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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

A quarter of consolidation has shown markets edging slightly higher which is a creditable performance against such a difficult economic background. Bonds have shown a slightly easier trend in the high quality sovereign issues whilst the feature of the currency markets has been the weakness of the yen, which will come as a relief to the authorities given the competitive difficulties it has caused many companies.

The tables below detail relevant movements in markets:

International Equities 31.08.12 - 30.11.12

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.5	+5.5	+6.5	+3.2
Finland	+8.8	+11.3	+12.3	+8.8
France	+5.3	+7.7	+8.7	+5.3
Germany	+6.4	+8.8	+9.8	+6.4
Hong Kong, China	+12.6	+11.7	+12.7	+9.2
Italy	+5.1	+7.5	+8.5	+5.1
Japan	+8.3	+1.9	+2.8	-0.4
Netherlands	+3.6	+6.0	+6.9	+3.6
Spain	+8.2	+10.6	+11.6	+8.2
Switzerland	+6.8	+8.9	+9.9	+6.5
UK	+3.6	+3.6	+4.6	+3.7
USA	+1.4	+0.5	+1.4	-1.7
Europe ex UK	+5.8	+7.8	+8.7	+5.4
Asia Pacific ex Japan	+5.2	+6.5	+7.4	+4.1
Asia Pacific	+6.4	+4.6	+5.5	+2.3
Latin America	+3.5	+0.9	+1.8	-1.4
All World All Emerging	+6.6	+5.6	+6.5	+3.3
The World	+3.4	+2.8	+3.7	+0.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.6%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.08.12	30.11.12
Sterling	1.66	1.79
US Dollar	1.57	1.61
Yen	0.80	0.71
Germany (Euro)	1.34	1.37

Sterling's performance during the quarter ending 30.11.12 (%)

Currency	Quarter Ending 30.11.12
US Dollar	+1.1
Canadian Dollar	+1.7
Yen	+6.5
Euro	-2.3
Swiss Franc	-1.9
Australian dollar	+0.1

Other currency movements during the quarter ending 30.11.12 (%)

Currency	Quarter Ending 30.11.12
US Dollar/Canadian Dollar	+0.7
US Dollar/Yen	+5.4
US Dollar/Euro	-3.3
Swiss Franc/Euro	-0.4
Euro/Yen	+9.0

Significant Commodities (US dollar terms) 31.08.12 - 30.11.12 (%)

Currency	Quarter Ending 30.11.12
Oil	-2.9
Gold	+4.2

Markets

Markets have consolidated earlier gains in the year with a tendency to drift higher during the quarter. In total return terms, the FTSE World Index in local currency terms has returned 3.4%, in sterling terms 2.8%, in US dollar terms 3.7% and in euro terms 0.5%. Looking at local currency performance first, we note that the USA underperformed other markets, returning just 1.4%, although market performances were quite closely bunched. Europe ex UK showed an above average performance, returning 5.8%, and Australia also did well with the FTSE Australia Index returning 5.5%. Emerging Markets also put up a good performance with the FTSE All World All Emerging Markets Index returning 6.6%. The strongest performance of all of the major markets came from Japan where the FTSE Japan Index returned 8.3% in local currency terms. However, currency movements had a significant effect on the sterling performance of the indices in the case of Japan where the yen showed marked weakness. So, in sterling terms, a strong local currency performance from the Japanese market turned into a below average return in sterling terms of 1.9%. With sterling weakening against the euro and Swiss Franc, the FTSE Europe ex UK Index returned 7.8% in sterling terms to provide the best returns of the major markets. The FTSE UK Index return of 3.6% was slightly better than that of the FTSE World Index but, with the US dollar weakening, the FTSE USA Index sterling adjusted was barely in positive territory, returning just 0.5%.

High quality sovereign bonds drifted slightly lower during the quarter. Taking the ten year government bond yield as the benchmark, UK gilts saw a rise of 13 basis points in the gross redemption yield to 1.79%, US Treasuries a rise of 4 basis points to 1.61% and German Bunds of 3 basis points to 1.37%. Only yen bonds showed a decline in yields, one of 9 basis points to 0.71% for Japanese government bonds.

As indicated above, the feature of the currency market was the weakness of the yen which will have come as a relief to the government and many Japanese exporting companies. Against the yen, sterling rose by 6.5%, with smaller gains against the Canadian dollar, 1.7%, and the US dollar, 1.1%. Against the euro, sterling weakened by 2.3% and by 1.9% against the Swiss Franc.

