

VERITAS PRIVATE CLIENT LETTER

9th January, 2009

*Annual income twenty pounds,
annual expenditure nineteen nineteen and six,
result happiness.*

*Annual income twenty pounds,
annual expenditure twenty pounds ought and six,
result misery.*

Mr Micawber, in Charles Dickens' *David Copperfield*



The Federal Reserve will win, ultimately. There are no rules, there are no limits on what the Fed will consider. Its Chairman, Dr Bernanke, will put Federal Reserve ATMs on every corner, if that's what it takes. The US government has pledged \$7.4 trillion – or half the value of everything produced in the US last year – to rescue the financial system.¹ Barack Obama is mooting a stimulus plan of circa \$1 trillion, and in November Gordon Brown tabled his plan for the UK that will result in the largest budget deficit of any of the G7 countries.

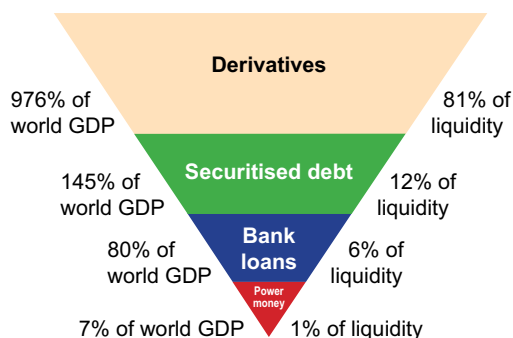
And indeed slithers of light are appearing in the gloom. The crisis was kicked off by the rise in interest rates on Adjustable Rate Mortgages (ARMs) as rates re-set upwards; the LIBOR and US Treasury rates to which ARMs are linked have now fallen sharply and homeowners whose mortgages re-set in the near future will see their monthly payments fall. US banks are having trouble coping with the surge of applications to re-finance to bring down mortgage costs. The oil price has plummeted and petrol prices are back to pre-crisis levels, welcome relief for the consumer.

However, not all credit markets are fixed. Tighter underwriting standards are restricting the supply of new mortgages. Commercial paper spreads are at historic highs. And not all policy makers are as profligate as the Fed: European Central Bank ATMs as one steps off the Eurostar in Paris are not in prospect! (It took the European Union almost three decades to agree on what could legitimately be called chocolate. This does not bode well for its handling of the worst financial crisis in its history.)

Why are the sums being spent by the Authorities so big and why, nearly 18 months after the crisis broke, is there not more evidence that it's working? David Roche of *Independent Strategy* has devised a 'Liquidity Pyramid' to illustrate.

THE LIQUIDITY PYRAMID

Global liquidity by source of claim



Source: *Independent Strategy*, courtesy CLSA

The figures to the left of the pyramid put these various sources of liquidity into the context of the world's Gross Domestic Product: the value of derivatives had ballooned to almost 10 times global output! The numbers to the right of the pyramid record that derivatives and the securitisation of debt (such as mortgages) together accounted for 93% of the liquidity created around the world before the credit crisis began. These two instruments were effectively a huge 'virtual' printing press, fuelled by low interest rates and permitted by the Authorities to remain outside conventional controls. In sharp contrast Central Banks ('Power money' in red at the bottom) contributed a mere 1% of global liquidity.

Thus, although in the last 3 months of 2008, the Fed injected liquidity that expanded its balance sheet by 129% (2700% annualised!) and the European Central Bank by 41%, this is a mere drop in the ocean of credit that they are seeking to revive. David and Goliath.

Payback

Mervyn King, Governor of the Bank of England, told the following tale in his speech to the CBI last October. In 1958 "in the very first television interview given by a Governor of the Bank of England, Cameron Cobbold explained National Debt to Robin Day.

Cobbold: The National Debt represents the sums of money which the Government has over the years borrowed from the public, mainly in this country and, to some extent, abroad. This is really the amount of expenditure which they have failed over the period to cover by revenue.

Day: Have we paid for World War II?

Cobbold: No.

Day: Have we paid for World War I?

Cobbold: No.

Day: Have we paid for the Battle of Waterloo?

Cobbold: I don't think you can exactly say that."

Gordon Brown is doing his best to carry on the tradition of previous governments in building the national debt. He aspires to bring the public finances back on track by 2015, but by then other hurdles will be rearing their heads, for example, public sector pension liabilities. Certainly the present massive support policies are storing up liabilities for taxpayers, which will undermine future growth.

¹ Gerard Minack, Morgan Stanley, 'Downunder Daily', 18th December 2008.

The other reason the vast sums being thrown at the problem by the Authorities are taking so long to revive the patient is that all efforts are designed to make credit more accessible to shaken consumers - who aren't sure that they want more debt! Hank Paulson wants to spur lending for automobile purchases – but there is already one car on American roads for every licensed driver... A glut of unsold properties is keeping housing depressed, shrivelled savings are discouraging consumers, companies are reluctant to build inventories and hire new workers while profits are under pressure.

