

# Thesis Market Commentary

## July 2011

**"Gold and Silver are money. Everything else is credit."**

Financier JP Morgan

**"Confidence is what you have before you understand the problem."** Woody Allen *Film Director*

### Gold Sovereign?

One of my shopaholic colleagues (who will remain nameless) told me recently that there is now a cash machine at the Westfield Shopping Centre in London... with a difference. Instead of dispensing nice crisp notes, it sells gold at constantly updated prices: for about £41 you can buy a one gram gold bar, which the machine's promoters describe as "cheap as a bouquet of flowers but sure not to wither". So far they have installed similar gold dispensers in Germany, Italy, Spain, US and United Arab Emirates. Perhaps their next machine should be based in Athens, to capitalise on gold's traditional status as a safe haven investment in times of economic turmoil - apparently sales of gold in Greece have been increasing, unsurprisingly.

Whilst Greece remains in the Euro for now, their €2 coin has a picture of a bull, which relates to the original Greek myth of Europa, who was a beautiful princess in Asia Minor abducted by the Greek god Zeus in the form of a bull and taken to Crete.

This month, rather than discuss Greece or gold, I thought it might be worth looking at a few myths that relate to the investment world, many of which have been overturned or at least questioned more closely in the last three years of the credit crunch. One is that investing in the developed world is safer than the Emerging Markets: this is taking a knock as my colleague Giles Marriage points out in his article that follows. Broadly speaking the West now has the debt and the East has the money.

A second myth is that Government or Sovereign debt or loans are safer than those issued by companies, or corporate bonds. A Sovereign state can always raise taxes on its own citizens and/or print money to pay back its loans, provided it is only having to repay domestic lenders and not foreigners. There have been times recently when the prices of CDSs (a form of debt insurance) have indicated that markets feel more comfortable with loans issued by global multi-nationals such as Unilever than

countries such as the UK. There is also a certain logic in this, in that companies can switch operations to other countries, and can also take uncomfortable decisions regarding their finances, which politicians would be unable to get past their voters.

Another investment myth is that of the 'risk free asset' beloved of investment academics. This refers to a benchmark against which returns available from other assets, such as shares, are compared. Such a risk free asset is usually taken to be one of the highest rated Government stocks such as UK Government Stock gilts or US Treasuries. In the strange world of investment theory, risk free does not mean that you cannot lose money, it's just that with a risk free Government bond you just know that you are guaranteed to lose money and you know exactly how much you will lose.

So is Sovereign debt, even issued by the strongest Governments, secure? Greece is just the latest country to run into difficulties and potentially default on its debt to the international community. Since the mid-1990s the list of defaulters includes Argentina, the Dominican Republic, Ecuador, Indonesia, Moldova, Russia, Uruguay and Jamaica. In fact one can often trace financial difficulties to the same cycle that affects individuals and companies. After all whatever one might think, the members of Governments are only human and suffer the same emotions as anyone. The steps have been outlined on the following lines:

- **Surprise** - financial difficulties often come after a strong period of capital inflows, leading to complacency in economic policy
- **Denial** - don't underestimate a Government's creativity in trying to escape from reality
- **Anger** - usually directed at market 'speculators' who can be anything from hedge funds to US banks etc
- **Acceptance** - usually the earlier the situation is recognised, the better the chance of an orderly outcome.

Does all this matter? Well it could do if markets move on from Greece to worry about the next big potential default, and here I am not talking of Spain or Italy but the mighty USA itself. Currently Republicans and Democrats are playing a game of 'chicken' on reaching a deal on America's debt ceiling which is governed by law. The next crisis point is reached in August, and there is a risk that an interest payment could be missed, meaning that the US is in technical default on some of its debt. This is far from a Greece situation, but could mean the US loses its AAA credit rating, and more likely causes massive disruption in the financial industry given the wide use of US Treasury stocks as a reference point.

However it perhaps points investors to the changing world in which US economic influence is declining. Instead it may well pay to review investment theory and think more laterally about where to invest. Currently gold is a fairly hot investment, as evidenced by the gold dispenser in London, whilst others are looking at China and seeing the Renminbi as a long term replacement for the US Dollar. Perhaps in the nearer term there may be other, rather overlooked nations that are better off, those nations that have not racked up huge debts but instead have accumulated assets, often built on oil and mineral wealth. At Thesis we are considering investing in a fund based on this premise of buying the debt issued by some of these wealthy nations.

