

Anxious?

Just over a year ago, we launched a new investment profile which we called Capital Preservation and Income. Our intention was to provide an alternative to cash at a time when interest rates were historically low, by constructing a portfolio aimed at maintaining the capital value over the medium term, while producing a stable overall return higher than cash.

The portfolios which we manage on this basis have had a core of fixed-income investments, including domestic and international government bonds, and high-quality corporate bonds. This broadly continues in 2010 although we have recently reduced UK gilts replacing them with strategic bond funds which we feel are better able to exploit increasing volatility. In addition, we hold money market funds, infrastructure companies, hedge funds, some equities exposure on an absolute return basis, and a small exposure to gold. Return expectations for both the income and capital growth elements of the portfolio have been met, exceeding both cash and inflation by a good margin.

For 2010, we intend to make some small changes in the profile: we will drop the reference to Income in the name, as we have found that our investors are seeking foremost to preserve their capital and achieve a better return than that which could be obtained in cash through a combination of income and capital growth.

Should you wish to find out more about this, please get in touch with your investment manager or John MacMahon.

Treloar Art Lecture

We have continued our sponsorship of the Treloar Art Lecture, which was again a fascinating evening. Douglas Lyndon-Skeggs, in his inimitable way, gave us a brief insight into the world of the Romanovs, coloured by anecdotes and witticisms. He would surely have thrived in a Parisian salon. We are delighted to support such an attractive event.

Follow The Money

“Annual income twenty pounds, annual expenditure nineteen, nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery.”

Mr Micawber had recently been imprisoned for debt. While we are not suggesting that Gordon Brown should be sent to the Marshalsea, we do need to heed the lesson on husbandry. The key to investing, when many parties are short of cash, is to recognise that those with cash will emerge stronger. This belief drives our current investment strategy.

While the financial crisis may look as though it is over, anyone who believes that the side-effects of the trauma and its medicine are benign and short-lived should think again. The much vaunted and vilified bankers' bonuses are a mirage masking the state of liquidity in western economies. Now it is time to pay. So who will pay?

Mervyn King, the Governor of the Bank of England, points out that ‘the patience of UK households is likely to be sorely tried over the next couple of years.’ He expects unemployment to remain high and take home pay to show little growth. The UK Government budget deficit must be substantially reduced.

This expectation causes us to be cautious of investments in areas dependent upon either public or private discretionary consumption for years to come. The path of free spending will be littered with disappointments. The big state driven stimuli are largely behind us.

In the stock market rally since last March, many top performing shares have not been the well-financed ones, but those of companies coming back from the brink of a financial chasm. Many such companies will now find this sense of relief is replaced with the drudgery of eking out profits while sales growth is difficult to achieve.

Banks were among these, and were particular beneficiaries of last year's reflationary policies. Headwinds will now become brisker. Various forms of tax on them are politically popular; regulators are forcing them to build stronger balance sheets, which will constrain loan growth; there remain trillions of dollars of private equity and property loans to be re-financed, and write-downs are inevitable; longer term the structure of global banking needs radical overhaul, and this will cause uncertainty.

Inflationary fears will rise, and should then subside, but will add to uncertainty, especially about interest rates, the cost of debt, and the wherewithal to service that debt.

We believe that a combination of tighter fiscal policies and loose monetary policies around the world is likely for several years. This should be positive for many shares, and difficult for government bonds, which will also be in immense supply, but markets are likely to be volatile. Growth in demand should come predominantly from developing, not developed, economies, while the supply of energy, infrastructure and food will be important themes. Technologies, and the imagination and drive of entrepreneurs, should reap rewards in a sluggish environment.

We retain good exposure to emerging economies, not only by investing in them across all asset classes, but also by backing western companies which are global leaders with strong positions in these markets. We seek companies, directly or in funds, which have strong balance sheets, excess cash flow, relatively high yields, and the ability to increase their dividends. Follow the money.

Inflation or Deflation?

UK consumer price inflation was 2.9% in December. It is going higher, and may reach 4% by midsummer. Commodity prices have risen sharply in the last year, and some commentators are worried that inflation in China will cause the economic world's locomotive to raise interest rates and slow its growth.

We believe that the high levels of unemployment and unused capacity globally will not allow inflation to get out of hand, because there should be no transmission to wage growth. However markets will be worried, not least because they fear that if central banks do restrict growth then the risk is that there will be a return to recession.

What Now for the Banks?

We've had the taxes, and now the UK and US Governments and central banks are talking of the need for substantial change in structure. Bankers, naturally, do not wish to have their levers of power taken away.

There appears to be consensus that a global agreement is necessary, but it will be difficult to bring Anglo-Saxons to an agreement with the French, Germans or Chinese on this issue.

Ultimately however the investment banks should not have to be bound by restrictions with which commercial banks should be. This should cause them to elect for freedom – which did Goldman Sachs no harm before it elected to become a commercial bank in the darkest moments of the credit crisis!

Can China keep us going?

Will the Chinese economy continue to grow rapidly? Having just reported its fastest quarterly growth rate for two years, it also announced that inflation is rising and that monetary policy is being tightened.

This is triggering concern that policymakers will now slow domestic expansion in China and that the slowing growth of the western world will cause

Chinese exports to stutter, with the result that Chinese growth will fall sharply.

The Chinese government can afford further domestic stimulus, investing in infrastructure and social services with a financial freedom, and political imperative, unknown in the West. Inflation is predominantly a result of food prices, which should be temporary. The property 'bubble' is confined to six major cities.

China will continue to grow rapidly. Whether it can keep the rest of us going depends upon our own policymakers avoiding mistakes.

Are Central Banks and Governments about to Tighten?

George Soros says the 'recovery is incomplete'. The IMF comments that the biggest risk to economic recovery is 'a premature and incoherent exit from supportive policies.' Many people reckon you cannot trust a politician to do the right thing.

The mainstream view of economists is that fiscal policies should be tightened soon (taxes up/spending down), and that monetary policy should then follow somewhat later (interest rates up).

Our view is that pragmatic politicians and bureaucrats will 'muddle through', and that policies will be changed gradually,

A Necessary Return to Privatisation?

We are all very much aware that the Government must rein in its spending plans for the next few years. The Chancellor of the Exchequer has made it clear that this will include substantial reductions to planned investments. The difficulty is that, even excluding investments in hospitals and schools, the required investment in infrastructure in the UK during the next decade exceeds £400 billion.

Policy Exchange believes we shall have to invest £264bn in energy, £120bn in transport, £5bn in telecommunications, and £45bn in water.

By comparison Alastair Darling is planning £16bn of asset sales by 2013-4. This would include the Tote, some of the student loan portfolio, the Dartford Crossing, the high speed rail link to the Channel Tunnel, and the remaining shares in Urenco. This leaves a huge funding gap.

The state sector owns some £370bn of property, and the Shareholder Executive, which manages the Government's share of publicly owned enterprises, is examining the feasibility of creating companies which might realise part of the value of these assets, and the services based upon them.

A new Treasury-based body, Infrastructure UK, is exploring the possibility of establishing an infrastructure bank, which would syndicate the financing of future infrastructure projects.

NM Rothschild, the investment bank, believes that privatising the motorways could raise £100bn, while the Adam Smith Institute has identified a large number of potential candidates.

The energy is returning to this debate, the Government needs money, while pension funds and insurers need assets with attractive returns to match with their long term liabilities. Watch this space.

not suddenly. This however will not provide markets with any degree of comfort, and thus anxieties will prevail during this period of transition from unconstrained reflationary drive to sustainable financial management.

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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