

VERITAS PRIVATE CLIENT LETTER

January 2010

Those species which are best adapted to change in the environment are most likely to survive.

Charles Darwin



The baton is passing from stage one of the recovery to stage two. Stage one was of course liquidity-driven on the back of massive fiscal and monetary stimulus; stage two is the tightrope walk, with the Authorities balancing between withdrawing the stimulus without upsetting the still-fragile economy on the one hand, and avoiding the potentially inflationary consequences of such massive injections of money on the other.

Policy unquestionably remains accommodative and the sweet spot for risky assets consequently continues. The developed world is expanding moderately, the developing world is enjoying something brisker and almost all official rates remain at rock-bottom levels. Inflation and long bond yields are inching back up, but healthily so, towards levels that might be regarded as normal.

Last year's equity rally was not just liquidity-based. Corporate earnings grew strongly as companies slashed costs – both labour and inventories. For stage two of the rally to gain traction, the driver of profits needs to progress to top line growth. This will be aided by the easing of credit markets and an end to consumer de-leveraging as house prices stabilise and unemployment peaks. Growth in emerging markets will also be supportive.

However, pockets of turbulence must be expected. The withdrawal of the extraordinary stimulus is challenging and bond yields need to be monitored closely. Sovereign debt issuance will be huge on the back of bloated fiscal deficits and sovereign stress on a bigger scale than Greece may become a threat.

What a difference a decade makes! Just ten years ago, at the end of Bill Clinton's Presidency, Western government bond markets were disappearing on the back of fiscal surpluses.

Learning nothing

Obama's Chief of Staff said a few weeks after the Presidential election: "You never want a serious crisis to go to waste. It's an opportunity to do things you could not do before." And yet Western governments have dallied. Credit default swaps are still not exchange traded. The Bank for International Settlements is worrying that financial firms are returning to the aggressive behaviour of the pre-crisis years. The political system remains beholden to the financial industry.

Federal Reserve Chairman Ben Bernanke in his recent testimony stated that it was not record low interest rates that caused the housing price bubble!

As Talleyrand once observed of the Bourbon monarchs: "They have learned nothing."

The Authorities, hooked on economic growth and unable to bear the political pain of downturns, have opted for short term fixes. The problems are deferred, not solved.

The fact is that the model of the last 20 – 30 years, based on consumer growth, credit and the maturing of the baby boomer bulge in the work force, has faltered, and we haven't managed to re-boot.¹ Western governments need to change their fiscal priorities from the short term planning of one term in office to the longer term need to enhance growth potential by investing in education, infrastructure and other structural reforms.

In the UK, instead of running up a fiscal deficit of over 12% of GDP by supporting consumer spending and encouraging even more debt, Gordon Brown might for example have pulled the trigger on the Severn Barrage project, harnessing the power of the Severn estuary which has the second highest tidal range in the world and adding 8% to the country's electricity generating capacity. This would have stimulated employment for thousands of engineers and construction workers, and taken advantage of the cyclical fall in energy prices.²

Gordon Brown's love affair with 'Prudence' in his early years as Chancellor seems not to have lasted terribly long.

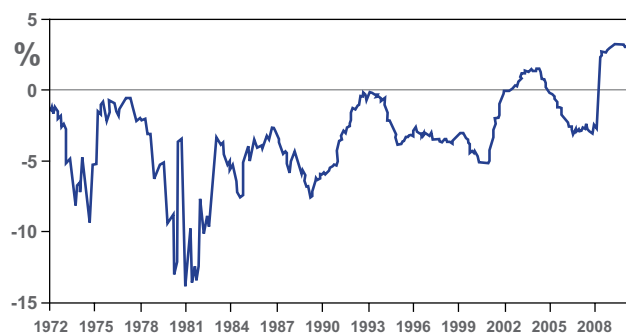
Dexterous investing

The economic backdrop thus remains precarious. Investors need to be dexterous. Stock selection remains key – a challenge to which we at Veritas respond readily in our quest for real returns, ahead of inflation.

Last year's outperformance of cyclicals seems to us to have run its course. With our global thematic hats on, looking for tailwinds to spur growth in profits and free cash flow, we would rather direct our attention to non-cyclicals such as healthcare, which of course now at last also has the US healthcare reform bill as a support.

In this environment of unattractive, generation-low interest rates, with equity yields still higher than bond yields,

MSCI WORLD EQUITY INDEX DIVIDEND YIELD *minus* US 3 MONTH EURODOLLAR RATE



Source: Factset

we are also focused on equities offering a sustainable yield, particularly where that yield is supported by growth.

