interpreted by investors as an effort to shore up the financial system.

Investment strategy and investment returns

Since the second part of 2007, we have taken increasingly defensive measures to protect the capital value of investment portfolios by reducing equity holdings to below benchmark positions. Fixed income positions were also defensive, meaning that cash and short dated fixed income securities accounted for a high proportion of the portfolio.

The credit crisis caused libor rates to rise sharply and this provided the opportunity for portfolios to lock in high short term interest rates for a up to one year. This meant, however, that portfolios did not benefit fully from the rally in longer dated government bonds. With bond yields historically low and below cash rates there was little incentive to purchase them other than for the 'safe-haven' value which could prove ephemeral given the presence of inflationary pressures in the global economy.

Investment returns from fund of hedge funds managers have been depressed during this period as market volatility reduced returns in most investment strategies. Hedging strategies have suffered as correlations between instruments and hedging vehicles moved outside their usual parameters. Some individual hedge funds which were short sub- prime debt registered spectacular investment returns but these were few in number.

Clients with diversified investment portfolios will have made significant losses on their equity holdings and overall investment returns will have been depressed. The losses, however, are not beyond the historic norm and the application of appropriate benchmarks means that the investment returns will be consistent with clients' overall financial targets.

Outlook

The investment team concluded that the economic outlook remained extremely uncertain (unsurprising) because the cause of the economic downturn was the restriction of credit rather than an imbalance in the real economy. The economic consequences of a financial market shock are more difficult to quantify than a macro economic shock.

It was noted, though, that the very pessimistic view currently held by many commentators may be excessive as economic trends do not yet support the recession thesis. Consequently financial markets were likely to be more surprised by stronger growth than weaker growth and the former could not yet be ruled out.

Fixed income securities were pricing a significant amount of 'safe-haven' value which was not expected to be sustained, particularly if a recession was avoided. Short rates were expected to fall and yield curves to continue steepening. Yields in the US have fallen the most and offer little or no value and it was decided to reduce exposure to the US bond market and increase exposure to European bonds where there appeared to be considerable scope for lower yields. The UK gilt market was not seen as offering much value except at the short end of the yield curve.

Notwithstanding the uncertain economic outlook, the decline in equity values over the past two months appeared excessive. Whilst further declines could not be ruled out, it was decided to reduce the extent of the under weighting in equities. This would still leave investment portfolios in a defensive position relative to benchmark.

The foreign exchange markets were being driven by a number of different themes; rebalancing between the economies of the west and east, economic growth prospects and expectations for interest rate differentials. Despite the pessimistic economic forecasts for the US economy the rapid reduction of US interest rates was likely to support capital values more effectively than in Europe or the UK. The growing financial power of Sovereign Wealth Funds was likely to be an additional support for distressed US assets. The only currency which appeared to be significantly overvalued was sterling and the decision was taken to under-weight sterling against the US dollar and the euro.

Future Policy

Financial markets are currently extremely fragile and the situation may change significantly because of a number of factors; weakness in financial institutions, economics, policy, regulatory changes or politics. As a result the investment team has increased the frequency of internal meetings in order to be prepared to take advantage of investment opportunities that may arise.

Marc Hendriks

25th January 2008

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