

VERITAS ASSET MANAGEMENT

REAL RETURN INVESTING

## VERITAS PRIVATE CLIENT LETTER

*April 2009*



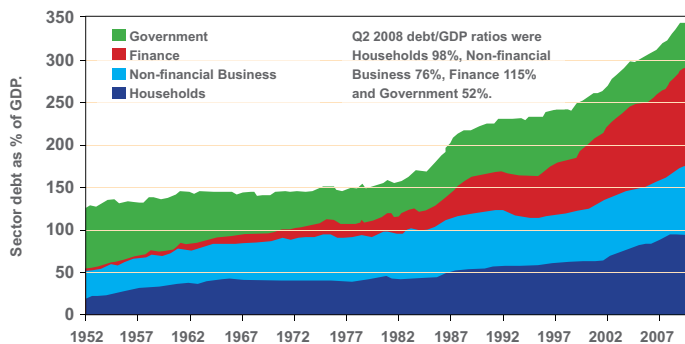
## Background

In the present volatile world it is difficult getting one's bearings. In such circumstances it is useful to go back to how we got here and hope that this gives some insights as to where we should go.

How did we get into this mess? After Volcker tamed inflation in the early 1980s we entered a long period of falling interest rates, rising asset values, and a growing risk appetite. Not surprisingly the longer these trends continued the more greed raised its head; rigorous analysis and common sense were regarded as not relevant, too conservative or just old fashioned. Moreover, the Greenspan "put" and weak regulation supported all these trends, especially since 2002.

As a result there has been an explosion of debt and a sharp fall in savings, particularly in the US and UK.

US: Sector Debt as % of GDP.



Source: Z1 Table D3 © 2008 Smithers & Co. Ltd.

Not surprisingly in this world of cheap and plentiful credit, standards of bank lending generally slipped. The combination of these factors, encouraged by friendly regulators and politicians who sought growth, meant that the party was set to continue for as long as possible. Time was extended by globalisation, with US and Europe corporates keen to satisfy the hunger of consumers for cheap product from Asia and the Third World. China played its part by keeping its currency low as it reinvested a significant part of its reserves in dollars.

Moreover, at another level, European financial institutions in search of yields bought packaged poor quality/toxic debt to generate income and capital.

As a consequence contagion spread around the world.

This is the first big message – namely, the problem is global. Such problems previously have been regional, with the result that a contaminated region could be bailed out by another geographic area, the Asian crisis being an example. This time there is no hiding place.

It is the sheer scale of the problem that is difficult to comprehend. People no longer talk in hundreds of millions or even billions, but in trillions.

Secondly, globalisation resulted in the problem being much bigger.

The third point is that democratically elected politicians, faced with these issues, have focused on the short term without regard for the longer term. This has been usually true in the past, but their actions this time have been so substantial that the impact will be felt for many, many years. Certainly in some countries there has been quantitative easing and government spending to reduce the pain of the deleveraging and banking crisis. The scale of this Government intervention is unprecedented.

While we support the principle of easing in these circumstances, mistakes have been made as politicians and central bankers wrestled with immediate crises. The key driver has been to deal with the problem today and worry about the consequences tomorrow.

It is not clear what the impact of the actions will be, which will vary from country to country. A country's history and culture may be an indicator. Germany will be more concerned about inflation getting out of control and the US about a depression. Some countries are already having to start addressing the issues e.g. Ireland has had to take draconian actions. Doubtless others will follow, the only question is when, where and what action will be taken. There will be a tendency for everyone to take their bat and ball home and become self-centred. As Wen, China's Premier, said "running our own affairs well is our biggest contribution to mankind".

The reaction of the politicians and central bankers has been to slash interest rates to help the borrowers, encourage spending and discourage savings, when the main problem is too much borrowing and spending. This has been compounded by Government borrowing to bail out the banks and to support economies. The actions taken should help reduce the short term pain but will not provide the long term solutions, only short term palliatives.

