

JUN  
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# the View

A Thesis Asset Management view of the market



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## OurView



Michael Lally

***"I know that I can save this country and that nobody else can"***

**William Pitt (1756)**

As the PM comes to question his own infallibility, and the loyalty of his ministers and assorted acolytes, and the media feeding frenzy over MPs' expenses begins to abate, meanwhile stock markets have quietly got on with their day to day business.

In the March issue of TheView, written at a time when the BBC's Robert Preston, amongst others, was still forecasting economic meltdown, I suggested that we would instead likely experience a series of uncoordinated cyclical swings in different sectors of markets, and that fear of being left behind was greater than that of losing more. In the event, the last 3 months has seen rises averaging 35% in the key global markets (more in smaller and emerging markets).

Whilst these may not, as some have suggested, signal the start of the next bull market, there have been a number of positive constituent factors which are encouraging. In relation to the bear market which originated 2 years ago then, as Winston Churchill once said, *"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."* It is worth noting that a return of risk appetite was initially concentrated not in safer defensive issues, but high risk sectors, coined by one wag as 'a dash for trash'. This resulted in massive rises in bombed out financial, real estate and construction stocks. However, the behaviour in broader sectors is encouraging, with rises in defensive and financially sound stocks more constrained. This is important as we are all well aware that this year, and possibly next, are going to be tough and that lower margins/ profits will be the norm. Higher unemployment will impact on consumer spending whilst lenders of credit will still demand a risk premium.

The crucial question is to what extent this has already been factored into valuations (ie. have analysts now swapped their rose tinted glasses for microscopes). Most markets are now selling on historically low earnings multiples, and high dividend yields (even allowing for cuts). Not necessarily the basis for a massive rise, but perhaps more importantly the grounds for a clearer support level in terms of potential

downside risk from current levels. As the origins of the bear market lie in credit markets then, as I have said before, this is where to look first for signs of a return of confidence. Heavily oversold corporate bond markets have rallied this year, but as with the equity markets, rises have been very selective apart from a brief bounce at the toxic end. Top named global companies, like Unilever and Vodafone, have recently successfully issued billions of pounds of debt at around one half the premium to gilts that would have been the case at the turn of the year.

With a little more economic stability now on the horizon, and having monitored commodity markets closely for the last year or so, we have now initiated a modest stake in clients' portfolios (albeit at this stage only via a long/ short fund covering both metals and soft/agricultural commodities). Prices can be influenced by a wide range of factors, eg. industrial/ consumer demand, supply, weather, exchange rates, political unrest and, perhaps of more relevance over the last couple of years, speculative trading. Much of the speculative excesses have been unwound since last year which makes it a little easier to see the proverbial wood from the trees.

Whilst on the subject of long/ short funds I would like to comment on the beleaguered hedge fund sector, an area about as popular as an MP's expenses. Whilst there have been some spectacular failures, unlike MPs resignations, the overall percentage is insignificant. Being largely unregulated (something Western governments are changing) there are a large number of very high risk funds around. We prefer ungeared funds of funds with robust due diligence screening procedures. Prices of quoted funds fell heavily last year (unlike their underlying asset values) due to an overabundance of distressed (read 'panic') sellers. As expected many have recovered this year but confidence is still fragile.

For the record, over the last 19 years (according to a study by Collins Stewart), funds of hedge funds have outperformed equities by 200% and bonds by 95%. Bear in mind also that, with no individual stock specific risk and the ability of the underlying funds to 'short sell', then these returns have effectively been achieved with a lower level of risk. Greater volatility in markets should be like manna from heaven for hedge funds, and as confidence generally returns so also, we believe, will performances.

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## News



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### Markets

Indices	Value as at 31/05/09	% Change on Month	% Change 2009 year to date	% Change on 12 Months
FTSE 100 Share	4417.94	4.11%	-0.37%	-27.02%
FTSE All Share	2252.64	3.66%	1.96%	-26.92%
Dow Jones	8500.33	4.07%	-3.15%	-32.74%
DJ Euro Stoxx 50 €	2451.24	3.20%	-0.01%	-35.12%
Nikkei 225	9522.50	7.86%	7.48%	-33.59%
FTSE A British Government All Stocks	152.53	-2.11%	-5.16%	6.13%

So year to date the market is now virtually back where it started, but what have we learned along the way? Speculation over the shape of the economic recovery still remains rife, will it be V-shaped, U-shaped or as one colleague put it 'like a corrugated bottom?' Meanwhile, Bulls and Bears argue over whether this recent rally is the start of a new Bull market or a dead cat bounce. Whilst on a daily basis the stockmarket fluctuates up and down based upon the latest economic numbers, be they positive or negative, the last ten years have actually shown very little correlation between the market and UK GDP. So what use are economists?! The left chart on page three highlights this clearly - whilst GDP growth has been steadily and consistently rising until 2007, the stockmarket has been very volatile during this same period.