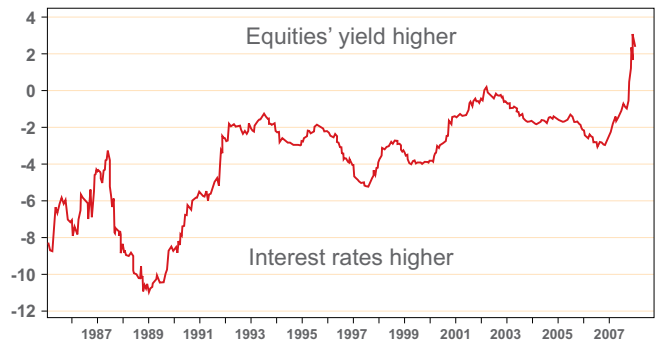
Take the case of the US auto industry, recent recipient of a chunk of TARP, the Troubled Assets Relief Programme. This is an industry that is saddled with enormously high costs compared to competitors and unable to deliver a product that is attractive enough to earn a mark-up adequate to pay its own way. A key argument for the bail-out is social conscience. Let's examine this more closely. People all over the country are losing their jobs and get either a minimal severance pay-out or nothing; when a US auto worker who has worked at least 10 years loses his job, he gets a severance package of \$140,000. Those UAW members who don't lose their jobs earn on average \$73 per hour; the average cost of a Honda Motor worker in the US is \$43 per hour. Some of the higher costs are retirement benefits, which average approximately double that of the typical Senior Citizen relying on social Security. It's a gravy train. Organised labour contributed \$58 million to the 2008 US election: Republicans received \$5million, the Democrats \$53 million. The bail-out is not economics, it's politics.

Much of what is happening now is not sound long term, sustainable policy; rather it is political expediency, driven by the short term nature of the electoral cycle that is the cornerstone of democracy. Woe betide politicians who wag their finger at the City for short termism!

Market measures

Markets of course discount ahead however: the MSCI World Index in £ terms was down by -18% in 2008 (a more savage -41% in \$ terms) and the FT All Share by -30% (\$ terms: -44%). Some of this reflects forced sales of equities as the principal liquid asset on the back of de-leveraging, particularly by hedge funds. Unquestionably though, a lot of bad news is already in prices: for decades equities have yielded less than bonds, but the dividend yield on the FT All Share is now 2.9% higher than the Bank of England's benchmark rate!

FT ALL SHARE YIELD *minus* BANK RATE



Source: Bloomberg

In addition, the sheer scale of the bail-outs from governments and central banks will provide support. Enthusiasm over Obama's Presidency is running high. Inflation is low and falling; interest rates are following. Many investors have a lot of cash lying fallow. Some would argue that conditions are in place for a rally.

At Veritas we are not drawn into the siren song of forecasting markets. Rather, with our thematic approach, we remain focused at present on businesses that, based on our own analysis, we believe will prove resilient in the current climate – the 'strong survivors', established companies with a competitive edge, the prospect of sustainable growth and underpinned by abundant cash flow.

What of our theme of Asia? Clearly Eastern markets have not proved resilient and even China's economy has decelerated more sharply than we anticipated.

We nonetheless remain committed Asia-philes. China's growth over the past few years has been accompanied by rising savings and declining debt. Trade and current account surpluses rose, as did foreign exchange reserves. Investment was financed more out of retained earnings and fund raising than by bank loans or government spending. Western woes are structural; Eastern woes are cyclical.

Beijing is using its fiscal surplus to stimulate. For example, after years of spending on the expressways, there is now increased emphasis on the railways. Rural land reform has been in the headlines: the 30-year lease system has gone, enabling people to use their properties as capital to sell or to mortgage. In effect this transfers into the hands of the private sector \$16 trillion of capital, potentially unleashing significant new consumer power on a 10 year view.

Veritas Report Card

In recent Private Client Letters we have shown the risk/ return profile of our segregated portfolios as assessed by Asset Risk Consultants, an independent firm of advisers. We are pleased to record that, in their latest report showing the returns for the 3 years to 30th September 2008, the returns on our High Equity portfolios were in the top decile of their universe of 32 private client managers and our risk in the lowest decile. These combine together to give a Sharpe Ratio of risk-adjusted returns that is also in the top decile.

For interest we also table the returns achieved by our *Veritas* family of funds (long only) as illustrative of the performance our 'real return' philosophy. (We are for regulatory reasons precluded from publishing the performance of our *Real Return* funds here because they are long/short, but the numbers may be found on our web-site at www.veritas-asset.com.)

£ terms	Calendar years					3 years to 31 Dec08
	2004	2005	2006	2007	2008	
Veritas Global Focus Fund	7.4	10.9	16.0	17.9	-5.8	28.9
<i>MSCI World Equity Index TR</i>	7.0	22.4	5.3	7.2	-17.9	-7.3
Veritas Global Income Fund			14.5	16.1	-8.7	21.4
<i>MSCI World Equity Index TR</i>			5.3	7.2	-18.9	-7.3
Veritas Asian Fund (ex Japan)		25.8	30.5	40.7	-20.8	45.4
<i>MSCI Asia Pacific ex Japan TR</i>		34.4	16.1	34.2	-33.5	3.7

Source: HSBC, Veritas, MSCI

Clearly we are disappointed that the 2008 numbers were negative. Nevertheless performance was resilient in the face of tough markets. On a rolling 3-year view, our minimum time horizon, our funds have clearly delivered strong real returns.

Note: The above figures refer to the past and past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. Performance for 2008 is unaudited and subject to change. Indices are not benchmarks and are provided for information only.

Meg Woods
9th January, 2009



VERITAS ASSET MANAGEMENT

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Veritas Asset Management (UK) Ltd., Elizabeth House, 39 York Road, London SE1 7NQ,

Phone: +44(0)20 7961 1600 Fax: +44(0)20 7961 1602

www.veritas-asset.com