

VERITAS ASSET MANAGEMENT

REAL RETURN INVESTING

## VERITAS PRIVATE CLIENT LETTER

*31<sup>st</sup> March, 2008*



The cavalry is galloping in from all sides! The great monetary easing is under way...

The US Federal Reserve (“the Fed”) has thrown traditional tactics to the wind with aggressive efforts to alleviate the credit crisis in the hope of staving off an economic one. The Treasury and Congress have pitched in with a stimulus package. Even the Office of Federal Housing Enterprise Oversight has loosened the reins on the capital requirements of mortgage giants Fannie Mae and Freddie Mac.

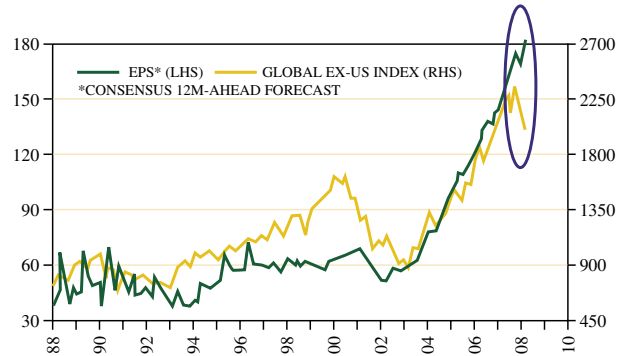
It is possible that the de-leveraging downturn could become a vicious circle of credit contraction causing an economic contraction, requiring further write-downs which lead to more credit contraction. It’s an iceberg: we simply don’t know how much is still under the water. However, the Fed has further firepower in its armoury – and Chairman Bernanke, based on his comprehensive studies of the 1929 Depression and of Japanese deflation in the 1990s, has made clear that he will do whatever it takes to stabilise the situation.

It is a balancing act, however. In his zeal, Bernanke must also avoid these liquidity injections becoming inflationary. There are those who argue that one should worry about either growth or inflation, but not both. However, those theorists are looking only at demand pull inflation; the situation is complicated this time by cost-push pressures with energy and food prices at record highs and inflation in emerging economies rising sharply.

### *Efficient markets?*

Under the scenario of contracting demand and rising costs, the risk to investors is shrinking margins as economic weakness spreads beyond the US. Markets though, as ever, are a discounting mechanism, and it is instructive to examine to what extent the recent upheavals in equity markets have already taken earnings risk into account. Our friends at Morgan Stanley show in the graph below that global earnings estimates (ex the USA) have continued to rise as equity prices have fallen.

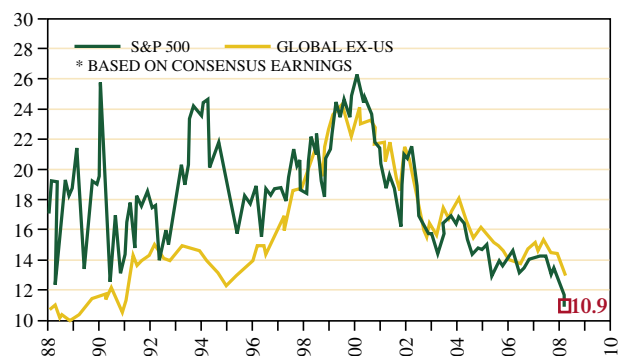
GLOBAL EX-US MSCI AND EXPECTED EPS



Source: Morgan Stanley

As a consequence, the Global ex US Equity Index, started in 1988, is now on its lowest recorded prospective p/e ratio of 11 times. Earnings estimates could fall by 20% and the index would still be on a p/e ratio of only 14 times.

US AND WORLD -EX US PRICE EARNING RATIOS\*



Source: Morgan Stanley

Thus a lot of bad news is already in equity prices. It may be that equities have further to fall (remember the iceberg principle), but as we cast our rule over the list of stocks we hold for clients – established, well managed companies with strong free cash flows and a moat around the business – we feel comfortable urging clients to look through the current volatility on our rolling 3 – 5 year approach.

