



Market Review



OCTOBER 2007

From the sub-prime to the ridiculous

As we go to press, global markets are attempting to recover from the "credit crunch" affecting money-market interest rates over the summer months in the US (where sub-prime mortgages are more common than in the UK). Banks had packaged together good, bad and downright toxic mortgages and sold them with undeserved investment-grade ratings to other investors. The intention was to diversify risk and free up the balance sheets of the issuing banks. As these banks have been forced to bail out in-house funds and have become reluctant to lend (even to each other), money markets have seized up. Since the Bank of England has sole responsibility for monetary policy and had concluded that overnight rates at 5.75% were appropriate, it seems strange that they should sit back while the market set 3-month rates 1.25% higher and take no remedial action which seems ridiculous.

One of the side issues during this period has been dollar weakness and related strength in the price of gold as a safe haven. Other metal and commodity prices, which are priced in dollars, have also risen strongly, leading to inflationary concerns. Interest rates were expected to rise further before year-end to quell inflationary pressure, but the US has now cut rates, the UK is expected to follow, and Europe no longer has a tightening bias. As inflation becomes less of a worry and the rate outlook softens, prospects for sectors such as house builders may not be as bleak as previously thought.

It may take many months for the western banking system to establish the full extent of the damage, during which period local economies are likely to suffer. Nevertheless the global economy, (especially in the Far East and the Gulf) is thriving, hence the robust demand for oil and commodities (albeit in depreciating dollars). Although hedge funds and private equity groups will have less scope to engage in mergers and acquisitions, not all activity will cease since these institutions need fees in order to survive. Trade deals such as Akzo Nobel for ICI or Royal Bank of Scotland for ABN Amro are likely to continue to be tabled, while sovereign wealth bids such as the Qatari royal family's approach to Sainsbury's is likely to be replicated. Sovereign wealth may even reinforce the balance sheets of private equity businesses, as with the Chinese investment in

Blackstone earlier this year.

At current levels UK equities, with the right timing, still offer reasonable value with average dividends yielding 3% and P/E ratios at 12. The gilt market has rallied 3% since our July recommendations were made, and may rise further depending on the future level of interest rates - although a slower UK local economy implies lower tax revenues and a consequent increase in issuance. Those for whom the risk level is appropriate may wish to examine the UK bank and housebuilding sectors where recent share price weakness has thrown up net yields considerably higher than the gross yields prevailing in the gilt market.

Three Month Performance

	28/09/07	29/06/07	Change
FTSE 100	6466.8	6571.3	-1.6%
FT All Share	3316.89	3404.14	-2.6%
US Dow Jones	13895.63	13408.62	+3.6%
Nasdaq Comp	2701.50	2603.22	+3.8%
FTSE Eurotop 300	1550.89	1605.33	-3.4%
Japan Nikkei	16785.68	18138.36	-7.5%
APCIMS Growth	3495.30	3529.47	-1.0%
APCIMS Balanced	3019.27	3036.83	-0.6%
APCIMS Income	2324.51	2324.53	unch
£/\$	\$2.0468	\$2.0092	+1.9%
Euro/£	€1.4338	€1.4834	-3.3%
Gold (per ounce)	\$743.00	\$648.90	+14.5%
Brent Oil	\$79.79	\$73.08	+9.2%

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Stock Selections (prices as at 10th October 2007)

FTSE 100

Royal Bank of Scotland

Sector – Banks

Price 546.5p Yield 5.53% PE 8.42

Mkt.Cap. £52588m High/Low 726p/501p

RBS owns Nat West, Direct Line, Churchill Insurance, Ulster Bank, Coutts & Co., and Citizens in the US.

Its US business has not been involved in sub-prime lending directly, but has experienced lower trading volumes due to the market turmoil. This is one of two drags on profit, the other being substantial insurance payouts in the UK due to the floods. The latter should be a one-off. Underlying earnings should still expand by 10% to 15% over the year thanks to continued strong growth in global corporate banking, UK retail, Asia, and Ulster Bank.

RBS, Fortis and Santander form a consortium which is likely to be successful in taking over Dutch bank ABN. The deal should be positive longer-term for RBS, but has weighed on the share price in the short-term.