In the commodity markets, oil fell by 2.9% and gold rose by 4.2%.

Economics

The background remains very difficult, with the eurozone, UK and Japan basically stagnant, the USA showing modest growth, but there are some tentative signs that growth in China, having decelerated, may be about to accelerate again. Having held up well in the face of unpromising economic news, markets are now experiencing signs of nerves, not unexpected given the background. Our view has been that equity markets, whilst being the asset class of choice at present, would experience setbacks from time to time in the context of an upward trend.

It is not possible to find a new angle on the present economic situation. It is much as we have been portraying it for some time. Many countries and individuals are very overborrowed and are deleveraging, so this exerts a contractionary economic influence, the problems of the eurozone are profound and fundamental, the highly partisan nature of US politics risks a "fiscal cliff" occurring from next year and the UK struggles to tackle its serious deficit. After a recovery in growth post the March 2011 earthquake and tsunami, Japan's growth is halting and it is engaged in a potentially dangerous stand off with China over disputed islands. A new leadership has been unveiled for China and there are some early encouraging signs for the economy which, if confirmed, will be good for other economies.

Because of the need for public and parts of the private sector (not necessarily the case with many companies where balance sheets are strong) to tackle their excessive debt, the chosen methods of doing that for the public sector, tax rises and public spending cuts, exert a contractionary effect on the relevant economies. So, monetary policy, orthodox and unorthodox, is almost certain to remain very loose for the foreseeable future in order to try to offset the contractionary effect of fiscal policy. This is one of the key factors in informing our investment policy at present because many investors might find it strange to be invested in shares when the economic background is so unpromising. In most of the major economies or economic regions of the world, the USA, UK, eurozone and Japan, this very loose monetary policy is in place with variations. In most cases, short term official interest rates are below inflation and that is often also the case with, say, ten year government benchmark bond yields. The clear risk of such a policy is that it will stoke inflationary trends. An analogy might be the property price crashes in Ireland and Spain. One of the major catalysts of the boom and bust was that the "one size fits all" policy of the eurozone meant that interest rates were set too low for these countries so that cheap and plentiful loans sparked property price increases which proved to be unsustainable. However, where the analogy is not relevant is that economies are so depressed at the moment that the sort of freewheeling economic conditions that led to the problems are not present now. Banks are not easily going to lend money for property speculation. Nevertheless, extremely low interest rates and, where practised, quantitative easing, are laying the foundations for inflation to return, perhaps at a dangerously high level. For the moment, equity investors do not have to worry about this and can absorb the positive aspect of monetary policy for shares but, later on, it may be a different matter.

The reason that it may be a different matter later on is that in those countries where the unorthodox aspect of monetary policy, quantitative easing, has been practised, the USA, UK and Japan, it will have to be reversed at some stage because it will cause inflation to rise. It is, however, not going to be easy because the economy and financial system might become dependent upon it. But, at a later stage, if the money is not withdrawn, the stock of money, enlarged by the money "printed" chasing a finite amount of goods and services, will push up prices. Printing money risks currency debasement and we already see evidence in, say, the gold price of some investors seeking a store of value to protect themselves against this eventuality.

The same may also be said for shares. Their most direct competitor, bonds, would fare very badly in an environment of sharply increasing inflation. As it is, with inflation internationally low, typically between 1% and 3% in the main economies (except Japan where inflation is non-existent), high quality sovereign bonds, as measured by ten year benchmark maturities, are still showing negative real yields (except Japan) and they look very bad value as a result of this. Companies are in a better position to deal with inflation if they have some pricing power in countries prone to inflation and exposure elsewhere to balance the risks. They would offer a better store of value in many circumstances, but not all. If inflation were to take off, say as it did in the UK in the 1970s, when it reached over 25%, and if interest rates were raised by the Bank of England to try to suppress and then reduce inflation, it could cause economic contraction on a sufficient scale to reduce company profits and dividends significantly. Then shares could well offer unattractive dividend yields against bonds and cash and perform accordingly. At the moment, we are a long way from such a position and the arguments favour shares over bonds. Corporate profit margins are high and balance sheets strong, hence the generally positive dividend experience at present.