So if all the speculation over the state of the economy is fruitless for investors, what can we use as our guide to the future? The second chart on page three (on the right) potentially provides investors with an answer - market valuations. Here the chart shows that the cheaper the market, the better the following ten year return (obvious really!). With the UK market Price Earnings Ratio at 8x on 20 January, extrapolating against trend suggests a +13.5% average return. Interestingly, this is in-line with

the average levels of stockmarket returns in the eighties and the chart also helps explain the 'doldrums' of the last decade since 1998. Further longer term trend analysis of asset classes points to the ongoing tussle between property and the stockmarket for top spot (over ten year periods) and with property's recent glory days in the sun now far behind it, perhaps it could just be the re-emergence of the 'class of equity' - time will tell!

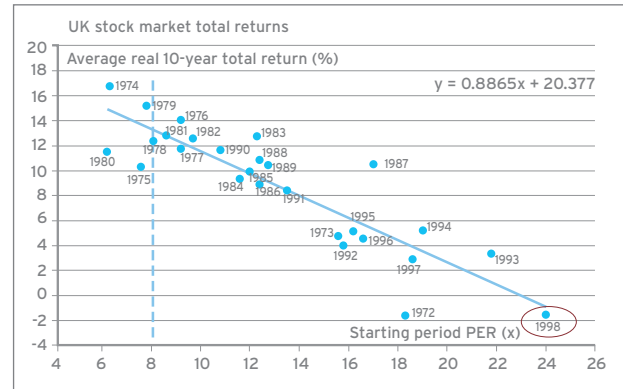
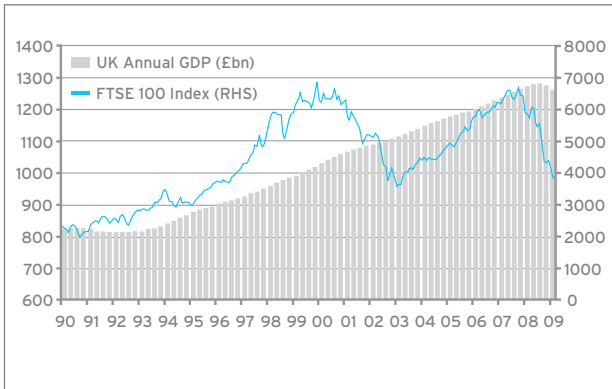
In addition to valuation levels, as evidence for the Bulls that markets are indeed on the early slopes of an upward trend, they also point out at that having seen market falls of 50% and significant negative sentiment leading to a tidal wave exodus into cash, now is surely the time to be more positive. During the last three Bear markets, the percentage value held in US money market funds (ie. cash) relative to the total value of the US stockmarket peaked at no more than 25%, yet currently this figure stands at a whopping 47%. Surely this is not because of the attractive interest rates currently on offer?! Therefore, according to the Bulls, even the slightest improvement in confidence levels will lead to further investors returning to equities and this could possibly maintain the current rally for some time to come.

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## News



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### News

One thing for certain is that appetite for risk has seemingly returned in the short term. Daily movements have continued to be dominated by the financial and resource sectors. To the end of May, **Barclays** has made a staggering +75% return over six months and **Rio Tinto** was not far behind at +74%. Rio's have been keeping the Chinese happy too, by cutting iron ore prices by 33%. At the other end of the spectrum, **Lloyds** is down -60% and **Xstrata** -26%, highlighting the divergence within sectors too. The property and housebuilding sectors also remain volatile, driven more by daily sentiment, rather than news flow. Smaller companies, private equity and emerging market investment trusts have all become flavour of the month again by posting strong returns and this is further evidence of a reversal of sentiment.

