VERITAS ASSET MANAGEMENT

REAL RETURN INVESTING

VERITAS PRIVATE CLIENT LETTER

3rd October, 2008

Daedalus fashioned a pair of wax wings for himself and his son. Before they took off from the island, Daedalus warned his son not to fly too close to the sun, nor too close to the sea. Overcome by the sublime feeling that flying gave him, Icarus soared through the sky joyfully, but in the process he came too close to the sun, which melted his wings. Icarus kept flapping his wings but soon realised that he had no feathers left and that he was only flapping his bare arms. And so Icarus fell into the sea.

Etymologiae xiv.6

Warren Buffet famously observed in his 2001 Chairman's letter that it's only when the tide goes out that you can tell who's swimming naked.

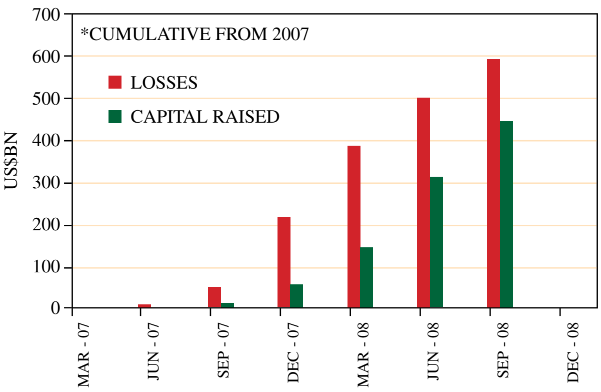
Wall Street has now conclusively been shown to be a nudist colony.

The 'Great Unwinding' has accelerated at an astonishing pace in the third quarter. Even now, over a year since the credit crisis broke, the iceberg principle applies: we simply don't know how much still lies below the surface.

The credit default swaps (CDS) market is a clear example. These purport to be a form of insurance: one party insures another against a company defaulting on its debt. The advantage, alleged by many including Alan Greenspan, is that this spreads the risk around the system rather than leaving it all with the banks. The upshot however is that 'the system' has taken on far more debt than would have been taken on if only the banks had been involved: by December 2007, the notional amounts insured reached $62,000 billion – more than all the credit outstanding worldwide! While insurance is regulated, this market is not. It is a private market with contracts registered only in the books of the two parties. Institutions have exploited accounting and regulatory loopholes to conceal the resultant leverage and risk. This was fine and well when defaults were rare, but now they are materialising and CDS losses are spreading rapidly.

The process of de-leveraging is not over yet. Bank loan loss provisions are generally based on historical trends that do not reflect the current quagmire and banks are therefore probably under-reserved; once reserves are adjusted, further capital will need to be raised.

GLOBAL BANKING: LOSSES AND CAPITAL RAISED*



Source: Morgan Stanley

Corporate clients, blocked from accessing capital markets, are tapping revolving credit lines obtained prior to the onset of the crisis in July 2007. Untapped loan commitments at that date totalled $1.4 trillion, the most on record. Credit oils the wheels of the economy, and it would seem that relief from tight conditions is not imminent.

In the face of this financial stress and dislocation, with the private sector unwilling or unable to stump up the necessary capital, the Authorities have been forced to step into the breach. Try, try and try again! Save Freddie Mac & Fannie Mae, let Lehman go under, save AIG. And now the $700 billion "Troubled Asset Relief Programme". The Fed has loaned so much money through its various lending facilities that its Treasury holdings are down to 42% of its balance sheet compared with a pre-crisis 90%. Churchill mused that the Americans will do the right thing, but only after trying all other alternatives first.

The price of all this assistance will be an increase in the burden of regulation (shutting the door after the horse has bolted?). In the UK we have witnessed over a decade of silent re-regulation of the economy under Labour. The tax code now stretches to more than 5,500 pages. The cost of regulation in this country is estimated at 10-12% of GDP, equivalent to the country's annual income tax revenue.

What goes around, comes around

A few years ago Hank Paulson went to China to lecture them on the virtues of free markets. Now the Chinese are thinking they didn't have a very good teacher.

In 2005 legislation came before Congress following accounting scandals at Fannie Mae and Freddie Mac to impose strict requirements on their ability to take excessive risks. Had that legislation been passed, those two organisations would not have hit the buffers a few weeks ago and the current melt-down could probably have been avoided. John McCain was a sponsor of the bill. It was over-turned by the Democrats. Barrack Obama voted against it.

In 2000 when Japan was deeply mired in deflation and bad debts, American banks were masters of the universe and coming to the rescue of their Japanese counter-parts. Now, like Icarus, the Americans are finding that their wings have melted and it is the Japanese banks bailing them out, with Mitsubishi UFJ helping re-capitalise Morgan Stanley.

Kathy Fuld, the art-collecting wife of Lehman Brothers' CEO, is selling a $20 million set of rare abstract Expressionist drawings at Christie's in November.

Chinese prominence

Through all this Western turmoil, China continues to rise to prominence. A hugely successful Olympic Games has been followed by the nation's first space walk, in the footsteps only of the United States and the former Soviet Union. The aim is to put a Chinese national on the moon by 2020.

Clearly the West's travails are affecting China. GDP growth of 12% in 2007 will slow to 8 or 9% this year, reflecting the becalming of export markets. However, domestic consumption and fixed investment, which together account for two-thirds of GDP, are still rising at double digit rates.

