Investment Matters

Fish Financial Newsletter no.10 • February 2011

Interesting Times

Market Overview

In the month when China overtook Japan to become the world's second largest economy, it is apparent that we must be prepared to embrace change. Whilst we in Britain (and the West in general) are fortunate enough to see evolution not revolution, it seems that the people of North Africa and the Middle East are in for a rougher ride. Quite apart from the human story, the turmoil, having spread to Libya means that a proper oil producing country is now directly involved. With 3% of world production, it may not seem like a major issue, and indeed OPEC has announced that it will increase production to cover any shortfall - but what if the unrest spreads to the big boys like Saudi Arabia or Iran? Oil shocks have preceded 10 of the last 11 major world recessions and so we will continue to watch with great interest as events unfold.

In our last issue we highlighted that the traditionally "safe" asset class of Fixed Interest was now exhibiting signs of volatility and risk. This is important because Fixed Interest is traditionally the backbone (40% to 75%) of a cautious portfolio, where capital preservation is the primary goal. With cash still paying minimal returns and inflation hitting 4%, where is the cautious investor to turn to? Our feature this month is on Fixed Interest investing.

The two Ugly Sisters here in the West - Sovereign Debt "sticking plasters" in Europe and Quantitative Easing (QE) in the US - have re-enforced our concerns.

Our portfolios remain diversified into a greater range of asset classes (commodities and currencies etc.) than industry norms. We have deliberately positioned them to benefit from the geographical balance of power shift that appears to be taking place from West to East where large emerging populations and stronger economic fundamentals can be seen.

Feature Article: **Fixed Interest**

It is a fact that one person's debt is another person's investment. Fixed interest is the asset class that enables us to invest in debt rather than equity. Historically, this asset class has behaved with much less volatility or risk than equities because the interest rates are fixed and the companies and governments doing the borrowing risk massive reputational damage if they default on the loan or fail to pay the interest. However, the credit crisis of 2008, with the associated bank and corporate defaults plus the debt loads of Western Governments have introduced greater levels of volatility.

So how does it work? Quite simply, if a government (say the UK or US) or a major corporation wishes to raise money they can issue debt on the bond market. The rate of interest (or coupon) is fixed based upon the perceived creditworthiness of the borrower and of course prevailing interest rates. For example, the rate might be 3.5% for one company but higher for another with a lower credit rating.

The risk to the investor is that if there is a subsequent increase in the perceived risk of the company/government, or an increase in global interest rates and/or inflation, the market is likely to demand a higher return, say 5%, for that same debt. Since the coupon is fixed, the price of the debt (or bond) will fall.

We have noted that the two main components of Fixed Interest (Sovereign/Government Debt e.g. UK gilts and US treasuries and Corporate Bonds) have performed markedly differently to each other over the last two years. We saw gilts and treasuries benefit from the sharp falls in interest rates down to historical lows (gilt prices rise as interest rates fall) but there appears only one direction now - in fact interest rates appear at the end of a 30 year downtrend. We then saw some very attractive yields on corporate bonds (due to global credit crisis) but had to choose carefully in order to balance the returns against the likely default risk.

Back to the present, November 2010 saw the commencement of the Federal Reserve's 2nd round of Quantitative Easing (QE2). Armed with $600 billion of paper money a team from the Fed are buying US Treasuries on the open market with the remit to keep interest rates low (artificially high demand keeps prices high and yields low) for the revival of the economy and benefit of the ordinary American. However, by providing liquidity for US Investment Houses to buy up cheap assets it has (perversely) helped create inflation on commodities that are every day necessities (i.e. food). Despite QE, the yields on Treasuries have still increased suggesting that for all the colossal and ongoing intervention the

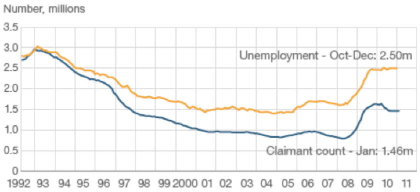
continued on back page

Underweights and Overweights

UK Equity

The UK stock market continued its recovery in 2010 however, whilst we are believers in the great British entrepreneurial spirit, we feel many UK-focused businesses will suffer stagnant, if not negative, growth going forward as austerity measures start to bite. The country has to address a £850 billion bailout package. Economists predict that 350,000 to 500,000 public sector jobs will be lost by 2014, yet haven't accounted for the fallout for the peripheral businesses servicing that sector. We expect employment figures will be an area of stress.