One of the earliest and most deliberate aims of very loose monetary policy, standard and non standard, although it was not paraded at the time, was to push up asset values to try to engender a positive wealth effect. The absence of yield on some assets, such as cash, diverted money into other assets and this has inflated the value of bonds, shares and some commodities to bubble conditions in the case of bonds, although not shares. In our view, one of the main reasons why loose monetary policy has not been successful in lifting economic growth is that the weakened conditions of the banks and official pressure for them to raise their capital buffers has kept them in defensive mode. Regulators and politicians have often been pulling in opposite directions, excoriating banks for not lending, in the case of politicians, yet demanding a stronger capital base. The objectives are mutually contradictory. US banks are generally in a much better position. The link between the banks and the sovereign is a real issue for the eurozone, perhaps Spain being the best example. Although the two very large publicly quoted banks in Spain are robust, lower down the scale there are big problems. Given the current thrust of political and regulatory pressure on the banks, particularly in the eurozone and the UK, they cannot always provide the practical support to business to complement the beneficial effects of very low interest rates which should be available to borrowers.

It is very difficult to say any more about the eurozone over and above what we have said in all our recent reviews. The monetary union cannot work as it presently exists but what is frustrating for many detached observers is that there is absolutely no recognition from within the eurozone hierarchy, whether it be politicians, central bankers or eurocrats, that the whole project is flawed because it is not an optimal currency zone. If the fundamental problem is not acknowledged then no amount of sticking plaster will work. A number of eurozone economies, which are having their policy dictated to them by the troika or EU, are being ground into the economic dust by the policy measures being forced on them. When the history books come to be written, economic historians will scratch their heads as to how the current situation came to be as it is. The eurozone has fallen into recession in the second and third quarters, 0.2% and 0.1% respectively, and the latest European Commission economic forecasts make for grim reading.

The eurozone is forecast to contract by 0.1% this year, to grow by 0.1% next year and 1.4% the year after. Even mighty Germany is only expected to grow by 0.8% this year and the same next year. The number two economy, France, is forecast to grow by 0.2% this year and by 0.4% next year, whilst the number three economy, Italy, is forecast to decline by 2.3% this year and 0.5% next year. The number four economy, Spain, widely expected to be the next eurozone country to require a bail out, is expected to contract by 1.4% this year and next. Of the bailed out countries, Ireland, a rather different case from the rest, is expected to grow by 0.4% this year and 1.1% next year. Portugal, also in a bail out, is forecast to contract by 3.0% this year and 1.0% next year, whilst Greece, the most troubled of all, is forecast to contract by 6.0% this year and 4.2% next year.

The problem in the eurozone is compounded because of the disagreements between the various countries and the need for the politicians to play to their own electorates, Germany being a prime example of this. Because of its economic power, Germany calls the tune for the creditor countries but, with elections due next year, Mrs Merkel has to watch her electoral flank, with the electorate becoming increasingly disenchanted with the potential size of Germany's financial liabilities. The objections of the President of the Bundesbank are being brushed aside for the present but, powerful as her position is, Mrs Merkel is constrained in her actions, not least by the Constitutional Court. Germany, after a powerful economic performance in 2011, is slowing down rapidly, as the above EC forecasts show, and the prospects for the eurozone economies remain blighted by the debt problems of some of its members.

The reasons for remaining invested in eurozone equities are as before. There are world class companies based in the eurozone with a big international reach of business, some of it in the faster growing areas of the world like Asia. This gives them some diversification benefits and these companies are well used to dealing with currency issues so that they will have taken precautions against a country or countries leaving the eurozone. If this happens, it will be a messy situation, but companies may be better placed than countries to deal with the situation. Many people will be very weary of the never ending problems of the eurozone and may be becoming complacent because it has not yet fragmented but the social unrest which is increasing will not go away and it is likely to force the issue of whether it is worth countries remaining in the eurozone. But we do see value in eurozone shares, notwithstanding the area's serious problems. If we look at Bloomberg estimates for this year's price/earnings ratios for the Euro Stoxx 50 Index covering large company eurozone shares, it stands at around 11.0, whilst the dividend yield is currently about 4.6% gross. Whilst the share price multiple is quite modest, the dividend yield looks very attractive relative to the top rated eurozone government bonds. If we take the ten year German government bond, we see a yield of just 1.37%.