InterContinental Hotels

Sector – Travel & Leisure

Price 1076p Yield 1.71% PE 28.69

Mkt.Cap. £3195m High/Low 1420p/914p

In April 2003 Six Continents demerged into InterContinental and Mitchells and Butler (Its UK pubs and restaurants group). InterContinental controls 3,700 hotels across brands such as Crowne Plaza, Staybridge, and Holiday Inn.

The group's outright ownership of hotels has decreased steadily due to asset sales - it has returned £3.6bn to shareholders over the last 3 years. Expansion continues to take the form of franchising its brands in what has proved to be a very successful strategy. Growth in Asia Pacific has positioned it as number one in the region. In July it said it was on track to open 125 hotels in China by end-2008.

The shares are oversold following the recent sell-off of all hotel stocks.

Home Retail Group

Sector – General Retailers

Price 400.5p Yield 3.25% PE 13.67

Mkt.Cap. £3514m High/Low 502p/346p

Home Retail is the UK's leading home and general merchandise retailer, comprising in-store catalogue retailer Argos, and Homebase, the UK's second largest DIY retailer. Together they operate over 1,000 stores in the UK and Ireland.

It is just over a year since Home Retail demerged from GUS. In May it announced its first full year results which showed a pro-forma pre-tax profit of £321m compared to £271m a year earlier. September's Q2 update was not as positive with underlying sales at Homebase down 8% due to the wet weather in the summer. The affect of this on profits should be limited as gross profit margins grew strongly.

The share price has corrected by over 20% since the May peak, more than pricing in any bad news.

Compass Group

Sector – Travel & Leisure

Price 319.75p Yield 3.16% PE 23.34

Mkt.Cap. £6146m High/Low 384p/267p

Compass is one of the largest contract caterers in the world. It provides contract and concession catering services to businesses in over 90 countries.

Compass endured a number of difficult years following its demerger from Granada in 2001, with a string of profits warnings as well as a US government/UN investigation into alleged improper conduct in securing contracts with the UN and a related £600m lawsuit.

In the last financial year the group reported sales ahead by 7%, and a 60% increase in pre-tax profits. A raft of disposals raised £1.8bn enabling the pension deficit to be halved and a return of £500m to shareholders.

In its September trading update Compass said its full year results would be at the higher end of market expectations, as the positive trading momentum of the first half continued throughout the summer.

FTSE 250

Filtrona

Sector – Support Services

Price 243.5p Yield 2.83% PE 15.41

Mkt.Cap. £528m High/Low 300p/217p

Demerged from Bunzl in June 2005, Filtrona is an international market leading speciality plastic and fibre products supplier. Products include cigarette filters, printer wicks, and medical devices.

Results for the year ending 31st December 2006 – its first year as an independent company – showed a 5.9% increase in revenue to £544m, and a 9.2% jump in pre-tax profits to £54.6m. Earnings growth is partly being driven by moving its manufacturing into lower cost regions, such as China, but it has also invested heavily in geographic expansion, product innovation and intellectual property development to drive organic growth.

The shares trade on an undeserved discount to the sector.

Venture Production

Sector – Oil & Gas Producers

Price 695p Yield 1.44% PE 10.78

Mkt.Cap. £988m High/Low 918p/612p

Venture is a specialist oil and gas production company dedicated to acquiring, revitalising and operating 'stranded' assets (oil and gas fields with proven but untapped potential) in the North Sea.

Profit forecasts for this year have had to be reduced due to lower oil and gas production, and lower prices in the wholesale market for gas. Venture's strategy however - of developing reserves which would be marginal to the oil majors - is likely to remain lucrative as long as the oil price remains anywhere near the current lofty levels. Venture capitalists 3i Group and ArcLight believe in the business model and strategy, increasing their investment in the company to over £200m in July. The company has a reserve replacement ratio of 455% and a reserve life of 11.1 years at the present rate of usage.

Trading 15% below the best levels for the year, the shares are attractive at this price.

Too late to take advantage of the bull market in commodity prices?