Growth of 8% to us Westerners still sounds very impressive. However, Charles Richardson, Veritas UK's Chief Executive, has just returned from a fortnight there and reports that the slowdown from 12% to 8% is tangible, particularly in the export manufacturing, property and construction sectors. Significantly though, the Beijing government has the financial surpluses and the political will to be able to stimulate the economy as necessary. After its 31% rise in tax revenues last year, it is one of the few governments of consequence that can pump prime without damaging its fiscal position. Slowly but steadily measures to support consumer confidence and economic activity will be rolled out. Maintaining higher single digit growth is significant not only for domestic social reasons, but Beijing in addition views it as important to their standing in the world. Their goal is the restoration of China as the Middle Kingdom – the country that is the centre of the world, the country to which everyone turns. The Olympics, the space walk, the only major economy still growing robustly are all part of the game plan.

The Veritas Approach

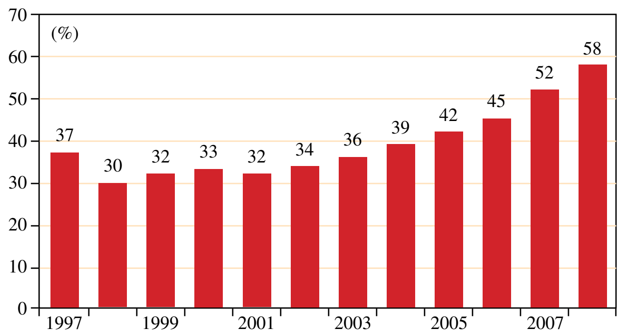
What is our strategy at Veritas in dealing with all this turmoil? Since we first opened our doors in 1993, our philosophy has not changed. First and foremost, keep it simple and transparent. Invest in the equity of businesses we know and understand, financially strong, with a competitive edge, attractively valued. Current conditions seem to us to vindicate the wisdom of this approach.

In the last handful of years a plethora of "modern tools" introduced to reduce the portfolio risk of private clients has become hugely popular. However, many are now not delivering on their promises. The hedge fund industry is this year reporting its worst performance in nearly two decades. Structured products, sold under the banner of 'capital protection', have in fact exposed clients to the bonds of the issuer, often banks. Despite the hefty built-in fees, it transpires that capital was often not protected after all.

Our strategy in stock selection is thematically led, seeking tailwinds and avoiding headwinds.

Asia remains a "plate-shift" theme.

ASIA EX-JAPAN GDP/US GDP

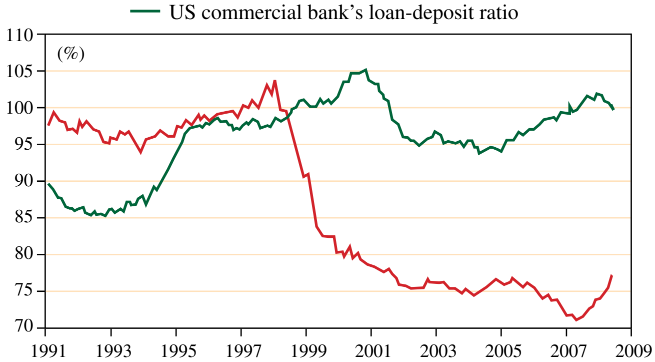


Source: CLSA Asia-Pacific Markets

We trimmed our exposure to Asia at the start of the year in anticipation of the cyclical slowdown, but our faith in its future remains undaunted given the inexorable shift of economic power to the East. Just look at the strength of their banks relative to American banks!

ASIA VERSUS US LOAN-DEPOSIT RATIO

Asia ex-Japan ex-Korea loan-deposit ratio
US commercial bank's loan-deposit ratio



Source: CEIC, CLSA Asia-Pacific Markets

While the US is tapped out near the end of a cycle of excessive borrowing, Asia still has the capacity to lend and borrow.

'Resilience' has been another core Veritas theme for some while. It has kept us substantially out of financials, which has clearly been advantageous for performance. Even now we remain out of the sector: the era of super-normal profits is over, and until opacity converts to transparency, we will not venture back. This includes Asian banks, although for cyclical reasons

Instead we find resilience in such sub-themes as strong cash flow: almost all the companies in which we invest are characterised by the strength of their free cash flow – Vodafone, Capita, Diageo. And of course Berkshire Hathaway! We read with great pleasure of Warren's putting $8bn to work in recent weeks for stakes in Goldman Sachs and GE on a 10% dividend yield. Unsurprisingly, the stock has risen sharply on the news - and has outperformed the S&P 500 Index by over 20% in 2008 to date.

Other 'resilience' sub-themes include outsourcing, a beneficiary of pressured fiscal and corporate budgets (Capita, Bunzl); healthcare (Fresenius, global leader in dialysis); emphasis on the environment (Praxair, which decomposes air to help customers reduce both their energy usage and environmental footprint). These companies will, we believe, demonstrate resilience in the tough economic climate in which we find ourselves.

We are delighted to record that our high equity portfolios again achieved a top decile Sharpe Ratio[1] in Asset Risk Consultants' analysis of private client managers in the 3 years to 30th June this year.

Meg Woods

3rd October, 2008

[1]Sharpe Ratio measures risk-adjusted returns. A detailed explanation appears in our June 2008 Private Client Letter.

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