GoreBrowne
INVESTMENT MANAGEMENT

Newsletter
SUMMER 2009

Insipid Growth Ahead

Equity prices probably reached their nadir in March, since when investors seem to have thrown off their fears that we were entering a period of depression, and now think that we shall merely have suffered a deep recession. There has been talk of 'green shoots'.

Analysts appear to be assuming that growth rates in the US and the UK will return to trends of the last decade, and that profitability will revert to the historic mean; we believe this is overly optimistic.

We have entered a period which will, at least partially, reverse two major drivers of the American and British expansion of the last two decades: debt, and de-regulation.

The credit crisis was a function of the dramatic de-leveraging of financial institutions. This withdrawal of liquidity caused governments and central banks to step in as lenders of last resort, but they will have to restore their own balance sheets in the coming years. Discretionary Government spending will become tighter than it has been for the last decade.

Over-indebted consumers have spent next year's income for too long, and are now saving more than they have for years, as they try to rebuild their wealth. Banks' willingness to lend, at anything other than punitive rates, reflects a sobriety sadly lacking in the years when they threw caution to the wind. Unemployment in both countries is rising rapidly, and wage growth is fragile. The 'under-employed' are not counted, but are becoming more numerous. Consumer spending should remain under pressure for years.

Financial institutions will become more closely monitored, and be required to hold higher levels of capital. But Governments will not wish to be long term shareholders of bank equity, and they should ultimately be able to sell many of their holdings at a profit.

Corporate profit margins have been at exceptionally high levels in recent years, but more conservative financial models, and slower growth rates, will probably result in these levels not being restored in the economic recovery. The efficient balance sheet will once again be one of which Lord Weinstock would have approved: one with low net debt, and good cash flow.

It is likely that asset valuations will not be as rich as they were for much of the last two and a half decades, when inflation and interest rates were falling, debt was increasing, and equity, whether in property or companies, was being withdrawn.

In summary, we should become accustomed to lower returns from investments, especially in the UK, in the years to come. We shall have to think about how to make money from factors other than anglo-saxon demand growth.

Thank you. All of us at GBIM are very grateful for the support of all our clients in these tough times, and are delighted that we are now managing some 25% more than a year ago, despite the fall of many markets.

Interest Rates to stay low

The Bank of England base rate is likely to remain low for a long time. This does not mean that it will not go up, but it will stay historically low. Up to 3% would be low.

In the short term our economy remains fragile, and unemployment will continue to increase (going to 3m). Wages are under control, while indebtedness is causing more saving and de-leveraging, and so demand growth will be weak for the foreseeable future.

In the medium term UK fiscal policy must be tightened, and will be by either party, post-election. In a weak economic environment, fiscal policy restraint must be balanced by an expansionary monetary policy, which will keep base rates low. Unfortunately the growth of money supply will sustain caution about inflation which, together with substantial issuance of gilts, will keep longer term interest rates at higher levels.

But this does not herald much good news for the consumer. Banks may trim their lending margins a little, but not substantially. They need to keep profitability up because they will incur further loan losses, and do not want further governmental involvement. Thus for mortgages, tracker rates are likely to go up, and fixed rates will remain above them. Savers too are unlikely to get much benefit, again for reasons of banks' profitability.

Structured Products

Please consult us if you receive offers to invest in 'structured products'. Sales of these are running at very high levels because interest rates are low and fear of stock markets is high. These are complex products, and a thorough analysis of any given product should be done before deciding whether to invest.

Investing in Infrastructure provides high inflation-linked yields

Infrastructure investments are those made in asset intensive businesses, which provide essential services to society. Typically they are regulated and have long term contracts, of 25 to 30 years, which define significant parts of both revenues and costs.

There are broadly two types of infrastructure from an investor's point of view: economic and social. The former have income which is based upon the level of demand, and includes both transport infrastructure, such as ports, railways or toll roads, and public utilities such as water and electricity distribution.

Social infrastructure is normally available as an investment through public private partnerships (PPP) or private finance initiatives (PFI). Common investments are schools, hospitals and prisons, and revenues are based not upon usage but upon provision, and service levels.

In the current economic environment we have chosen to invest in social infrastructure, as we are wary about the level of economic demand over the next few years. Typically the contracts are backed by governments, and annual adjustments to income and some costs are made according to an inflation-linked agreement. The cash flows are relatively high, and paid regularly. Meanwhile long term loans are put in place at the outset, and typically mature after 20 to 30 years, thus there is little interim concern about financing current operations.

Given the state of the UK fiscal deficit it is possible that future governments will try to constrain the returns on these investments. In mitigation of this risk we have looked mainly at funds which are listed on the stock exchange, which have a good degree of non-UK exposure, and which have shares which trade at a discount to their stated asset values. Their dividends yield about 6% to investors at current prices.

The potential for additional returns can also be found in portfolios which have assets under construction, or cash available for new developments. The funds we are using have these characteristics.

Profiting from Future Scarcity

We are wary of anaemic growth in total global consumption in the next few years, and so are looking for ways to invest which require us to be less dependent upon demand. Thus we are looking at sectors where there is evidence of current or future supply constraint, with a view to investing in future scarcity. Having written previously about the prospects for oil depletion, here we are focusing upon agriculture and water.

According to the UN, in 1960 there were 1.1 acres of arable farmland per capita globally; in 2000 there were only 0.6 acres per capita. Now the development of bio-fuels causes a proportion of this to be diverted from food production.

There are currently about 6 billion people worldwide, but by 2050 the UN expects that number to have reached 9 billion. Even today the World Food Programme reckons there are 1.1 billion people without adequate food.

As the developing world gets richer, so they demand more meat in their diet. The US Development Agency estimates it takes 7lbs of grain to rear 1lb of beef. Clearly higher yields will be required. New seed technologies and fertilisers are essential to enable this, together with better processing, logistics and distribution.

All food production requires water, and water resources are becoming increasingly stretched. Consider the problems in the Murray/Darling Basin in Australia, or at Lake Mead in America, which threaten farmers with drought. Drought is not only an African problem. In the Middle East aquifers are under stress with the same implications for agriculture. Glacial waters are melting with obvious longer term consequences, particularly for India and China.

Water infrastructure, metering, desalination and other treatments, all represent potential areas of investment.

We are exploring the best ways to gain access to these themes without tying up money for lengthy periods, and have short-listed some funds for when the time is right.

Dancing, not Cycling

This year the partners have raised money for charities by organising Scottish dancing, rather than cycling, which they did last year. John's wife, Vanessa, arranged several evenings on behalf of Treloar's, while Simon and some friends held an evening to raise money for Help for Heroes.

Mens sana in corpore sano?

Risk Warning: You should remember that the value of investments and the income derived there from may fall as well as rise and you may not get back the amount that you invest. Past performance is not a guide to the future.

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