Not much has changed in the USA, we still have the Democrats controlling the White House and the Senate, whilst the Republicans have retained a significant majority in the House of Representatives. The "fiscal cliff" looms on 1st January 2013 and, if no budget agreement is reached, the effect on GDP is estimated to be around 4%, in money terms just over US$600 billion, as tax rises and spending cuts come into effect. Whilst the budget deficit would be reduced, growth would be badly hit and unemployment would rise, so it is not an attractive outlook. The Congressional Budget Office said, in August, that, if the "fiscal cliff" occurs, growth in 2013 would be just 0.5% and unemployment 9.0% by the end of 2013 (it is currently 7.9%). If the "fiscal cliff" does not occur because the tax cuts etc. are extended indefinitely, then growth would be 1.7% and unemployment would be 8% by the end of 2013. The budget deficit would be US$1 trillion (US$1.089 billion in the year to September 2012). One must hope that common sense prevails, but the polarisation of the political parties in the USA means that the ill will between them makes compromise very difficult. Ben Bernanke has observed that the prospect of the "fiscal cliff" is already dragging down the US economy and pressed the country's politicians to come to an agreement. Addressing the "fiscal cliff", and then agreeing a plan beyond that for addressing the USA's very serious debt problem as entitlements grow, is of paramount importance. The USA's creditors will eventually tire of the lack of a credible policy for addressing its debt problems. Its advantages, being able to issue its own money and being the world's largest reserve currency, will not enable it to borrow with impunity for ever. In the short term, if a "fiscal cliff" is averted, we would expect the US equity market to recover its poise. Because of the poisonous atmosphere in US politics, one cannot guarantee a positive outcome of the negotiations which will have to take place between the two parties. Notwithstanding the fact that third quarter US earnings were slightly down on this time last year, corporate profits are at high levels and share price multiples offer reasonable value. According to Bloomberg estimates, the S&P 500 Index is on an estimated price/earnings ratio of about 13.0 this year, whilst the dividend yield of approximately 2.40%, as forecast for this year, compares favourably with the 1.61% of the ten year US Treasury bond. What started the financial problems of the USA in 2007/8 was the housing market and it is encouraging to note some better news.

The latest survey shows that homebuilder confidence has hit a six year high. The latest Case/Shiller index shows that US house prices have risen for the sixth consecutive month. Also encouraging is that the Conference Board's consumer attitudes index has risen to its highest level since February 2008.

In Japan, a stand off over raising the government's borrowing limit has been averted, with the Japanese Prime Minister calling a general election, which his party is widely expected to lose, paving the way for the LDP to return to power. Japan's debt problem is even worse than that of the USA but it does have the advantage that almost all of it is financed domestically. Japan also has a current account surplus, even if it is diminishing. The Japanese parliament has agreed to raise consumption tax in two stages to 10% from 5% at present. A 230% level of gross public debt to GDP is not sustainable even if most of it is financed internally, so major change has to take place in Japan also. In the short term, the stand off between Japan and China over the disputed Senkakus islands, as the Japanese call them, or the Diaoyus, as the Chinese call them, is exacting a costly price for some Japanese companies with operations in China or those Japanese companies which export to China. Japanese manufacturing companies have been struggling with the high value of the yen which is why they have a substantial manufacturing presence in China. As evidence of the effect, at least in the short term, of the Japanese/Chinese stand off is that the latest trade figures show that Japan has recorded its biggest monthly trade deficit with China. There are many structural rigidities in Japan which inhibit its growth potential, for example an inflexible labour market, and it has to address its budget deficit problem (an estimated deficit of nearly 10% of GDP this year). Japan is a market from which many investors switch off, but it does not look expensive and the estimated dividend yield according to Bloomberg estimates this year of 2.20% compares favourably with the ten year government bond yield of 0.71%. There was a time when Japanese companies offered minuscule dividend yields but the above yield effectively means a 2.50% real yield, with deflation in the Japanese economy.