Unemployment in the UK 1992-2011



Source: ONS

It is hoped the private sector will take up the slack from the public sector fallout but although mid cap stocks have performed very well over the past year, we don't feel this is sustainable. We favour world class companies listed in the FTSE100, whose business focus is international, and who pay a healthy dividend. With oil prices tipping over $110 a barrel though, we could be in for a rocky ride!

US Equities

Unlike the UK, Ben Bernanke, the US Fed Chairman has continued with an artificial stimulus to ramp up liquidity and stave off recession. Until June, when QE2 is scheduled to end, this is likely to lend support to the equity markets. We suspect we will see a correction thereafter, but as we cannot predict the exact timing we feel a blend between large cap and mid cap US stocks is the most prudent strategy.

We note that Mr Bernanke recently issued a statement that inflation remains very, very low yet corporate America is seeing different signals courtesy of his QE programme.

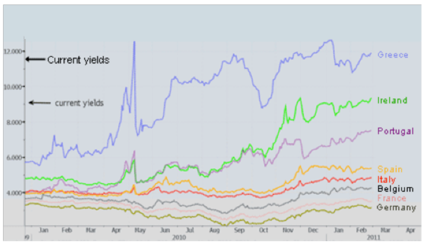
DuPont and Co, Procter and Gamble, Colgate-Palmolive, 3M Company, Pepsico, Goodyear, Whirlpool, and Electrolux have all recently issued 4th quarter results showing increasing sales but falling profits due to significant commodity cost inflation. In light of these first-hand accounts from the business world, Mr Bernanke's QE2 campaign is succeeding all too well with inflation on the upswing.

But once the inflation genie is free of the bottle, there is no telling what will happen next! Before long the genie makes up rules that punish the prudent and reward the reckless. The Federal Reserve Chairman may need more than three wishes to fix this problem.

European Equities

In Europe the focus is still on the four PIGS (Portugal Ireland Greece and Spain respectively) although a wandering eye must be kept on Italy and Belgium whose debt loads may prove unsustainable if confidence fractures. All has been quiet on the Western Front as the general consensus of opinion is Germany, sorry Europe, will sooner or later announce an increase in the funding of the European Financial Stability Facility (EFSF). Frau Merkel is in no hurry as Germany's most important state election will be held on 27th March in Baden - Wurttemberg which is the industrial heartland of Germany where the population is known for its thrift and work ethic. The reality is the Franco/ German alliance simply cannot afford sovereign default as their collective banking sector exposure to the PIGS is over $900 billion. Whilst the German public are becoming increasingly intolerant to their neighbours' fiscal irresponsibility we think it's a fire Merkel can contain for now.

MoneyWeek eurozone bond watch – ten-year sovereign yields
Yields are broadly pausing. But on the edge of the eurozone, Portugal, Ireland & Greece are rising again



With banking reform on the back burner as "more pressing" issues are at hand we still remain sceptical on European bank balance sheets and we wonder whether Frau Merkel's statement in 2008 that the banking crisis was an "Anglo Saxon problem" may prove to come back and bite her on the derriere!

Far East (ex Japan)

The key issue in Asia is China's growth projections as the East continues to dilute its reliance on western demand. We think there are parallels between Chinese and American growth patterns in the 19th century. China will encounter all manner of boom and bust cycles, but ultimately exposure to the region represents the single greatest wealth creation opportunity in our lifetime.