Threaded through all our investments, we continue our theme of “strong survivors”, companies that we are confident will emerge from the ongoing economic difficulties in a strong position.

Another of our conviction themes at present is ‘Scarcity’, resources that we anticipate will become scarce for demographic or other reasons. One such resource is energy – perhaps not obvious with oil still at half its pre-crisis peak levels!

When economists tell us that oil is “only” 4-5% of GDP, they refer simply to the cost of extraction. The reality is that our lives were transformed in the 19th century by the introduction of the steam engine, and then in the 20th century by the combustion engine and large scale electricity generation. As the US Energy Secretary Steven Chu puts it, each modern American has the equivalent of 100 servants working for them thanks to oil, gas and electricity. In the August 2003 black-outs across the US eastern seaboard, car owners could not buy petrol as neither the pumps nor the cash tills had electricity; there were no traffic lights; water couldn’t even be pumped in certain counties.

Total conventional oil output, onshore plus offshore, peaked in 2005 and the International Energy Agency estimates that production from existing fields is declining at 6.7% p.a.

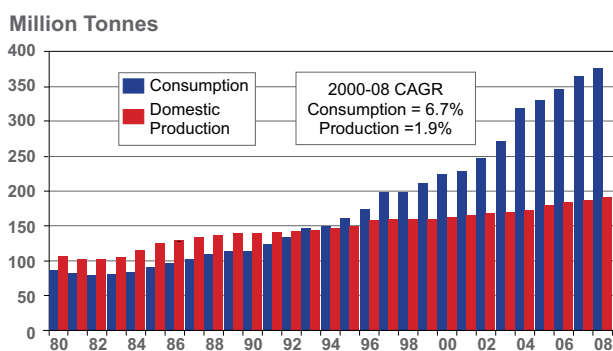
Costs are rising: a hundred years ago the energy of only one barrel of crude oil was required to extract 100 barrels from Texan or Arab oilfields; today expending the same one barrel produces a mere 15 barrels. And the cost to extract oil from newly discovered fields is higher than conventional sources as these fields are less easily accessible. New sources - tar sands, ethanol and gas liquids – are similarly more expensive, as are “alternative” energies – wind, solar, ethanol – which in addition carry environmental baggage: some solar farms are now being denied planning permission in the US because of their high demands on increasingly scarce water.

Perhaps unsurprisingly therefore, the percentage of free cash flow being re-invested by the oil industry into exploration and production is just 40% compared to 80% in the early 80s. Cash flow has instead been diverted to unproductive share buy-backs.

There is plenty of gas available – but not in the parts of the world in which it is needed. Freezing it to -160° C for transport as Liquid Nitrogen Gas wastes 20 - 25% of the energy.

The biggest new source of fuel over the last 20-30 years has in fact been China whose coal production has risen from negligible levels to the equivalent of an astonishing 33 million barrels of oil per day, or almost 40% of global oil output! Her energy consumption has however doubled since 1990 and, despite the huge increase in domestic output, her net coal imports are soaring

CHINA'S GROWING OIL SUPPLY GAP



Source: BP / ISI Group

China is very energy inefficient, using as much energy as the United States although its economy is about one-third the size of that of the US.

Secular demand in the developing world is also rising steadily. The I.T. industry now throws off as much CO₂ as the world’s airlines. Performing two internet searches from a desktop computer generates as much carbon dioxide as boiling a kettle for a cup of tea. The server “farms” that support the internet consume more energy than aluminium smelters. Google’s server farm in Oregon in the US, once it is operating at full capacity in 2011, will require energy equal to 9% of the UK’s Sizewell B nuclear reactor. Google has 35 of these around the world – and Google is just one of many.²

The National Institute of Economic & Industry Research suggests that actually we should not worry about carbon emissions because fossil fuels will be depleted before global warming becomes a serious issue...

We believe that at some point energy prices will rise substantially, and this is reflected in our portfolios.

Structural support

We have written at length previously about one of our favourite structural growth themes, namely, Asia and especially China – and it remains at the top our “structural growth” list, all important in this economically challenged world.

However, we are not oblivious to the country’s challenges. It is growing at an astonishing rate and it would be extraordinary if there were not some signs of strain.

Over 20% of China is desert – and spreading. Water supplies are stretched. One imagines that labour supply will never be an issue, but the one-child policy has meant that the number of children born fell by 75% over just two generations. Over the last 15 years, the industrial workforce expanded by over 100 million people - but it has now peaked and is forecast to fall by 80 million over the