In the UK, the government has been making strenuous efforts to tackle the very serious state of the country's public finances, but these have been hampered by the eurozone's problems which have damaged an important export market, and above expected rates of inflation, according to the OBR analysis. Although the first estimate of third quarter GDP was for growth of 1%, since confirmed, this came after negative quarters and the economy is essentially flatlining; at least, that is what would be inferred from the GDP figures. But, strangely, the employment numbers have been at variance with what one would expect from the GDP figures. The latest unemployment figure is 7.8% of the workforce against 8.4% at the end of 2011 and the employment rate was 71.2% of the workforce. The explanation might be that the GDP figures will be revised up in due course, as sometimes happens, or that productivity has been falling. After a bit of a lift arising from better than expected third quarter GDP figures, the most recent economic data has been disappointing. The Purchasing Managers Index for manufacturing fell from 48.1 in September to 47.5 in October. The one for the services sector was just in positive territory at 50.6, but this represented a decline from 52.2 in September. The construction industry's Purchasing Managers Index improved slightly, from 49.5 to 50.9, but this represented just 7.0% of the economy, and it reported more job cuts and a fifth successive month of a fall in new orders. Further unwelcome news for the UK came from the retail sales figures which showed a fall of 0.8% between September and October. There was an unpleasant surprise on inflation where the rise in university fees contributed to a 0.5% increase in the rate of inflation, as measured by the Consumer Price Index. We noted above that the OBR had said that one of the reasons why growth had disappointed against forecasts was that inflation was higher than expected. With pay held down, as a result of harsh economic conditions, higher inflation adversely affects purchasing power and, hence, growth. If that was not enough, the Governor of the Bank of England has painted a gloomy view of the UK economy. He said that the UK economy "may be in for a period of persistently low growth". He was not happy about the effect of the strengthening pound and he went on to add that "we face the rather unappealing combination of a subdued recovery, with inflation remaining above target for a while". From a stock market point of view, the substantial direct and indirect exposure of UK companies to overseas markets, many of them more buoyant than the UK, provides some welcome profits boost.

Whilst the outlook for the UK economy remains unexciting, as the Governor of the Bank of England suggested, many British companies can expect to perform better. A dividend yield of around 3.9% on the FTSE 100 Index and a prospective price/earnings ratio forecast of around 11.0 for this year represents reasonable value, in our view, especially when measured against the ten year UK government bond yield of 1.79%. Dividends are still growing as well.

One area where there is possibly some good economic news is China, although it is too early to be sure. The deceleration in the rate of growth appears to have been halted and, perhaps, reversed. The Chinese authorities, boosted by a sharp fall in the rate of inflation to 1.7%, have felt able to relax monetary policy and this seems to be having an effect. Looking at industrial output, the rate of increase accelerated in October to 9.6% compared with 9.2% in September. Retail sales growth also accelerated to 14.5% from 14.2%. If China could raise its growth rate and achieve its policy aim of raising consumption in the economy, it would be a positive signal for the world economy. But, of course, it is not just economic events which everyone is watching in China. It is also the politics with the change of leadership and the jury is out on what this may mean. For the moment, against a rather gloomy economic background, China offers a possible respite.

Away from direct economic news and more into the political sphere, investors should be aware of the increase in anti business and anti finance sentiment which finds its influence in the media and amongst politicians. People might say that because one is writing as a member of the finance industry one cannot be objective. It is quite understandable that many people are very angry about what has happened in the finance sector, but venting one's wrath on business does not send out a good message because it is the private sector which creates the wealth for an economy. Unfortunately, politicians' time horizons are rarely stretched beyond their next election, and jumping on anti business bandwagons can seem tempting. But outsiders notice. To give just two examples. The UK says it is open for business but it is getting a reputation of being anti business, partly because of the politicians' relentless attack on the banking sector. It may seem clever, and electorally popular, but the diminution in the size of the finance sector threatens severe budgetary problems for the UK as time goes on. Another example is France, where hostility to business and the so-called rich is overt. Populist actions taken since the election have increased France's unwelcome reputation as a country which does not value its business. France needs foreign investment but its brow beating of companies on policies which the government does not like must be damaging the country. Investors must be aware of these trends because they could be influences on their investment decision making.

Our investment conclusion is much as it has been for many months, namely that the balance of advantage lies with equities, especially as opposed to bonds. Investors face a unique set of circumstances arising from monetary policy decisions made in the aftermath of the financial crisis, which are helping to push up share prices. However, investors must be under no illusion that economic conditions remain very dangerous and that, although we expect shares to rise over the next year, there will be turbulence along the way. For investors, who are retaining cash for investment purposes, those setbacks will provide an opportunity. For those heavily into cash, the opportunity cost could be high at these market levels, given that we do see some fundamental value in equities.