Fish Financial Sentiment Indicator

Asset Class	Feb 2011	Dec 2010	Move
UK Equity	◆	◆	■
US Equities	◆	◆	■
European Equities	●	●	■
Japan	★	★	■
Far East	★	★	■
Emerging Markets	★	★	■
Gov't Bonds	●	●	■
Corporate Bonds	◆	◆	■
Property	●	●	■
Gold	★	★	■

Sentiment		Trend	
Underweight	●	Negative	▼
Neutral	◆	No Change	■
Overweight	★	Positive	▲

Japanese Equities

Japanese companies have had to adapt to Yen appreciation of 30/40% against many currencies over the past three years in order to remain competitive. They have had to address all aspects of costs. As a result these companies are not only valued at less than their current assets but they are now representing some of the most fiscally disciplined on the world stage. In our view, there is a strong chance of Yen depreciation as a backlash against the Japanese government debt standing at 220% of GDP (ouch!) and this will prove a fillip to export-focused companies. Furthermore, the biggest buyer of Japanese government debt has been its own, extremely cautious citizens. There may be a time soon when they realise the high risk and start to divert their savings back in to equities.

Emerging Market Equities

Whilst economic growth has been strong, which generally bodes well for the general trend of emerging market equities, inflation has been picking up in many emerging markets of late. In simple terms the effects of food prices affect the masses a lot more than us in the West. People in developed countries typically spend 15% of their income on food in comparison to 40/70% in less privileged areas of the globe. This is an area of concern for us as nothing stirs up unrest more than hungry people!

The current spate of popular uprising throughout the Middle East and North Africa may have roots in a youth movement for freedom of speech and democracy, but growing frustrations with increased costs of living are also to blame. At present, the fact that the price of rice, which is the largest staple food of the developing world, has not followed other soft commodities upwards is a relief for many other countries. Hotspots of conflict and unrest may appear in the most surprising of areas, therefore we favour a broad emerging market exposure.

Fixed Interest:

Our latest thoughts on fixed interest and our portfolio positioning is discussed in this months' feature article on the front and back cover.

Currencies

USD: Overweight
Euro: Underweight
JPY: Underweight

The current currency focus is on the USD with the general consensus that QE2 will be followed by QE3 if the US economy stalls. We believe that the market has 'priced in' this information, yet Europe's pending sovereign debt issue (including large refinancing) appears to be below the investment community's radar at the moment. The shocking reality is that the European sovereign states have to renew over 1 trillion Euros of debt over the next 3 years. We therefore favour retaining our earlier 'Long USD / Short Euro' recommendation.

Commercial Property

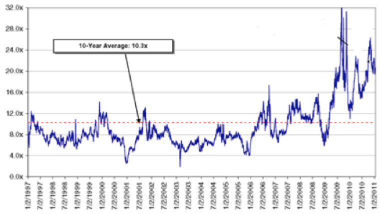
Courtesy of inflation expectations many areas of the world are experiencing renewed interest in property. We remain cautious as lending criteria generally remains tight and rental demand is still static. We prefer sectors of the US that represent long term value due to suppressed prices, as well as Hong Kong and Singapore where, due to constrained supply at a time of strong economic growth, commercial property prices should outperform other markets.

Commodities

All eyes are on China and a continuation of its own fiscal stimulus, by way of easy credit. China currently accounts for between 40% and 50% of global demand for many metals and natural resources as it fast tracks it's infrastructure. If their credit expansion contracts, then so will many commodity prices. We believe in a healthy weighting to hard commodities yet at these relatively high prices, an overweight position would carry high risk. We have also noted the strong performance of soft commodities during 2010 and have commented in earlier issues on the long term food demand/supply argument for grains, softs and agriculture in general. At current, high prices we will retain a watching brief.