COMMODITIES – CONCLUSION

The bullish story for commodity prices is compelling. China and India are not going to reverse the process of industrialisation so demand for metals and energy looks likely to remain strong, unless the global economy goes into recession. As the emerging economies grow, the populace become increasingly wealthy and consume more food. This is a long-term bull factor for agricultural commodities.

In terms of timing we are reluctant to chase the recent strength and would look to buy the funds mentioned below when prices have corrected 15% to 20%.

The 80's and 90's was a period of deflation for commodity prices. By 1998 oil was trading at \$10 per barrel, gold was at \$260 per ounce (having been over \$880 in 1980) and silver was \$4 per ounce. Now oil is over \$70, gold over \$700 and silver \$13. The prices of base metals such as copper, and soft commodities such as wheat, have also risen substantially during the last 3 to 4 years.



Chart - spot gold price over last 20 years

The main driving force behind this bull market is accelerating demand from China and India. Just as the US dollar started to weaken in the early part of this decade, China and India began to make the push to industrialise their countries and become gluttonous consumers of commodities. This demand continues to grow, and with half the world's population between them, the cumulative effect on the supply/demand ratio is significant. Other factors have contributed. Governments in North and South America are pushing ethanol and bio diesel production, leaving less grains and sugar to meet food demand.



CRB index measuring prices of 22 basic commodities



Chart - Soybeans price has risen by 50% since 2005

It has not been easy for investors to benefit from the commodity bull market. It remains impractical for investors to buy and store physical commodities. Even precious metals attract high costs and storage charges in modest amounts. Direct equity investment into mining or gold shares, has, until very recently been regarded as high risk due to the volatility and lack of liquidity. The number of funds providing exposure to this area is very small compared to the huge number of general equity funds. The situation is improving however. The raised profile of the sector is leading to an increasing number of investment vehicles providing access to commodity prices. We detail some of these new funds, as well as some of the more established funds, below.

Merrill Lynch Gold and General Fund

This is specialised unit trust investing in gold, mining and precious metal related shares. Manager Graham Birch has extensive experience and knowledge of the sector. Over the last 5 years the fund has grown by 163%.

Merrill Lynch World Mining Trust

Also managed by Graham Birch, this is a London listed investment trust that invests in a world-wide portfolio of mining and metal securities. Again performance has been impressive – the Net Asset Value has grown by 378% over the last 5 years.

BNP Paribas Agrinvest

This is a structured product that has a 6 year life and will provide a return equal to 130% of any positive performance of the DCI® Agriculture BNP Paribas Enhanced Index. This index is the broadest agriculture index available – it is composed of 23 agricultural commodities including cocoa, coffee, sugar, wheat, rubber, live cattle, rice and orange juice.

ETFS Agriculture DJ-AIGCI

This is an exchange traded fund listed on the London Stock Exchange. Effectively it trades like a normal share and tracks a commodity index – in this case the DJ-AIGCI Agriculture sub-index. This index has a food focus – it amalgamates prices of soybeans, corn, wheat, cotton, sugar, coffee and soybean oil.

Investec Global Energy

This is an OEIC that invests in global equities of companies involved in the exploration, production or distribution of oil, gas and other energy sources or companies which service the energy industry. Its excellent record is reflected in S&P rating it AAA.

CAPITAL GAINS TAX REFORM

While a lot of publicity has been given to the changes to Inheritance Tax announced by the Chancellor in his Pre-Budget Report, the effects of which many well-advised clients have already achieved through writing their Wills in a tax efficient manner, less attention has been given to the reform of Capital Gains Tax (CGT). The reform applies to individuals, trusts and estates, but the rules for companies are unaffected.

The CGT rules will be simplified by the withdrawal of indexation allowance and taper relief, and the introduction of a flat tax rate of 18% on gains in excess of the annual exemption. The share identification rules will also be simplified with the reintroduction of pooling, but the rules negating 'bed and breakfasting' are still in place. It is disappointing that the Chancellor did not take the opportunity to advance the rebasing date of March 1982 to a more recent time.

The detailed rules will be published later this year. The legislation will take effect for disposals after 5 April 2008, and for held over gains coming into charge after that date. This allows taxpayers, and their advisers, a few months to work out if there are specific tax reasons for preferring to crystallise gains under the old or new rules.

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