We were amused to read on Bloomberg a few days ago a comparison of the current position of Stephen Schwartzman, Chairman of the Blackstone Group, America’s biggest private equity fund, and Warren

Buffett, Chairman of Berkshire Hathaway, one of Veritas' longstanding core holdings. Schwartzman relies on lenders to fund acquisitions. He is at the moment being forced to bypass Wall Street banks as they have stopped financing most leveraged buy-outs, and instead is knocking on the doors of hedge funds and mutual funds. Buffett on the other hand, who relies on interest-free insurance premiums, has a float of \$59 billion in the kitty! Investors are unsurprisingly backing Buffett: since the sub-prime crisis started, the S&P 500 has fallen by 20%, Blackstone by 43% - while Berkshire Hathaway is up by 5%.

### Pendulum

We've written many times about the secular decline of the US and rise of Asia. Might it even be that the US is going the way of Japan? The graphs below show the shrinking share of these two economic behemoths of global equity market capitalisation.



Source: Datastream, Morgan Stanley



Source: Datastream, Morgan Stanley

As the importance of the US shrinks, the secular rise of Asia is timely for Westerners in many ways, including some unexpected ones – an enjoyable retirement, for one! Let me explain.

In 1950 (I quote Jeremy Siegel, Professor of Finance at Wharton in the US), with the retirement age in the US averaging 67 years and life expectancy 69, the expected length of retirement averaged a mere two years. By 2005, the retirement age had dropped to 62 and life expectancy had risen to 78 years (yes, there is a causal link: UBS report that, for every year that you work beyond 55, your life expectancy falls by 2 years!). Thus by 2005 the average retirement had lengthened sharply to 16 years. Add into the equation that in 1950 seven workers were paying into Social Security for every retiree, but with the Baby Boom generation this had dropped to five by 2005 and will be only 2.5 in 2025.

Increasingly therefore, Americans (and indeed, all Westerners) need to provide for a longer retirement with less reliance on state pension benefits and more on accumulated wealth. The only way to live on wealth however, is to persuade someone else to buy it: investors cannot eat their stock or bond certificates. In the next 20 years, Baby Boomers in the US will need to sell literally trillions of dollars of wealth in order to enjoy their retirement. With the ratio of workers to retirees falling so steeply in the West, it will require the youth of China and India to step into the breach.

Economic historians estimate that in the 16th – 18th centuries, China and India produced one-third of the world's GDP, so this forecast is not unprecedented but simply China and India re-asserting themselves. The pendulum swings.

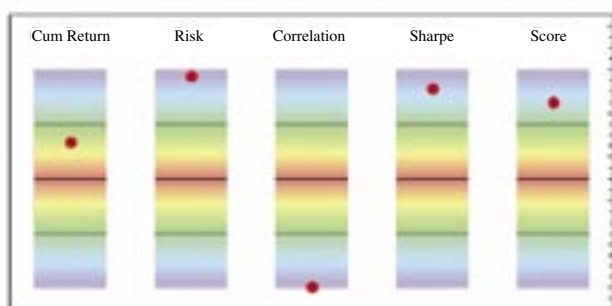
For Asian retirees to bail Western retirees out however, it is essential that developed nations keep their capital markets open. They must not make the parochial error of establishing trade barriers, and we listen to current political rhetoric in the US Presidential election campaign with some concern. In contrast we applaud the New York Philharmonic's

historic performance in Pyongyang, North Korea on 26th February. Cultural exchanges helped transformed US relations with China and with the Soviet Union. May they work their magic again...

## Veritas report card

In our January letter, we mentioned that ARC (Asset Risk Consultants, an independent performance analysis consultancy) had examined the risk / return characteristics of representative Veritas client portfolios. We now have their final report, and show below the verdict on our 'High Equity' segregated accounts. The red dots are Veritas and the bar charts show the range of the performances reported by 19 other private client managers who have also elected to be "ARC-ed".

### OVERVIEW BY RANK 12 QUARTERS



— VERITAS STERLING EQUITY RISK INDEX

Source: Asset Risk Consultants

Thus over the 3 years to December 2007, we achieved cumulative returns that are above the average of the other managers, our risk profile was almost

the lowest in the sector (low risk ranks highly) and our correlation with world equity markets was the lowest. This combination produced a top quartile risk / return profile, encapsulated in the Sharpe ratio.

In addition we are delighted to record that our *Veritas Global Income Fund* has been awarded an A rating by the highly regarded fund rating agency, OBSR, the *Veritas Asian Fund* has been awarded a AA rating by OBSR – and the *Real Return Asian Fund* won the Lipper Hedge Fund Award for the best long / short fund in its sector for 2007.

**Meg Woods**

**31st March, 2008**



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## VERITAS ASSET MANAGEMENT

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