Natural Gas

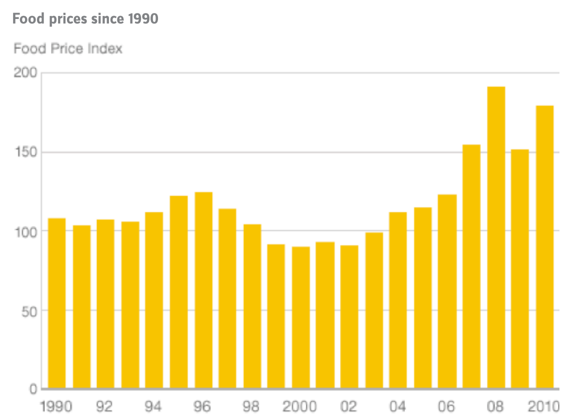
Crude oil to natural gas ratio



Due to excess inventory, gas prices still disappoint and are an area our Investment Committee is monitoring. The OIL/GAS price ratio ranks historically between 6 to 12 times and is currently at 27 (see above graph). This price disparity we feel is unsustainable. Some would argue that oil prices are expensive but accounting for the world's expanding desire for energy our view is that long term, both are likely to trade at high levels. We expect the relationship between oil and natural gas prices to move closer to the historical norm.

continued from front page

markets may demand higher rates for the risk of holding bonds on a country that is adding to its debt pile. We wonder how long this aggressive monetary policy will be tolerated by mainstream America as this stance is increasing food and energy costs, and holding down the value of the dollar.



Source: FAO

As we are all aware, in the UK inflation figures remain stubbornly well above the B.O.E Consumer Price Index target of 2% yet they can ill afford to raise the cost of borrowing as many households are only being kept afloat by near zero rates. The key indicator is wage inflation which has been suppressed by forthcoming public sector job losses and those with regular work even prepared to take salary cuts. Although unlikely in the short term, if wage inflation also kicks in then Mr King may have no alternative but to aggressively address the problem by raising the cost of borrowing

We'd like to quote Bill Gross, who runs PIMCO, the world's largest Bond Funds; *"If yields are too low... an investor should analyse other yields or other spreads which are not... recognition that credit (corporate) spreads or emerging market (debt) returns... are more attractive than those old-fashioned Gilts and Treasury Bonds offering 2-3 %. ...It is still possible to produce 4 to 5% returns from a conservatively positioned bond portfolio - you just have to do it with a different mix of global assets."*

We concur and that is why we have already introduced an Emerging Market Debt Fund, and are now proposing both a Total Return bond and an Index Linked Gilt bonds.

Tax Planning Opportunities

There are a number of new tax and pension initiatives that make this tax year end quite significant. These are opportunities that require your attention now, before April 5th. We can advise you on all of the following points;

- People with income of £100,000 p.a. lose their tax-free personal allowances progressively up to about £113,000, creating an effective 60% tax rate in this income band. Can you transfer or divert some income?
- People with income of over £150,000 will be paying 50% income tax on the top slice. Can you transfer income to a spouse?
- ISA Tax-free Allowances are £10,200 p.a. per person. Use it or lose it?
- Pension contributions revert to income tax relief at your highest marginal rate from 6 April, but a new £50,000 p.a. limit is introduced. This means:
  - An effective 50% discount on a £50k investment, every year, for high earners.
  - The can potentially be backdated for 3 years to maximise your contributions.
  - With the clever use of pension input periods now, it may be possible for high earners to achieve a £100,000 pension contribution in April 2011 for a net cost of £50,000.
- CGT Tax-Free Allowances are £10,100 p.a. each person. Use it or lose it? It may be time to crystallise some gains?
- For high earners, EIS and VCT investments will generate immediate 20% and 30% income tax relief respectively, plus possible CGT deferral in the case of EIS.
- Never let the 'tax tail wag the investment dog'; however we can advise upon well diversified EIS and VCT schemes to suit a variety of risk profiles.

Stay In Touch

Fish Financial Limited
Town Hall Exchange
Castle Street
Farnham GU9 7ND
Tel: 084 5470 7800 | Email: info@fishfin.co.uk

Fish Financial is authorised and regulated by the Financial Services Authority.

FISHFINANCIAL
fishfin.co.uk