Finally, if you are looking to invest in debt issued by a relatively new and small state with some oil wealth, then you might soon be able to buy bonds guaranteed by Scotland itself rather than the UK. These bonds have already been nicknamed 'kilt edged'!



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## Market News

### Retail woes

**Home Retail Group** announced a steep decline in sales at Argos, its primary division, underlining the weakness of UK retailing. Home Retail has since swooped on **Habitat**, purchasing the home furnishings brand after the firm was placed into administration, where it is seeking to address its slump in sales by diversifying its product offering.

**Thorntons** the chocolatier, which had a profit warning in May, is to close 120 shops, with the possibility of an extra 60 closures.

**Carpentryright** has seen its annual profits slump by 70% in the face of "very challenging trading conditions". Pre-tax profit for the year was £6.6 million, down from £22.3 million a year earlier. It could be worse - as **TJ Hughes** and **Jane Norman** have called in the administrators.

Struggling British entertainment retailer **HMV** has sold its 121-store Canadian unit to **Hilco UK**, raising £2 million to cut debt and help the firm stay in business.

Online delivery company **Ocado** saw its shares slump 9% after reporting its first half-year results. Despite making its first ever profit and rising sales of 21%, this was a slowdown on the 25% growth achieved in the first 12 weeks of the period.

**JD Sports** has further expanded its operations in Continental Europe with the €20 million

purchase of a stake in **Sprinter**, a Spanish sports retailer.

**M&S's** ex-chief Sir Stuart Rose has again come under fire from shareholders after receiving a final pay-out of more than £8 million.

### Financials

Nick Clegg's proposal of giving away shares to the general public in the state-owned banks, **RBS** and **Lloyds**, went down in the City like a lead balloon. The sheer administrative issues alone should perhaps have rung alarm bells prior to the announcement?

**Aviva** agreed to sell its roadside assistance unit **RAC** to the **Carlyle Group** for £1 billion and appointed John McFarlane as chairman,

he was previously the highly regarded chief executive of **ANZ** bank in Australia.

**Sanae Group**, one of China's wealthiest families, has swooped to acquire funds from the wreckage of London-based **RAB Capital** in a move that will create one of the biggest new hedge fund start-ups this year.

### Oils

**BG** signed a £940 million agreement with the Bank of China to fund an expansion of the oil and gas giant's activities in the country

**Royal Dutch Shell** has received C\$865 million of Canadian government funding for a carbon capture and storage facility to reduce emissions from its growing oil sands operations.

### Comparative Index performance ▼

Indices	Value as at 30/06/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5945.71	-0.74%	0.78%	20.92%
FTSE All Share	3096.72	-0.78%	1.11%	21.75%
Dow Jones	12414.34	-1.24%	7.23%	27.01%
Euro Stoxx 50 EUR	2848.53	-0.47%	1.99%	10.69%
Nikkei 225	9816.09	1.26%	-4.04%	4.62%
FTSE A British Government All Stocks	155.68	-0.58%	-0.45%	-1.12%
Sterling/US\$	1.6053	-2.40%	2.82%	7.41%
Sterling/Euro	1.1070	-3.11%	-5.09%	-9.37%



### Oh dear what can the matter be...

Whilst we have been indulging ourselves in frivolous consumerism paid for with borrowed money, the developing nations have sensibly been salting money away in their bank accounts. The result is that they have money and we sadly have debt. For instance, of the estimated \$10 trillion of global reserves \$6 trillion is sitting in the bank accounts of the Far and Middle East. China alone has over \$3 trillion laid aside. Meanwhile nations like the United States have racked up debts of over \$14 trillion and have to go cap in hand to Congress in a regular game of "chicken" to raise their national debt limit in order to keep the whole country

afloat. Greece is not the only bad guy! This is not a sustainable policy and the US dollar is a vulnerable currency going forwards.

China now buys more cars per year than the US, but its economy still has a long way to go. To service this energy intensive economy now and in the future, China is mopping up energy assets all over the world using that big bank account. For instance, in 2007 China was opening two new coal-fired power stations a week. At the same time demands on oil resources is creating a fundamental mismatch between supply and demand just at the time when the size of new oil reserve discoveries is falling at an alarming rate. Despite the recent fall in the oil price, the notion of "Peak Oil" will over time send the

oil price to above \$150 a barrel, based on fundamentals. Our energy costs are set to double whilst we have limited penetration of alternative energy sources (including nuclear) into our total energy needs. Our carbon addiction is going to cost us dearly in the future. Buy renewables and emerging markets now...