Over the month, the quarterly statements from the banks have generally been better than expected. **Standard Chartered** announced a record profit in its wholesale banking division and is making good margins at present. **HSBC** reduced the value of its own debt and announced a prospective 4% dividend which will be covered by earnings. **Royal Bank of Scotland's** figures were unsurprisingly the worst and it's still not expected to recover any time soon! It was also announced that Sir Sandy Crombie, the outgoing chief executive of **Standard Life** is joining the board of RBS as its senior non-executive director. Elsewhere, the US banks thankfully passed their 'stress tests', although ten banks

are required to raise \$75 billion, which has helped the sector outlook improve. However, all is not well in Ireland, as the Government there injected €4 billion into **Anglo Irish**, where deposit accounts are still protected until September 2009.

Certainly in respect of UK consumers, who are always the last to know about any economic slowdown, now is amazingly proving to be a good period for a handful of retail stocks and just as importantly for investors to invest. **Kingfisher**, Europe's biggest home improvement retailer by sales, said retail profits jumped 39% at constant currency rates to £128 million in the 13 weeks to May 2, compared with a year earlier. Sales from stores open at least year at B&Q, rose +3.2% in the UK as warm spring weather drove sales of garden furniture sets, barbecues, vegetable seeds and plants. Its profits doubled as the chain also cut costs and margins rose. Whilst at **Next**, combined sales from Next Retail and Directory rose +1.2% in the same period, also helped by a later Easter, warmer weather and fewer people taking overseas Easter breaks. Their Chief Executive, Simon Wolfson said: 'I don't think the consumer environment's as bad as all the doom-mongers made out it was going to be. We've still got to be careful, but there's definitely been a lot less volatility recently.'

Pawnbrokers are perhaps unsurprisingly also thriving in current market conditions. **Harvey & Thompson** and more recently **Albemarle & Bond** are both seeing good demand for their services and consequently profit growth.

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## News



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**British Airways** stalled, with much worse losses than the City expected. The cost of fuel and rising debts did little to help its quest to merge with **Iberia**. **Daily Mail & General Trust** was also in the red, thanks to falling revenues, restructuring costs and a series of one-off charges.

**BT's** fourth quarter results showed no big surprises. Their pension fund deficit as at 31 March was £2.9 billion, which is now being partly propped up by annual contributions of £525 million over the next 3 years. The final dividend was cut as expected, making 6.5p for the year, whilst the Board is committed to a sustainable dividend policy. Leadership has been changed in the main problem area, BT Global Services, and this division has reportedly started to turn around. Going forward, BT should deliver well over £1 billion savings in operating costs and capital expenditure in 2009/10. This should enable them to grow dividends even after debt and pension fund servicing. We remain believers that the shares are too cheap in the short term.

**National Grid's** results were reasonably good, with particularly strong performances from the UK regulated businesses as well as US gas distribution, offsetting the expected weakness in US electricity distribution and generation. The outlook statement was also positive, with the group expecting another strong year in 2009/10. However, their balance sheet continues to be a cause for concern for some brokers, with net debt at 31 March 2009 up to £22.7 billion, but interest cover at 3.1x means this is not a major issue, so long as the company can continue to finance itself in the debt markets. **Scottish & Southern's** results were in line with consensus with earnings per share of 108p versus consensus of 107.1p and the shares currently yield 6.2%. Interest cover is very healthy at around 5x. The Company has boldly committed to growing the dividend by at least 4% in 2009/10 and looks well placed to meet the challenges of the future via its increased investment in wind farms, with renewable investments rising some 296% from £132.8 million to £525.6 million. We believe both companies offer investors quality assets, producing solid income streams.

In the media sector, Standard & Poor's upgraded **BSkyB's** unsecured debt, as **Carphone Warehouse** has agreed to purchase **Tiscali**, which Sky was also bidding for. If Sky had been successful this would have negatively affected its debt rating. Sky continues to focus on its triple play of offering TV, broadband and telephone services to all customers. Sky has also been up in arms about Canvas, a video-on-demand internet enabled set-top-box, which the BBC and ITV are jointly working on. Oh to be monopolistic!

Debt laden industrial property real-estate investment trust **Brixton** has revealed preliminary approaches relating to possible offers for the company, including one from quoted rival **Segro**. Watch this space going forward, as we are certainly expecting a lot more takeover action in this sector, where only the strong will survive...

Sources: With thanks to Invesco Perpetual, JP Morgan Cazenove & Fidelity International.



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