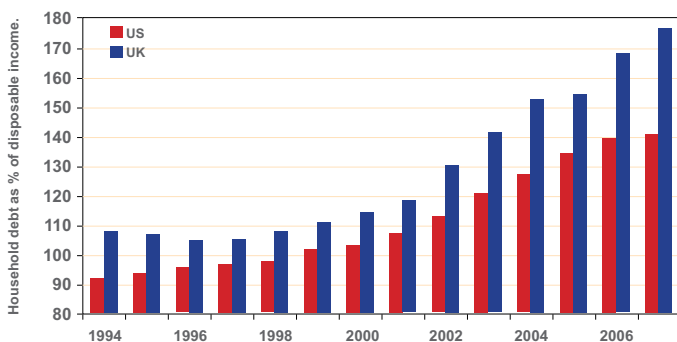
As the party finished, the focus switched from spending to saving, from taking out debt to repayment. There are

now significant cash pools but the reality is that many remain overborrowed, especially in an environment of depressed activity. This environment of significant overborrowing and large pools of cash will inevitably lead to considerable volatility in asset values and between asset classes. However, net real borrowings still need to be reduced significantly over time. This could be achieved by repayment, default, or inflation.

### **Some of the key issues that flow from these comments**

1. The world will remain uncertain and volatile. This will be reflected in asset values.
2. Many important decisions have yet to be made by politicians. At best the overall quality is likely to be mixed with many decisions “made on the hoof”.
3. The problems are so large that they will not be resolved quickly, i.e. years not months.
4. Financial strength will be important in weathering these storms. The strong will get stronger.
  - (i) At the country level the likes of China, Canada and Norway are much better placed than the UK or Eire.
  - (ii) At another level we would pick out the heavily indebted UK consumer (even more so than the US) as having a tough time ahead.

UK & US: Household Debt.



Source: OECD Economic Outlook Vols 81 & 83 © 2007 Smithers & Co. Ltd.

Conversely the cash rich Chinese consumer is relatively well placed.

- (iii) Corporates with sound balance sheets and free

cash flow are well placed to grow through taking market share or acquiring weaker brethren. The strong will get stronger.

5. The UK is poorly placed in this environment. Its growth has been accentuated by
  - (i) its exposure to the international finance industry,
  - (ii) the run down in personal savings, and
  - (iii) growth to public sector spending.

The first two have reversed. This puts public finances under great pressure as revenues fall and cost continues to rise, coupled with the need to fund banks, etc. What is needed in this environment is for the private sector to increase its market share but the opposite is presently happening and is likely to continue. This is similar to the problems of the 1970s. The probability is that with big fixed costs (e.g. pensions, health) the public sector will find it difficult to cut back at a time of rising unemployment and weak economic activity. The likelihood is that the quantitative easing will not be reversed in time to stop inflation rising and the consequent rise in costs of Government funding. The real danger is that the foreign investor loses confidence in the prospects for the UK economy and its management. While the authorities will wish to avoid this at all costs, the fear that it could happen will restrict and even impose decisions. It was such pressures that forced the Governor of the Bank of England to say that further meaningful fiscal easing was not appropriate. This is not an attractive environment for the UK economy.

6. The liquidity of assets held is important so that an investor can change tack if there is an unexpected turn.
7. Diversify risk – do not put all one’s money on red.

### **Equity investment**

Against this background and relative values, we do believe that cash generative, well managed companies supported by the tailwinds of our themes will provide real returns over the medium to longer term if bought in a disciplined way. Moreover, such assets usually offer liquidity and a growing yield.

However, there will be times when a portfolio built on the above characteristics underperforms. This would be particularly so should there be a surge in speculative activity. Playing such rallies is a dangerous game.

Despite the tough and depressing outlook we do believe opportunities will occur for those who are operating with clear philosophies and objectives, and are prepared to commit to serious analysis and be disciplined as to price.

Tough times are when the real opportunities occur.

**Stewart Newton**

**17th April, 2009**



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### **Veritas Report Card**

In the private client management industry, awards are made annually by an organisation called 'PAM', which stands for Private Asset Managers. Any private client fund management firm may enter any of the nine categories and the decision is made by a panel of 15 judges, all of whom are leading experts in our industry.

Veritas decided to enter the Investment Performance 'Growth Portfolios' category this year, based on the performance of our 'high equity' client portfolios for the three years to December 2008.

We were delighted at the ceremony held in the Dorchester's Ballroom on 5th March to learn that we had won this prestigious award.



**Winner Investment Performance –  
Growth Portfolios PAM Awards 2009**

## **VERITAS ASSET MANAGEMENT**

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