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## Market News

**Premier Oil** is to pay **BP** £64 million to boost its stake in the Wytch Farm fields in Dorset. Meanwhile, Tony Hayward and Nathaniel Rothschild's acquisition vehicle **Vallares** has raised £1.35 billion as it seeks out oil and gas companies and assets.

### Miners

**Kazakhmys** has agreed to borrow \$1.5 billion from **China Development Bank** to help develop a large copper deposit in eastern Kazakhstan and it will set up a secondary listing on the Hong Kong exchange.

**Tata Steel** is to sell its 26% stake in **Riversdale** the Australian coal miner to **Rio Tinto** for \$1.1 billion. The agreement finally gives Rio Tinto 100% control.

After the earnings announcement lead to its shares dropping, **Glencore** said that it was not actively considering a takeover of the Kazakh mining company, **ENRC**.

### Drugs & booze

**Diageo** will spend as much as £815 million to acquire control of **Shuijingfang**, a famous brand of baijiu, a fiery spirit; the deal paves the

way for one of the first foreign acquisitions of a big Chinese listed company.

**AstraZeneca** said that it was selling its Astra Tech dental and medical device business to **Dentsply** for \$1.8 billion, in a deal that would create the third-largest dental implant company in the world.

### Entertainment news

Crispin Odey, one of the largest investors in **BSkyB**, is calling on **News Corporation** to pay an extra £4 billion to take full ownership of the satellite broadcaster.

**Rank Group** has fallen foul in terms of the bid from **Guoco Group**, having to sell out a lower than expected price of £1.50 per share, because of Guoco's significant 41% stake and the UK's takeover and listing rules.

**EMI**, the music company owned by Citigroup, said that it was looking at a possible sale, recapitalisation or initial public offering.

### Other news

**Cheung Kong Infrastructure**, an investment vehicle controlled by Li Ka-shing, the Hong

Kong tycoon, has revealed it is considering a cash offer for **Northumbrian Water**.

**British Land** is planning to raise close to \$500 million by issuing bonds in the US private placement market.

**Southern Cross** plans to surrender control of 132 care homes as part of a financial restructuring package aimed at saving the struggling group; as the Government will not bail out the ailing care homes operator.

**Rexam**, Europe's leading beverage can maker, has agreed the sale of its plastic lid-making business for \$360 million as it hinted at further efforts to reduce its debt.

British credit information firm **Experian** is buying medical payments specialist **Medical Present Value** for \$185 million in cash to tap growing demand for payment administration systems in the US medical sector.

The Swedish carmaker **Saab** has announced a big order from a Chinese company, which means it now can afford to pay its staff.

Sources: Old Mutual - Stewart Cowley, Citywire, BBC News, Reuters, Minweb, Moneysaving expert & dealbook.



### Land of opportunity: too good to be true

Beware cold callers selling parcels of land with speculative potential for obtaining development permission at some time in the future. There is no guarantee on timing or it ever happening. Typically the land is originally bought for a higher price than the agricultural land value because of this potential. So a 5 acre site may cost them £65,000.

They produce very professional looking literature which is sent out to potential investors who have been contacted by phone and had the hard sell. The document has a plan showing the whereabouts of the land and a more detailed one showing how it will be divided up into individual plots, which is what they are trying to sell.

The catches are:

- They squeeze in a ridiculous number of plots, typically 25+ per acre. Some of them are so tiny it would be impossible to build on them
- The cost per plot to them is therefore about £500 each - and they are selling them for £10,000 upwards. In other words a site costing them £65,000 they will sell for £1.25 million
- They will say that "if" planning permission is granted (and they play no part in applying for this) the value is likely to multiply by a factor of at least 10. This is possible - but 10x what they paid for it, not what the secondary investor will pay for it!
- So theoretically (and at best) the land could end-up valued at £5,000 per plot. But the worst part of this is that the land,

in individual plots, is worthless even with planning permission. It would be impossible for each plot owner to build on his own piece of land. It would be 100 or more people having to negotiate access over land owned by others to get to his plot, agreeing together about paying and laying access roads, and the supply of water, gas, electricity sewage etc

■ The only viable way to make money would be for a development company to take over the whole site. The difficulties are that they would not be interested in negotiating with 100+ owners to buy their plots and even if they did they would never pay the price paid by the investors.

**Caveat emptor!**

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